Exh. AMM-1T

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-240006

DOCKET NO. UG-240007

DIRECT TESTIMONY OF

ADRIEN M. MCKENZIE, CFA

REPRESENTING AVISTA CORPORATION

DIRECT TESTIMONY OF ADRIEN M. MCKENZIE

TABLE OF CONTENTS

I. INTRODUCTION

Q. Please state your name and business address.

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

Q. In what capacity are you employed?

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

Q. Please describe your educational background and professional experience.

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

A. Overview

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

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

Q. Please summarize the information and materials you rely on to support the opinions and conclusions contained in your testimony.

A. To prepare my testimony, I use information from a variety of sources that would normally be relied upon by a person in my capacity. I am familiar with the organization,

finances, and operations of Avista from my participation in prior proceedings before the WUTC, the Idaho Public Utilities Commission, the Oregon Public Utility Commission, and the Federal Energy Regulatory Commission ("FERC"). In connection with the present filing, I consider and rely upon corporate disclosures, publicly available financial reports and filings, and other published information relating to Avista. I have also visited the Company's main offices and had discussions with management in order to better familiarize myself with Avista's utility operations. My evaluation also relies upon information relating to current capital market conditions and specifically to current investor perceptions, requirements, and expectations for electric and natural gas utilities. These sources, coupled with my experience in the fields of finance and utility regulation, have given me a working knowledge of the issues relevant to investors' required return for Avista, and they form the basis of my analyses and conclusions.

Q. How is your testimony organized?

A. After first summarizing my conclusions and recommendations, my testimony reviews Avista's operations and finances, industry-specific risks and capital market uncertainties perceived by investors. With this as a background, I present the application of well-accepted quantitative analyses to estimate the current cost of equity for a reference group of comparable-risk utilities ("Utility Group"). These include the discounted cash flow ("DCF") model, the Capital Asset Pricing Model ("CAPM"), the empirical form of the CAPM ("ECAPM"), an equity risk premium approach based on allowed ROEs for electric utilities, and reference to expected rates of return for electric utilities, which are all methods that are commonly relied on in regulatory proceedings. Based on the cost of equity estimates indicated by my analyses, the Company's ROE is evaluated taking into account the specific risks and

potential challenges for Avista's utility operations in Washington, as well as flotation costs, which are properly considered in setting a fair ROE for the Company.

In addition, I corroborate my utility quantitative analyses by applying the DCF model to a group of low risk non-utility firms. Finally, my testimony addresses the impact of regulatory mechanisms, including the implications of the Company's multi-year rate plan ("MYRP"), on an evaluation of a fair ROE for Avista.

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

A. The ROE is the cost of attracting and retaining common equity investment in the utility's physical plant and assets. This investment is necessary to finance the asset base needed to provide utility service. Investors commit capital only if they expect to earn a return on their investment commensurate with returns available from alternative investments with comparable risks. Moreover, a fair and reasonable ROE is integral in meeting sound regulatory economics and the standards set forth by the U.S. Supreme Court. The *Bluefield*[1] case set the standard against which just and reasonable rates are measured:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties. . . . The return should be reasonable, sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise money necessary for the proper discharge of its public duties.[2]

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

The *Hope*[3] case expanded on the guidelines as to a reasonable ROE, reemphasizing its findings in *Bluefield* and establishing that the rate-setting process must produce an end-result that allows the utility a reasonable opportunity to cover its capital costs. The Court stated:

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. . . . By that standard, the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain credit and attract capital.[4]

In summary, the Supreme Court's findings in *Hope* and *Bluefield* established that a just and reasonable ROE must be sufficient to 1) fairly compensate the utility's investors, 2) enable the utility to offer a return adequate to attract new capital on reasonable terms, and 3) maintain the utility's financial integrity. These standards should allow the utility to fulfill its obligation to provide reliable service while meeting the needs of customers through necessary system replacement and expansion, but they can only be met if the utility has a reasonable opportunity to actually earn its allowed ROE.

While the *Hope* and *Bluefield* decisions did not establish a particular method to be followed in fixing rates (or in determining the allowed ROE),[5] these and subsequent cases enshrined the importance of an end result that meets the opportunity cost standard of finance. Under this doctrine, the required return is established by investors in the capital markets based on expected returns available from comparable risk investments. Coupled with modern financial theory, which has led to the development of formal risk-return models (*e.g.,* DCF

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[3] *Federal Power Comm'n v. Hope Natural Gas Co.* (320 U.S. 391, 1944). ("Hope")
[4] *Id.*
[5] *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. at 602 (1944) (*finding,* "the Commission was not bound to the use of any single formula or combination of formulae in determining rates." and, "[I]t is not theory but the impact of the rate order which counts.")

and CAPM), practical application of the *Bluefield* and *Hope* standards involves the independent, case-by-case consideration of capital market data in order to evaluate an ROE that will produce a balanced and fair end result for investors and customer

B. Summary of Conclusions

Q. Please summarize your ROE analyses.

A. In order to reflect the risks and prospects associated with Avista's jurisdictional utility operations, my analyses focus on a proxy group of 22 utilities with comparable investment risks. Because investors' required return on equity is unobservable and no single method should be viewed in isolation, I apply the DCF, CAPM, ECAPM, and risk premium methods to estimate a fair ROE for Avista, as well as referencing the expected earnings approach. The results of my analyses are presented on Exh. AMM-4.

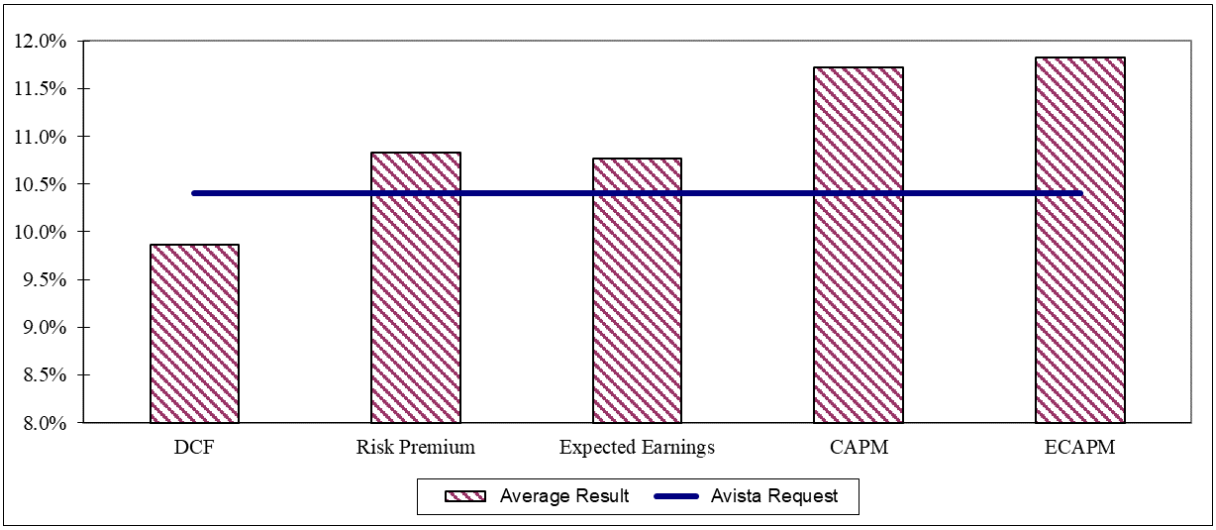
Q. What are your findings regarding the 10.4 percent ROE requested by Avista?

A. Based on the results of my analyses and the economic requirements necessary to support continuous access to capital under reasonable terms, I conclude that 10.4 percent is a conservative estimate of investors' required ROE for Avista. The bases for my conclusion are summarized below:

- Based on the results of my analyses shown on Exh. AMM-4, and giving less weight to extremes at the high and low ends of the range, I conclude that the cost of equity for the proxy group of utilities is in the **10.3 percent to 11.3 percent** range.
- Accounting for issuance costs specific to Avista's historical sales of common stock supports a flotation cost adjustment of 8 basis points.
- After making a flotation cost adjustment, my recommended ROE range is **10.38 percent to 11.38 percent**.
- As reflected in the testimony of Company witness Kevin Christie, Avista is requesting a fair ROE of **10.4 percent**, which falls below the **10.88 percent** midpoint of my recommended range. Considering capital market expectations, the exposures faced by Avista, and the economic requirements necessary to maintain financial integrity and support additional capital investment even under adverse circumstances, it is my opinion that 10.4 percent represents a conservative ROE for Avista.

Figure 1, below, summarizes the cost of equity estimates produced by my alternative analyses and compares them with Avista's 10.4 percent ROE request:

FIGURE 1
RESULTS OF ANALYSES VS. AVISTA REQUEST



As the figure shows, four of the five cost of equity methods I implement produce ROE estimates that exceed 10.4 percent. It is also worth noting that all five ROE methods produce

estimates of Avista's cost of equity that significantly exceed the Company's currently authorized ROE of 9.4 percent.

Q. What other evidence do you consider in evaluating your ROE recommendation in this case?

A. My recommendation is reinforced by the following findings:

- Recent trends in bond yields document a significant increase in the returns on long-term capital demanded by investors.
- The reasonableness of a 10.4 percent ROE for Avista is supported by the need to consider the challenges to the Company's credit standing:
  - The pressure of funding significant capital expenditures exceeding $1.5 billion over the 2024 to 2026 period heightens the uncertainties associated with Avista, especially given that the Company's existing rate base is approximately $4.3 billion.
  - As demonstrated in the testimony of Company witnesses Kinney and Kalich, Avista's reliance on hydroelectric generation and dependence on natural gas fueled capacity exposes the Company to relatively greater risks of power cost volatility.
  - As documented in the testimony of Company witness Kinney, the existing Energy Recovery Mechanism ("ERM") exacerbates the risks to Avista associated with price volatility in energy markets, reduced market liquidity, and exposure to forecast errors.
  - Allowing Avista the opportunity to actually earn a fair ROE and mitigate exposure to earnings attrition and improve credit metrics is an important objective.
  - My conclusion that a 10.4 percent ROE for Avista is a conservative estimate of investors' required return is also reinforced by the greater uncertainties associated with Avista's exposure to wildfires and relatively small size.
- Investors recognize that constructive regulation is a key ingredient in supporting utility credit standing and financial integrity and providing Avista with the opportunity to earn a return that adequately reflects its risks is an essential ingredient to support the Company's financial position, which ultimately benefits customers by ensuring reliable service at lower long-run costs.
- Continued support for Avista's financial integrity, including the opportunity to actually earn a reasonable ROE, is imperative to ensure that the Company has the capability to maintain and build its credit standing while confronting potential challenges associated with funding infrastructure development necessary to meet the needs of its customers.

- As my testimony documents, the electric utilities in my proxy group operate under a wide variety of regulatory mechanisms, including decoupling and infrastructure cost trackers. Similarly, the vast majority of these proxy firms operate in regulatory jurisdictions that allow for future test years, formula rates, and MYRPs. As a result, there is no basis to distinguish Avista from the proxy group used as the basis of my analyses.

These findings indicate that the 10.4 percent ROE requested by Avista is reasonable and should be approved.

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

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

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

A. Average DCF estimates for a low-risk group of firms in the competitive sector of the economy range from 10.5 percent to 11.0 percent, and average 10.8 percent. These results confirm that a 10.4 percent ROE is reasonable to maintain Avista's financial integrity, provide a return commensurate with investments of comparable risk, and support the Company's ability to attract capital.

Q. Does an ROE of 10.4 percent represent a reasonable cost for Avista's customers to pay?

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

Q. What other factors support the need for a higher ROE than is currently approved for the Company?

A. The following considerations indicate that Avista's cost of equity has increased and is higher than its industry peers:

- Yields on Baa-rated utility bonds have increased more than 300 basis points since the Commission's order in Dockets UE-200900 and UG-200901 and more than 100 basis points since the Full Multiparty Settlement Stipulation ("Stipulation") in Dockets UE-220053 and UG-220054 (see Table 1). These higher bond yields document a substantial increase in capital costs and support a significant increase in the Company's allowed ROE.
- Avista's market capitalization makes it one of the smallest investor-owned utilities (see Figure 3), which heightens the need to support capital attraction relative to its much larger counterparts in the industry.
- Exposure to environmental risks, including the potential for devastating wildfires, heightens the uncertainties faced by investors.

In addition, my testimony documents that objective measures of investment risk for Avista support a higher ROE relative to others in the industry:

- Inflation, delayed recovery of purchased fuel costs, and regulatory lag continue to undermine Avista's credit standing, with S&P Global Ratings ("S&P") assigning

a "Negative" outlook to the Company due to an expected weakening of financial performance below the threshold for a downgrade.

- The Company's existing credit ratings are sub-par for the industry and an insufficient ROE would further undermine Avista's credit standing.

Because Avista will have to shoulder these risks over the course of a two-year rate plan, there is little margin for error based on changed circumstances. All of these considerations warrant a significantly higher ROE for Avista.

Q. What is your conclusion as to the reasonableness of the Company's capital structure?

A. Based on my evaluation, I conclude that a common equity ratio of 48.5 percent represents a reasonable basis from which to calculate Avista's overall rate of return. This conclusion is based on the following findings:

- Avista's requested capitalization is consistent with the Company's need to support its credit standing and financial flexibility as it seeks to raise additional capital to fund significant system investments, refinance maturing debt obligations, and meet the requirements of its service territory.
- Avista's proposed common equity ratio is consistent with the range of capitalizations for the proxy utilities and their utility operating subsidiaries, both for the most recent fiscal year-end available and based on near-term expectations of The Value Line Investment Survey ("Value Line").
- The requested capitalization reflects the importance of an adequate equity layer to accommodate Avista's operating risks and recognize the impact of off-balance sheet commitments such as purchased power agreements, which carry with them some level of imputed debt.

II. RISKS OF AVISTA

Q. What is the purpose of this section?

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

A. Operating Risks

Q. How does Avista's generating resource mix affect investors' risk perceptions?

A. Because approximately 48 percent of Avista's total energy requirements are provided by hydroelectric facilities,[6] the Company is exposed to a level of uncertainty not faced by most utilities. While hydropower confers advantages in terms of fuel cost savings and diversity, reduced hydroelectric generation due to below-average water conditions forces Avista to rely more heavily on wholesale power markets or more costly thermal generating capacity to meet its resource needs. As S&P has observed:

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

Similarly, Moody's Investors Service ("Moody's") concluded that, "Avista's high dependency on hydro resources (approximately 50% of its production comes from hydro fueled electric generation resources) is viewed as a supply concentration risk which also lends to the potential for metric volatility, especially since hydro levels, due to weather, are a factor outside of management's control."[8] The cost pressures associated with Avista's hydroelectric exposure came to light last summer, with S&P noting that, "Unprecedented hot weather led to lower-than-expected hydro generation and a higher reliance on costlier thermal production and

[6] Avista Corp. SEC Form 10-K for fiscal year ended Dec. 31, 2022 at 9.
[7] Standard & Poor's Corporation, *Pacific Northwest Hydrology And Its Impact On Investor-Owned Utilities' Credit Quality*, RatingsDirect (Jan. 28, 2008).
[8] Moody's Investors Service, *Credit Opinion: Avista Corp.*, Global Credit Research (Mar. 17, 2011), https://s25.q4cdn.com/253745149/files/doc_downloads/annual-info-forms/AIF-2023.pdf.

purchased power, which increased Avista's costs."[9] More recently, S&P reiterated that a key risk for the Company is its "[s]ignificant dependence on hydroelectric generation, which introduces some fuel replacement risk."[10]

Investors recognize that volatile energy markets, unpredictable stream flows, and Avista's reliance on wholesale purchases to meet a significant portion of its resource needs can expose the Company to the risk of reduced cash flows and unrecovered power supply costs. Avista's reliance on purchased power to meet shortfalls in hydroelectric generation magnifies the importance of strengthening financial flexibility, which is essential to guarantee access to the cash resources and interim financing required to cover inadequate operating cash flows.

Q. How has global warming impacted investors' assessment of Avista's risk exposure?

A. The risk posed by climate-related weather events has served to magnify concerns over Avista's exposure to below-average water conditions. S&P concluded that "water-intensive assets like power plants [are] especially vulnerable in the absence of adaptation," and concluded that "water stress is also a serious threat" for Avista.[11] In addition, rising temperatures and reduced rainfall have led to increasing exposure to wildfires, particularly for utilities in the western U.S. The Spokesman-Review reported that the number of homes at risk for wildfire damage in Washington is expected to grow by 30 percent by

[9] S&P Global Ratings, *Avista Corp. Continues To Face Cost Pressures*, RatingsDirect (Aug. 8, 2023).
[10] S&P Global Ratings, *Avista Corp.*, RatingsDirect, Ratings Score Snapshot (Dec. 8, 2023).
[11] S&P Global Ratings, *Keeping The Lights On: U.S. Utilities' Exposure To Physical Climate Risks, RatingsDirect* (Sep. 16, 2021).

2053.[12] S&P classifies Avista as one of ten utilities with the highest average exposure to wildfires.[13] While noting that the risks of such events are generally manageable under recovery mechanisms that allow related costs to be recuperated, S&P also observed that:

> In the most extreme events, including those of late, utility companies' exposure to acute and chronic climate risks can damage assets or disrupt supplies, which can weaken their financial position and ultimately credit quality.[14]

Climate related exposure lead S&P to recently conclude that, "Overall, we view climate change as negative for [Avista's] credit quality."[15]

In response, Avista is implementing additional measures to mitigate these risks through its comprehensive Wildfire Resiliency Plan. Over its ten-year life, Avista expects to spend approximately $433.5 million to implement this plan,[16] which will place further strain on the Company's credit metrics.

Q. Have recent events in Hawaii brought the potential risks of wildfires into sharp focus for investors?

A. Yes. In addition to the terrible toll exacted on the citizens of Lahaina, the catastrophic wildfires that ravaged Maui in early August 2023 have also pushed Hawaiian Electric Industries, Inc. ("HEI") to the brink of bankruptcy. Lawsuits alleging that negligence on the part of HEI's subsidiary, Maui Electric Company, was responsible for the fires led the credit rating agencies to downgrade HEI and its utility subsidiaries to "junk" status.[17] HEI was forced to suspend common dividend payments in an effort to conserve cash due to the

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[12] Ellen Dennis, *As wildfire risk grows across the west, insurance experts fear economic turmoil*, The Spokesman-Review (Sep. 25, 2023).
[13] *Id.*
[14] *Id.*
[15] S&P Global Ratings, *Avista Corp.'s Rising Risk Of Wildfires Is Negative For Credit Quality*, RatingsDirect (Aug. 22, 2023).
[16] Exh. DRH-5, page 2.
[17] HEI is rated "B1" by Moody's and "B-" by S&P.

associated financial constraints and its common stock price has fallen on the order of 65 percent.

Q. Do recent wildfires in Washington further highlight Avista's wildfire risk?

A. Yes. In August 2023, the Gray Wildfire and the Oregon Road Wildfire damaged hundreds of structures and more than 20,000 acres of land in Spokane County. As S&P recently noted, "such incidents of wildfires highlight Avista's vulnerability to physical risks—which we believe is an ongoing concern for the company."[18] S&P also noted that they are monitoring legal proceedings related to the September 2020 Babb Road fire, in which Avista has been named as a defendant in 11 lawsuits. With regard to this litigation, S&P concluded that "an adverse outcome could further weaken Avista's financial measures, constraining the company's credit quality."[19]

Q. Do financial pressures associated with Avista's planned capital expenditures also impact investors' risk assessment?

A. Yes. Avista will require capital investment to meet customer growth, provide for necessary maintenance and replacements of its natural gas utility systems, as well as fund new investment in electric generation, transmission and distribution facilities and increase wildfire resiliency. As discussed in the testimony of Mr. Christie, Avista's capital additions are expected to total approximately $500-$575 million annually through 2026. This represents a substantial investment given Avista's current rate base of approximately $4.3 billion.

Continued support for Avista's financial integrity and flexibility will be instrumental in attracting the capital necessary to fund these projects and debt repayments in an effective

[18] S&P Global Ratings, *Avista Corp.*, RatingsDirect, Ratings Score Snapshot (Dec. 8, 2023).
[19] *Id.*

manner. Investors are aware of the challenges posed by significant capital expenditure requirements, especially in light of ongoing capital market and economic uncertainties. Moody's has noted that, "The company's financial buffer will be limited over the next several years" and that a key measure of cash flow sufficiency is expected to weaken "below our indicated financial metric threshold for a possible downgrade."[20] Similarly, S&P concluded that "there is minimal cushion between Avista's financial measures and the ratings downside trigger . . ."[21]

Q. Do utilities such as Avista continue to face environmental risks?

A. Yes. Environmental concerns are leading to a profound transformation in the electric utility industry. The generation segment is undergoing material changes in fuel mix, as natural gas and renewable sources increasingly supplant coal. But even the future prospects for the continued use of natural gas for residential and commercial use and ultimately for electric generation remain uncertain, given various decarbonization initiatives.[22] Even so, over the next decade, renewable sources are widely expected to account for a rising share of the electricity generated in the U.S., including a significant expansion in distributed generation, which will accompany declining costs and increased efficiency of energy storage technologies. Accommodating this effort to decarbonize generation will also require significant investment to modernize the transmission grid. And while this disruption offers the potential for growth through increased capital investment, it also conveys higher risks,

[20] *Id.*
[21] S&P Global Ratings, *Avista Corp.*, RatingsDirect (Aug. 5, 2021).
[22] Recent amendments to Washington's building costs effectively rule out the use of natural gas heating for new residential construction after March of 2024. *See, e.g.,* Isabella Breda, *WA adopts new rules to phase out fossil fuels in new construction*, The Seattle Times (Nov. 29, 2023). Meanwhile, the Climate Commitment Act ("CCA") in Washington, which was effective on January 1, 2023, requires the purchases of "allowances" for any natural gas-fired generation facilities in the state. *See,* https://ecology.wa.gov/air-climate/climate-commitment-act.

such as the potential for stranded costs. With respect to Avista, the Company is faced with achieving 100 percent clean electricity by 2045 and a carbon-neutral electricity supply by the end of 2027.

Credit rating agencies have taken note of Avista's environmental risk. For example, S&P recently concluded that "[e]nvironmental factors are a moderately negative consideration in our credit rating analysis of Avista Corp."[23] As S&P explained, "[t]his reflects the company's elevated physical risks due to its service territory's exposure to higher-than-average wildfire risk."[24]

B. Regulatory Mechanisms

Q. Did you consider the implications of regulatory mechanisms?

A. Yes. Adjustment mechanisms, cost trackers, and future test years have been increasingly prevalent in the utility industry in recent years, along with alternatives to traditional ratemaking such as formula rates and MYRPs. As summarized on Exh. AMM-5, the companies in my Utility Group operate under a wide variety of cost adjustment mechanisms, which encompass revenue decoupling and adjustment clauses designed to address rising capital investment outside of a traditional rate case and increasing costs of environmental compliance measures, as well as riders to recover the cost of environmental compliance measures, bad debt expenses, certain taxes and fees, post-retirement employee benefit costs and transmission-related charges. *RRA Regulatory Focus* concluded in its recent review of adjustment clauses that:

> More recently and with greater frequency, commissions have approved mechanisms that permit the costs associated with the construction of new generation capacity or delivery infrastructure to be reflected in rates,

[23] S&P Global Ratings, *Avista Corp.*, RatingsDirect, Ratings Score Snapshot (Dec. 8, 2023).
[24] *Id.*

> effectively including these items in rate base without a full rate case. In some instances, these mechanisms may even provide the utilities a cash return on construction work in progress.
>
> . . . [C]ertain types of adjustment clauses are more prevalent than others. For example, those that address electric and fuel and gas commodity charges are in place in all jurisdictions. Also, about two-thirds of all utilities have riders in place to recover costs related to energy efficiency programs, and roughly half of the utilities utilize some type of decoupling mechanism.[25]

With respect to formula rates and MYRPs, a report prepared for the DOE noted that "[MYRPs] are used in many states today to regulate utilities."[26] Meanwhile, formula rates have been used at FERC as the basis to establish rates for interstate electric transmission service for decades, and they have been adopted in numerous retail jurisdictions.[27] As documented on Exh. AMM-5, the majority of firms included in the Utility Group operate in states that have approved formula rates or MYRPs for utilities under their jurisdiction.

Q. What regulatory mechanisms are applicable to Avista's electric utility operations in Washington?

A. In addition to the ERM, Avista operates under revenue decoupling and the WUTC has authorized the establishment of a regulatory asset account to capture and track COVID-19-related incremental costs and benefits and a balancing account for wildfire costs. Consistent with the requirements of Senate Bill 5295, the Company is proposing an MYRP in this proceeding.

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[25] S&P Global Market Intelligence, *Adjustment Clauses, A State-by-State Overview*, RRA Regulatory Focus (Nov. 12, 2019).

[26] U.S. Department of Energy, *State Performance-Based Regulation Using Multiyear Rate Plans for U.S. Electric Utilities*, GRID Modernization Laboratory Consortium (Jul. 2017) at 2.3. See also, ScottMadden, *Innovative Ratemaking – Multiyear Rate Plans* (Feb. 2014).

[27] *See, e.g.*, Edison Electric Institute, *Alternative Regulation for Emerging Utility Challenges: 2015 Update* (Nov. 11, 2015).

Q. Is Avista supporting any changes to the ERM in this proceeding?

A. Yes. As discussed in the testimony of Company witnesses Kinney and Kalich, Avista is proposing modifications to the ERM that better accommodate evolving market conditions. Under the ERM that currently governs recovery of electric supply costs for Avista's Washington-jurisdictional electric utility operations, 90 percent of the difference between actual costs and base level costs are passed through to customers, with 10 percent absorbed/retained by shareholders, subject to a deadband of $4 million.[28]

Investors recognize that the current ERM exposes the Company to unrecovered electric supply costs and contributes to regulatory lag.[29] In addition, the sharing provisions of the current ERM exacerbate the risks associated with any shortfall in the output of Avista's hydroelectric generating capacity during periods of rising energy prices. S&P has previously cited the existing deadbands in the ERM—and a history of deferred power cost balances and rate lag—as a significant credit weakness, and noted that the ERM disadvantages Avista relative to other utilities in the region:

> [T]he threshold it must meet to true-up uncollected costs in Washington is high, and the company does not automatically collect deferred costs. Each year, uncollected costs are subject to defined sharing bands, allowing the company to potentially defer certain portions for collection from customers. This mechanism is weaker than that for some utilities operating in western states with high hydrological or significant gas generation exposure.[30]

[28] Applicable to annual power supply cost variability that exceeds $10 million. The Company assumes 100 percent of the risk of variability within the deadband. Power costs that exceed the deadband by between $4-$10 million are shared equally between Avista and customers, while power costs falling below the deadband by $4-$10 million are apportioned 75 percent to customers and 25 percent to the Company.

[29] At December 31, 2022, total net deferred power costs under the ERM amounted to $30.5 million. Avista Corporation, Form 10-K Report (Dec. 31, 2022) at 46.

[30] 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).

Moreover, the WUTC's instruction to avoid adjustments to the power cost baseline absent "extraordinary circumstances" further heightens the Company's exposure to deferred energy costs and reduced cash flows.[31]

Investors recognize that the ability to adjust rates to recover energy costs is universally prevalent in the utility industry. As discussed in Company witness Kinney's testimony, of the 35 state jurisdictions with vertically integrated utilities that have regulated power supply, only six have fuel/power cost adjustment mechanisms that incorporate risk sharing and only three have risk sharing and a deadband. In light of the long history of under-earning experienced by Avista, approval of the modified ERM would represent a constructive step that would bring the Company more into line with its peers in the industry. Thus, while investors would consider Avista's regulatory mechanisms—including its proposed ERM—to be supportive of the Company's financial integrity, this does not provide a basis to distinguish the risks of Avista from the utilities in my proxy group. As discussed above, the two-year horizon of the proposed MYRP carries its own set of risks, given the potential for actual experience to deviate from the underlying assumptions of the plan.

C. Other Factors

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

A. Yes. The deterioration of actual return below the allowed return that occurs when the relationships between revenues, costs, and rate base used to establish rates (e.g., using a historical test year without adequate adjustments) do not reflect the actual costs incurred to serve customers can lead to earnings shortfalls. Investors are concerned with what

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

they can expect in the future, not what they might expect in theory if a historical test year were to repeat. To be fair to investors and to benefit customers, a regulated utility must have a reasonable opportunity to actually earn a return that will maintain financial integrity, facilitate capital attraction, and compensate for risk. In other words, it is the end result in the future that determines whether or not the *Hope* and *Bluefield* standards are met.

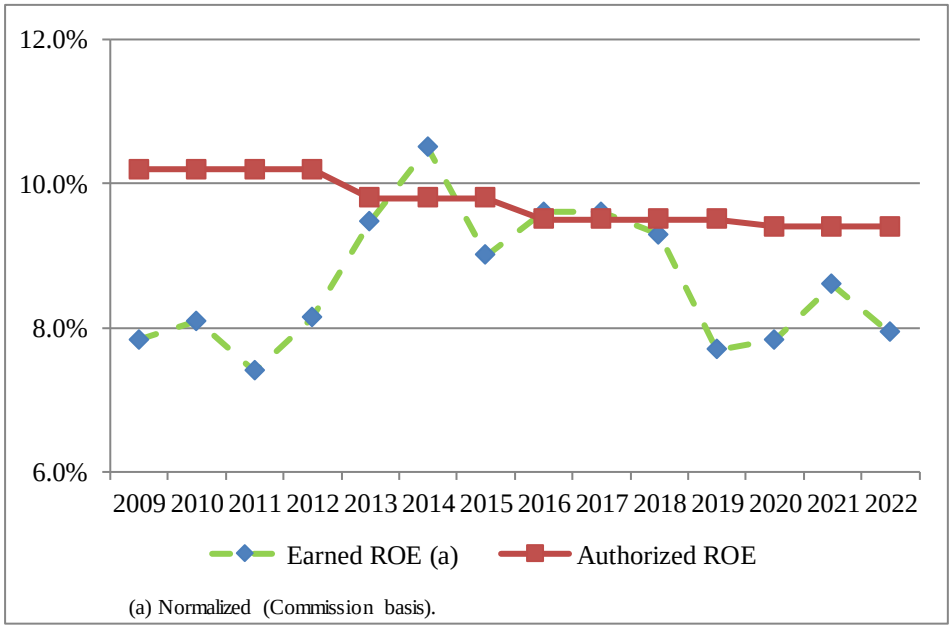
Ratemaking practices that allow the utility an opportunity to actually earn its authorized ROE are consistent with fundamental regulatory principles. The Supreme Court has reaffirmed that the end result test must be applied to the actual returns that investors expect if they put their money at risk to finance utilities.[32] That end result would maintain the utility's financial integrity, ability to attract capital and offer investors fair compensation for the risk they bear. S&P recently cited Avista's ongoing risk of earnings shortfalls, noting their "expectation that Avista's weakening financial performance will cause its metrics to fall below [their] downgrade thresholds because of … regulatory lag," among other factors.[33]

Q. Has Avista experienced attrition with respect to its Washington operations?

A. Yes. Regulatory lag and attrition have been consistent issues for Avista. Figure 2 below compares the Company's actual earned ROE attributable to its Washington-jurisdictional utility operations with its authorized ROE over the 2009-2022 period:

[32] *Verizon Communications, et al v. Federal Communications Commission, et al*, 535 U.S. 467 (2002).
[33] S&P Global Ratings, *Avista Corp.*, RatingsDirect, Ratings Score Snapshot (Dec. 8, 2023).

FIGURE 2
ACTUAL VS. AUTHORIZED ROE



As shown above, Avista's earned ROE has fallen below its authorized ROE in 11 of the past 14 years, in many cases by a substantial margin, especially without the means to address regulatory lag since 2018. The credit rating agencies have also recognized the negative implications of attrition for the Company. Moody's noted that "the lag in cash flow recovery and limited revenue increases have pressured Avista's credit metrics particularly during a time when the sector faced material headwinds from higher natural gas prices and other cost pressures."[34] Similarly, S&P reported the prospect of lowering Avista's ratings over the next 12 to 24 months if financial metrics are pressured by "regulatory lag."[35]

[34] Moody's Investors Service, *Avista Corp., update to credit analysis*, Credit Opinion (Aug. 16, 2023).
[35] S&P Global Ratings, *Avista Corp.*, RatingsDirect, Ratings Score Snapshot (Dec. 8, 2023).

Q. Has the opportunity to file for MYRPs fully addressed earnings erosion?

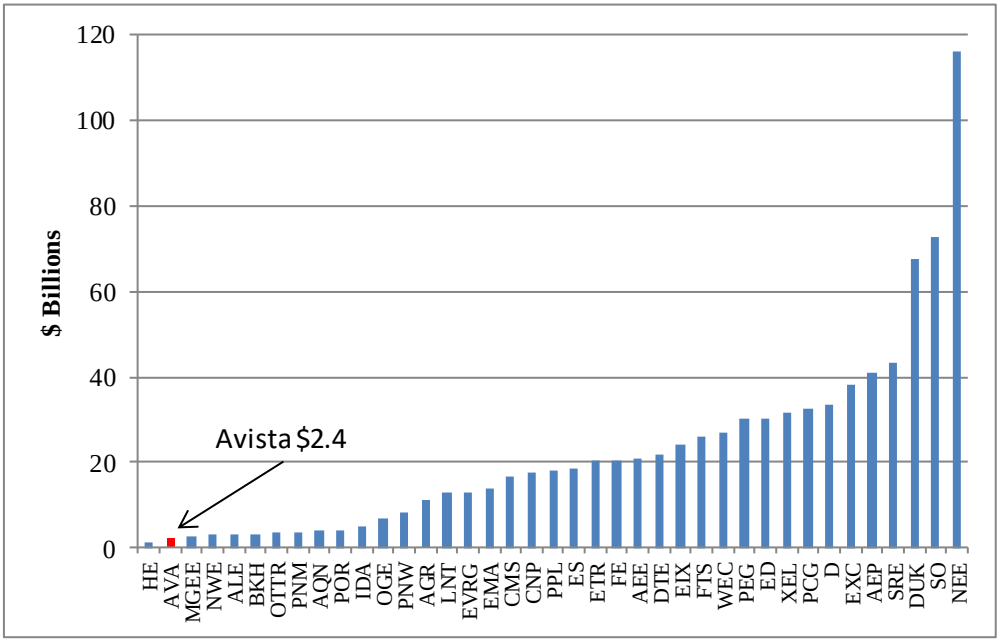
A. No. As illustrated above, Avista's earned returns have continued to fall well short of the authorized ROE since the passage of Senate Bill 5295. This issue is addressed further in the testimony of Company witness Christie.

Q. Would investors consider Avista's relative size in their assessment of the Company's risks and prospects?

A. Yes. A firm's relative size has important implications for investors in their evaluation of alternative investments, and it is well established that smaller firms are more risky than larger firms. Avista's market capitalization is compared with the publicly traded electric utilities followed be Value Line in the following figure:[36]

[36] This comparison includes Algonquin Power and Utilities, Inc. and Emera, Inc. As discussed in Exh. AMM-3, both of these companies would be regarded as electric utilities by investors.

FIGURE 3
COMPARISON OF MARKET CAPITALIZATION



As shown above, within this universe of publicly traded utilities, the only firm smaller than Avista is HEI, whose survival has been threatened by a lack of sufficient size and financial resources to absorb the risk of potential financial liabilities stemming from the Maui wildfires.[37]

The magnitude of the size disparity between Avista and other firms in the utility industry has important practical implications with respect to the risks faced by investors. All else being equal, it is well accepted that smaller firms are more risky than their larger counterparts, due in part to their relative lack of diversification and lower financial

[37] As discussed earlier, HEI's stock price plummeted in the aftermath of the devastating August 2023 wildfires on Maui, which led to a collapse in its market capitalization.

resiliency.[38] These greater risks imply a higher required rate of return, and there is ample empirical evidence that investors in smaller firms realize higher rates of return than in larger firms.[39] Accepted financial doctrine holds that investors require higher returns from smaller companies, and unless that compensation is provided in the rate of return allowed for a utility, the legal tests embodied in the *Hope* and *Bluefield* cases cannot be met.

D. Support for Avista's Credit Standing

Q. What credit ratings have been assigned to Avista?

A. Moody's has set Avista's long-term issuer rating at Baa2. S&P has assigned Avista an issuer credit rating of BBB; however, on November 11, 2022 S&P revised its outlook for Avista to "Negative," warning investors of the potential for a future downgrade to the Company's credit standing.[40] S&P cited an "expectation for a weakening of financial performance below our downgrade threshold because of inflation, rising interest rates, and regulatory lag."[41]

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

A. Numerous factors impact investors' perceptions of relative risks in the utility industry and the financial standing of the utilities themselves. These include the possibility of volatile fuel or purchased power costs, uncertain environmental mandates and associated

[38] 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).
[39] See for example Rolf W. Banz, *The Relationship Between Return and Market Value of Common Stocks,* Journal of Financial Economics (September 1981) at 16.
[40] S&P Global Ratings, *Avista Corp. Outlook Revised To Negative On Weaker Financial Measures; Ratings Affirmed*, Research Update (Nov. 11, 2022).
[41] *Id.*

costs, the implications of declining demand associated with economic weakness (such as that resulting from the COVID-19 pandemic) or structural changes in usage patterns, pressures associated with mandates concerning renewable resources, and increased reliance on distributed generation or other alternatives to the incumbent utility. Apart from these considerations, utilities may face increasing costs of operating their systems, as well as the financial pressures associated with large capital expenditure programs, which are magnified during periods of turmoil in capital markets.

Q. What are the implications for Avista?

A. The pressures of significant capital expenditure requirements reinforce the importance of supporting improvement in Avista's credit standing. Investors understand from past experience in the utility industry that large capital needs can lead to significant deterioration in financial integrity that can constrain access to capital, especially during times of unfavorable capital market conditions. Considering the potential for financial market instability, competition with other investment alternatives, and investors' sensitivity to the potential for market volatility, greater credit strength is a key ingredient in maintaining access to capital at reasonable cost. As Mr. Christie confirms in his testimony, ongoing regulatory support will be a key driver in maintaining and enhancing Avista's financial health.

Q. Throughout your testimony you refer repeatedly to the concepts of "financial strength," "financial integrity," and "financial flexibility." Would you briefly describe what you mean by these terms?

A. These terms are generally synonymous and refer to the utility's ability to attract and retain the capital that is necessary to provide service at reasonable cost, consistent with the Supreme Court standards. Avista's plans call for a continuation of capital investments to

preserve and enhance service reliability for its customers. The Company must generate adequate cash flow from operations to fund these requirements, together with access to capital from external sources under reasonable terms, on a sustainable basis.

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

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

A. Regulatory signals are a major driver of investors' risk assessment for utilities. Investors recognize that constructive regulation is a key ingredient in supporting utility credit ratings and financial integrity, particularly during times of adverse conditions. As Moody's noted, "the regulatory environment is the most important driver of our outlook because it sets the pace for cost recovery,"[42] Similarly, S&P observed that, "Regulatory advantage is the

[42] Moody's Investors Service, *Regulation Will Keep Cash Flow Stable As Major Tax Break Ends*, Industry Outlook (Feb. 19, 2014). See also, Moody's Investors Service, *Regulated Electric and Gas Networks*, Rating Methodology (Apr. 13, 2022) (noting that, "the predictability and supportiveness of the regulatory framework in which a network operates, as well as the legal and political framework that underpins it, are key credit considerations.").

most heavily weighted factor when S&P Global Ratings analyzes a regulated utility's business risk profile."[43] Value Line summarizes these sentiments:

> As we often point out, the most important factor in any utility's success, whether it provides electricity, gas, or water, is the regulatory climate in which it operates. Harsh regulatory conditions can make it nearly impossible for the best run utilities to earn a reasonable return on their investment.[44]

Q. Is Avista's ability to achieve supportive regulatory outcomes in Washington an ongoing concern for investors?

A. Yes. Investors are keenly aware of regulatory actions and their implications for the risks they face. For example, while S&P originally anticipated that the signing of SB 5295 in May 2021 could lead to improvement in Avista's credit quality,[45] S&P subsequently cited ongoing regulatory lag as a key contributor supporting its decision to revise the Company's outlook to "Negative."[46] Moody's also noted that "WUTC decisions . . . have been historically inconsistent,"[47] and that "[d]elayed cost recovery due to persistent regulatory lag with no forward test year or interim rates" remain key credit challenges.[48]

Further strengthening Avista's financial integrity is imperative to ensure that the Company has the capability to maintain an investment grade rating while confronting large capital expenditures and other potential challenges. Credit ratings for other utilities are predominantly in the A- or BBB+ categories, as shown in Figure 4, below:

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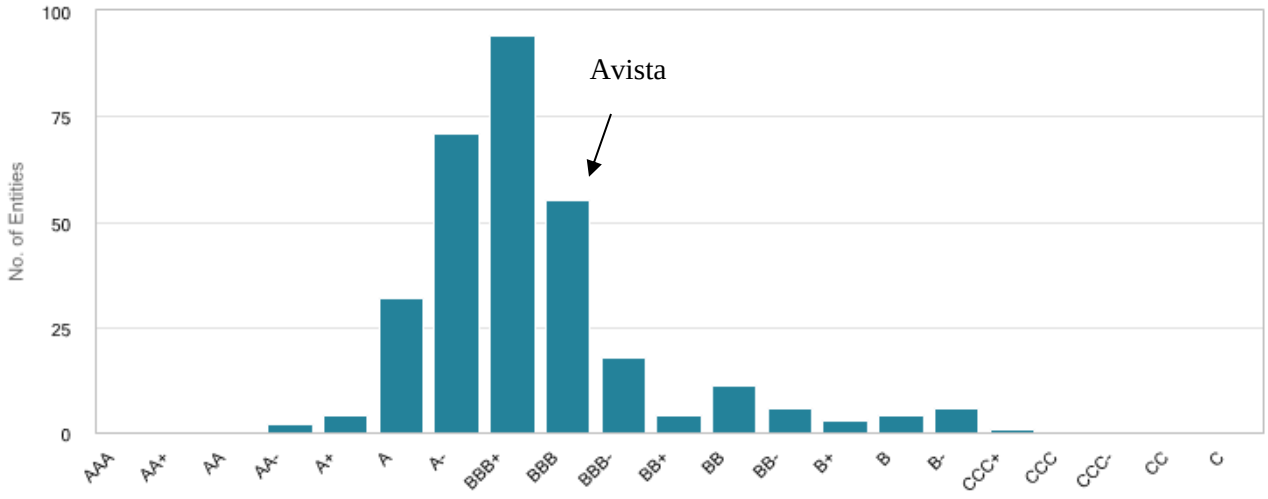
[43] S&P Global Ratings, *Assessing U.S. Investors-Owned Utility Regulatory Environments*, RatingsExpress (Aug. 10, 2016).
[44] Value Line Investment Survey, *Water Utility Industry* (Jan. 13, 2017) at p. 1780.
[45] S&P Global Ratings, *Avista Corp.*, RatingsDirect (Aug. 5, 2021).
[46] S&P Global Ratings, *Research Update: Avista Corp. Outlook Revised To Negative On Weaker Financial Measures; Ratings Affirmed*, RatingsDirect (Nov. 11, 2022); *Avista Corp.*, RatingsDirect (Dec. 8, 2023) (noting, "The negative outlook reflects our expectation that Avista's weakening financial performance will cause its metrics to fall below our downgrade thresholds because of inflation, rising interest rates, and regulatory lag.").
[47] Moody's Investors Service, *Puget Sound Energy, Inc. and Avista Corp., Legislation supporting multi-year rate plans has credit positive implications for Washington's investor owned utilities*, Issuer Comment (May 10, 2021).
[48] Moody's Investors Service, *Avista Corp., Update to credit analysis*, Credit Opinion (Aug. 16, 2023).

FIGURE 4
S&P CORPORATE CREDIT RATINGS – UTILITIES



S&P recently reported that of the 243 regulated utilities covered in its survey, only 19 had a weaker credit profile than Avista.[49] Continued regulatory support will be instrumental in achieving Avista's objective of a BBB+ rating from S&P, which is consistent with the average credit standing in the electric utility industry.

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

A. Yes. Providing an ROE that is sufficient to maintain Avista's ability to attract capital under reasonable terms, even in times of financial and market stress, is not only consistent with the economic requirements embodied in the U.S. Supreme Court's *Hope* and *Bluefield* decisions, but also in customers' best interests. Customers enjoy the benefits that

[49] S&P Global Ratings, *Issuer Ranking: North American Electric, Gas, And Water Regulated Utilities, Strongest To Weakest*, RatingsDirect (Aug. 15, 2023).

come from ensuring that the utility has the financial wherewithal to take whatever actions are required to ensure safe and reliable service.

E. Outlook for Capital Costs

Q. Please summarize current economic and capital market conditions.

A. U.S. real GDP contracted 2.2 percent during 2020, but with the easing of COVID-19 lockdowns, the economic outlook improved significantly in 2021, with GDP growing at a pace of 5.8 percent, though growth was more subdued in 2022 at 1.9 percent.[50] More recently, increases in consumer spending and federal government spending led real GDP to grow by 2.2 percent and 2.1 percent in the first and second quarters of 2023, respectively.[51] Meanwhile, indicators of employment remain stable, with the national unemployment rate falling slightly from the previous month to 3.7 percent in November 2023.[52]

The underlying risk and price pressures associated with the COVID-19 pandemic have been overshadowed by a dramatic increase in geopolitical risks following Russia's invasion of Ukraine in February 2022 and recent events in the Middle East. These events have also been accompanied by heightened economic uncertainties as inflationary pressures due to COVID-19 supply chain disruptions were further stoked by sharp increases in global commodity prices. The substantial disruption in the energy economy and dramatic rise in inflation led to sharp declines in global equity markets as investors reacted to the related exposures. S&P concluded that:

> The balance of risks is firmly on the downside—with rapid monetary tightening potentially pushing major economies into recession; growing geopolitical tensions exacerbating Europe's energy crisis; lingering high prices

[50] https://www.bea.gov/sites/default/files/2023-09/gdp2q23_3rd.pdf (last visited Dec. 20, 2023).
[51] *Id.*
[52] https://www.bls.gov/news.release/empsit.nr0.htm (last visited Dec. 20, 2023).

> pressuring costs and eroding households' purchasing power; and China grappling with structural factors that are undermining its economic growth.[53]

Stimulative monetary and fiscal policies, coupled with supply-chain disruptions and rapid price rises in the energy and commodities markets, led to increasing concern that inflation would remain significantly above the Federal Reserve's longer-run benchmark of 2 percent. In June 2022, CPI inflation peaked at its highest level since November 1981. Since then, CPI inflation has gradually moderated, and it stood at 3.1 percent in November 2023.[54] The so-called "core" price index, which excludes more volatile energy and food costs, rose at an annual rate of 4.0 percent in November 2023.[55] Similarly, PCE inflation rose 3.0 percent in October 2023, or 3.5 percent after excluding more volatile food and energy costs.[56] As Federal Reserve Chair Powell has noted, "inflation is still too high, ongoing progress in bringing it down is not assured, and the path forward is uncertain."[57]

Investor confidence has also been tested by turmoil in the banking sector, which led to increased volatility in bond and equity markets. The Federal Reserve and U.S. Treasury took quick and dramatic action to shore up banks' liquidity needs and strengthen public confidence in the banking system, but as Moody's noted, "bank stress has added uncertainty to the outlook."[58] More recently, heightened geopolitical tensions in the Middle East have led to concerns over possible disruptions in crude oil supplies and attendant price volatility that could deliver another shock to the world economy.

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[53] S&P Global Ratings, *Global Credit Conditions Q4 2022: Darkening Horizons*, Comments (Sept. 29, 2022).
[54] https://www.bls.gov/news.release/cpi.nr0.htm (last visited Dec. 20, 2023).
[55] *Id.*
[56] https://www.bea.gov/news/2023/personal-income-and-outlays-october-2023 (last visited Dec. 20, 2023).
[57] Federal Reserve, *Transcript of Chair Powell's Press Conference* (Dec. 13, 2023), https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20231213.pdf.
[58] Moody's Investors Service, *Baseline US macro forecasts unchanged but outlook more uncertain*, Sector Comment (Apr. 12, 2023).

Q. How have these developments impacted the Federal Reserve's monetary policies?

A. Beginning in March 2022, the FOMC has responded to concerns over accelerating inflation by steadily raising the benchmark range for the federal funds rate.[59] Chair Powell noted that, "Since early last year, the FOMC has significantly tightened the stance of monetary policy. We have raised our policy interest rate by 5¼ percentage points and have continued to reduce our securities holdings at a brisk pace."[60] Chair Powell has surmised that the significant draw-down of its balance sheet holdings that began in June 2022 could be the equivalent of another one quarter percent rate hike over the course of a year.[61]

Q. What impact do higher inflation expectations have on the return that equity investors require from electric utilities, including Avista?

A. Implicit in the required rate of return for long-term capital—whether debt or common equity—is compensation for expected inflation. This is highlighted in the textbook, *Financial Management, Theory and Practice*:

> The four most fundamental factors affecting the cost of money are (1) production opportunities, (2) time preferences for consumption, (3) risk, and (4) inflation.[62]

In other words, a part of investor's required return is intended to compensate for the erosion of purchasing power due to rising price levels. This inflation premium is added to the real

[59] The FOMC is a committee composed of twelve members that serves as the monetary policymaking body of the Federal Reserve System.
[60] Federal Reserve, *Transcript of Chair Powell's Press Conference* (Dec. 13,, 2023), https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20231213.pdf.
[61] Federal Reserve, *Transcript of Chair Powell's Press Conference* (May 4, 2022), https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20220504.pdf.
[62] Eugene F. Brigham, Louis C. Gapenski, and Michael C. Ehrhardt, *Financial Management, Theory and Practice*, Ninth Edition (1999) at 126.

rate of return (pure risk-free rate plus risk premium) to determine the nominal required return. As a result, higher inflation expectations lead to an increase in the cost of equity capital.

Q. Have these developments impacted the risks faced by utilities and their investors?

A. Yes. S&P reported that since 2020 credit ratings downgrades in the utility sector have outpaced upgrades by more than 3 to 1, with the median rating falling to the triple-B category for the first time.[63] S&P noted that, while inflation has moderated, it will continue to pressure credit quality in the utility industry, along with rising interest rates and higher capital spending.[64] Meanwhile, Fitch Ratings, Inc. noted that its deteriorating outlook for utilities "reflects mounting cost pressures for electric and gas utilities due to elevated commodity prices, inflationary headwinds and rising interest costs."[65] Value Line echoed these sentiments for electric utilities, concluding that:

> **A Challenging Macroeconomic Backdrop Remains**
> Inflationary pressure, rising interest rates, and high energy and raw material prices will likely remain a significant burden for most utilities. Inflationary headwinds are raising operating and maintenance costs, as well as fuel prices. Meanwhile, the rising interest rate environment is leading income-oriented investors to the bond market, as well as increasing borrowing costs, which is especially significant for utilities as the usually have low returns on total capital and rely heavily on debt borrowings. We think many of these companies will continue to struggle with the higher costs related to the challenging macroeconomic climate in the near term.[66]

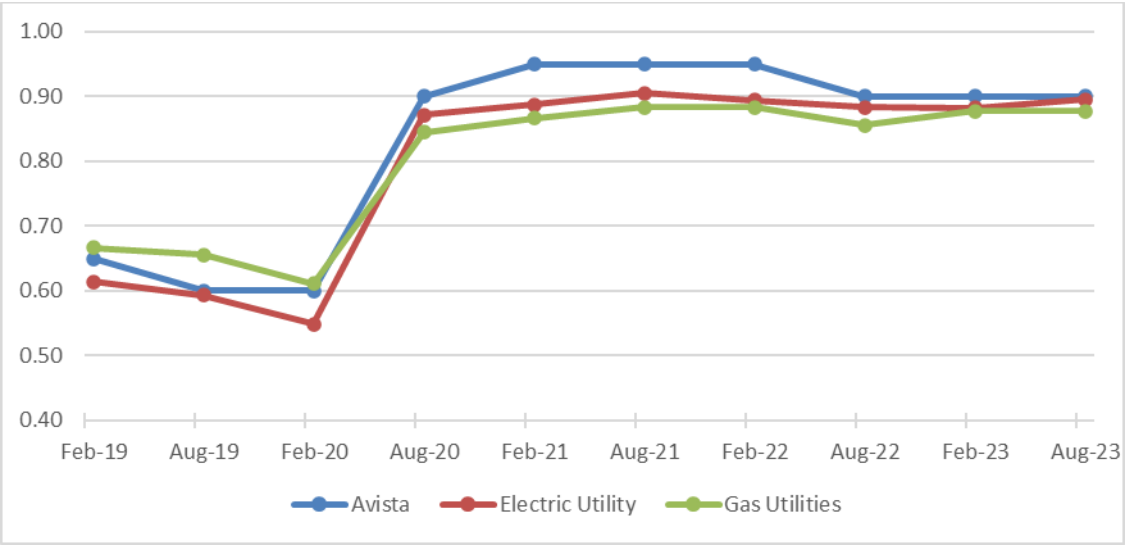
[63] S&P Global Ratings, *The Outlook For North American Regulated Utilities Turns Stable*, RatingsDirect (May 18, 2023).
[64] *Id.*
[65] Fitch Ratings, Inc., *North American Utilities*, Power & Gas Outlook 2023 (Dec. 7, 2022).
[66] The Value Line Investment Survey, *Electric Utility (Central) Industry* (Sep. 8, 2023) (emphasis original).

Q. Do changes in utility company beta values corroborate an increase in industry risk?

A. Yes. Beta measures a stock's price volatility relative to the overall market and reflects the tendency of a stock's price to follow changes in the market. The investment community relies on beta as an important guide to investors' risk perceptions. A stock that tends to respond less to market movements has a beta less than 1.00, while stocks that tend to move more than the market have betas greater than 1.00. Generally, a higher beta means the market perceives the stock to be riskier than a stock with a lower beta.

The significant shift in pre- and post-pandemic beta values for utilities is illustrated in Figure 5 below. As illustrated there, beta values for Avista, and for the electric and gas utilities covered by Value Line, increased significantly with the beginning of the pandemic in March 2020, continued to increase during 2021, and have remained elevated. This dramatic increase in a primary gauge of investors' risk perceptions is further proof of the higher risk of utility common stocks.

FIGURE 5
UTILITY BETA VALUES



Q. Have increased risks and higher inflation resulted in higher capital costs?

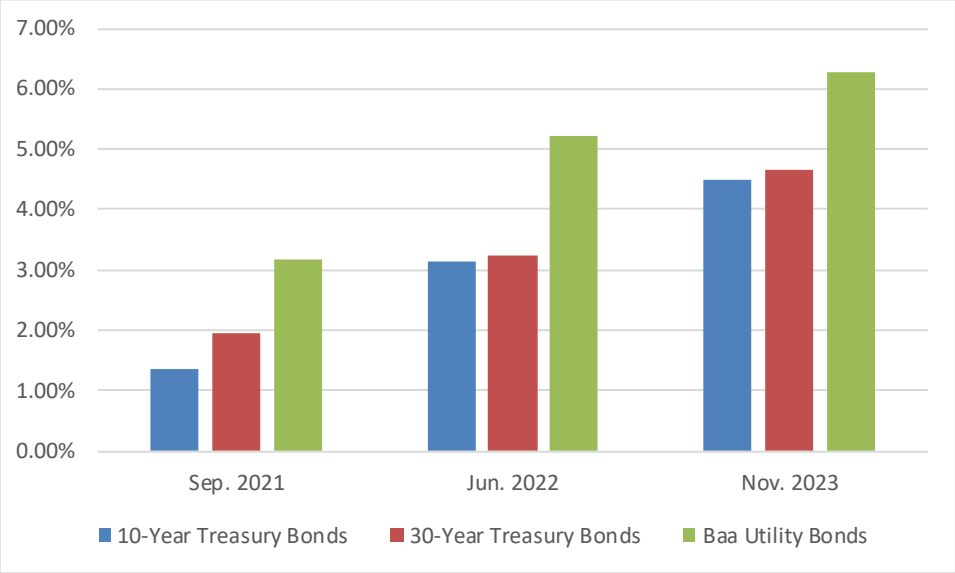
A. Yes. While the cost of equity is unobservable, the yields on long-term bonds provide a widely referenced benchmark for the direction of capital costs, including required returns on common stocks. Table 1 and Figure 6 below compare the average yields on Treasury securities and Baa-rated public utility bonds in November 2023 with those corresponding to the Stipulation in Avista's last rate proceeding and the WUTC's order in Dockets UE-200900 and UG-200901.

TABLE 1
BOND YIELD TRENDS

Series	Nov. 2023	(a) Jun. 2022	Change (bps)	(b) Sep. 2021	Change (bps)
10-Year Treasury Bonds	4.50%	3.14%	136	1.37%	313
30-Year Treasury Bonds	4.66%	3.25%	141	1.94%	272
Baa Utility Bonds	6.29%	5.22%	107	3.19%	310

Source: https://fred.stlouisfed.org/series/GS30; Moody's Credit Trends.
(a) Full Multiparty Settlement Stipulation in Dockets UE-220053 and UG-220054 was filed with the WUTC on June 28, 2022.
(b) Final Order 08 / 05 was issued in Dockets UE-200900 and UG-200901 on September 27, 2021, and resolved a contested ROE.

FIGURE 6
BOND YIELD TRENDS

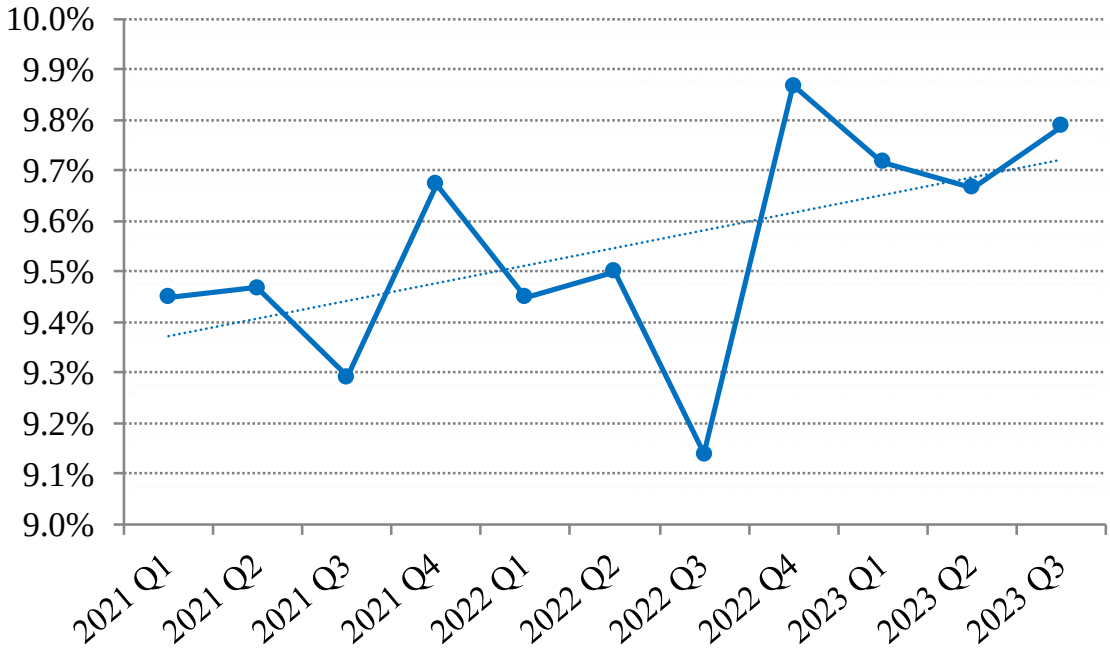


As shown above, the upward trend in the returns on long-term capital demanded by investors that began in the first quarter of 2022 has continued. With respect to utility bond yields—which are the most relevant indicator in gauging the implications for the Company's common equity investors—average yields in November 2023 are 310 basis points higher than when the Commission last set Avista's ROE at 9.4 percent in a litigated case in 2021, and exceed those prevailing at the time of the Stipulation in 2022 by more than 100 basis points.

Q. Have recently authorized ROEs begun to trend upwards?

A. Yes. Reflective of the trend in capital costs documented above, recently authorized ROEs for electric utilities have also begun to trend upwards, which can be seen in Figure 7 below.

FIGURE 7
AUTHORIZED ROES
VERTICALLY INTEGRATED ELECTRIC UTILITIES



Source: S&P Global Market Intelligence, *Major Energy Rate Case Decisions*, Regulatory Focus (Nov. 1, 2023, Feb. 2023, Feb. 10, 2022). Excludes Limited Issue Riders.

The average ROE authorized for vertically integrated electric utilities in the last four quarters was 9.76 percent, which is 36 basis points higher than Avista's currently authorized ROE of 9.4 percent.

Q. Would it be reasonable to disregard the implications of current capital market conditions in evaluating a just and reasonable ROE for Avista?

A. No. Current capital market conditions reflect the reality of the situation in which Avista must attract and retain capital. The standards underlying a fair rate of return require an authorized ROE for the Company that is competitive with other investments of comparable risk and sufficient to preserve its ability to maintain access to capital on

reasonable terms. These standards can only be met by considering the requirements of investors over the time period when the rates established in this proceeding will be in effect. If the upward shift in investors' risk perceptions and required rates of return for long-term capital is not incorporated in the allowed ROE, the results will fail to meet the comparable earnings standard that is fundamental in determining the cost of capital. From a more practical perspective, failing to provide investors with the opportunity to earn a rate of return commensurate with Avista's risks will weaken its financial integrity, while hampering the Company's ability to attract necessary capital.

F. Capital Structure

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

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

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

A. Avista's capital structure is presented in the testimony of Mr. Christie. As summarized in his testimony, the proposed capital structure used to compute Avista's overall rate of return consists of 48.5 percent equity / 51.5 percent long-term debt in this filing.

Q. What is the average capitalization maintained by the Utility Group?

A. As shown on page 1 of Exh. AMM-6, for the 22 firms in the Utility Group, common equity ratios at December 31, 2022, range between 33.0 percent and 63.5 percent and average 44.0 percent.

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

A. As shown on page 1 of Exh. AMM-6, Value Line expects an average common equity ratio for the proxy group of utilities of 44.8 percent for its three-to-five year forecast horizon, with the individual common equity ratios ranging from 27.0 percent to 59.5 percent. The WUTC has previously observed that "[i]t is appropriate … to afford more weight to forward considerations than to historic conditions as we determine the appropriate equity ratio to be embedded in prospective rates."[67]

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

A. The individual operating company capital structures are presented on pages 2-3 of Exh. AMM-6. As shown there, the operating company equity ratios range from 40.1 percent to 80.4 percent. The average of these results points to an equity ratio of 50.6 percent.

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

A. As discussed earlier, utilities are facing the need to finance significant capital investment plans, uncertainties over accommodating operating and financial market

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

uncertainties, and ongoing regulatory risks. Coupled with the potential for turmoil in capital markets, these considerations warrant a stronger balance sheet to deal with an increasingly uncertain environment. A more conservative financial profile, in the form of a higher common equity ratio, is consistent with increasing uncertainties and the need to maintain the continuous access to capital under reasonable terms that is required to fund operations and necessary system investment, including times of adverse capital market conditions. This is consistent with the views of the investment community, as reflected in the comments of the ratings agencies discussed earlier in my testimony.

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

A. Yes. Financial flexibility plays a crucial role in ensuring the wherewithal to meet funding needs, and utilities with higher financial leverage may be foreclosed or have limited access to additional borrowing, especially during times of stress. As Moody's observed:

> Utilities are among the largest debt issuers in the corporate universe and typically require consistent access to capital markets to assure adequate sources of funding and to maintain financial flexibility. During times of distress and when capital markets are exceedingly volatile and tight, liquidity becomes critically important because access to capital markets may be difficult.[68]

As a result, the Company's capital structure must maintain adequate equity to preserve the flexibility necessary to maintain continuous access to capital even during times of unfavorable market conditions.

[68] Moody's Investors Service, *FAQ on credit implications of the coronavirus outbreak*, Sector Comment (Mar. 26, 2020).

Q. What other factors do investors consider in their assessment of a company's capital structure?

A. Depending on their specific attributes, contractual agreements or other obligations that require the utility to make specified payments may be treated as debt in evaluating Avista's financial risk. Power purchase agreements, leases, and pension obligations typically require the utility to make specified minimum contractual payments akin to those associated with traditional debt financing and investors consider a portion of these commitments as debt in evaluating total financial risks. Because investors consider the debt impact of such fixed obligations in assessing a utility's financial position, they imply greater risk and reduced financial flexibility. These commitments have been repeatedly cited by major bond rating agencies in connection with assessments of utility financial risks.[69] In order to offset the debt equivalent associated with off-balance sheet obligations, the utility must rebalance its capital structure by increasing its common equity in order to restore its effective capitalization ratios to previous levels. Unless the utility takes action to offset this additional financial risk by maintaining a higher equity ratio, the resulting leverage will weaken its creditworthiness and imply greater risk.

Q. What does this evidence indicate with respect to Avista's capital structure?

A. Based on my evaluation, I conclude that Avista's requested capital structure represents a reasonable mix of capital sources from which to calculate the Company's overall rate of return. While industry averages provide one benchmark for comparison, each firm must select its capitalization based on the risks and prospects it faces, as well its specific needs

[69] See, e.g., Standard & Poor's Corporation, *Utilities: Key Credit Factors For The Regulated Utilities Industry*, RatingsDirect (Nov. 19, 2013).

to access the capital markets. A public utility with an obligation to serve must maintain ready access to capital under reasonable terms so that it can meet the service requirements of its customers. Financial flexibility plays a crucial role in ensuring the wherewithal to meet the needs of customers, and utilities with higher leverage may be foreclosed from additional borrowing under reasonable terms, especially during times of stress.

Avista's capital structure is consistent with the range of equity ratios maintained by the parent firms in the Utility Group and their operating subsidiaries, and reflects the challenges posed by its resource mix, the burden of significant capital spending requirements, and the Company's ongoing efforts to strengthen its credit standing and support access to capital on reasonable terms. The reasonableness of a 48.5 percent common equity / 51.5 percent long-term debt capital structure for Avista is reinforced by the importance of supporting continued investment in system improvements even during times of adverse capital market conditions.

III. CAPITAL MARKET ESTIMATES

Q. What is the purpose of this section?

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

A. Quantitative Analyses

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

A. No. In my opinion, no single method or model should be relied upon to determine a utility's cost of equity because no single approach can be regarded as wholly reliable. Therefore, I used the DCF, CAPM, and risk premium methods to estimate the cost

of common equity. In addition, I also evaluate a fair ROE using an earnings approach based on investors' current expectations in the capital markets. In my opinion, comparing estimates produced by one method with those produced by other approaches ensures that the estimates of the cost of equity pass fundamental tests of reasonableness and economic logic. My consideration of multiple methods and approaches is consistent with the conclusions of the WUTC:

> We value each of the methodologies used to calculate the cost of equity and do not find it appropriate to select a single method as being the most accurate or instructive. Financial circumstances are constantly shifting and changing, and we welcome a robust and diverse record of evidence based on a variety of analytics and cost of capital methodologies.[70]

Q. More recently, the WUTC elected to assign greater weight to the DCF model and concluded that CAPM results should be given little weight.[71] Do you agree with these findings?

A. No. It is widely recognized that no single method can be regarded as fail-safe; with all approaches having advantages and shortcomings. As FERC has noted, "The determination of rate of return on equity starts from the premise that there is no single approach or methodology for determining the correct rate of return."[72] FERC also recognized the potential for any application of the DCF model to produce unreliable results.[73] Similarly, a publication of the Society of Utility and Regulatory Financial Analysts concluded that:

> Each model requires the exercise of judgment as to the reasonableness of the underlying assumptions of the methodology and on the reasonableness of the proxies used to validate the theory. Each model has its own way of examining investor behavior, its own premises, and its own set of simplifications of reality. Each method proceeds from different fundamental premises, most of

[70] *PacifiCorp D/B/A Pacific Power & Light Company*, Docket UE-100749, Final Order at P 91 (Mar. 25, 2011).
[71] Docket UE-200900, et al., Final Order 08/05 (Sep. 27, 2021) at PP 100, 103.
[72] *Northwest Pipeline Co.*, Opinion No. 396-C, 81 FERC ¶ 61,036 at 4 (1997).
[73] Opinion No. 531, 147 FERC ¶ 61,234 at P 41 (2014).

> which cannot be validated empirically. Investors clearly do not subscribe to any singular method, nor does the stock price reflect the application of any one single method by investors.[74]

As this treatise succinctly observed, "no single model is so inherently precise that it can be relied on solely to the exclusion of other theoretically sound models."[75] Similarly, *New Regulatory Finance* concluded that:

> There is no single model that conclusively determines or estimates the expected return for an individual firm. Each methodology possesses its own way of examining investor behavior, its own premises, and its own set of simplifications of reality. Each method proceeds from different fundamental premises that cannot be validated empirically. Investors do not necessarily subscribe to any one method, nor does the stock price reflect the application of any one single method by the price-setting investor. There is no monopoly as to which method is used by investors. In the absence of any hard evidence as to which method outdoes the other, all relevant evidence should be used and weighted equally, in order to minimize judgmental error, measurement error, and conceptual infirmities.[76]

Thus, while the DCF model is a recognized approach to estimating the ROE, it is not without shortcomings and does not otherwise eliminate the need to ensure that the "end result" is fair. The Indiana Utility Regulatory Commission has recognized this principle:

> There are three principal reasons for our unwillingness to place a great deal of weight on the results of any DCF analysis. One is. . . the failure of the DCF model to conform to reality. The second is the undeniable fact that rarely if ever do two expert witnesses agree on the terms of a DCF equation for the same utility – for example, as we shall see in more detail below, projections of future dividend cash flow and anticipated price appreciation of the stock can vary widely. And, the third reason is that the unadjusted DCF result is almost always well below what any informed financial analysis would regard as defensible, and therefore require an upward adjustment based largely on the expert witness's judgment. In these circumstances, we find it difficult to regard the results of a DCF computation as any more than suggestive.[77]

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[74] David C. Parcell, *The Cost of Capital – A Practitioner's Guide*, Society of Utility and Regulatory Financial Analysts (2010) at 84.
[75] *Id.*
[76] Roger A. Morin, *New Regulatory Finance*, Pub. Util. Reports, Inc. (2006) at 429.
[77] *Ind. Michigan Power Co.*, Cause No. 38728, 116 PUR4th, 1, 17-18 (IURC 8/24/1990).

As this discussion indicates, consideration of the results of alternative approaches reduces the potential for error associated with any single quantitative method. Just as investors inform their decisions through the use of a variety of methodologies, my evaluation of a fair ROE for the Company considers the results of multiple financial models.

Q. Why is the CAPM an appropriate component of evaluating the cost of equity for Avista?

A. The CAPM (which also forms the foundation of the ECAPM) generally is considered to be the most widely referenced method for estimating the cost of equity among academicians and professional practitioners, with the pioneering researchers of this method receiving the Nobel Prize in 1990. Because this is the dominant model for estimating the cost of equity outside the regulatory sphere, the CAPM provides important insight into investors' required rate of return for utility stocks, including Avista. As FERC explained in support of its decision to weight the CAPM equally in its evaluation of the ROEs for electric utilities:

> Academic literature similarly indicates that investors rely on the CAPM. Moreover, the CAPM is directly relevant to the Commission's task in this context of assessing what rate of return on equity investors require to invest in a utility. John Graham and Campbell Harvey have explained that "the CAPM is by far the most popular method of estimating the cost of equity capital."[78]

Q. What specific proxy group of utilities do you rely on for your analysis?

A. In estimating the cost of equity, the DCF model is typically applied to publicly traded firms engaged in similar business activities or with comparable investment risks. As

[78] *Ass'n of Bus. Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc.*, Opinion No. 569, 169 FERC ¶ 61,129 at P 236 (2019).

described in detail in Exh. AMM-3, I apply the DCF model to a utility proxy group composed of 22 companies, which I refer to as the "Utility Group."[79]

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

A. Table 2 compares the Utility Group with Avista across five key indicators of investment risk:

TABLE 2
COMPARISON OF RISK INDICATORS

			Value Line		
			Safety	Financial	
	S&P	Moody's	Rank	Strength	Beta
Utility Group	BBB+	Baa2	2	A	0.94
Avista Corp.	BBB	Baa2	2	B++	0.90

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 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, considers three alternative measures of expected earnings growth, as well as the sustainable growth rate based on the relationship between expected retained earnings and

[79] 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).

earned rates of return ("br+sv"). As shown on Exh. AMM-7 and summarized below in Table 3, after eliminating illogical values,[80] application of the constant growth DCF model results in the following cost of equity estimates:

TABLE 3
DCF RESULTS – UTILITY GROUP

Growth Rate	Average	Midpoint
Value Line	9.7%	9.7%
IBES	10.7%	11.9%
Zacks	9.9%	10.3%
br + sv	9.2%	9.7%

Q. How do you apply the CAPM to estimate the cost of equity?

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

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

Q. What cost of equity is indicated by the CAPM approach?

A. As shown on Exh. AMM-9, my forward-looking application of the CAPM model indicates an average ROE of 11.3 percent for the Utility Group, and 11.7 percent after adjusting for the impact of firm size.

Q. What cost of equity estimates is indicated by the ECAPM?

A. Empirical tests of the CAPM have shown that low-beta securities earn returns somewhat higher than the CAPM would predict, and high-beta securities earn less than predicted. The ECAPM incorporates a refinement to address this observed relationship documented in the financial research. My application of the ECAPM is based on the same forward-looking market rate of return, risk-free rates, and beta values discussed above in connection with the CAPM. As shown on Exh. AMM-10, applying the forward-looking ECAPM approach to the firms in the Utility Group results in an average ROE estimate of 11.4 percent, or 11.8 percent after incorporating the size adjustment corresponding to the market capitalization of the individual utilities.

Q. How do you implement the risk premium method?

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

Q. What cost of equity is indicated by the risk premium approach?

A. As shown on page 1 of Exh. AMM-11, adding an adjusted risk premium of 4.74 percent to the six-month average yield on long-term Baa utility bonds at November 2023 of 6.09 percent results in an implied cost of equity of 10.83 percent.[81]

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

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

As shown on Exh. AMM-12, Value Line's projections for the Utility Group suggest an average ROE of approximately 10.8 percent.

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

B. Flotation Costs

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

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

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

A. No. While debt flotation costs are recorded on the books of the utility, amortized over the life of the issue, and thus increase the effective cost of debt capital, there is no similar accounting treatment to ensure that equity flotation costs are recorded and ultimately recognized. No rate of return is authorized on flotation costs necessarily incurred to obtain a portion of the equity capital used to finance plant. In other words, equity flotation costs are not included in a utility's rate base because neither that portion of the gross proceeds from the sale of common stock used to pay flotation costs is available to invest in plant and equipment, nor are flotation costs capitalized as an intangible asset. Unless some provision is made to recognize these issuance costs, a utility's revenue requirements will not fully reflect all of the costs incurred for the use of investors' funds. Because there is no accounting convention to

accumulate the flotation costs associated with equity issues, they must be accounted for indirectly, with an upward adjustment to the cost of equity being the most appropriate mechanism.

Q. Is there academic evidence that supports a flotation cost adjustment?

A. Yes, the financial literature and evidence in this case supports an adjustment to include consideration of flotation costs. An adjustment for flotation costs associated with past equity issues is appropriate, even when the utility is not contemplating any new sales of common stock. The need for a flotation cost adjustment to compensate for past equity issues has been recognized in the financial literature. In a *Public Utilities Fortnightly* article, for example, Brigham, Aberwald, and Gapenski demonstrated that even if no further stock issues are contemplated, a flotation cost adjustment in all future years is required to keep shareholders whole, and that the flotation cost adjustment must consider total equity, including retained earnings.[82] Similarly, *New Regulatory Finance* contains the following discussion:

> Another controversy is whether the flotation cost allowance should still be applied when the utility is not contemplating an imminent common stock issue. Some argue that flotation costs are real and should be recognized in calculating the fair rate of return on equity, but only at the time when the expenses are incurred. In other words, the flotation cost allowance should not continue indefinitely, but should be made in the year in which the sale of securities occurs, with no need for continuing compensation in future years. This argument implies that the company has already been compensated for these costs and/or the initial contributed capital was obtained freely, devoid of any flotation costs, which is an unlikely assumption, and certainly not applicable to most utilities. … The flotation cost adjustment cannot be strictly forward-looking unless all past flotation costs associated with past issues have been recovered.[83]

[82] E. F. Brigham, D. A. Aberwald, and L. C. Gapenski, *Common Equity Flotation Costs and Rate Making*, Pub. Util. Fortnightly (May 2, 1985).
[83] Roger A. Morin, *New Regulatory Finance*, Pub. Util. Reports, Inc. (2006) at 335.

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

A. Yes. Assume a utility sells $10 worth of common stock at the beginning of year 1. If the utility incurs flotation costs of $0.48 (5 percent of the net proceeds), then only $9.52 is available to invest in rate base. Assume that common shareholders' required rate of return is 10.5 percent, the expected dividend in year 1 is $0.50 (i.e., a dividend yield of 5 percent), and that growth is expected to be 5.5 percent annually. As developed in Table 4 below, if the allowed rate of return on common equity is only equal to the utility's 10.5 percent "bare bones" cost of equity, common stockholders will not earn their required rate of return on their $10 investment, since growth will really only be 5.25 percent, instead of 5.5 percent:

TABLE 4
NO FLOTATION COST ADJUSTMENT

Year	Common Stock	Retained Earnings	Total Equity	Market Price	M/B Ratio	Allowed ROE	EPS	DPS	Payout Ratio
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	$10.55	$11.08	1.050	10.50%	$ 1.11	$ 0.55	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 5 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 5
INCLUDING FLOTATION COST ADJUSTMENT

Year	Common Stock	Retained Earnings	Total Equity	Market Price	M/B Ratio	Allowed ROE	EPS	DPS	Payout Ratio
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	$10.60	$11.13	1.050	10.75%	$ 1.14	$ 0.56	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 equity. This is the case regardless of whether or not the utility is expected to issue additional shares of common stock in the future.

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

A. Yes. In Case No. INT-G-16-02 the staff of the Idaho Public Utilities Commission supported consideration of flotation costs[84] More recently, the Wyoming Office of Consumer Advocate, an independent division of the Wyoming Public Service Commission, recommended a 10 basis point flotation cost adjustment for a gas utility.[85] Similarly, the South Dakota Public Utilities Commission has recognized the impact of issuance costs, concluding

[84] Case No. INT-G-16-02, *Direct Testimony of Mark Rogers* (Dec. 16, 2016) at 18.
[85] Docket No. 30011-97-GR-17, *Pre-Filed Direct Testimony of Anthony J. Ornelas* (May 1, 2018) at 52-53.

that, "recovery of reasonable flotation costs is appropriate."[86] Another example of a regulator that approves common stock issuance costs is the Mississippi Public Service Commission, which routinely includes a flotation cost adjustment in its Rate Stabilization Adjustment Rider formula.[87] The Public Utilities Regulatory Authority of Connecticut,[88] the Minnesota Public Utilities Commission,[89] and the Virginia State Corporation Commission[90] have also recognized that flotation costs are a legitimate expense worthy of consideration in setting a fair and reasonable ROE.

Q. Has the WUTC previously considered flotation costs in establishing a fair ROE for Avista?

A. Yes. In Docket UE-991606 the WUTC concluded that a flotation cost adjustment of 25 basis points should be included in the allowed return on equity:

> The Commission also agrees with both Dr. Avera and Dr. Lurito that a 25 basis point markup for flotation costs should be made. This amount compensates the Company for costs incurred from past issues of common stock. Flotation costs incurred in connection with a sale of common stock are not included in a utility's rate base because the portion of gross proceeds that is used to pay these costs is not available to invest in plant and equipment.[91]

Q. What was the WUTC's position regarding flotation costs in Avista's last litigated rate proceeding?

A. While the WUTC concluded that flotation costs "may be legitimate adjustments made during the underwriting process," the Commission rejected my proposed

[86] *Northern States Power Co*, EL11-019, Final Decision and Order at P 22 (2012).
[87] *See, e.g.*, Entergy Mississippi Formula Rate Plan FRP-7, https://cdn.entergy-mississippi.com/userfiles/content/price/tariffs/eml_frp.pdf (last visited Dec. 12, 2023).
[88] *See, e.g.*, Docket No. 14-05-06, Decision (Dec. 17, 2014) at 133-134.
[89] *See, e.g.*, Docket No. E001/GR-10-276, Findings of Fact, Conclusions, and Order at 9.
[90] *Roanoke Gas Company*, Case No. PUR-2018-00013, *Final Order*, (Jan. 24, 2020) at 6.
[91] *Third Supplemental Order*, WUTC Docket No. UE-991606, et al., p. 95 (September 2000).

10 basis point adjustment, concluding that "the Company had failed to demonstrate the level of flotation costs it had actually incurred during the test year."[92]

Q. How have you addressed the Commission's concern?

A. Rather than developing a generic flotation cost adjustment based on industry-wide data, my analysis is predicated on actual issuance costs incurred by Avista. Specifically, Exh. AMM-13 documents the flotation costs associated with the Company's sales of common stock, including those under its Dividend Reinvestment Plan. As shown there, this results in an issuance expense factor of 1.464 percent. Applying this expense percentage to the 5.5 percent dividend yield for Avista produces a flotation cost adjustment on the order of 8 basis points. I thus recommend the Commission increase the cost of equity by 8 basis points in arriving at a fair ROE for Avista.

Q. In accounting for the impact of flotation costs, would it be relevant to consider only expenses incurred during the test year, as the WUTC's finding in Dockets UE-200900 and UG-2009001 might suggest?

A. No. There is no economic rationale that would support considering only equity flotation costs incurred during a single historical test year. As discussed earlier, flotation costs reflect a difference between the amount paid by equity investors and the capital received by the utility. This difference represents a permanent shortfall between the capital committed by investors and the funds invested in rate base. Therefore, the flotation cost adjustment is required to reflect this perpetual, ongoing difference irrespective of whether the utility issues new common stock in any given test year.

[92] Docket UE-200900, *et al.*, Final Order 08/05 (Sep. 27, 2021) at P 96.

C. Non-Utility DCF Model

Q. What other proxy group do you consider in evaluating a fair ROE for Avista?

A. As indicated earlier, I also present a DCF analysis for a low risk group of non-utility firms, with which Avista must compete for investors' capital. Under the regulatory standards established by *Hope* and *Bluefield*, the salient criterion in establishing a meaningful benchmark to evaluate a fair ROE is relative risk, not the particular business activity or degree of regulation. With regulation taking the place of competitive market forces, required returns for utilities should be in line with those of non-utility firms of comparable risk operating under the constraints of free competition. Consistent with this accepted regulatory standard, I also apply the DCF model to a reference group of low-risk companies in the non-utility sectors of the economy. I refer to this group as the "Non-Utility Group." I explain this approach in more detail in Exh. AMM-3 at 28-32.

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

A. Table 6 compares the Non-Utility Group with the Utility Group and Avista across the five key risk measures discussed earlier:

TABLE 6
COMPARISON OF RISK INDICATORS

			Value Line		
			Safety	Financial	
	S&P	Moody's	Rank	Strength	Beta
Non-Utility Group	A-	A2	1	A+	0.80
Utility Group	BBB+	Baa2	2	A	0.94
Avista Corp.	BBB	Baa2	2	B++	0.90

As shown above, all of the risk indicators for the Non-Utility Group suggest less risk than for the Utility Group and Avista. These objective indicators suggest that investors would likely conclude that the overall investment risks for the Utility Group and Avista are greater than those of the firms in the Non-Utility Group.

Q. What are the results of your DCF analysis for the Non-Utility Group?

A. As shown on Exh. AMM-14 and summarized below in Table 7, after eliminating illogical values, application of the constant growth DCF model resulted in the following cost of equity estimates:

TABLE 7
DCF RESULTS – NON-UTILITY GROUP

Growth Rate	Average	Midpoint
Value Line	10.5%	11.0%
IBES	10.9%	11.4%
Zacks	11.0%	11.7%

As discussed in Exh. AMM-3, reference to the Non-Utility Group is consistent with established regulatory principles. Required returns for utilities should be in line with those of non-utility firms of comparable risk operating under the constraints of free competition. Because the actual cost of equity is unobservable, and DCF results inherently incorporate a degree of error, cost of equity estimates for the Non-Utility Group provide an important benchmark in evaluating a fair and reasonable ROE for Avista. The DCF results for the Non-Utility Group support a finding that the 10.4 percent requested ROE for Avista's utility operations is reasonable.

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

A. Yes.