BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-20_____

DOCKET NO. UG-20_____

DIRECT TESTIMONY OF

ADRIEN M. MCKENZIE, CFA

REPRESENTING AVISTA CORPORATION

DIRECT TESTIMONY OF ADRIEN M. MCKENZIE

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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, and the Oregon Public Utility Commission. 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 the operations and finances of Avista and 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. 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 other factors (*e.g.*, flotation costs) that 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 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:

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

> 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]

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.

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[2] *Id.*
[3] *Federal Power Comm'n v. Hope Natural Gas Co.* (320 U.S. 391, 1944). ("*Hope*")
[4] *Id.*

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 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 the results of your analyses.

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

[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.")

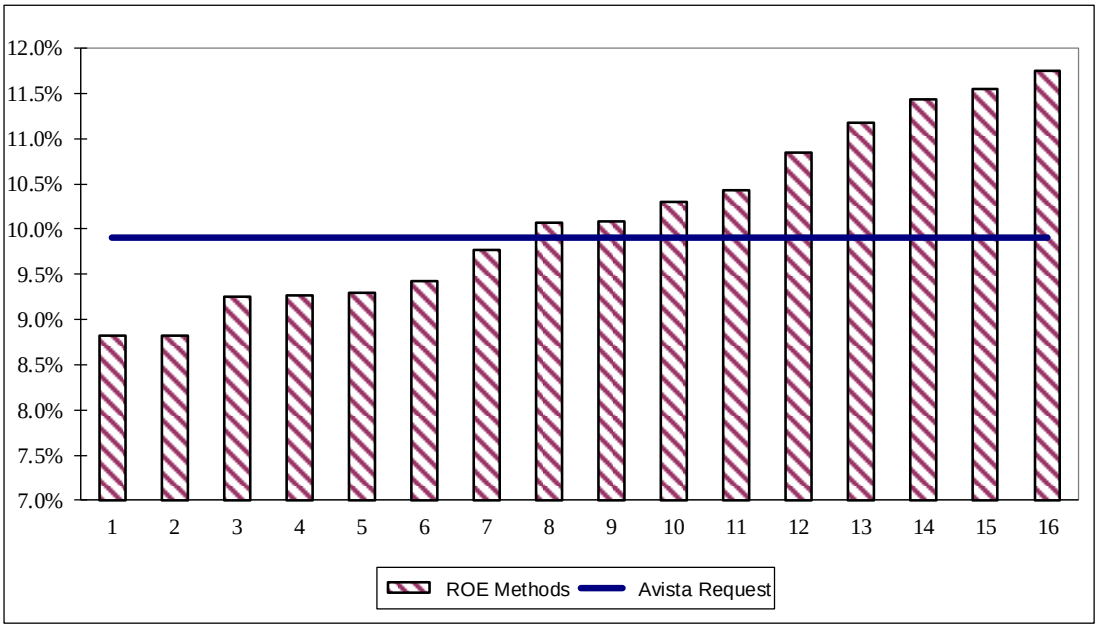
TABLE 1
SUMMARY OF RESULTS

DCF	**Average**	**Midpoint**
Value Line	9.3% [3]	10.4% [11]
IBES	9.4% [6]	9.8% [7]
Zacks	9.3% [5]	10.1% [8]
Internal br + sv	8.8% [1]	8.8% [2]
CAPM	11.2% [13]	11.6% [15]
Empirical CAPM	11.4% [14]	11.8% [16]
Utility Risk Premium		
Current Bond Yields	9.3% [4]	
Projected Bond Yields	10.1% [9]	
Expected Earnings	10.3% [10]	10.9% [12]
Cost of Equity Recommendation		
Cost of Equity Range	**9.3% -- 10.7%**	
Flotation Cost Adjustment	0.1%	
Recommended ROE Range	**9.4% -- 10.8%**	

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

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

FIGURE 1
RESULTS OF ANALYSES VS. AVISTA REQUEST



Q. What are your findings regarding the 9.9 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 determine that 9.9 percent is a reasonable estimate of investors' required ROE for Avista. The bases for my conclusion are summarized below:

- In order to reflect the risks and prospects associated with Avista's jurisdictional utility operations, my analyses focus on a proxy group of 21 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.

- Based on the results of these analyses, 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 **9.3 percent to 10.7 percent** range, or **9.4 percent to 10.8 percent** after incorporating an adjustment to account for the impact of common equity flotation costs.
- As reflected in the testimony of Mark T. Thies, Avista is requesting a fair ROE of **9.9 percent**, which is below the **10.1 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 9.9 percent represents a reasonable ROE for Avista.

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

A. My recommendation is reinforced by the following findings:

- The reasonableness of a 9.9 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 of approximately $405 million per year through 2024 heighten the uncertainties associated with Avista, especially given that the Company's existing rate base is approximately $3.5 billion.
  - Because of Avista's reliance on hydroelectric generation and increasing dependence on natural gas fueled capacity, the Company is exposed to relatively greater risks of power cost volatility, even with the Energy Recovery Mechanism ("ERM").
  - Avista's opportunity to actually earn a fair ROE and mitigate exposure to earnings attrition is an important objective.
  - My conclusion that a 9.9 percent ROE for Avista is a reasonable, even conservative, estimate of investors' required return is also reinforced by the greater uncertainties associated with Avista's 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.

- Regulatory mechanisms approved for Avista, including decoupling, are viewed as supportive by investors, and the implications of revenue decoupling and other regulatory mechanisms are already fully reflected in Avista's credit ratings, which are comparable to those of the proxy group used to estimate the cost of equity. Because the utilities in my proxy group operate under a wide variety of regulatory mechanisms, including decoupling, the mitigation in risks associated with the ability to adjust revenues and attenuate the risk of cost recovery is already reflected in the results of my analyses.

These findings indicate that the 9.9 percent ROE requested by Avista is reasonable and should be approved.

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

A. 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.[6] As shown in Table 1, alternative risk premium models (i.e., the CAPM, ECAPM, 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 9.6 percent to 10.4 percent, and average 9.8 percent. These results confirm that a 9.9 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.

[6] As discussed in Exh. AMM-3 at 3-6.

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

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

Q. Does an ROE of 9.9 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 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 50.0 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 year-end 2019 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 51 percent of Avista's total energy requirements are provided by hydroelectric facilities,[7] the Company is exposed to a level of uncertainty not faced by most utilities. While hydropower confers advantages in terms of fuel cost savings

[7] Avista Corp. SEC Form 10-K for fiscal year ended Dec. 31, 2019 at 5-6.

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 Global Ratings (formerly Standard & Poor's Corporation) ("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.[8]

In a recent report on Avista, S&P reiterated that a key risk for the Company is its "heavy dependence on hydroelectric generation" which "introduces some fuel replacement risk."[9] 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.

S&P has noted that Avista, along with Idaho Power Company, "face the most substantial risks despite their PCAs and cost-update mechanisms."[10] Similarly, Moody's Investors Service ("Moody's") has recognized 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, is a factor outside of

[8] Standard & Poor's Corporation, *Pacific Northwest Hydrology And Its Impact On Investor-Owned Utilities' Credit Quality*, RatingsDirect (Jan. 28, 2008).
[9] S&P Global Ratings, *Avista Corp.*, RatingsDirect (May 29, 2020).
[10] *Id*.

management's control."[11] 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. The significance of Avista's financial strength is further enhanced by the WUTC's instruction to avoid adjustments to the power cost baseline absent "extraordinary circumstances," which heightens the Company's exposure to deferred energy costs and reduced cash flows.[12]

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. Utility capital additions are expected to total approximately $405 million annually for the annual period ending December 31, 2022.[13] This represents a substantial investment given Avista's current rate base of approximately $3.5 billion. In addition, as discussed in the testimony of Mr. Thies, beginning in 2020 through 2022 the Company is obligated to repay maturing long-term debt totaling $302 million.

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 manner. Investors are aware of the challenges posed by significant capital expenditure requirements, especially in light of ongoing capital market and economic uncertainties.

[11] Moody's Investors Service, *Credit Opinion: Avista Corp.,* Global Credit Research (Mar. 17, 2011).
[12] Dockets UE-170485 and UG-170486 (*consolidated*), Order 07 at para. 160.
[13] Avista Corp. SEC Form 10-K for fiscal year ended Dec. 31, 2019 at 55.

Moody's has noted that weakened financial metrics as a result of additional debt to support liquidity and capital investment are a primary credit concern for Avista.[14]

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

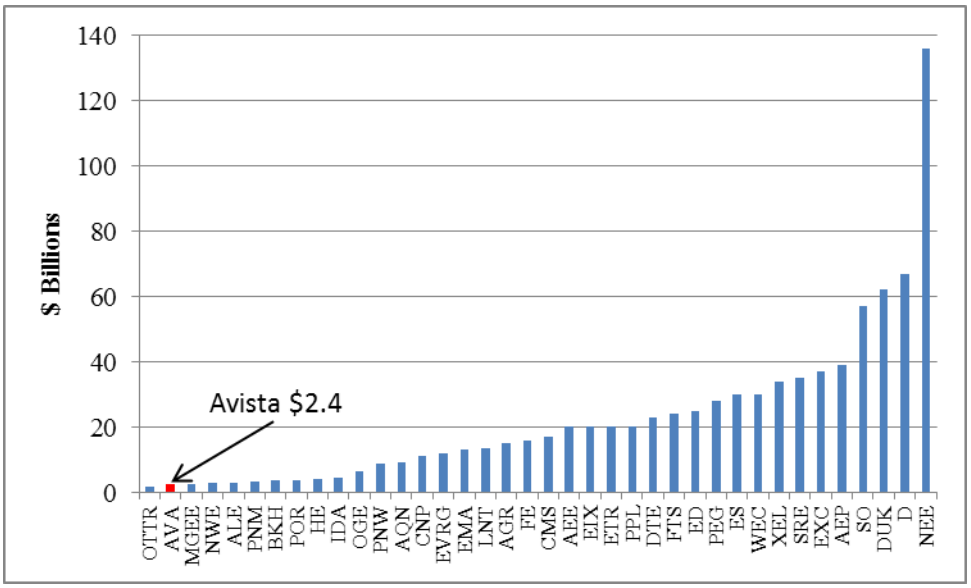
A. Yes. Environmental concerns are leading to a profound transformation in the electric utility industry. The generation segment is undergoing material changes in fuel mix, as natural gas and renewable sources increasingly supplant coal. Over the next decade, renewable sources are widely expected to 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, such as the potential for stranded costs. With respect to Avista, S&P noted that the "environmental footprint is a significant risk factor." As S&P explained, "[t]his reflects the potential for ongoing cost of operating fossil units in the face of disruptive technology advances and the potential for changing environmental regulations that may require significant capital investments."[15] The testimony of Company witnesses Mr. Vermillion and Mr. Thackston discuss Avista's recently announced goal of achieving 100 percent clean electricity by 2045 and a carbon-neutral electricity supply by the end of 2027.

[14] Moody's Investors Service, *Credit Opinion: Avista Corp, Update to Credit Analysis* (July 28, 2020).
[15] S&P Global Ratings, *Avista Corp. Ratings Affirmed; Off Watch Positive; Outlook Stable*, Research Update (Dec. 10, 2018).

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:[16]

FIGURE 2
COMPARISON OF MARKET CAPITALIZATION



As shown above, within this universe of publicly traded utilities, there is only one other firm smaller than Avista.

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

[16] 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.

counterparts, due in part to their relative lack of diversification and lower financial resiliency.[17] 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.[18] 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.

B. 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 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.

[17] 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).
[18] See for example Rolf W. Banz, *The Relationship Between Return and Market Value of Common Stocks*, Journal of Financial Economics (September 1981) at 16.

Ratemaking practices that allow the utility an opportunity to actually earn its authorized ROE are consistent with fundamental regulatory principles.[19] 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.[20] 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 notes that a key risk to the Company is "minimal cushion at the current rating level" and that "we expect regulatory lag to persist until 2023."[21]

C. Support for Avista's Credit Standing

Q. What credit ratings have been assigned to Avista?

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

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

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

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

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

[21] S&P Global Ratings, *Avista Corp.*, RatingsDirect (May 29, 2020).

demand associated with economic weakness (related to the COVID-19 pandemic, for instance) 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, given the potential for further dislocations in the capital markets?

A. The pressures of significant capital expenditure requirements, along with the need to refinance maturing long-term debt obligations, 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. Thies 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 and for repayment of maturing debt, 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,"[22] Similarly, S&P observed that, "Regulatory advantage is the most heavily weighted factor when S&P Global Ratings analyzes a regulated utility's business risk profile."[23] 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.[24]

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, in response to the Commission's recent order in Puget Sound Energy Inc.'s ("PSE") rate proceeding, S&P concluded:

> The WUTC's decision raises concerns regarding the company's regulatory construct and increases business risk for PSE and PE. We will be focusing on future rate cases in the state . . . to give us additional information on whether the regulatory environment for the utilities to operate has materially weakened.[25]

S&P noted that this decision was inconsistent with its expectation that the Clean Energy Transformation Act ("CETA") could lead to the implementation of more supportive regulatory provisions. Similarly, Moody's noted that although they had expected more credit supportive outcomes following the passage of the CETA, a focus on mitigating the economic fallout of the COVID-19 pandemic on customers resulted in a rate case outcome

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[22] Moody's Investors Service, *Regulation Will Keep Cash Flow Stable As Major Tax Break Ends*, Industry Outlook (Feb. 19, 2014).
[23] S&P Global Ratings, *Assessing U.S. Investors-Owned Utility Regulatory Environments*, RatingsExpress (Aug. 10, 2016).
[24] Value Line Investment Survey, *Water Utility Industry* (Jan. 13, 2017) at p. 1780.
[25] S&P Global Ratings, *Puget Energy Inc. And Subsidiary Ratings Placed On CreditWatch Negative Over Regulatory Concerns*, RatingsDirect (Jul. 23, 2020).

that was credit negative for PSE.[26]

With respect to Avista specifically, S&P observed that "the COVID-19 pandemic will likely lead to additional regulatory lag,"[27] and notes that "[o]verall, while we expect the company will work with its regulators to mitigate the effects of higher expenses related to the pandemic, it will likely result in additional regulatory lag primarily due to delays in its planned rate case filings, and the uncertain timing for recovering and incremental expenses tied to the outbreak."[28] 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. As noted in the testimony of Mr. Thies, 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.[29]

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, it is also in customers' best interests. Customers enjoy the benefits that come from ensuring that the utility has the financial wherewithal to take whatever actions are required to ensure safe and reliable service.

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[26] Moody's Investors Service, *Puget Sound Energy, Inc.* Issuer Comment (Jul. 17, 2020).
[27] S&P Global Ratings, *Avista Corp.*, RatingsDirect (May 29, 2020).
[28] *Id.*
[29] As noted in Mr. Thies' testimony, credit ratings for other combined electric and gas utilities are predominantly in the A- or BBB+ categories.

D. Outlook for Capital Costs

Q. Please summarize current economic and capital market conditions.

A. In the second quarter of 2020, U.S. real GDP growth declined sharply at -31.7 percent, following a decline of 0.5 percent in the prior quarter. The unemployment rate continued to fall gradually to 8.4 percent in August of 2020, from its peak at 14.7 percent in April, which is indicative of a frail but improving labor market and an economy that remains significantly below full employment. Inflation, as evidenced by the Consumer Price Index, was low at around 1.3 percent in August 2020. Investors continue to face volatility as capital markets respond to uncertainties surrounding the sharp decline in real economic output associated with the COVID-19 pandemic and related state and federal shutdowns, as well as the resulting economic stimulus packages that characterized the first half of 2020. This underlying risk and unease has been felt worldwide as countries have struggled to manage the pandemic. China's GDP showed a sharp contraction in the first quarter of 2020, followed by tepid growth in the second quarter. The European Union evidenced sharp declines in GDP during the first and second quarters of 2020. Economic activity has remained weak in many emerging market economies, including Brazil and Mexico. The global economic contraction comes on top of already heightened geopolitical tensions in the Middle East, which in the past have led to ongoing concerns over possible disruptions in crude oil supplies and attendant price volatility.

Q. How have common equity markets been impacted by COVID-19?

A. The threat posed by the coronavirus pandemic has led to extreme volatility in the capital markets as investors dramatically revise their risk perceptions and return requirements in the face of the severe disruptions to commerce and the world economy.

Simultaneously, energy markets have been roiled by the threat to demand posed by a worldwide economic slowdown and a breakdown of Russia's partnership with the Organization of the Petroleum Exporting Countries ("OPEC"). These simultaneous demand and supply shocks have led to sharp declines in oil prices, which have further confounded investors and destabilized the economic outlook and asset prices.

Despite the actions of the world's central banks to ease market strains and bolster the economy, global financial markets have experienced extreme volatility and precipitous declines in asset values. On March 12, 2020, the Dow Jones Industrial Average ("DJIA") suffered its worst decline since the 1987 "Black Monday" crash, falling by almost 10 percent in a single session, and pushing the index into a bear market, defined as a 20 percent drop from a previous high. On March 16, 2020, the DJIA experienced its greatest fall, point-wise, in history, ending the day with a decline of 2,997 points. Similarly, between February 19 and March 23, 2020, the S&P 500 lost more than 30 percent of its total value. The Chicago Board Options Exchange Volatility Index (commonly known as the "VIX"), which is a key measure of expectations of near-term volatility and market sentiment, rose to levels not seen since the 2008-2009 Financial Crisis.

Q. Have utilities and their investors faced similar turmoil?

A. Yes. As of March 23, 2020, the Dow Jones Utility Average ("DJUA") had fallen approximately 36 percent from the previous high reached on February 18, 2020, demonstrating the fact that regulated utilities and their investors are not immune from the impact of financial market turmoil. As with the broader market, utility stock prices have recovered from these lows, but as of September 30, 2020 the DJUA remains 15 percent below its previous high. While equity markets have recovered from the lows reached in

March 2020, the pronounced selloff and ongoing volatility evidences investors' trepidation to commit capital and marks a significant upward revision in their perceptions of risk and required returns.

Concerns over weakening credit quality prompted S&P to revise its outlook for the regulated utility industry from "stable" to "negative."[30] As S&P explained:

> Even before the current downturn and COVID-19, a confluence of factors, including the adverse impacts of tax reform, historically high capital spending, and associated increased debt, resulted in little cushion in ratings for unexpected operating challenges.[31]

While recognizing regulatory protections that should mitigate the impact of the coronavirus pandemic, S&P noted that "the timing and extent of these protections adds uncertainty to already stretched financial profiles."[32] S&P warned investors that pressure on utility finances "sets the stage for downgrades."[33] As S&P concluded, challenges posed by the coronavirus crisis "have the potential to significantly impact the financial performance of the investor-owned utilities, increasing the overall level of investor risk, and will have to be addressed by . . . regulators."[34]

Meanwhile Moody's noted that utilities were forced to seek alternatives to volatile commercial paper markets in order to fund operations, and emphasized the importance of maintaining adequate liquidity in the sector to weather a prolonged period of financial

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[30] S&P Global Ratings, *COVID-10: The Outlook For North American Regulated Utilities Turns Negative*, RatingsDirect (Apr. 2, 2020).
[31] S&P Global Ratings, *North American Regulated Utilities Face Tough Financial Policy Tradeoffs To Avoid Ratings Pressure Amid The COVID-19 Pandemic*, RatingsDirect (May 11, 2020).
[32] *Id.*
[33] *Id.*
[34] S&P Global Market Intelligence, *State Regulatory Evaluations*, RRA Regulatory Focus (Mar. 25, 2020).

volatility and turbulent capital markets.[35] As Moody's concluded in its recent review of PG&E's investment risks:

> The coronavirus outbreak, weak global economic outlook and asset price declines are creating a severe and extensive credit shock across many sectors, regions and markets. The combined credit effects of these developments are unprecedented.[36]

Q. What actions has the Federal Reserve taken in response to the threat to the economy posed by the coronavirus pandemic?

A. In early 2020, the Federal Reserve quickly lowered its policy rate to close to zero to support economic activity, stabilize markets and bolster the flow of credit to households, businesses, and communities. In March 2020, the Federal Reserve lowered the target range for its benchmark federal funds rate by a total of 150 basis points, to the current range of 0 percent to 0.25 percent. The FOMC expects to maintain this target range until it is confident that the economy has weathered recent events.

In addition, the Federal Reserve has announced a broad range of unprecedented programs designed to support financial market liquidity and economic stability. The QE measures initially adopted in response to the 2008 financial crisis were reintroduced by directing the purchase of Treasury securities and agency mortgage-backed securities "in the amounts needed to support the smooth functioning of markets,"[37] while continuing to reinvest all principal payments from its existing holdings. In addition, the Federal Reserve has also announced wide-raging initiatives designed to support credit markets and ensure

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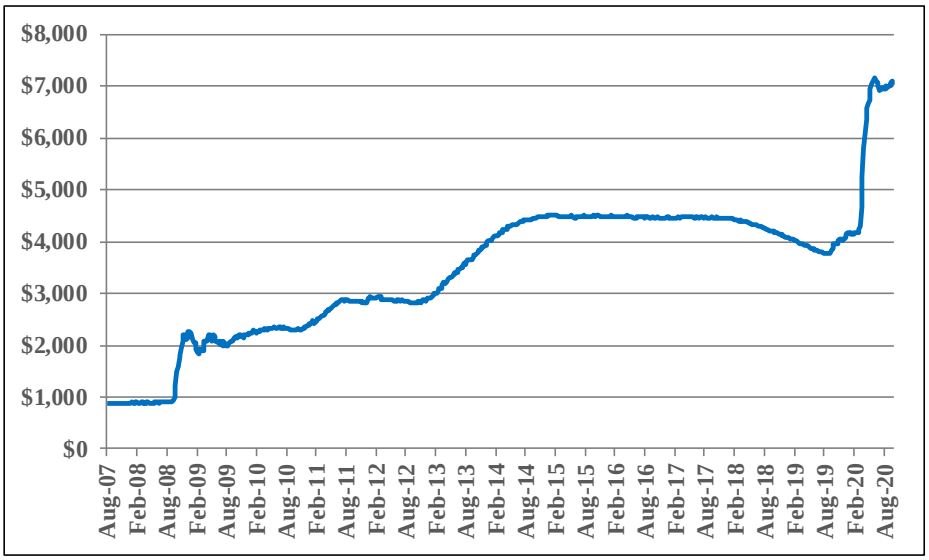
[35] Moody's Investors Service, *FAQ on credit implications of the coronavirus outbreak*, Sector Comment (Mar. 26, 2020).
[36] Moody's Investors Service, *Moody's assigns Baa3 rating to Pacific Gas & Electric's first mortgage bonds and B1 rating to PG&E Corp's senior secured debt; outlooks stable*, Rating Action (Jun. 15, 2020).
[37] Federal Reserve, *Press Release* (Mar. 23, 2020). https://www.federalreserve.gov/monetarypolicy/files/monetary20200323a1.pdf.

liquidity, including credit facilities to support households, businesses, and state and local governments, as well as the purchase of corporate bonds on the secondary market.[38]

As illustrated below, the Federal Reserve's asset holdings exceed $7 trillion, which is an all-time high, and the resulting effect on capital market conditions has likely never been more pronounced. While the Federal Reserve's aggressive monetary stimulus may help to ensure market liquidity and support the economy, these actions also support financial asset prices, which in turn place artificial downward pressure on bond yields.

FIGURE 3
FEDERAL RESERVE BALANCE SHEET
(BILLION $)



https://fred.stlouisfed.org/series/WALCL

[38] *See, e.g., Federal Reserve takes additional actions to provide up to $2.3 trillion in loans to support the economy*, Press Release (Apr. 9, 2020). https://www.federalreserve.gov/newsevents/pressreleases/monetary20200409a.htm.

Q. Do trends in the yields on Treasury notes and bonds accurately reflect the expectations and requirements of the Company's equity investors?

A. No. While Treasury bond yields provide one indicator of capital costs, they do not serve as a direct guide to the magnitude—or even direction—for changes in the cost of equity for utilities. For example, during times of heightened uncertainty and risk, investors may prefer the relative safety of U.S. government bonds, which can lead to a significant fall in Treasury bond yields at the same time that required returns on common stocks are increasing. Treasury bond yields may also be disproportionally impacted by monetary policies, such as QE, designed with the express intent of artificially suppressing bond yields. FERC has recognized that movements in Treasury bond yields do not provide a reliable guide to changes in required returns for utilities, concluding that, "adjusting ROEs based on changes in U.S. Treasury bond yields may not produce a rational result, as both the magnitude and direction of the correlation may be inaccurate."[39]

Q. Does the prospect of economic recession imply lower capital costs?

A. No. Investors' required rates of return for Avista and other financial assets are a function of risk, with greater exposure to uncertainty requiring higher—not lower—rates of return to induce long-term investment. With respect to credit markets, S&P observed that conditions "look set to remain extraordinarily difficult for borrowers at least into the second half of the year, with the economic stop associated with coronavirus-containment measures continuing with no clear end in sight."[40] And while regulated utilities

[39] Opinion No. 531, 147 FERC ¶ 61,234 at P 159 (2014).
[40] S&P Global Ratings, *Credit Conditions North America: Unprecedented Uncertainty Slams Credit* (Mar. 31, 2020).

are favorably positioned relative to other industry sectors, S&P nevertheless noted that "access to the equity markets remains extraordinarily challenging."[41]

While expected growth rates may moderate as the economy softens, it is important not to confuse investors' expectations for future growth with their required rate of return. In fact, trends in growth rates say nothing at all about investors' overall risk perceptions. The fact that investors' required rates of return for long-term capital can rise in tandem with expectations of declining growth that might accompany an economic slowdown is demonstrated in the equity markets, where perceptions of greater risks led investors to sharply reevaluate what they are willing to pay for common stocks. While the decline in utility stock prices may in part be attributed to somewhat diminished expectations of future cash flows, there is also every indication that investors' discount rate, or cost of common equity, has moved significantly higher to accommodate the greater risks they now associate with equity investments.

Q. Do changes in utility company beta values since the pandemic began corroborate an increase in industry risk?

A. Yes. As I explain in Exh. AMM-3, beta is used by the investment community as an important guide to investors' risk perceptions.[42] As shown in Table 1 of Exh. AMM-3, the current average beta for the proxy group of comparable utilities I rely on in this case for estimating the Company's ROE, is 0.89. The beta value for Avista itself is 0.90. Prior to the pandemic, the average beta for the same group of companies was 0.61 and the beta for

[41] S&P Global Ratings, *COVID-19: The Outlook For North American Regulated Utilities Turns Negative,* RatingsDirect (Apr. 2, 2020).
[42] McKenzie AMM-3 at 8.

Avista was 0.60. This dramatic increase in a primary gauge of investors' risk perceptions is further proof of the rise in electric utility risk in 2020.

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

A. No. They reflect the reality of the situation in which Avista and other businesses must attract and retain capital. The standards underlying a fair rate of return require that the Company's authorized ROE reflect a return competitive with other investments of comparable risk and preserve its ability to maintain access to capital on reasonable terms. These standards can only be met by considering the requirements of investors in today's capital markets. As S&P concluded, challenges posed by the coronavirus crisis "have the potential to significantly impact the financial performance of the investor-owned utilities, increasing the overall level of investor risk, and will have to be addressed by state regulators."[43]

While market dislocations may complicate the evaluation of the cost of common equity, there has been little indication that the challenges confronting the economy and financial markets will be resolved quickly. If the increase in investors' required rate of return 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 only serve to weaken its financial integrity, while

[43] S&P Global Market Intelligence, *State Regulatory Evaluations*, RRA Regulatory Focus (Mar. 25, 2020).

hampering the Company's ability to attract the capital needed to meet the economic and reliability needs of its service area.

Q. Might the economic dislocations caused by the coronavirus pandemic be temporary?

A. No one knows the future of our complex global economy. While there is continued hope for a swift economic rebound as COVID-19 containment measures are gradually lifted, residual impacts of the unprecedented economic and health crisis could linger indefinitely. In any event, it would be imprudent to gamble the interests of customers and the economy of Washington in the hope that the harsh economic reality will suddenly be resolved. Avista must raise capital in the real world of financial markets. To ignore the current reality would be unwise given the importance of reliable utility service for customers and the economy.

E. 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. Thies. As summarized in his testimony, the proposed capital structure used to compute Avista's overall rate of return consists of 50 percent equity / 50 percent long-term debt in this filing.

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

A. As explained by Mr. Thies, the results from the Traditional Pro Forma Study will not yield the electric and natural gas rate relief necessary to provide the Company the opportunity to earn the proposed overall rate of return requested in this case. One of the ratemaking "tools" identified by the WUTC that can be used to arrive at an end result that provides sufficient revenues is an adjusted capital structure. In this case, Avista has adjusted its capital structure to exclude short-term debt. Both Idaho and Oregon adjust the capital structure to exclude short-term debt, and currently, Avista's approved capital structures in Idaho and Oregon are 50 percent equity / 50 percent debt. In this case Avista is proposing a similar adjustment to its capital structure, excluding short-term debt from the calculation.[44]

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

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

A. As shown on page 1 of Exh. AMM-5, for the 21 firms in the Utility Group, common equity ratios at December 31, 2019 range between 25.9 percent and 67.7 percent and average 45.8 percent.

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

A. As shown on page 1 of Exh. AMM-5, Value Line expects an average common equity ratio for the proxy group of utilities of 47.2 percent for its three-to-five year forecast horizon, with the individual common equity ratios ranging from 32.0 percent to 59.0 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."[45]

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-5. As shown there, the operating company equity ratios range from 39.6 percent to 77.1 percent. The average of these results points to an equity ratio of 53.0 percent.

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

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 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.[46]

Confirming this view, S&P noted that "availability to the equity market remains extraordinarily challenging" for utilities, and concluded that "lack of access to the equity market" will also pose a risk to financial standing in the industry.[47] 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.

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.[48] In order to offset the debt equivalent associated with off-balance sheet

[46] Moody's Investors Service, *FAQ on credit implications of the coronavirus outbreak*, Sector Comment (Mar. 26, 2020).
[47] S&P Global Ratings, *COVID-19: The Outlook For North American Regulated Utilities Turns Negative* (Apr. 2, 2020).
[48] *See, e.g.*, Standard & Poor's Corporation, *Utilities: Key Credit Factors For The Regulated Utilities Industry*, RatingsDirect (Nov. 19, 2013).

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 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 50 percent common equity / 50 percent long-term debt capital structure for Avista is reinforced by the importance

of supporting continued investment in system improvements and the Company's debt repayment obligations, 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, ECAPM, 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.[49]

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 described in detail in Exh. AMM-3, I apply the DCF model to a utility proxy group composed of 21 companies, which I refer to as the "Utility Group."[50]

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

	Credit Rating		Value Line		
	S&P	Moody's	Safety Rank	Financial Strength	Beta
Utility Group	BBB	Baa2	2	B++	0.89
Avista	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

[49] *PacifiCorp D/B/A Pacific Power & Light Company*, Docket UE-100749, Final Order at P 91 (Mar. 25, 2011).
[50] 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).

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 earned rates of return ("br+sv"). As shown on Exh. AMM-6 and summarized below in Table 3, after eliminating illogical values,[51] 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	9.3%	10.4%
IBES	9.4%	9.8%
Zacks	9.3%	10.1%
br + sv	8.8%	8.8%

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

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

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.

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

A. As shown on page 1 of Exh. AMM-8, my forward-looking application of the CAPM model indicates an average ROE of 11.2 percent for the Utility Group 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 page 1 of Exh. AMM-9, applying the forward-looking ECAPM approach to the firms in the Utility Group results in an average cost of equity estimate of 11.4 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-10, adding an adjusted risk premium of 5.90 percent to the six-month average yield on long-term triple-B utility bonds at September 2020 of 3.37 percent results in an implied cost of equity of approximately 9.3 percent.[52]

Recognizing that widely-referenced forecasting services continue to document expectations for higher interest rates over the near-term, I also apply the risk premium based on forecasted utility bond yields. As shown on page 2 of Exh. AMM-10, incorporating a forecasted yield for 2021-2025 and adjusting for changes in interest rates since the 1974-2019 study period implies a cost of equity of approximately 10.1 percent.

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

A. Reference to rates of return available from alternative investments of comparable risk provide 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 simple, but powerful concept 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

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

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-11, Value Line's projections for the Utility Group suggest an average ROE of approximately 10.3 percent, with a midpoint value of 10.9 percent.

B. 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 38-41.

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

A. Table 4 compares the Non-Utility Group with the Utility Group and Avista across the five key risk measures discussed earlier:

TABLE 4
COMPARISON OF RISK INDICATORS

	Credit Rating		Value Line		
	S&P	Moody's	Safety Rank	Financial Strength	Beta
Non-Utility Group	A	A2	1	A+	0.83
Utility Group	BBB	Baa2	2	B++	0.89
Avista	BBB+	Baa1	2	B++	0.80

As shown above, the average credit ratings, Safety Rank, and Financial Strength Rating for the Non-Utility Group suggest less risk than for Avista and the proxy group of utilities. 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-12, I apply the DCF model to the non-utility companies using analysts' earnings per share ("EPS") growth projections, as described earlier for the Utility Group. As summarized below in Table 5, after eliminating illogical values, application of the constant growth DCF model resulted in the following cost of equity estimates:

TABLE 5
DCF RESULTS – NON-UTILITY GROUP

Growth Rate	Average	Midpoint
Value Line	10.4%	10.4%
IBES	9.5%	9.9%
Zacks	9.6%	9.9%

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 9.9 percent requested ROE for Avista's utility operations is reasonable.

C. 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.[53] Similarly, *New Regulatory Finance* contains the following discussion:

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

> 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.[54]

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 6 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:

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

TABLE 6
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 7 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 7
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. What is the magnitude of the adjustment to the "bare bones" cost of equity to account for issuance costs?

A. The most common method used to account for flotation costs in regulatory proceedings is to apply an average flotation-cost percentage to a utility's dividend yield. Exhibit AMM-13 presents an analysis of flotation costs associated with the most recent open-market common stock issues for each company in Value Line's electric and gas utility industries. This data includes Avista's 2006 public offering where it incurred issuance costs equal to approximately 2.3 percent of the gross proceeds. For all companies in the electric and gas industries, flotation costs average approximately 2.9 percent. Applying this expense percentage to the 4.0 percent average dividend yield for the Utility Group produces a flotation cost adjustment on the order of 10 basis points. I thus recommend the Commission increase the cost of equity by 10 basis points in arriving at a fair ROE for Avista.

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

A. Yes. For example, in Docket No. 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.[55]

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 the use of the same flotation cost methodology that I recommend above, concluding:

> [I]s the standard equation for flotation cost adjustments and is referred to as the "conventional" approach. Its use in regulatory proceedings is widespread, and the formula is outlined in several corporate finance textbooks.[56]

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.[57] Similarly, the South Dakota Public Utilities Commission has recognized the impact of issuance costs, concluding that, "recovery of reasonable flotation costs is appropriate."[58] 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.[59] The Public

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[55] *Third Supplemental Order*, WUTC Docket No. UE-991606, et al., p. 95 (September 2000).
[56] Case No. INT-G-16-02, *Direct Testimony of Mark Rogers* (Dec. 16, 2016) at 18.
[57] Docket No. 30011-97-GR-17, *Pre-Filed Direct Testimony of Anthony J. Ornelas* (May 1, 2018) at 52-53.
[58] *Northern States Power Co*, EL11-019, Final Decision and Order at P 22 (2012).
[59] *See, e.g.*, Entergy Mississippi Formula Rate Plan FRP-7, https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=&ved=2ahUKEwiLs4Sy67nsAhVKHqwKHddgA1wQFjABegQIBRAC&url=https%3A%2F%2Fcdn.entergy-mississippi.com%2Fuserfiles%2Fcontent%2Fprice%2Ftariffs%2Feml_frp.pdf&usg=AOvVaw1vyc6J_1IccZshzpfCtD0v (last visited Oct. 16, 2020).

Utilities Regulatory Authority of Connecticut,[60] the Minnesota Public Utilities Commission,[61] and the Virginia State Corporation Commission[62] have also recognized that flotation costs are a legitimate expense worthy of consideration in setting a fair and reasonable ROE.

IV. IMPACT OF REGULATORY MECHANISMS

Q. Would any adjustment to the ROE be warranted due to Avista's ERM?

A. No. S&P has 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.[63]

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.[64] Investors recognize that the ability to adjust rates to recover energy costs is universally prevalent in the utility industry. Such adjustment mechanisms act to level the playing field, placing the Company on equal footing with its peers in the industry. As a result, no downward adjustment to the ROE is justified or warranted.

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[60] *See, e.g.*, Docket No. 14-05-06, Decision (Dec. 17, 2014) at 133-134.
[61] *See, e.g.*, Docket No. E001/GR-10-276, Findings of Fact, Conclusions, and Order at 9.
[62] Roanoke Gas Company, Case No. PUR-2018-00013, *Final Order*, (Jan. 24, 2020) at 6.
[63] 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).
[64] Dockets UE-170485 and UG-170486 (*consolidated*), Order 07 at para. 160.

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

A. No. Decoupling is supportive of Avista's financial integrity, but there is no evidence to suggest that implementation of these mechanisms has altered the relative risk of Avista enough to warrant any adjustment to its ROE. As noted earlier, the investment community and the major credit rating agencies in particular, pay close attention to the regulatory framework, including various adjustment mechanisms. Based largely on the expanded use of ratemaking mechanisms such as revenue decoupling and cost-recovery riders, Moody's upgraded most regulated utilities in January 2014.[65] Similarly, Moody's and S&P have noted Avista's ability to benefit from these regulatory mechanisms in their assessment of the Company's risk profile.[66] In other words, the implications of revenue decoupling and other regulatory mechanisms are already fully reflected in Avista's credit ratings, which are comparable to those of the proxy group used to estimate the cost of equity.

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

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

[66] Moody's Investors Service, *Credit Opinion: Avista Corp, Update to Credit Analysis* (July 28, 2020). While noting that Washington allows for "credit supportive mechanisms," Moody's also observed that "the use of historic test years result in the need for Avista to file general rate cases frequently to recover and earn on investments." *See also,* S&P Global Ratings, *Avista Corp.* RatingsDirect (May 29, 2020).

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

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

Reflective of this trend, the companies in the electric and gas utility industries operate under a wide variety of cost adjustment mechanisms, which range from revenue decoupling, and adjustment clauses designed to address rising capital investment outside of a traditional rate case and increasing costs of environmental compliance measures, to riders to recover bad debt expense and post-retirement employee benefit costs. *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, 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.
>
> As shown in the graphic on the next page, certain 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.[67]

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

RRA Regulatory Focus observed that "[capital expenditures] for the companies covered by Regulatory Research Associates…is estimated to exceed $134 billion for the full year 2019, more than twice the amount spent in 2008," and noted that a "key component" in addressing the financial and regulatory implications of elevated capital spending "has been the implementation of adjustment clauses to address recovery of these expenditures."[68] As the report summarized, "[m]ore 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, effectively including these items in rate base without a full rate case."[69] In contrast to this industry trend, Avista does not operate under an adjustment clause for new capital investment. The Company's need to file successive rate proceedings is primarily driven by increased capital expenditures and the lack of a comparable infrastructure mechanism puts Avista, and its common equity investors, at a disadvantage relative to a majority of its peers.[70]

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

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[68] *Id.*
[69] *Id.*
[70] *RRA Regulatory Focus* reported that 52 percent of the utilities it follows benefit from infrastructure tracking mechanisms and revenue decoupling. *Id.*

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

A. Yes. As summarized on Exh. AMM-14, reflective of industry trends, the companies in the Utility Group operate under a variety of regulatory adjustment mechanisms.[71] For example, thirteen of the twenty-one other utilities benefit from some form of revenue decoupling mechanism and eighteen operate in jurisdictions that allow the use of future test years. In contrast to Avista, thirteen of the firms in the proxy group have operating utilities that benefit from mechanisms that allow for cost recovery of infrastructure investment outside a formal rate proceeding. Many of these utilities also have the ability to implement periodic rate adjustments to reflect changes in a diverse range of operating and capital costs, including expenditures related to environmental mandates, conservation programs, transmission costs, and storm recovery efforts.

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

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

> We believe it is correct that cost of capital analysis cannot be expected to produce results that support measurement of decrements to ROE ostensibly due to approval of one risk mitigation mechanism or another. Nor would cost of capital analysis be adequate to the task of identifying increments to ROE that might be considered due to some measure of additional risk a company takes on at some point in time. The Commission has never tried to account separately in its ROE determinations for specific risks or risk mitigating factors, nor should it. Circumstances in the industry today and modern regulatory practice that have led to a proliferation of risk reducing

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

> mechanisms being in place for utilities throughout the United States make it particularly inappropriate and unnecessary to consider such an undertaking. **The effects of these risk mitigating factors was by 2013, and is today, built into the data experts draw from the samples of companies they select as proxies.**[72]

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

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

> Those mechanisms differ from company to company and jurisdiction to jurisdiction. Regardless of their nuances, the intent is the same; reduce cash-flow volatility year to year and place recent capital expenditures in rates as quickly as possible. Investors are aware of these mechanisms and their benefits are a factor when investors value those stocks. Thus, any risk reduction associated with these mechanisms is captured in the market data (stock prices) used in Staff's analysis.[73]

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

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

A. While investors would consider Avista's regulatory mechanisms to be supportive of the Company's financial integrity and credit ratings, this does not support a downward adjustment to the ROE. The only relevant question in evaluating a fair ROE is

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[72] *Wash. Utils. & Transp. Comm'n v. Puget Sound Energy, Inc.*, Dockets UE-130130 and UG-130138 (consolidated) et al., Order 15.14 at 69, ¶ 155 (June 29, 2015) (internal citations omitted, emphasis added).
[73] *Direct Testimony Prepared by Adam H. Gatewood*, State Corporation Commission of the State of Kansas, Docket No. 12-ATMG-564-RTS, pp. 8-9 (June 8, 2012). This proceeding was ultimately resolved through a stipulated settlement.

how Avista's risks compare with those of other utilities—and in particular those that are used as the basis to estimate the cost of equity. As demonstrated by my review of regulatory mechanisms for the Utility Group, any risk-reducing impact of recovery mechanisms like decoupling is already reflected in the cost of equity estimates underlying my recommended ROE range, and no separate adjustment to Avista's ROE is necessary or warranted. Moreover, Avista's lack of an infrastructure mechanism places the Company at a disadvantage relative to the majority of the firms in the Utility Group, especially in light of elevated future capital expenditures.

Q. In summary, how have the risks confronting Avista's common shareholders changed since the Company's last rate proceeding?

A. Investors are confronting unprecedented economic uncertainty and dramatically higher volatility due to the impact of the COVID-19 pandemic. While GDP growth and employment figures have improved since plunging sharply earlier in the year, future prospects are highly uncertain. Not surprisingly, these exposures have prompted a profound reevaluation of utility stocks. Unlike investors in debt securities, for whom capital gains generally accompany declining yields, Avista's common stockholders have lost over 30 percent of their capital investment since March 2020.[74] This is indicative of a substantial upward revision to their underlying discount rate, or cost of capital. Consistent with this view, beta values for utilities—which are a widely cited barometer for equity risk—have increased dramatically. Considered along with Avista's relative size and operating and

[74] Avista's common stock closed at $52.59 per share on March 6, 2020, versus $34.01 on October 16, 2020.

financial risks, these factors support the conclusion that the risks faced by the Company's shareholders have increased.

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

A. Yes.