**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,**<br><br>**Complainant,**<br><br>**v.**<br><br>**AVISTA CORPORATION d/b/a AVISTA UTILITIES,**<br><br>**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

| Item | Percent | Cost | Weighted Cost | | |
|------|---------|------|------|------|------|
| 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% | |

1        Avista's application requests a COC of 7.43 percent and a cost of equity ("ROE")

2        of 9.90 percent.[1]

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,[2] which is a hypothetical capital structure.  I note that

18         Avista proposed the same capital structure in its last two rate proceedings.[3]  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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[1] Thies, Exh. MTT-1T at 17:16-21.

[2] *Id*. at 17:10-12.

[3] *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.[4]  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,[5] 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.[6]  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:

19

---

[4] *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).
[5] 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.
[6] 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) |

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

5     percent to 9.5 percent, which is based upon the mid-point of the upper end of the range of

6     the results for the DCF model and mid-point of the range of results for the CE model.

7     This is also supported by the results of my RP analysis. I specifically recommend a 9.3

8     percent ROE for Avista, which is the mid-point of this range. I note that I do not give the

9     results of my CAPM weight in my final recommendation, since these are low relative to

10     the other model results and can be considered anomalous.

11

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

13

14 **Q.**     **What are the primary economic and legal principles that establish the standards for**

15       **determining a fair rate of return for a regulated utility?**

16 A.    Public utility rates are normally established in a manner designed to allow the recovery of

17     their costs, including capital costs. This is frequently referred to as "cost of service"

18     ratemaking. Rates for regulated public utilities traditionally have been primarily

19     established using the "rate base – rate of return" concept. Under this method, utilities are

20     allowed to recover a level of operating expenses, taxes, and depreciation deemed

21     reasonable for rate-setting purposes, and are granted an opportunity to earn a fair rate of

22     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 form 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."[7]

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

---

[7] *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:

| Business Cycle | Expansion Cycle | Contraction Period |
| --- | --- | --- |
| 1975-1982 | Mar. 1975-July 1981 | Aug. 1981-Oct. 1982 |
| 1982-1991 | Nov. 1982-July 1990 | Aug. 1990-Mar. 1991 |
| 1991-2001 | Mar. 1991-Mar. 2001 | Apr. 2001-Nov. 2001 |
| 2001-2009 | Nov. 2001-Nov. 2007 | Dec. 2007-June 2009 |
| Current | July 2009-Feb. 2020 | Mar. 2020- |

Source: The National Bureau of Economic Research, "U.S. Business Cycle
Expansions and Contractions."[8]

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.

---

[8] *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.[9]  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.

---

[9] *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.[10]

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.

---

[10] 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.[11]

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.[12]  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

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[11]  Thies, Exh. MTT-1T at 24:10-20.

[12] 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."[13]  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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[13] *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.[14]  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:[15]

|      | Electric | | Natural Gas | |
|------|----------|--------|-------------|--------|
| Year | 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%  |

---

[14]  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.
[15]  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:[16]

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.[17]

---

[16] Avista Corp., 2020 Form 10-K page 5.
[17] *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.[18]

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

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

7

8

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

---

[18] *Id*. at 38.

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

2      testimony.[19]

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

---

[19] 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 S-T Debt | Excluding S-T Debt | Including S-T Debt | Excluding S-T Debt |
| 2016 | 47.1% | 48.7% | 48.1% | 49.9% |
| 2017 | 47.3% | 48.7% | 48.1% | 49.7% |
| 2018 | 45.7% | 48.1% | 46.3% | 48.9% |
| 2019 | 47.6% | 49.9% | 47.7% | 50.0% |
| 2020 | 47.3% | 49.6% | 48.5% | 49.8% |

14     This indicates that Avista, on a consolidated basis, has had an equity ratio that has

15     generally been stable over the past five years.  The Avista Utilities (Division) capital

16     structure[20] has also been fairly stationary, with equity ratios (including short-term debt)

17     of about 48 percent or less over the past five years.

18

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

20        **utilities?**

---

[20] 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:

4

|  | Period | Average | Median |
|---|---|---|---|
| Parcell Proxy Group | 2016-2020 | 52.6% | 54.3% |
|  | 2024-2026 | 52.1% | 52.0% |
| McKenzie Proxy Group (Adjusted)[21] | 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:[22]

16

|  | Electric |
|---|---|
| 2015 | 49.54% |
| 2016 | 48.91% |
| 2017 | 48.90% |
| 2018 | 48.95% |
| 2019 | 49.41% |
| 2020 | 48.56% |

20

---

[21] Adjusted to reflect removal of four entities, as described *infra* on pages 27-28.
[22] 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
|              | Percent |
|--------------|---------|
| 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+."[23]  I note that Avista also proposed this same hypothetical capital structure in its

16    last two rate proceedings.[24]

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

---

[23] Thies, Exh. MTT-1 at 18:19-20.
[24] 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.[25]  This capital structure was Avista's "forecast capital

2    structure at December 31, 2015."[26]  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.[27]  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.[28]

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% |
| Long-Term Debt | 49.02% |
| Common Equity | 48.50% |

14

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.

---

[25] 2015 Avista GRC Order, Appendix C (Multiparty Settlement Stipulation) at 2.
[26] Dockets UE-150204 & UG-150205, Thies, Exh. MTT-1T at 14:20-23 (February 9, 2015).
[27] 2017 Avista GRC Order at 39-40, ¶¶ 111-112.
[28] 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.[29]  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.[30]

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.[31]

20

---

[29] 2019 Avista GRC Order at 13, ¶ 34; 2017 Avista GRC Order at 39-40, ¶¶ 111-112.
[30] *See* 2017 Avista GRC Order at 39, ¶ 107.
[31] *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.[32] Avista's applications show a cost of short-term debt of 3.26 percent as

10 of this same date.[33] 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

---

[32] Thies, Exh. MTT-2 at 3.
[33] *Id*. at 4.

1                               VII.    SELECTION OF PROXY GROUPS

2

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

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

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

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

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

8        group of electric utilities similar to the Avista using the criteria listed in Exh. DCP-8.

9        These criteria area as follows:

10               (1)    Market cap of $1 billion to $10 billion.

11               (2)    Common equity ratio 40% or greater.

12               (3)    Value Line Safety rank of 1 or 2.

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

14               (5)    Currently pays dividends; and

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

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

17       group that was selected by Company witness, Adrien M. McKenzie.  My analyses do not

18       include Algonquin Power & Utilities, which is a Canadian firm and is not followed by

19       Value Line, which is an apparent criterion for his selection process.[34]  In addition, I do

20       not include PNM Resources (pending acquisition by AVANGRID), as well as Edison

21       International and Sempra Energy (California utilities whose financial characteristics have

---

[34] *See* McKenzie, Exh. AMM-1T at 37: Table 2, (citing a selection criterion of "Value Line Safety Rank of "2").  In addition, Mr. McKenzie's exhibits show "n/a" for all data citing Value Line, reflecting the fact that such entities are "not available" as Value Line does not report data for this Company.

1    been significantly impacted by the state's wildfires and related liability by utilities).

2    These entities have had their financial circumstances impacted by the wildfires in

3    California.  This impact is demonstrated, for example, by Edison International's two

4    California utility subsidiaries. Those subsidiaries filed rate cases in 2019 requesting

5    ROEs six percentage points higher than the "base" ROE level to compensate the utilities

6    from the elevated risks associated with the wildfires.[35]  Clearly, Edison International does

7    not consider itself to be a representative utility at the current time.

8

9  **Q.    Please explain why you are using two proxy groups in your cost of equity analyses.**

10  A.    It has long been my practice to develop my own independently-determined proxy group

11    and to also conduct cost of equity analyses on the utility witness' proxy group.  My

12    conclusions and recommendations, in turn, are based upon the results of both proxy

13    groups.

14

15                           **VIII.   DCF ANALYSIS**

16

17  **Q.    What is the theory and methodological basis of the DCF model?**

18  A.    The DCF model is one of the oldest and most commonly-used models for estimating the

19    ROE for public utilities.

20         The DCF model is based on the "dividend discount model" of financial theory,

21    which maintains that the value (price) of any security or commodity is the discounted

22    present value of all future cash flows.

---

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

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

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:

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

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

3   increases.

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

5   each proxy company for the most recent three-month period (January - March 2021).

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

7

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

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

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

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

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

13       recognize that individual investors have different expectations and consider alternative

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

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

16       investment decision to sell that stock.

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

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

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

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

21       DCF analyses.  These are:

22            1.  Years 2016-2020 (5-year average) earnings retention, or fundamental growth

23                (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:

21

| | Mean | Median | Mean Low[36] | Mean High[37] | Median Low[38] | Median High[39] |
|---|---|---|---|---|---|---|
| Parcell Proxy Group | 8.0% | 8.0% | 7.1% | 8.9% | 7.2% | 9.3% |
| McKenzie Proxy Group[40] | 8.2% | 8.0% | 7.4% | 9.1% | 7.3% | 9.1% |

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

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

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

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

---

[36] Using only the lowest average growth rate.
[37] Using only the highest average growth rate.
[38] Using the lowest median growth rate.
[39] Using only the highest median growth rate.
[40] 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.[41]

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:[42]

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:[43]

20

21

| Growth Rate | Average | Midpoint |
|---|---|---|
| Value Line EPS | 9.3% | 10.4% |
| IBES EPS | 9.4% | 9.8% |
| Zacks EPS | 9.3% | 10.1% |
| br + sv | 8.8% | 8.8% |

---

[41] McKenzie, Exh. AMM-6 at 1-2.
[42] *Id*. at 2.
[43] 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").[44]  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[45]

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.[46]

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

---

[44] McKenzie, Exh. AMM-1T at 38:7-9; Exh. AMM-3 at 20:7-10.
[45] *See* McKenzie, Exh. AMM-3 at 21:3-11 *citing* Opinion No. 531, 147 FERC ¶ 61,234 at ¶ 122 (2014).
[46] *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 <div align="center">**IX.**     **CAPM ANALYSIS**</div>

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                   $R_f$ = risk free rate

14                   $R_m$ = return on market

15                   $\beta$ = beta

16                   $R_m$-$R_f$ = 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.

21

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:

15

|            | S&P 500 | L-T Gov't Bonds | Risk Premium |
|------------|---------|-----------------|--------------|
| 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[47] 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:

|  | Mean | Median |
|---|---|---|
| Parcell Proxy Group | 7.5% | 7.4% |
| McKenzie Proxy Group[48] | 7.4% | 7.4% |

6

7

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:[49]

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?**

---

[47] 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.
[48] Adjusted to reflect removal of four entities, as described *supra* at 27-28.
[49] 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" (Rm)

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 Rm the 1.4 percent average yield on 30-year U.S. Treasury bonds

13        to derive a 10.2 percent risk premium.[50]

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.

---

[50] *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.[51]  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.

---

[51] *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.[52]  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."[53]  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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[52] *See e.g*., "Security Analysts and their Recommendations", *available at*
http://thismatter.com/money/stocks/valuation/security-analysts.htm.
[53] 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:[54]

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.[55] 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

---

[54] United States Securities and Exchange Commission "Investor Alert: Analyzing Analysts Recommendations", 2010.
[55] McKenzie, Exh. AMM-8 & Exh. AMM-9 (Otter Tail Corp., Row 19).

1      to the previously-cited Duff & Phelps (formerly Morningstar/Ibbotson) studies.[56]

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.[57]
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

---

[56] McKenzie, Exh. AMM-3 at 27, n.35 & 36.
[57] 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.

| Cap Size | Safety | Beta | Financial Strength | S&P Rating | Moody's Rating |
|---|---|---|---|---|---|
| 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 |

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.

22

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 it 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 [58] |
|---|---|---|
| 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% |

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

---

[58] 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.[59]  He concludes that 10.3 percent to 10.9 percent is the Expected Earnings

4     Approach findings.[60]

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.

---

[59] McKenzie, Exh. AMM-11.
[60] McKenzie, Exh. AMM-1T at 41:5-6.

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

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

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

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

5

6                    **XI.    RISK PREMIUM ANALYSIS**

7

8  **Q.  Please summarize Company witness McKenzie's electric utility risk premium**

9  **approach.**

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

11    (between 1974 and 2019) with yields on public utility bonds.  He then performs a

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

13    interest rates and risk premiums.[61]  He concludes that the current risk premium is 5.90

14    percent, which he adds to the current yield on Baa utility bonds (3.37 percent) to get a

15    9.27 percent risk premium.[62]  He also combines the projected utility bond yield (4.79

16    percent) with a 5.31 percent risk premium to get his prospective risk premium

17    conclusions to 10.10 percent.[63]  This latter yield significantly exceeds the current yield on

18    triple-B rated utility bonds.

19

---

[61] McKenzie, Exh. AMM-10 at 4.
[62] *Id*. at 1.
[63] *Id*. at 2.

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.[64]  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."[65]  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.[66]

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

---

[64] *Id.* at 3.
[65] McKenzie, Exh. AMM-1T at 26:5-7.
[66] *See e.g.*, Moody's Investors Service, Sector Comments, "US Utility Sector Upgrades Driven by Stable and Transparent Regulatory Frameworks", February 3, 3014.

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:

11

|      | Mid-Point | Range |
|------|-----------|-------|
| 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% |

14

15   These results indicate an overall broad range of 7.4 percent to 10.0 percent, which

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

17   7.5 percent to 9.5 percent.  I recommend a ROE range of 9.1 percent to 9.5 percent for

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

19   the mid-point of my CE results, and is supported by the results of the RP analysis.  My

20   specific ROE recommendation is 9.3 percent.

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

# XIII.   TOTAL COST OF CAPITAL

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

A.     Exh. DCP-3 reflects the total COC for Avista using my proposed capital structure and embedded costs of debt, as well as my ROE recommendations.  The resulting COC is a range of 6.97 percent to 7.16 percent.  With my 9.3 percent ROE, my COC recommendation is 7.07 percent.

# XIV.   COMMENTS ON COMPANY TESTIMONY

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

A.     Avista is requesting a 9.90 percent ROE for both its electric and natural gas operations. This 9.90 percent ROE is sponsored by Avista's cost of capital witness Adrien M. McKenzie.[67]

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

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

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[67] McKenzie, Exh. AMM-1T at 6:4.

| | Average | Midpoint |
|---|---|---|
| **DCF** | | |
| Value Line | 9.3% | 10.4% |
| IBES | 9.4% | 9.8% |
| Zacks | 9.3% | 10.1% |
| Internal br + sv | 8.8% | 8.8% |
| **CAPM** | 11.2% | 11.6% |
| **Empirical CAPM** | 11.4% | 11.8% |
| **Utility Risk Premium** | | |
| Current Bond Yields | 9.3% | |
| Projected Bond Yields | 10.1% | |
| **Expected Earnings** | 10.3% | 10.9% |
| **Cost of Equity Recommendation** | | |
| Cost of Equity Range | 9.3% -- | 10.7% |
| **Flotation Cost Adjustment** | | |
| Flotation Cost Percentage Adjustment | 0.10% | |
| **ROE Recommended Range** | 9.4% -- | 10.8% |

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.

19

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.[68] 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.

---

[68] 2017 Avista GRC Order 30, ¶ 76.