Exhibit No.___(WEA-1T)

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-11_____

DOCKET NO. UG-11_____

DIRECT TESTIMONY OF

WILLIAM E. AVERA

REPRESENTING AVISTA CORPORATION

DIRECT TESTIMONY OF WILLIAM E. AVERA

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I. INTRODUCTION

Q. Please state your name and business address.

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

Q. In what capacity are you employed?

A. I am the President of FINCAP, Inc., a firm providing financial, economic, and policy consulting services to business and government.

Q. Please describe your educational background and professional experience.

A. A description of my background and qualifications, including a resume containing the details of my experience, is attached as Exhibit No.___(WEA-2).

A. Overview

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

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

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

A. To prepare my testimony, I used information from a variety of sources that would normally be relied upon by a person in my capacity. I am familiar with the organization, finances, and operations of Avista from my participation in prior proceedings before the UTC, the Idaho Public Utilities Commission, and the Oregon Public Utility Commission. In connection with the present filing, I considered and relied upon corporate disclosures, publicly available financial reports and filings, and other published information relating to Avista. I also reviewed information relating generally to current capital market conditions and specifically to current investor perceptions, requirements, and expectations for Avista's utility operations. These sources, coupled with my experience in the fields of finance and utility regulation, have given me a working knowledge of the issues relevant to investors' required return for Avista, and they form the basis of my analyses and conclusions.

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

A. The ROE serves to compensate common equity investors for the use of their capital to finance the plant and equipment necessary to provide utility service. Investors commit capital only if they expect to earn a return on their investment

commensurate with returns available from alternative investments with comparable risks. To be consistent with sound regulatory economics and the standards set forth by the U.S. Supreme Court in the *Bluefield*[1] and *Hope*[2] cases, a utility's allowed ROE should be sufficient to: 1) fairly compensate the utility's investors, 2) enable the utility to offer a return adequate to attract new capital on reasonable terms, and 3) maintain the utility's financial integrity.

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

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

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

Washington, as well as other factors (*e.g.*, flotation costs) that are properly considered in setting a fair ROE for the Company.

B. Summary of Conclusions

Q. What are your findings regarding the 10.9 percent ROE requested by Avista?

A. Based on the results of my analyses and the economic requirements necessary to support continuous access to capital under reasonable terms, I determined that 10.9 percent is a fair and reasonable estimate of investors' required ROE for Avista. The bases for my conclusion are summarized below:

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

- Because investors' required return on equity is unobservable and no single method should be viewed in isolation, I applied both the DCF and CAPM methods, as well as the expected earnings approach, to estimate a fair ROE for Avista;

- Based on the results of these analyses, and giving less weight to extremes at the high and low ends of the range, I concluded that the cost of equity for the proxy groups of utilities and non-utility companies is in the **10.3 percent to 11.3 percent** range, or **10.45 percent to 11.45 percent** after incorporating an adjustment to account for the impact of common equity flotation costs; and,

- As reflected in the testimony of Mark T. Thies, Avista is requesting a fair ROE of 10.9 percent, which is essentially equal to the midpoint of my recommended range. Considering capital market expectations, the

exposures faced by Avista, and the economic requirements necessary to maintain financial integrity and support additional capital investment even under adverse circumstances, it is my opinion that 10.9 percent represents a fair and reasonable ROE for Avista.

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

A. My recommendation is reinforced by the following findings:

- The reasonableness of a 10.9 percent ROE for Avista is supported by the need to consider the challenges to the Company's credit standing:
  - The pressure of funding significant capital expenditures of $482 million in the next two years, given that the Company's rate base is $2.1 billion, coupled with increased operating risks, heighten the uncertainties associated with Avista;
  - Because of Avista's reliance on hydroelectric generation and increasing dependence on natural gas fueled capacity, the Company is exposed to relatively greater risks of power cost volatility, even with the energy recovery mechanism ("ERM"); and,
  - My conclusion that a 10.9 percent ROE for Avista is a reasonable estimate of investors' required return is also reinforced by the greater uncertainties associated with Avista's relatively small size, the economic reality that Avista's actual returns have fallen consistently short of the allowed ROE, and the fact that current cost of capital estimates are likely to understate investors' requirements at the time the outcome of this proceeding becomes effective and beyond.

- Sensitivity to financial market and regulatory uncertainties has increased dramatically and investors recognize that constructive regulation is a key ingredient in supporting utility credit standing and financial integrity; and,

- Providing Avista with the opportunity to earn a return that reflects these realities is an essential ingredient to support the Company's financial position, which ultimately benefits customers by ensuring reliable service at lower long-run costs.

- Continued support for Avista's financial integrity, including a reasonable ROE, is imperative to ensure that the Company has the capability to maintain an investment grade rating while confronting potential challenges associated with funding infrastructure development necessary to meet the needs of its customers.

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

A. Based on my evaluation, I concluded that a common equity ratio of 48.04 percent represents a reasonable basis from which to calculate Avista's overall rate of return. This conclusion was based on the following findings:

- Avista's requested capitalization is consistent with the Company's need to maintain its credit standing and financial flexibility as it seeks to raise additional capital to fund significant system investments and meet the requirements of its service territory;

- Avista's proposed common equity ratio is entirely consistent with the range of capitalizations maintained by the proxy group of utilities, and falls below the 49.3 percent and 51.5 percent average common equity ratios for the proxy utilities, based on year-end 2010 data and near-term expectations, respectively; and,

- The requested capitalization reflects the importance of an adequate equity layer to accommodate Avista's operating risks and the pressures of funding significant capital investments. This is reinforced by the need to consider the impact of uncertain capital markets conditions, as well as off-balance sheet commitments such as purchased power agreements, which carry with them some level of imputed debt.

II. RISKS OF AVISTA

Q. What is the purpose of this section?

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

A. Operating Risks

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

A. Because over 40 percent of Avista's total energy requirements are provided by hydroelectric facilities, the Company is exposed to a level of uncertainty not faced by most utilities. While hydropower confers advantages in terms of fuel cost savings and diversity, reduced hydroelectric generation due to below-average water conditions forces Avista to rely more heavily on wholesale power markets or more costly thermal generating capacity to meet its resource needs. As Standard & Poor's Corporation ("S&P") has observed:

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

> creating potentially a double impact – companies have to buy more power than under normal conditions, paying higher prices.[3]

Investors recognize that volatile energy markets, unpredictable stream flows, and Avista's reliance on wholesale purchases to meet a significant portion of its resource needs can expose the Company to the risk of reduced cash flows and unrecovered power supply costs. S&P noted that Avista, along with Idaho Power Company, "face the most substantial risks despite their PCAs and cost-update mechanisms,"[4] and concluded that Avista's "chief risks include the electric utility's exposure to replacement power costs (particularly in low water years)."[5] S&P recently confirmed that, "the threshold [Avista] must meet to true-up uncollected costs in Washington is high, and the company does not automatically collect deferred costs."[6] Similarly, Fitch Ratings Ltd. ("Fitch") concluded, "Credit concerns include the relatively unpredictable nature of hydroelectric operating conditions from year to year and the negative impact on cash flows during times of low hydroelectric output."[7]

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

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[3] Standard & Poor's Corporation, "Pacific Northwest Hydrology And Its Impact On Investor-Owned Utilities' Credit Quality," *RatingsDirect* (Jan. 28, 2008).
[4] Id.
[5] Standard & Poor's Corporation, "Research Update: Avista Corp. Corporate Credit Rating Raised To 'BBB'; Outlook Stable," *RatingsDirect* (Mar. 2, 2011).
[6] *Id*.
[7] Fitch Ratings, Ltd., "Fitch Affirms Avista's Ratings; Outlook Stable.," *Global Power U.S. Credit Analysis* (Aug. 2, 2010).

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

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

A. Yes. Avista will require capital investment to meet customer growth, provide for necessary maintenance and replacements of its natural gas utility systems, as well as fund new investment in electric generation, transmission and distribution facilities. As discussed by Company witness Mr. Thies, planned capital additions for 2010-2011 alone total approximately $482 million, with $1.2 billion in expenditures being expected through 2015. This represents a substantial investment given Avista's rate base was $2.1 billion as of year-end 2010.

Continued support for Avista's financial integrity and flexibility will be instrumental in attracting the capital necessary to fund these projects in an effective manner. Avista's reliance on purchased power to meet shortfalls in hydroelectric generation magnifies the importance of strengthening financial flexibility, which is essential to guarantee access to the cash resources and interim financing required to cover inadequate operating cash flows, as well as fund required investments in the utility system.

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

A. Yes. In recent years utilities and their customers have had to contend with dramatic fluctuations in fuel costs due to ongoing price volatility in the spot markets, and investors recognize the potential for further turmoil in energy markets. In times of extreme volatility, utilities can quickly find themselves in a significant under-recovery position with respect to power costs, which can severely stress liquidity. The power industry and its customers have had to contend with dramatic fluctuations in gas costs due to ongoing price volatility in the spot markets.

While current expectations for significantly lower wholesale power prices reflect weaker fundamentals affecting current load and fuel prices, investors recognize the potential that such trends could quickly reverse. For example, heightened uncertainties in the Middle East have led to sharp increases in petroleum prices, and the potential ramifications of the Japanese nuclear crisis on the future cost and availability of nuclear generation in the U.S. have not been lost on investors. S&P observed that "short-term price volatility from numerous possibilities … is always possible,"[8] while Moody's recognized that "the inherent volatility of

[8] Standard & Poor's Corporation, "Top 10 Investor Questions: U.S. Regulated Electric Utilities," *RatingsDirect* (Jan. 22, 2010).

commodity costs comprises one of the most significant risk factors to the industry,"[9] and concluded, "This view, that commodity prices remain low, could easily be proved incorrect, due to the evidence of historical volatility."[10]

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

A. Investors are aware of the financial and regulatory pressures faced by utilities associated with rising costs and the need to undertake significant capital investments. S&P noted that cost increases and capital projects, along with uncertain load growth, were a significant challenge to the utility industry.[11] As Moody's observed:

> [W]e also see the sector's overall business risk and operating risks increasing, owing primarily to rising costs associated with upgrading and expanding the nation's trillion dollar electric infrastructure.[12]

Providing the infrastructure necessary to meet the energy needs of customers imposes additional financial responsibilities on Avista. As noted earlier, the Company's plans include utility capital expenditures of approximately $482 million

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[9] Moody's Investors Service, "Credit Opinion: Avista Corp.," *Global Credit Research* (Mar. 17, 2011).
[10] Moody's Investors Service, "U.S. Electric Utilities: Uncertain Times Ahead; Strengthening Balance Sheets Now Would Protect Credit," *Special Comment* (Oct. 28, 2010).
[11] Standard & Poor's Corporation, "Industry Economic And Ratings Outlook," *RatingsDirect* (Feb. 2, 2010).
[12] Moody's Investors Service, "Regulation Provides Stability As Risks Mount," *Industry Outlook* (Jan. 19, 2011).

just over the 2011-2012 period, and Moody's has noted that Avista's primary challenge is related to cost recovery of increasing capital investment."[13] Investors are aware of the challenges posed by rising costs and burdensome capital expenditure requirements, especially in light of ongoing capital market and economic uncertainties.

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

A. Utilities are confronting increased environmental pressures that could impose significant uncertainties and costs. Moody's noted that "the prospect for new environmental emission legislation – particularly concerning carbon dioxide – represents the biggest emerging issue for electric utilities."[14] While the momentum for carbon emissions legislation has slowed, expectations for eventual regulations continue to pose uncertainty. Fitch recently concluded, "Prospects of costly environmental regulations will create uncertainty for investors in the electricity business in 2011."[15]

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[13] Moody's Investors Service, "Credit Opinion: Avista Corp.," *Global Credit Research* (Mar. 17, 2011).
[14] Moody's Investors Service, "U.S. Investor-Owned Electric Utilities," *Industry Outlook* (Jan. 2009).
[15] Fitch Ratings Ltd., "2011 Outlook: U.S. Utilities, Power, and Gas," *Global Power North America Special Report* (Dec. 20, 2010)

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

A. Yes. A firm's relative size has important implications for investors in their evaluation of alternative investments, and it is well established that smaller firms are more risky than larger firms. With a market capitalization of approximately $1.3 billion, Avista is one of the smallest publicly traded electric utilities followed by The Value Line Investment Survey ("Value Line"), which have an average capitalization of approximately $7.3 billion.[16]

The magnitude of the size disparity between Avista and other firms in the utility industry has important practical implications with respect to the risks faced by investors. All else being equal, it is well accepted that smaller firms are more risky than their larger counterparts, due in part to their relative lack of diversification and lower financial resiliency.[17] These greater risks imply a higher required rate of return, and there is ample empirical evidence that investors in smaller firms realize higher rates of return than in larger firms.[18] Common sense

[16] www.valueline.com (Retrieved Mar. 25, 2011).
[17] It is well established in the financial literature that smaller firms are more risky than larger firms. See, *e.g.*, Eugene F. Fama and Kenneth R. French, "The Cross-Section of Expected Stock Returns", *The Journal of Finance* (June 1992); George E. Pinches, J. Clay Singleton, and Ali Jahankhani, "Fixed Coverage as a Determinant of Electric Utility Bond Ratings", *Financial Management* (Summer 1978).
[18] See for example Rolf W. Banz, "The Relationship Between Return and Market Value of Common Stocks", *Journal of Financial Economics* (September 1981) at 16.

and accepted financial doctrine hold that investors require higher returns from smaller companies, and unless that compensation is provided in the rate of return allowed for a utility, the legal tests embodied in the *Hope* and *Bluefield* cases cannot be met.

B. Implications of Attrition

Q. What causes attrition?

A. Attrition is the deterioration of actual return below the allowed return that occurs when the relationships between revenues, costs, and rate base used to establish rates (e.g., using a historical test year without adequate adjustments) do not reflect the actual costs incurred to serve customers during the period that rates are in effect. For example, if external factors are driving costs to increase more than revenues, then the rate of return will fall short of the allowed return even if the utility is operating efficiently. Similarly, when growth in the utility's investment outstrips the rate base used for ratemaking, the earned rate of return will fall below the allowed return through no fault of the utility's management. These imbalances are exacerbated as the regulatory lag increases between the time when the data used to establish rates is measured and the date when the rates go into effect.

Q. Why is it necessary to address the impact of attrition?

A. Investors are concerned with what they can expect in the future, not what they might expect in theory if a historical test year were to repeat. To be fair to investors and to benefit customers, a regulated utility must have an opportunity to actually earn a return that will maintain financial integrity, facilitate capital attraction, and compensate for risk. In other words, it is the end result in the future that determines whether or not the *Hope* and *Bluefield* standards are met. S&P observed that its risk analysis focuses on the utility's ability to consistently earn a reasonable return:

> Notably, the analysis does not revolve around "authorized" returns, but rather on actual earned returns. We note the many examples of utilities with healthy authorized returns that, we believe, have no meaningful expectation of actually earning that return because of rate case lag, expense disallowances, etc.[19]

Similarly, Moody's concluded, "we evaluate the framework and mechanisms that allow a utility to recover its costs and investments and earn allowed returns. We are less concerned with the official allowed return on equity, instead focusing on the earned returns and cash flows."[20]

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[19] Standard & Poor's Corporation, "Assessing U.S. Utility Regulatory Environments," *RatingsDirect* (Nov. 7, 2008).
[20] Moody's Investors Service, "Electric Utilities Face Challenges Beyond Near-Term," *Industry Outlook* (Jan. 2010).

Q. Has the investment community recognized the risks associated with attrition and lag in its evaluation of Avista?

A. Yes. In 2010, S&P confirmed that attrition has acted as a drag on Avista's finances:

> Regulatory lag has been a consistent issue for Avista's utilities, with the utility operations … collectively unable to earn the company's authorized return on equity (ROE) on a consolidated basis. On a consolidated basis, average earned ROE over the past three years has been just under 7%, based on Standard & Poor's Ratings Services' calculations.[21]

More recently, while acknowledging the financial benefits of the Company's frequent filing of rate cases, S&P reiterated the credit risks associated with rate lag and concluded, "The company's most significant regulatory exposure is in Washington."[22] Similarly, Value Line recently noted, "Regulatory lag is a persistent issue,"[23] observing, "Avista has been underearning its allowed returns on equity for a long time."[24]

Q. What are the ways to deal with attrition?

A. For many utilities, the widespread adoption of pass-through clauses for fuel, purchased power, and other costs that were rising rapidly in the late 1970's and early 1980's helped to partially offset the impact of attrition. The use of future

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[21] Standard & Poor's Corporation, "Summary: Avista Corp.," *RatingsDirect* (Feb. 18, 2010).
[22] Standard & Poor's Corporation, "Avista Corp.," *RatingsDirect* (Jul. 23, 2010).
[23] *The Value Line Investment Survey* at 2238 (Feb. 4, 2011).
[24] *Id.*

test years and other forward-looking adjustments and mechanisms is also useful in ameliorating the impact of attrition, as is accelerated depreciation and inclusion of CWIP in rate base, particularly where financing an expensive generating plant addition is undermining a utility's financial indicators. Many jurisdictions have developed methods to attenuate regulatory lag, such as allowing interim rates, putting rates into effect subject to refund, future test years, as well as accelerating the administrative process to allow faster rate decisions.

Q. Is it reasonable to consider the impact of Avista's exposure to attrition?

A. Yes. Setting rates at a level that considers the impact of attrition and allows the utility an opportunity to actually earn its authorized ROE is consistent with fundamental regulatory principles. Central to the determination of reasonable rates for utility service is the notion that owners of public utility properties are protected from confiscation. The Supreme Court has reaffirmed that the end result test must be applied to the actual returns that investors expect if they put their money at risk to finance utilities.[25] This end result can only be achieved for Avista if the allowed return is sufficient to offset the impact of attrition. That end result

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

would maintain the utility's financial integrity, ability to attract capital and offer investors fair compensation for the risk they bear. Given the Company's inability to earn its authorized ROE in the past and the dynamics faced by Avista, there is every reason to believe that attrition will result in under-earning the allowed ROE if the impact of regulatory lag and rising capital requirements are ignored.

In real world capital markets, investors have many competing places to put their money. If the money that is dedicated to utility public service does not have an opportunity to earn a return commensurate with that available from alternatives of equivalent risk in the capital markets, investors are not being adequately compensated for the use of their money and bearing risk. Since the capital dedicated to utility service cannot be withdrawn from public service, its economic value to investors is reduced by the amount necessary to make the utility investment competitive with alternative investments on the open market. This reduction in economic value necessary to bring the rate of earnings on utility investment into line with market opportunities of commensurate risk constitutes a taking of investors' capital by the governmental authority setting rates.

C. Impact of Capital Market Conditions

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

A. The deep financial and real estate crisis that the country experienced in late 2008, and continuing into 2009 led to unprecedented price fluctuations in the

capital markets as investors dramatically revised their risk perceptions and required returns. As a result of investors' trepidation to commit capital, stock prices declined sharply while the yields on corporate bonds experienced a dramatic increase.

With respect to utilities specifically, as of December 2010, the Dow Jones Utility Average stock index remained approximately 25 percent below the previous high reached in May 2008. This prolonged sell-off in common stocks and sharp fluctuations in utility bond yields reflect the fact that the utility industry is not immune to the impact of financial market turmoil and the ongoing economic downturn. As the Edison Electric Institute ("EEI") noted in a letter to congressional representatives in September 2008 as the financial crisis intensified, capital market uncertainties have serious implications for utilities and their customers:

> In the wake of the continuing upheaval on Wall Street, capital markets are all but immobilized, and short-term borrowing costs to utilities have already increased substantially. If the financial crisis is not resolved quickly, financial pressures on utilities will intensify sharply, resulting in higher costs to our customers and, ultimately, could compromise service reliability.[26]

While conditions have improved significantly since the depths of the crisis, investors have nonetheless had to confront ongoing fluctuations in share prices and stress in the credit markets. As the Wall Street Journal noted in February 2010:

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[26] *Letter to House of Representatives*, Thomas R. Kuhn, President, Edison Electric Institute (Sep. 24, 2008).

> Stocks pulled out of a 167-point hole with a late rally Friday, capping a wild week reminiscent of the most volatile days of the credit crisis. … It was a return to the unusual relationships, or correlations, seen at major flash points over the past two years when investors fled risky assets and jumped into safe havens. This market behavior, which has reasserted itself repeatedly since the financial crisis began, suggests that investment decisions are still being driven more by government support and liquidity concerns than market fundamentals.[27]

In response to renewed capital market uncertainties initiated by unrest in the Middle East, the natural disaster in Japan, ongoing concerns over the European sovereign debt crisis, and questions over the sustainability of economic growth, investors have repeatedly fled to the safety of U.S. Treasury bonds, and stock prices have experienced renewed volatility.[28] The dramatic rise in the price of gold and other commodities also attests to investors' heightened concerns over prospective challenges and risks, including the overhanging threat of inflation and renewed economic turmoil. With respect to electric utilities, Fitch observed that, "the outlook for the sector would be adversely affected by significantly higher inflation and interest rates."[29] Moody's recently concluded:

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[27] Gongloff, Mark, "Stock Rebound Is a Crisis Flashback – Late Surge Recalls Market's Volatility at Peak of Credit Difficulties; Unusual Correlations," *Wall Street Journal* at B1 (Feb. 6, 2010).
[28] The Wall Street Journal recently reported that the Dow Jones Industrial Average experienced its largest drop since August 2010, which marked the fourth triple-digit move in less than two weeks. Tom Lauricella and Jonathan Cheng, "Dow Below 12000 on Mideast Worries – Troubles in Europe and China Add to Jitters," *Wall Street Journal* C1 (March. 11, 2011).
[29] Fitch Ratings Ltd., "2011 Outlook: U.S. Utilities, Power, and Gas," *Global Power North America Special Report* (Dec. 20, 2010).

> Over the past few months, we have been reminded that global financial markets, which are still receiving extraordinary intervention benefits by sovereign governments, are exposed to turmoil. Access to the capital markets could therefore become intermittent, even for safer, more defensive sectors like the power industry.[30]

Uncertainties surrounding economic and capital market conditions heighten the risks faced by electric utilities, which, as described earlier, face a variety of operating and financial challenges.

Q. How do interest rates on long-term bonds compare with those projected for the next few years?

A. Table WEA-1 below compares current interest rates on 30-year Treasury bonds, triple-A rated corporate bonds, and double-A rated utility bonds with near-term projections from the Value Line, IHS Global Insight, Blue Chip Financial Forecasts ("Blue Chip"), and the Energy Information Administration ("EIA"), which is a statistical agency of the U.S. Department of Energy ("DOE"):

[30] Moody's Investors Service, "Regulation Provides Stability As Risks Mount," *Industry Outlook* (Jan. 19, 2011).

TABLE WEA-1
INTEREST RATE TRENDS

	Current (a)	2012	2013	2014	2015
30-Yr. Treasury					
Value Line (b)	4.2%	4.9%	5.2%	5.5%	6.0%
IHS Global Insight (c)	4.2%	4.7%	5.0%	5.1%	6.0%
Blue Chip (d)	4.2%	4.8%	5.2%	5.4%	5.5%
AAA Corporate					
Value Line (b)	4.9%	5.6%	6.0%	6.3%	6.5%
IHS Global Insight (c)	4.9%	5.2%	6.0%	6.2%	6.8%
Blue Chip (d)	4.9%	5.4%	5.8%	6.1%	6.3%
S&P (e)	4.9%	6.5%	7.1%	7.2%	--
AA Utility					
IHS Global Insight (c)	5.1%	5.4%	6.3%	6.4%	7.2%
EIA (f)	5.1%	5.5%	6.4%	7.0%	7.4%

(a) Based on monthly average bond yields for the six-month period Sep. 2010 - Feb. 2011 reported at www.credittrends.moodys.com and http://www.federalreserve.gov/releases /h15/data.htm.
(b) The Value Line Investment Survey, Forecast for the U.S. Economy (Feb. 25, 2011).
(c) IHS Global Insight, *U.S. Economic Outlook* at 19 (February 2011).
(d) *Blue Chip Financial Forecasts*, Vol. 29, No. 12 (Dec. 1, 2010).
(e) Standard & Poor's Corporation, "U.S. Economic Forecast: Warming Up Or Frozen Over?," *RatingsDirect* (Feb. 14, 2011).
(f) Energy Information Administration, *Annual Energy Outlook 2011 Early Release* (Dec. 16, 2010).

As evidenced above, there is a clear consensus that the cost of permanent capital will be higher in the 2012-2015 timeframe than it is currently. As a result, current cost of capital estimates are likely to understate investors' requirements at the time the outcome of this proceeding becomes effective and beyond.

Q. What do these events imply with respect to the ROE for Avista?

A. No one knows the future of our complex global economy. We know that the financial crisis had been building for a long time, and few predicted that the economy would fall as rapidly as it has, or that corporate bond yields would

fluctuate as dramatically as they did. While conditions in the economy and capital markets appear to have stabilized significantly since 2009, investors continue to react swiftly and negatively to any future signs of trouble in the financial system or economy. The fact remains that the electric utility industry requires significant new capital investment. Given the importance of reliable electric utility service, it would be unwise to ignore investors' increased sensitivity to risk and future capital market trends in evaluating a fair ROE in this case. Similarly, the Company's capital structure must also preserve the financial flexibility necessary to maintain access to capital even during times of unfavorable market conditions.

D. Support For Avista's Credit Standing

Q. What credit ratings have been assigned to Avista?

A. Reflecting improved financial metrics, S&P recently raised its corporate credit rating for Avista one notch from "BBB-" to "BBB",[31] and Moody's upgraded Avista's Corporate Credit Rating to "Baa2" from "Baa3".[32] Fitch continues to assign Avista an issuer default rating of "BBB-".

[31] Standard & Poor's Corporation, "Research Update: Avista Corp. Corporate Credit Rating Raised To 'BBB'; Outlook Stable," *RatingsDirect* (Mar. 2, 2011).
[32] Moody's Investor Services, "Rating Action: Moody's Upgrades Avista's Ratings to Baa2," *Global Credit Research* (Mar. 2011).

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

A. The past decade witnessed steady erosion in credit quality throughout the utility industry, both as a result of revised perceptions of the risks in the industry and the weakened finances of the utilities themselves. In December 2009, S&P observed with respect to the industry's future that:

> Looming costs associated with environmental compliance, slack demand caused by economic weakness, the potential for permanent demand destruction caused by changes in consumer behavior and closing of manufacturing facilities, and numerous regulatory filings seeking recovery of costs are some of the significant challenges the industry has to deal with.[33]

Similarly, Moody's noted:

> [A] sustained period of sluggish economic growth, characterized by high unemployment, could stress the sector's recovery prospects, financial performance, and credit ratings. The quality of the sector's cash flows are already showing signs of decline, partly because of higher operating costs and investments.[34]

More recently, Moody's concluded, "we also see the sector's overall business and operating risks increasing."[35]

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[33] Standard & Poor's Corporation, "U.S. Regulated Electric Utilities Head Into 2010 With Familiar Concerns," *RatingsDirect* (Dec. 28, 2009).
[34] Moody's Investors Service, "U.S. Electric Utilities: Uncertain Times Ahead; Strengthening Balance Sheets Now Would Protect Credit," *Special Comment* (Oct. 28, 2010).
[35] Moody's Investors Service, "Regulation Provides Stability As Risks Mount," *Industry Outlook* (Jan. 19, 2011).

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

A. As documented in the testimony of Mr. Mark Thies, the Company's prolonged efforts to regain investment grade ratings and improve its financial stature have been successful. Nevertheless, continued support for Avista's financial integrity and credit standing is imperative to ensure the Company's capability to confront potential challenges.

Fitch observed that when credit market conditions are unsettled, "'flight to quality' is selective within the [utility] sector, favoring companies at higher rating levels."[36] As Avista has experienced, the negative impact of declining credit quality on a utility's capital costs and financial flexibility becomes more pronounced as debt ratings move down the scale from investment to non-investment grade. As the Chairman of the New York State Public Service Commission noted in his role as spokesman for the National Association of Regulatory Utility Commissioners:

> While there is a large difference between A and BBB, there is an even brighter line between Investment Grade (BBB-/Baa3 bond ratings by S&P/Moody's, and higher) and non-Investment Grade (Junk) (BB+/Ba1 and lower). The cost of issuing non-investment grade debt, assuming the market is receptive to it, has in some cases been hundreds of basis points over the yield on investment grade securities. To me this

[36] Fitch Ratings Ltd., "U.S. Utilities, Power, and Gas 2010 Outlook," *Global Power North America Special Report* (Dec. 4, 2009).

> suggests that you do not want to be rated at the lower end of the BBB range because an unexpected shock could move you outside the investment grade range.[37]

The pressures of significant capital expenditure requirements reinforce the importance of supporting continued improvement in Avista's credit standing. Investors understand from past experience in the utility industry that large capital needs can lead to significant deterioration in financial integrity that can constrain access to capital, especially during times of unfavorable capital market conditions. Considering the uncertain state of financial markets, competition with other investment alternatives, and investors' sensitivity to the potential for market volatility, greater credit strength is a key ingredient in maintaining access to capital at reasonable cost.

As Mr. Thies confirms in his testimony, regulatory support will be a key driver in solidifying Avista's financial health, which serves as a critical backstop in the event of a recurring capital market crisis or other operating challenges, such as poor hydro conditions or increased capital outlays.

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

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

A. The major rating agencies have warned of exposure to uncertainties associated with political and regulatory developments. Investors recognize that constructive regulation is a key ingredient in supporting utility credit ratings and financial integrity, particularly during times of adverse conditions. With respect to Avista specifically, the major bond rating agencies have explicitly cited the potential that adverse regulatory rulings could compromise the Company's credit standing, with Moody's concluding that, "Avista's ratings could be negatively impacted if the level of regulatory support wanes."[38] S&P observed that management of Avista's regulatory relationships "is a critical underpinning of its investment-grade credit quality."[39]

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

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

[38] Moody's Investors Service, "Credit Opinion: Avista Corp.," *Global Credit Research* (Mar. 17, 2011).
[39] Standard & Poor's Corporation, "Avista Corp. Corporate Credit Rating Raised To 'BBB'; Outlook Stable," *RatingsDirect* (Mar. 2, 2011).

area economy enjoy the benefits that come from ensuring that the utility has the financial wherewithal to take whatever actions are required to ensure reliable service.

E. Capital Structure

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

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

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

A. Avista's capital structure is presented in the testimony of Mr. Thies. As summarized in his testimony, the pro-forma common equity ratio used to compute Avista's overall rate of return was 48.04 percent in this filing.

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

A. As shown on Exhibit No.___(WEA-4), for the 28 firms in the utility proxy group, common equity ratios at December 31, 2010 ranged between 39.1 percent and 63.6 percent and averaged 48.0 percent.

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

A. As shown on Exhibit No.___(WEA-4), Value Line expects an average common equity ratio for the proxy group of utilities of 50.3 percent for its three-to-five year forecast horizon, with the individual common equity ratios ranging from 41.4 percent to 67.3 percent.[40] The UTC has previously observed that "[i]t is appropriate … to afford more weight to forward considerations than to historic conditions as we determine the appropriate equity ratio to be embedded in prospective rates."[41]

[40] Because Value Line does not include short-term debt in its capital structure ratios, these projections were adjusted to include the same proportion of short-term debt outstanding at year-end 2010.
[41] *Order No. 06*, Docket Nos. UG-040640 and UE-040641 (consolidated) (Feb. 18, 2005) at P. 32.

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

A. The 48.04 percent common equity ratio requested by Avista is entirely consistent with the range of equity ratios maintained by the firms in the Utility Proxy Group and is in-line with the 48.0 percent and 50.3 percent average equity ratios at year-end 2010 and based on Value Line's near-term expectations, respectively.

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

A. As discussed earlier, utilities are facing energy market volatility, rising cost structures, the need to finance significant capital investment plans, uncertainties over accommodating economic and financial market uncertainties, and ongoing regulatory risks. Taken together, these considerations warrant a stronger balance sheet to deal with an increasingly uncertain environment. A more conservative financial profile, in the form of a higher common equity ratio, is consistent with increasing uncertainties and the need to maintain the continuous access to capital under reasonable terms that is required to fund operations and necessary system investment, including times of adverse capital market conditions.

Moody's has repeatedly warned investors of the risks associated with debt leverage and fixed obligations and advised utilities not to squander the opportunity to strengthen the balance sheet as a buffer against future uncertainties.[42] More recently, Moody's concluded:

> From a credit perspective, we believe a strong balance sheet coupled with abundant sources of liquidity represents one of the best defenses against business and operating risk and potential negative ratings actions.[43]

Similarly, S&P noted that, "we generally consider a debt to capital level of 50% or greater to be aggressive or highly leveraged for utilities."[44] Fitch affirmed that it expects regulated utilities "to extend their conservative balance sheet stance," and employ "a judicious mix of debt and equity to finance high levels of planned investments."[45]

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[42] Moody's Investors Service, "Storm Clouds Gathering on the Horizon for the North American Electric Utility Sector," *Special Comment* (Aug. 2007); "U.S. Electric Utility Sector," *Industry Outlook* (Jan. 2008).
[43] Moody's Investors Service, "U.S. Electric Utilities Face Challenges Beyond Near-Term," *Industry Outlook* (Jan. 2010).
[44] Standard & Poor's Corporation, "Ratings Roundup: U.S. Electric Utility Sector Maintained Strong Credit Quality In A Gloomy 2009," *RatingsDirect* (Jan. 26, 2010).
[45] Fitch Ratings Ltd., "U.S. Utilities, Power, and Gas 2010 Outlook," *Global Power North America Special Report* (Dec. 4, 2009).

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

A. Depending on their specific attributes, contractual agreements or other obligations that require the utility to make specified payments may be treated as debt in evaluating Avista's financial risk. Power purchase agreements ("PPAs") and leases typically obligate the utility to make specified minimum contractual payments akin to those associated with traditional debt financing and investors consider a portion of these commitments as debt in evaluating total financial risks. Because investors consider the debt impact of such fixed obligations in assessing a utility's financial position, they imply greater risk and reduced financial flexibility. In order to offset the debt equivalent associated with off-balance sheet obligations, the utility must rebalance its capital structure by increasing its common equity in order to restore its effective capitalization ratios to previous levels. The capital structure ratios presented earlier do not include imputed debt associated with power purchase agreements or the impact of other off-balance sheet obligations.

These commitments have been repeatedly cited by major bond rating agencies in connection with assessments of utility financial risks.[46] For example, S&P reported that it adjusts Avista's capitalization to include approximately $139.5 million in imputed debt from PPAs, leases, and postretirement benefit obligations.[47] Unless Avista takes action to offset this additional financial risk by maintaining a higher equity ratio, the resulting leverage will weaken the Company's creditworthiness, implying a higher required rate of return to compensate investors for the greater risks.[48]

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

A. Based on my evaluation, I concluded that Avista's requested capital structure represents a reasonable mix of capital sources from which to calculate the Company's overall rate of return. While industry averages provide one benchmark

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[46] *See, e.g.*, Standard & Poor's Corporation, "Standard & Poor's Methodology For Imputing Debt For U.S. Utilities' Power Purchase Agreements," *RatingsDirect* (May 7, 2007); Standard & Poor's Corporation, "Implications Of Operating Leases On Analysis Of U.S. Electric Utilities," *RatingsDirect* (Jan. 15, 2008); Standard & Poor's Corporation, "Top 10 Investor Questions: U.S. Regulated Electric Utilities," *RatingsDirect* (Jan. 22, 2010).

[47] Standard & Poor's Corporation, "Avista Corp.," *RatingsDirec*t (Jul. 23, 2010). Similarly, Moody's noted that imputed debt may cause a deterioration in Avista's financial performance. Moody's Investors Service, "Credit Opinion: Avista Corp.," Global Credit Research (Mar. 17, 2011).

[48] Apart from the immediate impact that the fixed obligation of purchased power costs has on the utility's financial risk, higher fixed charges also reduce ongoing financial flexibility, and the utility may face other uncertainties, such as potential replacement power costs in the event of supply disruption.

for comparison, each firm must select its capitalization based on the risks and prospects it faces, as well its specific needs to access the capital markets. A public utility with an obligation to serve must maintain ready access to capital under reasonable terms so that it can meet the service requirements of its customers.

Avista's capital structure is consistent with industry benchmarks and reflects the challenges posed by its resource mix, the burden of significant capital spending requirements, and the Company's ongoing efforts to strengthen its credit standing and support access to capital on reasonable terms. Moody's observed that its ratings for Avista anticipate "a balanced mix of debt and equity."[49] The need for access becomes even more important when the company has capital requirements over a period of years, and financing must be continuously available, even during unfavorable capital market conditions.

III. CAPITAL MARKET ESTIMATES

Q. What is the purpose of this section?

A. This section presents capital market estimates of the cost of equity. The details of my quantitative analyses are contained in Exhibit No.___(WEA-3), with the results being summarized below.

[49] Moody's Investors Service, "Credit Opinion: Avista Corp.," *Global Credit Research* (Mar. 17, 2011).

A. Overview

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

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

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

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

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

> We value each of the methodologies used to calculate the cost of equity and do not find it appropriate to select a single method as being the most accurate or instructive. Financial circumstances are constantly shifting and changing, and we welcome a robust and diverse record of evidence based on a variety of analytics and cost of capital methodologies. [50]

Q. What was your conclusion regarding a fair ROE for the proxy companies?

A. Based on the results of my quantitative analyses, and my assessment of the relative strengths and weaknesses inherent in each method, I concluded that the cost of equity for the proxy companies is in the 10.3 percent to 11.3 percent range, or 10.45 percent to 11.45 percent after including a minimum adjustment for flotation costs.

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

B. Results of Quantitative Analyses

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

A. In estimating the cost of equity, the DCF model is typically applied to publicly traded firms engaged in similar business activities or with comparable investment risks. As described in detail in Exhibit No.___(WEA-3), I applied the DCF model to a utility proxy group composed of those dividend-paying companies included by Value Line in its Electric Utilities Industry groups with: (1) S&P corporate credit ratings of "BBB-" to "BBB+," (2) a Value Line Safety Rank of "2" or "3", and (3) a Value Line Financial Strength Rating of "B+" to "B++".[51] I refer to this group of 28 comparable-risk firms as the "Utility Proxy Group."[52]

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

A. Under the regulatory standards established by *Hope* and *Bluefield*, the salient criterion in establishing a meaningful benchmark to evaluate a fair ROE is relative risk, not the particular business activity or degree of regulation. With regulation taking the place of competitive market forces, required returns for

[51] In addition, I excluded four utilities (Allegheny Energy, Inc., FirstEnergy Corp., Northeast Utilities, and Progress Energy, Inc.) that otherwise would have been in the proxy group, but are not appropriate for inclusion because they are currently involved in a major merger or acquisition.

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

utilities should be in line with those of non-utility firms of comparable risk operating under the constraints of free competition. Consistent with this accepted regulatory standard, I also applied the DCF model to a reference group of comparable risk companies in the non-utility sectors of the economy. I refer to this group as the "Non-Utility Proxy Group".

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

A. Yes. The cost of capital is an opportunity cost based on the returns that investors could realize by putting their money in other alternatives. Clearly, the total capital invested in utility stocks is only the tip of the iceberg of total common stock investment, and there are a plethora of other enterprises available to investors beyond those in the utility industry. Utilities must compete for capital, not just against firms in their own industry, but with other investment opportunities of comparable risk.

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

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

attended with comparable risks and uncertainties." [53] It does not restrict consideration to other utilities. Similarly, the *Hope* case states:

> By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks.[54]

As in the *Bluefield* decision, there is nothing to restrict "other enterprises" solely to the utility industry.

Indeed, in teaching regulatory policy I usually observe that in the early applications of the comparable earnings approach, utilities were explicitly eliminated due to a concern about circularity. In other words, soon after the *Hope* decision regulatory commissions did not want to get involved in circular logic by looking to the returns of utilities that were established by the same or similar regulatory commissions in the same geographic region. To avoid circularity, regulators looked only to the returns of non-utility companies.

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

A. Yes. The estimates of growth from the DCF model depend on analysts' forecasts. It is possible for utility growth rates to be distorted by short-term trends in the industry or the industry falling into favor or disfavor by analysts. The result

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[53] *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679 (1923).
[54] *Federal Power Comm'n v. Hope Natural Gas Co.* (320 U.S. 391, 1944).

of such distortions would be to bias the DCF estimates for utilities. For example, Value Line recently observed that near-term growth rates understate the longer-term expectations for gas utilities:

> Natural Gas Utility stocks have fallen near the bottom of our Industry spectrum for Timeliness. Accordingly, short-term investors would probably do best to find a group with better prospects over the coming six to 12 months. Longer-term, we expect these businesses to rebound. An improved economic environment, coupled with stronger pricing, should boost results across this sector over the coming years.[55]

Because the Non-Utility Proxy Group includes low risk companies from many industries, it diversifies away any distortion that may be caused by the ebb and flow of enthusiasm for a particular sector.

Q. What criteria did you apply to develop the Non-Utility Proxy Group?

A. My comparable risk proxy group of non-utility firms was composed of those U.S. companies followed by Value Line that: (1) pay common dividends; (2) have a Safety Rank of "1"; (3) have a Financial Strength Rating of "B++" or greater; (4) have a beta of 0.85 or less; and, (5) have investment grade credit ratings from S&P.

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

A. Table WEA-2 compares the Utility Proxy Group with the Non-Utility Proxy Group and Avista across four key indicators of investment risk:

[55] The Value Line Investment Survey at 445 (Mar. 12, 2010).

TABLE WEA-2
COMPARISON OF RISK INDICATORS

	S&P Credit Rating	Value Line Safety Rank	Value Line Financial Strength	Value Line Beta
Utility Group	BBB	3	B++	0.74
Non-Utility Proxy Group	A	1	A+	0.70
Avista	BBB	2	B++	0.70

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

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

With respect to the Non-Utility Proxy Group, its average credit ratings, Safety Rank, and Financial Strength Rating suggest less risk than for Avista, with its 0.70 average beta indicating identical risk. While the impact of differences in regulation is reflected in objective risk measures, my analyses conservatively focus on a lower-risk group of non-utility firms.

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

A. My application of the DCF model, which is discussed in greater detail in Exhibit No.___(WEA-3), considered three alternative measures of expected earnings growth, as well as the sustainable growth rate based on the relationship between expected retained earnings and earned rates of return ("br+sv"). As shown on Exhibit No.___(WEA-5) and summarized below in Table WEA-3, after eliminating illogical low- and high-end values, application of the constant growth DCF model resulted in the following cost of equity estimates:

TABLE WEA-3
DCF RESULTS – UTILITY PROXY GROUP

Growth Rate	Average Cost of Equity
Value Line	10.9%
IBES	10.6%
Zacks	10.6%
br+sv	9.2%

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

A. As shown on Exhibit No.___(WEA-7), I applied the DCF model to the non-utility companies in exactly the same manner described earlier for the Utility Proxy Group. As summarized below in Table WEA-4, after eliminating illogical low-

and high-end values, application of the constant growth DCF model resulted in the following cost of equity estimates:

TABLE WEA-4
DCF RESULTS – NON-UTILITY GROUP

Growth Rate	Average Cost of Equity
Value Line	11.9%
IBES	12.4%
Zacks	12.5%
br+sv	12.1%

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

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

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

A. As shown on Exhibit No.___(WEA-9), my forward-looking application of the CAPM model indicated an ROE of 11.5 percent for the utility proxy group. Applying the CAPM approach to the firms in the non-utility proxy group (Exhibit No.___(WEA-10)) implied a cost of equity of 10.1 percent.

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

A. As I noted earlier, I also evaluated the cost of equity using the expected earnings approach. Reference to rates of return available from alternative investments of comparable risk can provide an important benchmark in assessing the return necessary to assure confidence in the financial integrity of a firm and its ability to attract capital. This expected earnings approach is consistent with the economic underpinnings for a fair rate of return established by the U.S. Supreme Court. Moreover, it avoids the complexities and limitations of capital market methods and instead focuses on the returns earned on book equity, which are readily available to investors.

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

A. Value Line reports that its analysts anticipate an average rate of return on common equity for the electric utility industry of 10.5 percent in 2011 and over its

2013-2015 forecast horizon.[56] The capital structure corresponding with this expected return reflects an equity ratio of 49.5 percent. Meanwhile, for the gas utility industry Value Line expects returns on common equity of 10.0 percent throughout its forecast horizon.[57] As shown on Exhibit No.___(WEA-11), Value Line's projections for the utility proxy group suggested an average ROE of 10.4 percent after eliminating outliers.[58]

C. Flotation Costs

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

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

[56] The Value Line Investment Survey at 139 (Feb. 25, 2011).
[57] The Value Line Investment Survey at 546 (Mar. 11, 2011).
[58] As highlighted on Exhibit No.___(WEA-11), I eliminated two extreme low-end outliers.

common stock and other market factors may further reduce the amount of funds a utility nets when it issues common equity.

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

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

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

A. While there are a number of ways in which a flotation cost adjustment can be calculated, one of the most common methods used to account for flotation costs in regulatory proceedings is to apply an average flotation-cost percentage to a utility's dividend yield. Based on a review of the finance literature, *New Regulatory Finance* concluded:

> The flotation cost allowance requires an estimated adjustment to the return on equity of approximately 5% to 10%, depending on the size and risk of the issue.[59]

Alternatively, a study of data from Morgan Stanley regarding issuance costs associated with utility common stock issuances suggests an average flotation cost percentage of 3.6 percent.[60]

Issuance costs are a legitimate consideration in setting the ROE for a utility, and applying these expense percentages to a representative dividend yield for a utility of 4.5 percent implies a flotation cost adjustment on the order of 15 to 45 basis points.

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[59] Roger A. Morin, "New Regulatory Finance," *Public Utilities Reports, Inc.* at 323 (2006).
[60] Application of Yankee Gas Services Company for a Rate Increase, DPUC Docket No. 04-06-01, Direct Testimony of George J. Eckenroth (Jul. 2, 2004) at Exhibit GJE-11.1. Updating the results presented by Mr. Eckenroth through April 2005 also resulted in an average flotation cost percentage of 3.6%.

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

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

> The Commission also agrees with both Dr. Avera and Dr. Lurito that a 25 basis point markup for flotation costs should be made. This amount compensates the Company for costs incurred from past issues of common stock. Flotation costs incurred in connection with a sale of common stock are not included in a utility's rate base because the portion of gross proceeds that is used to pay these costs is not available to invest in plant and equipment.[61]

IV. RETURN ON EQUITY RECOMMENDATION

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

A. The cost of equity estimates implied by my quantitative analyses are summarized in Table WEA-5, below:

[61] *Third Supplemental Order*, UTC Docket No. UE-991606, et al., p. 95 (September 2000).

TABLE WEA-5
SUMMARY OF QUANTITATIVE RESULTS

DCF	**Utility**	**Non-Utility**
Earnings Growth		
Value Line	10.9%	11.9%
IBES	10.6%	12.4%
Zacks	10.6%	12.5%
br + sv	9.2%	12.1%
CAPM	11.5%	10.1%
Expected Earnings	**Electric**	**Gas**
Value Line 2014-16	10.5%	10.0%
Utility Proxy Group	10.4%	--

Considering the relative strengths and weaknesses inherent in each method, and conservatively giving less emphasis to the upper- and lower-most boundaries of the range of results, I concluded that the cost of common equity is in the 10.3 percent to 11.3 percent range.

Q. What then is your conclusion regarding a fair ROE based on your analyses for the companies in your proxy groups?

A. After incorporating a minimum adjustment for flotation costs of 15 basis points to my "bare bones" cost of equity range, I concluded that my analyses indicate a fair ROE in the 10.45 percent to 11.45 percent range, with a midpoint of 10.95 percent.

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

A. Because the Company's requested 10.9 percent ROE falls essentially at the midpoint of my recommended range it represents a reasonable estimate of investors' required return that is adequate to compensate investors, while maintaining Avista's financial integrity and ability to attract capital on reasonable terms.

Apart from the results of the quantitative methods summarized above, it is crucial to recognize the importance of supporting the Company's financial position so that Avista remains prepared to respond to unforeseen events that may materialize in the future. Recent challenges in the economic and financial market environment highlight the imperative of maintaining the Company's financial strength in attracting the capital needed to secure reliable service at a lower cost for customers. The reasonableness of the Company's requested ROE is reinforced by the operating risks associated with Avista's reliance on hydroelectric generation, the higher uncertainties associated with Avista's relatively small size, the need to consider the implications of regulatory lag, and the fact that current cost of capital estimates are likely to understate investors' requirements at the time the outcome of this proceeding becomes effective and beyond.

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

A. Yes.