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BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION	)	CASE NO. AVU-E-04-01
OF AVISTA CORPORATION FOR THE	)	CASE NO. AVU-G-04-01
AUTHORITY TO INCREASE ITS RATES	)	
AND CHARGES FOR ELECTRIC AND	)	
NATURAL GAS SERVICE TO ELECTRIC AND	)	DIRECT TESTIMONY
NATURAL GAS CUSTOMERS IN THE STATE	)	OF
OF IDAHO	)	MALYN K. MALQUIST
	)	

FOR AVISTA CORPORATION

(ELECTRIC AND NATURAL GAS)

1 **I. INTRODUCTION**

2 **Q. Please state your name, business address, and present position with**
3 **Avista Corp.**

4 A. My name is Malyn K. Malquist. My business address is 1411 East Mission
5 Avenue, Spokane, Washington. I am employed by Avista Corp. as Senior Vice President and
6 Chief Financial Officer.

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

8 A. I received Bachelors and Master in Business Administration degrees from
9 Brigham Young University. I have also attended a wide variety of utility finance courses and
10 leadership programs.

11 I joined Avista Corp in September of 2002 as Senior Vice President and was named
12 to the additional position of Chief Financial Officer in November 2002. Prior to joining
13 Avista, I was General Manager of Truckee Meadows Water Authority in Reno, Nevada,
14 which was separated out from Sierra Pacific Power Company in 2001. I was Chief Executive
15 Officer of Data Engines, Inc., a high tech company located in Reno from June to October of
16 2000. From April 1994 to April 2000, I was employed by Sierra Pacific Resources, first as
17 the company's chief financial officer and later as its chairman of the board and chief
18 executive officer. Following the merger of Sierra Pacific Resources with Nevada Power
19 Company in 1999, I became the President of both Sierra Pacific Power Company and Nevada
20 Power Company. For the sixteen-year period up to 1994, I was employed by San Diego Gas
21 & Electric Company in various positions, including Treasurer and Vice President – Finance.

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

1 A. I will provide a financial overview of the Company and will explain the
2 overall rate of return proposed by the Company in this filing for its electric and natural gas
3 operations. The proposed rate of return is derived from Avista Utilities' costs of debt, trust
4 preferred securities, preferred equity and common equity, weighted in proportion to the
5 proposed capital structure.
6 I will address the debt cost and preferred cost components. Witness Avera will testify
7 to the Company's proposed capital structure and return on equity. Witness Wilson will
8 provide additional testimony regarding the appropriate return on equity for the Company.
9 **Q. Are you sponsoring any exhibits with your direct testimony?**
10 A. Yes. I am sponsoring Exhibit No. 2, which was prepared under my direction.
11 **II. FINANCIAL OVERVIEW**
12 **Q. Please provide an overview of Avista's financial situation.**
13 A. During the energy crisis of 2000 and 2001, it was necessary for the Company
14 to issue a significant amount of debt to cover deferred electric and natural gas costs that
15 reached over $347 million in 2001 on a system basis. The electric deferrals were driven
16 primarily by the combination of record-low hydroelectric conditions and unprecedented high
17 wholesale market prices that occurred in 2001.
18 At the same time, the Company was in the midst of constructing additional electric
19 resources to meet its long-term load requirements, including the Coyote Springs 2 (CS2)
20 plant. The Company began construction of CS2 in January 2001. These construction
21 projects also required a relatively large amount of financing. During this time investors and
22 lenders were resistant to invest in the utility industry, including Avista, and were demanding

1 higher interest rates. Much of the debt issued by Avista during this time was at rates
2 exceeding 9%. As a result, Avista's annual interest costs rose from approximately $69
3 million in 2000 to over $105 million in 2001 and 2002. In addition, Avista's debt ratio rose
4 to over 59% in December 2001.

5 These events led to significant cash needs and a deterioration of the Company's
6 financial strength. In October 2001, Avista Corp's senior unsecured debt and corporate
7 rating were downgraded to below investment grade by Standard & Poor's (S&P), and
8 Moody's Investors Service. Furthermore, as Mr. Hirschkorn will explain in his testimony,
9 Avista's electric and natural gas customers over the past several years have reduced their
10 energy usage. In fact, electricity use per customer has declined 8% to 14% across all
11 customer classes (1997 to 2002), and natural gas use per customer has declined 11%
12 (residential and small commercial, 1999 to 2002). The combination of the decline in use per
13 customer, and an increase in utility operating costs and capital investment since the last
14 electric and natural gas general rate cases has led to an under recovery of costs.

15 The continuing under recovery of costs and increase in debt costs, and the debt ratio,
16 have weakened the Company's financial condition such that its financial indicators do not
17 currently support an investment grade credit rating.

18 **Q. What actions is the Company taking to improve its financial health?**

19 A. We have been aggressively rebuilding our financial health by improving our
20 cash flow, managing our costs and paying down debt. Since 2001, we repurchased $256
21 million of the higher-cost debt. In December 2002, S&P affirmed its credit ratings for Avista

1 and upgraded its credit outlook from negative to stable. However, we remain on a rating
2 outlook of "negative" by Moody's.
3 We are making significant strides in improving the Company's financial stability. Our
4 operating cash flow is positive, thanks to a combination of cost management efforts and rate
5 relief by all four of our regulatory jurisdictions. We will continue to aggressively manage all
6 costs that are within our control. Going forward, it is important that the Company attain
7 revenues that provide recovery of its costs, and earned returns that are in line with the returns
8 allowed by our regulators.
9 Our total debt ratio of about 53 percent is below the utility industry average – down
10 from 59 percent at the end of 2001, but we still need to reduce the debt ratio if we are to
11 reach our goal of regaining our investment grade rating. Our goal for total debt is below 50
12 percent excluding the impacts of new Accounting Standards FAS 150 and FIN 46, and we
13 should be able to make additional progress toward this goal in 2004 and beyond.
14 **Q. Is Avista experiencing risks that are different from the past?**
15 A. Yes, there have been some very definite changes in business risk in recent
16 years. Among the risk factors are the price and supply of purchased power, natural gas and
17 other fuels, recoverability of natural gas and power costs, streamflow and weather conditions,
18 the effects of changes in legislative and governmental regulations, security concerns related
19 to terrorism, and availability of funding. Many of these factors are manifest in the increased
20 earnings volatility the Company has experienced, as well as in the many credit rating
21 downgrades by rating agencies in recent years for utilities across the country. As Mr. Avera
22 will explain in more detail in his testimony, during 2002 S&P recorded 182 downgrades in

1 the electric power industry, as compared to only 15 upgrades. In addition, S&P reported an
2 unprecedented 88 utility ratings downgrades during the first half of 2003.

3 **Q. Please explain further the Company's efforts to improve its financial**
4 **situation.**

5 A. The Company is continuing to rebuild its financial condition in three arenas.
6 First, we are working with the financial community to assure we have adequate funds for
7 operations, for capital expenditures and for debt maturities. As I discuss later in my
8 testimony, we are working with our banks to insure that we have adequate liquidity through
9 the availability of our credit facility on the most economic basis possible. We also maintain
10 an ongoing dialogue with the rating agencies regarding the measures being taken by the
11 Company to regain an investment grade credit rating.

12 Second, the Company is making every attempt to minimize expenses without
13 compromising safety and reliability.

14 Finally, the Company is working through the regulatory processes to work toward
15 recovery of our costs to more closely align earned returns with those allowed by regulators in
16 each of the states we serve. This is a key determinant from the rating agencies standpoint
17 when they are reviewing our overall credit rating.

18 **Q. What internal measures has the Company taken to conserve cash and**
19 **improve earnings?**

20 A. During the past three years the Company has focused especially on controlling
21 costs and preserving cash through several initiatives and strategic steps. Specific actions that
22 Avista has taken include:

1 ▪ Sale of 50% of the Coyote Springs 2 project in the Fall of 2001.

2 ▪ Cutting capital expenditures sharply in 2001 and limiting the 2002 and 2003 capital
3 budgets.

4 ▪ Sharp reductions in operating and maintenance expenses and implementation of strict
5 approval procedures to control expenditures.

6 ▪ Implementing hiring restrictions.

7 ▪ Reduced the capital commitments otherwise required to fund subsidiaries, including the
8 decision to terminate the Company's involvement in Avista Communications, sale of
9 83% of Avista Labs, and discontinued operations of Avista Power.

10 ▪ Payment of significant dividends from Avista Energy to Avista Corporation (Avista
11 Utilities), which were then used to repurchase high cost long-term debt.

12 **Q. In addition to these internal measures, what else has the Company done**
13 **to improve its financial situation?**

14 A. In the past two years the Company has received regulatory approval of a
15 number of measures to address its financial condition. For example, the Company now has
16 tracking mechanisms in place in all of its jurisdictions to provide recovery of the changes in
17 electric and natural gas costs. Some of the recent regulatory approvals are as follows:

18 ▪ In June 2002, the Washington Utilities and Transportation Commission approved a
19 settlement agreement, which included an overall electric rate increase of 31.2% effective
20 July 1, 2002. Of the 31.2%, 19.2% represented a general rate increase, and the remaining
21 12% was designed to provide recovery of deferred power costs over time.

1 ▪ In June 2002 the WUTC also approved the implementation of an Energy Recovery
2 Mechanism (ERM) effective July 1, 2002, which is similar to the power cost adjustment
3 (PCA) mechanism in Idaho. The ERM tracks changes in power costs over time, under
4 the specific terms of the mechanism.
5 ▪ In October 2003, the Idaho Commission approved the extension of the 19.4% electric
6 surcharge that continues to provide recovery of the power cost deferral balance in the
7 Idaho jurisdiction.
8 ▪ During the Fall of 2003, Avista Utilities received approval of Purchased Gas Adjustment
9 (PGA) filings in all of its jurisdictions— Idaho, Washington, Oregon, and California—
10 which were designed to more closely align the rates paid by customers with the costs to
11 provide service. The Company will continue to periodically file PGAs to align gas costs
12 and revenues and keep gas deferral balances at manageable levels.
13 ▪ In September 2003, the Oregon Public Utility Commission approved a natural gas general
14 rate increase of $6.3 million or 10%.
15 This general rate request for electricity and natural gas in the State of Idaho is another
16 important component of the rate relief necessary to provide recovery of costs incurred to
17 serve customers, and improve our financial condition to provide opportunity to regain an
18 investment grade credit rating.
19 **Q. Please summarize the recent actions the Company has taken with regard**
20 **to its subsidiaries.**
21 A. In 2001 the Company adjusted its corporate strategy to focus on the energy
22 and energy-related businesses. Since then, we have divested our telecommunications

1 subsidiary, Avista Communications, and obtained a cash infusion for Avista Labs, the fuel
2 cell company, such that our ownership is now only 17.5%. We have no further obligations to
3 fund that business. Avista Advantage became cash-flow positive in 2003 and virtually
4 requires no cash to fund its operations. Avista Energy continues to be a solid performer and
5 in fact, provided over $158.5 million in cash contributions since 2001 that funded a
6 significant portion of the debt we repurchased in the last two years. Our strategy to the future
7 will continue to be focused primarily on the regulated utility and other energy-related
8 businesses.

9 **III. CREDIT RATINGS AND PLAN TO RETURN TO INVESTMENT GRADE**

10 **Q. Please explain the ratings for Avista's debt and other securities, and what**
11 **the implications of these ratings are in terms of the Company's ability to access**
12 **financial markets and the Company's financial health.**

13 A. Avista's credit ratings by the three principal rating agencies are summarized
14 on page 1 of Exhibit No. 2. For each type of investment a potential investor could make, the
15 investor looks at the quality of that investment in terms of the risk they are taking and the
16 legal priority that they would have in the event that the organization is unable to meet all of
17 its obligations. Investment risks include the likelihood that a company will not meet all of its
18 obligations related to that obligation or security, both in terms of timeliness and amounts
19 owed for principal and interest. Secured debt receives the highest ratings and legal priority
20 for repayment and, hence, has the lowest relative risk. The highest risk securities are
21 generally common equity shares since they have no priority for payment over other creditors.

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

1 A. Avista Utilities should operate at a level that will support a strong investment
2 grade credit rating, meaning at least a strong "BBB" or weak "A," using S&P's rating scale.
3 Up until the most recent past, the Company has always maintained ratings in this range. This
4 Commission has historically recognized that financially healthy utilities have lower financing
5 costs which, in turn, benefits customers.

6 **Q. Why is it important to be investment grade?**

7 A. A utility is a capital-intensive business and as such needs to have ready access
8 to capital markets. Access is more difficult and more expensive for non-investment grade
9 companies. Many times, investors that are normally tapped by utility securities issuers are
10 precluded by law, regulation or policy from investing in non-investment grade securities.
11 And, even if you can access the market as a non-investment grade issuer, the cost will be
12 substantially higher. As debt matures and new financing is required in the future to finance
13 utility plant additions and new customer additions, the cost of new and replacement debt will
14 be higher.

15 Non-investment grade companies are also subject to more restrictive credit
16 requirements from vendors and other counterparties. In fact, the Company's ability to
17 purchase power and natural gas has been impacted by the below investment grade rating, and
18 there are fewer counterparties willing to do business with us. The lower credit rating also
19 requires the Company to post more collateral with those counterparties that are willing to do
20 business with us, than would otherwise be required with a higher credit rating. This results in
21 increased costs. The higher costs of financing for being below investment grade ultimately
22 results in higher rates for our customers.

1 **Q. What events or conditions are necessary for Avista Utilities to regain an**
2 **investment grade credit rating?**
3 A. Improved credit ratings are only likely if the Company's financial strength and
4 its outlook improve for a sustained period of time. To restore satisfactory credit ratings, the
5 Company will need, at a minimum, the following:

6 - improved cash flow from operations (higher general revenues),
7 - continued regulatory mechanisms in place such as PGAs, PCAs, and the ERM, that will
8 provide more certainty of positive cash flows from operations,
9 - reductions in the level of debt that is being carried and the cost of that debt,
10 - improved cash coverage of interest charges,
11 - consistent and predictable financial results, and
12 - the ability to earn a rate of return close to our cost of capital.

13 The effort and sustained performance required to return Avista Corp's credit ratings
14 to investment grade levels will take time, and can be achieved only with a supportive
15 regulatory climate that provides timely recovery of costs. The Company's initiatives to
16 carefully manage its operating costs and capital expenditures are an important part of
17 improving performance, but are not sufficient without revenues that cover costs and provide a
18 fair return on investment.

19 **IV. CASH FLOW**

20 **Q. What are the Company's near-term capital requirements?**
21 A. Over the next few years, capital will be required for customer growth, necessary
22 maintenance and replacements of our electric and natural gas utility systems and other new

1 plant construction, including $100 million for new transmission projects. In addition, the
2 Company has securities of $58 million that mature in 2004-2005. The amount of capital
3 expenditures planned for 2004-2005 is approximately $230 million.

4 The Company must have adequate cash flows to fund operations, capital
5 expenditures, and maturing debt. We need a combination of adequate cash flow from
6 operations (earnings before interest, taxes, depreciation and amortization, known as
7 "EBITDA" or "internally generated cash") plus the ability to access capital markets to fund
8 these requirements.

9 In addition, the Company needs access to bank financing for seasonal working capital
10 and to occasionally fund capital projects between normal "permanent" financing and to
11 provide collateral for power and gas purchases. Even in normal years, the utility's annual
12 operating cycle requires more funds during certain quarters, because electricity and natural
13 gas is obtained and delivered well before collections are received from customers. We have
14 been impacted even more in recent years as the need for liquidity has increased for energy
15 purchases to meet daily, next day and short-term load requirements.

16 Many purchases of power or natural gas, fuel for generating power, or contracts for
17 pipeline capacity to provide natural gas transportation have required collateral, or
18 prepayments, given the Company's credit rating. The line of credit is our only source of
19 immediate cash for borrowing to meet these needs and for supporting the use of letters of
20 credit. We need a line of credit just to manage daily cash flow since the timing of cash
21 receipts versus cash disbursements is never totally balanced.

1 Major capital expenditures are a normal part of utility operations. Customers are
2 added to the service area, roads are relocated and require existing facilities to be moved, and
3 facilities continue to wear out and need replacement. These and other requirements create the
4 need for significant capital expenditures each year. Many of the commitments made in the
5 past to provide quality customer service, to insure customer and employee safety, and to
6 respond to regulatory or licensing requirements at the Company's facilities cannot be
7 eliminated. Issuance of securities depends upon the Company maintaining an adequate
8 capital structure, sufficient interest coverage, and investment grade credit ratings to be able to
9 access capital at reasonable costs.

10 **Q. How does Avista use short-term financing, and how much short-term**
11 **financing does the Company need?**

12 A. The need for a working line of credit depends on a number of factors, including
13 the timing and availability of long-term financing, the seasonal nature of operating cash flow
14 requirements in our utility, the extent of capital projects, uncertainties of energy market
15 prices and the amounts of energy purchased or sold to balance loads and resources,
16 counterparty collateral requirements and other factors. Because cash requirements cannot
17 generally be matched precisely to the size or timing of efficient and economical long-term
18 financing instruments, it is necessary to either pre-fund requirements and hold excess cash, or
19 to obtain short-term financing which can then be rolled over into longer-term instruments
20 when the amount needed is large enough and market conditions are favorable.

21 The overall size of the short-term facility must be large enough that the Company will
22 not experience a cash shortage at any time, or result in being in default on any obligations.

1 Our plan is to maintain a bank line of at least $245 million. The facility needs to be large
2 enough to allow the Company to fund at least one year of capital expenditures, plus required
3 working capital and counterparty collateral requirements to assure flexibility given volatile
4 financial markets and volatility of energy commodity costs. In addition, due to the turmoil in
5 the energy industry, the rating agencies have stated that more than minimum liquidity is
6 absolutely critical in their minds so that we don't have to depend so heavily on the capital
7 markets.

8 **Q. What is the status of the Company's short-term line of credit?**

9 A. The bank market has become tougher and acquiring credit from the banks has
10 become more difficult. In the past two years, many banks either reduced, or limited
11 altogether, their exposure to the utility and energy industry. Recent consolidations in the
12 banking industry have reduced the number of banks willing to participate in utility short-term
13 credit facilities. In 2002, we had to "secure" our credit line with First Mortgage Bonds
14 whereby the banks now have the same ranking in priority as our other First Mortgage Bond
15 holders. This is the highest ranking we can give our debt holders. In May 2003, the
16 Company renewed its $245 million line of credit and is now starting the process to renew the
17 facility, which expires in May 2004. While we are starting to see some improvements in the
18 bank market, the banks continue to require the safety of a line secured by bondable utility
19 property even with our improving financial condition. In addition, with our current credit
20 ratings, the banks currently have restrictions on the amount of new first mortgage bonds the
21 company can issue, and they charge higher bank line fees and borrowing costs than if the
22 company held an investment grade credit rating.

1 **Q. How does equity capital fit into a sound financial plan for Avista?**

2 A. Avista needs to improve the equity ratio of its capital structure. We need to be
3 in position to issue equity on reasonable terms that provides a fair return for new investors
4 without unduly diluting existing equity investors. In addition, we need to earn our authorized
5 return on existing equity, so that retained earnings can build the equity ratio as well. Longer
6 term, utilities and energy companies need to have access to capital markets to raise equity.
7 We do not have any current plans to issue equity, other than the small amounts to fund the
8 requirements of our dividend reinvestment and employee benefit plans, and are concentrating
9 on lowering our debt ratio and improving the common equity ratio through current cash
10 flows. But, the more flexibility the Company has by maintaining access to both the debt and
11 equity markets, the stronger our financial condition will become.

12 During times of credit uncertainty, which has been the case across the U.S. capital
13 markets in recent years, the available capital is allocated first to the highest quality borrowers.
14 Companies with lower credit ratings have more restricted choices for credit, in addition to the
15 higher cost that comes with the perceived risk.

16 <u>**V. CAPITAL STRUCTURE**</u>

17 **Q. When you use the terms "cost of capital" and "capital structure" in your**
18 **testimony, what are you referring to?**

19 A. Cost of capital is the amount that an investor in a specific security charges the
20 user of money. It is generally stated in terms of an interest rate or percentage of expected
21 return on investment. Capital structure refers to the collective set of funding provided by all
22 investors to provide the necessary funds to operate that company. When all the components

1 of capital are aggregated for the company's overall capital structure, the weighted average
2 cost of those components is the "cost of capital" for the firm. The incremental cost of capital
3 is the cost of the next available component of capital that a company may be able to obtain
4 given the willingness of the financial markets to invest in that company with a specific type
5 of security.

6 **Q. What is Avista Corp's capital structure and how does it impact the rate**
7 **of return?**

8 A. Avista's capital structure consists of the blend of long-term debt, preferred
9 trust securities, preferred equity and common equity necessary to support the assets and
10 operating capital of the utility. The proportionate shares of Avista Corp's actual capital
11 structure on December 31, 2003, are shown on page 2 of Exhibit No. 2. A pro forma capital
12 structure is also shown in the Exhibit, which reflects known changes in long-term debt and
13 preferred equity through September 30, 2004. I will describe these adjustments later in my
14 testimony.

15 The rate of return to be applied against rate base in this proceeding is equal to the
16 weighted average cost of capital, taking into account the pro forma adjusting items. As
17 shown on page 2 of Exhibit No. 2, Avista Utilities is proposing an overall rate of return of
18 9.82%.

19 The level of debt in the capital structure continues to be above the desired level for
20 Avista Utilities to achieve and maintain an investment grade credit rating, but we did see
21 improvement in 2002 and 2003 and we expect a continued improvement in 2004 and beyond.

1 **Q. How does Avista conduct its financing as a multi-jurisdictional and multi-**
2 **service utility?**
3 A. Avista provides electric service in Idaho and Washington and natural gas
4 service in Idaho, Washington, Oregon and California. Our funding for all these jurisdictions
5 is provided through a central treasury function. It is more efficient and cost-effective to pool
6 our resources across jurisdictions rather than attempting to fund each of them separately.
7 The cost of funds for each jurisdiction is the same. Likewise, we provide shared
8 services across all jurisdictions that give a benefit of scale to each of them as compared to
9 separate complete utility operations to serve them each independently. The benefits of being
10 a combination electric and natural gas utility that operates in an area spanning parts of four
11 states means all customers share in the costs of service, cost of capital, and the level of
12 service provided. Reasonable allocations can be made to determine the fair sharing of costs
13 among jurisdictions, but all jurisdictions use the same pool of resources for these items and it
14 is impossible to specifically assign many of the dollars for shared resources directly to
15 specific jurisdictions.
16 The capital requirements for the entire utility are managed as a whole. Capital for
17 customer demands is provided from the same shared funding pool, driven by the needs of
18 customers in each area. Any arbitrary distinctions between the cost of capital among our
19 jurisdictions would be difficult to determine and unsupportable by the facts of how capital is
20 obtained and used for the entirety of utility operations.
21 Our selection of debt financing comes from a combination of financial market
22 dynamics, funding needs, our outlook for financial flexibility and judgment. Debts mature

1 and must be paid off and, in some cases, it is advantageous to retire debts before their
2 ultimate maturity to reduce the cost of debt or to avoid requirements related to particular debt
3 instruments. We continuously look at our existing debt obligations and what may be
4 available in the financial markets. Our goal is to provide the lowest cost debt structure
5 possible while preserving long-term and short-term flexibility and access to needed funds.

6 **VI. COST OF DEBT**

7 **Q. Please describe the Company's use of debt.**

8 A. Avista Utilities obtains part of its capital needs through debt rather than all of
9 it from equity owners. By borrowing part of its capital requirements, the overall cost of
10 capital can be reduced since, most often, the cost of debt is lower than the expected returns
11 on equity. Debt holders have superior rights to repayment over equity investors, which
12 reduces their investment risk. Equity holders receive their investment returns only after debt
13 commitments have been satisfied. However, the cost of debt is not generally directly tied to
14 the company's profits; it doesn't change, in general, with the fluctuating net income level of
15 the firm. However, if income fluctuates negatively it does become more difficult to meet
16 fixed charge coverage ratios that are required in virtually all bank and debt financing today.

17 **Q. What is the time period chosen for the cost of debt included in this case?**

18 A. The Company is proposing a capital structure and cost of long-term debt based
19 on actual results December 31, 2003, with adjustments to reflect known and projected
20 changes in long-term debt issuances/redemptions and associated costs through September 30,
21 2004. Adjustments through this time period are intended to coincide with the approximate
22 timing of the Commission's Final Order in this case.

1 **Q. How have you determined the cost of debt?**

2 A. As shown on page 2 of Exhibit No. 2, the average actual cost of long-term
3 debt outstanding on December 31, 2003 was 8.68%, which is a weighted average of all long-
4 term debt components. The size and mix of debt funding changes over time. As noted
5 earlier, we have made certain pro forma adjustments to update the debt cost through
6 September 30, 2004 to 8.70%.

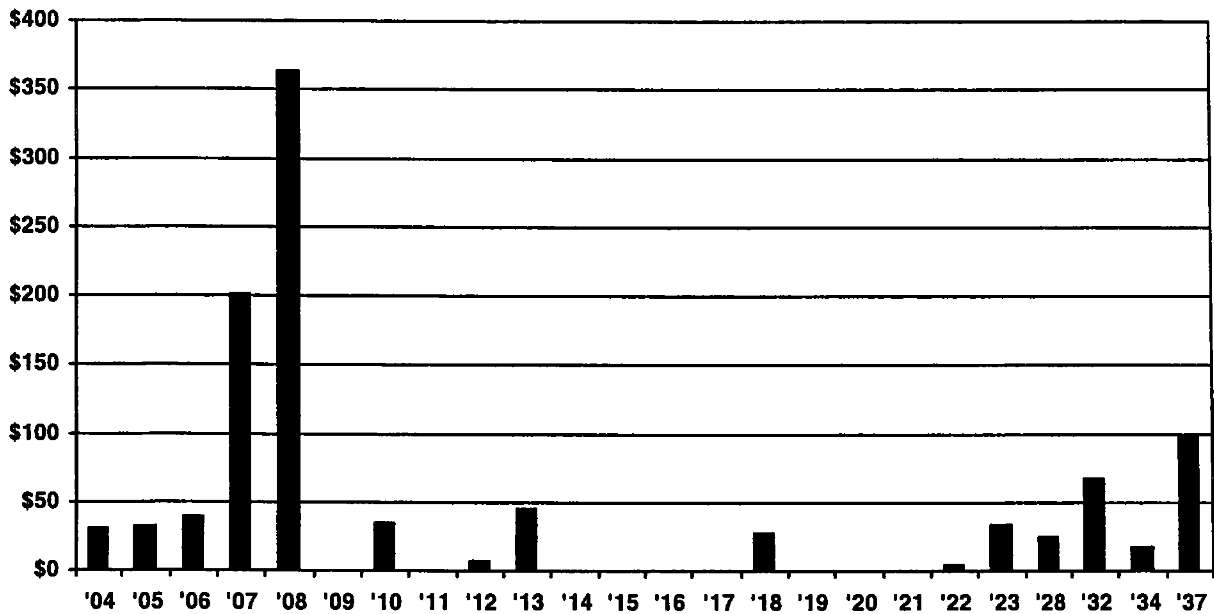
7 **Q. What has Avista Utilities done recently to lower its cost of debt?**

8 A. During 2002 and 2003, we repurchased $256 million of debt on the open
9 market in an effort to reduce interest costs. Our plan is to carry total debt below 50% of total
10 capital, excluding the effects of the new Accounting Standards FAS 150 and FIN 46, and to
11 take advantage of opportunities that may allow us to reduce the cost of debt. However, the
12 Company's present credit ratings are below investment grade and the alternatives available to
13 us are somewhat limited. It is critical that the Company continue to improve its cash flows
14 and earnings. Our cost of debt is higher than it would be with an investment grade rating.
15 Improved financial performance must be sustained if we are to expect the rating agencies to
16 restore Avista Corp's investment grade credit rating.

17 As we look to the future, the Company has over 50% of its total debt maturing in
18 2007 and 2008, as shown in the chart below. A stronger credit rating would allow the
19 Company to refinance the debt at lower interest rates. Therefore, it is important for the
20 Company to regain its financial health and credit ratings, quickly, which will result in lower
21 financing costs for customers in the future.

22

Future Debt Maturities By Year



VII. COST OF PREFERRED EQUITY

Q. What is the role of preferred equity in Avista Utilities' long-term capital structure?

A. Preferred equity securities have attributes that are similar to both debt and to common equity. Certain investors are interested in owning preferred securities rather than common equity because of the greater certainty of a specified return on preferred securities than common stock. Preferred securities often have a longer term or an indefinite maturity than typical debt securities, which is attractive to certain investors. Because of their unique niche in the capital structure, preferred securities have specific covenants and restrictions that must be carefully considered in light of our long-term financing needs and ability to adapt to changing situations. In the past, Avista Utilities has been able to issue preferred securities with costs and terms that are advantageous to our capital structure.

1 However, there is a limited capacity to use preferred equity as part of the overall
2 capital structure. The rating agencies assign various levels of "equity credit" to preferred
3 equity depending on the specific structure and the company's credit rating. The higher the
4 credit rating, the lower the level of equity treatment given and vice versa. In addition,
5 Generally Accepted Accounting Principles (GAAP) changed in 2003 whereby trust-preferred
6 securities are now treated as "debt" on the balance sheet. While the Company currently has
7 about 7.5% of its capital structure in preferred securities, to the future, we will be focusing
8 more on improving the common equity ratio and reducing the total debt ratio rather than
9 specifically focusing on a targeted preferred stock ratio target. To issue new preferred
10 securities, the financial markets and the company's financial condition must support the
11 needs of a particular form of preferred securities and a particular investor group's appetite to
12 buy them. We monitor market trends and evaluate opportunities to see what the best
13 alternatives are for the Company to pursue.

14 **Q. How does preferred equity affect the rate of return?**

15 A. Preferred equity, which includes both trust preferred securities and preferred
16 stock, comprised 7.51% of Avista Utilities' capitalization, including proforma adjustments
17 through September 30, 2004. We have included the actual cost of preferred equity in our
18 calculation of weighted average cost of capital shown on page 2 of Exhibit No. 2.

19 ## VIII. COST OF COMMON EQUITY

20 **Q. What rate of return on common equity is the company proposing in this**
21 **proceeding?**

1 A. The company is proposing an 11.5% return on common equity (ROE). Dr.
2 William Avera testifies to analyses related to the cost of common equity for a benchmark
3 group of electric utilities in the western U.S., with an ROE range of 10.4% to 11.9%. In his
4 testimony Dr. Avera states that:

5 The investment risks associated uniquely with Avista, however, are
6 significantly greater than those of the utilities in the benchmark
7 group and investors require a higher rate of return to compensate for
8 that risk. (P. 6, L. 13)
9

10 Dr. Avera further states in his testimony that:

11 Based on my capital market analyses and the economic requirements
12 for electric utility operations, I conclude that a 11.5 percent ROE
13 falls below the current required rate of return for Avista, in light of
14 investors' economic requirements and the Company's specific risks.
15 (P. 6, L. 8)
16

17 In addition, Dr. Bill Wilson presents analyses of the appropriate return on equity for
18 Avista, based on an assessment of utility industry risk, and the specific operating risk for
19 Avista. His analyses also support a return on equity for Avista in excess of 11.5%.

20 **Q. Dr. Avera and Dr. Wilson are suggesting that an ROE of more than**
21 **11.5% is warranted. Why is Avista not requesting an ROE greater than 11.5%?**

22 A. As I have testified, the Company has made progress in its quest to regain
23 financial health. If Avista can earn an 11.5% ROE in 2005, I believe the financial results
24 would support a bond rating upgrade to investment grade within a reasonable period of time.

25 Furthermore, as the Company has worked toward regaining its financial health over
26 the last few years, it has done so with the customer in mind. Avista has attempted to balance

1 the time frame for financial recovery with the impacts that increased retail rates have on its
2 customers.
3 In this case, although we believe an ROE greater than 11.5% is supported and is
4 warranted, we also believe the 11.5% provides a reasonable balance of the competing
5 objectives of regaining financial health within a reasonable period of time, and the impacts
6 that increased rates have on our customers.
7 **Q. Please summarize the proposed capital structure and the cost components**
8 **for debt, preferred, and common equity.**
9 A. As also shown on page 2 of Exhibit No. 2, the following table shows the
10 capital structure and cost components proposed by the Company.
11
12–19

Component	Percentage	Cost	Weighted Cost
Total long-term debt	48.19%	8.70%	4.19%
Trust preferred securities	5.79%	7.01%	0.41%
Preferred equity	1.72%	7.34%	0.13%
Common equity	44.30%	11.50%	5.09%
Total Weighted Cost of Capital	100.00%		9.82%

20
21 **Q. Does that conclude your prefiled direct testimony?**
22 A. Yes.