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**BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION**

| | | |
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| IN THE MATTER OF THE APPLICATION | ) | CASE NO. AVU-E-16-03 |
| OF AVISTA CORPORATION FOR THE | ) | |
| AUTHORITY TO INCREASE ITS RATES | ) | |
| AND CHARGES FOR ELECTRIC SERVICE | ) | DIRECT TESTIMONY |
| TO ELECTRIC CUSTOMERS IN THE | ) | OF |
| STATE OF IDAHO | ) | MARK T. THIES |
| | ) | |

FOR AVISTA CORPORATION

(ELECTRIC)

## I. INTRODUCTION

**Q. Please state your name, business address, and present position with Avista Corporation.**

A. My name is Mark T. Thies. My business address is 1411 East Mission Avenue, Spokane, Washington. I am employed by Avista Corporation as Senior Vice President, Chief Financial Officer and Treasurer.

**Q. Would you please describe your education and business experience?**

A. I received a Bachelor of Arts degree in 1986 with majors in Accounting and Business Administration from Saint Ambrose College in Davenport, Iowa, and became a Certified Public Accountant in 1987. I have extensive experience in finance, risk management, accounting and administration within the utility sector.

I joined Avista in September of 2008 as Senior Vice President and Chief Financial Officer (CFO). Prior to joining Avista, I was Executive Vice President and CFO for Black Hills Corporation, a diversified energy company, providing regulated electric and natural gas service to areas of South Dakota, Wyoming and Montana. I joined Black Hills Corporation in 1997 upon leaving InterCoast Energy Company in Des Moines, Iowa, where I was the manager of accounting. Previous to that I was a senior auditor for Arthur Anderson & Co. in Chicago, Illinois.

**Q. What is the scope of your testimony in this proceeding?**

A. I will provide a financial overview of Avista Corporation as well as explain the proposed capital structure, overall rate of return, and our credit ratings. Additionally, I will summarize our capital expenditures program. Mr. Adrien McKenzie, on behalf of Avista, will provide additional testimony related to the appropriate return on equity for Avista, based on our specific circumstances, together with the current state of the financial markets.

In brief, I will provide information that shows:

- Avista's plans call for a continuation of utility capital investments in generation, transmission and distribution systems to preserve and enhance service reliability for our customers. Capital expenditures of approximately $1.2 billion are planned for the three-year period ending December 31, 2018. Avista needs adequate cash flow from operations to fund these requirements and for repayment of maturing debt, together with access to capital from external sources under reasonable terms, on a sustainable basis.

- We are proposing an overall rate of return of 7.78 percent, which includes a 50.0 percent common equity ratio, a 9.9 percent return on equity, and a cost of debt of 5.67 percent. We believe our proposed overall rate of return of 7.78 percent and proposed capital structure provide a reasonable balance between safety and economy.

- Avista's corporate credit rating from Standard & Poor's is currently BBB and Baa1 from Moody's Investors Service. Avista must operate at a level that will support a solid investment grade corporate credit rating in order to access capital markets at reasonable rates. A supportive regulatory environment is an important consideration by the rating agencies when reviewing Avista. Maintaining solid credit metrics and credit ratings will also help support a stock price necessary to issue equity under reasonable terms to fund capital requirements.

A table of contents for my testimony is as follows:



**Q. Are you sponsoring any exhibits with your direct testimony?**

A. Yes. I am sponsoring Exhibit No. 2, Schedules 1 through 3. Schedule 1, page 1, includes Avista's credit ratings by S&P and Moody's. Avista's actual capital structure at December 31, 2015, and proposed capital structure at December 31, 2016, are included on page 2, with supporting information on pages 3 and 4. Confidential Exhibit No. 2, Schedule 2C includes the Company's planned capital expenditures and long-term debt issuances by year. Confidential Exhibit No. 2, Schedule 3C includes our Interest Rate Risk Management Plan.

## II. FINANCIAL OVERVIEW

**Q. Please provide an overview of Avista's financial situation.**

A. We are operating the business efficiently for our customers, ensuring that our energy service is reliable and customers are satisfied while at the same time keeping costs as low as reasonably possible. An efficient, well-run business is not only important to our customers but also important to investors. We plan and execute on a capital financing plan that provides a prudent capital structure and liquidity necessary for our operations. We honor prior financial commitments and we continue to rely on external capital for sustained utility operations. We initiate regulatory processes to seek timely recovery of our costs with the goal of achieving earned returns close to those allowed by regulators in each of the states we serve. These elements – cost management, capital and revenues that support operations – are key determinants to the rating agencies whose credit ratings are critical measures of our financial situation.

**Q. What steps is the Company taking to maintain and improve its financial health?**

A. We are working to assure there are adequate funds for operations, capital expenditures and debt maturities. We obtain a portion of these funds through the issuance of long-term debt and common equity. We actively manage risks related to the issuance of long-term debt through our interest rate risk mitigation plan and we maintain a proper balance of debt and common equity through regular issuances and other transactions. We actively manage energy resource risks and other financial uncertainties inherent in supplying reliable energy services to our customers. We create financial plans and forecasts to model our income, expenses and investments, providing a basis for prudent financial planning. We seek timely recovery of our costs through general rate cases and other ratemaking mechanisms.

The Company currently has a sound financial profile. It is very important for Avista to maintain and enhance its financial position in order to access debt and equity financing as Avista funds significant future capital investments and refinances maturing debt.

## III. CAPITAL EXPENDITURES

**Q. Would you please explain how Avista plans and prioritizes its incremental capital investments?**

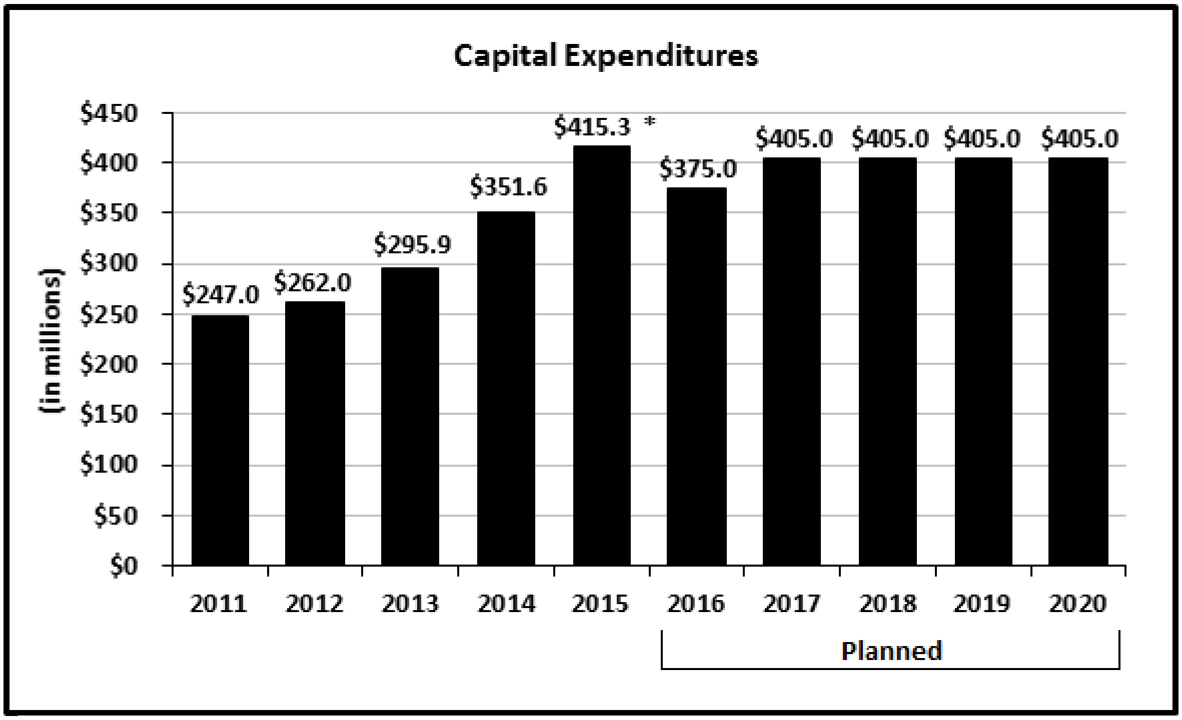
A. Yes. We are continuing to make significant capital investments related to electric generation, transmission and distribution facilities, natural gas distribution plant, new customer connections, environmental and regulatory requirements, information technology, and other supporting functions such as fleet services and facilities. The objective in all of these investments is to enable the Company to continue to provide safe, reliable service to our customers, maintain a high level of customer satisfaction, and meet the current and future needs and expectations of our customers and other stakeholders, while at the same time being sensitive to the rate impacts to customers resulting from the investments.

In order to meet these objectives, there are a number of factors that must be balanced as we determine the appropriate level of investment each year including, but not limited to: 1) the level of investment needed to meet safety, service and reliability objectives and to further optimize our facilities; 2) the degree of overall rate pressure faced by our customers; 3) the variability of investments required for major projects; 4) unanticipated capital requirements, such as an unplanned outage on a large generating unit or significant storm affecting transmission and distribution facilities; and 5) the cost and availability of funding, which includes internally generated funds, terms for debt financing, and the opportunity to issue equity on reasonable terms.

**Q. What have been Avista's recent capital expenditure levels, and what do you expect them to be for the next several years?**

A. Illustration No. 1 below summarizes the capital expenditure levels for recent years, as well as planned expenditures through 2020.

**Illustration No. 1**




** The relatively higher level of capital expenditure in 2015 was driven by approximately $23 million related to storm costs for the November storm, and approximately $8 million related to a renegotiation of the Coyote Springs Long Term Service Agreement, which occurred late in the year.*

After the Company's expected $375 million capital investments in 2016, the capital expenditure level is expected to increase to $405 million annually from 2017 through 2020.

**Q. Why has the Company increased the level of its capital expenditures?**

A. The increase in the level of capital investment in recent years is driven primarily by the business need to fund a greater portion of the departmental requests for new capital investments that, in the past, were unfunded.

While there are numerous factors driving the need for increased investment, they generally fall into six broad categories. These categories are: (1) Asset Management, (2) Compliance, (3) Improvements and Efficiencies, (4) Reliability Maintenance, (5) Resource Supply, and (6) Safety and Security. There are overlaps and interdependencies among these categories, and they are not necessarily all-encompassing.

A brief description of each of these categories is provided below. As other Avista witnesses present and explain the specific capital projects and capital-related programs included in this general rate case filing, they will provide additional details on the specific purpose and objectives of the capital investments.

> **Asset Management:** In many instances we have asset management plans, which are designed to determine the efficient life cycle of the assets. These asset management plans assess the useful life of the particular assets and the appropriate time to replace the assets, balanced against the operations and maintenance costs associated with maintaining assets that are toward the end of their useful life. These asset management plans allow the Company to systematically replace the assets over time in a manner that optimizes the value of the assets, while still maintaining reliable service to customers. There are a number of programs within electric distribution, substation, and transmission operations that require programmatic annual proactive maintenance investment in order to maximize the lifetime value of the associated assets. Specific asset management programs and projects include wood pole management, Aldyl-A pipe replacement,

transmission line rebuilds, and substation equipment replacements and rebuilds.

**Compliance:** The compliance category is related to mandates from state and federal governments and regulators, including, but not limited to FERC requirements; NERC requirements; PHMSA requirements; requirements under franchise and right-of-way agreements, cities, and counties; and environmental regulations; among others. Additionally, this category includes the Company's compliance with contractual agreements.

**Improvements and Efficiencies:** This category is related to keeping pace with technological innovation, the identification of process improvements or efficiency gains, and other opportunities to improve the Company's operating assets. For example, as technology has evolved, our customers have grown to expect new functionality from our customer-facing technology assets (e.g., increased website functionality and mobile-friendly interaction).

**Reliability Maintenance:** This category represents the backbone of Avista's ability to meet its obligation to serve all customers with safe, reliable service. As discussed by Company witness Scott Morris, we believe the current reliability of our system is satisfactory and is meeting the needs and expectations of our customers and other stakeholders. However, in order to maintain this level of reliability, continued capital investment is necessary, given that both new and existing assets deteriorate over time and require replacement. Without responsibly working to maintain our plant in service over time, we cannot continue to maintain our reliability levels.

**Resource Supply:** Avista's ability to serve its customers is only as effective as its ability to generate and procure energy resources. As discussed by Company witness Scott Kinney, Avista's 2015 Electric Integrated Resource Plan shows forecasted annual energy deficits and sustained annual capacity deficits beginning in the next 10 years. In light of this fact, it is critical that the Company continue to invest in maintaining its current generating assets, along with planning to meet future resource needs with both supply-side and demand-side resources.

**Safety and Security:** This category of investment includes security considerations driven by threats to Avista's operations, both cyber and physical. As cybersecurity risks grow,[1] continued investment is required to respond to these risks. Additionally, as evidenced by the Metcalf sniper attack on a PG&E substation, physical security risks also exist, requiring investment to improve physical security. Aside from security considerations, safety considerations are also important factors in investment decisions and must be continually evaluated to ensure that customers, the public at large, as well as Avista's employees remain safe.

**Q. How do these categories ultimately translate into plant investment?**

A. As Mr. Morris briefly explained in his testimony, each year the departments across the Company assess the near-term needs to maintain and upgrade the utility infrastructure and technology necessary to continue to provide safe, reliable service to customers, as well as maintain a high level of customer satisfaction. The departments develop business cases for specific projects and programs that explain and support the need for the capital investment. These business cases are submitted to a Capital Planning Group that meets on a regular basis to review and prioritize all proposed utility capital investment projects.[2]

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[1] As recently as December 2015, a substantial portion of Ukraine's energy grid was blacked out by what is believed to be a hacking attack.

[2] The business cases supporting capital projects included in this case for 2016 and 2017 are provided as Exhibit No. 10, Schedule 4 (Company witness Ms. Schuh).

After taking into consideration a number of factors, senior management of Avista establishes a proposed capital plan amount for each year of the next five years, which is presented to the Finance Committee of the Board of Directors[3]. These factors include, but are not limited to, the total capital investment requests of the departments submitted to the Capital Planning Group, the urgency of the projects, the opportunities and risks associated with delaying the projects to a later date, and the overall bill impact to customers associated with the annual capital planned spend ultimately approved. These five-year capital spend amounts are revisited each year to ensure that capital dollars are dedicated to the highest priority projects.

In recent years Avista has chosen to not fund all of the capital investment projects proposed by the various departments in the Company, driven, in part, by the Company's desire to mitigate the retail rate impacts to customers. The decision to delay funding certain projects is made only in cases where the Company believes the amount of risk associated with the delay is reasonable and prudent.

As a result of this constrained capital spend level, capital projects must be prioritized so that the dollars flow

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[3] The Finance Committee is presented with a five-year plan, but approves the plan for only the next operating year.

where they are most needed. As unexpected, high-priority capital projects arise, the capital projects for the year must be reprioritized to limit the total spend to the amount established by the Company and approved by the Finance Committee of the Board. This can cause some projects to be delayed so that higher-priority projects can be completed.[4]

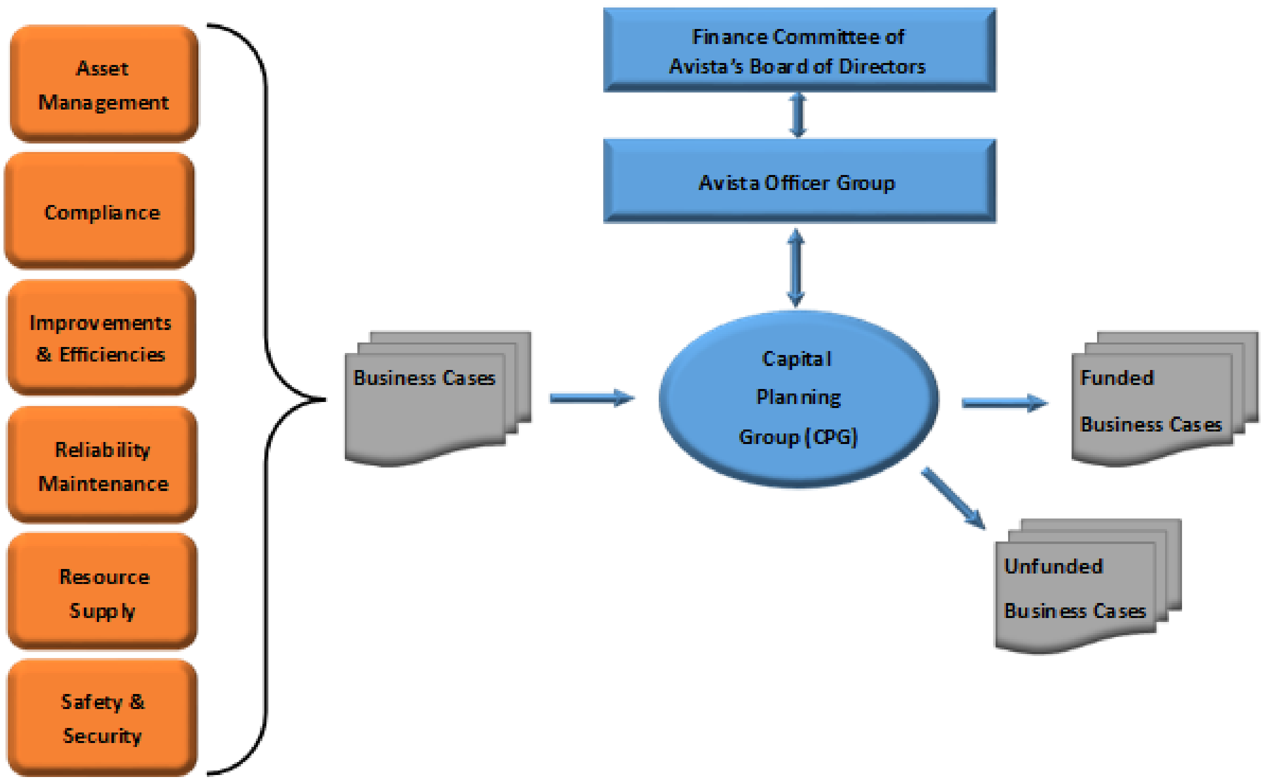
In addition, some scheduled capital projects will encounter unexpected delays due to such things as permitting issues, delays in receipt of materials and equipment, etc. A delay in one project may allow another project to be accelerated in time as part of managing the availability of our workforce and to continue to make progress on projects next in the "queue" that need to be done. This reprioritization occurs within the Capital Planning Group, which is charged with ensuring that the total capital spend for the year stays within the limit approved by the Finance Committee of the Board.[5]

[4] The CPG is a group of Avista employee directors that represent all capital intensive areas of the Company. The CPG meets to review the submitted Business Cases and prioritize funding to limit the capital spend to the level set by senior management. After approval from senior management, the annual capital planned spend is sent to the Finance Committee of the Board of Directors to approve the capital spend amount. The CPG meets monthly to review the status of the capital projects and programs, and approves or declines new business cases as well as monitors the overall capital spend.

[5] If circumstances indicate the capital spend for a year will exceed the level previously approved by the Finance Committee of the Board, the additional capital spend is presented to the Finance Committee for approval.

The following illustration provides a graphical representation of how the Company develops and prioritizes its capital investments.

**<u>Illustration No. 2:</u>**




**Q. How has the <u>historical</u> level of annual capital spending for Avista compared with the <u>planned</u> level?**

A. The actual and planned capital spending for the utility for the years 2006 through 2015 are shown in Table No. 1 below. The table shows that actual capital spending has been very close to the planned spending on a consistent basis. The ten-year average of <u>actual</u> additions is 102% of the planned spending. This table also shows that while Avista has been increasing its capital spending it is generally remaining on target with its planned spend.

**Table No. 1:**[6]

| TABLE NO. 1<br>Planned vs. Actual Expenditures | | | |
|---|---|---|---|
| | **Planned Expenditures ($ millions)** | **Actual Expenditures ($ millions)** | **Percentage of Planned** |
| 2006 | $160.00 | $158.30 | 99% |
| 2007 | 183.10 | 198.40 | 108% |
| 2008 | 190.00 | 205.40 | 108% |
| 2009 | 220.00 | 199.70 | 91% |
| 2010 | 235.00 | 206.80 | 88% |
| 2011 | 260.00 | 247.00 | 95% |
| 2012 | 255.00 | 262.00 | 103% |
| 2013 | 275.00 | 296.00 | 108% |
| 2014 | 336.00 | 352.00 | 105% |
| 2015 | 376.30 | 415.30 | 110% |
| **Ten Year Average** | **$249.04** | **$254.09** | **102%** |

**Q. Does the Company believe the current level of planned expenditures are necessary prudent investments?**

A. Yes. The Company has the obligation to responsibly manage the replacement of assets over time to maintain reliability and balance a number of competing factors such as the bill impacts to customers. Although we could choose to put off for tomorrow what does not absolutely need to be done today, it would be imprudent to allow the system to deteriorate and

[6] The relatively higher level of capital expenditure in 2015 was driven by approximately $23 million related to storm costs for the November storm, and approximately $8 million related to a renegotiation of the Coyote Springs Long Term Service Agreement, which occurred late in the year.

begin to jeopardize reliability, as well as potentially create a "bow-wave" of investment that needs to be made in a relatively short period of time.

As indicated earlier, the objectives in our investments are to enable the Company to continue to provide safe, reliable service to our customers, maintain a high level of customer satisfaction, and meet the current and future needs and expectations of our customers and other stakeholders, while at the same time being sensitive to the rate impacts to customers resulting from the investments.

In this filing, the Company has provided detailed information, explanation and supporting documentation to support the level of new capital investment proposed to be included in retail rates for the 2017 rate period.

**Q. Please identify the witnesses providing this detailed information.**

A. The following witnesses provide detailed information, explanation and supporting documentation related to new capital investment from 2016 through December 2017.

> **Scott Kinney's** testimony addresses the drivers of the Company's generation investment, totaling $241.2 million from 2016 through December 2017, mainly related to the Company's 100 year old hydroelectric facilities along the Spokane River (i.e., Nine Mile, Post Falls and Little Falls generating facilities), as well as our larger Clark Fork River hydroelectric facility at Cabinet Gorge. Additional capital investments, such as those related to our Colstrip

thermal generating facility and other projects are also discussed.

**Bryan Cox's** testimony addresses the Company's need to invest in its electric transmission plant, totaling $120.9 million from 2016 through December 2017, to maintain reliable customer service and meet mandatory reliability standards (e.g., by the North American Electric Reliability Corporation (NERC)), including projects such as the Noxon Switchyard Rebuild project, as well as many other transmission, substation, and environmental projects to meet reliability improvements, compliance and replacement, as well as contractual agreements.

**Heather Rosentrater's** testimony addresses the Company's investment in electric distribution plant, totaling $102.3 million from 2016 through December 2017, explaining that the Company's investment is primarily driven by a combination of the following factors: (1) new customer connections and changing customer usage, (2) maintaining system reliability and safety, (3) realizing operational and electrical efficiencies, and (4) minimizing life cycle costs of assets. Ms. Rosentrater also discusses Avista's Asset Management approach, which strives to prioritize and plan work that results in maximizing the value of Avista's physical assets by integrating information about repairing, maintaining, inspecting, monitoring, and replacing those physical assets through a comprehensive analysis. Examples of Avista's Asset Management programs (and related capital investment projects) include its Wood Pole Management, grid modernization, transformer change-out, and improving worst feeders, to name a few. Examples of additional capital projects discussed by Ms. Rosentrater, include the reconductor and feeder tie programs, new distribution substation projects, storm damage repair, and street light management, to name a few.

**Jim Kensok's** testimony addresses the Company's investment in information systems and information technology plant, totaling $119.5 million from 2016 through December 2017. Mr. Kensok discusses in further detail that the utility industry is undergoing a period of renewal, calling for technology in all areas of our business. Specific drivers that prompt capital projects during the 2016 and 2017 time periods include: (1) a transition from legacy custom-coded applications to commercial off-the-shelf solutions to increase security and reliability (i.e., outage management system), allow flexibility and scalability, and forecast system lifecycle planning, (2) continuous upgrades of Operating System and Database software to maintain vendor maintenance and support, (3) technology infrastructure investment, such as communication equipment on mountain tops and radios in fleet vehicles to increase worker safety during unplanned outages or emergency events, and (4) network infrastructure efforts to respond to an ever increasing demand for secure data transfer, sensor technology, reliability and redundancy.

**Karen Schuh's** testimony addresses the Company's investment in general plant, totaling $36.2 million from 2016 through December 2017, which is mainly due to the Central Office Long Term Campus restructuring plans, phases 1 and 2. Ms. Schuh also discusses in further detail the capital planning and review process, including the oversight provided by the Capital Planning Group.

In the supporting documentation provided by Avista in this general rate case filing, the Company has attempted to strike a reasonable balance of supplying robust supporting explanation and documentation for its planned capital investments, while at the same time not placing an undue burden on the record through the submittal of voluminous documentation.

To the extent any party to the case requires additional information or documentation associated with any of the Company's planned capital projects or programs, Avista is prepared to provide additional information through responses to discovery, by conference call, through site visits by the parties and other means. Avista's practice has been to be transparent and responsive to requests for information in these, as well as other, regulatory proceedings, and the same is true for this case.

## IV. MATURING DEBT

**Q. How is Avista affected by maturing debt obligations in the next five years?**

A. In the next five years the Company is obligated to repay maturing long-term debt totaling $504.5 million. The table in Illustration No. 3 below shows the Company's maturing long-term debt from 2016 through 2020. Within this five-year period, a large concentration – $272.5 million – matures within the second quarter of 2018.

**Illustration No. 3**

| Avista Corp<br>Long-Term Debt Maturities, 2016-2020 | | | | |
|---|---|---|---|---|
| **Maturity Year** | **Principal Amount** | **Coupon Rate** | **Date Issued** | **Maturity Date** |
| 2016 | $90,000,000 | 0.84% | 8/14/2013 | 8/14/2016 |
| 2017 | - | - | - | - |
| 2018 | $7,000,000<br>$250,000,000<br>$15,500,000 | 7.39%<br>5.95%<br>7.45% | 5/11/1993<br>4/3/2008<br>6/9/1993 | 5/11/2018<br>6/1/2018<br>6/11/2018 |
| 2019 | $90,000,000 | 5.45% | 11/18/2004 | 12/1/2019 |
| 2020 | $52,000,000 | 3.89% | 12/20/2010 | 12/20/2020 |
| **Total** | $504,500,000 | | | |

These debt obligations originated as early as 1993 and their original terms were three, ten, fifteen and twenty-five years. These maturing obligations represent over a third (36%) of the Company's long-term debt outstanding at the end of 2015, which is a significant portion of our capital structure. The Company typically replaces maturing long-term debt with new issuances of debt. It will be necessary for Avista to be in a favorable financial position to complete the expected debt refunding, while also obtaining debt and equity to fund capital expenditures each year.

**Q. What are the Company's expected long-term debt issuances in the next several years?**

A. To provide adequate funding for the significant capital expenditures noted in Section III above and to repay maturing long-term debt, we are forecasting the issuance of long-term debt every year for the next several years, as shown in Exhibit No. 2, Confidential Schedule 2C.

**Q. Are there other debt obligations that the Company must consider?**

A. Yes. In addition to long-term debt, the Company's $400 million revolving credit facility expires in April 2021. The Company relies on this credit facility to provide, among other things, funding to cover month-to-month variations in cash flows, interim funding for capital expenditures, and credit support in the form of cash and letters of credit that are required for energy resources commitments and other contractual obligations. Our credit facility was amended in April 2014, which stretched the expiration date to April 2019, five years past the amendment date, and reduced interest rates and fees.

In April 2016 the Company requested an extension of the expiration date, requesting an additional two years to April 2021. This extension was approved in May 2016. Any outstanding balances borrowed under the revolving credit facility become due and payable when the facility expires.

## V. CAPITAL STRUCTURE

**Q. What capital structure and rate of return does the Company request in this proceeding?**

A. Our requested capital structure is 50.0 percent total debt and 50.0 percent equity with a requested overall rate of return in this proceeding of 7.78 percent, as shown in Illustration No. 4 below. The requested capital structure is consistent with that currently authorized (per Case No. AVU-15-05), and similar to that expected prior to rates going into effect at December 31, 2016 of 49.2 percent debt and 50.8 percent equity.

**Illustration No. 4**

| Avista Corporation<br>Proposed Cost of Capital | | | |
|---|---|---|---|
| | Percent of Total Capital | Cost | Component Cost |
| Total Long-Term Debt | 50.0% | 5.67% | 2.83% |
| Common Equity | 50.0% | 9.90% | 4.95% |
| Total | 100.00% | | 7.78% |

**Q. Is the capital structure reflected in Illustration No. 4 above calculated in a manner similar to the capital structure calculated in Avista's recent rate proceedings?**

A. Yes. This methodology considers debt and equity outstanding for Avista Corp., including the impact of costs related to the issuance of that debt and equity.

Debt and equity for AERC[7], which was acquired in mid-2014, are excluded from this calculation and do not impact the capital structure calculation for this rate proceeding.

**Q. How does the Company determine the amount of long-term debt and common equity to be included in its capital structure?**

[7]On July 1, 2014, the Company acquired Alaska Energy and Resources Company (AERC). AERC's primary subsidiary is Alaska Electric Light and Power Company (AEL&P), a wholly-owned corporation of AERC and a vertically integrated electric utility providing electric service to the City and Borough of Juneau. AERC and AEL&P are separate legal entities and their debt is backed by the assets and equity of AERC and AEL&P.

A. As a regulated utility, Avista has an obligation to provide safe and reliable service to customers while balancing fiscal safety and economy, in both the short term and long term. Through our planning process we determine the amount of new financing needed to support our capital expenditure programs while maintaining an optimal capital structure that balances and supports our current credit ratings and provides flexibility for anticipated future capital requirements.

**Q. Why is the Company proposing a 50.0 percent equity ratio?**

A. On December 31, 2015, Avista's common equity percentage for the Idaho jurisdiction was 49.3 percent. The Company continues to evaluate the extent and timing of equity issuances for 2016-2018, taking into account our capital expenditures and other financial requirements. These steps to manage our equity level are expected to result in a common equity level of 50.8 percent at December 31, 2016.

Maintaining a 50.0 percent common equity ratio has several benefits for customers. We are dependent on raising funds in capital markets throughout all business cycles. These cycles include times of contraction and expansion. A solid financial profile will assist us in accessing debt capital markets on reasonable terms in both favorable financial markets and when there are disruptions in the financial markets.

Additionally, a 50.0 percent common equity ratio solidifies our current credit ratings and moves us closer to our long-term goal of having a corporate credit rating of BBB+. A rating of BBB+ would be consistent with the natural gas and electric industry average, which I will further explain later in my testimony. We rely on credit ratings in order to access capital markets on reasonable terms. Moving further away from non-investment grade (BB+) provides more stability for the Company, which is also beneficial for customers. We believe our requested 50.0 percent equity appropriately balances safety and economy for customers.

**Q. In attracting capital under reasonable terms, is it necessary to attract capital from both debt and equity investors?**

A. Yes, it is absolutely essential. As a publicly traded company we have two primary sources of external capital: debt and equity investors. As of December 31, 2015, we had approximately $2.95 billion of debt and equity. Approximately half of our capital structure is funded by debt holders and the other half is funded by equity investors and retained earnings. Rating agencies and potential debt investors tend to place significant emphasis on maintaining strong financial metrics and credit ratings that support access to debt capital markets under reasonable terms. Leverage – or the extent that a company uses debt in lieu of equity in its capital structure – is a key credit metric and, therefore, access to equity capital markets is critically important to long-term debt investors. This emphasis on financial metrics and credit ratings is shared by equity investors who also focus on cash flows, capital structure and liquidity, much like debt investors.

The level of common equity in our capital structure can have a direct impact on investors' decisions. A balanced capital structure allows us access to both debt and equity markets under reasonable terms on a sustainable basis. Being able to choose specific financing methods at any given time also allows the Company to take advantage of better choices that may prevail as the relative advantages of debt or equity markets can ebb and flow at different times.

**Q. Are the debt and equity markets competitive markets?**

A. Yes. Our ability to attract new capital, especially equity capital, under reasonable terms is dependent on our ability to offer a risk/reward opportunity that is equal to or better than investors' other alternatives. We are competing with not only other utilities but also with businesses in other sectors of the economy. Demand for our stock supports our stock price, which provides us the opportunity to issue additional shares under reasonable terms to fund capital investment requirements.

**Q. What is Avista doing to attract equity investment?**

A. We are requesting a capital structure that provides us the opportunity to have financial metrics that offer a risk/reward proposition that is competitive and attractive for equity holders. We target a dividend payout ratio that is comparable with other utilities in the industry. This is an essential element, along with potential growth, in providing a competitive risk/reward opportunity for equity investors.

Tracking mechanisms, such as the Fixed Cost Adjustment, the Power Cost Adjustment and the Purchased Gas Adjustment approved by the IPUC, and similar mechanisms approved by Avista's other regulatory commissions, help balance the risk of owning and operating the business in a manner that places us in a position to offer a risk/reward opportunity that is competitive with not only other utilities, but with businesses in other sectors of the economy.

## VI. PROPOSED RATE OF RETURN

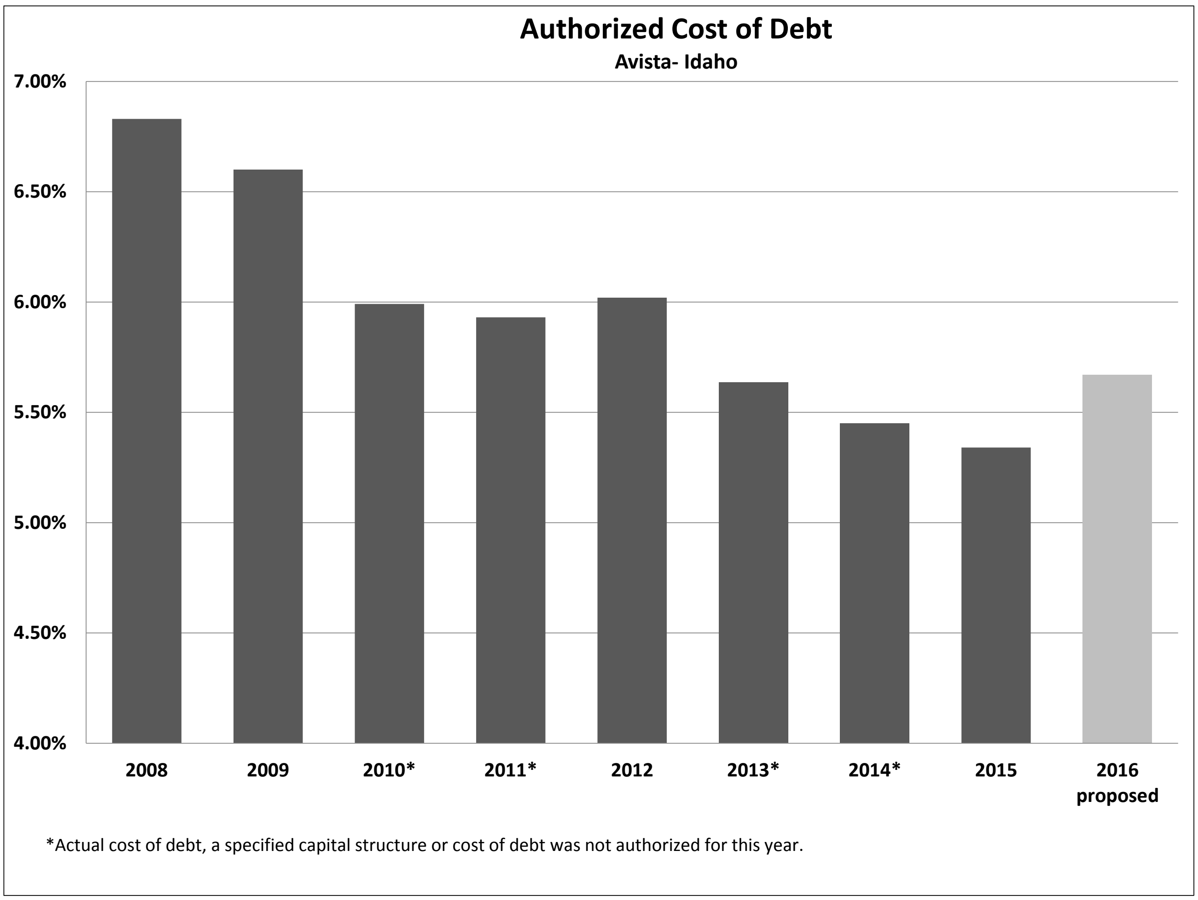
**Q. Has Avista prepared an exhibit that includes the components of Avista's requested rate of return of 7.78 percent?**

A. Yes. Exhibit No. 2, Schedule 1, page 2 shows the components of Avista's requested rate of return of 7.78 percent.

**Q. What is the Company's overall cost of debt and how does the Company's current overall cost of debt compare to its historic cost?**

A. Our requested overall cost of debt is 5.67 percent. The cost of debt has trended downward for Avista in recent years with an increase in 2016, as shown in Illustration No. 5 below.

**<u>Illustration No. 5</u>**




**Q. Please explain why Avista's cost of long-term debt has decreased.**

A. There has been a general decline in interest rates for several years while Avista has issued new debt, causing the

Company's overall cost of debt to decrease. There is an increase in the proposed cost of debt for 2016, as compared to 2015, due to the maturation of $90 million of debt with a coupon of 0.84 percent and an effective yield of -0.04 percent during 2016. In August 2013 we issued $90 million of debt with a 3-year term. Avista executed interest rate hedges for $85 million related to this debt, and at the time the debt was issued received a benefit of $2.9 million related to the hedges. This benefit is amortized over the life of the debt, which results in an effective yield of -0.04 percent. We expect the effective yield on our 2016 debt issuance to be higher than the effective yield on the maturing 2016 debt and, therefore, the average cost of debt will increase in 2016.

We have been prudently managing our interest rate risk in anticipation of debt issuances, which has involved fixed rate long-term debt with varying maturities, and executing on our interest rate risk mitigation program for our forecasted debt issuances.

From 2011 through 2015 we issued $415 million in long-term debt. The weighted average coupon rate of these issuances is 3.55 percent. These issuances have varying maturities ranging from 3 years to 35 years, and a weighted average maturity of 23.6 years.

Our most recent issuance (in 2015) was $100 million of first mortgage bonds with a thirty year maturity at a rate of 4.37%. This new debt has an effective cost of 5.015% after taking into account issuance costs and the settlement of interest rate hedges.

The prior year (in 2014) we issued $60 million of first mortgage bonds with a thirty year maturity at a rate of 4.11%. This debt, which matures in 2044, was the lowest priced debt with a term beyond twenty years that the Company has issued since the 1950s. The effective cost of this debt is even lower at 3.65%, which includes cost of issuance and the impact of interest rate hedges. The $5.4 million positive value of the interest rate hedges (hedges were settled when the coupon rate was set) improved the effective yield on this debt by 0.52%. I will discuss the interest rate hedging program later in my testimony.

We have continued to issue debt with varying maturities to balance the cost of debt and the weighted average maturity. This practice has provided us with the ability to take advantage of historically low rates on both the short end and long end of the yield curve.

The Company's credit ratings have supported reasonable demand for Avista debt by potential investors. We have further enhanced credit quality and reduced interest cost by issuing debt that is secured by first mortgage bonds.

We plan to continue issuing long-term debt with various maturities for the foreseeable future in order to fund our capital expenditure program and long-term debt maturities.

**Q. What is the Company doing to mitigate interest rate risk related to future long-term debt issuances?**

A. As mentioned earlier, we are forecasting $1.2 billion in capital expenditures over the next three years. Additionally, we have $362.5 million of debt maturing during the same period. This results in a significant need for the issuance of long-term debt to fund these capital expenditures and maturing debt while maintaining an appropriate capital structure.

We usually rely on short-term debt as interim financing for capital expenditures, with issuances of long-term debt in larger transactions approximately once a year. As a result, we access long-term debt capital markets on limited occasions, so our exposure to prevailing long-term interest rates can occur all at once rather than across market cycles. To mitigate interest rate risks, we hedge the rates for a portion of forecasted debt issuances over several years leading up to the date we anticipate each issuance.

We also manage interest rate risk exposure by limiting the extent of outstanding debt that is subject to variable interest rates rather than fixed rates. In addition, we issue fixed rate long-term debt with varying maturities to manage the amount of debt that is required to be refinanced in any period (looking ahead to its future maturity), and to obtain rates across a broader spectrum of prevailing terms which tend to be priced at different interest rates.

**Q. Does the Company have guidelines regarding its interest rate risk management?**

A. Yes. The Company's Interest Rate Risk Management Plan, attached as Exhibit No. 2, Confidential Schedule 3C, is designed to reduce uncertainty of the effective interest cost of future debt issuances. The plan provides guidelines for hedging a portion of interest rate risk with financial derivative instruments. We settle these hedge transactions for cash simultaneously when a related new fixed-rate debt issuance is priced in the market. The settlement proceeds (which may be positive or negative) are amortized over the life of the new debt issuance.

The interest rate risk management plan provides that hedge transactions are executed solely to reduce interest rate uncertainty on future debt that is included in the Company's five-year forecast[8]. The hedge transactions do not involve speculation about the movement of future interest rates.

**Q. The Company is requesting a 9.9% return on equity. Please explain why the Company believes this is reasonable.**

A. We agree with the analyses presented by Mr. McKenzie which demonstrate that the proposed 9.9 percent ROE, together with the proposed equity layer of 50.0%, would properly balance safety and economy for customers, provide Avista with an opportunity to earn a fair and reasonable return, and provide access to capital markets under reasonable terms and on a sustainable basis.

## <u>VII. CREDIT RATINGS</u>

**Q. How important are credit ratings for Avista?**

A. Utilities require ready access to capital markets in all types of economic environments. The capital intensive nature of our business with energy supply and delivery dependent on costly long-term projects to fulfill our obligation to serve customers necessitates the ability to obtain funding from the financial markets under reasonable terms at regular intervals. In order to have this ability, investors need to understand the risks related to any of their investments. Financial

[8] The interest rate risk management plan also provides for the Company to hedge interest rate risk beyond the five-year horizon in some situations.

commitments by our investors generally stretch for many years – even decades – and the potential for volatility in costs (arising from energy commodities, natural disasters and other causes) is a key concern to them. To help investors assess the creditworthiness of a company, nationally recognized statistical rating organizations (rating agencies) developed their own standardized ratings scales, otherwise known as credit ratings. These credit ratings indicate the creditworthiness of a company and assist investors in determining if they want to invest in a company and its comparative level of risk compared to other investment choices.

**Q. Please summarize the credit ratings for Avista.**

A. Avista' credit ratings, assigned by Standard & Poor's (S&P) and Moody's Investor Service (Moody's) are as follows:

| | S&P | Moody's |
|---|---|---|
| **Senior Secured Debt** | A- | A2 |
| **Corporate Credit Rating** | BBB | Baa1 |
| **Outlook** | Stable | Stable |

Additional information on our credit ratings has been provided on page 1 of Exhibit No. 2, Schedule 1.

**Q. Please explain the implications of the credit ratings in terms of the Company's ability to access capital markets.**

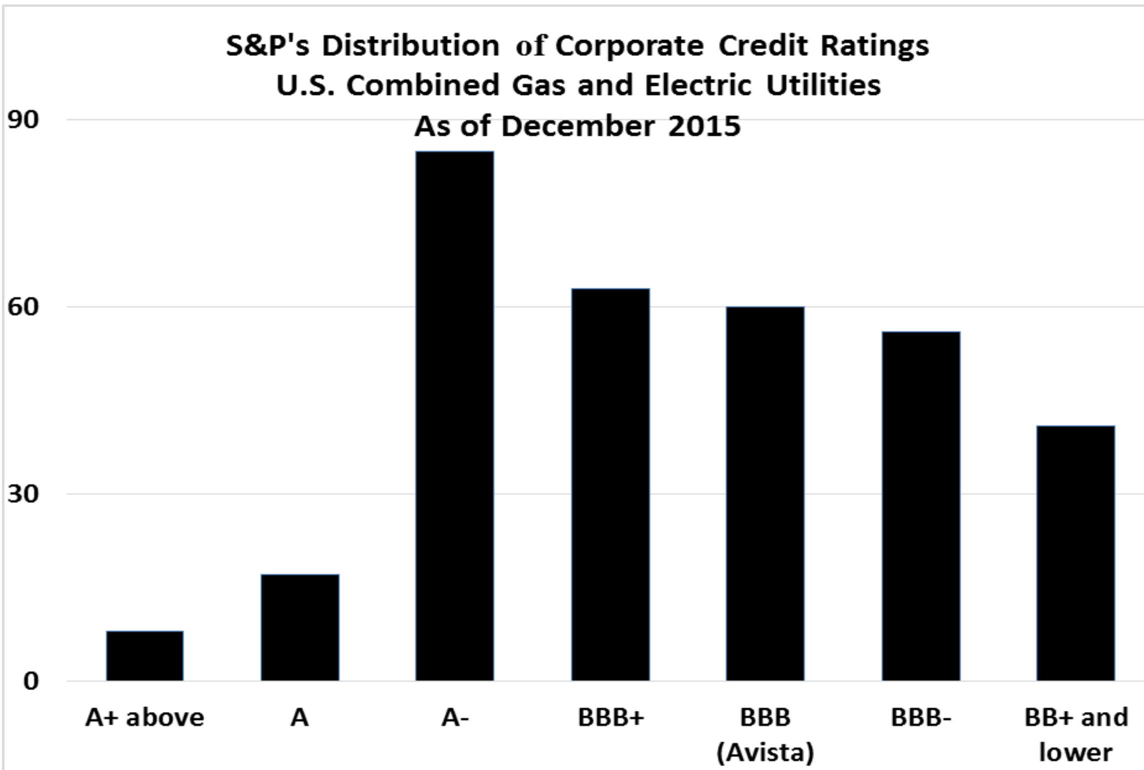
A. Credit ratings impact investor demand and expected returns. More specifically, when we issue debt, the credit rating can affect the determination of the interest rate at which the debt will be issued. The credit rating can also affect the type of investor who will be interested in purchasing the debt. For each type of investment a potential investor could make, the investor looks at the quality of that investment in terms of the risk they are taking and the priority they would have for payment of principal and interest in the event that the organization experiences severe financial stress. Investment risks include, but are not limited to, liquidity risk, market risk, operational risk, regulatory risk, and credit risk. These risks are considered by S&P, Moody's and investors in assessing our creditworthiness.

In challenging credit markets, where investors are less likely to buy corporate bonds (as opposed to U.S. Government bonds), a stronger credit rating will attract more investors, and a weaker credit rating could reduce or eliminate the number of potential investors. Thus, weaker credit ratings may result in a company having more difficulty accessing capital markets and/or incurring significantly higher costs when accessing capital.

**Q. What credit rating does Avista believe is appropriate?**

A. Avista's current S&P corporate credit rating is BBB. We believe operating at a corporate credit rating level (senior unsecured) of BBB+ is comparable with other US utilities providing both electricity and natural gas. As shown in Illustration No. 6, the average credit rating for U.S. Regulated Combined Gas and Electric Utilities is BBB+ and the most common rating is A-. The average and most common ratings are one and two notches higher, respectively, than Avista's rating.

**Illustration No. 6**




We expect that a continued focus on the regulated utility, conservative financing strategies and a supportive regulatory environment will contribute toward an upgrade to a BBB+ corporate credit rating for Avista. Operating with a BBB+ credit rating would likely attract additional investors, lower our debt pricing for future financings, and make us more competitive with other utilities. In addition, financially healthy utilities are better able to invest in the required infrastructure over time to serve their customers, and to withstand the challenges facing the industry and disruptions in the financial market.

**Q. How important is the regulatory environment in which the Company operates?**

A. Both Moody's and S&P cite the regulatory environment in which a regulated utility operates as the dominant qualitative factor to determine a company's creditworthiness. Moody's rating methodology is based on four primary factors. Two of those factors – a utility's "regulatory framework" and its "ability to recover costs and earn returns" – make up 50 percent of Moody's rating methodology[9].

S&P states the following[10]:

> Regulation is the most critical aspect that underlies regulated integrated utilities' creditworthiness. Regulatory decisions can profoundly affect financial performance. Our assessment of the regulatory environments in which a utility operates is guided by certain principles, most prominently consistency and predictability, as well as efficiency and timeliness. For a regulatory process to be considered supportive of credit quality, it must limit uncertainty in the recovery of a utility's investment. They must also eliminate, or at least greatly reduce, the issue of rate-case lag, especially when a utility engages in a sizable capital expenditure program.

[9]Moody's Investors Service, Rating Methodology: Regulated Electric and Gas Utilities, December 23, 2013.
[10]Standard and Poor's, Key Credit Factors: Business and Financial Risks in the Investor-owned Utility Industry, March 2010.

Because of the major capital expenditures planned by Avista and future maturities of long-term debt, a supportive regulatory environment is essential in maintaining our current credit rating.

**Q. Does this conclude your pre-filed direct testimony?**

A. Yes.