BEFORE THE WASHINGTON
UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, v. AVISTA CORPORATION d/b/a AVISTA UTILITIES, Respondent.	DOCKETS UE-190334, UG-190335 and UE-190222 (*Consolidated*)

TESTIMONY OF

DAVID C. PARCELL

ON BEHALF OF THE STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

Cost of Capital

October 3, 2019

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I. INTRODUCTION

1

2

3 **Q. Please state your name, and address.**

4 A. My name is David C. Parcell.   My address is 2218 Worchester Rd., Midlothian, VA

5 23113.

6

7 **Q. By whom are you employed and in what capacity?**

8 A. I am a Principal and Senior Economist of Technical Associates, Inc.

9

10 **Q. Please state your qualifications to provide testimony in this proceeding**

11 A. I hold B.A. (1969) and M.A. (1970) degrees in economics from Virginia Polytechnic

12 Institute and State University (Virginia Tech) and a M.B.A. (1985) from Virginia

13 Commonwealth University. I have been a consulting economist with Technical

14 Associates since 1970. I have provided cost of capital testimony in public utility

15 ratemaking proceedings dating back to 1972 and I have previously filed testimony and/or

16 testified in over 575 utility proceedings before about 50 regulatory agencies in the United

17 States and Canada.

18

19 **Q. Have you testified previously before the Commission?**

20 A. Yes.   I have previously filed testimony on behalf of the Staff of the Washington Utilities

21 and Transportation Commission (Commission) in several proceedings involving Cascade

22 Natural Gas, Puget Sound Energy and Pacific Power & Light Company, as well as Avista

1   Corporation d/b/a Avista Utilities ("Avista"). Exh. DCP-2 provides a more complete

2   description of my education and relevant work experience.

3

4 **Q.** **What is the purpose of your testimony in this proceeding?**

5 A. I have been retained by the Commission Staff to evaluate the cost of capital ("COC")

6   aspects of the current electric and natural gas rate cases of Avista. I have performed

7   independent studies and I am making recommendations of the current COC for Avista.

8

9 **Q.** **Have you prepared an exhibit in support of your testimony?**

10 A. Yes. In addition to Exh. DCP-2, identified above, I have prepared Exh. DCP-3 through

11   DCP-17. These exhibits were prepared either by me or under my direction. The

12   information contained in these exhibits is correct to the best of my knowledge and belief.

13

14   **II. RECOMMENDATIONS AND SUMMARY**

15

16 **Q.** **What are your COC recommendations in this proceeding?**

17 A. My overall COC recommendations for Avista are shown on Exh. DCP-3 and can be

18   summarized as follows:

19

Item	Percent	Cost			Weighted Cost		
Short-Term Debt	2.65%	4.36%			0.12%		
Long-Term Debt	48.85%	5.19%			2.54%		
Common Equity	48.50%	9.1%	9.3%	9.5%	4.41%	4.51%	4.61%
Total	100.0%				7.06%		7.24%
						7.16%	

23

1   Avista's application requests a COC of 7.52 percent and a cost of equity ("ROE")

2   of 9.90 percent.

3

4 **Q.   Please summarize your analyses and conclusions.**

5 A.   This proceeding is concerned with Avista's regulated electric utility and natural gas

6   operations in Washington. My analyses concern the Company's COC. As noted in a

7   later section of my testimony, Avista performs its electric and natural gas operations in

8   Washington, and all other states except Alaska, through its Avista Utilities division.

9   Avista Utilities is not a distinct corporate entity and does not have its own financial

10   statements and capital structure. Avista has traditionally used its corporate structure,

11   exclusive of its Alaska operations, to establish rates in Washington. In addition, it has

12   not distinguished between its electric and natural gas operations from a cost of capital

13   perspective. I have followed this tradition in my analyses and thus focus on Avista's

14   capitalization and a single COC and ROE for both its electric and natural gas operations.

15   The first step in performing my COC analyses is to develop the appropriate

16   capital structure. Avista proposes use of a capital structure comprised of 50 percent

17   common equity and 50 percent debt,[1] which is a hypothetical capital structure. I note that

18   Avista proposed the same capital structure in its last rate proceeding. The Commission

19   did not adopt 50 percent capital structure ratios in the two previous rate proceedings that

20   reached a decision on the issue.[2] Instead, the Commission employed a capital structure

---

[1] Thies, Exh. MTT-1T at 15:10-12.
[2] *Wash. Utils. & Transp. Comm'n v. Avista Corp.*, Dockets UE-150204 & UG-150205, Order 05, p. 6, ¶ 5 (Jan. 6, 2016) (2015 Avista GRC Order); *Wash. Utils. & Transp. Comm'n v. Avista Corp.*, Dockets UE-170485 & UG-170486, Order 07, p. 39, ¶ 107 (April 26, 2018) (2017 Avista GRC Order).

1   with 48.5 percent common equity. I use this previously-adopted capital structure,[3] which

2   I believe remains the proper capital structure for the Company. I also include short-term

3   debt in the capital structure, in contrast to Avista's proposal to exclude short-term debt.

4   The second step in a cost of capital calculation is to determine the embedded cost

5   rates of debt. Avista proposes use of a 5.15 percent cost of debt (this includes both the

6   costs of long-term debt and short-term debt), which is an estimated cost rate as of

7   December 31, 2019.[4] In my analyses, I have utilized separate costs for long-term debt

8   and short-term debt. The cost of long-term debt is not shown in the Company's

9   application. As shown on Exh. DCP-3, I have derived the cost of long-term debt from

10   the information contained in Exh. MTT-2, page 3, which is 5.19 percent. I have accepted

11   the Company's cost of short-term debt, as shown on Exh. MTT-2, page 4, which is 4.36

12   percent.

13   The third step in the COC calculation is to estimate the ROE. I employ three

14   recognized methodologies to estimate Avista's ROE, each of which I apply to two proxy

15   groups of utilities. These three methodologies and my findings are:

16

Methodology	Range
Discounted Cash Flow ("DCF")	8.2%-9.1% (8.65% mid-point)
Capital Asset Pricing Model ("CAPM")	5.8%-6.0% (5.9% mid-point)
Comparable Earnings ("CE")	9.0%-10.0% (9.5% mid-point)

19   Based upon these findings, I conclude that Avista's ROE is within a range of 9.1 percent

20   to 9.5 percent, which is based upon the upper end of the range of the results for the DCF

21   model and mid-point of the range of results for the CE model. I specifically recommend a

---

[3] My COC analyses separate the short-term debt and long-term debt components. Avista proposes to exclude short-term debt in its capital structure, although it includes the cost of short-term debt in its proposed cost of debt.
[4] Thies, Exh. MTT-2 at 3.

1	9.3 percent ROE for Avista. I note that I do not give the results of my CAPM weight in
2	my final recommendation, since these are low relative to the other model results and can
3	be considered anomalous.
4	
5	**III. ECONOMIC/LEGAL PRINCIPLES AND METHODOLOGIES**
6	
7	**Q. What are the primary economic and legal principles that establish the standards for**
8	**determining a fair rate of return for a regulated utility?**
9	A. Public utility rates are normally established in a manner designed to allow the recovery of
10	their costs, including capital costs. This is frequently referred to as "cost of service"
11	ratemaking. Rates for regulated public utilities traditionally have been primarily
12	established using the "rate base – rate of return" concept. Under this method, utilities are
13	allowed to recover a level of operating expenses, taxes, and depreciation deemed
14	reasonable for rate-setting purposes, and are granted an opportunity to earn a fair rate of
15	return on the assets utilized (i.e., rate base) in providing service to their customers.
16	The rate base is derived from the asset side of the utility's balance sheet as a
17	dollar amount and the rate of return is developed form the liabilities/owners' equity side
18	of the balance sheet as a percentage. Thus, the revenue impact of the cost of capital is
19	derived by multiplying the rate base by the rate of return, including income taxes.
20	The rate of return is developed from the cost of capital, which is estimated by
21	weighting the capital structure components (i.e. debt, preferred stock, and common
22	equity) by their percentages in the capital structure and multiplying these values by their
23	cost rates. This is also known as the weighted cost of capital.

1   Technically, "fair rate of return" is a legal and accounting concept that refers to an

2   *ex post* (after the fact) earned return on an asset base, while the cost of capital is an

3   economic and financial concept which refers to an *ex ante* (before the fact) expected, or

4   required, return on a capital base. In regulatory proceedings, however, the two terms are

5   often used interchangeably, and I have equated the two concepts in my testimony.

6   From an economic standpoint, a fair rate of return is normally interpreted to mean

7   that an efficient and economically managed utility will be able to maintain its financial

8   integrity, attract capital, and establish comparable returns for similar risk investments.

9   These concepts are derived from economic and financial theory and are generally

10   implemented using financial models and economic concepts.

11   Although I am not a lawyer and I do not offer a legal opinion, my testimony is

12   based on my understanding that two United States Supreme Court decisions provide the

13   controlling standards for a fair rate of return. The first decision is *Bluefield Water Works*

14   *and Improvement Co. v. Public Serv. Comm'n of West Virginia*, 262 U.S. 679 (1923). In

15   this decision, the Court stated:

16   The annual rate that will constitute just compensation depends upon many
17   circumstances and must be determined by the exercise of fair and
18   enlightened judgment, having regard to all relevant facts. A public utility
19   is entitled to such rates as will permit it to earn a return on the value of the
20   property which it employs for the convenience of the public equal to that
21   generally being made at the same time and in the same general part of the
22   country on investments in other business undertakings which are attended
23   by corresponding risks and uncertainties; but it has no constitutional right
24   to profits such as are realized or anticipated in highly profitable enterprises
25   or speculative ventures. The return should be reasonably sufficient to
26   assure confidence in the financial soundness of the utility, and should be
27   adequate, under efficient and economical management, to maintain and
28   support its credit and enable it to raise the money necessary for the proper
29   discharge of its public duties. A rate of return may be reasonable at one
30   time, and become too high or too low by changes affecting opportunities
31   for investment, the money market, and business conditions generally.

1   It is generally understood that the *Bluefield* decision established the following

2   standards for a fair rate of return: comparable earnings, financial integrity, and capital

3   attraction. It also noted that required returns change over time, and there is an underlying

4   assumption that the utility be operated efficiently.

5   The second decision is *Federal Power Comm'n v. Hope Natural Gas Co.*, 320

6   U.S. 591 (1942). In that decision, the Court stated:

7   The rate-making process under the [Natural Gas] Act, i.e., the fixing of
8   'just and reasonable' rates, involves a balancing of the investor and
9   consumer interests . . . From the investor or company point of view it is
10   important that there be enough revenue not only for operating expenses
11   but also for the capital costs of the business. These include service on the
12   debt and dividends on the stock. By this standard the return to the equity
13   owner should be commensurate with returns on investments in other
14   enterprises having corresponding risks. That return, moreover, should be
15   sufficient to assure confidence in the financial integrity of the enterprise,
16   so as to maintain its credit and to attract capital.
17
18   The three economic and financial parameters in the *Bluefield* and *Hope* decisions

19   – comparable earnings, financial integrity, and capital attraction – reflect the economic

20   criteria encompassed in the "opportunity cost" principle of economics. The opportunity

21   cost principle provides that a utility and its investors should be afforded an opportunity

22   (not a guarantee) to earn a return commensurate with returns they could expect to achieve

23   on investments of similar risk. The opportunity cost principle is consistent with the

24   fundamental premise on which regulation rests, namely, that it is intended to act as a

25   surrogate for competition.

26

27   **Q.   How can the *Bluefield* and *Hope* parameters be employed to estimate the cost of**

28   **capital for a utility?**

29   A.   Neither the courts nor economic/financial theory has developed exact and mechanical

1   procedures for precisely determining the cost of capital. This is the case because the cost

2   of capital is an opportunity cost and is prospective-looking, which dictates that it must be

3   estimated. However, there are several useful models that can be employed to assist in

4   estimating the ROE, which is the capital structure item that is the most difficult to

5   determine. These include the DCF, CAPM, CE and risk premium ("RP") methods. I

6   have not directly employed a RP model in my analyses although, as discussed later, my

7   CAPM analysis is a form of the RP methodology. Each of these methodologies will be

8   described in more detail later in my testimony.

9

10   IV.   GENERAL ECONOMIC CONDITIONS

11

12   Q.   **Are economic and financial conditions important in determining the costs of capital**

13   **for a public utility?**

14   A.   Yes. The costs of capital for both fixed-cost (debt and preferred stock) components and

15   common equity are determined in part by current and prospective economic and financial

16   conditions. At any given time, each of the following factors has an influence on the costs

17   of capital:

18   • The level of economic activity (*i.e.*, growth rate of the economy);

19   • The stage of the business cycle (*i.e.*, recession, expansion, or transition);

20   • The level of inflation;

21   • The level and trend of interest rates; and,

22   • Current and expected economic conditions.

1		My understanding is that this position is consistent with the *Bluefield* decision, which
2		noted "[a] rate of return may be reasonable at one time and become too high or too low
3		by changes affecting opportunities for investment, the money market, and business
4		conditions generally."[5]
5		
6	**Q.**	**What indicators of economic and financial activity did you evaluate in your**
7		**analyses?**
8	A.	I examined several sets of economic statistics from 1975 to the present. I chose this time
9		period because it permits the evaluation of economic conditions over four full business
10		cycles, plus the current cycle, allowing for an assessment of changes in long-term trends.
11		Consideration of economic/financial conditions over a relatively long period of time
12		allows me to assess how such conditions have impacted the level and trends of the costs
13		of capital. This period also approximates the beginning and continuation of active rate
14		case activities by public utilities that generally began in the mid-1970s.
15		A business cycle is commonly defined as a complete period of expansion
16		(recovery and growth) and contraction (recession). A full business cycle is a useful and
17		convenient period over which to measure levels and trends in long-term capital costs
18		because it incorporates the cyclical (*i.e.*, stage of business cycle) influences and, thus,
19		permits a comparison of structural (or long-term) trends.
20		
21	**Q.**	**Please describe the timeframes of the four prior business cycles and the current**
22		**cycle.**

---

[5] *Bluefield*, 262 U.S. at 693.

1   A.   The four prior complete cycles and current cycle cover the following periods:

2

Business Cycle	Expansion Cycle	Contraction Period
1975-1982	Mar. 1975-July 1981	Aug. 1981-Oct. 1982
1982-1991	Nov. 1982-July 1990	Aug. 1990-Mar. 1991
1991-2001	Mar. 1991-Mar. 2001	Apr. 2001-Nov. 2001
2001-2009	Nov. 2001-Nov. 2007	Dec. 2007-June 2009
Current	July 2009 -	

Source: The National Bureau of Economic Research, "U.S. Business Cycle Expansions and Contractions."[6]

7

8   **Q.**   **Do you have any general observations concerning the recent trends in economic**

9   **conditions and their impact on capital costs over this broad period?**

10   A.   Yes, I do. From the early 1980s until the end of 2007, the United States economy

11   enjoyed general prosperity and stability. This period was characterized by longer

12   economic expansions, relatively tame contractions, low and declining inflation, and

13   declining interest rates and other capital costs.

14   However, in 2008 and 2009 the economy declined significantly, initially as a

15   result of the 2007 collapse of the "sub-prime" mortgage market and the related liquidity

16   crisis in the financial sector of the economy. Subsequently, this financial crisis

17   intensified with a more broad-based decline initially based on a substantial increase in

18   petroleum prices and a dramatic decline in the U.S. financial sector of the economy.

19   This decline has been described as the worst financial crisis since the Great

20   Depression of the 1930s and has been referred to as the "Great Recession." Beginning in

21   2008, the U.S. and other governments implemented unprecedented policies to attempt to

---

[6] *Available at* http://www.nber.org/cycles/cyclesmain.html.

1   correct or minimize the scope and effects of this recession. Some of these policies are

2   still in effect.

3

4   **Q.**   **Please describe recent and current economic and financial conditions and their**

5   **impact on the costs of capital.**

6   A.   One impact of the Great Recession has been a reduction in actual and expected

7   investment returns and a corresponding reduction in capital costs. This reduction is

8   evidenced by a decline in both short-term and long-term interest rates and in the

9   expectations of investors. The cost of capital model results (such as DCF, CAPM, and

10   CE) reflect this reduction as well. Regulatory agencies throughout the U.S. have

11   recognized the decline in capital costs by authorizing lower ROEs for regulated utilities

12   in each of the last several years.[7]

13   Exh. DCP-4 shows several sets of relevant economic and financial statistics for

14   the cited time periods. Page 1 contains general macroeconomic statistics, page 2 shows

15   interest rates, and page 3 contains equity market statistics.

16   Page 1 shows that in 2007 the economy stalled and subsequently entered a

17   significant decline, as indicated by the lower growth rate in real (*i.e.*, adjusted for

18   inflation) Gross Domestic Product ("GDP"), lower levels of industrial production, and an

19   increase in the unemployment rate. This recession lasted until mid-2009, making it a

20   longer-than-normal, as well as a much deeper, recession. Since then, economic growth

21   has been somewhat erratic, and the economy has grown more slowly than in prior

22   expansions.

---

[7] S&P, Regulatory Research Associates (RRA), "Regulatory Focus", April 11, 2019.

1   Page 1 also shows the rate of inflation. As reflected in the Consumer Price Index

2   ("CPI"), inflation rose significantly during the 1975-1982 business cycle and reached

3   double-digit levels in 1979-1980. The rate of inflation has declined substantially since

4   1981. Since 2008, the CPI has been 3 percent or lower on an annual basis, with 2014 and

5   2015 growth below 1 percent, 2016 and 2017 growth at 2.1 percent, and 2018 growth at

6   1.9 percent. It is thus apparent that the rate of inflation has generally been declining over

7   the past several business cycles. Recent and current levels of inflation are at the lowest

8   levels of the past 35 years, which is reflective of lower capital costs.[8]

9

10 **Q.**   **What have been the trends in interest rates over the four prior business cycles and**

11   **at the current time?**

12 A.   Exh. DCP-4 page 2, shows several series of interest rates. Both short-term and long-term

13   rates rose sharply to record levels in 1975-1982 when the inflation rate was high. Interest

14   rates have declined substantially in conjunction with the corresponding declines in

15   inflation since the early 1980s.

16   From 2008 to late 2015, the Federal Reserve System ("Federal Reserve")

17   maintained the Federal Funds rate (*i.e.*, short-term interest rate) at 0.25 percent, an all-

18   time low. Following much anticipation, the Federal Reserve subsequently raised the

19   Federal Funds rate on nine occasions between December of 2015 and December of

20   2018.[9] Most recently, the Federal Reserve again lowered the Federal Funds rate in July

---

[8] The rate of inflation is one component of interest rate expectations of investors, who generally expect to receive a return in excess of the rate of inflation. Thus, a lower rate of inflation has a downward impact on interest rates and other capital costs.
[9] The Fed Funds increases took place in December 2015, December 2016, March 2017, June 2017, December 2017, March 2018, June 2018, September 2018, and December 2018. The decline took place in July 2019.

1   and again in September of 2019. The Federal Reserve also purchased U.S. Treasury

2   securities to stimulate the economy.[10]

3   As seen on Exh. DCP-4 page 2, since 2011 both U.S. and public utility bond

4   yields have declined to their lowest levels in the past four business cycles and in more

5   than 35 years. Even with the "tapering" and eventual ending of the Federal Reserve's

6   Quantitative Easing program, as well as the Federal Reserve's raising of the Federal

7   Funds rate (prior to the most recent lowering of the rate), interest rates have remained

8   relatively low. The rates on U.S. Treasury and public utility securities increased

9   somewhat in the first several months of 2018, before falling over each of the past several

10   months. Both government and utility long-term lending rates remain near historically

11   low levels, again reflective of lower capital costs.

12

13 **Q.   What does Exh. DCP-4 show for trends of common share prices?**

14 A.   Page 3 shows several series of common stock prices and ratios. These indicate that stock

15   prices were essentially stagnant during the high inflation/high interest rate environment

16   of the late 1970s and early 1980s. The 1983-1991 business cycle and the more recent

17   cycles witnessed a significant upward trend in stock prices. The beginning of the recent

18   financial crisis saw stock prices decline precipitously, as stock prices in 2008 and early

19   2009 were down significantly from peak 2007 levels, reflecting the financial/economic

20   crisis. Beginning in the second quarter of 2009, prices recovered substantially and

---

[10] This is referred to as Quantitative Easing which was comprised of three "rounds." In "round" 3, known as QE3, the Federal Reserve initially purchased some $85 billion of U.S. Treasury Securities per month in order to stimulate the economy. The Federal Reserve eventually "tapered" its purchase of U.S. Treasury securities through October 2014, at which time Quantitative Easing ended.

1		ultimately reached and exceeded the levels achieved prior to the "crash." On the other
2		hand, recent equity markets have been somewhat volatile, including much of 2018. As
3		an example of this, the end of 2018 witnessed significant declines in stock prices, with
4		many indexes declining more than 20 percent (*i.e.*, a "bear" market). Since the beginning
5		of 2019, stocks have risen with many of the indices reaching record levels.
6		
7	**Q.**	**What conclusions do you draw from your discussion of economic and financial**
8		**conditions?**
9	A.	Recent economic and financial circumstances have differed from any that have prevailed
10		since at least the 1930s. Concurrent with the Great Recession, there was a decline in
11		capital costs and returns which significantly reduced the value of most retirement
12		accounts, investment portfolios, and other assets. One significant aspect of this has been
13		a decline in investor expectations of returns even with the return of stock prices to levels
14		achieved prior to the "crash."[11] This is evidenced by: (1) lower interest rates on bank
15		deposits; (2) lower interest rates on U.S. Treasury and utility bonds; and (3) lower
16		authorized returns on equity by regulatory commissions. Finally, as noted above, utility
17		bond interest rates are currently at levels well below those prevailing prior to the financial
18		crisis of late 2008 to early 2009 and remain near the lowest levels in the past 35 years and
19		are also generally lower than the embedded cost rates for most utilities, including Avista.
20		
21	**Q.**	**How do these economic/financial conditions impact the determination of a ROE for**
22		**regulated utilities?**

[11] *See, e.g.*, Vanguard News & Perspectives, "Stabilization, Not Stagnation: Expect Modest Returns", March 30, 2017, *available at* www.personal.vanguard.com/us/insights/artical/infographic-stabilization-032017.

1 A. The costs of capital for regulated utilities have declined in recent years. This is also true

2   for Avista, whose debt costs have declined since the last rate proceeding.[12] The current

3   interest costs (e.g., the most recent yield on triple-B utility bonds is 3.63 percent, as

4   shown on Exh. DCP-4 page 2) that utilities (including Avista) pay on new debt remain

5   near the low point of the last several decades and are lower than existing embedded cost

6   rates.

7   In addition, the results of the traditional ROE models (*i.e.*, DCF, CAPM and CE)

8   are lower than was the case prior to the Great Recession. In light of this, it is not

9   surprising that the average ROEs authorized by state regulatory agencies have declined

10   and continued to remain relatively low through 2019, as follows:[13]

11

	Electric		Natural Gas	
	Average	Median	Average	Median
2007	10.32%	10.23%	10.22%	10.20%
2008	10.37%	10.30%	10.39%	10.45%
2009	10.52%	10.50%	10.22%	10.26%
2010	10.29%	10.26%	10.15%	10.10%
2011	10.19%	10.14%	9.91%	10.05%
2012	10.02%	10.00%	9.93%	10.00%
2013	9.82%	9.82%	9.68%	9.72%
2014	9.76%	9.75%	9.78%	9.78%
2015	9.60%	9.53%	9.60%	9.68%
2016	9.60%	9.60%	9.53%	9.50%
2017	9.68%	9.60%	9.73%	9.60%
2018	9.55%	9.57%	9.60%	9.60%
2019 (1Q)		9.57%		9.55%

19

20

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[12] Avista's cost of debt has declined from 5.62% in that case to 5.15% proposed currently. Thies, Exh. MTT-1T at 24:1-8; 2017 Avista GRC Order at 106, ¶ 351.
[13] S&P, RRA, "Regulatory Focus", April 11, 2019, General Rate Cases, for electric and gas utilities.

1	**Q.**	**The table above appears to indicate that the average and median authorized ROEs**

1   **Q.**   **The table above appears to indicate that the average and median authorized ROEs**

2   **for electric utilities in recent years, which may appear to indicate that the decline in**

3   **ROEs has moderated. Is this a proper assessment of the trend in ROEs?**

4   A.   No, this does not tell the whole story of the trend in authorized ROEs. Another relevant

5   consideration is how the recently-authorized ROEs compare to the previously-authorized

6   ROE for the various utilities that have had rate decisions in recent years. On average,

7   general rate cases decided in 2017 and 2018 resulted in lower authorized ROE compared

8   with all rate cases decided between 2012 and 2018. I have shown this comparison on

9   Exh. DCP-5, which reflects the electric utility proceedings in 2017 and 2018 where an

10   authorized ROE was identified. This exhibit also identifies the previously-authorized

11   ROE if it was determined in 2012 or after. As this exhibit indicates, there were 64

12   proceedings that meet these criteria. Of these 64, only nine reflected an increased ROE

13   in 2017 or 2018, 14 reflected no change in ROE, and 41 reflected a decrease in the ROE.

14   Clearly, the vast majority of authorized ROEs represented a decline from the previously

15   authorized ROE over this period. Furthermore, the average ROE declined by 0.22

16   percent and the median ROE declined by 0.20 percent.

17

18   **V.   AVISTA'S OPERATIONS AND BUSINESS RISKS**

19

20   **Q.**   **Please summarize Avista and its operations.**

21   A.   Avista, formerly known as Washington Water Power, is a public utility that generates and

22   delivers electricity and natural gas through its generation, transmission, and distribution

1   systems to customers in Washington, Oregon, Idaho, Alaska and a small portion of

2   Montana.

3   Avista, in its present form, is a public utility that operates two reportable business

4   segments:[14]

5   • Avista Utilities – an operating division of Avista that delivers electricity

6   (approximately 388,000 customers) and natural gas (approximately 355,000

7   customers) in Washington, Oregon, Idaho and Montana; and,

8   • Alaska Electric Light & Power ("AEL&P") – a subsidiary of Avista (acquired

9   July 1, 2014), and is an electric utility located in Juneau, Alaska. AEL&P is a

10   direct subsidiary of Alaska Energy and Resources Co. ("AERC") which, in

11   turn, is owned by Avista.

12   Avista's other businesses include sheet metal fabrication, venture fund

13 investments, real estate investments, as well as certain other investments of Avista

14 Capital, which is a direct, wholly owned subsidiary of Avista. These activities do not

15 represent a reportable business segment and are conducted by various direct and indirect

16 subsidiaries of Avista Corp.[15]

17   The Avista Utilities segment accounts for the vast majority of Avista's operations,

18 as it accounted for about 95 percent of Avista's 2018 operating revenues.[16]

19

20 **Q.   What are the current security ratings of Avista?**

21 A.   The present debt ratings of Avista's debt are shown on Exh. DCP-6 and are as follows:

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[14] Avista Corp., 2018 Form 10-K page 4.
[15] *Id.*
[16] *Id*. at 27.

	Secured	Corp./Issuer
Moody's	A3	Baa2
Standard & Poor's	A-	BBB

Q. **What have been the trends in Avista's bond ratings?**

A. This is also shown on Exh. DCP-6. As this indicates, Avista's current ratings by

Standard & Poor's have remained the same throughout the period 2013 to the present.

The ratings by Moody's are currently the same as they were in 2013. Moody's ratings

were increased by a "notch" (i.e., from Baa2 to Baa1) in 2014 and were reduced by a

"notch" (i.e., from Baa1 to Baa2) in 2018.

Q. **How do the bond ratings of Avista compare to other electric and combination**

gas/electric utilities?

A. Avista's ratings are generally similar to most electric utilities in the U.S. This is

evidenced by the relative Moody's and Standard & Poor's debt ratings, as shown on my

Exh. DCP-9 and which indicates that Avista's ratings are generally similar to those of the

two groups of proxy electric utilities used to develop the ROE recommendations in my

testimony.[17]

Q. **Avista claims that the existence of the Tax Cuts and Jobs Act ("TCJA") is a factor**

that should be considered in assessing Avista's risks and thus its COC. What exactly

does Avista assert?

---

[17] Avista witness McKenzie also cites Avista's ratings as being "comparable" to those of his proxy group. *See*, McKenzie, Exh. AMM-1T at 7:1-2.

1   A.   Mr. Thies states that the TCJA has had "detrimental implications for the credit standing

2   of regulated utilities."[18] In addition, Mr. McKenzie's direct testimony uses identical

3   language.[19] Avista thus appears to maintain that the TCJA provides support for an

4   increase in the common equity ratio and thus its COC.

5

6   **Q.**   **Do you believe that any changes to Avista's capital structure or COC are proper**

7   **due to TCJA?**

8   A.   No, I do not. I disagree with Avista's assessment of the TCJA and its implications for the

9   COC for Avista. I first note that this is not the first rate proceeding of Avista since the

10   passage of TCJA. In its last rate proceedings, Avista cited the TCJA as a justification for

11   increasing its common equity ratio and thus its COC. In those proceedings, the

12   Commission acknowledged the TCJA but did not adjust the common equity ratios to

13   reflect this.[20]

14   In addition, any impact of a significant financial factor, such as a change in

15   income taxes, would be expected to have an impact on the stock price and/or expected

16   growth rates of all the affected companies (i.e., the proxy groups companies).

17   Correspondingly, the impact on the stock price, as well as growth expectations, would be

18   captured in the cost of equity calculations. No additional adjustments are either

19   necessary or appropriate.

---

[18] Thies, Exh. MTT-1T at 19:22-25.
[19] McKenzie, Exh. AMM-1T at 15:4-6.
[20] 2017 Avista GRC Order at 29-30, ¶¶ 72-73; 39-40, ¶¶ 109-112 ("We also note the TCJA will increase stress on the Company's balance sheet and credit metrics as short-term cash flows are impacted by customer refunds.").

1   Finally, I note that Mr. McKenzie goes to great lengths to claim that any utility-

2   positive regulatory mechanisms (e.g., decoupling) are not a factor to be considered in

3   establishing the COC. He states:

4   "Regulatory mechanisms approved for Avista, and the implications of revenue
5   decoupling, are viewed as supportive by investors, and the implications of
6   revenue decoupling and other regulatory mechanisms are already fully reflected in
7   Avista's credit ratings, which are comparable to those of the proxy group used to
8   estimate the cost of equity. Because the utilities in my proxy group operate under
9   a wide variety of regulatory mechanisms, including decoupling, the mitigation of
10   risks associated with the ability to adjust revenues and attenuate the risk of cost
11   recovery is already reflected in the results of my analyses."[21]
12

13   If Mr. McKenzie is correct that the utility-positive regulatory mechanisms are

14   already captured in cost of capital analyses for the proxy companies, it follows that any

15   perceived utility-negative factors, such as TCJA, are also reflected in stock prices and

16   therefore ROE analyses. Mr. McKenzie, as well as Avista, are thus inconsistent in their

17   assessment of the impact of TCJA and the favorable regulatory mechanisms Avista has.

18   They attempt to minimize the favorable impact of decoupling and other regulatory

19   mechanisms while maximizing the perceived unfavorable impact of TCJA. I suggest

20   they cannot have it both ways.

21

22   **VI.   CAPITAL STRUCTURE AND COSTS OF DEBT**

23

24   **Q.   What is the importance of determining a proper capital structure in a regulatory**

25   **framework?**

---

[21] McKenzie, Exh. AMM-1T at 6:38-7:6.

1   A.   A utility's capital structure is important because the concept of rate base – rate of return

2   regulation requires the capital structure to be utilized in estimating the total cost of

3   capital. Within this framework, it is proper to ascertain whether the utility's capital

4   structure is appropriate relative to its level of business risk and relative to other utilities.

5   As discussed in Section III of my testimony, the purpose of determining the

6   proper capital structure for a utility is to ascertain its capital costs. The rate base – rate of

7   return concept recognizes the assets employed in providing utility services and provides

8   for a return on these assets by identifying the liabilities and common equity (and their

9   cost rates) used to finance the assets. In this process, the rate base is derived from the

10   asset side of the balance sheet and the cost of capital is derived from the

11   liabilities/owners' equity side of the balance sheet. The inherent assumption in this

12   procedure is that the dollar values of the capital structure and the rate base are

13   approximately equal and the former is utilized to finance the latter.

14   The common equity ratio (i.e., the percentage of common equity in the capital

15   structure) is the capital structure item which normally receives the most attention. This is

16   the case because common equity: (1) usually commands the highest cost rate; (2)

17   generates associated income tax liabilities; and (3) causes the most controversy since its

18   cost cannot be precisely determined.

19

20   Q.   **What are the historic capital structure ratios of Avista?**

21   A.   I have examined the historic (2014-2018) capital structure ratios of Avista, which is

22   shown on Exh. DCP-7. The actual (as opposed to Commission-approved) common

23   equity ratios have been:

	Avista Consolidated		Avista Utilities	
	Including S-T Debt	Excluding S-T Debt	Including S-T Debt	Excluding S-T Debt
2014	47.2%	48.9%	48.6%	50.4%
2015	46.9%	48.5%	48.0%	49.7%
2016	47.1%	48.7%	48.0%	49.8%
2017	47.3%	48.7%	48.1%	49.6%
2018	47.5%	50.0%	46.3%	48.9%

This indicates that Avista, on a consolidated basis, has had an equity ratio that has generally been stable over the past five years. The Avista Utilities (Division) capital structure[22] has also been fairly stationary, with equity ratios (including short-term debt) of about 48 percent or less over the past five years.

Q. How do these capital structures compare to those of investor-owned electric utilities?

A. Exh. DCP-8 shows the common equity ratios (excluding short-term debt in capitalization) for the groups of proxy electric utilities used in developing my cost of equity models and related conclusions. These are:

	Period	Average	Median
Parcell Proxy Group	2014-2018	52.4%	54.8%
	2022-2024	52.9%	52.0%
McKenzie Proxy Group	2014-2018	46.6%	46.8%
	2022-2024	47.3%	47.5%

The equity ratios for my proxy group are slightly higher than those of Avista Utilities (excluding short-term debt), whereas the equity ratios of the McKenzie group are similar to those of Avista Utilities.

---

[22] Avista's Utilities (Division) capital structures exclude affiliate debt and equity.

1   **Q.   What have been the average common equity ratios adopted by U.S. State**

2   **Regulatory Agencies in recent years?**

3   A.   Over the past several years, the average common equity ratios cited in U.S. state

4   regulatory electric and gas rate proceedings have been:[23]

5
	Electric	Gas
2012	50.69%	51.13%
2013	49.25%	50.60%
2014	50.28%	51.11%
2015	49.54%	49.93%
2016	48.91%	50.06%
2017	48.90%	49.88%
2018	48.95%	50.09%

10   These are slightly higher than those of Avista Utilities' common equity ratios, except for

11   2017. It is noteworthy, on the other hand, that these equity ratios reflect a combination of

12   approved capital structures, some of which include short-term debt and some of which

13   exclude short-term debt.

14

15   **Q.   What capital structure has Avista requested in the proceedings?**

16   A.   Avista proposes a capital structure comprised as follows:

17
	Percent
Debt	50.0
Common Equity	50.0

19   Avista's proposed capital structure excludes short-term debt, which is an additional

20   change from the currently-authorized capital structure.

21   According to the Direct Testimony of Avista witness Mark T. Thies, this

22   requested capital structure would allow Avista to have "a solid financial profile", would

---

[23] S&P, RRA, "Regulatory Focus", January 31, 2019.

1		solidify Avista's current credit ratings, and move Avista "closer to our long-term goal of
2		having a corporate credit rating of BBB+."[24] I note that Avista proposed this same
3		hypothetical capital structure in its last rate proceeding.[25]
4		
5	**Q.**	**How does this proposed capital structure compare to the capital structure approved**
6		**in Avista's most recent rate proceedings?**
7	A.	It reflects an increase in Avista's equity ratio from 48.5 percent to 50.0 percent. In
8		Dockets UE-150204/UG-150205, the parties stipulated to a capital structure with 51.5
9		percent debt/48.5 percent equity.[26] This capital structure was Avista's "forecast capital
10		structure at December 31, 2015."[27] In Dockets UE-170485/UG-170486 the Commission
11		continued use of a capital structure with 48.5 percent common equity, 2.9 percent short-
12		term debt and 48.6 percent long-term debt.[28]
13		
14	**Q.**	**What capital structure do you propose to use in these proceedings?**
15	A.	I have used a capital structure with 48.5 percent and the inclusion of short-term debt for
16		the purposes of these proceedings. My proposed capital structure is derived in Exh.
17		DCP-3 and is as follows:
18		

Short-Term Debt	2.65%
Long-Term Debt	48.85%
Common Equity	48.50%

20

---

[24] Thies, Exh. MTT-1 at 16:14-20.
[25] 2017 Avista GRC Order at 35, ¶ 93.
[26] 2015 Avista GRC Order, Appendix C (Multiparty Settlement Stipulation) at 2.
[27] Dockets UE-150204 & UG-150205, Thies, Exh. MTT-1T at 14:20-23 (February 9, 2015).
[28] 2017 Avista GRC Order at 39-40, ¶¶ 111-112.

1 **Q. Why are you proposing a capital structure for Avista containing 48.5 percent**

2   **common equity?**

3 A. I first note that Avista Utilities' actual capital structure as of December 31, 2018

4   contained 46.3 percent common equity, as shown on Exh. DCP-7 page 2. Thus, my

5   proposed capital structure is similar to, but slightly exceeds, the recent actual capital

6   structure ratio of Avista Utilities.

7   Second, Exh. DCP-7 shows the actual equity ratios of Avista Utilities have not

8   increased in recent years.

9   Third, this capital structure matches the capital structure stipulated to by the

10   parties and adopted by the Commission in Avista's prior rate proceeding,[29] as well as the

11   last litigated rate proceeding.[30] In the 2017 GRC, the Commission rejected Avista's

12   proposed 50/50 capital structure in part because the actual equity component over the last

13   few years was closer to 48.5 percent.[31]

14   Fourth, the proposed capital structure is similar to that of other electric and

15   combination electric utilities, as shown on Exh. DCP-8.

16

17 **Q. What is your understanding of this Commission's recent policy on the proper**

18   **capital structure to use to determine the COC?**

19 A. It is my understanding that the Commission's policy on determining a capital structure

20   balances safety (the preservation of investment quality credit ratings and access to

21   capital) against economy (the lowest overall cost to attract and maintain capital). The

---

[29] 2015 Avista GRC Order, Appendix C (Multiparty Settlement Stipulation) at 2.
[30] 2017 Avista GRC Order at 39-40, ¶¶ 111-112.
[31] *See*, *Id*. at 39, ¶ 107.

1		Commission noted that the appropriate capital structure can either be the Company's
2		historical capital structure, the projected capital structure, or a hypothetical capital
3		structure.[32]
4		
5	**Q.**	**Is your recommended capital structure consistent with this policy?**
6	A.	Yes. The capital structure that I use is similar to recent actual ratios of Avista, as well as
7		its 2018 capital structure, and is consistent with the capital structure of other utilities. I
8		also believe that the capital structure that I propose provides a "balance of safety and
9		economy" as cited above.
10		
11	**Q.**	**What are the cost rates of debt in Avista's applications?**
12	A.	Avista proposes the cost of debt as of December 31, 2019. Avista's proposed cost of debt
13		is 5.15 percent.[33] Avista's applications show a cost of short-term debt of 4.36 percent as
14		of this same date.[34] The applications do not identify the cost of long-term debt for Avista,
15		but I have derived this cost rate (5.19 percent) from the applications, as shown on Exh.
16		DCP-3.
17		
18	**Q.**	**Can the ROE be determined with the same degree of precision as the cost of debt?**
19	A.	No. The cost rates of debt are largely determined by interest payments, issue prices, and
20		related expenses. The ROE, on the other hand, cannot be precisely quantified, primarily
21		because this cost is an opportunity cost. As mentioned previously, there are several

---

[32] *Id*. at 39, ¶ 109, *see also*, *Wash. Utils. & Transp. Comm'n v. Puget Sound Energy, Inc.*, Dockets UE-040640 & UG-040641, Order 06 at 13, ¶ 27 (February 18, 2005).
[33] Thies, Exh. MTT-2 at 3.
[34] *Id*. at 4.

1   models that can be employed to estimate the ROE. Three of the primary methods – DCF,

2   CAPM, and CE – are developed in the following sections of my testimony.

3

4   **VII.   SELECTION OF PROXY GROUPS**

5

6   **Q.   How have you estimated the ROE for Avista?**

7   A.   Avista is a publicly-traded company. Consequently, it is possible to directly apply ROE

8   models to Avista. However, in COC analyses, it is customary to analyze groups of

9   comparison, or "proxy," companies as a substitute for Avista to determine its ROE.

10   I have accordingly selected two groups for comparison to Avista. I selected one

11   group of electric utilities similar to the Avista using the criteria listed on Exh. DCP-9.

12   These criteria area as follows:

13   (1)   Market cap of $1 billion to $10 billion;

14   (2)   Common equity ratio 40% or greater;

15   (3)   Value Line Safety rank of 1 or 2;

16   (4)   S&P and Moody's bond ratings of A or BBB;

17   (5)   Currently pays dividends; and

18   (6)   Not involved in major merger or acquisition.

19   In addition, I have conducted studies of the cost of equity for most of the proxy

20   group that was selected by Avista witness Adrien M. McKenzie. My analyses do not

1		include Algonquin Power & Utilities, which is a Canadian firm and is not followed by
2		Value Line, which is an apparent criterion for his selection process.[35]
3		I also exclude Edison International from my analyses of the McKenzie proxy
4		group. This entity has had its financial circumstances impacted by the wildfires in
5		California. This impact is demonstrated by the fact that its two California utility
6		subsidiaries have filed rate cases requesting ROEs six percentage points higher than the
7		"base" ROE level to compensate the utilities from the elevated risks associated with the
8		wildfires.[36] Clearly, Edison International does not consider itself to be a representative
9		utility at the current time.
10		Finally, I exclude El Paso Electric Co. from my analyses since this entity has
11		accepted a takeover offer from the Infrastructure Investments Fund.[37] This company is
12		thus not presently regarded as an independent entity.
13		
14	**Q.**	**Please explain why you are using two proxy groups in your cost of equity analyses.**
15	A.	It has long been my practice to develop my own independently-determined proxy group
16		and to also conduct cost of equity analyses on the utility witness' proxy group. My
17		conclusions and recommendations, in turn, are based upon the results of both proxy
18		groups.
19		

---

[35] *See*, McKenzie, Exh. AMM-1T at 33:4-18, (citing a selection criterion of "Value Line Safety Rank of "2" or "3""). In addition, Mr. McKenzie's exhibits show "na" for all entities citing Value Line, reflecting the fact that such entities are "not available" as Value Line does not report data for this Company.

[36] Value Line Investment Survey for Edison International, dated July 26, 2019.

[37] Value Line Investment Survey for El Paso Electric Co., dated July 26, 2019.

1		**VIII. DCF ANALYSIS**
2		
3	**Q.**	**What is the theory and methodological basis of the DCF model?**
4	A.	The DCF model is one of the oldest and most commonly-used models for estimating the
5		ROE for public utilities.

The DCF model is based on the "dividend discount model" of financial theory, which maintains that the value (price) of any security or commodity is the discounted present value of all future cash flows.

The most common variant of the DCF model assumes that dividends are expected to grow at a constant rate (the "constant growth" or "Gordon DCF model"). In this framework, the ROE is derived from the following formula:

$$K = \frac{D}{P} + g$$

where: P = current price

D = current dividend rate

K = discount rate (cost of capital)

g = constant rate of expected growth

This formula essentially recognizes that the return expected or required by investors is comprised of two factors: the dividend yield (current income) and expected growth in dividends (future income).

1   **Q.   Please explain how you employ the DCF model.**

2   A.   I use the constant growth DCF model. In doing so, I combine the current dividend yield

3   for each of the proxy utility stocks described in the previous section with several

4   indicators of expected dividend growth.

5

6   **Q.   How did you derive the dividend yield component of the DCF equation?**

7   A.   Several methods can be used to calculate the dividend yield component. These methods

8   generally differ in the manner in which the dividend rate is employed (i.e., current versus

9   future dividends or annual versus quarterly compounding variant). I used a quarterly

10   version of the dividend yield, which is expressed as follows:

11
$$Yield = \frac{D_0(1 + 0.5g)}{P_0}$$

12   This dividend yield component recognizes the timing of dividend payments and dividend

13   increases.

14   The P_0 in my yield calculation is the average of the high and low stock price for

15   each proxy company for the most recent three-month period (June-August 2019). The D_0

16   is the current annualized dividend rate for each proxy company.

17

18   **Q.   How do you estimate the dividend growth component of the DCF equation?**

19   A.   The DCF model's dividend growth rate component is usually the most crucial and

20   controversial element involved in using this methodology. The objective of estimating

21   the dividend growth component is to reflect the growth expected by investors that is

22   embodied in the price (and yield) of a company's stock. As such, it is important to

23   recognize that individual investors have different expectations and consider alternative

1   indicators in deriving their expectations. This is evidenced by the fact that every

2   investment decision resulting in the purchase of a particular stock is matched by another

3   investment decision to sell that stock.

4   A wide array of indicators exists for estimating investors' growth expectations.

5   As a result, it is evident that investors do not always use one single indicator of growth.

6   It therefore is necessary to consider alternative dividend growth indicators in deriving the

7   growth component of the DCF model. I have considered five indicators of growth in my

8   DCF analyses. These are:

9   1. Years 2014-2018 (5-year average) earnings retention, or fundamental growth

10   (per Value Line);

11   2. Five-year average of historic growth in earnings per share (EPS), dividends

12   per share (DPS), and book value per share (BVPS) (per Value Line);

13   3. Years 2019, 2020 and 2022-2024 projections of earnings retention growth

14   (per Value Line);

15   4. Years 2016-2018 to 2022-2024 projections of EPS, DPS, and BVPS (per

16   Value Line); and

17   5. Five-year projections of EPS growth (per First Call).

18   I believe this combination of growth indicators is a representative and appropriate set

19   with which to begin the process of estimating investor expectations of dividend growth

20   for the groups of proxy companies. I also believe that these growth indicators reflect the

21   types of information that investors consider in making their investment decisions. As I

22   indicated previously, investors have an array of information available to them, all of

23   which would be expected to have some impact on their decision-making process.

1 **Q.   Please describe your DCF calculations.**

2 A.   Exh. DCP-10 presents my DCF analysis. Page 1 shows the calculation of the "raw" (i.e.,

3   prior to adjustment for growth) dividend yield for each proxy company. Pages 2 and 3

4   show the growth rates for the groups of proxy companies. Page 4 shows the DCF

5   calculations, which are presented on several bases: mean, median, low and high values.

6   These results can be summarized as follows:

7

	Mean	Median	Mean Low[38]	Mean High[39]	Median Low[40]	Median High[41]
Parcell Proxy Group	7.2%	7.0%	6.4%	8.2%	6.0%	8.4%
McKenzie Proxy Group[42]	7.9%	7.8%	6.8%	8.9%	6.6%	9.1%

10

11   I note that the individual DCF calculations shown on Exh. DCP-10 should not be

12   interpreted to reflect the expected cost of capital for individual companies in the proxy

13   groups; rather, the individual values shown should be interpreted as alternative

14   information considered by investors.

15

16 **Q.   What do you conclude from your DCF analyses?**

17 A.   The DCF rates resulting from the analysis of the proxy groups fall into a wide range

18   between 6.0 percent and 9.1 percent. The highest DCF rates are 8.2 percent to 9.1

19   percent.

---

[38] Using only the lowest average growth rate.
[39] Using only the highest average growth rate.
[40] Using the lowest median growth rate.
[41] Using only the highest median growth rate.
[42] Adjusted to reflect removal of three entities, as described above.

1   I believe a range of 8.2 percent to 9.1 percent (8.65 percent mid-point) represents

2   the current DCF-derived ROE for the proxy groups. This range includes the highest DCF

3   rates and exceeds the low and mean/median DCF rates. My recommendation focuses on

4   the highest of the DCF results to incorporate my recognition that these results are

5   relatively lower than historic DCF results. As a result, my recommendation should be

6   considered conservative.

7

8   IX.   CAPM ANALYSIS

9

10   **Q.   Please describe the theory and methodological basis of the CAPM.**

11   A.   CAPM was developed in the 1960s and 1970s as an extension of modern portfolio theory

12   (MPT), which studies the relationships among risk, diversification, and expected returns.

13   The CAPM describes and measures the relationship between a security's investment risk

14   and its market rate of return.

15

16   **Q.   How is the CAPM derived?**

17   A.   The general form of the CAPM is:

18   $$K = R_f + \beta(R_m - R_f)$$

19   where: K = cost of equity

20   R_f = risk free rate

21   R_m = return on market

22   β = beta

23   R_m-R_f = market risk premium

1   The CAPM is a variant of the RP method. I believe the CAPM is generally superior to

2   the simple RP method because the CAPM specifically recognizes the risk of a particular

3   company or industry (i.e., beta), whereas the simple RP method assumes the same ROE

4   for all companies exhibiting similar bond ratings or other characteristics.

5

6   **Q.**   **What do you use for the risk-free rate?**

7   A.   The first input of the CAPM is the risk-free rate (R_f). The risk-free rate reflects the level

8   of return that can be achieved without accepting any risk.

9   In CAPM applications, the risk-free rate is generally recognized by use of U.S.

10   Treasury securities. Two general types of U.S. Treasury securities are often utilized as

11   the R_f component, short-term U.S. Treasury bills and long-term U.S. Treasury bonds.

12   I have performed CAPM calculations using the three-month average yield (June-

13   August 2019) for 20-year U.S. Treasury bonds. I use the yields on long-term Treasury

14   bonds since this matches the long-term perspective of ROE analyses. Over this three-

15   month period, these bonds had an average yield of 2.21 percent.

16

17   **Q.**   **What is beta and what betas do you employ in your CAPM?**

18   A.   Beta is a measure of the relative volatility (and thus risk) of a particular stock in relation

19   to the overall market. Betas less than 1.0 are considered less risky than the market,

20   whereas betas greater than 1 are riskier. Utility stocks traditionally have had betas below

21   1. I utilize the most recent Value Line betas for each company in the proxy groups.

22

		Q.	**How do you estimate the market risk premium component?**

1 Q. **How do you estimate the market risk premium component?**

2 A. The market risk premium component (R_m-R_f) represents the investor-expected premium

3 of common stocks over the risk-free rate, or long-term government bonds. For the

4 purpose of estimating the market risk premium, I considered alternative measures of

5 returns of the S&P 500 (a broad-based group of large U.S. companies) and 20-year U.S.

6 Treasury bonds (i.e., same timeframe as employed in Duff & Phelps source used to

7 develop risk premiums).

8 First, I compared the actual annual returns on equity of the S&P 500 with the

9 actual annual income returns of U.S. Treasury bonds. Exh. DCP-11 shows the ROE for

10 the S&P 500 group for the period 1978-2018 (all available years reported by S&P). This

11 schedule also indicates the annual yields on 20-year U.S. Treasury bonds and the annual

12 differentials (i.e., risk premiums) between the S&P 500 and U.S. Treasury 20-year bonds.

13 Based upon these returns, I conclude that the risk premium from this analysis is 7.26

14 percent.

15 I next considered the total returns (i.e., dividends/interest plus capital

16 gains/losses) for the S&P 500 group as well as for long-term government bonds, as

17 tabulated by Duff & Phelps (formerly Morningstar/Ibbotson), using both arithmetic and

18 geometric means. I considered the total returns for the entire 1926-2018 period reported

19 by this source, which are as follows:

20

	S&P 500	L-T Gov't Bonds	Risk Premium
Arithmetic	11.9%	5.9%	6.0%
Geometric	10.0%	5.5%	4.5%

22

1   I conclude from this analysis that the expected risk premium is about 5.9 percent (i.e.

2   average of all three risk premiums: 7.26 percent from Exh. DCP-11; 6.0 percent

3   arithmetic and 4.5 percent geometric from Duff & Phelps). I believe that a combination

4   of arithmetic and geometric means is appropriate since investors have access to both

5   types of means[43] and presumably, both types are reflected in investment decisions and

6   thus, stock prices and the ROE.

7

8 **Q.**   **What are your CAPM results?**

9 A.   Exh. DCP-12 shows my CAPM calculations. The results are:

	Mean	Median
Parcell Proxy Group	6.0%	5.8%
McKenzie Proxy Group[44]	5.9%	5.8%

10

11

12 **Q.**   **What is your conclusion concerning the CAPM ROE?**

13 A.   The CAPM results collectively indicate a ROE of 5.8 percent to 6.0 percent for the

14   groups of proxy utilities. I conclude that an appropriate CAPM ROE estimation for

15   Avista is 5.8 percent to 6.0 percent.

16

17   **X.**   **CE ANALYSIS**

18

19 **Q.**   **Please describe the basis of the CE methodology.**

20 A.   The CE method is derived from the "corresponding risk" concept discussed in the

---

[43] For example, Value Line uses compound (i.e., geometric) growth rates in its projection. In addition, mutual funds report growth rates on a compound basis.
[44] Adjusted to reflect removal of three entities, as described above.

1   *Bluefield* and *Hope* cases. This method is thus based upon the economic concept of

2   opportunity cost. As previously noted, the ROE is an opportunity cost: the prospective

3   return available to investors from alternative investments of similar risk.

4   The CE method is designed to measure the returns expected to be earned on the

5   original cost book value of similar risk enterprises. Thus, it provides a direct measure of

6   the fair return, since it translates into practice the competitive principle upon which

7   regulation rests.

8   The CE method normally examines the experienced and/or projected return on

9   book common equity. The logic for examining returns on book equity follows from the

10   use of original cost rate base regulation for public utilities, which uses a utility's book

11   common equity to determine the cost of capital. This cost of capital is, in turn, used as

12   the fair rate of return which is then applied (multiplied) to the book value of rate base to

13   establish the dollar level of capital costs to be recovered by the utility. This technique is

14   thus consistent with the rate base-rate of return methodology used to set utility rates.

15

16   **Q.   How do you apply the CE methodology in your analysis of Avista's ROE?**

17   A.   I apply the CE methodology by examining realized ROEs for the groups of proxy

18   utilities, as well as unregulated companies. My CE analysis also uses prospective returns

19   and thus is not backward looking. I evaluate investor acceptance of these returns by

20   reference to the resulting market-to-book ratios ("M/Bs"). In this manner it is possible to

21   assess the degree to which a given level of return equates to the COC. It is generally

22   recognized for utilities that an M/B of greater than one (i.e., 100 percent) reflects a

23   situation where a company is able to attract new equity capital without dilution (i.e.,

1   above book value). As a result, one objective of a fair cost of equity is the maintenance

2   of stock prices at or above book value. There is no regulatory obligation to set rates

3   designed to maintain an M/B significantly above one.

4   I further note that my CE analysis is based upon market data (through the use of

5   M/Bs) and is thus essentially a market test. Given that public utilities have their rates set

6   based upon the book value of their assets (i.e., rate base) and capital structure (i.e., cost of

7   capital), when a utility's stock price exceeds it book value (i.e., M/B greater than 1) this

8   indicates that investors consider its current and prospective earnings as adequate.   As a

9   result, my CE analysis is not subject to the criticisms occasionally made by some who

10   maintain that past earned returns do not represent the cost of capital.

11

12   **Q.**   **What time periods do you examine in your CE analysis?**

13   A.   My CE analysis considers the experienced ROEs of the proxy groups of utilities for the

14   period 2002-2018 (i.e., the last 17 years). The CE analysis requires that I examine a

15   relatively long period of time in order to determine trends in earnings over at least a full

16   business cycle. Further, in estimating a fair level of return for a future period, it is

17   important to examine earnings over a diverse period of time in order to avoid any undue

18   influence from unusual or abnormal conditions that may occur in a single year or shorter

19   period. Therefore, in forming my judgment of the current cost of equity, I focused on

20   two periods: 2009-2018 (the current business cycle) and 2002-2008 (the most recent

21   business cycle). I have also considered projected ROEs for 2019, 2020 and 2022-2024.

22

1 **Q. Please describe your CE analysis.**

2 A. Exhibit Nos. DCP-13 and DCP-14 contain summaries of experienced ROEs and M/Bs for

3 three groups of companies, while Exh. DCP-15 presents a risk comparison of utilities

4 versus unregulated firms.

5 Exh. DCP-13 shows the ROEs and M/Bs for the groups of proxy utilities. These

6 can be summarized as follows:

	Parcell Proxy Group	McKenzie Proxy Group [45]
Historic ROE		
Mean	9.0-9.2%	10.0-11.5%
Median	9.1-9.6%	9.9-10.2%
Historic M/B		
Mean	153-155%	168-174%
Median	150-153%	158-159%
Prospective ROE		
Mean	9.2-9.6%	9.8-10.7%
Median	9.0-9.5%	10.0-10.5%

19 These results indicate that historic ROEs of 9.0 percent to 11.5 percent have been

20 adequate to produce M/Bs of 150 percent to 174 percent for the groups of utilities.

21 Furthermore, projected returns on equity for 2019, 2020 and 2022-2024 are within a

22 range of 9.0 percent to 10.7 percent for the utility groups. These relate to 2018 M/Bs of

23 180 percent or greater. I note that Mr. McKenzie's proxy group exhibits both higher

24 ROEs and M/Bs relative to those of my proxy group.

25

26 **Q. Do you also review the earnings of unregulated firms?**

27 A. Yes. As an alternative, I also examine the S&P's 500 Composite group. This is a well-

28 recognized group of firms that is widely utilized in the investment community and is

---

[45] Adjusted to reflect removal of three entities, as described above.

1		indicative of the competitive sector of the economy. Exh. DCP-14 presents the earned
2		ROEs and M/Bs for the S&P 500 group over the past seventeen years (i.e., 2002-2018).
3		As this schedule indicates, over the two business cycle periods, this group's average
4		ROEs ranged from 12.4 percent to 13.6 percent, with average M/Bs ranging between 249
5		percent and 275 percent.
6		
7	**Q.**	**How can the above information be used to estimate Avista's ROE?**
8	A.	The recent ROEs of the proxy utilities and S&P 500 group can be viewed as an indication
9		of the level of return realized and expected in the regulated and competitive sectors of the
10		economy. In order to apply these returns to the ROE for the proxy utilities, however, it is
11		necessary to compare the risk levels of the utilities and the competitive companies. I do
12		this in Exh. DCP-15, which compares several risk indicators for the S&P 500 group and
13		the utility groups. The information in this exhibit indicates that the S&P 500 group is
14		riskier than the utility proxy groups.
15		
16	**Q.**	**What ROE is indicated by your CE analysis?**
17	A.	Based on recent ROEs and M/Bs, my CE analysis indicates that the ROE for the proxy
18		utilities is no more than 9.0 percent to 10.0 percent (9.5 percent mid-point). Recent
19		ROEs of 9.0 percent to 11.5 percent have resulted in M/Bs of 150 percent and over.
20		Prospective ROEs of 9.0 percent to 10.7 percent have been accompanied by M/Bs over
21		180 percent. As a result, it is apparent that authorized returns below this level would
22		continue to result in M/Bs of well above 100 percent. As I indicated earlier, the fact that
23		M/Bs substantially exceed 100 percent indicates that historic and prospective ROEs of

1   9.5 percent reflect earning levels that are well above the actual cost of equity for those

2   regulated companies. I also note that a company whose stock sells above book value can

3   attract capital in a way that enhances the book value of existing stockholders, thus

4   creating a favorable environment for financial integrity. Finally, I note that my 9.0

5   percent to 10.0 percent CE recommendation generally reflects the actual and prospective

6   ROEs for my proxy group. I have made no adjustments to these return levels to reflect

7   the high M/Bs.

8

9   XI.   RETURN ON EQUITY RECOMMENDATION

10

11   **Q.   Please summarize the results of your three ROE analyses.**

12   A.   My three ROE analyses produced the following:

13

	Mid-Point	Range
DCF	8.65%	8.2-9.1%
CAPM	5.9%	5.8-6.0%
CE	9.5%	9.0-10.0%

16   These results indicate an overall broad range of 5.8 percent to 10.0 percent, which

17   focuses on the respective individual model results. Using mid-point values, the range is

18   5.9 percent to 9.5 percent. I recommend a ROE range of 9.1 percent to 9.5 percent for

19   Avista (mid-point of 9.3 percent). This range includes the upper end of my DCF results

20   and the mid-point of my CE results. My specific ROE recommendation is 9.3 percent.

21

1   **Q.**   **It appears that your CAPM results are less than your DCF and CE results. Does**

2   **this imply that the CAPM results should not be considered in determining the cost**

3   **of equity for Avista?**

4   A.   No. It is apparent that the CAPM results are less than the DCF and CE results. There are

5   two reasons for the lower CAPM results. First, risk premiums are lower currently than

6   was the case in prior years. This is the result of lower equity returns that have been

7   experienced over the past several years. This is also reflective of a decline in investor

8   expectations of equity returns and risk premiums. Second, the level of interest rates on

9   U.S. Treasury bonds (i.e., the risk-free rate) has been lower in recent years. This is

10   partially the result of the actions of the Federal Reserve System to stimulate the economy.

11   This also impacts investor expectations of returns in a negative fashion. I note that,

12   initially, investors may have believed that the decline in Treasury yields was a temporary

13   factor that would soon be replaced by a rise in interest rates. However, this has not been

14   the case, as interest rates have remained low and continued to decline for the past eight-

15   plus years. As a result, it cannot be maintained that low interest rates (and low CAPM

16   results) are temporary and do not reflect investor expectations. Investors have now

17   experienced nearly a ten-year period of low and declining interest rates, such that these

18   are the "new norm." Consequently, even though the CAPM results have not been given

19   weight in developing my recommended ROE range, they should be considered as one

20   factor in determining where, within the recommended range, the cost of equity for Avista

21   should fall. Therefore, I recommend that Avista's ROE be set at no higher than the mid-

22   point of the ROE range for the proxy companies.

23

XII. TOTAL COST OF CAPITAL

1   **XII.   TOTAL COST OF CAPITAL**

2

3   **Q.**   **What is the total COC for Avista?**

4   A.   Exh. DCP-3 reflects the total COC for Avista using my proposed capital structure and

5   embedded costs of debt, as well as my ROE recommendations. The resulting COC is a

6   range of 7.06 percent to 7.26 percent. With my 9.3 percent ROE, my COC

7   recommendation is 7.16 percent.

8

9   **Q.**   **Avista is requesting a two-year rate plan as part of its filings. Do your ROE and**

10   **COC recommendations apply to all years of this rate plan?**

11   A.   Yes, they do. I note, in this regard, that the proposed capital structure matches Avista's

12   recent capital structures, and so my COC recommendations reflect an "on-going" capital

13   structure. The costs of debt reflect 2019 figures and I am not aware of any significant

14   proposed new issues that would impact the 2019 cost of debt. Finally, my ROE

15   recommendation is based on financial models which are forward-looking and thus reflect

16   an on-going perspective.

17

18   **XIII.   COMMENTS ON COMPANY TESTIMONY**

19

20   **Q.**   **What ROE is Avista requesting in this proceeding?**

21   A.   Avista is requesting a 9.90 percent ROE for both its electric and natural gas operations.

22

1   This 9.90 percent ROE is sponsored by Avista's cost of capital witness Adrien M.

2   McKenzie.[46]

3

4 **Q.   What is the basis of Mr. McKenzie's 9.90 percent ROE recommendation?**

5 A.   Mr. McKenzie's ROE analyses are summarized on page 4 of Exh. AMM-1T as well as in

6   Exh. AMM-4. These are shown as follows:

	Average	Midpoint
DCF		
Value Line	10.0%	11.2%
IBES	10.0%	9.8%
Zacks	9.3%	10.9%
Internal br + sv	9.0%	10.2%
CAPM	10.2%	10.1%
Empirical CAPM	11.1%	11.1%
Utility Risk Premium		
Current Bond Yields	10.2%	
Projected Bond Yields	10.8%	
Expected Earnings	10.7%	10.6%
Cost of Equity Recommendation		
Cost of Equity Range	9.8% --	10.8%
Flotation Cost Adjustment		
Flotation Cost Percentage Adjustment	0.10%	
ROE Recommended Range	9.9% --	10.9%

20 **Q.   Do you have any general comments on Mr. McKenzie's methodologies and**

21   **conclusions?**

1   A.   Yes. Each of Mr. McKenzie's methodologies is biased in a way that overstates the

2   current and prospective ROE for his proxy group and for Avista. I address each of his

3   methodologies and conclusions below.

4

5   **Q.**   **Mr. McKenzie claims that "Investors continue to anticipate higher interest rates in**

6   **the foreseeable future."[47] What is your response to this assertion?**

7   A.   I disagree with Mr. McKenzie. I note that this is a crucial and underlying component of

8   Mr. McKenzie's testimony and conclusions. I further note that Mr. McKenzie made the

9   same prediction in his direct testimony in Docket Nos. UE-170485/UG-170486.[48]

10   There is no consensus that interest rates on long-term debt will increase

11   significantly. In fact, interest rates have steadily declined over the past several months.

12

13   **Q.**   **Have long-term utility bond yields risen in recent months as predicted by Mr.**

14   **McKenzie?**

15   A.   No, they have not. The table below depicts the trends in long-term utility Baa bond

16   yields over the latter months of 2018 and first quarter of 2019 (i.e., the time frame prior

17   to the filing of Mr. McKenzie's testimony), as well as the second and third quarters of

18   2019 (i.e., the time frame subsequent to the filing of Mr. McKenzie's testimony):

Month	Baa-Rated Utility Bonds
Sept. 2018	4.74%
Oct. 2018	4.91%
Nov. 2018	5.03%
Dec. 2018	4.92%
Jan. 2019	4.91%
Feb. 2019	4.76%

[47] McKenzie, AMM-1T at 25:1-5.
[48] Dockets UE-170485 & UG-170486, McKenzie, Exh. AMM-1T at 18:17-18 (May 26. 2017).

1	Mar. 2019	4.65%
	Apr. 2019	4.55%
2	May 2019	4.47%
	June 2019	4.31%
3	July 2019	4.13%
	Aug. 2019	3.63%
4		

5   This shows substantial declines in Baa-rated utility bond yields since September of 2018.

6   They have declined by 100 basis points since March 2019, the latest date of data in Mr.

7   McKenzie's analyses. This invalidates Mr. McKenzie's prediction of significantly

8   increasing long-term interest rates. My Exh. DCP-4, page 2 further shows that current

9   yields on Baa-rated utility bonds (i.e., 3.63%) are substantially lower than the yields in

10   2016 and 2017 (i.e., 4.69% and 4.38%, respectively) when Mr. McKenzie predicted

11   higher interest rates in his prior testimony.

12

13   **Q.**   **Please summarize Mr. McKenzie's DCF methodology and describe how he over-**

14   **states the ROE in his methodology and interpretation of DCF results.**

15   A.   Mr. McKenzie calculates DCF results for his group of 22 proxy electric utilities by

16   combining each proxy company's dividend yield (for last 30 trading days as of March 22,

17   2019) with four sets of growth rates, three of which are forecasts of EPS.[49]

18   I do not have any serious disagreements with Mr. McKenzie's yield calculation.

19   His use of 30 trading days, which usually amounts to about 40 calendar days, is a

20   somewhat shorter date than the three months I use in my DCF yield calculations, but our

21   respective calculations are not materially different due to the choice of timeframe. My

---

[49] McKenzie, Exh. AMM-6 at 1.

1   DCF calculations are, of course, more current than his due to the sequence of our

2   respective filings in this proceeding.

3   Mr. McKenzie considers four sets of growth rates in his DCF analyses:[50]

4   1. Value Line EPS estimates

5   2. IBES EPS Estimates

6   3. Zack's EPS Estimates

7   4. br + sv growth

8   Mr. McKenzie calculates individual DCF results for each proxy company with

9   each of the four growth rates, then calculates average and midpoint values for the proxy

10   group using each of the four growth rates. The respective results are:[51]

11

Growth Rate	Average	Midpoint
Value Line EPS	10.0%	11.2%
IBES EPS	10.0%	9.8%
Zacks EPS	9.3%	10.9%
br + sv	9.0%	10.2%

14

15   I note that these conclusions do not reflect all of Mr. McKenzie's individual DCF

16   calculations, as he eliminates those below a "low-end threshold" of 5.9 percent to 6.5

17   percent ("illogical values").[52] As justification for this "threshold," he cites the Federal

18   Energy Regulatory Commission's ("FERC") "100 basis-point premium to the historical

19   average utility bond yields…."[53]

20

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[50] *Id.* at 2.
[51] McKenzie, Exh. AMM-6 at 3.
[52] McKenzie, Exh. AMM-1T at 34:14-16; Exh. AMM-3 at 21:6-14.
[53] McKenzie, Exh. AMM-3 at 21:8-9.

1	Q.	**Do you agree with Mr. McKenzie's implied interpretation and use of the so-called**
2		**"FERC low-end threshold?"**
3	A.	No. Mr. McKenzie has mischaracterized the actual process that FERC uses to eliminate
4		"low-end outliers." What FERC actually does is eliminate individual DCF results that
5		are less than 100 basis points greater than actual historical yields on utility debt. FERC
6		does not apply the threshold to "projected" utility bond yields.[54]
7		During the six-month period (i.e., September 2018-February 2019) prior to Mr.
8		McKenzie's DCF analyses (i.e., a six-month time period is used by FERC), the average
9		yield on Baa utility bonds was 4.88 percent (see Baa-rated utility bond yields shown on a
10		prior page). This implies a low-end threshold of 5.88 percent. The average for the most
11		current six-month period (March-August, 2019) was 4.29 percent, which implies a low-
12		end threshold of 5.29 percent.
13		
14	Q.	**Have you updated and corrected Mr. McKenzie's DCF analyses?**
15	A.	Yes. Exh. DCP-16 updates and corrects Mr. McKenzie's DCF analyses using the
16		following data and methodologies:
17		Yield – current DPS and average stock prices for June-August 2019
18		Growth-
19		Most current Value Line EPS for each proxy company
20		Most current IBES EPS as of September 1, 2019

---

[54] *See*, *Coakley v. Bangor Hydro-Elec. Co.*, 147 FERC ¶ 61,234, ¶¶ 122-123 (Order on Initial Decision) (2014), *vacated and remanded on other grounds sub nom., Maine v. Fed. Energy Regulatory Comm'n*, 854 F.3d 9, 30 (D.C. Cir. 2017); *but see, Inquiry Regarding the Commission's Policy for Determining Return on Equity*, 166 FERC ¶ 61,207 (Requesting comments on whether FERC should modify its policies concerning the determination of ROE following the *Emera Maine* decision)(March 21, 2019).

1		Most current Zacks EPS as of September 18, 2019	
2		br + sv (not updated)	
3		Low-end outliers – individual DCF results less than 5.29 percent not included in	
4		averages	

5   As is shown on Exh. DCP-16, the updated and corrected DCF results are as

6   follows:

Growth Rate	Average	Midpoint	Median
Value Line EPS	10.1%	10.1%	9.5%
IBES EPS	8.6%	8.7%	8.5%
Zacks EPS	8.5%	8.5%	8.9%
br + sv[55]	8.4%	8.9%	8.0%

10   These DCF results are seen to be more-in-line with my DCF results (i.e., 8.2 percent to

11   9.1 percent).

12

13 **Q.**   **Describe Mr. McKenzie's CAPM analyses and conclusions.**

14 A.   Mr. McKenzie performs two sets of CAPM analyses:[56]

15   1.   Traditional (CAPM) with current bond yields.

16   2.   Empirical (ECAPM) with current bond yields.

17

18 **Q.**   **What are your disagreements with these various CAPM methodologies and**

19   **conclusions?**

20 A.   Each of Mr. McKenzie's CAPM methodologies overstates the cost of equity for his proxy

21   groups and Avista. Mr. McKenzie's methodologies contain the following problems:

---

[55] Using br + sv Growth, as shown in McKenzie, Exh. AMM-6 at 2-3.
[56] McKenzie, Exh. AMM-8 & Exh. AMM-9.

1   • Mr. McKenzie over-states the proper risk premium component in both his

2   CAPM and ECAPM, and

3   • Mr. McKenzie is incorrect in making a "size adjustment" to his CAPM and

4   ECAPM

5

6 **Q.**   **Please summarize Mr. McKenzie's risk premium components.**

7 A.   Mr. McKenzie calculates a risk premium as follows. The "market return" (Rm)

8   component of the risk premium is a 13.2 percent DCF cost of equity for the dividend-

9   paying companies of the S&P 500. The "current bond yield" risk premium subtracts

10   from this 13.2 percent Rm the 3.1 percent average yield on 30-year U.S. Treasury bonds

11   to derive a 10.1 percent risk premium.[57]

12

13 **Q.**   **Do you have any criticisms of Mr. McKenzie's CAPM Market Risk Premium**

14   **components?**

15 A.   Yes. There are several problems with his methodology employed to develop this market

16   risk premium. Mr. McKenzie's 10.1 percent risk premium greatly exceeds the historic

17   levels of risk premiums (i.e., 4.5 percent to 7.2 percent) I cited in my CAPM analyses.

18   He offers no explanation as to why investors would expect such a dramatic increase in

19   risk premiums.

20   In addition, Mr. McKenzie's CAPM risk premium is derived from his

21   development of a DCF cost for the dividend-paying stocks in the S&P 500 using only 5-

---

1	year EPS growth projections as the growth component.[58] It is not appropriate to rely
2	exclusively on analysts' short-term EPS growth projections in a DCF analysis.
3	
4	**Q.** **Please explain why it is not appropriate to rely exclusively on EPS growth forecasts**
5	**in a DCF context.**
6	A. There are several reasons why it is not appropriate to rely exclusively on analysts' short-
7	term EPS growth forecasts in a DCF context. First, it is not realistic to believe that
8	investors rely exclusively on a single factor, such as analysts' forecasts, in making their
9	investment decisions. Investors have an abundance of available information to assist
10	them in evaluating stocks; EPS forecasts are only one of many such statistics.
11	Second, Value Line – one of Mr. McKenzie's sources of EPS projections –
12	publishes both historic and forecasted data, as well as ratios, for a large number of
13	publicly-traded companies. Presumably, both types of information are published for the
14	consideration of its subscribers/investors. Yet Mr. McKenzie considers only one factor,
15	the forecast version of EPS, in his analyses.
16	Third, the vast majority of information available to investors, by both individual
17	companies in the form of annual reports and offering circulars, and by investment
18	publications such as Value Line, is historic data. It is neither realistic nor logical to
19	maintain that investors only consider projected (estimated) data to the exclusion of other
20	data.
21	Fourth, the experience over the past several years should be a clear signal to
22	investors that analysts cannot accurately predict EPS levels. Few, if any, analysts

---

[58] *Id*. (note (b)).

1   predicted the decline in security prices in the financial crisis of 2008 and 2009.[59] Thus,

2   relying only on forecasted EPS levels, while ignoring other growth indicators, cannot and

3   will not produce accurate results.

4   In summary, investors are now very much aware of recent inabilities of security

5   analysts to accurately predict EPS growth. These problems clearly call into question the

6   exclusive reliance on analysts' forecasts as the only source of growth in a DCF context.

7   As a result, the landscape has changed in recent years and investors have ample reasons

8   to doubt the exclusive reliability of such forecasts at the present time. In light of the

9   above, it is problematic to rely exclusively on such forecasts in determining the DCF

10   result for Mr. McKenzie's portfolio of S&P 500 stocks.

11

12 **Q.   Are you aware of any recent analyses and comments on the accuracy of analysts'**

13 **forecasts?**

14 A.   Yes, I am. A 2010 study by McKinsey & Company, titled, "Equity Analysts: Still Too

15   Bullish" concludes that "after almost a decade of stricter regulation, analysts' earnings

16   forecasts continue to be excessively optimistic."[60] The significance of this study, as well

17   as the points I raised previously, is that investors should be hesitant to rely exclusively on

18   analysts' forecasts in making investment decisions.

19

---

[59] *See, e.g.*, "Security Analysts and their Recommendations", *available at* http://thismatter.com/money/stocks/valuation/security-analysts.htm.
[60] Marc H. Goedhart, et al., "Equity Analysts: Still Too Bullish", McKinsey on Finance, No. 35, Spring 2010 at 14.

1	Q.	**Has the United States Securities and Exchange Commission issued any reports that**
2		**address the exclusive reliance on analysts' recommendations?**
3	A.	Yes. In a 2010 "Investor Alert: Analyzing Analyst Recommendations" the Securities
4		and Exchange Commission ("SEC") made the following statement:[61]

5 As a general matter, investors should not rely solely on an analyst's
6 recommendation when deciding whether to buy, hold, or sell a stock.
7 Instead, they should also do their own research – such as reading the
8 prospectus for new companies or for public companies, the quarterly and
9 annual reports filed with the SEC – to confirm whether a particular
10 investment is appropriate for them in light of their individual financial
11 circumstances.

13 This SEC "Investor Alert" also cites the potential conflicts of interests that analyst face.

14 This "Investor Alert" thus also calls into question the exclusive reliance on

15 analysts' forecasts, as proposed by Mr. McKenzie.

16

17 Q. **Please turn to the next problem with Mr. McKenzie's CAPM methodology.**

18 A. Mr. McKenzie adds a "size" premium to his CAPM results for each of his proxy group

19 companies. Mr. McKenzie maintains that there is justification for making a small-firm

20 risk adjustment that results in a higher cost of capital for small firms. His proposed size

21 adjustment varies among the proxy companies with individual values up to 1.58

22 percent.[62] Such an adjustment is improper and results in an overstatement of the ROE for

23 the proxy electric utilities.

24 There are compelling reasons why a small size adjustment is not proper for

25 regulated utilities. Mr. McKenzie's proposed size adjustment is based upon his reference

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[61] United States Securities and Exchange Commission "Investor Alert: Analyzing Analysts Recommendations",
2010.
[62] McKenzie, Exh. AMM-8 & Exh. AMM-9 (Otter Tail Corp., Row 20).

1   to the previously-cited Duff & Phelps (formerly Morningstar/Ibbotson) studies.[63]

2   However, the small size adjustment in the Duff & Phelps studies is based on the analysis

3   of all stocks, the majority of which are unregulated and include industries that are much

4   riskier than utilities. While it may or may not be true that on an overall market basis,

5   smaller publicly-traded firms exhibit more risk than larger firms, these smaller

6   companies' stocks tend to be engaged in riskier businesses as a whole than do larger

7   businesses. Such is not the case for regulated utilities.

8   Indeed, an academic study conducted by Professor Annie Wong found that:

9   [U]tility and industrial stocks do not share the same characteristics. First,
10   given firm size, utility stocks are consistently less risky than industrial
11   stocks. Second, industrial betas tend to decrease with firm size but utility
12   betas do not. These findings may be attributed to the fact that all public
13   utilities operate in an environment with regional monopolistic power than
14   regulated financial structure. As a result, the business and financial risks
15   are very similar among the utilities regardless of their sizes. Therefore,
16   utility betas would not necessarily be expected to be related to firm size.
17   . . .
18
19   This implies that although the price phenomenon has been strongly
20   documented for the industrials, the findings suggest that there is no need
21   to adjust for the firm size in utility rate regulation.[64]
22
23
24   **Q.   Can you provide any evidence that "size" or "business risk" adjustments are not**

25   **generally recognized as risk factors in regulatory proceedings such as this one?**

26   A.   Yes, I can. Implicit in Mr. McKenzie's proposal is an assumption that any perceived

27   small size risk adjustment for unregulated companies (*i.e.*, source of information cited in

28   the Duff & Phelps source Mr. McKenzie relies on for his small size adjustment) applies

29   to regulated public utilities. Exh. DCP-17 demonstrates objectively that this is not the

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[63] McKenzie, Exh. AMM-3 at 26, n. 28 & 29.
[64] Wong, Annie, "Utility Stocks And The Size Effect: An Empirical Analysis", Journal of the Midwest Finance Association, 1993, pp. 95-101.

1   case. As this exhibit shows, there is no significant difference and there is no discernible

2   pattern of increase among the risk indicators of publicly-traded electric utilities of

3   different sizes. The table below summarizes the information contained in this exhibit.

4

Cap Size	Safety	Beta	Financial Strength	S&P Rating	Moody's Rating
Under $5 B	2.0	.63	A/B++	BBB+	Baa1
$5-$15 B	2.0	.67	A	BBB+	Baa1
$15-$25 B	2.1	.58	B++	BBB+	Baa1/Baa2
$25 B Plus	1.5	.56	A	A-/B++	Baa1

8   The safety rank, beta values, financial strength, and Moody's/S&P bond ratings are about

9   the same for all sizes of electric utilities. These risk indicators do not reflect any risk

10   differential as the size of the electric utilities decrease from large to small. To the

11   contrary, this data indicates that regulated monopoly utility providers have approximately

12   the same risk regardless of size. As a result, the logic Mr. McKenzie uses to justify his

13   proposed small size adjustment is unsound.

14

15 **Q.   Why is it improper to use an ECAPM for public utilities?**

16 A.   The ECAPM is improper to use for Avista because it "adjusts" each proxy company's

17   actual beta by assigning only 75 percent weight to the actual beta and "assumes" a beta of

18   1.0 with the remaining 25 percent weight. As a result, the ECAPM does not use the

19   actual betas of the proxy companies, but rather calculates hypothetical betas that are

20   upward biased due to the fact that electric utility betas are below 1.0. In contrast, the

21   traditional CAPM directly recognizes and quantifies the risk of individual companies

22   through the use of the beta coefficient. As such, each proxy company's risk and beta are

23   identified and used in the calculation of its CAPM ROE.

1   **Q.**   **Please summarize Mr. McKenzie's electric utility risk premium approach.**

2   A.   Mr. McKenzie's risk premium approach compares authorized ROEs for electric utilities

3   (between 1974 and 2018) with yields on public utility bonds. He then performs a

4   regression analysis to account for his perception of the inverse relationship between

5   interest rates and risk premiums.[65] He concludes that the current risk premium is 5.35

6   percent, which he adds to the current yield on Baa utility bonds (4.87 percent) to get a

7   10.22 percent risk premium.[66] He also combines the projected utility bond yield (5.85

8   percent) with a 4.93 percent risk premium to get his prospective risk premium

9   conclusions to 10.87 percent.[67] Both of these yields significantly exceed the current yield

10   on triple-B rated utility bonds.

11

12   **Q.**   **What are your primary disagreements with this approach and Mr. McKenzie's**

13   **conclusions?**

14   A.   There are several problems with Mr. McKenzie's risk premium analyses, all of which

15   have the effect of overstating the ROE for the proxy companies and Avista. First, the

16   highest risk premium values over this period occurred in 2011-2018.[68] This corresponds

17   to the post-Great Recession period in which the actions of the Federal Reserve kept

18   interest rates low. Mr. McKenzie describes these yields as "uncharacteristically low."[69]

19   Thus, Mr. McKenzie's recent above-average risk premiums are driven by

20   "uncharacteristically low" interest rates. He cannot have it both ways – if recent interest

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[65] McKenzie, Exh. AMM-10 at 4.
[66] *Id.* at 1.
[67] *Id.* at 2.
[68] *Id.* at 3.
[69] McKenzie, Exh. AMM-3 at 22:10-13.

1 rates are "uncharacteristically low", they cannot be used as a standard for establishing

2 Avista's ROE.

3   Second, it is not proper to compare utility authorized ROEs in the 1970's and

4 1980's with the current time. Current ROE's reflect a suite of favorable regulatory

5 mechanisms that greatly enhance utilities' ability to recover costs, which is risk-reducing

6 and thus warrants low ROEs.[70]

7

8 **Q.** **Why is it not proper to use projected interest rates as the risk-free rate in a risk**

9 **premium analysis?**

10 A. It is improper to use prospective interest rates, because they are not measurable and not

11 achievable. For example, if the current yield on Triple-B is less than 4.0 percent, this

12 reflects the rate that investors can actually receive on their investment. Investors cannot

13 receive a prospective yield on their investments since such a yield is speculative, not

14 actual. It is instead proper to use the current yield as the risk-free rate in a CAPM

15 context. Because the current yield is known and measurable, it reflects investors'

16 collective assessment of all capital market conditions.

17   Use of the current risk-free rate in a CAPM context is similar to using the current

18 yield in a DCF context. Analysts do not use prospective stock prices as the basis for the

19 dividend yield in a DCF analysis, as use of prospective stock prices is speculative.

20 However, Mr. McKenzie's use of current stock prices is appropriate. Likewise, current

21 levels of interest rates reflect all current information (i.e., the efficient market hypothesis)

22 and should be used as the risk-free rate in the CAPM.

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[70] *See*, *e.g.*, Moody's Investors Service, Sector Comments, "US Utility Sector Upgrades Driven by Stable and Transparent Regulatory Frameworks", February 3, 3014.

1 Q. **Please now turn to Mr. McKenzie's Expected Earnings Approach. Please**

2   **summarize his use of this methodology and his conclusions.**

3 A. Mr. McKenzie's Expected Earnings Approach is a form of the comparable earnings

4   methodology. Mr. McKenzie has tabulated Value Line's "expected" return on equity for

5   his proxy group of companies, which he "adjusts" for a return on average equity (as

6   opposed to Value Line's reporting on year-end equity).

7   Mr. McKenzie's tabulation shows an "Adjusted Return on Common Equity"

8   range of 6.6 percent to 14.6 percent, with a 10.7 percent average and 10.6 percent mid-

9   point.[71] He concludes that 10.6 percent to 10.7 percent is the Expected Earnings

10   Approach findings.[72]

11

12 Q. **Do you have any criticisms of Mr. McKenzie's Expected Earnings Approach and**

13   **related conclusions?**

14 A. Yes. It is inappropriate to focus only on expected ROE without any reference to how such

15   returns are accepted by investors. A more appropriate analysis of expected returns on

16   equity is done in conjunction with M/Bs. I reviewed Mr. McKenzie's Expected Earnings

17   Approach by evaluating the investor acceptance of these cited ROEs by reference to the

18   corresponding M/Bs. In this manner, it is possible to assess the degree to which a given

19   level of ROE equates to the cost of capital, as I describe in a previous section of my

20   testimony. Book value is a relevant concept for regulated utilities due to the use of rate-

21   of-return rate-base regulation, which employs book value for both rate base and capital

22   structure. Investors know that utility rates are established based, in part, on book values.

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[71] McKenzie, Exh. AMM-11.
[72] McKenzie, Exh. AMM-1T at 37:17-18.

1		Exh. DCP-13 on page 2 shows the 2018 M/Bs of the proxy companies. These are above

1   Exh. DCP-13 on page 2 shows the 2018 M/Bs of the proxy companies. These are above

2   180 percent, which indicates that the ROEs are expected to exceed the cost of capital.

3   Third, it is evident that the expected ROEs for the proxy companies which are

4   mostly holding companies are substantially higher than the authorized ROEs for electric

5   utilities.

6   Mr. McKenzie's "Expected Earnings Approach" is thus shown to also overstate

7   the ROE for electric utilities. Mr. McKenzie's use of expected ROEs for the proxy

8   companies, without reference or corroboration with either M/Bs or the levels of

9   authorized ROEs, does not provide useful information concerning the ROE for Avista.

10

11 **Q.   Mr. McKenzie also performs DCF analyses unregulated firms. Is this proper?**

12 A.   No. I disagree with his use of unregulated firms as a proxy group for Avista. It is not

13   proper to use non-regulated firms in the manner Mr. McKenzie proposes. It is improper

14   because unregulated enterprises face different risk and operational characteristics than do

15   utilities. My use of unregulated firms as a proxy group accounts for these important

16   differences.

17

18 **Q.   Do you agree with Mr. McKenzie's proposal to add a 0.10 percent flotation cost**

19   **adjustment?**

20 A.   No, I do not. There has been no demonstration that Avista has or plans a public offering

21   of common stock with the intent of increasing the common equity ratio of Avista

22   Utilities. I note that the issuance of new shares through the dividend reinvestment plan

23   does not incur flotation costs. In addition, even if a public offering were to occur, it

1   would be at a stock price that substantially exceeds the book value of existing stock price,

2   which results in a gain to existing stockholders. Flotation costs, to the extent that they

3   occur, are known to investors and thus are reflected in the stock prices and thus, ROE

4   model results. As a result, there is no need to add flotation costs to the results of ROE

5   models, as Mr. McKenzie proposes.

6

7   **Q.**   **Has the Commission rejected the inclusion of flotation costs for Avista?**

8   A.   The Commission rejected Avista's request to include flotation costs in the 2017 general

9   rate case, noting that while flotation costs "may be legitimate adjustments made during

10   the underwriting process" the company did not demonstrate it actually incurred such

11   costs during the test year.[73] Avista has not demonstrated the existence of any such costs

12   in the instant case either.

13

14 **Q.**   **Does this conclude your testimony?**

15 A.   Yes, it does.

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[73] 2017 Avista GRC Order 30, ¶ 76.