Exhibit No.___(WEA-1T)

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-09_____

DOCKET NO. UG-09_____

DIRECT TESTIMONY OF

WILLIAM E. AVERA

REPRESENTING AVISTA CORPORATION

DIRECT TESTIMONY OF WILLIAM E. AVERA

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I. INTRODUCTION

Q. Please state your name and business address.

A. William E. Avera, 3907 Red River, Austin, Texas, 78751.

Q. In what capacity are you employed?

A. I am the President of 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 Exhibit No.___(WEA-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 gas utility operations of Avista Corp. ("Avista" or "the Company"). In addition, I also examined 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 relied on to support the opinions and conclusions contained in your testimony.

A. To prepare my testimony, I used 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 considered and relied upon corporate disclosures, publicly available financial reports and filings, and other published information relating to Avista. I also reviewed information relating generally to current capital market conditions and specifically to current investor perceptions, requirements, and expectations for Avista's utility operations. 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. What is the role of the rate of return on common equity in setting a utility's rates?

A. The ROE serves to compensate common equity investors for the use of their capital to finance the plant and equipment necessary 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. To be consistent with sound regulatory economics and the standards set forth by the U.S. Supreme Court in the

Bluefield[1] and *Hope*[2] cases, a utility's allowed ROE should 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.

Q. How did you go about developing your conclusions regarding a fair rate of return for Avista?

A. I first reviewed the general conditions in capital markets, as well as the operations and finances of Avista and industry-specific risks perceived by investors. With this as a background, I conducted various well-accepted quantitative analyses to estimate the current cost of equity, including alternative applications of the discounted cash flow ("DCF") model and the Capital Asset Pricing Model ("CAPM"), as well as reference to expected earned rates of return. Based on the cost of equity estimates indicated by my analyses, the Company's ROE was evaluated taking into account the specific risks and potential challenges for Avista's utility operations in Washington.

B. Summary of Conclusions

Q. What are your findings regarding the fair rate of return on equity for Avista?

A. Based on the results of my analyses and the economic requirements necessary to support continuous access to capital under reasonable terms, I determined that a fair ROE for Avista falls in the range of **11.3 percent to 13.3 percent**. The bases for my conclusion are summarized below:

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[1] *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679 (1923).
[2] Fed. Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944).

- The turmoil in financial markets has resulted in a fundamental shift in investors' risk perceptions, which has increased the cost of capital for utilities such as Avista:
    - The dramatic sell-off in common stocks and sharp increase in utility bond yields associated with the ongoing credit crisis are indicative of a significant revision in investors' willingness to assume risks, which has led to higher costs for long-term capital;
    - Yields on triple-B rated utility bonds have increased approximately 100 basis points since the Multi-party Settlement Stipulation ("Settlement") in Avista's last Washington rate proceeding was reached in August 2008, which specified an ROE of 10.2 percent;
    - Because of the "flight to quality", government bond yields have fallen sharply at the same time that the required returns for other asset classes, such as common stocks and public utility bonds, have moved sharply higher to compensate for increased perceptions of risk. As a result trends in Treasury bond yields have virtually no relevance in evaluating long-term capital costs for Avista in the current capital market climate.

- In order to reflect the risks and prospects associated with Avista's jurisdictional utility operations, my analyses focused on a proxy group of seventeen other utilities with comparable investment risks. Consistent with the fact that utilities must compete for capital with firms outside their own industry, I also referenced a proxy group of comparable risk companies in the non-utility sector of the economy;

- Because investors' required return on equity is unobservable and no single method should be viewed in isolation, I applied both the discounted cash flow ("DCF") and capital asset pricing model ("CAPM") methods, as well as the comparable earnings approach, to estimate a fair ROE for Avista:
    - My application of the constant growth DCF model considered four alternative growth measures based on projected earnings growth, as well as the sustainable, "br+sv" growth rate for each firm in the respective proxy groups;
    - After eliminating low- and high-end outliers, my DCF analyses implied a cost of equity range of **11.5 percent to 13.4 percent** for the proxy group of utilities and **13.1 percent to 13.5 percent** for the group of non-utility companies;
    - Application of the CAPM approach using forward-looking data that best reflects the underlying assumptions of this approach implied a cost of equity of **11.2 percent** for the utility proxy group and **11.5 percent** for the firms in the non-utility proxy group;

- My evaluation of earned rates of return expected for utilities suggested a cost of equity on the order of at least **11.4 percent**;
- Based on these results, I concluded that the cost of equity for the proxy groups of utilities and non-utility companies is in the **11.3 percent to 13.3 percent** range.

Considering investors' expectations for capital markets and the need to support financial integrity and fund crucial capital investment even under adverse circumstances, I concluded that Avista's requested ROE of 11.0 percent is reasonable and, if anything, understated. Based on my evaluation, I determined that:

- Because Avista's requested ROE of 11.0 percent falls below the lower bound of my recommended range, it represents a conservative estimate of investors' required rate of return;
- The reasonableness of an 11.0 percent minimum ROE for Avista is also supported by the need to consider the Company's credit standing, which remains relatively weak:
  - The pressure of funding significant capital expenditures of $420 million in the next two years, given that the Company's ratebase is $1.9 billion, coupled with increased operating risks, heighten the uncertainties associated with Avista;
  - 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;
  - Standard and Poor's Corporation ("S&P") ranks Avista as 159 out of a total 175 utilities with investment grade credit ratings, with only 16 companies in the industry having a credit profile weaker than Avista's;
  - Given Avista's present credit ratings, an inadequate rate of return imposed in this proceeding would further pressure the Company's financial flexibility and credit standing;
  - My conclusion that an 11.0 percent ROE for Avista is a conservative estimate of investors' required return is also reinforced by the Company's relatively greater risks as compared with the proxy groups, the greater uncertainties associated with Avista's relatively small size, and the fact that my recommended ROE range does not consider flotation costs.

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

A. Based on my evaluation, I concluded that a common equity ratio of approximately 47.5 percent represents a reasonable basis from which to calculate Avista's overall rate of return. This conclusion was based on the following findings:

- Avista's requested capitalization is consistent with the Company's need to strengthen its credit standing and financial flexibility as it seeks to raise additional capital to fund significant system investments and meet the requirements of its service territory;
- Avista's proposed common equity ratio is entirely consistent with the range of common equity ratios maintained by the proxy group of utilities. It is also in-line with the 45.3 percent and 50.1 percent average equity ratios for the proxy utiliites, based on year-end 2007 data and near-term expectations, respectively;
- My conclusion is reinforced by the investment community's focus on the need for a greater equity layer to accommodate higher operating risks and the pressures of funding significant capital investments. This is reinforced by the need to consider the impact of unfavorable capital markets conditions, as well as off-balance sheet commitments such as purchased power agreements, which carry with them some level of imputed debt.

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

A. My recommendation was reinforced by the following findings:

- Sensitivity to regulatory uncertainties has increased dramatically and investors recognize that constructive regulation is a key ingredient in supporting utility credit standing and financial integrity;
- Providing Avista with the opportunity to earn a return that reflects these realities is an essential ingredient to strengthen the Company's financial position, which ultimately benefits customers by ensuring reliable service at lower long-run costs;
- My conclusion is reinforced by the economic reality that Avista's actual returns have fallen systematically short of the allowed ROE; and the financial impact of

an ROE below the minimum level requested by Avista would threaten the Company's ability to maintain an investment grade credit rating;

- Investors are aware of the near-term challenges posed by upward pressure on costs and rising capital expenditures. For Avista, these concerns are magnified by the fact that its credit standing remains on the precipice between investment grade and speculative status;
- Regulatory support, including a reasonable ROE, will be a key driver in securing additional progress towards continued improvement in the Company's financial health. Further strengthening Avista's financial integrity is imperative to ensure that the Company has the capability to maintain an investment grade rating while confronting potential challenges associated with funding infrastructure development necessary to meet the needs of its customers.

II. CAPITAL MARKET CONDITIONS

Q. What is the purpose of this section?

A. This section evaluates the impact of recent capital market trends on Avista's ROE. In addition, I examine the implications of Avista's relatively weak credit standing and discuss why it is critical to support improvement in the Company's finances on an ongoing basis.

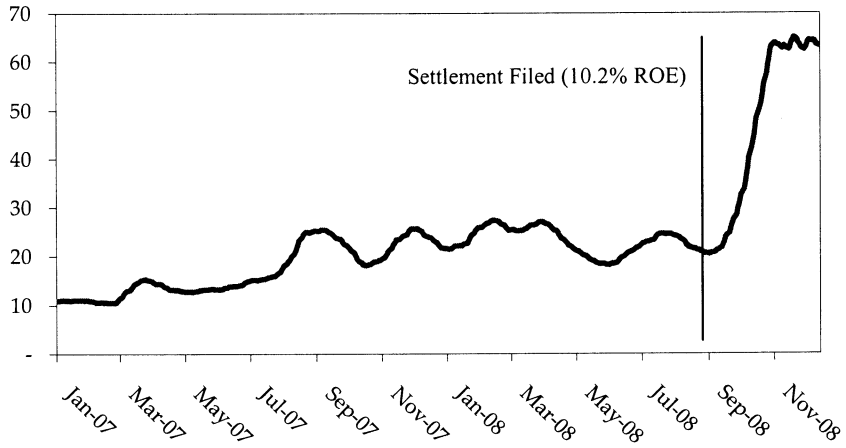
A. Long-term Capital Costs Have Increased

Q. What are the implications of recent capital market conditions?

A. Recent volatility in the debt and equity markets linked to the ongoing financial crisis and the economic downturn evidences investors' trepidation to commit capital and marks a significant upward revision in their perceptions of risk and required returns. The Chicago Board Options Exchange Volatility Index, commonly known as the "VIX", is a key measure of expectations of near-term volatility and market sentiment based on options prices for the S&P 500 Composite Stock Index ("S&P 500"). The unprecedented price fluctuations

and uncertainty that investors have endured since the third-quarter of 2008 is mirrored in the sharp and sustained increase in the VIX, plotted in Figure WEA-1, below:

FIGURE WEA-1
CBOE VIX INDEX – ONE-MONTH MOVING AVERAGE

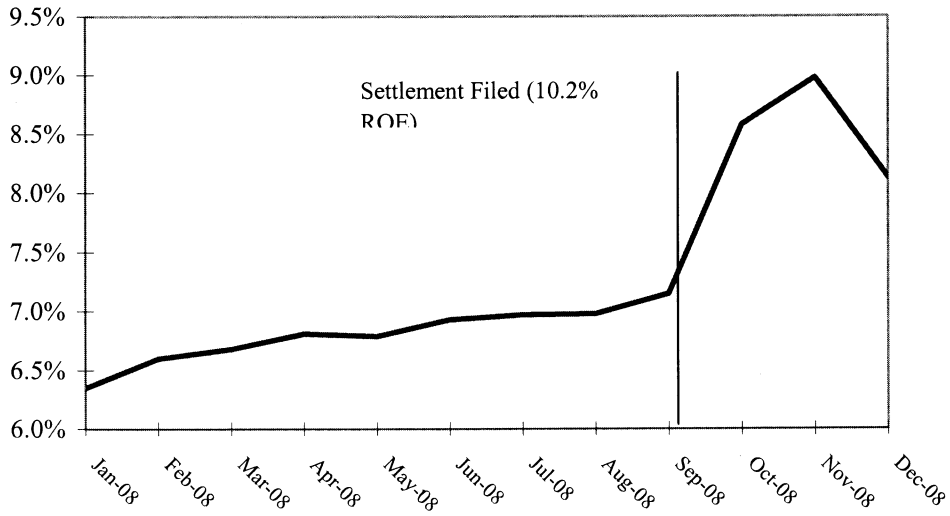


Bloomberg reported in October 2008 that the VIX had surged 26 percent to almost triple its average during the past year.[3]

With respect to utilities specifically, as of year-end 2008, the Dow Jones Utility Average stock index had declined over 28 percent since June 2008, while yields on utility bonds have increased precipitously. Figure WEA-2 below plots the monthly average yields on triple-B utility bonds reported by Moody's Investors Service ("Moody's") from January to December 2008:

[3] Kearns, Jeff, "VIX 'Exploding' as Stocks Plunge on Growing Recession Concern," *Bloomberg* (Oct. 15, 2008).

FIGURE WEA-2
MOODY'S TRIPLE-B PUBLIC UTILITY BOND YIELDS[4]



As illustrated above, from January to August 2008 the average yield on triple-B rated utility bonds increased gradually to approximately 7 percent. Meanwhile, Moody's reported that for the months of October and November 2008 the average yield on triple-B utility bonds had climbed to 8.6 percent and 9.0 percent, respectively. The monthly yield for December 2008 of 8.1 percent is approximately 100 basis points higher than the average in September 2008, when the Settlement in Avista's last Washington rate proceeding was filed. Thus, bondholders are demanding a higher return to hold utility debt.

Q. What does this evidence indicate with respect to establishing a fair ROE for Avista?

A. The dramatic sell-off in common stocks and sharp increase in utility bond yields are indicative of higher costs for long-term capital, and the ongoing credit crisis has

[4] Based on seasoned bonds with maturities of at least 20 years.

spilled over into the utility industry. For example, utilities have been forced to draw on short-term credit lines to meet debt retirement obligations because of uncertainties regarding the availability of long-term capital.[5] As the *Edison Electric Institute* ("EEI") noted in a letter to congressional representatives, the financial crisis has serious implications for utilities and their customers:

> In the wake of the continuing upheaval on Wall Street, capital markets are all but immobilized, and short-term borrowing costs to utilities have already increased substantially. If the financial crisis is not resolved quickly, financial pressures on utilities will intensify sharply, resulting in higher costs to our customers and, ultimately, could compromise service reliability.[6]

Similarly, an October 1, 2008, *Wall Street Journal* report confirmed that dislocations in credit markets were also impacting the utility sector:

> Disruptions in credit markets are jolting the capital-hungry utility sector, forcing companies to delay new borrowing or come up with different—often more costly—ways of raising cash.[7]

An October 2008 report on the implications of credit market upheaval for utilities noted that, while high-quality companies can still issue debt, "they now have to pay an unusually high risk premium over Treasuries."[8] Similarly, S&P recently concluded:

> Regulated electric issuers continued to access debt markets during the fourth quarter of 2008 at rates in line with the 10-year average of about 8% for five-

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[5] Riddell, Kelly, "Cash-Starved Companies Scrap Dividends, Tap Credit," Pittsburgh Post-Gazette (Oct. 2, 2008).
[6] *Letter to House of Representatives*, Thomas R. Kuhn, President, Edison Electric Institute (Sep. 24, 2008).
[7] Smith, Rebecca, "Corporate News: Utilities' Plans Hit by Credit Markets," *Wall Street Journal* at B4 (Oct. 1, 2008) .
[8] *Rudden's Energy Strategy Report* (Oct. 1, 2008).

> year notes, not the abnormally low interest rate environment of the 2000's which is a distant memory.[9]

Meanwhile, a Managing Director with Fitch Ratings, Ltd. ("Fitch") observed that with debt costs at present levels, "significantly higher regulated returns will be required to attract equity capital."[10] As Fitch concluded:

> The collapse in secondary market debt pricing and in equity valuations is worrisome. We see new debt now priced at around 9% or higher pushing up against average authorized ROEs for utilities of around 10.25% to 10.50%. Thus, raising new equity, which is now priced close to book value, is likely to be dilutive.[11]

More recently, Fitch confirmed "sharp repricing of and aversion to risk in the investment community," and noted that the disruptions in financial markets and the fundamental shift in investors' risk perceptions has increased the cost of capital for utilities such as Avista:

> The broad credit markets are in shambles and access to credit is restrictive, particularly at lower credit ratings. While credit is available to investment-grade issuers in the utilities, power and gas sectors, it is more expensive, particularly when viewed against the easy money environment which prevailed for most of this decade.[12]

Fitch concluded, "The sharp increase in the cost of equity capital is a negative credit development."[13]

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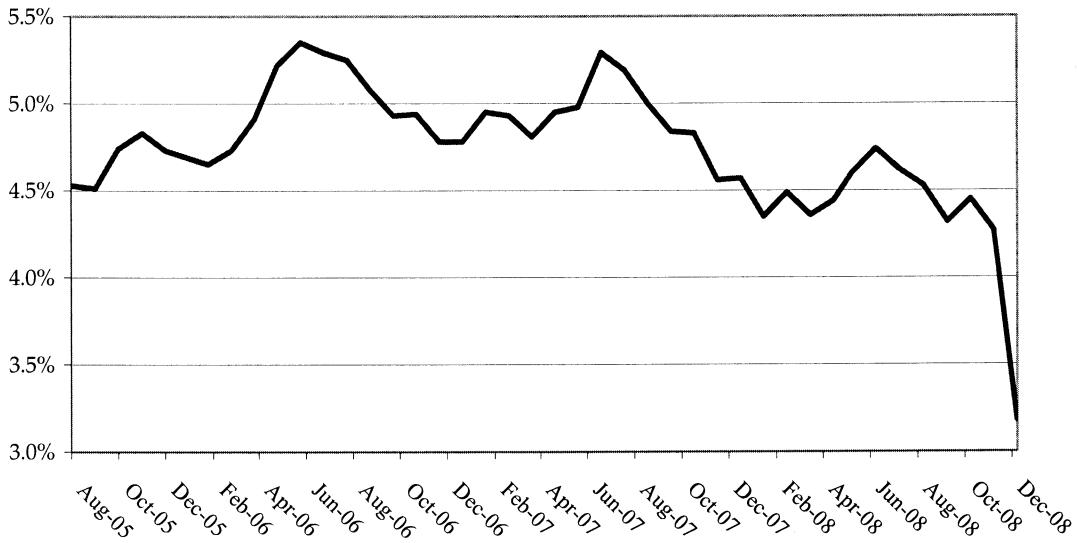
[9] Standard & Poor's Corporation, "Industry Report Card: U.S. Electric Utility Credit Quality Remains Strong Amid Continuing Economic Downturn," *RatingsDirect* (Dec. 19, 2008).
[10] Fitch Ratings Ltd., "EEI 2008 Wrap-Up: Cost of Capital Rising," *Global Power North America Special Report* (Nov. 17, 2008).
[11] Fitch Ratings Ltd., "Investing In An Unpredictable World," *Fitch Ratings' 20th Annual Global Power Breakfast* (Nov. 10, 2008).
[12] Fitch Ratings Ltd., "U.S. Utilities, Power and Gas 2009 Outlook," *Global Power North America Special Report* (Dec. 22. 2008).
[13] *Id.*

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

A. No. Figure WEA-3, below, plots the yields on 20-year Treasury bonds from 2006 through December 2008:

FIGURE WEA-3
20-YEAR TREASURY BOND YIELDS

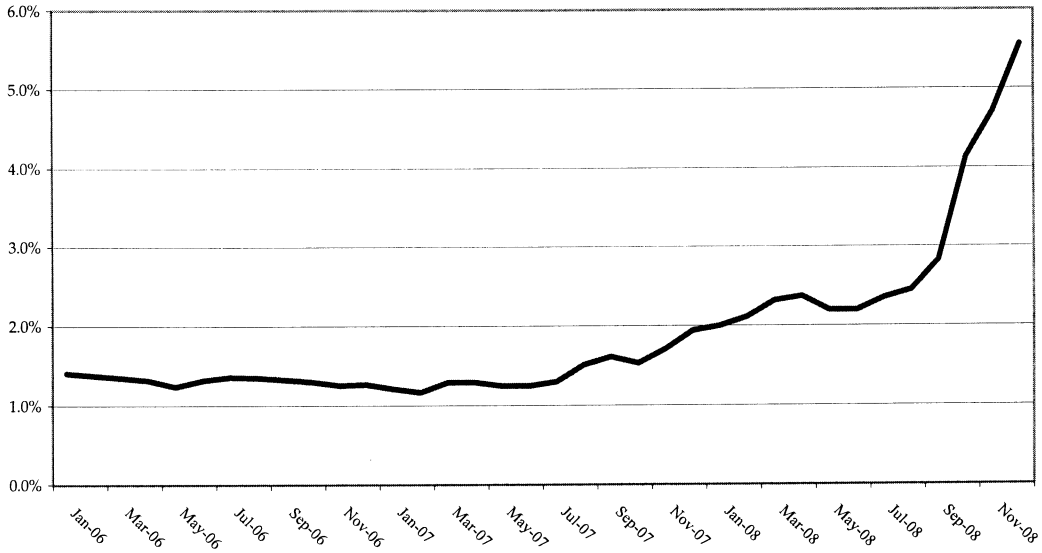


As shown above, beginning in the third quarter of 2007, the yields on 20-year Treasury bonds began a general decline. In response to accelerating concerns over economic uncertainties and the Federal Reserve's actions to increase liquidity in the face of a profound crisis in credit markets, the fall in Treasury bond yields has become increasingly pronounced, with daily yields on 20-year bonds falling below 3 percent in December 2008. Meanwhile, the price of 3-month Treasury bills rose high enough to push rates into the negative for the first time in history.[14]

[14] Kruger, Daniel and Cordell Eddings, "Treasury Bills Trade at Negative Rates as Haven Demand Surges," www.bloomberg.com (Dec. 9, 2008).

While the yields on Treasury securities have fallen significantly, the required returns for common stocks and public utility bonds have moved sharply higher to compensate for increased perceptions of risk. This "flight to quality" has caused the spread between the observable yields on triple-B rated utility bonds and 20-year Treasury bonds to spike dramatically. Figure WEA-4, below, plots the monthly spread between triple-B public utility bond yields and 20-year Treasury bond yields since January 2006:

FIGURE WEA-4
YIELD SPREAD – BBB UTILITY VERSUS 20-YR. TREASURY BONDS



As illustrated above, the gap between the yields on 20-year government bonds and triple-B utility bonds has widened as the extent of the challenges facing the financial system and economy became increasingly clear to investors. During 2007, this yield spread averaged 142 basis points, versus 293 basis point in 2008, and 556 basis points in December 2008. As Standard & Poor's recently observed:

> The Standard & Poor's composite spreads widened to new five-year highs yesterday, leaving the investment-grade spread at 554 basis points (bps) and the speculative grade spread at 1,598 bps, both well more than triple their five-year moving averages. … With speculative-grade defaults on the rise, a higher

preponderance of credit downgrades, and a general malaise about the future of the economy, we expect spreads to remain at their elevated levels for some time until confidence is restored to the market.[15]

Q. What does this imply with respect to the ROE for a utility such as Avista?

A. Because of the dramatic increase in the spreads between public utility and government bond yields, trends in Treasury bond yields have virtually no relevance in evaluating long-term capital costs for Avista.

As a result of the turmoil and uncertainty spreading through financial markets, investors have sought a safe haven in government-backed securities, such as Treasury bonds. While the required returns for other asset classes, such as common stocks and public utility bonds, have moved sharply higher to compensate for increased perceptions of risk, the yields on Treasury securities have fallen significantly. As evidenced above, the spread between the observable yields on utility bonds and Treasury securities has spiked dramatically as a result.

In other words, while focusing solely on the decrease in Treasury bond yields experienced since 2007 would suggest that investors' required returns might have fallen, the exact opposite is true. Treasury bond yields have declined because of a "flight to quality" as investors' risk perceptions have mounted in the face of the ongoing financial crisis. As the Wall Street Journal noted, "Real-world borrowing costs are in a different universe from Treasury yields and Fed rates."[16] The fact that the prices of Treasury bonds have been driven

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[15] Standard & Poor's Corporation, "Credit Trends: U.S. Composite Credit Spreads Daily (Dec. 2, 2008)," *RatingsDirect* (Dec. 2, 2008).

[16] Gongloff, Mark, "Ahead of the Tape: The Shocks Are Getting A Workout," *The Wall Street Journal* at C1 (Sep. 17, 2008) (emphasis added).

sharply higher is the mirror image of higher, not lower returns for more risky asset classes, such as the common stock of utilities like Avista.

Q. Would expectations of an economic recession lead to 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. This has been vividly demonstrated in numerous segments of the debt markets where heightened uncertainties regarding risk exposure has resulted in the almost complete inability of borrowers to access credit at reasonable rates.

It is important not to confuse investors' expectations for future growth and cash flows, which is one consideration in estimating the cost of equity, 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 would accompany an economic slowdown is demonstrated in the bond markets, where perceptions of greater risks have pushed yields on long-term utility bonds sharply higher.

Similarly, the uncertainty over future trends in corporate earnings and stock prices has led investors to sharply reevaluate what they are willing to pay for common stocks. While the precipitous 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 equity, has moved significantly higher to accommodate the greater risks they now associate with equity investments.

The idea that the current recession would lead the rate of return demanded by equity investors to decline is also contrary to economic logic. As documented above, the required yield on long-term utility bonds has increased substantially in response to investors' heightened risk perceptions. A drop in the cost of common equity would imply that the risk premium between common stocks and bonds has declined. The notion that equity risk premiums would be declining at a time of unprecedented capital market turmoil runs counter to common sense. Investors require a higher rate of return to assume more risk and common stocks have the lowest priority claim on a company's cash flows. Given the significant increase in triple-B utility bond yields documented earlier, the dramatic widening of the yield spreads between risk-free Treasury bonds and corporate debt instruments, and investors heightened sensitivity to risk, there is no evidence to suggest that the return demanded by equity investors has declined.

Q. Is there any basis to ignore current capital market conditions in establishing a fair ROE for Avista?

A. Absolutely not. As noted earlier, the standards underlying a fair rate of return require that Avista's authorized ROE reflect a return competitive with other investments of comparable risk and preserve the Company's ability to maintain access to capital on reasonable terms. This standard can only be met by considering the requirements of investors in today's capital markets.

The events of the last several months undoubtedly mark a significant transition in investors' expectations and there is very little indication that the dire conditions confronting the economy and financial markets will be resolved quickly. As Fitch recently concluded,

"higher corporate interest rates are likely to prevail through 2009 and into the foreseeable future."[17] Moreover, the fact that market volatility may complicate the evaluation of the cost of equity provides no basis to ignore the upward shift in investors' risk perceptions and required rates of return for long-term capital.

B. Support For Avista's Credit Standing

Q. What credit ratings have been assigned to Avista?

A. On February 7, 2008, S&P raised the Company's corporate credit rating from "BB+" to "BBB-", while Moody's Investors Service ("Moody's") upgraded Avista's issuer credit rating from "Ba1" to "Baa3" in December 2007.[18] Fitch Ratings, Ltd. ("Fitch") upgraded its issuer default rating for Avista one notch to "BB+" in 2007, and has since assigned the Company a "Positive Outlook", indicating the potential for higher ratings going forward.[19] The ratings assigned by S&P and Moody's represent the lowest rung on the ladder of the investment grade scale, with Fitch continuing to maintain a speculative grade, or "junk" credit rating.

Q. How have investors' risk perceptions for firms involved in the utility industry evolved?

A. The past decade witnessed steady erosion in credit quality throughout the utility industry, both as a result of revised perceptions of the risks in the industry and the

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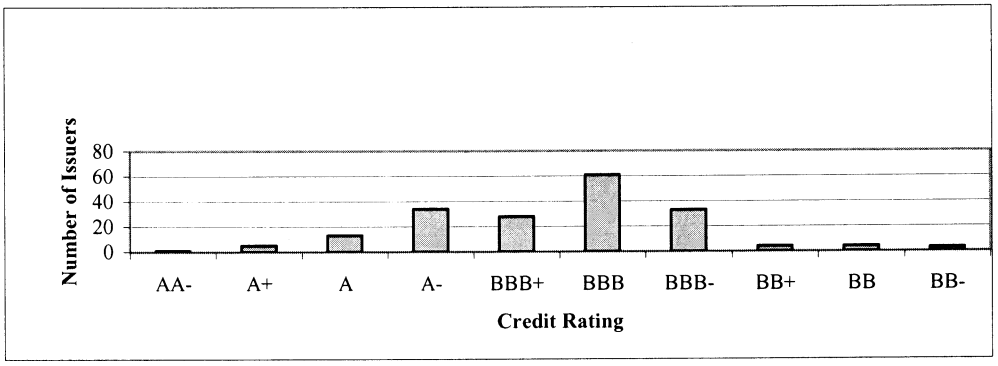
[17] Grabelsky, Glen, "Surviving the Present, Preparing for the Future," *Fitch Ratings' 20th Annual Global Power Breakfast* (Nov. 10, 2008).
[18] Moody's Investors Service, "Credit Opinion: Avista Corp.," *Global Credit Research* (Dec. 21, 2007).
[19] Fitch Ratings, Ltd, "Fitch Upgrades Avista Corp.'s IDR to 'BB+' from 'BB'; Outlook Positive," *Press Release* (Aug. 9, 2007).

weakened finances of the utilities themselves. As illustrated in Figure WEA-5, below, S&P reports that the majority of the companies in the utility sector now fall in the "BBB" rating category:[20]

FIGURE WEA-5
S&P'S DISTRIBUTION OF CREDIT RATINGS OF
U.S. REGULATED ELECTRIC UTILITIES



Fitch recently concluded that the short- and long-term outlook for investor-owned electric utilities is negative.[21] Similarly, Moody's observed, "Material negative bias appears to be developing over the intermediate and longer term due to rapidly rising business and operating risks."[22]

Q. How does Avista's relative credit standing compare with others in the utility industry?

A. Avista's senior debt ratings from S&P and Moody's remain at the very bottom of the investment grade scale, with the "BB+" rating assigned by Fitch falling in the

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[20] Standard & Poor's Corporation, "Issuer Ranking: U.S. Regulated Electric Utilities, Strongest To Weakest," *RatingsDirect* (Jan. 8, 2009.

[21] Fitch Ratings, Ltd., "U.S. Utilities, Power and Gas 2009 Outlook," *Global Power North America Special Report* (Dec. 22, 2008).

[22] Moody's Investors Service, "U.S. Electric Utility Sector," *Industry Outlook* (Jan. 2008).

speculative grade category. In a recent report by S&P ranking U.S. regulated utilities from strongest to weakest, Avista was ranked 159 out of the total 175 companies with investment grade credit ratings.[23] In other words, only 16 companies in the utility industry with investment grade ratings have a credit profile weaker than Avista's. Meanwhile, in a ranking of electric and gas utility parent companies, Fitch placed Avista at 44th position out of 48 companies.[24]

Q. What are the implications of Avista's relative credit standing, given the current climate in the capital markets?

A. As documented earlier and in the testimony of Mr. Mark Thies, the current environment poses significant challenges with respect to a utility's ability to raise capital on reasonable terms. For Avista, these concerns are magnified by the fact that its credit standing remains relatively weak. The Company's efforts to regain investment grade credit ratings have been successful, but Avista's finances remain pressured.

Fitch recently observed that in current credit markets, "'flight to quality' is selective within the [utility] sector, favoring companies at higher rating levels."[25] Because Avista's ratings are at the very bottom of the investment grade barrel, there is no backstop in the event of a prolonged and/or worsening crisis and reduced flexibility to respond to other challenges, such as a continuation of poor hydro conditions or increased capital outlays.

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[23] Standard & Poor's Corporation, "Issuer Ranking: U.S. Regulated Electric Utilities, Strongest To Weakest," *RatingsDirect* (Jan. 8, 2009).
[24] Fitch Ratings Ltd., "U.S. Utilities, Power and Gas 2009 Outlook," *Global Power North America Special Report* (Dec. 22, 2008).
[25] *Id.*

As Mr. Thies confirms in his testimony, regulatory support will be a key driver in securing additional progress towards restoring the Company's financial health. Further strengthening Avista's financial integrity and continued progress in raising the Company's credit standing is imperative to ensure the capability to maintain an investment grade rating while confronting potential challenges.

Moreover, the negative impact of declining credit quality on a utility's capital costs and financial flexibility becomes more pronounced as debt ratings move down the scale from investment to non-investment grade. Fitch recently noted the penalty associated with speculative grade ratings:

> The incentives for companies to attain investment grade ratings are significant. As of June 20, 2008, the Bloomberg US 10-year 'BB'-rated Corporate Bond Composite Index (BB Index) was trading at a yield of 8.75%, representing a spread of approximately 452 basis points over US Treasuries. The Bloomberg 10-year 'BBB'-rated Corporate Bond Composite Index (BBB Index) was trading at a yield of 6.56%, a spread of 233 basis points over US Treasuries. The yield and spread differential of 219 basis points between the BBB Index and the BB Index underscores the considerably lower cost of capital incurred by investment grade companies relative to speculative grade companies in the public debt markets at present. In addition to a lower cost of capital, investment grade companies also typically enjoy significantly fewer covenant constraints in bond indentures and loan agreements as well as less security in the form of collateral than their speculative grade counterparts[26]

Since that time, speculative grade yields spreads have increased dramatically. As noted earlier, S&P reported that the premium paid on speculative debt issues was now more than triple the five-year moving average and exceeded 1,500 basis points. This assessment of widening yield spreads for utilities was recently confirmed by Fitch:

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[26] Fitch Ratings Ltd., "Borderline Credits – Part II," *Leveraged Finance US Special Report* (June 24, 2008).

> Several investment-grade issuers, mostly 'BBB' to 'A' rated operating companies, have issued senior unsecured debt with financing costs clustered in a range approximating 250 to 450 basis points above the 5% to 6% range of just 12 months ago, and spreads have widened 700–1000 basis points for speculative-grade companies.[27]

As the Chairman of the New York State Public Service Commission recently noted in his role as spokesman for the National Association of Regulatory Utility Commissioners:

> While there is a large difference between A and BBB, there is an even brighter line between Investment Grade (BBB-/Baa3 bond ratings by S&P/Moody's, and higher) and non-Investment Grade (Junk) (BB+/Ba1 and lower). The cost of issuing non-investment grade debt, assuming the market is receptive to it, has in some cases been hundreds of basis points over the yield on investment grade securities. To me this suggests that you do not want to be rated at the lower end of the BBB range because an unexpected shock could move you outside the investment grade range.[28]

With Avista's credit ratings poised on the precipice between investment grade and junk bond status, the stakes associated with an inadequate rate of return are increased dramatically. In turn, the need for supportive regulation and an adequate ROE may never have been greater.

Q. What are the implications of disregarding actual capital market conditions in setting the allowed rate of return on equity?

A. If the increase in investors' required rate of return on long-term capital is not incorporated in the allowed rate of return on equity, 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

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[27] Fitch Ratings Ltd., "U.S. Utilities, Power and Gas 2009 Outlook," *Global Power North America Special Report* (Dec. 22, 2008).

[28] Brown, George, "Credit and Capital Issues Affecting the Electric Power Industry," *Federal Energy Regulatory Commission Technical Conference* (Jan. 13, 2009).

return commensurate with Avista's risks will only serve to further weaken its financial integrity, while hampering the Company's ability to attract the capital needed under reasonable terms to meet the economic and reliability needs of its service area.

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

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

– companies have to buy more power than under normal conditions, paying higher prices.[29]

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 concluded that Avista's "key utility risk going forward is its exposure to high-cost replacement power, particularly in low water years,"[30] and concluded that Avista, along with Idaho Power Company, "face the most substantial risks despite their PCAs and cost-update mechanisms."[31] In fact, S&P went on to note that Avista's recovery mechanism ("ERM") is not as strong as Idaho Power's for a number of reasons, most notably because of the "deadband" that "in recent years [has] resulted in [Avista] absorbing the majority of its cost undercollections."[32] Similarly, Fitch concluded, "The potential negative cash flow impact from a prolonged period of below normal hydro conditions and high natural gas prices are primary sources of concern" for Avista's investors.[33]

Additionally, Avista has become increasingly reliant on natural gas fired generating capacity to meet base-load needs. Given the significant price fluctuations experienced in

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[29] Standard & Poor's Corporation, "Pacific Northwest Hydrology And Its Impact On Investor-Owned Utilities' Credit Quality," *RatingsDirect* (Jan. 28, 2008).
[30] Standard & Poor's Corporation, "Avista Corp.'s Corporate Credit Rating Raised One Notch To 'BBB-'," *RatingsDirect* (Feb. 7, 2008).
[31] Standard & Poor's Corporation, "Pacific Northwest Hydrology And Its Impact On Investor-Owned Utilities' Credit Quality," *RatingsDirect* (Jan. 28, 2008).
[32] *Id.*
[33] Fitch Ratings, Ltd., "Fitch Affirms Avista Corp.'s IDR at 'BB+'; Outlook Positive," *Press Release* (Feb. 6, 2008).

energy markets discussed subsequently, increasing reliance on natural gas heightens Avista's exposure to fuel cost volatility.

Q. Does Avista anticipate the need to access the capital markets going forward?

A. Most definitely. 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. As discussed by Company witness Mr. Thies, planned capital expenditures for 2009-2010 total approximately $420 million for Avista's electric utility operations alone. This represents a substantial investment given Avista's ratebase was $1.9 billion as of November 30, 2008.

Continued support for Avista's financial integrity and flexibility will be instrumental in attracting the capital necessary to fund these projects in an effective manner. 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, as well as fund required investments in the utility system.

Q. Is the potential for energy market volatility an ongoing concern for investors?

A. Yes. Investors recognize that the prospect of further turmoil in energy markets is an ongoing concern. S&P has reported continued spikes in wholesale energy market

prices,[34] with Moody's warning investors of ongoing exposure to "extremely volatile" energy commodity costs, including purchased power prices, which are heavily influenced by fuel costs.[35] Similarly, the FERC Staff has continued to recognize the ongoing potential for market disruption, with a 2008 market assessment report noting ongoing concerns regarding tight supply and congestion.[36] FERC continues to warn of load pockets vulnerable to periods of high peak demand and unplanned outages of generation or transmission capacity and ongoing reliability concerns that led FERC to establish mandatory standards for the bulk power system.[37]

In recent years utilities and their customers have also had to contend with dramatic fluctuations in gas costs due to ongoing price volatility in the spot markets. S&P concluded that "natural gas prices have proven to be very volatile" and warned of a "turbulent journey" due to the uncertainty associated with future fluctuations in energy costs.[38] Fitch has also highlighted the challenges that fluctuations in commodity prices can have for utilities and recently noted that:

> From their September 2007 low of $5.29, spot natural gas prices as reported at Henry Hub rose 150% to $13.31 in early July 2008 and declined 57% to $5.68 per million British thermal unit (mmBtu) on Dec. 10, 2008. The sharp run-up and subsequent collapse of natural gas prices in 2008 is emblematic of the

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[34] Standard & Poor's Corporation, "Fuel and Purchased Power Cost Recovery in the Wake of Volatile Gas and Power Markets – U.S. Electric Utilities to Watch" *RatingsDirect* (Mar. 22, 2006).
[35] Moody's Investors Service, "Storm Clouds Gathering on the Horizon for the North American Electric Utility Sector," *Special Comment* at 6 (Aug. 2007).
[36] FERC, Office of Market Oversight and Investigations, "2008 Summer Market and Reliability Assessment," (May 15, 2008).
[37] *See Open Commission Meeting Statement of Chairman Joseph T. Kelliher,* Item E-13: Mandatory Reliability Standards for the Bulk-Power System (Docket No. RM06-16-000) (Mar. 15, 2007).
[38] Standard & Poor's Corporation, "Top Ten Credit Issues Facing U.S. Utilities," *RatingsDirect* (Jan. 29, 2007).

extreme price volatility that characterizes the commodity and is likely to persist in the future.[39]

Q. What other financial pressures impact investors' risk assessment of Avista?

A. Investors are aware of the financial and regulatory pressures faced by utilities associated with rising costs and the need to undertake significant capital investments. As Moody's observed:

> [P]ressures are building. Utilities are facing rising operating costs and infrastructure investment needs that are prompting them to seek more-frequent requests for rate relief. Meanwhile, as energy (and other commodity) costs rise, so does the risk of a consumer backlash over electric rates that could prompt legislative intervention or a more contentious atmosphere between utilities and their regulators.[40]

Similarly, S&P noted that "heavy construction programs", along with rising operating and maintenance costs and volatile fuel costs, were a significant challenge to the utility industry.[41] Fitch recently echoed this assessment, concluding:

> Continued access to capital at reasonable rates in 2009 remains uncertain at a time when many utility holding groups have historically high capital investment programs and will require ongoing access to reasonably priced capital in order to fund new investment and refinance maturing debt.[42]

While providing the infrastructure necessary to meet the energy needs of customers is certainly desirable, it imposes additional financial responsibilities on Avista. As noted earlier,

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[39] Fitch Ratings, Ltd., "U.S. Utilities, Power and Gas 2009 Outlook," *Global Power North American Special Report* (Dec. 22, 2008).
[40] Moody's Investors Service, "U.S. Investor-Owned Electric Utilities: Six-Month Industry Update," *Industry Outlook* (July 2008).
[41] Standard & Poor's Corporation, "Ratings Roundup: Utility Sector Experienced Equal Number Of Upgrades And Downgrades During Second Quarter Of 2008," *RatingsDirect* (Jul. 22, 2008).
[42] Fitch Ratings Ltd., "U.S. Utilities, Power and Gas 2009 Outlook," *Global Power North America Special Report* (Dec. 22, 2008).

the Company's plans include electric utility capital expenditures of approximately $420 million just over the 2009-2010 period. S&P recently noted the pressures associated with financing Avista's infrastructure investment, concluding:

> For a utility of its size, Avista has a large capital program and will need to rely on external financing at a time when credit markets continue to be in turmoil.[43]

Investors are aware of the challenges posed by rising costs and burdensome capital expenditure requirements, especially in light of Avista's relatively weak credit standing and the ongoing capital market turmoil.

Q. What other considerations affect investors' evaluation of Avista?

A. Avista and other utilities are confronting increased environmental pressures that could impose significant uncertainties and costs. In 2007 S&P cited environmental mandates, including emissions, conservation, and renewable resources as one of the top ten credit issues facing U.S. utilities.[44] Similarly, Moody's noted that "the prospect for new environmental emission legislation, via federal or state carbon emission rules, represents the single-biggest emerging issue on the horizon",[45] while Fitch recently observed that:

> Profound changes in energy policies and environmental regulations are likely to result from the upcoming change of presidential administration, changes in Democratic leadership in the House of Representatives, and a wide Democratic legislative majority. Accelerating support for carbon emissions reductions to combat global climate change is expected to result in enactment

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[43] Standard & Poor's Corporation, "Avista Corp.'s $200 Million, 364-Day Credit Facility Addresses Liquidity Constraints," *RatingsDirect* (Dec. 1, 2008).
[44] Standard & Poor's Corporation, "Top Ten Credit Issues Facing U.S. Utilities," *RatingsDirect* (Jan. 29, 2007).
[45] Moody's Investors Service, "U.S. Investor-Owned Electric Utilities," *Industry Outlook* (July 2008).

of carbon legislation to dramatically reduce emissions late next year or in 2010, but the structure, timing and implementation is still uncertain.[46]

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. With a market capitalization of approximately $1.0 billion, Avista is one of the smallest publicly traded electric utilities followed by Value Line, which have an average capitalization of approximately $6.3 billion.[47]

The magnitude of the size disparity between Avista and other firms in the utility industry has important practical implications with respect to the risks faced by investors. All else being equal, it is well accepted that smaller firms are more risky than their larger counterparts, due in part to their relative lack of diversification and lower financial resiliency.[48] 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.[49] Common sense and accepted financial doctrine hold that investors require higher returns from smaller companies, and unless that compensation is provided in the rate of

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[46] Fitch Ratings, Ltd., "U.S. Utilities, Power and Gas 2009 Outlook," *Global Power North America Special Report* (Dec. 22, 2008).

[47] www.valueline.com (Retrieved Dec. 29, 2008).

[48] 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", *The 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).

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

return allowed for a utility, the legal tests embodied in the *Hope* and *Bluefield* cases cannot be met.

B. 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, or 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 his 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, if any, 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 pro-forma common equity ratio used to compute Avista's overall rate of return was 47.5 percent in this filing.

Q. What was the average capitalization maintained by the utility proxy group?

A. As shown on Exhibit No.___(WEA-4), for the 17 firms in the utility proxy group, common equity ratios at December 31, 2007 ranged between 34.4 percent and 56.7 percent and averaged 45.3 percent.

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

A. As shown on Exhibit No.___(WEA-4), The Value Line Investment Survey ("Value Line") expects an average common equity ratio for the proxy group of utilities of 50.1 percent for its three-to-five year forecast horizon, with the individual common equity ratios ranging from 41.0 percent to 63.6 percent.[50] 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."[51]

Q. How does Avista's common equity ratio compare with those maintained by the reference group of utilities?

A. The 47.5 percent common equity ratio requested by Avista is entirely consistent with the range of equity ratios maintained by the firms in the Utility Proxy Group

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[50] Because Value Line does not include short-term debt in its capital structure ratios, these projections were adjusted to include the same proportion of short-term debt outstanding at year-end 2007.
[51] *Order No. 06*, Docket Nos. UG-040640 and UE-040641 (consolidated) (Feb. 18, 2005) at P. 32.

and is in-line with the 45.3 percent and 50.1 percent average equity ratios at year-end 2007 and based on Value Line's near-term expectations, respectively.

Q. What implication does the increasing risk of the utility industry have for the capital structures maintained by utilities?

A. As discussed earlier, the average credit rating associated with firms in the electric industry has fallen to triple-B, with Avista's "BBB-" rating occupying the lowest rung on the ladder of the investment grade scale. At the same time, electric utilities are facing, among other things, rising cost structures, the need to finance significant capital investment plans, and uncertainties over accommodating future environmental mandates. 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 that is required to fund operations and necessary system investment, even during times of adverse capital market conditions.

Moody's has warned investors of the risks associated with debt leverage and fixed obligations and advised utilities not to squander the opportunity to strengthen the balance sheet as a buffer against future uncertainties.[52] Moody's noted that, absent a thicker equity layer, utilities would be faced with lower credit ratings in the face of rising business and operating risks:

> There are significant negative trends developing over the longer-term horizon. This developing negative concern primarily relates to our view that the sector's overall business and operating risks are rising – at an increasingly fast

[52] Moody's Investors Service, "Storm Clouds Gathering on the Horizon for the North American Electric Utility Sector," *Special Comment* (Aug. 2007).

> pace – but that the overall financial profile remains relatively steady. A rising risk profile accompanied by a relatively stable balance sheet profile would ultimately result in credit quality deterioration.[53]

This is especially the case for Avista, which faces the dual challenge of financing significant capital expansion plans in a turbulent market while at the same time endeavoring to improve its credit standing.

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. Because power purchase agreements ("PPAs") and leases typically obligate the utility to make specified minimum contractual payments akin to those associated with traditional debt financing, 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. In order to offset the debt equivalent associated with off-balance sheet obligations, the utility must rebalance its capital structure by increasing its common equity in order to restore its effective capitalization ratios to previous levels.[54] These commitments have been repeatedly cited by major bond rating agencies in connection with assessments of utility financial risks. For example, in explaining its evaluation of the

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[53] Moody's Investors Service, "U.S. Electric Utility Sector," *Industry Outlook* (Jan. 2008).

[54] The capital structure ratios presented earlier do not include imputed debt associated with power purchase agreements or the impact of other off-balance sheet obligations.

credit implications of PPAs, S&P affirmed its position that such agreements give rise to "debt equivalents" and that the increased financial risk must be considered in evaluating a utility's credit risks.[55] S&P also noted that it has refined its methodology to include imputed debt associated with shorter-term PPAs and operating leases.[56]

As discussed earlier, a significant portion of the Company's power requirements are currently obtained through purchased power contracts. These contractual payment obligations, along with operating leases and obligations associated with postretirement benefits, are fixed commitments with debt-like characteristics and are properly considered when evaluating the financial risks implied by Avista's capital structure. S&P reported that it adjusts Avista's capitalization to include approximately $123 million in imputed debt from PPAs, leases, and postretirement benefit obligations.[57] Unless the Company takes action to offset this additional financial risk by maintaining a higher equity ratio, the resulting leverage will weaken Avista's creditworthiness, implying a higher required rate of return to compensate investors for the greater risks.[58]

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[55] Standard & Poor's Corporation, "Standard & Poor's Methodology For Imputing Debt For U.S. Utilities' Power Purchase Agreements," *RatingsDirect* (May 7, 2007).
[56] Standard & Poor's Corporation, "Implications Of Operating Leases On Analysis Of U.S. Electric Utilities," *RatingsDirect* (Jan. 15, 2008).
[57] Standard & Poor's Corporation, "Avista Corp.," *RatingsDirect* (Aug. 29, 2008).
[58] Apart from the immediate impact that the fixed obligation of purchased power costs has on the utility's financial risk, higher fixed charges also reduce ongoing financial flexibility, and the utility may face other uncertainties, such as potential replacement power costs in the event of supply disruption.

Q. What did you conclude with respect to the Company's capital structure?

A. Based on my evaluation, I concluded 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. Moody's recently concluded that the electric utility sector "is entering a major period of capital-raising needs, and will need to attract a significant amount of new equity capital in order to maintain existing ratings."[59] Moody's also observed that its ratings for Avista anticipate "conservative financing strategies."[60]

Avista's capital structure 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 need for access becomes even more important when the company has capital requirements over a period of years, and financing must be continuously available, even during unfavorable capital market conditions.

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[59] Moody's Investors Service, "U.S. Investor-Owned Electric Utilities: Six-Month Industry Update," *Industry Outlook* (July 2008).
[60] Moody's Investors Service, "Credit Opinion: Avista Corp.," *Global Credit Research* (Dec. 3, 2008).

IV. 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 Exhibit No.___(WEA-3), with the results being summarized below.

A. Overview

Q. What role does the rate of return on common equity play in a utility's rates?

A. The return on common equity is the cost of inducing and retaining investment in the utility's physical plant and assets. This investment is necessary to finance the asset base needed to provide utility service. Investors will commit money to a particular investment only if they expect it to produce a return commensurate with those from other investments with comparable risks. Moreover, the return on common equity is integral in achieving the sound regulatory objectives of rates that are sufficient to: 1) fairly compensate capital investment in the utility, 2) enable the utility to offer a return adequate to attract new capital on reasonable terms, and 3) maintain the utility's financial integrity. Meeting these objectives allows the utility to fulfill its obligation to provide reliable service while meeting the needs of customers through necessary system expansion.

Q. Did 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. For example, a publication of the Society of Utility and Financial Analysts (formerly the National Society of Rate of Return Analysts), concluded that:

> Each model requires the exercise of judgment as to the reasonableness of the underlying assumptions of the methodology and on the reasonableness of the proxies used to validate the theory. Each model has its own way of examining investor behavior, its own premises, and its own set of simplifications of reality. Each method proceeds from different fundamental premises, most of which cannot be validated empirically. Investors clearly do not subscribe to any singular method, nor does the stock price reflect the application of any one single method by investors.[61]

Therefore, I used both the DCF and CAPM methods to estimate the cost of equity. In addition, I also evaluated a fair ROE return 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.

Q. What was your conclusion regarding a fair rate of return on equity for the proxy companies?

A. Based on the results of my quantitative analyses, and my assessment of the relative strengths and weaknesses inherent in each method, I concluded that the cost of equity for the proxy companies is in the 11.3 percent to 13.3 percent range.

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[61] Parcell, David C., "The Cost of Capital – A Practitioner's Guide," *Society of Utility and Regulatory Financial Analysts* (1997) at Part 2, p. 4.

B. Results of Quantitative Analyses

Q. How did you define the comparable risk proxy groups you used to implement the DCF model?

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 Exhibit No.___(WEA-3), I applied the DCF model to a utility proxy group composed of those dividend-paying companies included by Value Line in its Electric Utilities Industry groups with: (1) S&P corporate credit ratings of "BBB-" or "BBB," (2) a Value Line Safety Rank of "2" or "3", and (3) a Value Line Financial Strength Rating of "B+" to "B++". I excluded three firms that otherwise would have been in the proxy group, but are not appropriate for inclusion because they either do not pay common dividends or were in the process of being acquired.

Under the regulatory standards established by *Hope* and *Bluefield*, the salient criteria in establishing a meaningful benchmark to evaluate a fair rate of return is relative risk, not the particular business activity or degree of regulation. Consistent with this accepted regulatory standard, I also applied the DCF model to a reference group of comparable risk companies in the non-utility sector of the economy. My non-utility proxy group was composed of those U.S. companies followed by Value Line that 1) pay common dividends, 2) have a Safety

Rank of "1", 3) have a Financial Strength Rating of "A" or above, and 4) have investment grade bond ratings.[62]

Q. How do the overall risks of your proxy groups compare with Avista?

A. As shown below, Table 1 compares the non-utility proxy group with the utility proxy group and Avista across four key indicators of investment risk:

TABLE 1
COMPARISON OF RISK INDICATORS

	S&P	Value Line		
	Credit Rating	Safety Rank	Financial Strength	Beta
Non-Utility Group	A+	1	A+	0.84
Utility Proxy Group	BBB	3	B++	0.82
Avista Corp.	BBB-	3	B+	0.85

Considered together, a comparison of these objective measures indicates that the risks investors associate with Avista generally exceed those of the proxy groups. As a result, the cost of equity estimates indicated by my analyses provide a conservative estimate of investors' required rate of return for Avista.

Q. What cost of equity is implied by your DCF results for the utility proxy group?

A. My application of the DCF model, which is discussed in greater detail in Exhibit No.___(WEA-3), considered four alternative measures of expected earnings growth,

[62] In addition, I also included only those firms with at least two published growth estimates from Value Line, IBES, First Call, or Zacks.

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 Exhibit No.___(WEA-5) and summarized below in Table 2, after eliminating illogical low- and high-end values, application of the constant growth DCF model resulted in the following cost of equity estimates:

TABLE 2
DCF RESULTS – UTILITY PROXY GROUP

Growth Rate	Average Cost of Equity
Value Line	13.4%
IBES	12.3%
First Call	11.5%
Zacks	11.8%
br+sv	11.9%

Q. What were the results of your DCF analysis for the non-utility reference group?

A. As shown on Exhibit No.___(WEA-7), I applied the DCF model to the non-utility companies in exactly the same manner described earlier for the utility proxy group. As summarized below in Table 3, after eliminating illogical low- and high-end values, application of the constant growth DCF model resulted in the following cost of equity estimates:

TABLE 3
DCF RESULTS – NON-UTILITY GROUP

Growth Rate	Average Cost of Equity
Value Line	13.1%
IBES	13.4%
First Call	13.2%
Zacks	13.5%
br+sv	13.3%

Q. Do you believe the constant growth DCF model should be relied on exclusively to evaluate a reasonable ROE for Avista?

A. No. As noted earlier, because the cost of equity is unobservable, no single method should be viewed in isolation. Moreover, evidence suggests that reliance on the DCF model as a tool for estimating investors' required rate of return has declined outside the regulatory sphere, with the CAPM being "the dominant model for estimating the cost of equity."[63]

Q. How did 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 applied the CAPM to the utility proxy group based on a forward-looking estimate for investors' required rate of return from common stocks. Because this forward-

[63]See, *e.g.*, Bruner, R.F., Eades, K.M., Harris, R.S., and Higgins, R.C., "Best Practices in Estimating Cost of Capital: Survey and Synthesis," Financial Practice and Education (1998).

looking application of the CAPM looks directly at investors' expectations in the capital markets, it provides a more meaningful guide to the expected rate of return required to implement the CAPM.

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

A. As shown on Exhibit No.___(WEA-9), my forward-looking application of the CAPM model indicated an ROE of approximately 11.2 percent for the utility proxy group. Applying the CAPM approach to the firms in the non-utility proxy group (Exhibit No.___(WEA-10)) implied a cost of equity of 11.5 percent.

Q. What other analyses did you conduct to estimate the cost of equity?

A. As I noted earlier, I also evaluated the cost of equity using the comparable earnings method. Reference to rates of return available from alternative investments of comparable risk can 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. This comparable earnings approach is consistent with the economic underpinnings for a fair rate of return established by the U.S. Supreme Court. Moreover, it avoids the complexities and limitations of capital market methods and instead focuses on the returns earned on book equity, which are readily available to investors.

Q. What rates of return on equity are indicated for utilities based on the comparable earnings approach?

A. Value Line reports that its analysts anticipate an average rate of return on common equity for the electric utility industry of 11.5 percent in 2009 and over its 2011-2013 forecast horizon,[64] with natural gas distribution utilities expected to earn an average rate of return on common equity of 11.5 percent to 12.0 percent.[65] As shown on Exhibit No.___(WEA-11), Value Line's projections for the utility proxy group suggested an average ROE of 11.4 percent after eliminating potential outliers.[66] Based on the results discussed above, I concluded that the comparable earnings approach implies a fair rate of return on equity of at least 11.4 percent.

Q. What did you conclude with respect to the cost of equity implied by your analyses for the proxy groups?

A. The cost of equity estimates implied by my quantitative analyses are summarized in Table 4, below:

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[64] The Value Line Investment Survey at 687 (Dec. 26, 2008). The capital structure corresponding with this expected return reflects an equity ratio of 50 percent.

[65] The Value Line Investment Survey 446 (Dec. 12, 2008). The capital structure corresponding with this expected return reflects an equity ratio of 46 percent.

[66] As highlighted on Exhibit No.___(WEA-11), I eliminated six extreme low- and high-end outliers. While these Value Line projections may accurately reflect expectations for actual earned rates of return on common equity over the forecast horizon, they are unlikely to be representative of investors' required rate of return.

TABLE 4
SUMMARY OF QUANTITATIVE RESULTS

Method	Cost of Equity Estimates: Utility Proxy Group	Cost of Equity Estimates: Non-Utility Proxy Group
DCF	11.5% - 13.4%	13.1% - 13.5%
CAPM	11.2%	11.5%
Comparable Earnings	11.4%	--

Based on the results of my quantitative analyses, and my assessment of the relative strengths and weaknesses inherent in each method, I concluded that the cost of equity is in the 11.3 percent to 13.3 percent range.

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 amount of funds a utility nets 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 logical mechanism.

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

A. There are any number of ways in which a flotation cost adjustment can be calculated, and the adjustment can range from just a few basis points to more than a full percent. One of the most common methods used to account for flotation costs in regulatory proceedings is to apply an average flotation-cost percentage to a utility's dividend yield. Based on a review of the finance literature, *Regulatory Finance: Utilities' Cost of Capital* concluded:

> The flotation cost allowance requires an estimated adjustment to the return on equity of approximately 5% to 10%, depending on the size and risk of the issue.[67]

Alternatively, a study of data from Morgan Stanley regarding issuance costs associated with utility common stock issuances suggests an average flotation cost percentage of 3.6%.[68] Applying these expense percentages to a representative dividend yield for a utility of 5.3 percent implies a flotation cost adjustment on the order of 19 to 50 basis points.

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.[69]

V. RETURN ON EQUITY FOR AVISTA CORP.

Q. What is the purpose of this section?

A. In addition to presenting the conclusions of my evaluation of a fair rate of return on equity range for Avista, this section also discusses the relationship between ROE

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[67] Roger A. Morin, *Regulatory Finance: Utilities' Cost of Capital*, 1994, at 166.
[68] *Application of Yankee Gas Services Company for a Rate Increase*, DPUC Docket No. 04-06-01, Direct Testimony of George J. Eckenroth (Jul. 2, 2004) at Exhibit GJE-11.1. Updating the results presented by Mr. Eckenroth through April 2005 also resulted in an average flotation cost percentage of 3.6%.
[69] *Third Supplemental Order*, WUTC Docket No. UE-991606, et al., p. 95 (September 2000).

and preservation of a utility's financial integrity and the ability to attract capital under reasonable terms on a sustainable basis.

A. Implications for Financial Integrity

Q. Why is it important to allow Avista an adequate return on equity?

A. Given the importance of the utility industry to the economy and society, it is essential to maintain reliable and economical service to all consumers. While Avista remains committed to provide reliable utility service, a utility's ability to fulfill its mandate can be compromised if it lacks the necessary financial wherewithal or is unable to earn a return sufficient to attract capital. Coupled with the ongoing potential for energy market volatility, Avista's exposure to variations in hydroelectric generation and natural gas price volatility, along with plans for significant infrastructure investment, pose a number of potential challenges that might require the relatively swift commitment of significant capital resources in order to maintain the high level of service that customers have come to expect. Investors' increased reticence to supply additional capital during times of crisis highlights the necessity of preserving the flexibility necessary to overcome periods of adverse capital market conditions. These considerations heighten the importance of allowing Avista an adequate return on the fair value of its investment.

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

A. Investors recognize that constructive regulation is a key ingredient in supporting utility credit ratings and financial integrity, particularly during times of adverse conditions. Fitch noted that:

> Regulatory risk remains a recurring theme for this year's outlook, as the pressure of a weak economic backdrop could result in political push-back to rate increase requests.[70]

The report went on to conclude, "Fitch is concerned that the recent rapid escalation in the cost of capital will not be reflected on a timely basis in utility rates."[71]

Moody's has emphasized the need for regulatory support "in an era of broadly rising costs," noting that as cost pressures have escalated for electric utilities, so too has the importance of timely recovery through the regulatory process and the risks associated with regulatory lag.[72] S&P concluded "the quality of regulation is at the forefront of our analysis of utility creditworthiness,"[73] and recently observed that its risk analysis focuses on the utility's ability to consistently earn a reasonable return:

> Notably, the analysis does not revolve around "authorized" returns, but rather on actual earned returns. We note the many examples of utilities with healthy authorized returns that, we believe, have no meaningful expectation of actually earning that return because of rate case lag, expense disallowances, etc.[74]

Similarly, with respect to Avista specifically, the major bond rating agencies have explicitly cited the potential that adverse regulatory rulings could compromise the Company's credit standing. Of particular concern to investors is the impact of regulatory lag and cost-recovery on Avista's ability to earn its authorized ROE and maintain its financial metrics,

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[70] Fitch Ratings Ltd., "U.S. Utilities, Power and Gas 2009 Outlook," *Global Power North America Special Report* (Dec. 22, 2008).
[71] *Id.*
[72] Moody's Investors Service, "Regulatory Pressures Increase For U.S. Electric Utilities," *Special Comment* (March 2007).
[73] Standard & Poor's Corporation, "Assessing U.S. Utility Regulatory Environments," *RatingsDirect* (Nov. 7, 2008).
[74] *Id.*

with Moody's concluding that:

> Failure to obtain adequate and timely support for recovery of and return on core utility investments through pending and expected future regulatory proceedings … could have negative ratings implications.[75]

S&P observed that rate relief will remain critical to Avista's credit outlook,[76] and concluded that "regulatory lag will continue to be a drag on the company's ability to earn its authorized ROE."[77]

For Avista, these concerns are magnified by the fact that its credit standing is poised on the precipice between investment and speculative grade ratings. While the Company's efforts to regain an investment grade credit rating have been successful, Avista's financial metrics remain pressured. As Mr. Thies confirms in his testimony, regulatory support will be a key driver in securing additional improvement in the Company's financial health. Further strengthening Avista's financial integrity is imperative to ensure that the Company has the capability to maintain an investment grade rating while confronting potential challenges.

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

A. Yes. While providing an ROE that is sufficient to maintain Avista's ability to attract capital, even in times of financial and market stress, is consistent with the economic requirements embodied in the U.S. Supreme Court's *Hope* and *Bluefield* decisions, it is also in customers' best interests. Ultimately, it is customers and the service area economy that

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[75] Moody's Investors Service, "Credit Opinion: Avista Corp.," *Global Credit Research* (Dec. 3, 2008).
[76] Standard & Poor's Corporation, "U.S. Electric Utility Credit Quality Remains Strong Amid Continuing Economic Downturn," *RatingsDirect* (Dec. 19, 2008).
[77] Standard & Poor's Corporation, "Avista Corp.'s Corporate Credit Rating Raised One Notch To 'BBB-'," *RatingsDirect* (Feb. 7, 2008).

enjoy the benefits that come from ensuring that the utility has the financial wherewithal to take whatever actions are required to ensure reliable service. By the same token, customers also bear a significant burden when the ability of the utility to attract necessary capital is impaired and service quality is compromised.

B. Return on Equity Recommendation

Q. What then is your conclusion as to a fair rate of return on equity range for Avista?

A. As explained above, based on the capital market oriented analyses for the utility and non-utility proxy groups described in my testimony, I concluded that the fair rate of return on equity range was 11.3 percent to 13.3 percent. Considering capital market expectations, the potential 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 this represents a fair and reasonable ROE range for Avista.

Q. Based on the results of your evaluation, what is your opinion regarding the reasonableness of the ROE requested by Avista in this case?

A. My evaluation indicates that Avista's requested ROE of 11.0 percent represents a conservative estimate of investors' required rate of return. Given the fact that the Company's requested ROE falls below the lower bound of my recommended range, it should be viewed as an absolute floor in establishing rates for Avista. This conclusion is reinforced by the need to buttress the Company's credit standing, which remains relatively weak, as well as the pressures of funding significant capital expenditures and meeting increased operating

risks, including those associated with Avista's reliance on hydroelectric generation and exposure to volatility in natural gas and wholesale power markets. The reasonableness of a minimum 11.0 percent ROE for Avista is also supported by the Company's relatively greater risks as compared with the proxy groups, the higher uncertainties associated with Avista's relatively small size, and the fact that my recommended ROE range does not consider flotation costs.

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

A. Yes.