

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-19_____

DOCKET NO. UG-19_____

DIRECT TESTIMONY OF

ADRIEN M. MCKENZIE, CFA

REPRESENTING AVISTA CORPORATION

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1 **I. INTRODUCTION**

2 **Q. Please state your name and business address.**

3 A. Adrien M. McKenzie, 3907 Red River, Austin, Texas, 78751.

4 **Q. In what capacity are you employed?**

5 A. I am President of Financial Concepts and Applications, Inc. (“FINCAP”),
6 Inc., a firm providing financial, economic, and policy consulting services to business and
7 government.

8 **Q. Please describe your educational background and professional**
9 **experience.**

10 A. A description of my background and qualifications, including a resume
11 containing the details of my experience, is attached as Exh. AMM-2.

12 **A. Overview**

13 **Q. What is the purpose of your testimony in this case?**

14 A. The purpose of my testimony is to present to the Washington Utilities and
15 Transportation Commission (the “Commission” or “WUTC”) my independent evaluation of
16 the fair rate of return on equity (“ROE”) for the jurisdictional electric and natural gas utility
17 operations of Avista Corp. (“Avista” or “the Company”). In addition, I also examined the
18 reasonableness of Avista’s capital structure, considering both the specific risks faced by the
19 Company and other industry guidelines.

1 **Q. Please summarize the information and materials you relied on to support**
2 **the opinions and conclusions contained in your testimony.**

3 A. To prepare my testimony, I used information from a variety of sources that
4 would normally be relied upon by a person in my capacity. I am familiar with the
5 organization, finances, and operations of Avista from my participation in prior proceedings
6 before the WUTC, the Idaho Public Utilities Commission, and the Oregon Public Utility
7 Commission. In connection with the present filing, I considered and relied upon corporate
8 disclosures, publicly available financial reports and filings, and other published information
9 relating to Avista. I have also visited the Company's main offices and had discussions with
10 management in order to better familiarize myself with Avista's utility operations. My
11 evaluation also relied upon information relating to current capital market conditions and
12 specifically to current investor perceptions, requirements, and expectations for electric and
13 natural gas utilities. These sources, coupled with my experience in the fields of finance and
14 utility regulation, have given me a working knowledge of the issues relevant to investors'
15 required return for Avista, and they form the basis of my analyses and conclusions.

16 **Q. How is your testimony organized?**

17 A. After first summarizing my conclusions and recommendations, my testimony
18 reviews the operations and finances of Avista and industry-specific risks and capital market
19 uncertainties perceived by investors. With this as a background, I present the application of
20 well-accepted quantitative analyses to estimate the current cost of equity for a reference
21 group of comparable-risk utilities. These include the discounted cash flow ("DCF") model,
22 the Capital Asset Pricing Model ("CAPM"), the empirical form of the CAPM ("ECAPM"),
23 an equity risk premium approach based on allowed ROEs for electric utilities, and reference

1 to expected rates of return for electric utilities, which are all methods that are commonly
2 relied on in regulatory proceedings. Based on the cost of equity estimates indicated by my
3 analyses, the Company's ROE was evaluated taking into account the specific risks and
4 potential challenges for Avista's utility operations in Washington, as well as other factors
5 (e.g., flotation costs) that are properly considered in setting a fair ROE for the Company.

6 In addition, I corroborated my utility quantitative analyses by applying the DCF
7 model to a group of low risk non-utility firms. Finally, my testimony addresses the impact
8 of regulatory mechanisms on an evaluation of a fair ROE for Avista.

9 **Q. What is the role of the ROE in setting a utility's rates?**

10 A. The ROE is the cost of attracting and retaining common equity investment in
11 the utility's physical plant and assets. This investment is necessary to finance the asset base
12 needed to provide utility service. Investors commit capital only if they expect to earn a
13 return on their investment commensurate with returns available from alternative investments
14 with comparable risks. Moreover, a fair and reasonable ROE is integral in meeting sound
15 regulatory economics and the standards set forth by the U.S. Supreme Court in the *Bluefield*¹
16 and *Hope*² cases. A utility's allowed ROE should be sufficient to: 1) fairly compensate the
17 utility's investors, 2) enable the utility to offer a return adequate to attract new capital on
18 reasonable terms, and 3) maintain the utility's financial integrity. These standards should
19 allow the utility to fulfill its obligation to provide reliable service while meeting the needs of
20 customers through necessary system replacement and expansion, but they can only be met if
21 the utility has a reasonable opportunity to actually earn its allowed ROE.

¹ *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679 (1923).

² *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

1 **B. Summary of Conclusions**

2 **Q. Please summarize the results of your analyses.**

3 A. The results of my analyses are presented on Exh. AMM-4, and in Table 1,
4 below:

5 **TABLE 1**
6 **SUMMARY OF RESULTS**

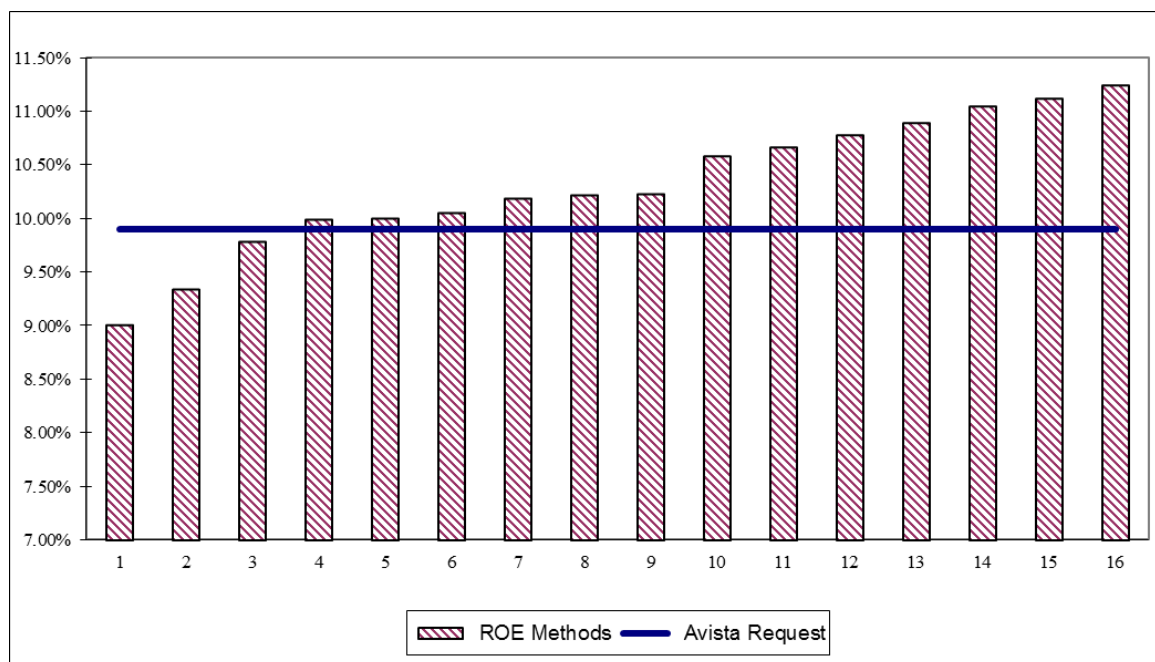
<u>DCF</u>	<u>Average</u>	<u>Midpoint</u>
Value Line	10.0% ⁵	11.2% ¹⁶
IBES	10.0% ⁴	9.8% ³
Zacks	9.3% ²	10.9% ¹³
Internal br + sv	9.0% ¹	10.2% ⁹
<u>CAPM</u>	10.2% ⁷	10.1% ⁶
<u>Empirical CAPM</u>	11.1% ¹⁵	11.1% ¹⁴
<u>Utility Risk Premium</u>		
Current Bond Yields	10.2% ⁷	
Projected Bond Yields	10.8% ¹²	
<u>Expected Earnings</u>	10.7% ¹¹	10.6% ¹⁰
<u>Cost of Equity Recommendation</u>		
Cost of Equity Range	9.8%	-- 10.8%
<u>Flotation Cost Adjustment</u>		0.1%
<u>Recommended ROE Range</u>	9.9%	-- 10.9%

Note: Footnotes correspond to rank order in the subsequent figure.

7 Figure 1, below, presents the 16 cost of equity estimates presented in Table 1 in rank
8 order, and compares them with Avista's 9.9 percent ROE request:

1
2

FIGURE 1
RESULTS OF ANALYSES VS. AVISTA REQUEST



3 **Q. What are your findings regarding the 9.9 percent ROE requested by**
4 **Avista?**

5 **A. Based on the results of my analyses and the economic requirements necessary**
6 **to support continuous access to capital under reasonable terms, I determined that 9.9 percent**
7 **is a conservative estimate of investors' required ROE for Avista. The bases for my**
8 **conclusion are summarized below:**

- 9 • In order to reflect the risks and prospects associated with Avista's jurisdictional
10 utility operations, my analyses focused on a proxy group of 21 other utilities with
11 comparable investment risks.
- 12 • Because investors' required return on equity is unobservable and no single
13 method should be viewed in isolation, I applied the DCF, CAPM, ECAPM, and
14 risk premium methods to estimate a fair ROE for Avista, as well as referencing
15 the expected earnings approach.
- 16 • Based on the results of these analyses, and giving less weight to extremes at the
17 high and low ends of the range, I concluded that the cost of equity for the proxy
18 group of utilities is in the **9.8 percent to 10.8 percent** range, or **9.9 percent to**

1 **10.9 percent** after incorporating an adjustment to account for the impact of
2 common equity flotation costs.

- 3 • As reflected in the testimony of Mark T. Thies, Avista is requesting a fair ROE
4 of **9.9 percent**, which is well below the **10.4 percent** midpoint of my
5 recommended range. Considering capital market expectations, the exposures
6 faced by Avista, and the economic requirements necessary to maintain financial
7 integrity and support additional capital investment even under adverse
8 circumstances, it is my opinion that 9.9 percent represents a conservatively low
9 ROE for Avista.

10 **Q. What other evidence did you consider in evaluating your ROE**
11 **recommendation in this case?**

12 A. My recommendation is reinforced by the following findings:

- 13 • The reasonableness of a 9.9 percent ROE for Avista is supported by the need to
14 consider the challenges to the Company's credit standing:
- 15 ○ The pressure of funding significant capital expenditures of approximately
16 \$400 million per year through 2030 heighten the uncertainties associated
17 with Avista, especially given that the Company's existing rate base is
18 approximately \$3.3 billion.
 - 19 ○ Because of Avista's reliance on hydroelectric generation and increasing
20 dependence on natural gas fueled capacity, the Company is exposed to
21 relatively greater risks of power cost volatility, even with the Energy
22 Recovery Mechanism ("ERM").
 - 23 ○ Avista's opportunity to actually earn a fair ROE and mitigate exposure to
24 earnings attrition is an important objective.
 - 25 ○ My conclusion that a 9.9 percent ROE for Avista is a conservative estimate
26 of investors' required return is also reinforced by the greater uncertainties
27 associated with Avista's relatively small size.
- 28 • Investors recognize that constructive regulation is a key ingredient in supporting
29 utility credit standing and financial integrity and providing Avista with the
30 opportunity to earn a return that adequately reflects its risks is an essential
31 ingredient to support the Company's financial position, which ultimately benefits
32 customers by ensuring reliable service at lower long-run costs.
- 33 • Continued support for Avista's financial integrity, including the opportunity to
34 actually earn a reasonable ROE, is imperative to ensure that the Company has the
35 capability to maintain and build its credit standing while confronting potential
36 challenges associated with funding infrastructure development necessary to meet
37 the needs of its customers.
- 38 • Regulatory mechanisms approved for Avista, including decoupling, are viewed
39 as supportive by investors, and the implications of revenue decoupling and other

1 regulatory mechanisms are already fully reflected in Avista’s credit ratings,
 2 which are comparable to those of the proxy group used to estimate the cost of
 3 equity. Because the utilities in my proxy group operate under a wide variety of
 4 regulatory mechanisms, including decoupling, the mitigation in risks associated
 5 with the ability to adjust revenues and attenuate the risk of cost recovery is
 6 already reflected in the results of my analyses.

- 7 • Finally, by proposing a two-year rate plan, the Company is at increased risk of an
 8 earnings shortfall if the underlying assumptions are not realized.

9 These findings indicate that the 9.9 percent ROE requested by Avista is conservatively low,
 10 but reasonable and should be approved.

11 **Q. What else is relevant in weighing your quantitative results?**

12 A. No single methodology used to estimate the cost of equity is inherently
 13 superior, and the results of alternative quantitative approaches should serve as an integral
 14 part of the decision-making underlying the determination of a just and reasonable ROE. In
 15 this light, it is important to consider alternatives to the DCF model.³ As shown in Table 1,
 16 alternative risk premium models (i.e., the CAPM, ECAPM, and utility risk premium
 17 approaches) produce ROE estimates that generally exceed the DCF results. My expected
 18 earnings approach corroborated these outcomes.

19 **Q. What did the DCF results for your select group of non-utility firms
 20 indicate with respect to your evaluation?**

21 A. DCF estimates for a low-risk group of firms in the competitive sector of the
 22 economy ranged from 9.5 percent to 10.3 percent, and averaged 9.9 percent. These results
 23 confirm that a 9.9 percent ROE is reasonable to maintain Avista’s financial integrity, provide

³ As discussed in Exh. AMM-3, this is consistent with the ROE methodology recently proposed by Federal Energy Regulatory Commission (“FERC”), which considers the results of four different methodologies, including the same CAPM, risk premium, and expected earnings approaches applied in my testimony. *See, e.g., Coakley v. Bangor Hydro-Elec. Co.*, Order Directing Briefs, 165 FERC ¶ 61,030 (2018).

1 a return commensurate with investments of comparable risk, and support the Company's
2 ability to attract capital.

3 **Q. What other factors should be considered in evaluating the ROE**
4 **requested by Avista in this case?**

5 A. Apart from the results of the quantitative methods summarized above, it is
6 crucial to recognize the importance of supporting the Company's financial position so that
7 Avista remains prepared to respond to unforeseen events that may materialize in the future.
8 Recent erosion in Avista's credit standing highlights the imperative of continuing to build
9 the Company's financial strength in order to attract the capital needed to maintain reliable
10 service at a reasonable cost for customers. The reasonableness of the Company's requested
11 ROE is further reinforced by the operating risks associated with Avista's reliance on
12 hydroelectric generation, the higher uncertainties associated with Avista's relatively small
13 size, and the financial exposure inherent in a two-year rate plan.

14 **Q. Does an ROE of 9.9 percent represent a reasonable cost for Avista's**
15 **customers to pay?**

16 A. Yes. Investors make investment capital available to Avista only if the
17 expected returns justify the risk. Customers will enjoy reliable and efficient service so long
18 as investors are willing to make the capital investments necessary to maintain and improve
19 Avista's utility system. Providing an adequate return to investors is a necessary cost to
20 ensure that capital is available to Avista now and in the future. If regulatory decisions
21 increase risk or limit returns to levels that are insufficient to justify the risk, investors will
22 look elsewhere to invest capital.

1 **Q. What is your conclusion as to the reasonableness of the Company’s**
2 **capital structure?**

3 A. Based on my evaluation, I concluded that a common equity ratio of 50.0
4 percent represents a reasonable basis from which to calculate Avista’s overall rate of return.
5 This conclusion was based on the following findings:

- 6 • Avista’s requested capitalization is consistent with the Company’s need to
7 support its credit standing and financial flexibility as it seeks to raise additional
8 capital to fund significant system investments, refinance maturing debt
9 obligations, and meet the requirements of its service territory.
- 10 • Avista’s proposed common equity ratio is consistent with the range of
11 capitalizations for the proxy utilities, both for year-end 2018 and based on Value
12 Line’s near-term expectations.
- 13 • The requested capitalization reflects the importance of an adequate equity layer
14 to accommodate Avista’s operating risks and recognize the impact of off-balance
15 sheet commitments such as purchased power agreements, which carry with them
16 some level of imputed debt.

17 **II. RISKS OF AVISTA**

18 **Q. What is the purpose of this section?**

19 A. As a predicate to my capital market analyses, this section examines the
20 investment risks that investors consider in evaluating their required rate of return for Avista.

21 **A. Operating Risks**

22 **Q. How does Avista’s generating resource mix affect investors’ risk**
23 **perceptions?**

24 A. Because approximately 49 percent of Avista’s total energy requirements are
25 provided by hydroelectric facilities, the Company is exposed to a level of uncertainty not
26 faced by most utilities. While hydropower confers advantages in terms of fuel cost savings
27 and diversity, reduced hydroelectric generation due to below-average water conditions
28 forces Avista to rely more heavily on wholesale power markets or more costly thermal

1 generating capacity to meet its resource needs. As Standard & Poor’s Corporation (“S&P”)
2 has observed:

3 A reduction in hydro generation typically increases an electric utility’s costs
4 by requiring it to buy replacement power or run more expensive generation to
5 serve customer loads. Low hydro generation can also reduce utilities’
6 opportunity to make off-system sales. At the same time, low hydro years
7 increase regional wholesale power prices, creating potentially a double
8 impact – companies have to buy more power than under normal conditions,
9 paying higher prices.⁴

10 Investors recognize that volatile energy markets, unpredictable stream flows, and Avista’s
11 reliance on wholesale purchases to meet a significant portion of its resource needs can
12 expose the Company to the risk of reduced cash flows and unrecovered power supply costs.

13 S&P has noted that Avista, along with Idaho Power Company, “face the most
14 substantial risks despite their PCAs and cost-update mechanisms.”⁵ Similarly, Moody’s
15 Investors Service (“Moody’s”) has recognized that, “Avista’s high dependency on hydro
16 resources (approximately 50% of its production comes from hydro fueled electric generation
17 resources) is viewed as a supply concentration risk which also lends to the potential for
18 metric volatility, especially since hydro levels, due to weather, is a factor outside of
19 management’s control.”⁶ More recently, S&P affirmed the importance of constructive
20 regulation in light of the potential need to “maintain operating cash flow after purchase
21 power for customers when the hydroelectric generation is unavailable,”⁷ and confirmed that
22 “dependence on hydro-electric generation introduces fuel replacement risk during periods of

⁴ Standard & Poor’s Corporation, *Pacific Northwest Hydrology And Its Impact On Investor-Owned Utilities’ Credit Quality*, RatingsDirect (Jan. 28, 2008).

⁵ *Id.*

⁶ Moody’s Investors Service, *Credit Opinion: Avista Corp.*, Global Credit Research (Mar. 17, 2011).

⁷ Standard & Poor’s Financial Services, *Avista Corp.*, RatingsDirect (May 26, 2016).

1 unfavorable hydro conditions.”⁸ Avista’s reliance on purchased power to meet shortfalls in
2 hydroelectric generation magnifies the importance of strengthening financial flexibility,
3 which is essential to guarantee access to the cash resources and interim financing required to
4 cover inadequate operating cash flows. The significance of Avista’s financial strength is
5 further enhanced by the WUTC’s instruction to avoid adjustments to the power cost baseline
6 absent “extraordinary circumstances,” which heightens the Company’s exposure to deferred
7 energy costs and reduced cash flows.⁹

8 **Q. Do financial pressures associated with Avista’s planned capital**
9 **expenditures also impact investors’ risk assessment?**

10 A. Yes. Avista will require capital investment to meet customer growth, provide
11 for necessary maintenance and replacements of its natural gas utility systems, as well as
12 fund new investment in electric generation, transmission and distribution facilities. Utility
13 capital additions are expected to total approximately \$400 million annually for the five year
14 period ending December 31, 2023. This represents a substantial investment given Avista’s
15 current rate base of approximately \$3.3 billion. In addition, as discussed in the testimony of
16 Mr. Theis, beginning in 2019 through 2023 the Company is obligated to repay maturing
17 long-term debt totaling \$405.5 million.

18 Continued support for Avista’s financial integrity and flexibility will be instrumental
19 in attracting the capital necessary to fund these projects and debt repayments in an effective
20 manner. Investors are aware of the challenges posed by significant capital expenditure
21 requirements, especially in light of ongoing capital market and economic uncertainties, and

⁸ S&P Global Ratings, *Avista Corp. Ratings Affirmed; Off Watch Positive; Outlook Stable*, Research Update (Dec. 10. 2018).

⁹ Dockets UE-170485 and UG-170486 (*consolidated*), Order 07 at para. 160.

1 Moody's has noted that elevated capital expenditures are a primary credit concern for
2 Avista.¹⁰

3 **Q. Do utility such as Avista continue to face environmental risks?**

4 A. Yes. Environmental concerns are leading to a profound transformation in the
5 electric utility industry. The generation segment is undergoing material changes in fuel mix,
6 as natural gas and renewable sources increasingly supplant coal. Over the next decade,
7 renewable sources are widely expected to account for a rising share of the electricity
8 generated in the U.S., including a significant expansion in distributed generation, which will
9 accompany declining costs and increased efficiency of energy storage technologies.
10 Accommodating this effort to decarbonize generation will also require significant
11 investment to modernize the transmission grid. And while this disruption offers the potential
12 for growth through increased capital investment, it also conveys higher risks, such as the
13 potential for stranded costs. With respect to Avista, S&P noted that the "environmental
14 footprint is a significant risk factor." As S&P explained, "[t]his reflects the potential for
15 ongoing cost of operating fossil units in the face of disruptive technology advances and the
16 potential for changing environmental regulations that may require significant capital
17 investments."¹¹ The testimony of Company witnesses Vermillion and Thackston discuss
18 Avista's recently announced goal of achieving 100% clean electricity by 2045 and a carbon-
19 neutral electricity supply by the end of 2027.

¹⁰ Moody's Investors Service, *Credit Opinion: Avista Corp.*, Global Credit Research (Mar. 11, 2015).

¹¹ S&P Global Ratings, *Avista Corp. Ratings Affirmed; Off Watch Positive; Outlook Stable*, Research Update (Dec. 10, 2018).

1 **Q. Would investors consider Avista’s relative size in their assessment of the**
2 **Company’s risks and prospects?**

3 A. Yes. A firm’s relative size has important implications for investors in their
4 evaluation of alternative investments, and it is well established that smaller firms are more
5 risky than larger firms. With a market capitalization of approximately \$2.7 billion, Avista is
6 one of the smallest publicly traded utilities followed by The Value Line Investment Survey
7 (“Value Line”), with the firms in the utility Group having an average capitalization of
8 approximately \$15.6 billion.

9 The magnitude of the size disparity between Avista and other firms in the utility
10 industry has important practical implications with respect to the risks faced by investors. All
11 else being equal, it is well accepted that smaller firms are more risky than their larger
12 counterparts, due in part to their relative lack of diversification and lower financial
13 resiliency.¹² These greater risks imply a higher required rate of return, and there is ample
14 empirical evidence that investors in smaller firms realize higher rates of return than in larger
15 firms.¹³ Accepted financial doctrine holds that investors require higher returns from smaller
16 companies, and unless that compensation is provided in the rate of return allowed for a
17 utility, the legal tests embodied in the *Hope* and *Bluefield* cases cannot be met.

¹² It is well established in the financial literature that smaller firms are more risky than larger firms. *See, e.g.,* Eugene F. Fama and Kenneth R. French, *The Cross-Section of Expected Stock Returns*, *Journal of Finance* (June 1992); George E. Pinches, J. Clay Singleton, and Ali Jahankhani, *Fixed Coverage as a Determinant of Electric Utility Bond Ratings*, *Financial Management* (Summer 1978).

¹³ See for example Rolf W. Banz, *The Relationship Between Return and Market Value of Common Stocks*, *Journal of Financial Economics* (September 1981) at 16.

B. Other Factors

1
2 **Q. Would investors consider the potential impact of Avista's exposure to**
3 **earnings shortfalls?**

4 A. Yes. The deterioration of actual return below the allowed return that occurs
5 when the relationships between revenues, costs, and rate base used to establish rates (e.g.,
6 using a historical test year without adequate adjustments) do not reflect the actual costs
7 incurred to serve customers can lead to earnings shortfalls. Investors are concerned with
8 what they can expect in the future, not what they might expect in theory if a historical test
9 year were to repeat. To be fair to investors and to benefit customers, a regulated utility must
10 have a reasonable opportunity to actually earn a return that will maintain financial integrity,
11 facilitate capital attraction, and compensate for risk. In other words, it is the end result in
12 the future that determines whether or not the *Hope* and *Bluefield* standards are met.

13 Ratemaking practices that allow the utility an opportunity to actually earn its
14 authorized ROE are consistent with fundamental regulatory principles.¹⁴ The Supreme
15 Court has reaffirmed that the end result test must be applied to the actual returns that
16 investors expect if they put their money at risk to finance utilities.¹⁵ That end result would
17 maintain the utility's financial integrity, ability to attract capital and offer investors fair
18 compensation for the risk they bear.

¹⁴ In its most recent evaluation of Avista's credit standing, Moody's noted the Washington Court of Appeals August 2018 decision reversing rate base attrition adjustments, which it had considered to be credit supportive. Moody's Investors Service, *Moody's downgrades Avista Corp. to Baa2, outlook stable*, Rating Action (Dec. 20, 2018).

¹⁵ *Verizon Communications, et al v. Federal Communications Commission, et al*, 535 U.S. 467 (2002). While I cannot comment on the legal significance of this case, I found the economic wisdom of looking to the reasonable expectations of actual investors compelling. Economic logic and common sense confirm that a utility cannot attract capital on reasonable terms if investors expect future returns to fall short of those offered by comparable investments.

1 **Q. What other considerations have impact investors’ risk evaluation for**
2 **utilities?**

3 A. Income taxes, like other expenses necessary to provide utility service, are one
4 component of the cost of service. Amendments to the tax code stemming from the Tax Cuts
5 and Jobs Act (“TCJA”) have served to reduce rates for customers, but they also have had
6 detrimental implications for the credit standing of regulated utilities. By lowering the
7 income tax allowance reflected in rates and requiring the eventual refund of excess
8 accumulated deferred income taxes, the TCJA results in reduced cash flow and weaker credit
9 metrics for utilities.

10 For example, Moody’s initially revised its ratings outlook for 24 utilities from
11 “stable” to “negative,” and one utility from “positive” to “stable,” due to the potential
12 impact of the TCJA on cash flows and financial integrity.¹⁶ As Moody’s observed:

13 Investors-owned utilities’ rates, revenue and profits are heavily regulated.
14 The rate regulators allow utilities to charge customers based on a cost-plus
15 model, with tax expense being one of the pass-through items. In practice,
16 regulated utilities collect revenues from customers based on book tax expense
17 but typically pay much less tax in cash. Under the new tax regime, utilities
18 will collect less revenue associated with tax expenses and pay out more cash
19 tax, squeezing its cash flows.¹⁷

20 Moody’s noted that supportive regulatory actions, in the form of timely cost recovery and
21 constructive determinations regarding capital structure and ROE, would be important to
22 stave off deterioration in credit metrics and potential ratings downgrades.¹⁸

¹⁶ Moody’s Investors Service, *Moody’s changes outlooks on 25 US regulated utilities primarily impacted by tax reform*, Ratings Action (Jan. 19, 2018).

¹⁷ Moody’s Investor Service, *Tax reform is credit negative for sector, but impact varies by company*, Sector Comment (Jan. 24, 2018).

¹⁸ Moody’s Investors Service, *Moody’s changes outlooks on 25 US regulated utilities primarily impacted by tax reform*, Ratings Action (Jan. 19, 2018).

1 Similarly, S&P highlighted the potential negative financial consequences of the TCJA for
2 rate-regulated utilities:

3 The impact of tax reform on utilities is likely to be negative to varying
4 degrees depending on a company's tax position going into 2018, how its
5 regulators react, and how the company reacts in return. It is negative for
6 credit quality because the combination of a lower tax rate and the loss of
7 stimulus provisions related to bonus depreciation or full expensing of capital
8 spending will create headwinds in operating cash-flow generation capabilities
9 as customer rates are lowered in response to the new tax code. . . . Regulators
10 must also recognize that tax reform is a strain on utility credit quality, and we
11 expect companies to request stronger capital structures and other means to
12 offset some of the negative impact.¹⁹

13 Fitch also highlighted its expectation that the TCJA “has negative credit implications
14 for regulated utilities and utility holding companies over the short to medium term,”²⁰ and
15 concluded that:

16 The impact could be sharpened or softened by regulators depending on how
17 much they want to lower utility rates immediately instead of using some of
18 the lower revenue requirement from tax reform to allow the utility to retain
19 the cash for infrastructure investment or other expenses. Regulators must
20 also recognize that tax reform is a strain on utility credit quality, and we
21 expect companies to request stronger capital structures and other means to
22 offset some of the negative impact.²¹

23 As Fitch concluded, “[a]bsent mitigating strategies on the regulatory front, this is expected
24 to lead to weaker credit metrics and negative ratings actions,”²² and an “[i]ncrease in
25 authorized equity ratio and/or return on equity” would be one tool to support utilities’ credit
26 standing.²³ Coupled with the need to undertake significant new capital investment, the

¹⁹ S&P Global Ratings, *U.S. Tax Reform: For Utilities’ Credit Quality, Challenges Abound*, RatingsDirect (Jan. 24, 2018) (emphasis added).

²⁰ Fitch Ratings Inc., *Tax Reform Impact on the U.S. Utilities, Power & Gas Sector*, Special Report (Jan. 24, 2018).

²¹ *Id.*

²² *Id.*

²³ *Id.* (emphasis added).

1 implications of the TCJA heighten the importance of supportive regulatory actions in order
2 to maintain utilities' financial integrity and access to capital.

3 **Q. What is Moody's current outlook for utilities?**

4 A. On June 18, 2018, Moody's announced that it was changing the utility sector
5 outlook from stable to negative.²⁴ Moody's stated that:

6 The change in outlook primarily reflects a degradation in key financial credit
7 ratios...The change in outlook also reflects uncertainty with respect to the
8 timing and extent of potential changes in regulatory recovery provisions,
9 authorized returns and equity layers or self-help options by individual
10 companies in response to lower cash flow."²⁵

11 The change in fundamental sector outlook reflects a declining financial trend,
12 which is a function of higher holding company debt levels incurred in the
13 past few years and a lower deferred tax contribution to cash flow going
14 forward due to tax reform.²⁶

15 **Q. Has the TCJA impacted Avista's risk profile?**

16 A. Yes. With respect to Avista specifically, Moody's recently downgraded the
17 Company's credit rating from Baa1 to Baa2, in part due to the impact of the TCJA.
18 Moody's noted that "[p]re-tax reform, deferred income taxes constituted a significant
19 portion of Avista's operating cash flow," and concluded declining cash flow due to the TCJA
20 has eroded Avista's financial metrics.²⁷

²⁴ Moody's Investors Service, *Announcement: Moody's changes the US regulated utility sector outlook to negative from stable*, (June 18, 2018).

²⁵ *Id.*

²⁶ *Id.*

²⁷ Moody's Investors Service, *Moody's downgrades Avista Corp. to Baa2, outlook stable*, Rating Action (Dec. 2, 2018).

1 **C. Support for Avista's Credit Standing**

2 **Q. What credit ratings have been assigned to Avista?**

3 A. S&P has assigned Avista a corporate credit rating of "BBB", while Moody's
4 has set Avista's Issuer Rating at "Baa2".

5 **Q. What considerations impact investors' assessment of the firms in the**
6 **utility industry?**

7 A. Numerous factors have the potential to impact investors' perceptions of the
8 relative risks inherent in the utility industry and have implications for the financial standing
9 of the utilities themselves. These include the possibility of volatile fuel or purchased power
10 costs, uncertain environmental mandates and associated costs, the implications of declining
11 demand associated with economic weakness or structural changes in usage patterns,
12 pressures associated with mandates concerning renewable resources, and increased reliance
13 on distributed generation or other alternatives to the incumbent utility. Apart from these
14 considerations, utilities may face increasing costs of operating their systems, as well as the
15 financial pressures associated with large capital expenditure programs, which are magnified
16 during periods of turmoil in capital markets.

17 **Q. What are the implications for Avista, given the potential for further**
18 **dislocations in the capital markets?**

19 A. The pressures of significant capital expenditure requirements, along with the
20 need to refinance maturing long-term debt obligations, reinforce the importance of
21 supporting improvement in Avista's credit standing. Investors understand from past
22 experience in the utility industry that large capital needs can lead to significant deterioration
23 in financial integrity that can constrain access to capital, especially during times of

1 unfavorable capital market conditions. Considering the potential for financial market
2 instability, competition with other investment alternatives, and investors' sensitivity to the
3 potential for market volatility, greater credit strength is a key ingredient in maintaining
4 access to capital at reasonable cost. As Mr. Thies confirms in his testimony, ongoing
5 regulatory support will be a key driver in maintaining and enhancing Avista's financial
6 health.

7 **Q. Throughout your testimony you refer repeatedly to the concepts of**
8 **“financial strength,” “financial integrity,” and “financial flexibility.” Would you**
9 **briefly describe what you mean by these terms?**

10 A. These terms are generally synonymous and refer to the utility's ability to
11 attract and retain the capital that is necessary to provide service at reasonable cost, consistent
12 with the Supreme Court standards. Avista's plans call for a continuation of capital
13 investments to preserve and enhance service reliability for its customers. The Company
14 must generate adequate cash flow from operations to fund these requirements and for
15 repayment of maturing debt, together with access to capital from external sources under
16 reasonable terms, on a sustainable basis.

17 Rating agencies and potential debt investors tend to place significant emphasis on
18 maintaining strong financial metrics and credit ratings that support access to debt capital
19 markets under reasonable terms. This emphasis on financial metrics and credit ratings is
20 shared by equity investors who also focus on cash flows, capital structure and liquidity,
21 much like debt investors. Investors understand the important role that a supportive
22 regulatory environment plays in establishing a sound financial profile that will permit the

1 utility access to debt and equity capital markets on reasonable terms in both favorable
2 financial markets and during times of potential disruption and crisis.

3 **Q. What role does regulation play in ensuring that Avista has access to**
4 **capital under reasonable terms and on a sustainable basis?**

5 A. Regulatory signals are a major driver of investors' risk assessment for
6 utilities. Investors recognize that constructive regulation is a key ingredient in supporting
7 utility credit ratings and financial integrity, particularly during times of adverse conditions.
8 As Moody's noted, "the regulatory environment is the most important driver of our outlook
9 because it sets the pace for cost recovery,"²⁸ Similarly, S&P observed that, "Regulatory
10 advantage is the most heavily weighted factor when S&P Global Ratings analyzes a
11 regulated utility's business risk profile."²⁹ Value Line summarizes these sentiments:

12 As we often point out, the most important factor in any utility's success,
13 whether it provides electricity, gas, or water, is the regulatory climate in
14 which it operates. Harsh regulatory conditions can make it nearly impossible
15 for the best run utilities to earn a reasonable return on their investment.³⁰

16 More recently, in response to concerns regarding the potential negative impact of the TCJA
17 on utilities' financial strength, the investment community has emphasized the need for
18 supportive regulatory actions to bolster cash flows.

²⁸ Moody's Investors Service, *Regulation Will Keep Cash Flow Stable As Major Tax Break Ends*, Industry Outlook (Feb. 19, 2014).

²⁹ S&P Global Ratings, *Assessing U.S. Investors-Owned Utility Regulatory Environments*, RatingsExpress (Aug. 10, 2016).

³⁰ Value Line Investment Survey, *Water Utility Industry* (Jan. 13, 2017) at p. 1780.

1 **Q. Is Avista’s ability to achieve supportive regulatory outcomes in**
2 **Washington an ongoing concern for investors?**

3 A. Yes. Following the rejection of Avista’s 2016 rate filing, Moody’s observed
4 that “significant miscommunication” between Avista and the WUTC created “credit
5 challenges.”³¹ Moody’s concluded that, “we view this snafu as temporary, and expect that
6 the company will continue to receive adequate and timely cost recovery of prudently
7 incurred costs.”³² Nevertheless, in explaining its recent decision to downgrade the
8 Company’s credit ratings from Baa1 to Baa2, Moody’s cited continued concern regarding
9 “less predictable regulatory outcomes in Washington.” In early 2018 Value Line noted that
10 “a lack of rate relief in [Washington] last year was a key reason why earnings almost
11 certainly declined significantly in 2017,”³³ and more recently cited the benefit from the
12 outcome of the 2018 rate order.³⁴ For its part, S&P also observed the potential for “adverse
13 regulatory decisions” to compromise Avista’s financial integrity and credit standing.³⁵
14 Further strengthening Avista’s financial integrity is imperative to ensure that the Company
15 has the capability to maintain an investment grade rating while confronting large capital
16 expenditures and other potential challenges. As noted in the testimony of Mr. Thies,
17 continued regulatory support will be instrumental in achieving Avista’s objective of a BBB+

³¹ Moody’s Investors Service, *Avista Corp. A Vertically Integrated Electric and Gas Utility*, Credit Opinion Mar. 22, 2017.

³² *Id.*

³³ The Value Line Investment Survey, *Avista Corp.* (Jan. 26, 2018).

³⁴ The Value Line Investment Survey, *Avista Corp.* (Jan. 25, 2019).

³⁵ S&P Global Ratings, *Avista Corp. Ratings Affirmed; Off Watch Positive; Outlook Stable*, Research Update (Dec. 10, 2018).

1 rating from S&P, which is consistent with the average credit standing in the electric utility
2 industry.³⁶

3 **Q. Do customers benefit by enhancing the utility's financial flexibility?**

4 A. Yes. Providing an ROE that is sufficient to maintain Avista's ability to attract
5 capital under reasonable terms, even in times of financial and market stress, is not only
6 consistent with the economic requirements embodied in the U.S. Supreme Court's *Hope* and
7 *Bluefield* decisions, it is also in customers' best interests. Customers enjoy the benefits that
8 come from ensuring that the utility has the financial wherewithal to take whatever actions
9 are required to ensure safe and reliable service.

10 **D. Outlook for Capital Costs**

11 **Q. Please summarize current economic and capital market conditions.**

12 A. Investors have faced renewed volatility as capital markets have responded to
13 uncertainties regarding the implications of an expanding economy at or near full
14 employment, indications of price pressures and wage gains, coupled with the massive fiscal
15 stimulus under the TCJA. These underlying risks have been exacerbated by concerns over
16 the implications of the Trump Administration's tariff policies. While fears of an escalating
17 international trade war with China have eased in the face of optimism over the prospect of a
18 potential trade deal, investors continue to confront signs of global economic weakness.
19 Economic activity has remained weak in many emerging market economies, including
20 Brazil and Mexico, along with continued signs of softening in China and the euro-zone,
21 which faces uncertain developments surrounding Brexit.

³⁶ As noted in Mr. Thies' testimony, credit ratings for other combined electric and gas utilities are predominantly in the A- or BBB+ categories.

1 In the U.S., growth in real gross domestic product appears to have slowed from its
2 solid pace in the fourth quarter of 2018, despite weakness in the automotive sector and
3 softening growth in business investment and industrial production. After disappointing job
4 gains in February 2019, employment resumed a more favorable trend and the unemployment
5 rate remains in the neighborhood of 3.8%, which is indicative of a strong labor market.
6 Consumer spending remains upbeat and inflation has appears to have moderated, with
7 changes in the core price index falling somewhat below the Federal Reserve’s 2.0%
8 guideline. On balance, these indicators point to continued resilience in the U.S. economy.

9 **Q. What is the recent direction of Federal Reserve monetary policies?**

10 A. On December 20, 2018, the Federal Reserve raised the target range for its
11 benchmark funds rate by 25 basis points, the ninth such move since the Fed began
12 normalizing rates in December 2015. In response to muted upward pressure on prices and a
13 number of potential risks to the economic outlook—including international developments—
14 the Federal Reserve has indicated that intends to adopt a more patient and accommodative
15 stance to future policy adjustments. While observing that the appropriate target range for
16 the federal funds rate might shift in either direction based on future data, a majority of the
17 Federal Open Market Committee now expects the range could remain unchanged for the
18 remainder of 2019.

19 The Federal Reserve continues to exert considerable influence over capital market
20 conditions through its massive holdings of Treasuries and mortgage-backed securities, which

1 continue to exceed \$3.8 trillion.³⁷ While beginning a gradual balance sheet normalization
2 program in October 2017, the Fed has indicated that it now intends to slow the reduction in
3 its holdings of Treasury securities by reducing the cap on monthly redemptions from \$30
4 billion to \$15 billion beginning in May 2019. Reductions to the holdings of Treasury bonds
5 are expected to conclude in September 2019, while the Federal Reserve intends to continue
6 shrinking its investment in agency debt and mortgage-backed securities at a gradual pace.

7 **Q. Have the ongoing uncertainties regarding Federal Reserve policies been**
8 **recognized by the investment community?**

9 A. Yes. As The Economist noted:

10 Concerns are growing that the Fed might trip up. It has no guiding example
11 of reversing [quantitative easing] and quitting a zero-interest-rate policy. Tax
12 cuts in America complicate the Fed's task. Higher barriers to trade will add
13 to inflation and hurt GDP, but to an extent that is hard to fathom.³⁸

14 Despite an apparent hiatus in the policy of normalizing short-term interest rates and the size
15 of its balance sheet, investors continue to confront uncertainties over the future trajectory of
16 monetary policies, which have significant, but unknown implications for financial markets.
17 The unprecedented nature of these normalization efforts and their impacts on investors'
18 expectations further support the consideration of alternatives to DCF analyses and other
19 ROE benchmarks when evaluating a just and reasonable ROE for Avista.

³⁷ *Factors Affecting Reserve Balances*, H.4.1 (Feb. 21, 2019).

<https://www.federalreserve.gov/releases/h41/current/>. Prior to the initiation of the stimulus program in 2009, the Federal Reserve's holdings of U.S. Treasury bonds and notes amounted to approximately \$400-\$500 billion.

³⁸ The Economist, *Even stockmarket bulls are more cautious than at the start of the year*, Buttonwood (Jul. 12, 2018).

1 **Q. Is it necessary that interest rate forecasts, like those shown above, be**
2 **perfectly accurate in order to be relied on?**

3 A. No. When estimating investors' required rate of return, what investors
4 expect, not what actually happens, is what matters most. While the projections of various
5 services may be proven optimistic or pessimistic in hindsight, this is irrelevant in assessing
6 expected interest rates and how they might influence the Company's allowed ROE. Any
7 difference in actual rates as compared to analysts' forecasts is beside the point. What is key
8 is that investors share analysts' views when the forecasts were made and incorporate those
9 views into their decision making process, not the actual rates that ultimately transpire.

10 **Q. Does a Two-Year Rate Plan heighten the Company's exposure to**
11 **anticipated increased in the cost of long-term capital?**

12 A. Yes. Given that there will be no opportunity for the Company to alter rates in
13 response to higher trends in capital costs during the pendency of the plan, Avista will be
14 exposed to the potential that the ROE established in this proceeding will fall below
15 investors' required return over the period when rates are in effect. Accordingly, this supports
16 consideration of forecasts for higher interest rates in evaluating a just and reasonable ROE in
17 this case.

18 **Q. Do ongoing economic and capital market uncertainties also influence the**
19 **appropriate capital structure for Avista?**

20 A. Yes. Financial flexibility plays a crucial role in ensuring the wherewithal to
21 meet funding needs, and utilities with higher financial leverage may be foreclosed or have
22 limited access to additional borrowing, especially during times of stress. As a result, the
23 Company's capital structure must maintain adequate equity to preserve the flexibility

1 necessary to maintain continuous access to capital even during times of unfavorable market
2 conditions.

3 **E. Capital Structure**

4 **Q. Is an evaluation of the capital structure maintained by a utility relevant**
5 **in assessing its return on equity?**

6 A. Yes. Other things equal, a higher debt ratio and lower common equity ratio,
7 translates into increased financial risk for all investors. A greater amount of debt means
8 more investors have a senior claim on available cash flow, thereby reducing the certainty
9 that each will receive their contractual payments. This increases the risks to which lenders
10 are exposed, and they require correspondingly higher rates of interest. From common
11 shareholders' standpoint, a higher debt ratio means that there are proportionately more
12 investors ahead of them, thereby increasing the uncertainty as to the amount of cash flow
13 that will remain.

14 **Q. What common equity ratio is implicit in Avista's requested capital**
15 **structure?**

16 A. Avista's capital structure is presented in the testimony of Mr. Thies. As
17 summarized in his testimony, the proposed capital structure used to compute Avista's overall
18 rate of return consists of 50.0 percent equity / 50.0 percent long-term debt in this filing.

19 **Q. Why is Avista proposing to exclude short-term debt from the capital**
20 **structure calculation in this case?**

21 A. As explained by Mr. Thies, the results from the Company's Pro Forma
22 Studies will not yield the electric and natural gas rate relief necessary to provide the
23 Company the opportunity to earn the proposed overall rate of return requested in this

1 case. One of the rate making “tools” identified by the WUTC that can be used to arrive at an
 2 end result that provides sufficient revenues is an adjusted capital structure. In this case,
 3 Avista has adjusted its capital structure to exclude short-term debt. Both Idaho and Oregon
 4 adjust the capital structure to exclude short-term debt, and currently, Avista’s approved
 5 capital structures in Idaho and Oregon are 50 percent equity / 50 percent debt. In this case
 6 Avista is proposing a similar adjustment to its capital structure, excluding short-term debt
 7 from the calculation.³⁹

8 **Q. What was the average capitalization maintained by the Utility Group?**

9 A. As shown on page 1 of Exh. AMM-5, for the 22 firms in the Utility Group,
 10 common equity ratios at December 31, 2018 ranged between 26.9 percent and 89.4 percent
 11 and averaged 46.7 percent.

12 **Q. What capitalization is representative for the proxy group of utilities**
 13 **going forward?**

14 A. As shown on page 1 of Exh. AMM-5, Value Line expects an average
 15 common equity ratio for the proxy group of utilities of 47.2 percent for its three-to-five year
 16 forecast horizon, with the individual common equity ratios ranging from 33.5 percent to
 17 61.5 percent. The WUTC has previously observed that “[i]t is appropriate ... to afford more
 18 weight to forward considerations than to historic conditions as we determine the appropriate
 19 equity ratio to be embedded in prospective rates.”⁴⁰

³⁹ In Order 08 of Docket No. UE-111048 and UG-111049 of Puget Sound Energy’s proceeding, the Commission stated its willingness to consider adjustments to rate base beyond the historical test period, including, “Use of plant accounts (rate base) measured at the end, or subsequent to the end of the test-year rather than the test-year average,” as well as an “Upward adjustment to the equity share in the capital structure.” Docket No. UE-111048 and UG-111049, Order 08 at p. 181.

⁴⁰ *Order No. 06*, Docket Nos. UG-040640 and UE-040641 (consolidated) (Feb. 18, 2005) at P. 32.

1 **Q. How does Avista’s proposed equity ratio compare with those of the**
2 **operating companies held by the proxy group parent companies?**

3 A. The individual operating company capital structures are presented on page 2
4 of Exh. AMM-5. As shown there, the operating company equity ratios ranged from 43.1
5 percent to 75.5 percent. The simple average of these results points to an equity ratio of 53.5
6 percent; the average weighted by total capitalization for each operating entity was 51.3
7 percent.

8 **Q. What implication do the uncertainties inherent in the utility industry**
9 **have for the capital structures maintained by utilities?**

10 A. As discussed earlier, utilities are facing the need to finance significant capital
11 investment plans, uncertainties over accommodating operating and financial market
12 uncertainties, and ongoing regulatory risks. Coupled with the potential for turmoil in capital
13 markets, these considerations warrant a stronger balance sheet to deal with an increasingly
14 uncertain environment. A more conservative financial profile, in the form of a higher
15 common equity ratio, is consistent with increasing uncertainties and the need to maintain the
16 continuous access to capital under reasonable terms that is required to fund operations and
17 necessary system investment, including times of adverse capital market conditions. This is
18 consistent with the views of the investment community, as reflected in the comments of the
19 ratings agencies discussed earlier in my testimony, with both Moody’s and Fitch
20 highlighting the need for constructive determinations regarding capital structure, with Fitch

1 expressly noting the importance of “stronger capital structures . . . to offset some of the
2 negative impact” associated with the TCJA.⁴¹

3 **Q. What other factors do investors consider in their assessment of a
4 company’s capital structure?**

5 A. Depending on their specific attributes, contractual agreements or other
6 obligations that require the utility to make specified payments may be treated as debt in
7 evaluating Avista’s financial risk. Power purchase agreements, leases, and pension
8 obligations typically require the utility to make specified minimum contractual payments
9 akin to those associated with traditional debt financing and investors consider a portion of
10 these commitments as debt in evaluating total financial risks. Because investors consider
11 the debt impact of such fixed obligations in assessing a utility’s financial position, they
12 imply greater risk and reduced financial flexibility. These commitments have been
13 repeatedly cited by major bond rating agencies in connection with assessments of utility
14 financial risks.⁴² In order to offset the debt equivalent associated with off-balance sheet
15 obligations, the utility must rebalance its capital structure by increasing its common equity
16 in order to restore its effective capitalization ratios to previous levels. Unless the utility
17 takes action to offset this additional financial risk by maintaining a higher equity ratio, the
18 resulting leverage will weaken its creditworthiness and imply greater risk.

19 **Q. What does this evidence indicate with respect to Avista’s capital
20 structure?**

⁴¹ Fitch Ratings Inc., *Tax Reform Impact on the U.S. Utilities, Power & Gas Sector*, Special Report (Jan. 24, 2018).

⁴² See, e.g., Standard & Poor’s Corporation, “Utilities: Key Credit Factors For The Regulated Utilities Industry,” *RatingsDirect* (Nov. 19, 2013).

1 A. Based on my evaluation, I conclude that Avista's requested capital structure
2 represents a reasonable mix of capital sources from which to calculate the Company's
3 overall rate of return. While industry averages provide one benchmark for comparison, each
4 firm must select its capitalization based on the risks and prospects it faces, as well its
5 specific needs to access the capital markets. A public utility with an obligation to serve must
6 maintain ready access to capital under reasonable terms so that it can meet the service
7 requirements of its customers. Financial flexibility plays a crucial role in ensuring the
8 wherewithal to meet the needs of customers, and utilities with higher leverage may be
9 foreclosed from additional borrowing under reasonable terms, especially during times of
10 stress.

11 Avista's capital structure is consistent with the range of equity ratios maintained by
12 the parent firms in the Utility Group and their operating subsidiaries, and reflects the
13 challenges posed by its resource mix, the burden of significant capital spending
14 requirements, the implications of the TCJA, and the Company's ongoing efforts to
15 strengthen its credit standing and support access to capital on reasonable terms. The
16 reasonableness of a 50 percent common equity / 50 percent long-term debt capital structure
17 for Avista is reinforced by the importance of supporting continued investment in system
18 improvements and the Company's debt repayment obligations, even during times of adverse
19 capital market conditions.

1 **III. CAPITAL MARKET ESTIMATES**

2 **Q. What is the purpose of this section?**

3 A. This section presents capital market estimates of the cost of equity. The
4 details of my quantitative analyses are contained in Exh. AMM-3, with the results being
5 summarized below.

6 **A. Quantitative Analyses**

7 **Q. Did you rely on a single method to estimate the cost of equity for Avista?**

8 A. No. In my opinion, no single method or model should be relied upon to
9 determine a utility's cost of equity because no single approach can be regarded as wholly
10 reliable. Therefore, I used the DCF, CAPM, ECAPM, and risk premium methods to
11 estimate the cost of common equity. In addition, I also evaluated a fair ROE using an
12 earnings approach based on investors' current expectations in the capital markets. In my
13 opinion, comparing estimates produced by one method with those produced by other
14 approaches ensures that the estimates of the cost of equity pass fundamental tests of
15 reasonableness and economic logic. My consideration of multiple methods and approaches
16 is consistent with the conclusions of the WUTC:

17 We value each of the methodologies used to calculate the cost of equity and
18 do not find it appropriate to select a single method as being the most accurate
19 or instructive. Financial circumstances are constantly shifting and changing,
20 and we welcome a robust and diverse record of evidence based on a variety
21 of analytics and cost of capital methodologies.⁴³

⁴³ *PacifiCorp D/B/A Pacific Power & Light Company*, Docket UE-100749, Final Order at P 91 (Mar. 25, 2011).

1 **Q. What specific proxy group of utilities did you rely on for your analysis?**

2 A. In estimating the cost of equity, the DCF model is typically applied to
3 publicly traded firms engaged in similar business activities or with comparable investment
4 risks. As described in detail in Exh. AMM-3, I applied the DCF model to a utility proxy
5 group composed of those companies included by Value Line in its Electric Utilities Industry
6 groups with:

- 7 1. Corporate credit ratings from S&P and Moody's corresponding to one notch
8 above and below the Company's current ratings. For S&P, this resulted in a
9 ratings range of BBB-, BBB, and BBB+; for Moody's the range was Baa3,
10 Baa2, or Baa1.
- 11 2. Moody's issuer ratings of Baa3, Baa2, or Baa1.
- 12 3. Value Line Safety Rank of "2" or "3".
- 13 4. No involvement in a major merger or acquisition that would distort
14 quantitative results.
- 15 5. No cuts in dividend payments during the past six months and no
16 announcement of a dividend cut since that time.

17 These criteria resulted in a proxy group composed of 21 companies, which I refer to firms as
18 the "Utility Group."⁴⁴

19 **Q. How do the overall risks of your Utility Group compare with Avista?**

20 A. Table 3 compares the Utility Group with Avista across five key indicators of
21 investment risk:

⁴⁴ The size and breadth of my proxy group addresses the WUTC's concern that, "In general, the smaller the proxy group, the greater possibility for bias to be introduced due to subjective factors." *PacifiCorp D/B/A Pacific Power & light Company*, Docket UE-100749, Final Order at P 78 (Mar. 25, 2011).

TABLE 3
COMPARISON OF RISK INDICATORS

	<u>Credit Rating</u>		<u>Value Line</u>		
			<u>Safety</u>	<u>Financial</u>	
	<u>S&P</u>	<u>Moody's</u>	<u>Rank</u>	<u>Strength</u>	<u>Beta</u>
Utility Group	BBB+	Baa2	2	B++	0.63
Avista	BBB	Baa2	2	A	0.65

Q. Do these comparisons indicate that investors would view the firms in your proxy groups as risk-comparable to the Company?

A. Yes. Considered together, a comparison of these objective measures, which consider of a broad spectrum of risks, including financial and business position, and exposure to firm-specific factors, indicates that investors would likely conclude that the overall investment risks for Avista are generally comparable to those of the firms in the Utility Group.

Q. What cost of equity is implied by your DCF results for the Utility Group?

A. My application of the DCF model, which is discussed in greater detail in Exh. AMM-3, considered three alternative measures of expected earnings growth, as well as the sustainable growth rate based on the relationship between expected retained earnings and earned rates of return (“ $br+sv$ ”). As shown on Exh. AMM-6 and summarized below in Table 4, after eliminating illogical values,⁴⁵ application of the constant growth DCF model resulted in the following cost of equity estimates:

⁴⁵ I provide a detailed explanation of my DCF analysis, including the evaluation of individual estimates, in Exh. AMM-3).

1 **TABLE 4**
2 **DCF RESULTS – UTILITY GROUP**

<u>Growth Rate</u>	<u>Average</u>	<u>Midpoint</u>
Value Line	10.0%	11.2%
IBES	10.0%	9.8%
Zacks	9.3%	10.9%
br + sv	9.0%	10.2%

3 **Q. How did you apply the CAPM to estimate the cost of equity?**

4 A. Like the DCF model, the CAPM is an *ex-ante*, or forward-looking model
5 based on expectations of the future. As a result, in order to produce a meaningful estimate
6 of investors' required rate of return, the CAPM is best applied using estimates that reflect the
7 expectations of actual investors in the market, not with backward-looking, historical data.
8 Accordingly, I applied the CAPM to the Utility Group based on a forward-looking estimate
9 for investors' required rate of return from common stocks. Because this forward-looking
10 application of the CAPM looks directly at investors' expectations in the capital markets, it
11 provides a more meaningful guide to the expected rate of return required to implement the
12 CAPM.

13 **Q. What cost of equity was indicated by the CAPM approach?**

14 A. As shown on page 1 of Exh. AMM-8, my forward-looking application of the
15 CAPM model indicated an average ROE of 10.2 percent for the Utility Group after adjusting
16 for the impact of firm size.

17 **Q. What cost of equity estimates were indicated by the ECAPM?**

18 A. Empirical tests of the CAPM have shown that low-beta securities earn returns
19 somewhat higher than the CAPM would predict, and high-beta securities earn less than
20 predicted. The ECAPM incorporates a refinement to address this observed relationship

1 documented in the financial research. My applications of the ECAPM were based on the
2 same forward-looking market rate of return, risk-free rates, and beta values discussed above
3 in connection with the CAPM. As shown on page 1 of Exh. AMM-9, applying the forward-
4 looking ECAPM approach to the firms in the Utility Group results in an average cost of
5 equity estimate of 11.1 percent after incorporating the size adjustment corresponding to the
6 market capitalization of the individual utilities.

7 **Q. How did you implement the risk premium method?**

8 A. I based my estimates of equity risk premiums for electric utilities on surveys
9 of previously authorized rates of return on common equity, which are frequently referenced
10 as the basis for estimating equity risk premiums. My application of the risk premium
11 method also considered the inverse relationship between equity risk premiums and interest
12 rates, which suggests that when interest rate levels are relatively high, equity risk premiums
13 narrow, and when interest rates are relatively low, equity risk premiums widen.

14 **Q. What cost of equity was indicated by the risk premium approach?**

15 A. As shown on page 1 of Exh. AMM-10, adding an adjusted risk premium of
16 5.33 percent to the six-month average yield on long-term triple-B utility bonds at March
17 2019 of 4.87 percent resulted in an implied cost of equity of approximately 10.2 percent.⁴⁶

18 Recognizing that widely-referenced forecasting services continue to document
19 expectations for higher interest rates over the near-term, I also applied the risk premium
20 based on the forecasted utility bond yields. As shown on page 2 of Exh. AMM-10,

⁴⁶ Moody's yield averages are based on seasoned bonds with a remaining maturity of at least 20 years.

1 incorporating a forecasted yield for 2019-2020 and adjusting for changes in interest rates
2 since the 1974-2018 study period implied a cost of equity of approximately 10.8 percent.

3 **Q. Please summarize the results of the expected earnings approach.**

4 A. Reference to rates of return available from alternative investments of
5 comparable risk provide an important benchmark in assessing the return necessary to assure
6 confidence in the financial integrity of a firm and its ability to attract capital. The simple,
7 but powerful concept underlying the expected earnings approach is that investors compare
8 each investment alternative with the next best opportunity. If the utility is unable to offer a
9 return similar to that available from other opportunities of comparable risk, investors will
10 become unwilling to supply the capital on reasonable terms. For existing investors, denying
11 the utility an opportunity to earn what is available from other similar risk alternatives
12 prevents them from earning their opportunity cost of capital. This expected earnings
13 approach is consistent with the economic underpinnings for a fair rate of return established
14 by the U.S. Supreme Court. Moreover, it avoids the complexities and limitations of capital
15 market methods and instead focuses on the returns earned on book equity, which are readily
16 available to investors.

17 As shown on Exh. AMM-11, Value Line's projections for the Utility Group suggest
18 an average ROE of approximately 10.7 percent, with a midpoint value of 10.6 percent.

19 **B. Non-Utility DCF Model**

20 **Q. What other proxy group did you consider in evaluating a fair ROE for**
21 **Avista?**

22 A. As indicated earlier, I also present a DCF analysis for a low risk group of
23 non-utility firms, with which Avista must compete for investors' capital. Under the

1 regulatory standards established by *Hope* and *Bluefield*, the salient criterion in establishing a
2 meaningful benchmark to evaluate a fair ROE is relative risk, not the particular business
3 activity or degree of regulation. With regulation taking the place of competitive market
4 forces, required returns for utilities should be in line with those of non-utility firms of
5 comparable risk operating under the constraints of free competition. Consistent with this
6 accepted regulatory standard, I also applied the DCF model to a reference group of low-risk
7 companies in the non-utility sectors of the economy. I refer to this group as the “Non-Utility
8 Group.”

9 **Q. Do utilities have to compete with non-regulated firms for capital?**

10 A. Yes. The cost of capital is an opportunity cost based on the returns that
11 investors could realize by putting their money in other alternatives. Clearly, the total capital
12 invested in utility stocks is only the tip of the iceberg of total common stock investment, and
13 there are a plethora of other enterprises available to investors beyond those in the utility
14 industry. Utilities must compete for capital, not just against firms in their own industry, but
15 with other investment opportunities of comparable risk. Indeed, modern portfolio theory is
16 built on the assumption that rational investors will hold a diverse portfolio of stocks, not just
17 companies in a single industry.

18 **Q. Is it consistent with the *Bluefield* and *Hope* cases to consider required**
19 **returns for non-utility companies?**

20 A. Yes. Returns in the competitive sector of the economy form the very
21 underpinning for utility ROEs because regulation purports to serve as a substitute for the
22 actions of competitive markets. The Supreme Court has recognized that it is the degree of
23 risk, not the nature of the business, which is relevant in evaluating an allowed ROE for a

1 utility. The *Bluefield* case refers to “business undertakings attended with comparable risks
2 and uncertainties.”⁴⁷ It does not restrict consideration to other utilities. Similarly, the *Hope*
3 case states:

4 By that standard the return to the equity owner should be commensurate with
5 returns on investments in other enterprises having corresponding risks.⁴⁸

6 As in the *Bluefield* decision, there is nothing to restrict “other enterprises” solely to the
7 utility industry.

8 **Q. Does consideration of the results for the Non-Utility Group make the**
9 **estimation of the cost of equity using the DCF model more reliable?**

10 A. Yes. The estimates of growth from the DCF model depend on analysts’
11 forecasts. It is possible for utility growth rates to be distorted by short-term trends in the
12 industry, or by the industry falling into favor or disfavor by analysts. Such distortions could
13 result in biased DCF estimates for utilities. Because the Non-Utility Group includes low
14 risk companies from more than one industry, it helps to insulate against any possible
15 distortion that may be present in results for a particular sector.

16 **Q. How do the overall risks of this Non-Utility Group compare with the**
17 **Utility Group and Avista?**

18 A. Table 7 compares the Non-Utility Group with the Utility Group and Avista
19 across the five key risk measures discussed earlier:

⁴⁷ *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm’n*, 262 U.S. 679 (1923).

⁴⁸ *Federal Power Comm’n v. Hope Natural Gas Co.* (320 U.S. 391, 1944).

1
2

TABLE 7
COMPARISON OF RISK INDICATORS

	<u>Credit Rating</u>		<u>Value Line</u>		
	<u>S&P</u>	<u>Moody's</u>	<u>Safety Rank</u>	<u>Financial Strength</u>	<u>Beta</u>
	Non-Utility Group	A-	A3	1	A+
Utility Group	BBB+	Baa2	2	B++	0.63
Avista	BBB	Baa2	2	A	0.65

3 As shown above, the average credit ratings, Safety Rank, and Financial Strength Rating for
4 the Non-Utility Group suggest less risk than for Avista and the proxy group of utilities.
5 These objective indicators suggest that investors would likely conclude that the overall
6 investment risks for the Utility Group and Avista are greater than those of the firms in the
7 Non-Utility Group.

8 **Q. What were the results of your DCF analysis for the Non-Utility Group?**

9 A. As shown on Exh. AMM-12, I applied the DCF model to the non-utility
10 companies using analysts' earnings per share ("EPS") growth projections, as described
11 earlier for the Utility Group. As summarized below in Table 8, after eliminating illogical
12 values, application of the constant growth DCF model resulted in the following cost of
13 equity estimates:

14
15

TABLE 8
DCF RESULTS – NON-UTILITY GROUP

<u>Growth Rate</u>	<u>Average</u>	<u>Midpoint</u>
Value Line	10.3%	11.3%
IBES	9.9%	10.2%
Zacks	9.5%	9.7%

16 As discussed earlier, reference to the Non-Utility Group is consistent with
17 established regulatory principles. Required returns for utilities should be in line with those

1 of non-utility firms of comparable risk operating under the constraints of free competition.
2 Because the actual cost of equity is unobservable, and DCF results inherently incorporate a
3 degree of error, cost of equity estimates for the Non-Utility Group provide an important
4 benchmark in evaluating a fair and reasonable ROE for Avista. The DCF results for the
5 Non-Utility Group support a finding that the 9.9 percent requested ROE for Avista's utility
6 operations is reasonable.

7 **C. Flotation Costs**

8 **Q. What other considerations are relevant in setting the return on equity for**
9 **a utility?**

10 A. The common equity used to finance the investment in utility assets is
11 provided from either the sale of stock in the capital markets or from retained earnings not
12 paid out as dividends. When equity is raised through the sale of common stock, there are
13 costs associated with "floating" the new equity securities. These flotation costs include
14 services such as legal, accounting, and printing, as well as the fees and discounts paid to
15 compensate brokers for selling the stock to the public. Also, some argue that the "market
16 pressure" from the additional supply of common stock and other market factors may further
17 reduce the amount of funds a utility nets when it issues common equity.

18 **Q. Is there an established mechanism for a utility to recognize equity**
19 **issuance costs?**

20 A. No. While debt flotation costs are recorded on the books of the utility,
21 amortized over the life of the issue, and thus increase the effective cost of debt capital, there
22 is no similar accounting treatment to ensure that equity flotation costs are recorded and
23 ultimately recognized. No rate of return is authorized on flotation costs necessarily incurred

1 to obtain a portion of the equity capital used to finance plant. In other words, equity flotation
2 costs are not included in a utility's rate base because neither that portion of the gross proceeds
3 from the sale of common stock used to pay flotation costs is available to invest in plant and
4 equipment, nor are flotation costs capitalized as an intangible asset. Unless some provision is
5 made to recognize these issuance costs, a utility's revenue requirements will not fully reflect
6 all of the costs incurred for the use of investors' funds. Because there is no accounting
7 convention to accumulate the flotation costs associated with equity issues, they must be
8 accounted for indirectly, with an upward adjustment to the cost of equity being the most
9 appropriate mechanism.

10 **Q. Is there a sound basis to include a flotation cost adjustment in this case?**

11 A. Yes, the financial literature and evidence in this case supports an adjustment
12 to include consideration of flotation costs. An adjustment for flotation costs associated with
13 past equity issues is appropriate, even when the utility is not contemplating any new sales of
14 common stock. The need for a flotation cost adjustment to compensate for past equity issues
15 has been recognized in the financial literature. In a *Public Utilities Fortnightly* article, for
16 example, Brigham, Aberwald, and Gapenski demonstrated that even if no further stock
17 issues are contemplated, a flotation cost adjustment in all future years is required to keep
18 shareholders whole, and that the flotation cost adjustment must consider total equity,
19 including retained earnings.⁴⁹ Similarly, *New Regulatory Finance* contains the following
20 discussion::

⁴⁹ E. F. Brigham, D. A. Aberwald, and L. C. Gapenski, *Common Equity Flotation Costs and Rate Making*, Pub. Util. Fortnightly (May, 2, 1985).

1 Another controversy is whether the flotation cost allowance should still be
2 applied when the utility is not contemplating an imminent common stock
3 issue. Some argue that flotation costs are real and should be recognized in
4 calculating the fair rate of return on equity, but only at the time when the
5 expenses are incurred. In other words, the flotation cost allowance should
6 not continue indefinitely, but should be made in the year in which the sale of
7 securities occurs, with no need for continuing compensation in future years.
8 This argument implies that the company has already been compensated for
9 these costs and/or the initial contributed capital was obtained freely, devoid
10 of any flotation costs, which is an unlikely assumption, and certainly not
11 applicable to most utilities. ... The flotation cost adjustment cannot be strictly
12 forward-looking unless all past flotation costs associated with past issues
13 have been recovered.⁵⁰

14 **Q. Can you illustrate why investors will not have the opportunity to earn**
15 **their required ROE unless a flotation cost adjustment is included?**

16 A. Yes. Assume a utility sells \$10 worth of common stock at the beginning of
17 year 1. If the utility incurs flotation costs of \$0.48 (5 percent of the net proceeds), then only
18 \$9.52 is available to invest in rate base. Assume that common shareholders' required rate of
19 return is 10.5 percent, the expected dividend in year 1 is \$0.50 (i.e., a dividend yield of 5
20 percent), and that growth is expected to be 5.5 percent annually. As developed in Table 5
21 below, if the allowed rate of return on common equity is only equal to the utility's 10.5
22 percent "bare bones" cost of equity, common stockholders will not earn their required rate of
23 return on their \$10 investment, since growth will really only be 5.25 percent, instead of 5.5
24 percent:

⁵⁰ Roger A. Morin, *New Regulatory Finance*, Pub. Util. Reports, Inc. (2006) at 335.

TABLE 5
NO FLOTATION COST ADJUSTMENT

<u>Year</u>	<u>Common Stock</u>	<u>Retained Earnings</u>	<u>Total Equity</u>	<u>Market Price</u>	<u>M/B Ratio</u>	<u>Allowed ROE</u>	<u>EPS</u>	<u>DPS</u>	<u>Payout Ratio</u>
1	\$ 9.52	\$ -	\$ 9.52	\$ 10.00	1.050	10.50%	\$ 1.00	\$ 0.50	50.0%
2	\$ 9.52	\$ 0.50	\$ 10.02	\$ 10.53	1.050	10.50%	\$ 1.05	\$ 0.53	50.0%
3	\$ 9.52	\$ 0.53	<u>\$ 10.55</u>	<u>\$ 11.08</u>	1.050	10.50%	<u>\$ 1.11</u>	<u>\$ 0.55</u>	50.0%
Growth			5.25%	5.25%			5.25%	5.25%	

The reason that investors never really earn 10.5 percent on their investment in the above example is that the \$0.48 in flotation costs initially incurred to raise the common stock is not treated like debt issuance costs (*i.e.*, amortized into interest expense and therefore increasing the embedded cost of debt), nor is it included as an asset in rate base.

Including a flotation cost adjustment allows investors to be fully compensated for the impact of these costs. One commonly referenced method for calculating the flotation cost adjustment is to multiply the dividend yield by a flotation cost percentage. Thus, with a 5 percent dividend yield and a 5 percent flotation cost percentage, the flotation cost adjustment in the above example would be approximately 25 basis points. As shown in Table 6 below, by allowing a rate of return on common equity of 10.75 percent (an 10.5 percent cost of equity plus a 25 basis point flotation cost adjustment), investors earn their 10.5 percent required rate of return, since actual growth is now equal to 5.5 percent:

TABLE 6
INCLUDING FLOTATION COST ADJUSTMENT

<u>Year</u>	<u>Common Stock</u>	<u>Retained Earnings</u>	<u>Total Equity</u>	<u>Market Price</u>	<u>M/B Ratio</u>	<u>Allowed ROE</u>	<u>EPS</u>	<u>DPS</u>	<u>Payout Ratio</u>
1	\$ 9.52	\$ -	\$ 9.52	\$ 10.00	1.050	10.75%	\$ 1.02	\$ 0.50	48.8%
2	\$ 9.52	\$ 0.52	\$ 10.05	\$ 10.55	1.050	10.75%	\$ 1.08	\$ 0.53	48.8%
3	\$ 9.52	\$ 0.55	<u>\$ 10.60</u>	<u>\$ 11.13</u>	1.050	10.75%	<u>\$ 1.14</u>	<u>\$ 0.56</u>	48.8%
Growth			5.50%	5.50%			5.50%	5.50%	

The only way for investors to be fully compensated for issuance costs is to include an ongoing adjustment to account for past flotation costs when setting the return on common

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1 equity. This is the case regardless of whether or not the utility is expected to issue additional
2 shares of common stock in the future.

3 **Q. What is the magnitude of the adjustment to the “bare bones” cost of**
4 **equity to account for issuance costs?**

5 A. The most common method used to account for flotation costs in regulatory
6 proceedings is to apply an average flotation-cost percentage to a utility’s dividend yield.
7 Exhibit AMM-14 presents an analysis of flotation costs associated with the most recent
8 open-market common stock issues for each company in Value Line’s electric and gas utility
9 industries. This data includes Avista’s 2006 public offering where it incurred issuance costs
10 equal to approximately 2.3% of the gross proceeds. For all companies in the electric and gas
11 industries, flotation costs averaged approximately 3.0%. Applying this 3.0% expense
12 percentage to the 3.5% average dividend yield for the Utility Group produces a flotation cost
13 adjustment on the order of 10 basis points. I thus recommend the Commission increase the
14 cost of equity by 10 basis points in arriving at a fair ROE for Avista.

15 **Q. Has the WUTC previously recognized that flotation costs are properly**
16 **considered in setting the allowed ROE?**

17 A. Yes. For example, in Docket No. UE-991606 the WUTC concluded that a
18 flotation cost adjustment of 25 basis points should be included in the allowed return on
19 equity:

20 The Commission also agrees with both Dr. Avera and Dr. Lurito that a 25
21 basis point markup for flotation costs should be made. This amount
22 compensates the Company for costs incurred from past issues of common
23 stock. Flotation costs incurred in connection with a sale of common stock are

1 not included in a utility's rate base because the portion of gross proceeds that
2 is used to pay these costs is not available to invest in plant and equipment.⁵¹

3 **Q. Have other regulators recognized flotation costs in evaluating a fair**
4 **ROE?**

5 A. Yes. For example, the South Dakota Public Utilities Commission has
6 recognized the impact of issuance costs, concluding that, “recovery of reasonable flotation
7 costs is appropriate.”⁵² Another example of a regulator that approves common stock
8 issuance costs is the Mississippi Public Service Commission, which routinely includes a
9 flotation cost adjustment in its Rate Stabilization Adjustment Rider formula.⁵³ The Public
10 Utilities Regulatory Authority of Connecticut⁵⁴ and the Minnesota Public Utilities
11 Commission⁵⁵ have also recognized that flotation costs are a legitimate expense worthy of
12 consideration in setting a fair ROE.

13 **IV. IMPACT OF REGULATORY MECHANISMS**

14 **Q. Would any adjustment to the ROE be warranted due to Avista’s ERM?**

15 A. No. S&P has cited the existing deadbands in the ERM, and a history of
16 deferred power cost balances and rate lag as a significant credit weakness, and noted that the
17 ERM disadvantages Avista relative to other utilities in the region:

18 [T]he threshold it must meet to true-up uncollected costs in Washington is
19 high, and the company does not automatically collect deferred costs. Each
20 year, uncollected costs are subject to defined sharing bands, allowing the
21 company to potentially defer certain portions for collection from customers.

⁵¹ *Third Supplemental Order*, WUTC Docket No. UE-991606, et al., p. 95 (September 2000).

⁵² *Northern States Power Co*, EL11-019, Final Decision and Order at P 22 (2012).

⁵³ *See, e.g.*, Entergy Mississippi, Inc., Formula Rate Plan, Rider Schedule FRP-6, https://www.energy-mississippi.com/userfiles/content/price/tariffs/eml_frp.pdf (last visited Apr. 19, 2019).

⁵⁴ *See, e.g.*, Docket No. 14-05-06, Decision (Dec. 17, 2014) at 133-134.

⁵⁵ *See, e.g.*, Docket No. E001/GR-10-276, Findings of Fact, Conclusions, and Order at 9.

1 This mechanism is weaker than that for some utilities operating in western
2 states with high hydrological or significant gas generation exposure.⁵⁶

3 Moreover, the WUTC's instruction to avoid adjustments to the power cost baseline absent
4 "extraordinary circumstances" further heightens the Company's exposure to deferred energy
5 costs and reduced cash flows.⁵⁷ Investors recognize that the ability to adjust rates to recover
6 energy costs is universally prevalent in the utility industry. Such adjustment mechanisms act
7 to level the playing field, placing the Company on equal footing with its peers in the
8 industry. As a result, no downward adjustment to the ROE is justified or warranted.

9 **Q. Does the fact that Avista's electric and gas rates include a revenue**
10 **decoupling mechanism warrant any adjustment in your evaluation of a fair ROE?**

11 A. No. Decoupling is supportive of Avista's financial integrity, but there is no
12 evidence to suggest that implementation of these mechanisms has altered the relative risk of
13 Avista enough to warrant any adjustment to its ROE. As noted earlier, the investment
14 community and the major credit rating agencies in particular, pay close attention to the
15 regulatory framework, including various adjustment mechanisms. Based largely on the
16 expanded use of ratemaking mechanisms such as revenue decoupling and cost-recovery
17 riders, Moody's upgraded most regulated utilities in January 2014.⁵⁸ Similarly, Moody's
18 and S&P have noted Avista's ability to benefit from these regulatory mechanisms in their

⁵⁶ Standard & Poor's Corporation, *Avista Corp.*, RatingsDirect (Jul. 26, 2011). More recently, S&P observed that Avista is "somewhat exposed to potential excess power costs, typically tied to an earnings sharing mechanism in Washington." S&P Global Ratings, *Avista Corp. Ratings Affirmed; Off Watch Positive; Outlook Stable*, Research Update (Dec. 10, 2018).

⁵⁷ Dockets UE-170485 and UG-170486 (*consolidated*), Order 07 at para. 160.

⁵⁸ Moody's Investors Service, *US utility sector upgrades driven by stable and transparent regulatory frameworks*, Sector Comment (Feb. 3, 2014).

1 assessment of the Company's risk profile.⁵⁹ In other words, the implications of revenue
2 decoupling and other regulatory mechanisms are already fully reflected in Avista's credit
3 ratings, which are comparable to those of the proxy group used to estimate the cost of
4 equity.

5 Moreover, approval of revenue decoupling does not remove overhanging regulatory
6 risks. Avista remains exposed to future determinations as to the prudence of its expenditures
7 and investments, and investors continue to evaluate expectations for balance in the
8 regulatory framework and in establishing allowed ROEs.

9 **Q. Do the regulatory mechanisms approved for Avista set the Company**
10 **apart from other firms operating in the utility industry?**

11 A. No. Adjustment mechanisms and cost trackers have been increasingly
12 prevalent in the utility industry in recent years. In response to the increasing risk sensitivity
13 of investors to uncertainty over fluctuations in costs and the importance of advancing other
14 public interest goals such as reliability, energy conservation, and safety, utilities and their
15 regulators have sought to mitigate some of the cost recovery uncertainty and align the
16 interest of utilities and their customers through a variety of adjustment mechanisms.

17 Reflective of this trend, the companies in the electric and gas utility industries
18 operate under a wide variety of cost adjustment mechanisms, which range from revenue
19 decoupling and adjustment clauses designed to address rising capital investment outside of a
20 traditional rate case and increasing costs of environmental compliance measures to riders to

⁵⁹ Moody's Investors Service, *Moody's downgrades Avista Corp. to Baa2, outlook stable*, Rating Action (Dec. 20, 2018). While noted that Washington allows for "some credit supportive mechanisms," Moody's also observed that "the use of historic test years results in the need to file general rate cases more frequently." See also, S&P Global Ratings, *Avista Corp. Ratings Affirmed; Off Watch Positive; Outlook Stable*, RatingsDirect (Dec. 10, 2018).

1 recover bad debt expense and post-retirement employee benefit costs. *RRA Regulatory*
 2 *Focus* concluded in its recent review of adjustment clauses that:

3 More recently and with greater frequency, commissions have approved
 4 mechanisms that permit the costs associated with the construction of new
 5 generation capacity or delivery infrastructure to be reflected in rates,
 6 effectively including these items in rate base without a full rate case. In some
 7 instances, these mechanisms may even provide the utilities a cash return on
 8 construction work in progress.

9 As shown in the bottom image on the next page, certain types of adjustment
 10 clauses are more prevalent than others. For example, those that address
 11 electric and fuel and gas commodity charges are in place in all jurisdictions.
 12 Also, nearly two-thirds of all utilities have riders in place to recover costs
 13 related to energy efficiency programs, and roughly half of the utilities utilize
 14 some type of decoupling mechanism.⁶⁰

15 *RRA Regulatory Focus* observed that “[capital expenditures] for the companies in the
 16 RRA universe [are] estimated to exceed \$130 billion for the full year 2018,” and noted that a
 17 “key component” in addressing the financial and regulatory implications of elevated capital
 18 spending “has been the implementation of adjustment clauses to address recovery of these
 19 expenditures.”⁶¹ As the report summarized, “[m]ore recently and with greater frequency,
 20 commissions have approved mechanisms that permit the costs associated with the
 21 construction of new generation capacity or delivery infrastructure to be reflected in rates,
 22 effectively including these items in rate base without a full rate case.”⁶² In contrast to this
 23 industry trend, Avista does not operate under an adjustment clause for new capital
 24 investment. The Company’s need to file successive rate proceedings is primarily driven by
 25 increased capital expenditures and the lack of a comparable infrastructure mechanism puts

⁶⁰ S&P Global Market Intelligence, *Adjustment Clauses, A State-by-State Overview*, RRA Regulatory Focus (Sep. 28, 2018) (emphasis added).

⁶¹ *Id.*

⁶² *Id.*

1 Avista, and its common equity investors, at a disadvantage relative to a majority of its
2 peers.⁶³

3 The firms in the Non-Utility Group also have the ability to alter prices in response to
4 rising production costs, with the added flexibility to withdraw from the market altogether.
5 As a result, the mitigation in risks associated with utilities' ability to adjust revenues and
6 attenuate the risk of cost recovery is already reflected in the cost of equity range determined
7 earlier, and no separate adjustment to Avista's ROE is necessary or warranted.

8 **Q. Have you summarized the various tracking mechanisms available to the**
9 **other firms in the Utility Group?**

10 A. Yes. As summarized on Exh. AMM-14, reflective of industry trends, the
11 companies in the Utility Group operate under a variety of regulatory adjustment
12 mechanisms.⁶⁴ For example, thirteen of the twenty-one other utilities benefit from some
13 form of revenue decoupling mechanism and sixteen operate in jurisdictions that allow the
14 use of future test years. In contrast to Avista, eighteen of the firms in the proxy group have
15 operating utilities that benefit from mechanisms that allow for cost recovery of infrastructure
16 investment outside a formal rate proceeding. Many of these utilities also have the ability to
17 implement periodic rate adjustments to reflect changes in a diverse range of operating and
18 capital costs, including expenditures related to environmental mandates, conservation
19 programs, transmission costs, and storm recovery efforts.

⁶³ *RRA Regulatory Focus* reported that 52% of the utilities it follows benefit from infrastructure tracking mechanisms and revenue decoupling. *Id.*

⁶⁴ Because this information is widely referenced by the investment community, it is also directly relevant to an evaluation of the risks and prospects that determine the cost of equity.

1 **Q. Has the Commission acknowledged the prevalence of risk mitigating**
 2 **mechanisms in the industry?**

3 A. Yes. As the Commission determined in a 2015 order in a Puget Sound
 4 Energy case:

5 We believe it is correct that cost of capital analysis cannot be expected to
 6 produce results that support measurement of decrements to ROE ostensibly
 7 due to approval of one risk mitigation mechanism or another. Nor would cost
 8 of capital analysis be adequate to the task of identifying increments to ROE
 9 that might be considered due to some measure of additional risk a company
 10 takes on at some point in time. The Commission has never tried to account
 11 separately in its ROE determinations for specific risks or risk mitigating
 12 factors, nor should it. Circumstances in the industry today and modern
 13 regulatory practice that have led to a proliferation of risk reducing
 14 mechanisms being in place for utilities throughout the United States make it
 15 particularly inappropriate and unnecessary to consider such an undertaking.
 16 **The effects of these risk mitigating factors was by 2013, and is today,**
 17 **built into the data experts draw from the samples of companies they**
 18 **select as proxies.**⁶⁵

19 **Q. Have other regulators recognized that approval of adjustment**
 20 **mechanisms do not warrant an adjustment to the ROE?**

21 A. Yes. For example, the Staff of the Kansas State Corporation Commission
 22 concluded that no ROE adjustment was justified in the case of certain tariff riders because
 23 the impact of similar mechanisms is already accounted for through the use of a proxy group:

24 Those mechanisms differ from company to company and jurisdiction to
 25 jurisdiction. Regardless of their nuances, the intent is the same; reduce cash-
 26 flow volatility year to year and place recent capital expenditures in rates as
 27 quickly as possible. Investors are aware of these mechanisms and their
 28 benefits are a factor when investors value those stocks. Thus, any risk

⁶⁵ *Wash. Utils. & Transp. Comm'n v. Puget Sound Energy, Inc.*, Dockets UE-130130 and UG-130138 (consolidated) et al., Order 15.14 at 69, ¶ 155 (June 29, 2015) (internal citations omitted, emphasis added).

1 reduction associated with these mechanisms is captured in the market data
2 (stock prices) used in Staff's analysis.⁶⁶

3 Similarly, the mitigation in risks associated with Avista's ability to attenuate regulatory lag
4 through various adjustment mechanisms is already reflected in the results of the quantitative
5 methods presented in my testimony.

6 **Q. What does this imply with respect to the evaluation of a fair ROE for**
7 **Avista?**

8 A. While investors would consider Avista's regulatory mechanisms to be
9 supportive of the Company's financial integrity and credit ratings, this does not support a
10 downward adjustment to the ROE. The only relevant question in evaluating a fair ROE is
11 how Avista's risks compare with those of other utilities—and in particular those that are
12 used as the basis to estimate the cost of equity. As demonstrated by my review of regulatory
13 mechanisms for the Utility Group, any risk-reducing impact of recovery mechanisms like
14 decoupling is already reflected in the cost of equity estimates underlying my recommended
15 ROE range, and no separate adjustment to Avista's ROE is necessary or warranted.
16 Moreover, Avista's lack of an infrastructure mechanism places the Company at a
17 disadvantage relative to the majority of the firms in the Utility Group, especially in light of
18 elevated capital expenditures under a Two-Year Rate Plan.

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

20 A. Yes.

⁶⁶ *Direct Testimony Prepared by Adam H. Gatewood*, State Corporation Commission of the State of Kansas, Docket No. 12-ATMG-564-RTS, pp. 8-9 (June 8, 2012). This proceeding was ultimately resolved through a stipulated settlement.