

**Exh. DCP-1T**  
**Dockets UE-200900, UG-200901,**  
**UE-200894**  
**Witness: David C. Parcell**

**BEFORE THE WASHINGTON  
UTILITIES AND TRANSPORTATION COMMISSION**

**WASHINGTON UTILITIES AND  
TRANSPORTATION COMMISSION,**

**Complainant,**

**v.**

**AVISTA CORPORATION d/b/a  
AVISTA UTILITIES,**

**Respondent.**

**DOCKETS UE-200900, UG-200901,  
UE-200984 (*Consolidated*)**

**TESTIMONY OF**

**DAVID C. PARCELL**

**ON BEHALF OF THE STAFF OF  
WASHINGTON UTILITIES AND  
TRANSPORTATION COMMISSION**

*Cost of Capital*

**April 21, 2021**

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1 I. INTRODUCTION

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 600 utility proceedings before more than 50 regulatory agencies in the  
17 United 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-16. These exhibits were prepared by me. The information contained in these  
12 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

<u>Item</u>	<u>Percent</u>	<u>Cost</u>	<u>Weighted Cost</u>
Short-Term Debt	2.48%	3.26%	0.08%
Long-Term Debt	49.02%	5.05%	2.48%
Common Equity	48.50%	9.1% 9.3% 9.5%	4.41% 4.51% 4.61%
Total	100.0%		6.97% 7.16%
			7.07%

20  
21  
22  
23

1 Avista's application requests a COC of 7.43 percent and a cost of equity ("ROE")  
2 of 9.90 percent.<sup>1</sup>

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,<sup>2</sup> which is a hypothetical capital structure. I note that  
18 Avista proposed the same capital structure in its last two rate proceedings.<sup>3</sup> The  
19 Commission has not adopted 50 percent capital structure ratios in any of Avista's recent  
20 rate proceedings, including the last Avista rate case which was settled with a capital

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<sup>1</sup> Thies, Exh. MTT-1T at 17:16-21.

<sup>2</sup> *Id.* at 17:10-12.

<sup>3</sup> *Wash. Utils. & Transp. Comm'n v. Avista Corp.*, Dockets UE-170485 & UG-170486, Order 07, 35, ¶ 93 (April 26, 2018) (2017 Avista GRC Order); Dockets UE-190334 & UG-190335, Thies, Exh. MTT-1T at 15:10-13 (filed April 29, 2019).

1 structure of 48.5 percent equity and 51.5 percent total debt.<sup>4</sup> In each of the prior  
2 proceedings, the Commission has employed a capital structure with 48.5 percent common  
3 equity. I use the 48.5 percent common equity ratio from these previously-adopted capital  
4 structures,<sup>5</sup> which I believe remains the proper capital structure for the Company. I also  
5 include short-term debt in the capital structure, in contrast to Avista's proposal to exclude  
6 short-term debt.

7 The second step in a cost of capital calculation is to determine the embedded cost  
8 rates of debt. Avista proposes use of a 4.97 percent cost of debt (this includes both the  
9 costs of long-term debt and short-term debt), which is an estimated cost rate as of  
10 December 31, 2020.<sup>6</sup> In my analyses, I have utilized separate costs for long-term debt  
11 and short-term debt. The cost of long-term debt is not shown in the Company's  
12 application. As shown on Exh. DCP-3, I have derived the cost of long-term debt from  
13 the information contained in Exh. MTT-2, page 3, which is 5.05 percent. I have accepted  
14 the Company's cost of short-term debt, as shown on Exh. MTT-2, page 4, which is 3.26  
15 percent.

16 The third step in the COC calculation is to estimate the ROE. I employ four  
17 recognized methodologies to estimate Avista's ROE, each of which I apply to two proxy  
18 groups of utilities. These three methodologies and my findings are:

---

<sup>4</sup> *Wash. Utils. & Transp. Comm'n v. Avista Corp.*, Dockets UE-150204 & UG-150205, Order 05, 6, ¶ 5 (Jan. 6, 2016) (2015 Avista GRC Order); *see generally Wash. Utils. & Transp. Comm'n v. Avista Corp.*, Dockets UE-160228 & UG-160229, Order 06 (Dec. 16, 2015) (2016 Avista GRC Order)(rejecting tariff filing, thereby maintaining the capital structure from the previous rate case); 2017 Avista GRC Order at 39, ¶ 107; *Washington Utilities & Transportation Commission v. Avista Corp.*, Dockets UE-190334 & UG-190335, Order 09, 13, ¶ 34; 14, ¶ 38 (March 25, 2020) (2019 Avista GRC Order).

<sup>5</sup> 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.

<sup>6</sup> Thies, Exh. MTT-2 at 3.

Methodology	Range
Discounted Cash Flow (“DCF”)	8.9%-9.3% (9.1% mid-point)
Capital Asset Pricing Model (“CAPM”)	7.4%-7.5% (7.5% mid-point)
Comparable Earnings (“CE”)	9.0%-10.0% (9.5% mid-point)
Risk Premium (“RP”)	8.4%-9.7% (9.0% mid-point)

Based upon these findings, I conclude that Avista’s ROE is within a range of 9.1 percent to 9.5 percent, which is based upon the mid-point of the upper end of the range of the results for the DCF model and mid-point of the range of results for the CE model. This is also supported by the results of my RP analysis. I specifically recommend a 9.3 percent ROE for Avista, which is the mid-point of this range. I note that I do not give the results of my CAPM weight in my final recommendation, since these are low relative to the other model results and can be considered anomalous.

**III. ECONOMIC/LEGAL PRINCIPLES AND METHODOLOGIES**

**Q. What are the primary economic and legal principles that establish the standards for determining a fair rate of return for a regulated utility?**

A. Public utility rates are normally established in a manner designed to allow the recovery of their costs, including capital costs. This is frequently referred to as “cost of service” ratemaking. Rates for regulated public utilities traditionally have been primarily established using the “rate base – rate of return” concept. Under this method, utilities are allowed to recover a level of operating expenses, taxes, and depreciation deemed reasonable for rate-setting purposes, and are granted an opportunity to earn a fair rate of return on the assets utilized (i.e., rate base) in providing service to their customers.



1           The rate base is derived from the asset side of the utility's balance sheet as a  
2           dollar amount and the rate of return is developed from the liabilities/owners' equity side  
3           of the balance sheet as a percentage. Thus, the revenue impact of the cost of capital is  
4           derived by multiplying the rate base by the rate of return, including income taxes.

5           The rate of return is developed from the cost of capital, which is estimated by  
6           weighting the capital structure components (i.e., debt, preferred stock, and common  
7           equity) by their percentages in the capital structure and multiplying these values by their  
8           cost rates. This is also known as the weighted cost of capital.

9           Technically, "fair rate of return" is a legal and accounting concept that refers to an  
10          *ex post* (after the fact) earned return on an asset base, while the cost of capital is an  
11          economic and financial concept which refers to an *ex ante* (before the fact) expected, or  
12          required, return on a capital base. In regulatory proceedings, however, the two terms are  
13          often used interchangeably, and I have equated the two concepts in my testimony.

14          From an economic standpoint, a fair rate of return is normally interpreted to mean  
15          that an efficient and economically managed utility will be able to maintain its financial  
16          integrity, attract capital, and establish comparable returns for similar risk investments.  
17          These concepts are derived from economic and financial theory and are generally  
18          implemented using financial models and economic concepts.

19          Although I am not a lawyer and I do not offer a legal opinion, my testimony is  
20          based on my understanding that two United States Supreme Court decisions provide the  
21          controlling standards for a fair rate of return. The first decision is *Bluefield Water Works*  
22          *and Improvement Co. v. Public Serv. Comm'n of West Virginia*, 262 U.S. 679 (1923). In  
23          this decision, the Court stated:

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

18 It is generally understood that the *Bluefield* decision established the following  
19 standards for a fair rate of return: comparable earnings, financial integrity, and capital  
20 attraction. It also noted that required returns change over time, and there is an underlying  
21 assumption that the utility be operated efficiently.

22 The second decision is *Federal Power Comm'n v. Hope Natural Gas Co.*, 320  
23 U.S. 591 (1942). In that decision, the Court stated:

24 The rate-making process under the [Natural Gas] Act, i.e., the fixing of 'just  
25 and reasonable' rates, involves a balancing of the investor and consumer  
26 interests . . . From the investor or company point of view it is important that  
27 there be enough revenue not only for operating expenses but also for the  
28 capital costs of the business. These include service on the debt and  
29 dividends on the stock. By this standard the return to the equity owner  
30 should be commensurate with returns on investments in other enterprises  
31 having corresponding risks. That return, moreover, should be sufficient to  
32 assure confidence in the financial integrity of the enterprise, so as to  
33 maintain its credit and to attract capital.  
34

35 The three economic and financial parameters in the *Bluefield* and *Hope* decisions  
36 – comparable earnings, financial integrity, and capital attraction – reflect the economic  
37 criteria encompassed in the “opportunity cost” principle of economics. The opportunity

1 cost principle provides that a utility and its investors should be afforded an opportunity  
2 (not a guarantee) to earn a return commensurate with returns they could expect to achieve  
3 on investments of similar risk. The opportunity cost principle is consistent with the  
4 fundamental premise on which regulation rests, namely, that it is intended to act as a  
5 surrogate for competition.  
6

7 **Q. How can the *Bluefield* and *Hope* parameters be employed to estimate the cost of**  
8 **capital for a utility?**

9 A. Neither the courts nor economic/financial theory has developed exact and mechanical  
10 procedures for precisely determining the cost of capital. This is the case because the cost  
11 of capital is an opportunity cost and is prospective-looking, which dictates that it must be  
12 estimated. However, there are several useful models that can be employed to assist in  
13 estimating the ROE, which is the capital structure item that is the most difficult to  
14 determine. These include the DCF, CAPM, CE and risk premium (“RP”) methods. I  
15 have not directly employed a RP model in my analyses although, as discussed later, my  
16 CAPM analysis is a form of the RP methodology. Each of these methodologies will be  
17 described in more detail later in my testimony.  
18

#### 19 IV. GENERAL ECONOMIC CONDITIONS

20

21 **Q. Are economic and financial conditions important in determining the costs of capital**  
22 **for a public utility?**

1 A. Yes. The costs of capital for both fixed-cost (debt and preferred stock) components and  
2 common equity are determined in part by current and prospective economic and financial  
3 conditions. At any given time, each of the following factors has an influence on the costs  
4 of capital:

- 5 • The level of economic activity (i.e., growth rate of the economy).
- 6 • The stage of the business cycle (i.e., recession, expansion, or transition).
- 7 • The level of inflation.
- 8 • The level and trend of interest rates; and,
- 9 • Current and expected economic conditions.

10 My understanding is that this position is consistent with the *Bluefield* decision, which  
11 noted “[a] rate of return may be reasonable at one time and become too high or too low  
12 by changes affecting opportunities for investment, the money market, and business  
13 conditions generally.”<sup>7</sup>

14  
15 **Q. What indicators of economic and financial activity did you evaluate in your**  
16 **analyses?**

17 A. I examined several sets of economic statistics from 1975 to the present. I chose this time  
18 period because it permits the evaluation of economic conditions over four full business  
19 cycles, plus the current cycle, allowing for an assessment of changes in long-term trends.  
20 Consideration of economic/financial conditions over a relatively long period of time  
21 allows me to assess how such conditions have impacted the level and trends of the costs

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<sup>7</sup> *Bluefield*, 262 U.S. at 693.

1 of capital. This period also approximates the beginning and continuation of active rate  
2 case activities by public utilities that generally began in the mid-1970s.

3 A business cycle is commonly defined as a complete period of expansion  
4 (recovery and growth) and contraction (recession). A full business cycle is a useful and  
5 convenient period over which to measure levels and trends in long-term capital costs  
6 because it incorporates the cyclical (i.e., stage of business cycle) influences and, thus,  
7 permits a comparison of structural (or long-term) trends.

8  
9 **Q. Please describe the time frames of the four prior business cycles and the current**  
10 **cycle.**

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

<u>Business Cycle</u>	<u>Expansion Cycle</u>	<u>Contraction Period</u>
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-Feb. 2020	Mar. 2020-

19 Source: The National Bureau of Economic Research, "U.S. Business Cycle  
20 Expansions and Contractions."<sup>8</sup>

21  
22  
23 **Q. Do you have any general observations concerning the recent trends in economic**  
24 **conditions and their impact on capital costs over this broad period?**

25 A. Yes, I do. From the early 1980s until the end of 2007, the United States economy  
26 enjoyed general prosperity and stability. This period was characterized by longer  
27 economic expansions, relatively tame contractions, low and declining inflation, and  
28 declining interest rates and other capital costs.

---

<sup>8</sup> Available at <http://www.nber.org/cycles/cyclesmain.html>.

1           However, in 2008 and 2009 the economy declined significantly, initially as a  
2 result of the 2007 collapse of the “sub-prime” mortgage market and the related liquidity  
3 crisis in the financial sector of the economy. Subsequently, this financial crisis  
4 intensified with a more broad-based decline, initially based on a substantial increase in  
5 petroleum prices and a dramatic decline in the U.S. financial sector of the economy. This  
6 decline has been described as the worst financial crisis since the Great Depression of the  
7 1930s and has been referred to as the “Great Recession.” Beginning in 2008, the U.S.  
8 and other governments implemented unprecedented policies in attempts to correct or  
9 minimize the scope and effects of this recession. Some of these policies are still in effect.

10           In addition, in the first quarter of 2020, the U.S. economy entered a new  
11 recession.<sup>9</sup> This is largely the result of the Coronavirus Disease 2019 (“COVID-19” or  
12 “novel coronavirus”) pandemic and the result that the economic and financial  
13 consequences of this serious health crisis created a recession as nations, including the  
14 U.S., instituted significant travel, social, and commercial restrictions designed to slow the  
15 spread of COVID-19. Beginning in March and lasting into June of 2020, much of the  
16 world and U.S. were in “lock down” as a significant portion of both businesses and  
17 governments operated under restrictive conditions in some instances and remained closed  
18 in other instances. In addition, the U.S. federal government has instituted two multi-  
19 trillion-dollar stimulus program (i.e., CARES Act in 2020 and American Relief Act in  
20 2021) to aid businesses, individuals and state/local governments during this crisis.  
21 Further, the Federal Reserve System (“Federal Reserve”) has implemented several  
22 financial and stimulus tools to help maintain the Country’s financial system.

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<sup>9</sup> *Id.*

1 **Q. Please describe recent and current economic and financial conditions and their**  
2 **impact on the costs of capital.**

3 A. One impact of the Great Recession and COVID-19 recession has been a continuing  
4 reduction in actual and expected investment returns and a corresponding reduction in  
5 capital costs. This decline is evidenced by a decline in both short-term and long-term  
6 interest rates and the expectations of investors and is reflected in cost of capital model  
7 results (such as DCF, CAPM, CE, and RP). Regulatory agencies throughout the U.S.  
8 have recognized the decline in capital costs by authorizing lower ROEs for regulated  
9 utilities in each of the last several years.

10 Exh. DCP-4 shows several sets of relevant economic and financial statistics for  
11 the cited time periods. Page 1 contains general macroeconomic statistics, page 2 shows  
12 interest rates, and page 3 contains equity market statistics.

13 Page 1 shows that in 2007 the economy stalled and subsequently entered a  
14 significant recession, which lasted until mid-2009, making it a longer-than-normal, as  
15 well as a much deeper, recession. Following the recession, economic growth was  
16 somewhat erratic, and the economy grew more slowly than in prior expansions. On the  
17 other hand, the subsequent expansion achieved the longest period of any expansion in  
18 recent financial history. As stated above, due to the COVID-19 pandemic, the recent  
19 expansion ended in February, and a recession has resulted. Following the onset of  
20 COVID-19, GDP declined by nearly 5 percent in the first quarter of 2020 and over 30  
21 percent in the second quarter before rebounding in the third quarter. For the full year  
22 2020, GDP declined by 3.5 percent, which is larger than the 2009 Great Recession  
23 decline. The unemployment rate significantly increased due to the COVID-19 pandemic,

1 although it has declined somewhat in recent months. This recession is continuing, as  
2 demonstrated by the recent adoption of a \$1.9 trillion stimulus “package” by the U.S.  
3 Congress.

4 Page 1 of Exh. DCP-4 also shows the rate of inflation. As reflected in the  
5 Consumer Price Index (“CPI”), inflation rose significantly during the 1975-1982 business  
6 cycle and reached double-digit levels in 1979-1980. The rate of inflation has declined  
7 substantially since 1981. Since 2008, the CPI has been 3 percent or lower on an annual  
8 basis, with 2014 and 2015 growth below 1 percent, 2016 and 2017 growth at 2.1 percent,  
9 2018 growth at 1.9 percent, 2019 growth at 2.3 percent, and 1.4 percent growth in 2020.  
10 It is thus apparent that the rate of inflation has generally been declining over the past  
11 several business cycles. Recent and current levels of inflation are at the lowest levels of  
12 the past 35 years, which is reflective of lower capital costs.<sup>10</sup>

13  
14 **Q. What have been the trends in interest rates over the four prior business cycles and**  
15 **at the current time?**

16 A. Page 2 of Exh. DCP-4 shows several series of interest rates. Both short-term and long-  
17 term rates rose sharply to record levels in 1975-1982 when the inflation rate was high.  
18 Interest rates have declined substantially in conjunction with the corresponding declines  
19 in inflation since the early 1980s.

20 As seen on page 2, since 2011 both U.S. and public utility bond yields have  
21 declined to their lowest levels in the past four business cycles and in more than 40 years.

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<sup>10</sup> 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.



1 Even with the 2016-2019 “tapering” and eventual ending of the Federal Reserve’s  
2 Quantitative Easing program, as well as the Federal Reserve’s raising of the Federal  
3 Funds rate (prior to again lowering this rate), interest rates have remained relatively low.  
4 Both government and utility long-term lending rates remain near historically low levels,  
5 again reflective of lower capital costs. In addition, current interest rates for many utilities  
6 are lower than historic (embedded) cost rates. This is also true for Avista, which  
7 acknowledges that its cost of debt has declined in recent years.<sup>11</sup>

8 Since the COVID-19 pandemic began in February of 2020, both long-term and  
9 short-term interest rates declined significantly and, even though rates have increased in  
10 recent months, they remain at historic lows. The Federal Reserve has established a “near  
11 zero” level of short-term interest rates and there is no expectation that this will end in the  
12 near-term.<sup>12</sup> The Federal Reserve has also re-implemented its Great Recession policy of  
13 Quantitative Easing as it has purchased U.S. Treasury securities and has also injected  
14 substantial liquidity into the economy. As shown on Exh. DCP-4, page 2, the yields on  
15 10-year U.S. Treasury bonds are currently less than 2 percent, after falling to under 1  
16 percent in 2020, the lowest level by far since at least the mid-1970s.

17  
18 **Q. What does Exh. DCP-4 show for trends of common share prices?**

19 A. Page 3 of Exh. DCP-4 shows several series of common stock prices and ratios. These  
20 indicate that stock prices were essentially stagnant during the high inflation/high interest  
21 rate environment of the late 1970s and early 1980s. The 1983-1991 business cycle and

---

<sup>11</sup> Thies, Exh. MTT-1T at 24:10-20.

<sup>12</sup> On June 10, 2020 the Federal Reserves announced its intention to maintain “zero” short-term rates until at least 2022 and also to maintain its purchases of long-term Treasury securities (QE).

1 the more recent cycles witnessed a significant upward trend in stock prices. The  
2 beginning of the Great Recession saw stock prices decline precipitously as stock prices in  
3 2008 and early 2009 were down significantly from peak 2007 levels, reflecting the  
4 financial/economic crisis. Beginning in 2009, stock prices again moved upward. On the  
5 other hand, recent equity markets have been somewhat volatile. Since the latter days of  
6 February 2020, on the other hand, stock prices have been extremely volatile and  
7 dramatically declined in March in response to the COVID-19 pandemic and  
8 corresponding uncertainty in the financial markets regarding the economic consequences  
9 of governmental, commercial and social measures designed to limit the spread of the  
10 virus. Since April, stock prices have largely recovered from the dramatic declines that  
11 took place.

12  
13 **Q. What conclusions do you draw from your discussion of economic and financial**  
14 **conditions?**

15 A. Recent economic and financial circumstances have differed from any that have prevailed  
16 since at least the 1930s. Concurrent with the Great Recession, there was a decline in  
17 capital costs and returns which significantly reduced the values of most retirement  
18 accounts, investment portfolios, and other assets. One significant aspect of this has been  
19 a decline in investor expectations of returns even with the return of stock prices to levels  
20 achieved prior to the “crash.”<sup>13</sup> This is evidenced by: (1) lower interest rates on bank  
21 deposits; (2) lower interest rates on U.S. Treasury and utility bonds; and (3) lower  
22 authorized returns on equity by regulatory commissions. Finally, as noted above, utility

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<sup>13</sup> See e.g., Vanguard News & Perspectives. “Stabilization, Not Stagnation: Expect Modest Returns” March 30, 2017.

1 bond interest rates are currently at levels well below those prevailing prior to the financial  
 2 crisis of late 2008 to early 2009 and remain near the lowest levels in the past 35 years and  
 3 are also generally lower than the embedded cost rates for most utilities, including Avista.

4  
 5 **Q. How do these economic/financial conditions impact the determination of a return on**  
 6 **equity for regulated utilities?**

7 A. The costs of capital for regulated utilities have declined in recent years. This is also true  
 8 for Avista, whose debt costs have declined since the last proceeding.<sup>14</sup> In addition, the  
 9 results of the traditional ROE models (i.e., DCF, CAPM, CE, and RP) are lower than was  
 10 the case prior to the Great Recession. Considering this, it is not surprising that the  
 11 average ROEs authorized by state regulatory agencies have declined and continued to  
 12 remain relatively low, as follows:<sup>15</sup>

Year	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	9.56%	9.58%	9.59%	9.60%
2019	9.65%	9.65%	9.72%	9.72%
2020	9.39%	9.48%	9.46%	9.42%

<sup>14</sup> Avista’s cost of total debt has declined from 5.15% in Docket Nos. UE-190334/UG-190335 to 4.97% in the current proceedings. Thies, Exh. MTT-1T at 17:11; 2019 Avista GRC Order at 13, ¶ 34.

<sup>15</sup> S&P Global, Market Intelligence, “Regulatory Focus,” January 31, 2021, General Rate Cases.

1                   **V. AVISTA’S OPERATIONS AND BUSINESS RISKS**

2

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

4 A. Avista, formerly known as Washington Water Power, is a public utility that generates and  
5 delivers electricity and natural gas through its generation, transmission, and distribution  
6 systems to customers in Washington, Oregon, Idaho, Alaska and a small portion of  
7 Montana.

8 Avista, in its present form, is a public utility that operates two reportable business  
9 segments:<sup>16</sup>

- 10 • Avista Utilities – an operating division of Avista that delivers electricity  
11 (approximately 400,000 customers) and natural gas (approximately 367,000  
12 customers) in Washington, Oregon, Idaho and Montana; and,
- 13 • Alaska Electric Light & Power (“AEL&P”) – a subsidiary of Avista (acquired  
14 July 1, 2014), and is an electric utility located in Juneau, Alaska. AEL&P is a  
15 direct subsidiary of Alaska Energy and Resources Co. (“AERC”) which, in  
16 turn, is owned by Avista.

17 Avista’s other businesses include venture fund investments, real estate  
18 investments, as well as certain other investments of Avista Capital, which is a direct,  
19 wholly owned subsidiary of Avista. These activities do not represent a reportable  
20 business segment and are conducted by various direct and indirect subsidiaries of Avista  
21 Corp.<sup>17</sup>

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<sup>16</sup> Avista Corp., 2020 Form 10-K page 5.

<sup>17</sup> *Id.* at 5.

1 The Avista Utilities segment accounts for the vast majority of Avista’s operations,  
2 as it accounted for about 96 percent of Avista’s 2020 net income.<sup>18</sup>

3  
4 **Q. What are the current security ratings of Avista?**

5 A. The present debt ratings of Avista’s debt are shown on Exh. DCP-5 and are as follows:

6

	<u>Secured</u>	<u>Corp./Issuer</u>
7 Moody’s	A3	Baa2
8 Standard & Poor’s	A-	BBB

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

10 A. This is also shown on Exh. DCP-5. As this indicates, Avista’s current ratings by  
11 Standard & Poor’s have remained the same throughout the period 2013 to the present.  
12 The ratings by Moody’s are currently the same as they were in 2013. Moody’s ratings  
13 were increased by a “notch” (i.e., from Baa2 to Baa1) in 2014 and were reduced by a  
14 “notch” (i.e., from Baa1 to Baa2) in 2018.

15  
16 **Q. How do the bond ratings of Avista compare to other electric and combination  
17 gas/electric utilities?**

18 A. Avista’s ratings are generally similar to most electric utilities in the U.S. This is  
19 evidenced by the relative Moody’s and Standard & Poor’s debt ratings, as shown on my  
20 Exh. DCP-8 and which indicates that Avista’s ratings are generally similar to those of the

---

<sup>18</sup> *Id.* at 38.

1 two groups of proxy electric utilities used to develop the ROE recommendations in my  
2 testimony.<sup>19</sup>

3  
4 **VI. CAPITAL STRUCTURE AND COSTS OF DEBT**

5  
6 **Q. What is the importance of determining a proper capital structure in a regulatory  
7 framework?**

8 A. A utility's capital structure is important because the concept of rate base – rate of return  
9 regulation requires the capital structure to be utilized in estimating the total cost of  
10 capital. Within this framework, it is proper to ascertain whether the utility's capital  
11 structure is appropriate relative to its level of business risk and relative to other utilities.

12 As discussed in Section III of my testimony, the purpose of determining the  
13 proper capital structure for a utility is to ascertain its capital costs. The rate base – rate of  
14 return concept recognizes the assets employed in providing utility services and provides  
15 for a return on these assets by identifying the liabilities and common equity (and their  
16 cost rates) used to finance the assets. In this process, the rate base is derived from the  
17 asset side of the balance sheet and the cost of capital is derived from the  
18 liabilities/owners' equity side of the balance sheet. The inherent assumption in this  
19 procedure is that the dollar values of the capital structure and the rate base are  
20 approximately equal, and the former is utilized to finance the latter.

21 The common equity ratio (i.e., the percentage of common equity in the capital  
22 structure) is the capital structure item which normally receives the most attention. This is

---

<sup>19</sup> Company witness McKenzie also cites Avista's ratings as being "comparable" to those of his proxy group. See McKenzie, Exh. AMM-1T at 7:9-11 and AMM-3 at 11:19-20.

1 the case because common equity: (1) usually commands the highest cost rate; (2)  
2 generates associated income tax liabilities; and (3) causes the most controversy since its  
3 cost cannot be precisely determined.

4  
5 **Q. What are the historic capital structure ratios of Avista?**

6 A. I have examined the historic (2016-2020) capital structure ratios of Avista, which is  
7 shown on Exh. DCP-6. The actual (as opposed to Commission-approved) common  
8 equity ratios have been:

9

	Avista Consolidated		Avista Utilities	
	Including	Excluding	Including	Excluding
	S-T Debt	S-T Debt	S-T Debt	S-T Debt
10 2016	47.1%	48.7%	48.1%	49.9%
11 2017	47.3%	48.7%	48.1%	49.7%
12 2018	45.7%	48.1%	46.3%	48.9%
13 2019	47.6%	49.9%	47.7%	50.0%
14 2020	47.3%	49.6%	48.5%	49.8%

15 This indicates that Avista, on a consolidated basis, has had an equity ratio that has  
16 generally been stable over the past five years. The Avista Utilities (Division) capital  
17 structure<sup>20</sup> has also been fairly stationary, with equity ratios (including short-term debt)  
18 of about 48 percent or less over the past five years.

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

---

<sup>20</sup> Avista's Utilities (Division) capital structures exclude affiliate debt and equity.

1 A. Exh. DCP-7 shows the common equity ratios (excluding short-term debt in capitalization)  
 2 for the groups of proxy electric utilities used in developing my cost of equity models and  
 3 related conclusions. These are:

	<u>Period</u>	<u>Average</u>	<u>Median</u>
4 Parcell Proxy Group	2016-2020	52.6%	54.3%
	2024-2026	52.1%	52.0%
6 McKenzie Proxy Group (Adjusted) <sup>21</sup>	2016-2020	46.7%	48.3%
	2024-2026	48.1%	49.5%

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

11  
 12 **Q. What have been the average common equity ratios adopted by U.S. State**  
 13 **Regulatory Commissions in recent years?**

14 A. Over the past several years, the average common equity ratios cited in U.S. state  
 15 regulatory electric proceedings have been:<sup>22</sup>

	<u>Electric</u>	
16 2015	49.54%	
17 2016	48.91%	
18 2017	48.90%	
19 2018	48.95%	
20 2019	49.41%	
	2020	48.56%

---

<sup>21</sup> Adjusted to reflect removal of four entities, as described *infra* on pages 27-28.  
<sup>22</sup> S&P, RRA, “Regulatory Focus”, January 31, 2019. Figures for 2019 and 2020 computed by Mr. Parcell from Regulatory Focus data obtained in recent rate proceedings.



1 The electric utility ratios are similar to Avista Utilities' common equity ratios. It is  
2 noteworthy, on the other hand, that these equity ratios reflect a combination of approved  
3 capital structures, some of which include short-term debt and some of which exclude  
4 short-term debt.

5  
6 **Q. What capital structure has Avista requested in the proceedings?**

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

8

	<u>Percent</u>
Debt	50.0
Common Equity	50.0

9

10 Avista's proposed capital structure excludes short-term debt, which is an additional  
11 change from the currently-authorized capital structure.

12 According to the Direct Testimony of Company witness Mark T. Thies, this  
13 requested capital structure would solidify Avista's current credit ratings, and move Avista  
14 "closer to our long-term goal of moving our corporate credit rating from BBB to  
15 BBB+."<sup>23</sup> I note that Avista also proposed this same hypothetical capital structure in its  
16 last two rate proceedings.<sup>24</sup>

17  
18 **Q. How does this proposed capital structure compare to the capital structure approved  
19 in Avista's most recent rate proceedings?**

20 A. It reflects an increase in Avista's equity ratio from 48.5 percent to 50.0 percent. In  
21 Dockets UE-150204/UG-150205, the parties stipulated to a capital structure with 51.5

---

<sup>23</sup> Thies, Exh. MTT-1 at 18:19-20.

<sup>24</sup> 2017 Avista GRC Order at 35, ¶ 93; Dockets UE-190334 & UG-190335, Thies, Exh. MTT-1T at 15:10-13 (filed April 29, 2019).

1 percent debt/48.5 percent equity.<sup>25</sup> This capital structure was Avista’s “forecast capital  
2 structure at December 31, 2015.”<sup>26</sup> In Dockets UE-170485/UG-170486, the Commission  
3 approved a capital structure with 48.5 percent common equity, 2.9 percent short-term  
4 debt and 48.6 percent long-term debt.<sup>27</sup> Finally, in Dockets UE-190334/UG-190335, the  
5 Commission approved a stipulation with a capital structure of 48.5 percent common  
6 equity and 48.85 percent long-term debt.<sup>28</sup>

7  
8 **Q. What capital structure do you propose to use in these proceedings?**

9 A. I have used a capital structure with 48.5 percent and the inclusion of short-term debt for  
10 the purposes of these proceedings. My proposed capital structure is derived in Exh.  
11 DCP-3 and is as follows:

12	Short-Term Debt	2.48%
13	Long-Term Debt	49.02%
14	Common Equity	48.50%

15 **Q. Why are you proposing a capital structure for Avista containing 48.5 percent**  
16 **common equity?**

17 A. I first note that Avista Utilities’ actual capital structure as of December 31, 2020  
18 contained 48.5 percent common equity, as shown on Exh. DCP-6 page 2. Thus, my  
19 proposed capital structure matches the recent actual capital structure ratio of Avista  
20 Utilities.

---

<sup>25</sup> 2015 Avista GRC Order, Appendix C (Multiparty Settlement Stipulation) at 2.

<sup>26</sup> Dockets UE-150204 & UG-150205, Thies, Exh. MTT-1T at 14:20-23 (February 9, 2015).

<sup>27</sup> 2017 Avista GRC Order at 39-40, ¶¶ 111-112.

<sup>28</sup> 2019 Avista GRC Order at 13, ¶ 34.

1           Second, Exh. DCP-6 shows the actual equity ratios of Avista Utilities have not  
2 increased in recent years.

3           Third, the common equity ratio in this capital structure matches the capital  
4 structure stipulated to by the parties and adopted by the Commission in Avista's last rate  
5 proceeding, as well as the capital structure determined by the Commission in Avista's last  
6 litigated rate proceeding.<sup>29</sup> In the 2017 GRC, the Commission rejected Avista's proposed  
7 50/50 capital structure in part because the actual equity component over the last few years  
8 was closer to 48.5 percent.<sup>30</sup>

9           Fourth, the proposed capital structure is similar to that of other electric and  
10 combination electric utilities, as shown on Exh. DCP-7.

11  
12 **Q.    What is your understanding of this Commission's recent policy on the proper**  
13 **capital structure to use to determine the COC?**

14 A.    It is my understanding that the Commission's policy on determining a capital structure  
15 balances safety (the preservation of investment quality credit ratings and access to  
16 capital) against economy (the lowest overall cost to attract and maintain capital). The  
17 Commission noted that the appropriate capital structure can either be the Company's  
18 historical capital structure, the projected capital structure, or a hypothetical capital  
19 structure.<sup>31</sup>

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<sup>29</sup> 2019 Avista GRC Order at 13, ¶ 34; 2017 Avista GRC Order at 39-40, ¶¶ 111-112.

<sup>30</sup> See 2017 Avista GRC Order at 39, ¶ 107.

<sup>31</sup> *Id.* at 39, ¶ 109, see also, *Wash. Utils. & Transp. Comm'n v. Puget Sound Energy, Inc.*, Dockets UE-040640 & UG-040641, Order 06, 13, ¶ 27 (February 18, 2005).

1 **Q. Is your recommended capital structure consistent with this policy?**

2 A. Yes. The capital structure that I use is similar to recent actual ratios of Avista, as well as  
3 its 2020 capital structure, and is consistent with the capital structure of other utilities. I  
4 also believe that the capital structure that I propose provides a “balance of safety and  
5 economy” as cited above.

6

7 **Q. What are the cost rates of debt in Avista’s applications?**

8 A. Avista proposes the cost of debt as of December 31, 2020. Avista’s proposed cost of debt  
9 is 4.97 percent.<sup>32</sup> Avista’s applications show a cost of short-term debt of 3.26 percent as  
10 of this same date.<sup>33</sup> The applications do not identify the cost of long-term debt for Avista,  
11 but I have derived this cost rate (5.05 percent) from the applications, as shown on Exh.  
12 DCP-3.

13

14 **Q. Can the ROE be determined with the same degree of precision as the cost of debt?**

15 A. No. The cost rates of debt are largely determined by interest payments, issue prices, and  
16 related expenses. The ROE, on the other hand, cannot be precisely quantified, primarily  
17 because this cost is an opportunity cost. As mentioned previously, there are several  
18 models that can be employed to estimate the ROE. Four of the primary methods – DCF,  
19 CAPM, CE, and RP – are developed in the following sections of my testimony.

20

---

<sup>32</sup> Thies, Exh. MTT-2 at 3.

<sup>33</sup> *Id.* at 4.





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

$$4 \qquad K = \frac{D}{P} + g$$

5           where: P = current price

6                     D = current dividend rate

7                     K = discount rate (cost of capital)

8                     g = constant rate of expected growth

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

12  
13 **Q. Please explain how you employ the DCF model.**

14 A. I use the constant growth DCF model. In doing so, I combine the current dividend yield  
15 for each of the proxy utility stocks described in the previous section with several  
16 indicators of expected dividend growth.

17  
18 **Q. How did you derive the dividend yield component of the DCF equation?**

19 A. Several methods can be used to calculate the dividend yield component. These methods  
20 generally differ in the manner in which the dividend rate is employed (i.e., current versus  
21 future dividends or annual versus quarterly compounding variant). I used a quarterly  
22 version of the dividend yield, which is expressed as follows:

1  
2  
3  
4  
5  
6  
7  
8  
9  
10  
11  
12  
13  
14  
15  
16  
17  
18  
19  
20  
21  
22  
23

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

This dividend yield component recognizes the timing of dividend payments and dividend increases.

The  $P_0$  in my yield calculation is the average of the high and low stock price for each proxy company for the most recent three-month period (January - March 2021).

The  $D_0$  is the current annualized dividend rate for each proxy company.

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

A. The DCF model's dividend growth rate component is usually the most crucial and controversial element involved in using this methodology. The objective of estimating the dividend growth component is to reflect the growth expected by investors that is embodied in the price (and yield) of a company's stock. As such, it is important to recognize that individual investors have different expectations and consider alternative indicators in deriving their expectations. This is evidenced by the fact that every investment decision resulting in the purchase of a particular stock is matched by another investment decision to sell that stock.

A wide array of indicators exists for estimating investors' growth expectations. As a result, it is evident that investors do not always use one single indicator of growth. It therefore is necessary to consider alternative dividend growth indicators in deriving the growth component of the DCF model. I have considered five indicators of growth in my DCF analyses. These are:

1. Years 2016-2020 (5-year average) earnings retention, or fundamental growth (per Value Line);



- 1                   2. Five-year average of historic growth in earnings per share (EPS), dividends  
2                   per share (DPS), and book value per share (BVPS) (per Value Line);
- 3                   3. Years 2021 and 2024-2026 projections of earnings retention growth (per  
4                   Value Line);
- 5                   4. Years 2018-2020 to 2024-2026 projections of EPS, DPS, and BVPS (per  
6                   Value Line); and
- 7                   5. Five-year projections of EPS growth (per First Call, Zack's and Value Line).

8                   I believe this combination of growth indicators is a representative and appropriate set  
9                   with which to begin the process of estimating investor expectations of dividend growth  
10                  for the groups of proxy companies. I also believe that these growth indicators reflect the  
11                  types of information that investors consider in making their investment decisions. As I  
12                  indicated previously, investors have an array of information available to them, all of  
13                  which would be expected to have some impact on their decision-making process.

14

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

16   A.    Exh. DCP-9 presents my DCF analysis. Page 1 shows the calculation of the “raw” (i.e.,  
17           prior to adjustment for growth) dividend yield for each proxy company. Pages 2, 3, and 4  
18           show the growth rates for the groups of proxy companies. Page 5 shows the DCF  
19           calculations, which are presented on several bases: mean, median, low and high values.  
20           These results can be summarized as follows:

	<u>Mean</u>	<u>Median</u>	<u>Mean Low<sup>36</sup></u>	<u>Mean High<sup>37</sup></u>	<u>Median Low<sup>38</sup></u>	<u>Median High<sup>39</sup></u>	
1							
2	Parcell Proxy Group	8.0%	8.0%	7.1%	8.9%	7.2%	9.3%
3	McKenzie Proxy Group <sup>40</sup>	8.2%	8.0%	7.4%	9.1%	7.3%	9.1%

4 I note that the individual DCF calculations shown on Exh. DCP-9 should not be  
5 interpreted to reflect the expected cost of capital for individual companies in the proxy  
6 groups; rather, the individual values shown should be interpreted as alternative  
7 information considered by investors.

8

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

10 A. The DCF rates resulting from the analysis of the proxy groups fall into a wide range  
11 between 7.1 percent and 9.3 percent. The highest DCF rates are 8.9 percent to 9.3  
12 percent.

13 I believe a range of 8.9 percent to 9.3 percent (9.1 percent mid-point) represents  
14 the current DCF-derived ROE for the proxy groups. This range includes the highest DCF  
15 rates and exceeds the low and mean/median DCF rates. My recommendation focuses on  
16 the highest of the DCF results to incorporate my recognition that these results are  
17 relatively lower than historic DCF results. As a result, my recommendation should be  
18 considered conservative.

19

---

<sup>36</sup> Using only the lowest average growth rate.

<sup>37</sup> Using only the highest average growth rate.

<sup>38</sup> Using the lowest median growth rate.

<sup>39</sup> Using only the highest median growth rate.

<sup>40</sup> Adjusted to reflect removal of four entities, as described above.

1 **Q. Please summarize Company witness McKenzie’s DCF methodology and describe**  
2 **how he over-states the ROE in his methodology and interpretation of DCF results.**

3 A. Mr. McKenzie calculates DCF results for his group of 21 proxy electric utilities by  
4 combining each proxy company’s dividend yield (for last 30 trading days as of October  
5 2, 2020) with four sets of growth rates, three of which are forecasts of EPS.<sup>41</sup>

6 I do not have any serious disagreements with Mr. McKenzie’s yield calculation.  
7 His use of 30 trading days, which usually amounts to about 40 calendar days, is a  
8 somewhat shorter date than the three months I use in my DCF yield calculations, but our  
9 respective calculations are not materially different due to the choice of timeframe. My  
10 DCF calculations are, of course, more current than his due to the sequence of our  
11 respective filings in this proceeding.

12 Mr. McKenzie considers four sets of growth rates in his DCF analyses:<sup>42</sup>

- 13 1. Value Line EPS estimates
- 14 2. IBES EPS Estimates
- 15 3. Zack’s EPS Estimates
- 16 4. br + sv growth

17 Mr. McKenzie calculates individual DCF results for each proxy company with  
18 each of the four growth rates, then calculates average and midpoint values for the proxy  
19 group using each of the four growth rates. The respective results are:<sup>43</sup>

	<u>Growth Rate</u>	<u>Average</u>	<u>Midpoint</u>
20	Value Line EPS	9.3%	10.4%
	IBES EPS	9.4%	9.8%
21	Zacks EPS	9.3%	10.1%
	br + sv	8.8%	8.8%

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<sup>41</sup> McKenzie, Exh. AMM-6 at 1-2.

<sup>42</sup> *Id.* at 2.

<sup>43</sup> McKenzie, Exh. AMM-6 at 3.

1 Five of these eight results fall within the same range as my DCF results. I note that these  
2 conclusions do not reflect all of Mr. McKenzie’s individual DCF calculations, as he  
3 eliminates those results that fall below a “low-end threshold” of 6.5 percent or less  
4 (“illogical values”).<sup>44</sup> As justification for this “threshold,” he cites a Federal Energy  
5 Regulatory Commission’s (“FERC”) decision which indicates a 100 basis-point premium  
6 to the historical average utility bond yields as a low-end threshold<sup>45</sup>

7  
8 **Q. Do you agree with Company witness McKenzie’s implied interpretation and use of**  
9 **the so-called “FERC low-end threshold?”**

10 A. No. Mr. McKenzie has mischaracterized the actual process that FERC uses to eliminate  
11 “low-end outliers.” What FERC actually does is eliminate individual DCF results that  
12 are less than 100 basis points greater than actual historical yields on utility debt. FERC  
13 does not apply the threshold to “projected” utility bond yields.<sup>46</sup>

14 During the six-month period (i.e., April-September 2020) prior to Mr.  
15 McKenzie’s DCF analyses (i.e., a six-month time period is used by FERC), the average  
16 yield on Baa utility bonds was 3.37 percent. This implies a low-end threshold of 4.37  
17 percent, which is well below his 6.5 percent lower threshold.

18  

---

<sup>44</sup> McKenzie, Exh. AMM-1T at 38:7-9; Exh. AMM-3 at 20:7-10.

<sup>45</sup> See McKenzie, Exh. AMM-3 at 21:3-11 *citing* Opinion No. 531, 147 FERC ¶ 61,234 at ¶ 122 (2014).

<sup>46</sup> 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 **IX. CAPM ANALYSIS**

2

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

4 A. CAPM was developed in the 1960s and 1970s as an extension of modern portfolio theory  
5 (MPT), which studies the relationships among risk, diversification, and expected returns.  
6 The CAPM describes and measures the relationship between a security's investment risk  
7 and its market rate of return.

8

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

10 A. The general form of the CAPM is:

11 
$$K = R_f + \beta(R_m - R_f)$$

12 where: K = cost of equity

13 R<sub>f</sub> = risk free rate

14 R<sub>m</sub> = return on market

15 β = beta

16 R<sub>m</sub>-R<sub>f</sub> = market risk premium

17 The CAPM is a variant of the RP method. I believe the CAPM is generally superior to  
18 the simple RP method because the CAPM specifically recognizes the risk of a particular  
19 company or industry (i.e., beta), whereas the simple RP method assumes the same ROE  
20 for all companies exhibiting similar bond ratings or other characteristics.

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

2 A. The first input of the CAPM is the risk-free rate ( $R_f$ ). The risk-free rate reflects the level  
3 of return that can be achieved without accepting any risk.

4 In CAPM applications, the risk-free rate is generally recognized by use of U.S.  
5 Treasury securities. Two general types of U.S. Treasury securities are often utilized as  
6 the  $R_f$  component, short-term U.S. Treasury bills and long-term U.S. Treasury bonds.

7 I have performed CAPM calculations using the three-month average yield  
8 (January – March 2021) for 20-year U.S. Treasury bonds. I use the yields on long-term  
9 Treasury bonds since this matches the long-term perspective of ROE analyses. Over this  
10 three-month period, these bonds had an average yield of 1.92 percent.

11

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

13 A. Beta is a measure of the relative volatility (and thus risk) of a particular stock in relation  
14 to the overall market. Betas less than 1.0 are considered less risky than the market,  
15 whereas betas greater than 1 are riskier. Utility stocks traditionally have had betas below  
16 1. I utilize the most recent Value Line betas for each company in the proxy groups.

17

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

19 A. The market risk premium component ( $R_m - R_f$ ) represents the investor-expected premium  
20 of common stocks over the risk-free rate, or long-term government bonds. For the  
21 purpose of estimating the market risk premium, I considered alternative measures of  
22 returns of the S&P 500 (a broad-based group of large U.S. companies) and 20-year U.S.

1 Treasury bonds (i.e., same timeframe as employed in Duff & Phelps source used to  
2 develop risk premiums).

3 First, I compared the actual annual returns on equity of the S&P 500 with the  
4 actual annual income returns of U.S. Treasury bonds. Exh. DCP-10 shows the ROE for  
5 the S&P 500 group for the period 1978-2019 (all available years reported by S&P). This  
6 schedule also indicates the annual yields on 20-year U.S. Treasury bonds and the annual  
7 differentials (i.e., risk premiums) between the S&P 500 and U.S. Treasury 20-year bonds.  
8 Based upon these returns, I conclude that the risk premium from this analysis is 7.40  
9 percent.

10 I next considered the total returns (i.e., dividends/interest plus capital  
11 gains/losses) for the S&P 500 group as well as for long-term government bonds, as  
12 tabulated by Duff & Phelps (formerly Morningstar/Ibbotson), using both arithmetic and  
13 geometric means. I considered the total returns for the entire 1926-2019 period reported  
14 by this source, which are as follows:

	<u>S&amp;P 500</u>	<u>L-T Gov't Bonds</u>	<u>Risk Premium</u>
Arithmetic	12.1%	6.0%	6.1%
Geometric	10.2%	5.5%	4.7%

17  
18 I conclude from this analysis that the expected risk premium is about 6.1 percent (i.e.,  
19 average of all three risk premiums: 7.40 percent from Exh. DCP-10; 6.1 percent  
20 arithmetic and 4.7 percent geometric from Duff & Phelps). I believe that a combination  
21 of arithmetic and geometric means is appropriate since investors have access to both

1 types of means<sup>47</sup> and presumably, both types are reflected in investment decisions and  
2 thus, stock prices and the ROE.

3  
4 **Q. What are your CAPM results?**

5 A. Exh. DCP-11 shows my CAPM calculations. The results are:

	<u>Mean</u>	<u>Median</u>
Parcell Proxy Group	7.5%	7.4%
McKenzie Proxy Group <sup>48</sup>	7.4%	7.4%

8  
9 **Q. What is your conclusion concerning the CAPM ROE?**

10 A. The CAPM results collectively indicate a ROE of 7.4 percent to 7.5 percent for the  
11 groups of proxy utilities. I conclude that an appropriate CAPM ROE estimation for  
12 Avista is 7.5 percent.

13  
14 **Q. Describe Company witness McKenzie's CAPM analyses and conclusions.**

15 A. Mr. McKenzie performs two sets of CAPM analyses:<sup>49</sup>

- 16 1. Traditional (CAPM) with current bond yields.
- 17 2. Empirical (ECAPM) with current bond yields.

18  
19 **Q. What are your disagreements with these various CAPM methodologies and  
20 conclusions?**

---

<sup>47</sup> 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.

<sup>48</sup> Adjusted to reflect removal of four entities, as described *supra* at 27-28.

<sup>49</sup> McKenzie, Exh. AMM-8 & Exh. AMM-9.



1 A. Each of Mr. McKenzie’s CAPM methodologies overstates the cost of equity for his proxy  
2 groups and Avista. Mr. McKenzie’s methodologies contain the following problems:

- 3 • Mr. McKenzie over-states the proper risk premium component in both his  
4 CAPM and ECAPM, and
- 5 • Mr. McKenzie is incorrect in making a “size adjustment” to his CAPM and  
6 ECAPM

7

8 **Q. Please summarize Company witness McKenzie’s risk premium components.**

9 A. Mr. McKenzie calculates a risk premium as follows: The “market return” (R<sub>m</sub>)  
10 component of the risk premium is a 11.6 percent DCF cost of equity for the dividend-  
11 paying companies of the S&P 500. The “current bond yield” risk premium subtracts  
12 from this 11.6 percent R<sub>m</sub> the 1.4 percent average yield on 30-year U.S. Treasury bonds  
13 to derive a 10.2 percent risk premium.<sup>50</sup>

14

15 **Q. Do you have any criticisms of Company witness McKenzie’s CAPM Market Risk**  
16 **Premium components?**

17 A. Yes. There are several problems with his methodology employed to develop this market  
18 risk premium. Mr. McKenzie’s 10.2 percent risk premium greatly exceeds the historic  
19 levels of risk premiums (i.e., 4.7 percent to 7.4 percent) I cited in my CAPM analyses.  
20 He offers no explanation as to why investors would expect such a dramatic increase in  
21 risk premiums.

---

<sup>50</sup> *Id.* (notes (a) and (c)).

1           In addition, Mr. McKenzie’s CAPM risk premium is derived from his  
2 development of a DCF cost for the dividend-paying stocks in the S&P 500 using only 5-  
3 year EPS growth projections as the growth component.<sup>51</sup> It is not appropriate to rely  
4 exclusively on analysts’ short-term EPS growth projections in a DCF analysis.

5  
6 **Q. Please explain why it is not appropriate to rely exclusively on EPS growth forecasts**  
7 **in a DCF context.**

8 A. There are several reasons why it is not appropriate to rely exclusively on analysts’ short-  
9 term EPS growth forecasts in a DCF context. First, it is not realistic to believe that  
10 investors rely exclusively on a single factor, such as analysts’ forecasts, in making their  
11 investment decisions. Investors have an abundance of available information to assist  
12 them in evaluating stocks; EPS forecasts are only one of many such statistics.

13           Second, Value Line – one of Mr. McKenzie’s sources of EPS projections –  
14 publishes both historic and forecasted data, as well as ratios, for a large number of  
15 publicly-traded companies. Presumably, both types of information are published for the  
16 consideration of its subscribers/investors. Yet Mr. McKenzie considers only one factor,  
17 the forecast version of EPS, in his analyses.

18           Third, the vast majority of information available to investors, by both individual  
19 companies in the form of annual reports and offering circulars, and by investment  
20 publications such as Value Line, is historic data. It is neither realistic nor logical to  
21 maintain that investors only consider projected (estimated) data to the exclusion of other  
22 data.

---

<sup>51</sup> *Id.* (note (b)).

1 Fourth, the experience over the past several years should be a clear signal to  
2 investors that analysts cannot accurately predict EPS levels. Few, if any, analysts  
3 predicted the decline in security prices in the financial crisis of 2008 and 2009.<sup>52</sup> Thus,  
4 relying only on forecasted EPS levels, while ignoring other growth indicators, cannot and  
5 will not produce accurate results.

6 In summary, investors are now very much aware of recent inabilities of security  
7 analysts to accurately predict EPS growth. These problems clearly call into question the  
8 exclusive reliance on analysts' forecasts as the only source of growth in a DCF context.  
9 As a result, the landscape has changed in recent years and investors have ample reasons  
10 to doubt the exclusive reliability of such forecasts at the present time. In light of the  
11 above, it is problematic to rely exclusively on such forecasts in determining the DCF  
12 result for Mr. McKenzie's portfolio of S&P 500 stocks.

13  
14 **Q. Are you aware of any recent analyses and comments on the accuracy of analysts'**  
15 **forecasts?**

16 A. Yes, I am. A 2010 study by McKinsey & Company, titled, "Equity Analysts: Still Too  
17 Bullish" concludes that "after almost a decade of stricter regulation, analysts' earnings  
18 forecasts continue to be excessively optimistic."<sup>53</sup> The significance of this study, as well  
19 as the points I raised previously, is that investors should be hesitant to rely exclusively on  
20 analysts' forecasts in making investment decisions.

21

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<sup>52</sup> See e.g., "Security Analysts and their Recommendations", available at <http://thismatter.com/money/stocks/valuation/security-analysts.htm>.

<sup>53</sup> 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:<sup>54</sup>

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.

12  
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 Company witness McKenzie's CAPM**  
18 **methodology.**

19 A. Mr. McKenzie adds a "size" premium to his CAPM results for each of his proxy group  
20 companies. Mr. McKenzie maintains that there is justification for making a small-firm  
21 risk adjustment that results in a higher cost of capital for small firms. His proposed size  
22 adjustment varies among the proxy companies with individual values up to 1.47  
23 percent.<sup>55</sup> Such an adjustment is improper and results in an overstatement of the ROE for  
24 the proxy electric utilities.

25 There are compelling reasons why a small size adjustment is not proper for  
26 regulated utilities. Mr. McKenzie's proposed size adjustment is based upon his reference

---

<sup>54</sup> United States Securities and Exchange Commission "Investor Alert: Analyzing Analysts Recommendations", 2010.

<sup>55</sup> McKenzie, Exh. AMM-8 & Exh. AMM-9 (Otter Tail Corp., Row 19).

1 to the previously-cited Duff & Phelps (formerly Morningstar/Ibbotson) studies.<sup>56</sup>  
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  
20 This implies that although the price phenomenon has been strongly  
21 documented for the industrials, the findings suggest that there is no need to  
22 adjust for the firm size in utility rate regulation.<sup>57</sup>  
23  
24

25 **Q. Can you provide any evidence that “size” or “business risk” adjustments are not**  
26 **generally recognized as risk factors in regulatory proceedings such as this one?**

27 A. Yes, I can. Implicit in Mr. McKenzie's proposal is an assumption that any perceived  
28 small size risk adjustment for unregulated companies (i.e., source of information cited in  
29 the Duff & Phelps source Mr. McKenzie relies on for his small size adjustment) applies

---

<sup>56</sup> McKenzie, Exh. AMM-3 at 27, n.35 & 36.

<sup>57</sup> Wong, Annie, “Utility Stocks And The Size Effect: An Empirical Analysis”, Journal of the Midwest Finance Association, 1993, pp. 95-101.

1 to regulated public utilities. Exh. DCP-12 demonstrates objectively that this is not the  
2 case. As this exhibit shows, there is no significant difference and there is no discernible  
3 pattern of increase among the risk indicators of publicly-traded electric utilities of  
4 different sizes. The table below summarizes the information contained in this exhibit.

<u>Cap Size</u>	<u>Safety</u>	<u>Beta</u>	<u>Financial Strength</u>	<u>S&amp;P Rating</u>	<u>Moody's Rating</u>
Under \$10 B	1.9	.89	A	BBB+	Baa1
\$10-\$20 B	2.3	.91	B++	BBB+	Baa2
\$20-\$30 B	1.7	.90	A	A-/BBB+	Baa2
\$30 B Plus	1.8	.88	A	A-/B++	Baa1/Baa2

5  
6  
7  
8  
9 The safety rank, beta values, financial strength, and Moody's/S&P bond ratings are about  
10 the same for all sizes of electric utilities. These risk indicators do not reflect any risk  
11 differential as the size of the electric utilities decrease from large to small. To the  
12 contrary, this data indicates that regulated monopoly utility providers have approximately  
13 the same risk regardless of size. As a result, the logic Mr. McKenzie uses to justify his  
14 proposed small size adjustment is unsound.

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

17 A. The ECAPM is improper to use for Avista because it "adjusts" each proxy company's  
18 actual beta by assigning only 75 percent weight to the actual beta and "assumes" a beta of  
19 1.0 with the remaining 25 percent weight. As a result, the ECAPM does not use the  
20 actual betas of the proxy companies, but rather calculates hypothetical betas that are  
21 upward biased due to the fact that electric utility betas are below 1.0. In contrast, the  
22 traditional CAPM directly recognizes and quantifies the risk of individual companies

1 through the use of the beta coefficient. As such, each proxy company's risk and beta are  
2 identified and used in the calculation of its CAPM ROE.

3  
4 **X. CE ANALYSIS**

5  
6 **Q. Please describe the basis of the CE methodology.**

7 A. The CE method is derived from the "corresponding risk" concept discussed in the  
8 *Bluefield* and *Hope* cases. This method is thus based upon the economic concept of  
9 opportunity cost. As previously noted, the ROE is an opportunity cost: the prospective  
10 return available to investors from alternative investments of similar risk.

11 The CE method is designed to measure the returns expected to be earned on the  
12 original cost book value of similar risk enterprises. Thus, it provides a direct measure of  
13 the fair return, since it translates into practice the competitive principle upon which  
14 regulation rests.

15 The CE method normally examines the experienced and/or projected return on  
16 book common equity. The logic for examining returns on book equity follows from the  
17 use of original cost rate base regulation for public utilities, which uses a utility's book  
18 common equity to determine the cost of capital. This cost of capital is, in turn, used as  
19 the fair rate of return which is then applied (multiplied) to the book value of rate base to  
20 establish the dollar level of capital costs to be recovered by the utility. This technique is  
21 thus consistent with the rate base-rate of return methodology used to set utility rates.

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

2 A. I apply the CE methodology by examining realized ROEs for the groups of proxy  
3 utilities, as well as unregulated companies. My CE analysis also uses prospective returns  
4 and thus is not backward looking. I evaluate investor acceptance of these returns by  
5 reference to the resulting market-to-book ratios ("M/Bs"). In this manner it is possible to  
6 assess the degree to which a given level of return equates to the COC. It is generally  
7 recognized for utilities that an M/B of greater than one (i.e., 100 percent) reflects a  
8 situation where a company is able to attract new equity capital without dilution (i.e.,  
9 above book value). As a result, one objective of a fair cost of equity is the maintenance  
10 of stock prices at or above book value. There is no regulatory obligation to set rates  
11 designed to maintain an M/B significantly above one.

12 I further note that my CE analysis is based upon market data (through the use of  
13 M/Bs) and is thus essentially a market test. Given that public utilities have their rates set  
14 based upon the book value of their assets (i.e., rate base) and capital structure (i.e., cost of  
15 capital), when a utility's stock price exceeds its book value (i.e., M/B greater than 1) this  
16 indicates that investors consider its current and prospective earnings as adequate. As a  
17 result, my CE analysis is not subject to the criticisms occasionally made by some who  
18 maintain that past earned returns do not represent the cost of capital.

19  
20 **Q. What time periods do you examine in your CE analysis?**

21 A. My CE analysis considers the experienced ROEs of the proxy groups of utilities for the  
22 period 2002-2020 (i.e., the last 19 years). The CE analysis requires that I examine a  
23 relatively long period of time in order to determine trends in earnings over at least a full



1 business cycle. Further, in estimating a fair level of return for a future period, it is  
 2 important to examine earnings over a diverse period of time in order to avoid any undue  
 3 influence from unusual or abnormal conditions that may occur in a single year or shorter  
 4 period. Therefore, in forming my judgment of the current cost of equity, I focused on  
 5 two periods: 2009-2020 (the current business cycle) and 2002-2008 (the most recent  
 6 business cycle). I have also considered projected ROEs for 2021 and 2024-2026.

7  
 8 **Q. Please describe your CE analysis.**

9 A. Exhibit Nos. DCP-13 and DCP-14 contain summaries of experienced ROEs and M/Bs for  
 10 three groups of companies, while Exh. DCP-15 presents a risk comparison of utilities  
 11 versus unregulated firms.

12 Exh. DCP-13 shows the ROEs and M/Bs for the groups of proxy utilities. These  
 13 can be summarized as follows:

	Parcell Proxy Group	McKenzie Proxy Group <sup>58</sup>
Historic ROE		
Mean	9.0-9.2%	9.9-11.3%
Median	9.0-9.3%	9.8-10.0%
Historic M/B		
Mean	148-162%	169-175%
Median	147-157%	158-161%
Prospective ROE		
Mean	9.1-9.8%	9.9-10.3%
Median	9.0%	9.0-10.0%

14  
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 24  
 25  
 26 These results indicate that historic ROEs of 9.0 percent to 11.3 percent have been  
 27 adequate to produce M/Bs of 147 percent to 175 percent for the groups of utilities.

28 Furthermore, projected returns on equity for 2021 and 2024-2026 are within a range of

---

<sup>58</sup> Adjusted to reflect removal of four entities, as described above.

1 9.0 percent to 10.3 percent for the utility groups. These relate to 2020 M/Bs of 170  
2 percent or greater. I note that Mr. McKenzie's proxy group exhibits both higher ROEs  
3 and M/Bs relative to those of my proxy group, primarily to the 2002-2008 experience of  
4 CenterPoint Energy and Exelon, two entities whose more recent experiences have shown  
5 much lower results.

6  
7 **Q. Do you also review the earnings of unregulated firms?**

8 A. Yes. As an alternative, I also examine the S&P's 500 Composite group. This is a well-  
9 recognized group of firms that is widely utilized in the investment community and is  
10 indicative of the competitive sector of the economy. Exh. DCP-14 presents the earned  
11 ROEs and M/Bs for the S&P 500 group over the past eighteen years (i.e., 2002-2019).  
12 As this schedule indicates, over the two business cycle periods, this group's average  
13 ROEs ranged from 12.4 percent to 13.8 percent, with average M/Bs ranging between 256  
14 percent and 275 percent.

15  
16 **Q. How can the above information be used to estimate Avista's ROE?**

17 A. The recent ROEs of the proxy utilities and S&P 500 group can be viewed as an indication  
18 of the level of return realized and expected in the regulated and competitive sectors of the  
19 economy. In order to apply these returns to the ROE for the proxy utilities, however, it is  
20 necessary to compare the risk levels of the utilities and the competitive companies. I do  
21 this in Exh. DCP-15, which compares several risk indicators for the S&P 500 group and  
22 the utility groups. The information in this exhibit indicates that the S&P 500 group is  
23 riskier than the utility proxy groups.

1 **Q. What ROE is indicated by your CE analysis?**

2 A. Based on recent ROEs and M/Bs, my CE analysis indicates that the ROE for the proxy  
3 utilities is no more than 9.0 percent to 10.0 percent (9.5 percent mid-point). Recent  
4 ROEs of 9.0 percent to 11.3 percent have resulted in M/Bs of 145 percent and over.  
5 Prospective ROEs of 9.0 percent to 10.3 percent have been accompanied by M/Bs over  
6 170 percent. As a result, it is apparent that authorized returns below this level would  
7 continue to result in M/Bs of well above 100 percent. As I indicated earlier, the fact that  
8 M/Bs substantially exceed 100 percent indicates that historic and prospective ROEs of  
9 9.5 percent reflect earning levels that are well above the actual cost of equity for those  
10 regulated companies. I also note that a company whose stock sells above book value can  
11 attract capital in a way that enhances the book value of existing stockholders, thus  
12 creating a favorable environment for financial integrity. Finally, I note that my 9.0  
13 percent to 10.0 percent CE recommendation generally reflects the actual and prospective  
14 ROEs for my proxy group. I have made no adjustments to these return levels to reflect  
15 the high M/Bs.

16

17 **Q. Please now turn to Company witness McKenzie's Expected Earnings Approach.**

18 **Please summarize his use of this methodology and his conclusions.**

19 A. Mr. McKenzie's Expected Earnings Approach is a form of the comparable earnings  
20 methodology. Mr. McKenzie has tabulated Value Line's "expected" return on equity for  
21 his proxy group of companies, which he "adjusts" for a return on average equity (as  
22 opposed to Value Line's reporting on year-end equity).

1 Mr. McKenzie's tabulation shows an "Adjusted Return on Common Equity"  
2 range of 5.0 percent to 16.3 percent, with a 10.3 percent average and 10.9 percent mid-  
3 point.<sup>59</sup> He concludes that 10.3 percent to 10.9 percent is the Expected Earnings  
4 Approach findings.<sup>60</sup>

5  
6 **Q. Do you have any criticisms of Company witness McKenzie's Expected Earnings**  
7 **Approach and related conclusions?**

8 A. Yes. It is inappropriate to focus only on expected ROE without any reference to how such  
9 returns are accepted by investors. A more appropriate analysis of expected returns on  
10 equity is done in conjunction with M/Bs. I reviewed Mr. McKenzie's Expected Earnings  
11 Approach by evaluating the investor acceptance of these cited ROEs by reference to the  
12 corresponding M/Bs. In this manner, it is possible to assess the degree to which a given  
13 level of ROE equates to the cost of capital, as I describe previously. Book value is a  
14 relevant concept for regulated utilities due to the use of rate-of-return rate-base  
15 regulation, which employs book value for both rate base and capital structure. Investors  
16 know that utility rates are established based, in part, on book values. Exh. DCP-13 on  
17 page 2 shows the 2020 M/Bs of the proxy companies. These are above 170 percent,  
18 which indicates that the ROEs are expected to exceed the cost of capital.

19 Third, it is evident that the expected ROEs for the proxy companies which are  
20 mostly holding companies are substantially higher than the authorized ROEs for electric  
21 utilities.

---

<sup>59</sup> McKenzie, Exh. AMM-11.

<sup>60</sup> McKenzie, Exh. AMM-1T at 41:5-6.



1 **Q. What are your primary disagreements with this approach and Company witness**  
2 **McKenzie's conclusions?**

3 A. There are several problems with Mr. McKenzie's risk premium analyses, all of which  
4 have the effect of overstating the ROE for the proxy companies and Avista. First, the  
5 highest risk premium values over this period occurred in 2011-2019.<sup>64</sup> This corresponds  
6 to the post-Great Recession period in which the actions of the Federal Reserve kept  
7 interest rates low. Mr. McKenzie describes the Federal Reserve policies as placing  
8 "artificial downward pressure on bond yields."<sup>65</sup> Thus, Mr. McKenzie's recent above-  
9 average risk premiums are driven by "uncharacteristically low" interest rates. He cannot  
10 have it both ways – if recent interest rates are "artificially low", they cannot be used as a  
11 standard for establishing Avista's ROE.

12 Second, it is not proper to compare utility authorized ROEs in the 1970's and  
13 1980's with the current time. Current ROEs reflect a suite of favorable regulatory  
14 mechanisms that greatly enhance utilities' ability to recover costs, which is risk-reducing  
15 and thus warrants low ROEs.<sup>66</sup>

16 Third, it is improper to use prospective interest rates, because they are not  
17 measurable and not achievable. For example, if the current yield on Triple-B is less than  
18 4.0 percent, this reflects the rate that investors can actually receive on their investment.  
19 Investors cannot receive a prospective yield on their investments since such a yield is  
20 speculative, not actual. It is instead proper to use the current yield as the risk-free rate in

---

<sup>64</sup> *Id.* at 3.

<sup>65</sup> McKenzie, Exh. AMM-1T at 26:5-7.

<sup>66</sup> See e.g., Moody's Investors Service, Sector Comments, "US Utility Sector Upgrades Driven by Stable and Transparent Regulatory Frameworks", February 3, 2014.

1 a CAPM or RP context. Because the current yield is known and measurable, it reflects  
2 investors' collective assessment of all capital market conditions.

3 Use of the current risk-free rate in a CAPM context is similar to using the current  
4 yield in a DCF context. Analysts do not use prospective stock prices as the basis for the  
5 dividend yield in a DCF analysis, as use of prospective stock prices is speculative.

6 However, Mr. McKenzie's use of current stock prices is appropriate. Likewise, current  
7 levels of interest rates reflect all current information (i.e., the efficient market hypothesis)  
8 and should be used as the risk-free rate in the RM.

9  
10 **Q. Have you performed an independent RP analysis in order to avoid the deficiencies**  
11 **in Company witness McKenzie's RP analyses?**

12 A. Yes, I have. As noted above, Mr. McKenzie's RP analyses consider the authorized ROEs  
13 of electric utilities dating back to 1974. As I have indicated in my testimony, this period  
14 has experienced significant declines in interest rates, which is another component of this  
15 RP analysis. Mr. McKenzie attempts to "correct" for changes in interest rates by  
16 performing a regression analysis that considers only the perceived relationship between  
17 authorized ROEs, interest rates, and the resulting period RPs. Such an analysis does not  
18 recognize any other changes in RPs, such as increased use of regulatory mechanisms (i.e.,  
19 decoupling, cost recovery mechanisms, etc.). As a result, his regression analysis does not  
20 properly capture the current relationship between authorized ROEs and interest rates, as  
21 demonstrated above by the fact that his regression-suggested RP and resulting ROEs is  
22 not consistent with the recent level of authorized ROEs.

1 I have accordingly performed a RP analysis that focuses on the most recent five-  
2 year period of authorized ROEs and Triple-B (i.e., Avista’s rating category) utility bond  
3 yields. My analysis, by focusing on the current time period, as well as using the yields on  
4 public utility bonds, is not subject to the deficiencies in Mr. McKenzie’s RP analyses.

5  
6 **Q. Please describe your RP analysis.**

7 A. I have compared the authorized ROEs of electric utilities that were decided in the period  
8 2016 through 2020, the most recent complete five-year period for which complete annual  
9 data is available. These are shown on Exh. DCP-16.

10 Also shown in Exh. DCP-16 are the levels of Triple-B utility bonds, with  
11 corresponding “lags” between the level of interest rates and the respective commission  
12 decisions. Exh. DCP-16 shows a range with no lags, 3-month lags, 6-month lags, 9-  
13 month lags and 12-month lags.

14 The purpose of showing the lags is to recognize that authorized ROEs often  
15 reflect test period and/or hearing period financial conditions that are not simultaneous  
16 with the date of the respective commission’s final decision establishing the authorized  
17 ROEs.

18 The data in Exh. DCP-16 shows the quarterly average authorized ROEs for  
19 electric utilities, along with several lagged interest rates, as well as the resulting RPs  
20 associated with the first two sets of figures.

21  
22 **Q. What are the results of your calculations?**

23 A. As shown on Exh. DCP-16, the annual and 5-year RPs are as follows:



Year	Avg ROE	Risk Premiums
2016	9.60%	4.36-4.92%
2017	9.68%	5.00-5.30%
2018	9.56%	4.89-5.24%
2019	9.65%	4.88-5.46%
2020	9.39%	5.20-6.00%
2016-2020 Avg.	9.58%	4.99-5.31%

1           The most recent two years (i.e., 2019 and 2020) generally show RPs of about 4.9  
2           percent to 6.0 percent, whereas the 5-year period generally shows RPs of about 5.0  
3           percent to 5.3 percent. I do not focus exclusively on the 2020 results since this is  
4           impacted by the low interest rate environment resulting from the Federal Reserve policies  
5           associated with the COVID-19 pandemic, although I do include the 2020 results in the  
6           multi-year averages.

7           I conclude that a reasonable current RP estimate for electric utilities is a range of  
8           5.0 percent to 6.0 percent over the prevailing level of Triple-B utility bond yields. This  
9           focuses on the upper end portions of the two cited ranges.

10  
11   **Q.    What is the appropriate RP ROE at the present time?**

12   A.    I focus on the level of Triple-B bond yields over two three-month periods. As is shown  
13           on Exh. DCP-4, over the three-month period January through March of 2021, the average  
14           yield is 3.42 percent. Combining this 3.42 percent Triple-B bond yield with a RP range of  
15           5.0 percent to 6.0 percent, the resulting RP-derived ROE is currently a range of 8.42  
16           percent to 9.42 percent.

17           I have also considered the three-month period averages for November 2019 to  
18           January 2020, which is the period preceding the COVID-19 pandemic. Use of this period  
19           is not impacted by the lower level of interest rates resulting from the Federal Reserve's

1           simulative monetary policies and the resulting decline in interest rates. Over this period,  
 2           the average yield on BBB-rated utility bonds was 3.70 percent. Combining this with the  
 3           RP range results in a RP-derived ROE of 8.7 percent to 9.7 percent.

4                     I conclude from this that the proper RP derived ROE for Avista is within a range  
 5           of 8.4 percent to 9.7 percent, with a mid-point of about 9.0 percent.

6  
 7                                     **XII.    RETURN ON EQUITY RECOMMENDATION**

8  
 9   **Q.    Please summarize the results of your four ROE analyses.**

10  **A.    My three ROE analyses produced the following:**

	<u>Mid-Point</u>	<u>Range</u>
DCF	9.1%	8.9-9.3%
CAPM	7.5%	7.4-7.5%
CE	9.5%	9.0-10.0%
RP	9.0%	8.4-9.7%

11  
 12                                     These results indicate an overall broad range of 7.4 percent to 10.0 percent, which  
 13           focuses on the respective individual model results. Using mid-point values, the range is  
 14           7.5 percent to 9.5 percent. I recommend a ROE range of 9.1 percent to 9.5 percent for  
 15           Avista (mid-point of 9.3 percent). This range includes the upper end of my DCF results,  
 16           the mid-point of my CE results, and is supported by the results of the RP analysis. My  
 17           specific ROE recommendation is 9.3 percent.  
 18  
 19  
 20  
 21

1 **Q. It appears that your CAPM results are less than your DCF, CE, and RP results.**  
2 **Does this imply that the CAPM results should not be considered in determining the**  
3 **cost of equity for Avista?**

4 A. No. It is apparent that the CAPM results are less than the DCF, CE, and RP results.  
5 There are two reasons for the lower CAPM results. First, risk premiums are lower  
6 currently than was the case in prior years. This is the result of lower equity returns that  
7 have been experienced over the past several years. This is also reflective of a decline in  
8 investor expectations of equity returns and risk premiums. Second, the level of interest  
9 rates on U.S. Treasury bonds (i.e., the risk-free rate) has been lower in recent years. This  
10 is partially the result of the actions of the Federal Reserve System to stimulate the  
11 economy. This also impacts investor expectations of returns in a negative fashion. I note  
12 that, initially, investors may have believed (as far back as 2010) that the decline in  
13 Treasury yields was a temporary factor that would soon be replaced by a rise in interest  
14 rates. However, this has not been the case, as interest rates have remained low and  
15 continued to decline for the past ten-plus years. As a result, it cannot be maintained that  
16 low interest rates (and low CAPM results) are temporary and do not reflect investor  
17 expectations. Investors have now experienced a ten-year period of low and declining  
18 interest rates, such that these are the “new norm.” Consequently, even though the CAPM  
19 results have not been given weight in developing my recommended ROE range, they  
20 should be considered as one factor in determining where, within the recommended range,  
21 the cost of equity for Avista should fall. Therefore, I recommend that Avista’s ROE be  
22 set at no higher than the mid-point of the ROE range for the proxy companies.

23

1 **XIII. 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 6.97 percent to 7.16 percent. With my 9.3 percent ROE, my COC  
7 recommendation is 7.07 percent.

8

9 **XIV. COMMENTS ON COMPANY TESTIMONY**

10

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

12 A. Avista is requesting a 9.90 percent ROE for both its electric and natural gas operations.  
13 This 9.90 percent ROE is sponsored by Avista's cost of capital witness Adrien M.  
14 McKenzie.<sup>67</sup>

15

16 **Q. What is the basis of Company witness McKenzie's 9.90 percent ROE**  
17 **recommendation?**

18 A. Mr. McKenzie's ROE analyses are summarized on page 4 of Exh. AMM-1T as well as in  
19 Exh. AMM-4. These are shown as follows:

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<sup>67</sup> McKenzie, Exh. AMM-1T at 6:4.

	<u>Average</u>		<u>Midpoint</u>
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14 **Q. Do you have any general comments on Company witness McKenzie’s methodologies**  
15 **and conclusions?**

16 A. Yes. Each of Mr. McKenzie’s methodologies is biased in a way that overstates the  
17 current and prospective ROE for his proxy group and for Avista. I have previously  
18 addressed each of his methodologies and conclusions above.

20 **Q. Do you agree with Company witness McKenzie’s proposal to add a 0.10 percent**  
21 **flotation cost adjustment to his ROE results?**

22 A. No, I do not. There has been no demonstration that Avista has or plans a public offering  
23 of common stock with the intent of increasing the common equity ratio of Avista

1 Utilities. I note that the issuance of new shares through the dividend reinvestment plan  
2 does not incur flotation costs. In addition, even if a public offering were to occur, it  
3 would be at a price that substantially exceeds the book value of existing stock price,  
4 which results in a gain to existing shareholders. Flotation costs, to the extent that they  
5 occur, are known to investors and thus are reflected in the stock prices that thus, ROE  
6 model results. As a result, there is no need to add flotation costs to the results of ROE  
7 models, as Mr. McKenzie proposes.

8  
9 **Q. Has the Commission rejected the inclusion of flotation costs for Avista?**

10 A. The Commission rejected Avista's request to include flotation costs in the 2017 general  
11 rate case, noting that while flotation costs "may be legitimate adjustments made during  
12 the underwriting process" the Company did not demonstrate it actually incurred such  
13 costs during the test year.<sup>68</sup> Avista has not demonstrated the existence of any such costs  
14 in the instant case either.

15  
16 **Q. Does this conclude your testimony?**

17 A. Yes, it does.

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<sup>68</sup> 2017 Avista GRC Order 30, ¶ 76.