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BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION	)	CASE NO. AVU-E-23-01
OF AVISTA CORPORATION FOR THE	)	CASE NO. AVU-G-23-01
AUTHORITY TO INCREASE ITS RATES	)	
AND CHARGES FOR ELECTRIC AND	)	
NATURAL GAS SERVICE TO ELECTRIC	)	DIRECT TESTIMONY
AND NATURAL GAS CUSTOMERS IN THE	)	OF
STATE OF IDAHO	)	MARK T. THIES
	)	

FOR AVISTA CORPORATION

(ELECTRIC AND NATURAL GAS)

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 Executive 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 Andersen & 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 our credit ratings and the Company's capital structure and overall rate of return proposed over the Two-Year Rate Plan in this case. Company witness Mr. McKenzie will provide additional testimony related to the appropriate return on equity for Avista, based on the Company's specific circumstances, together with the current state of the financial markets. I will provide an overview of our capital expenditures program, and other witnesses will provide details on what capital expenditures we are making, and why they are necessary in the time frame in which they are planned.

In brief, I will provide information that shows:

1. Avista's plans call for a continuation of utility capital investments in generation, transmission, electric and natural gas distribution systems, and technology to preserve and enhance service reliability for our customers, including the continued replacement of aging infrastructure. Capital expenditures of $475 million per year (system) are planned for the five-year period ending December 31, 2027. Avista needs adequate cash flow from operations to fund these requirements, together with access to capital from external sources under reasonable terms, on a sustainable basis.

2. We are proposing an overall rate of return of 7.59 percent, which includes a 50 percent common equity ratio, a 10.25 percent return on equity, and a cost of debt of 4.92 percent. We believe our proposed overall rate of return of 7.59 percent and the proposed capital structure provide a reasonable balance between safety and economy.

3. Avista's corporate credit rating from Standard & Poor's (S&P) is currently BBB and Baa2 from Moody's Investors Service. However, in November 2022, S&P revised their outlook on Avista to negative from stable and affirmed our 'BBB' issuer credit rating. S&P cited weaker financial measures due to higher expenses (inflation), customer refunds, rising interest rates and delayed recovery of purchased fuel costs as reasons for their revision. 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, which were prepared under my direction. Schedule 1 provides Avista's credit ratings by S&P and Moody's which are summarized on page 1. Avista's proposed capital structure and cost of capital are included on page 2, with supporting information on pages 3 through 5. Confidential Schedule 2 is our Interest Rate Risk Management Plan. Confidential Schedule 3 shows the Company's planned capital expenditures and long-term debt issuances by year for 2023-2026.

II. FINANCIAL OVERVIEW

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

A. Avista has and will continue to operate the business efficiently to keep costs as low as practicable for our customers, while at the same time ensuring that our energy service is reliable, and our customers are satisfied. An efficient, well-run business is not only important to our customers but also important to investors. Our capital financing plan, and our execution of that plan, provides a prudent capital structure and liquidity necessary for utility operations. We initiate regulatory processes to recover our costs in a timely manner with the goal of achieving earned returns close to those allowed by regulators in each of the States we serve. These elements – cost management, and ready access to capital and revenues that support operations – are key determinants to the rating agencies when they are reviewing our overall credit ratings.

Q. What steps does Avista undertake 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, and it is very important for Avista to maintain and enhance its financial position in order to access debt and equity financing under reasonable terms as Avista funds significant future capital investments and refinances maturing debt.

III. CAPITAL EXPENDITURES

Q. What is the Company's recent history related to capital investments?

A. Avista is making significant capital investments in our natural gas distribution system, electric generation, transmission and distribution facilities, and new technology to better serve the needs of our customers. These investments are focused on, among other things, the preservation and enhancement of safety, service reliability and the replacement of aging infrastructure.

Avista's plans continue to call for making significant utility capital investments in our electric and natural gas systems to preserve and enhance service reliability for our customers, including the continued replacement of aging infrastructure. Capital expenditures of approximately $475 million per year, on a system basis, are planned for the five-year period ending December 31, 2027. Avista needs adequate cash flow from operations to fund these requirements, together with access to capital from external sources under reasonable terms, on a sustainable basis.

Q. Please explain how Avista identifies and prioritizes capital investments, and why the investments are made in the time frame they are completed.

A. Avista's process to identify and prioritize capital investment is designed to meet the overall need for investment, in the appropriate time frame, in a manner that best meets the future needs and expectations of our customers, in both the short-term and long-term. The Company's practice has been to constrain the level of capital investment each year, such that not all of the prioritized projects and programs[1] will be funded in a given year at the level requested. Avista believes that holding capital spending below the level requested also accomplishes several important items, including:

- ***Promotes Innovation*** – Encourages ways to satisfy the identified investment need in a manner that may identify potential cost savings or at a lower cost, defer implementation, or other creative options or solutions.

- ***Balances Cost and Risk*** – Captures the benefits of deferring needed investments by prudently managing the cost consequences and risks associated with such deferrals.

- ***Efficiently Allocates Capital*** – Ensures that the highest-priority needs are adequately funded in the most efficient and effective way.

- ***Reduces Variability*** – Moderates the magnitude of year-to-year variability to avoid excessive rate impacts, and more efficiently optimizes the number and cost of personnel necessary to carry out the capital projects.

[1] "Project" refers to an individual investment for a specific period of time. "Programs" represent investments that address systemic needs that are ongoing with no recognized endpoint, but which may ramp up or down over time, such as the wood pole management program. For ease of reference, the term "capital project" will be used to represent both capital projects and capital programs.

Avista currently has chosen to stabilize the level of annual capital spending at what can be described as a constrained level of $475 million (system), in an effort to accomplish the objectives described above.

Q. Why do you characterize this as a constrained level?

A. Our needed expenditures are in excess of this level, but we work to prioritize our expenditures over time, as discussed below.

Q. What does Avista consider in setting the overall level of capital investment each year?

A. A range of factors influences the level of capital investment made each year, including: 1) the level of investment needed to meet safety, service and reliability requirements 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; 5) the cost of debt; and 6) the opportunity to issue equity on reasonable terms.

Several steps are involved in determining which projects should be considered for funding and how to maximize the value of limited budget dollars. Capital projects are organized into "Investment Drivers," six categories that are used to help explain the needs the project is trying to address. The Company developed these drivers in an effort to improve the transparency and consistency of decision making and they are a consideration for every project, regardless of where it resides. These drivers are:

1) **Customer Requested**. These projects are triggered by customer requests for new service connections, line extensions, transmission interconnections, transmission capacity, or system reinforcements to serve customers. Responding to customer requests for service is a requirement of providing utility service. Projects in this category also include customer service enhancements, line extensions or interconnections to serve large industrial or commercial customers, integrating

customer generating projects, or requested interconnections with neighboring utilities.

2) **Mandatory and Compliance**. The investments in this category are driven typically by compliance with laws, rules, and contract requirements that are external to the Company, areas for which the Company has little or no discretion in spending. Avista operates in a complex regulatory and business framework and must adhere to national and state laws, state and federal agency rules and regulations, and county and municipal ordinances. Compliance with these rules, as well as contracts and settlement agreements, represent obligations that are generally external to the company and generally beyond Company control. Projects in this category may include the obligation to relocate facilities based on road construction projects, dam safety upgrades, air and water quality permits, NERC requirements related to the interconnected grid, FERC required transmission upgrades, etc.

3) **Failed Plant and Operations**. Although Avista responds to thousands of forced outage events every year, asset replacement due to equipment failure or an outage event is only one component of the investment required to operate natural gas and electric operations. Operating conditions are driven by seasonal variations in weather, changes in customer demand patterns, economic trends, as well as large scale events such as windstorms, floods, fire, lightning, and snowstorms. The replacement and capital repair of equipment failures constitute requirements to replace assets that have failed, and which must be replaced in order to provide continuity and adequacy of service to customers (e.g. capital repair of storm-damaged facilities). This also includes investments in natural gas and electric infrastructure that is performed by Avista's operations staff, and which is typically budgeted under capital accounts by major asset or business class (e.g. Electric Distribution).

4) **Asset Condition**. Assets of every type will degrade with age, usage, and other factors, and must be replaced or substantially rebuilt at some point in order to ensure the reliable and acceptable continuation of service. Projects or programs in this category of need are defined as investments to replace assets based on established asset management principles and systematic programs adopted by the Company, which are designed to optimize the overall lifecycle value of the investment for our customers. The replacement of assets based on condition is essentially the practice of removing them from service and replacing them in the most cost efficiency way. This funding category replaces assets or portions of assets as needed to maintain function and usefulness, such as repairing or replacing parts that wear out, when safety or environmental concerns are identified, or when assets no longer provide optimized performance or customer value. Company witness Mr. DiLuciano sponsors testimony related to asset management.

5) **Customer Service Quality and Reliability**. Customer Service Quality and Reliability investments are those investments required to maintain or improve the quality of services provided to customers, to introduce new types of services and options based on an analysis of customer needs and expectations, to ensure customer service quality requirements are achieved, and to meet electric system reliability objectives. These investments include such programs as the Company's Customer at the Center projects supported by Company witness Ms. Hydzik, smart meter installation, replacing aging gas pipeline, changing out underground cables to reduce outages, or installing automation devices to help isolate outages and reduce their impact.

6) **Performance and Capacity**. Avista's projects and programs responsive to this category of need include a range of investments that address the capability of assets to meet defined performance standards, typically developed by the Company, or to maintain or enhance the performance level of assets based on a demonstrated need or analysis. This driver helps ensure that assets satisfy business needs and meet performance and reliability standards. Programs in this category ensure that assets satisfy business needs and meet performance standards. Examples might include adding a redundant feeder to reduce the chance of outages, upgrading systems to improve accuracy, monitoring, or service levels, or increasing capacity due to customer growth or to mitigate potential overloaded equipment.

Q. How are projects developed within the Company?

A. Projects are developed through various means including engineering planning studies, engineering & asset management analyses, required or scheduled upgrades, the result of observations of expert utility personnel, or as the need for investments are identified or otherwise required to provide safe and reliable service. Simply because a need is identified, though, does not mean that a project will ultimately be approved, funded, or completed. Any project will undergo internal review by multiple stakeholders within the business units themselves. There are any number of projects that are developed or scoped at some level, reviewed, and set aside for any number of reasons, including that a project might not meet the need, capital prioritization, risk mitigation, other alternatives, or resource constraints, among other things, within business units. For those projects that make it through that "informal phase gate," they will then go through a more formal review process at the appropriate business area level. Some of the more formal functional review teams are:

Engineering Round Table (ERT) evaluates and recommends business cases for electric Transmission, Substation, or Protection projects and prioritizes resources for those projects. It is comprised of a diverse group of engineering leaders[2] who track project requests, prioritize them, and establish committed construction package dates and required in-service dates for projects.

Generation, Production and Substation (SCRUM) is responsible for all projects within the scope of electric Generation, Production, and Substation Support. Each year Avista makes investment decisions for its generating facilities with the goals of maximizing the value of limited funding and other resources while managing competing requirements and aligning with Company goals and objectives. The group utilizes a process known as the Scheduling, Cost, and Resource Utilization Meeting or "SCRUM" to develop capital project requests. In these meetings, generation leaders and stakeholders discuss criticality, risks, costs, mandatory requirements, resource requirements, alternatives, and options in order to select and prioritize projects. If a project is approved, a more accurate cost and time estimate is developed, and once a proposed project is finalized, it is sent to the Capital Planning Group for further consideration and funding.

Operations Round Table (ORT) manages requests related to electric Distribution programs including new customer service, wood pole and vegetation management, storm restoration, transformer change outs, streetlights, and grid modernization. This also includes the meter shop.

Technology Planning Group (TPG) oversees technology projects and selects and prioritizes those that will be sent on for potential funding. The TPG in conjunction with the Enterprise Technology Steering Committee (ETSC) oversee Avista's investments in technology. They act as the custodian and governance body of Avista's technology investments across the enterprise by focusing on strategic long-term investment planning and oversight of resource or funding constraints across the technology investments.

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[2] Eleven representatives are included in this group from: Transmission and Distribution Planning, Transmission, Distribution, and Substation Design, System Protection, System Operations, Asset Management, Communications and Generation Engineering, and Transmission Services.

Gas Engineering Prioritization Investment Committee (EPIC) is accountable for the capital projects and programs that fall under the scope of natural gas operations and construction. Annually, this group prioritizes the projects and assess the spending level of the programs to support safe and reliable operation of the natural gas system and to maintain compliance with both State and Federal Regulations. The intent is to maximize risk reduction acknowledging there are limited funds to accomplish this. This committee reviews spend and budget data to provide monthly updates to the Capital Planning Group, as needed. The Business Cases to support these efforts are managed by this committee, reviewed by the Manager of Gas Engineering, and approved by the Director of Natural Gas.

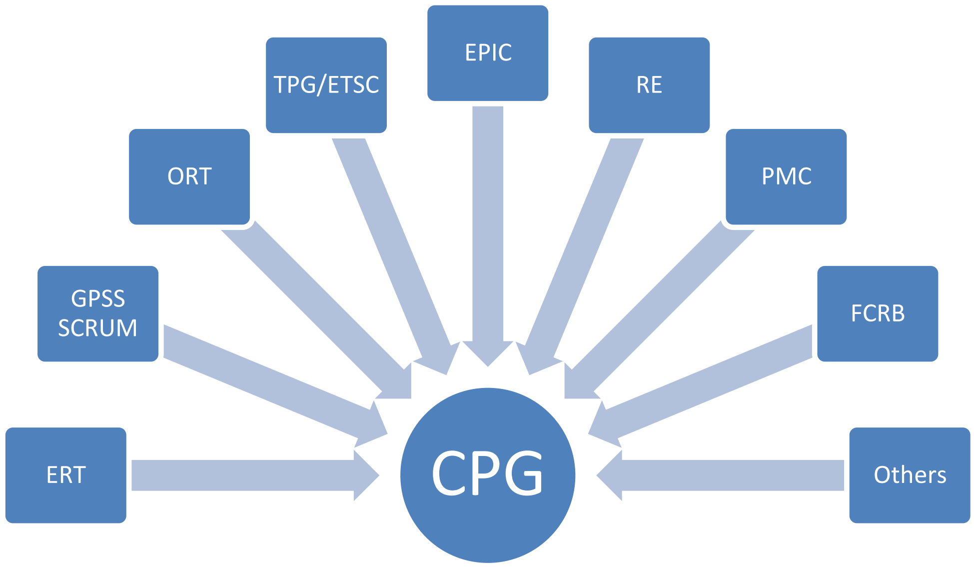
Real Estate and Environmental (RE) develops budgets for business cases based on requirements of our Clark Fork River and Spokane River FERC hydro licenses, as well as local, state & federal regulations related to environmental, hydro safety and rights-of-way matters. The final proposed budgets are informed by analysis of these requirements as well as resource availability to carry out capital projects and past patterns of project costs.

The Property Management Committee (PMC) ensures that the planning, purchasing, selling, and managing of real property is aligned with overall company strategies. The Committee will identify specific actions to improve that alignment, assess current policies and approaches related to property management and identify and adopt needed changes or new policies. The Committee ensures that decision-making processes related to real property are clear and effective and develop cohesive long-term strategies for managing properties.

Facilities Capital Request Board and Large Facilities Project Steering Committee (FCRB) vet facilities-related requests from across the service territory. If projects are approved by this Board, they are prioritized based on risk, safety, environmental impact, and compliance then sent on to the Capital Planning Group.

Illustration No. 1 provides a simple schematic of how these groups ultimately provide input to the Capital Planning Group, or CPG, who decides the funding for proposed projects, as described later in my testimony:

Illustration No. 1 – Project Team Schematic



Q. What are the requirements from a business plan perspective as it relates to documenting the need for a project?

A. In recent years Avista developed a Business Case template that is required for any capital project that is approved by the committees referenced earlier (and prior to funding). A Business Case is a summary document that defines the business problem addressed by a project or program, along with a proposal and recommended solution. The Business Case explains why the work is necessary, and the risks associated with not making the investment, as well as the options considered, the selected alternative and the timeline associated with the project. Avista is committed to making optimal investment decisions on behalf of our customers and stakeholders. Thorough, accurate, and evidence-based business case analyses are foundational to the capital investment decision making process. There have been ongoing improvement efforts over several years to improve and standardize the business case process, focusing on customers, financial and performance metrics, financial and risk analysis, prudence, and documentation. These improvement efforts have resulted in more robust narratives, increased standardization of processes and templates, and additional training.

When Avista makes any capital investment there is an obligation to demonstrate that the overall need, evaluations of alternatives, and the planned timing of implementation are prudent, and in the customer's best interests. Whether the investment touches the customer directly, such as customer service or metering systems, or indirectly, such as improving the capability and efficiency of employees and internal work processes, each dollar invested ultimately supports one purpose: to provide customers with safe, reliable, and cost-effective energy services that meet their expectations for quality of service and value.

Q. Once all of the projects are approved in their various committees, what is the next step in the approval process?

A. The various business units perform a thorough vetting of projects in their specific areas of responsibility. The resulting supported business cases are then sent to the Capital Planning Group (CPG) for final review and consideration. The CPG is comprised of Avista directors from across all of the capital-intensive areas of the Company. The CPG has the responsibility of determining how the capital budget, at a level which is approved by the Finance Committee of the Board of Directors, will be allocated across the business. The CPG evaluates all of the projects proposed for funding from a Company-wide perspective. Based on the members expertise and considerable discussion and give-and-take, the CPG ultimately determines which projects should be funded in full, in part, or which should be deferred to future years in order to stay within budget, all while appropriately balancing the risks of the Company while providing safe and reliable service to our customers.

Q. What does the CPG consider in their determination of funding?

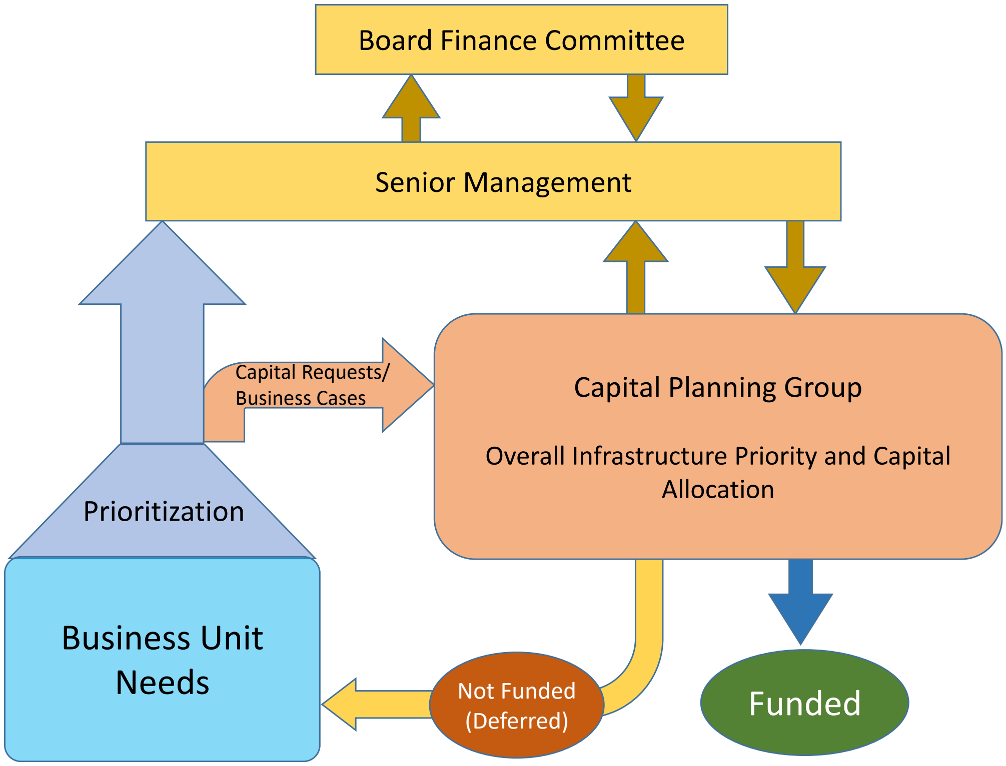
A. The CPG considers the immediacy of the need for investment, the financial and other impacts/risks of deferring projects, as well as safety, reliability, and partial funding versus an "all or nothing" approach. This group also evaluates and discusses the risks and consequences of not funding projects. Based on this iterative and comparative assessment, the team adjusts the list of projects to be funded, as well as the amounts to be funded, to arrive at the best-balanced allocation of capital among priority needs across the business. The final allocation recommended by the CPG reflects the need to fund the highest priority investments first, on a Company-wide basis, while taking care to ensure that the investments deferred will not result in excessive cost or risk.

Q. After the CPG balances the requests of the Company within the financial constraints, what happens next?

A. Once funding is allocated to priority projects for the coming five-year period, the CPG presents the budget to Avista's senior management who provide feedback and future direction, and ultimately approve the five-year funding plan. Planned spend by business driver is presented to the Finance Committee of the Board of Directors, which after discussion and the opportunity for amendment, approves the funding plan. The status of the planned versus actual investment spending is reviewed with the Finance Committee at least twice each year. In the end, the approved capital funding plan demonstrates a reasonable balance among competing needs required to maintain the performance of Avista's systems, as well as prudent management of the overall enterprise in the best interest of customers.

The process under which Avista's planned capital expenditures are identified and prioritized is illustrated in Illustration No. 2 below.

<u>Illustration No. 2 - Identification and Prioritization Process</u>



As discussed earlier, the capital projects are identified in the lower-left portion of the diagram labeled "Business Unit Needs," and are then <u>prioritized within each department</u>. This prioritization occurs with the knowledge of the continuing constraint on the capital spend level for the Company, while at the same time the leadership of each department informs Senior Management of both the near-term and longer-term needs that are being delayed. For the prioritized projects, Business Cases are developed for each of the Capital Requests that go to the CPG. The CPG prioritizes the Capital Requests across departments, such that the overall planned capital spend stays within the constrained spend level established by Senior Management. The highest priority Capital Requests are "Funded", and a portion of the Capital Requests are "Not Funded" (Deferred), as shown on the diagram. Each year, the Board Finance Committee reviews and approves the first year of the rolling five-year capital investment plan. Under this Identification and Prioritization Process, the capital projects are screened and prioritized twice: once within the departments, and then a second time across departments within the CPG.

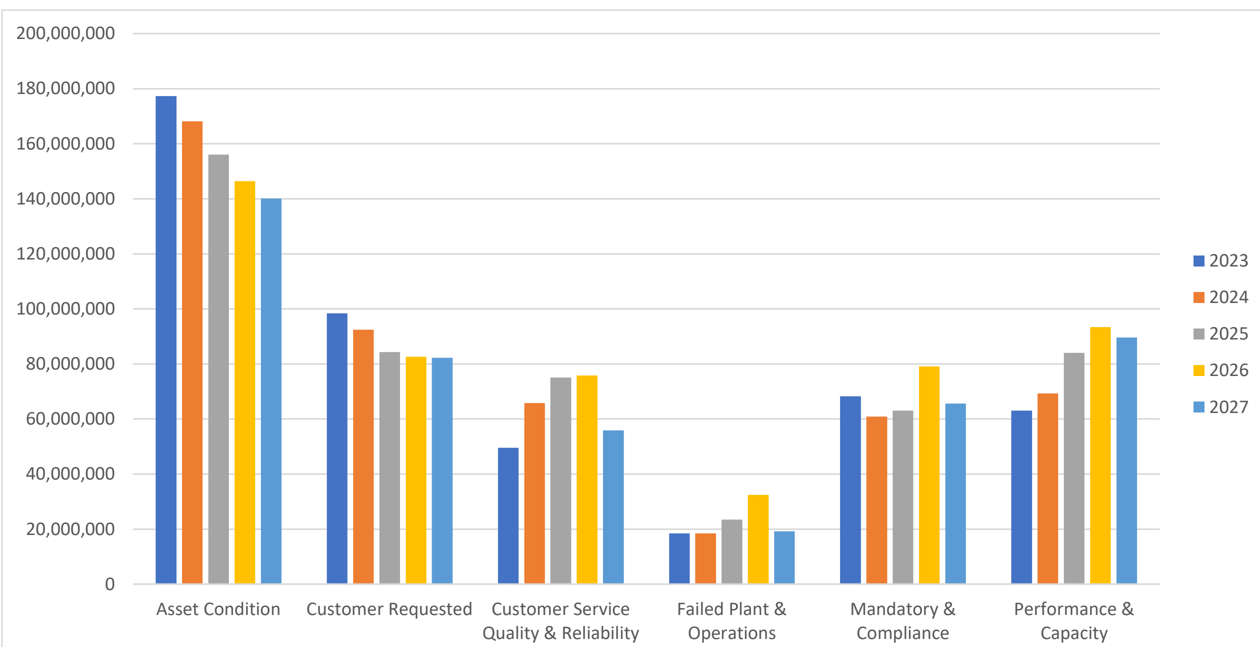
Q. Once the projects are approved, and the summarized plan is approved by the Finance Committee of the Board, is the plan essentially fixed and static?

A. Not at all. All good plans necessarily change. The projects in the Company's portfolio are regularly reviewed for changes in assumptions, constraints, project delays, accelerations, weather impacts, outage coordination, system operations, performance, permitting/licensing/agency approvals, safety, and customer-driven needs that arise. In recent years, we can also add responding to a pandemic to that list as well. The portfolio is continually updated throughout the year to remain as appropriate as possible.

Q. Would you please provide a summary of the Company's planned investments, by Investment Driver?

A. Yes. A breakdown of planned investments for each driver for 2023-2027 is shown in Illustration No. 3 below.

<u>Illustration No. 3 – Planned Investments by Capital Investment Driver (2023-2027)</u>



Q. If a project is delayed for whatever reason, can the Company simply lower the capital budget for that year rather than find another project to fund?

A. The continuing progress on projects in the queue is very important to avoid the creation of a large "bow-wave" of investment that needs to be done in a relatively short period of time. Generally, if a project is delayed, moving the next priority project up helps to alleviate that bow-wave. This reprioritization occurs within the CPG, which is charged with ensuring that the total capital spend for the year stays within the constrained spending limit established by the Company. The dollar amount of capital projects requested by departments with the amounts approved by the Company is provided in Table No. 1 below. The dollar amounts for projects that were delayed (not approved) are also shown:

Table No. 1: Capital Project Requests/Approvals ($ in millions)

Year	Requested	Approved	Delayed	% Capital Delayed
2019	$528	$405	$123	**23%**
2020	$505	$405	$100	**20%**
2021	$516	$407	$109	**21%**
2022	$501	$475	$26	**5%**
2023	$523	$475	$48	**9%**
2024	$595	$475	$120	**20%**
2025	$601	$475	$126	**21%**
2026	$581	$475	$106	**18%**
2027	$511	$475	$36	**7%**

As demonstrated in Table No. 1 above, the Company has a significant capital investment need, as determined by Company subject matter experts. If Avista were simply just trying to grow rate base for purposes of increasing earnings, we would not constrain ourselves to the $475 million capital budget level. Put another way, Avista could fully justify increasing its capital budget to <u>over</u> $500 million over the next several years, but is choosing not to, in order to balance investment need with customer affordability.

Q. Table No. 1, above, shows capital projects delayed. What accounts for that?

A. In short, the Company has necessarily smoothed our capital investments, balancing the overall rate pressure caused by capital investments on our customers, with a level that still allows Avista to provide safe and reliable service, while also balancing the risks of the organization along with the workloads of our crews and available contractors.

Q. What accounts for the increased capital budget from approximately $405 million in 2021 to $475 million per year for 2022 through 2027?

A. There are two pressures that led to the approximate $70 million annual increase. First, the approved capital budget of $405 million from 2017 through 2021 was held flat during those years, even while inflation of any kind was generally at least 2% annually. If Avista simply increased our capital budget annually by a 2% escalator starting after 2017, by 2022 the capital budget would have been $447 million. As such, the value of $405 million simply decreased due to inflation. The second reason has to do with even larger increases in capital project costs due to higher inflation we are experiencing today, along with an even larger backlog of project. We simply need more money to do the same work, and perhaps cut down on deferred capital.

Q. What is driving the investment in utility plant in Idaho?

A. That information is covered in general by Company witness Ms. Schultz, with the restating and pro forma capital adjustments provided by Company witness Ms. Benjamin. Other Company witnesses, (i.e., Mr. Kinney regarding Production assets; Mr. DiLuciano regarding Transmission, Electric and Natural Gas Distribution, and General Assets; Mr. Kensok regarding the costs associated with Avista's Information Service/Information Technology (IS/IT) projects; Mr. Howell regarding Wildfire investment; and Ms. Hydzik regarding investment related to Customer Technology) provide more specific information on the capital projects included in this case. These investments reflect, among other things, replacement and maintenance of Avista's utility system and the need to sustain reliability, safety, and service to customers. Major projects included for recovery in this case include Avista's Kettle Fall's Generating Facility fuel yard, Cabinet Gorge Station Service, Aldyl-A Pipe Replacement program, substation and transmission upgrades, investment to serve new electric and natural gas customers, required electric and natural gas facility relocations, wildfire resiliency plan investment, and the overall systematic replacement of aging infrastructure, among others.

IV. MATURING DEBT

Q. How is Avista affected by maturing debt obligations?

A. In the next four years, the Company is obligated to repay maturing long-term debt totaling $13.5 million as shown in Table No. 2 below. A large concentration – $250 million – of long-term debt recently matured April 1, 2022.

Table No. 2 – Long-Term Debt Maturities

Avista Corp Long-Term Debt Maturities, 2023-2026				
Maturity Year	Principal Amount	Coupon Rate	Date Issued	Maturity Date
2023	$ 5,500,000	7.530%	5/6/1993	5/5/2023
	$ 1,000,000	7.540%	5/7/1993	5/5/2023
	$ 7,000,000	7.180%	8/12/1993	8/11/2023
2024				
2025				
2026	$ -	-	-	-
Total	$ 13,500,000			

These debt obligations originated as early as 1993 and their original terms were between 10 and 20 years (and had been refinanced since that time). These maturing obligations represent about 1 percent of the Company's long-term debt outstanding at the end of 2022. It will be necessary for Avista to be in a favorable financial position to complete the expected debt refunding under reasonable terms, while also obtaining debt and equity to fund capital expenditures each year.

Q. What are the Company's expected long-term debt issuances through 2026?

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 in each year through 2026. We issued $400 million in 2022. Issuances planned for 2023 through 2026 are provided in Exhibit No. 2, Confidential Schedule 3.

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 June 2026. 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. A strong financial position will be necessary to gain access to a new or renewed revolving credit facility, under reasonable terms, prior to expiration of the existing facility.

V. PROPOSED CAPITAL STRUCTURE AND COST OF CAPITAL

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

A. Our proposed capital structure is 50 percent debt and 50 percent equity, with a proposed cost of debt of 4.92 percent, a proposed 10.25 percent return on equity (ROE), and a requested overall rate of return (ROR) in this proceeding of 7.59 percent, as shown in Table No. 3 below.[3] The proposed capital structure for the Two-Year Rate Plan is calculated excluding short-term debt.

<u>Table No. 3 – Proposed Cost of Capital</u>

Proposed Cost of Capital December 31, 2023			
	Percent of Total Capital	Cost	Component Cost
Total Debt	50%	4.92%	2.46%
Common Equity	50%	10.25%	5.13%
Total	100%		**7.59%**

Q. Why is the Company planning to maintain an equity ratio at this level?

A. Maintaining a 50 percent common equity ratio, excluding short-term debt, 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, this common equity ratio solidifies our current credit ratings and our long-term goal is to move our Standard & Poor's corporate credit rating from BBB to 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

[3] The calculations of the proposed capital structure (excluding short-term debt), cost of debt and overall cost of capital are provided with Exhibit No. 2, Schedule 1.

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 the proposed 50 percent equity appropriately balances safety and economy for customers and is consistent with that currently authorized for our Idaho jurisdiction. As previously discussed, however, recent "headwinds" (inflation, interest rates, depreciation, pension costs) have actually caused increased concerns from S&P, who recently revised their outlook to "negative."

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

A. A key component of a continued long-term sound financial profile is the ability to receive timely recovery of capital additions and expenses, so the Company can earn its authorized return. When regulatory mechanisms do not respond to changing cost factors, the level of return can move substantially below the authorized level. This creates financial weakness and concern in financial markets about the long-term stability of the Company.

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[4]. In addition, S&P stated:[5]

> 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

[4] Moody's Investors Service, Rating Methodology: Regulated Electric and Gas Utilities, June 23, 2017.
[5] Standard and Poor's, Key Credit Factors: Business and Financial Risks in the Investor-owned Utility Industry, March 2010.

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.

Q. The requested return on equity of 10.25% is above that requested in Avista's last general rate case. What explains that?

A. Mr. McKenzie explains that the increased risks associated with a Two-Year Rate Plan and an earnings shortfall if the underlying assumptions are not realized. He also addresses the increased risks associated with a business environment during the present pandemic, as well as the prospects for increased interest rates.

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 <u>external</u> capital: debt and equity investors. As of September 30, 2022, we had approximately $4.5 billion of long-term 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 place significant emphasis on maintaining credit 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 among a variety of 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 necessary capital investments.

Q. What is Avista doing to attract equity investment?

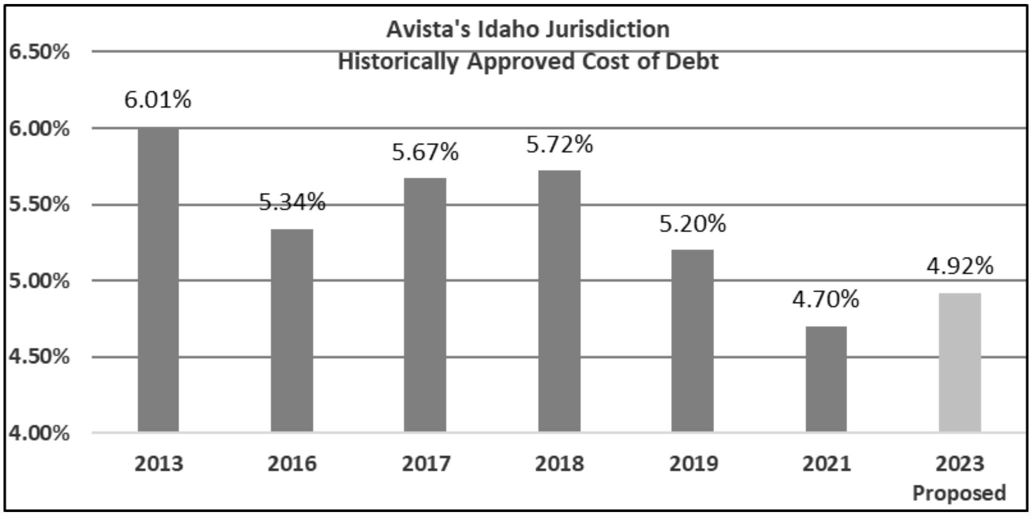
A. We are requesting a capital structure that provides us the opportunity to have financial metrics that offer a risk/reward proposition that is competitive and/or attractive for equity holders. We have steadily increased our dividend for common shareholders over the past several years, which is an essential element in providing a competitive risk/reward opportunity for equity investors.

Tracking mechanisms, such as the Power Cost Adjustment, Fixed Cost Adjustment, and Purchased Gas Adjustment approved by the 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.

Q. What is the Company's overall proposed cost of debt, and how does it compare to its historically approved cost?

A. Our requested overall cost of debt is 4.92%. The authorized cost of debt has trended downward for Avista from 2010 to 2021, with the exception of an uptick in 2018 due to low-cost debt that rolled off in 2016, as shown in Illustration No. 4 below.

Illustration No. 4: Historic Cost of Debt



Q. Please explain why Avista's cost of long-term debt has trended down.

A. Until just recently, there has been a general decline in interest rates over the past decade. At the same time Avista has issued new debt to fund capital expenditures and to replace higher cost debt maturing, which has caused the Company's overall cost of debt to decrease. We have been prudently managing our interest rate risk in anticipation of these periodic debt issuances, which has involved fixed rate long-term debt with varying maturities and executing forward starting interest rate swaps to mitigate interest rate risk on a portion of the future maturing debt and our overall forecasted debt issuances.

From 2016 through 2022, the Company issued $1.5 billion in long-term debt. The weighted average interest rate of these issuances is 3.76%. These issuances have varying maturities ranging from 30 years to 35 years. Our most recent issuance was funded on March 17, 2022. This issuance was a total of $400 million of first mortgage bonds with a thirty-year maturity and was completed at a coupon rate of 4.00%. On March 8, 2022, the debt was priced and $140 million of interest rate swaps were settled. These swaps were entered into in accordance with the Company's Interest Rate Risk Management Plan (discussed in more detail later in my testimony and provided as Exhibit No. 2, Confidential Schedule 2), in order to reduce concentration risk associated with a single issuance date. The effective cost of this debt is approximately 4.32%, including the issuance costs and the cost of settled interest rate hedges.

We have continued to take advantage of historically low rates. 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.

Q. How has inflation impacted Avista?

A. We are experiencing inflationary pressures in multiple areas of our business. Most notably, higher power and natural gas costs have impacted utility margin, labor and benefits costs have increased, and higher gasoline and diesel costs have increased the cost to operate our vehicle fleet. We are working to mitigate these pressures by monitoring the power and natural gas markets and following our various hedging and risk mitigation plans. We also have our Jackson Prairie natural gas storage facility which we use to optimize our natural gas system and limit our exposure to high natural gas prices. While we have various regulatory recovery mechanisms for our power and natural gas costs, there is a delay between the initial purchase of power and gas commodities, and the recovery of these costs.

In December 2022, the entire Northwest saw natural gas and power prices spike 5 to 8 times higher than normal, which led to increased liquidity needs for purchases of physical commodities as well as significant margin calls associated with future commodity activity and hedging arrangements. That, in turn, placed pressure on the Company's available liquidity, and as a result, the company entered into a $100 million term-loan with a March 30, 2022 maturity and increased our $50 million 364-day revolving credit facility to $100 million in order to maintain adequate liquidity. In addition, on December 29, 2022, the Company entered into an uncommitted and unsecured continuing letter of credit agreement for $50 million. On behalf of the Company, I extend my thanks to the Commission for its quick and supportive work to give us the necessary Order that allowed us to enter into those credit facilities.

Q. How much have interest rates increased in 2022?

A. Interest rates have increased significantly in 2022, and we expect interest rates to continue to increase into 2023.[6] The Federal Reserve aggressively raised interest rates 7 times in 2022 and they have signaled more increases are planned for 2023. The feds fund rate and our short-term borrowing rate has increased about 375 basis points since the beginning of 2022, and we expect our borrowing rate to continue to increase next year. Higher interest rates increase the cost of borrowing under the Company’s $400 million revolving credit facility and is expected to increase the cost of issuing long-term debt in 2023.

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

A. Our future borrowing requirements are primarily driven by our significant capital expenditure program and maturing debt, which creates exposure to interest rate risk. As mentioned earlier, we have approximately $1.9 billion in forecasted capital expenditures over the next four years. Additionally, we have $13.5 million of debt maturing during the

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[6] https://www.forbes.com/advisor/investing/fed-funds-rate-history/

same period. We are forecasting the issuance of approximately $330 million in long-term debt from 2023 through 2026 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 interest rates for a portion of forecasted debt issuances over several years leading up to the date we anticipate each issuance.

There are a number of factors that should be taken into consideration in choosing the term of new debt issuances. For example, the current interest rate environment where the interest rate spread for 30-year and 10-year terms is relatively narrow (i.e. presently there is a low premium for 30-year debt versus 10-year debt), supports increased reliance on longer-term debt.

In addition, the average life of plant assets for Avista exceeds 30 years. A 30-year term for debt is a closer match to the average life of the underlying assets that are being financed. Decisions on the term of the debt are generally made closer to the time that new debt is issued. Based on information available today, although the Company will consider some amount of 10-year debt, the issuances will likely be heavily weighted toward a 30-year term, due in large part to the matching of the financing to the life of the assets being financed, and the narrow rate spread for 30-year vs 10-year terms.

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 2, is designed to provide a certain level of stability to future cash flows and the associated retail rates related to future interest rate variability. 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. The hedge transactions do not involve speculation about the movement of future interest rates.

Q. Were the hedges that are included in the Company's cost of debt in this filing consistent with the same hedging plan that the Company operated under in its last several general rate cases?

A. Yes. The hedges included in this filing were entered into a manner that is consistent with the Company's Interest Rate Risk Management Plan in effect during prior general rate cases. The Company has executed interest rate swaps, for purposes of reducing interest rate risk for our customers as early as 2004 and has been fully transparent in communicating its interest rate hedging activities. The settlement values, either losses or gains, of the interest rate swaps have been clearly included as a component of cost of debt in previous filings and this filing.

Q. Turning now to return on equity ("ROE"), the Company is requesting a 10.25 percent ROE. Please explain why the Company believes this is reasonable.

A. We agree with the analyses presented by Mr. McKenzie, which demonstrate that the proposed 10.25 percent ROE, together with the proposed equity layer of 50.0 percent, 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. Please see the direct testimony of Mr. McKenzie for his support of a 10.25 percent ROE.

Q. Does the Company incur flotation costs?

A. Yes, the company incurs flotation costs when equity is issued. These costs include sale agent fees, registration fees and legal expenses. For example, for 2022, the Company incurred $1.9 million in flotation costs. Flotation costs are not recorded on the income statement and are not included in the cost of capital. Common equity raised through the sale of stock is recorded net of these costs. There are opportunity costs associated with issuing equity and flotation costs that will be further discussed by Mr. McKenzie related to the overall cost of equity.

VI. CREDIT RATINGS

Q. Please describe Avista's credit facility.

A. We have a credit facility in the amount of $400 million with a maturity date of June 4, 2026.[7] The credit facility involves participation by seven banks. Our credit facility provides the ability to take out or repay short-term debt based on day-to-day liquidity needs and to have letters of credit issued on the Company's behalf. The Company pays fees under three price elements in the agreement: 1) a facility fee to maintain the right to draw on the credit facility at any time, 2) interest on amounts borrowed, and 3) fees for letters of credit.

The Company may request letters of credit (LCs) underwritten by the participating banks and established for the benefit of counterparties to Avista. LCs are often used as

[7] The credit facility was originally established in 2011, amended in April 2014, extended in May 2016, amended and extended in June 2020, and then again in June 2021.

collateral when required for energy resources forward commitments, forward swap transactions to hedge interest rate risk on future long-term debt, and other contractual or legal requirements that involve the Company.

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 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 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 shown in Table No. 4 below:

<u>Table No. 4 – Avista's Current Credit Ratings</u>

	S&P	Moody's
Senior Secured Debt	A-	A3
Senior Unsecured Debt	BBB	Baa2
Outlook	Negative	Stable

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

Q. Have inflationary pressures negatively impacted Avista's credit ratings?

A. Yes. On November 11, 2022, S&P revised their outlook on Avista to negative from stable and affirmed our 'BBB' issuer credit rating and 'A-' rating on our senior secured debt. S&P states the following:[8]

> Inflation--which includes higher expenses, customer refunds, rising interest rates, and delayed recovery of purchased fuel costs--has contributed to the company's weakening financial measures. The negative outlook reflects our expectation for a weakening of financial performance below our downgrade threshold because of inflation, rising interest rates, and regulatory lag. We could lower our ratings on Avista over the next 12-24 months if adverse regulatory outcomes, regulatory lag, or rising expenses pressure the company's financial measures...

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

[8] "Avista Corp Outlook Revised to Negative on Weaker Financial Measures; Ratings Affirmed." https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/type/HTML/id/2916024 (November 11, 2022).

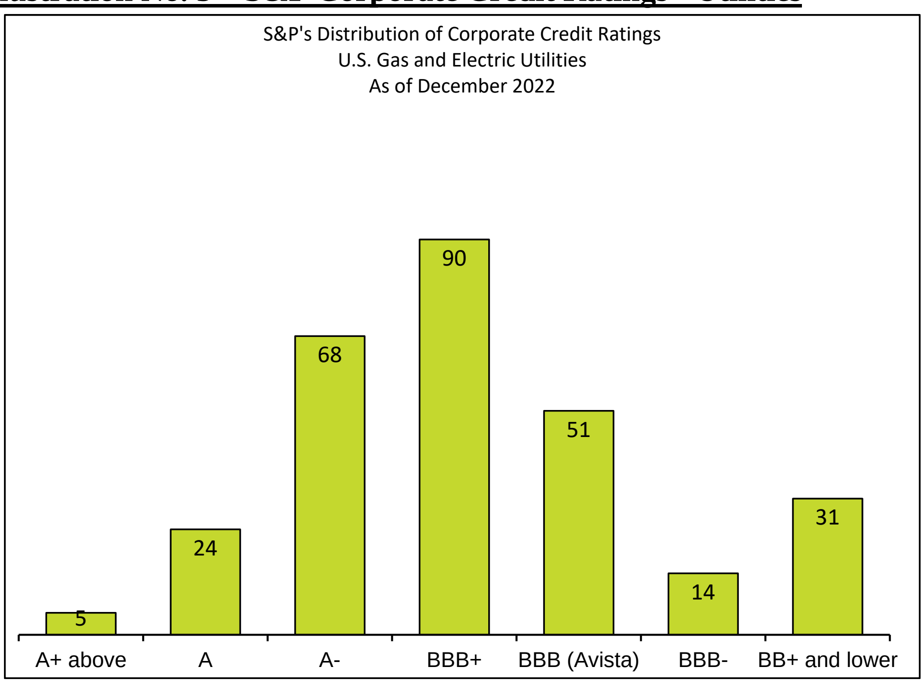
risks are considered by S&P, Moody's and investors in assessing our creditworthiness.

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 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 gives us the ability to continue to attract investors and to achieve competitive debt pricing. Although a corporate credit rating of BBB is a strong investment-grade credit rating, we continue to target a credit rating of BBB+ which is comparable with other US utilities providing both electricity and natural gas. As shown in Illustration No. 5, credit ratings for U.S. Regulated Combined Gas and Electric Utilities are highly concentrated at A- or BBB+.

Illustration No. 5 – S&P Corporate Credit Ratings - Utilities



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 potential financial market disruptions.

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

A. Yes.