BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,

Complainant,

v.

AVISTA CORPORATION d/b/a AVISTA UTILITIES,

Respondent.

DOCKET NOS UE-090134 & UG-090135 (*consolidated)*

In the Matter of the Petition of

AVISTA CORPORATION, D/B/A AVISTA UTILITIES,

For an Order Authorizing Implementation of a Natural Gas Decoupling Mechanism and to Record Accounting Entries Associated With the Mechanism

Docket No. UG-060518 (*consolidated)*

DIRECT TESTIMONY OF MICHAEL P. GORMAN (MPG-1T)

ON BEHALF OF

PUBLIC COUNSEL

AND

INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES (ICNU)

AUGUST 17, 2009

DIRECT TESTIMONY OF MICHAEL P. GORMAN (MPG-1T)
DOCKET NOS. UE-090134 & UG-090135, UG-060518

TABLE OF CONTENTS

TABLES AND FIGURES

DIRECT TESTIMONY OF MICHAEL P. GORMAN (MPG-1T)
DOCKET NOS. UE-090134 & UG-090135, UG-060518

MICHAEL P. GORMAN'S EXHIBIT LIST

Exhibit No. ___ (MPG-2)	Qualifications of Michael P. Gorman
Exhibit No. ___ (MPG-3)	Rate of Return
Exhibit No. ___ (MPG-4)	Capital Structure
Exhibit No. ___ (MPG-5)	Proxy Group
Exhibit No. ___ (MPG-6)	Growth Rates
Exhibit No. ___ (MPG-7)	Constant Growth DCF Model
Exhibit No. ___ (MPG-8)	Dividend Yields
Exhibit No. ___ (MPG-9)	Historical Growth Rates
Exhibit No. ___ (MPG-10)	Electricity Sales are Linked to U. S. Economic Growth
Exhibit No. ___ (MPG-11)	Current and Projected Payout Ratios
Exhibit No. ___ (MPG-12)	Sustainable Growth Rate
Exhibit No. ___ (MPG-13)	Sustainable Constant Growth DCF Model
Exhibit No. ___ (MPG-14)	Multi-Stage Growth DCF Model
Exhibit No. ___ (MPG-15)	Electric Common Stock Market/Book Ratio
Exhibit No. ___ (MPG-16)	Equity Risk Premium – Treasury Bond
Exhibit No. ___ (MPG-17)	Equity Risk Premium – Utility Bond
Exhibit No. ___ (MPG-18)	Bond Yield Spreads
Exhibit No. ___ (MPG-19)	Utility Bond Yields
Exhibit No. ___ (MPG-20)	Beta

Exhibit No. ___ (MPG-21) CAPM

Exhibit No. ___ (MPG-22) S&P Credit Metric Financial Ratios (Without Decoupling)

Exhibit No. ___ (MPG-23) S&P Credit Metric Financial Ratios (With Decoupling)

Exhibit No. ___ (MPG-24) Revision of Dr. Avera's DCF Model

Exhibit No. ___ (MPG-25) Revision of Dr. Avera's CAPM

I. INTRODUCTION/SUMMARY

Q: Please state your name and business address.

A: Michael P. Gorman. My business address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017.

Q: By whom are you employed and in what capacity?

A: I am a consultant in the field of public utility regulation and a Managing Principal with the firm of Brubaker & Associates, Inc. (BAI), regulatory and economic consultants with corporate headquarters in Chesterfield, Missouri.

Q: On whose behalf are you testifying?

A: I am testifying on behalf of the Public Counsel Section of the Washington Attorney General's Office (Public Counsel) and the Industrial Customers of Northwest Utilities (ICNU). ICNU is a non-profit trade association whose members are large industrial customers served by electric utilities throughout the Pacific Northwest, including Avista Corporation d/b/a Avista Utilities (Avista or the Company).

Q: Please describe your professional qualifications.

A: My professional qualifications are described in Exhibit No. ___ (MPG-2).

Q: What exhibits are you sponsoring in this proceeding?

A: I am sponsoring Exhibit No. ___ (MPG-1T) through Exhibit No. ___ (MPG-25).

Q: What is the subject matter of your testimony?

A: I will recommend a fair return on common equity and overall rate of return for Avista. I will also respond to Avista's rate of return witness Dr. William Avera and his proposed return on common equity range for Avista.

/ / /

A. *Summary*

Q: Please summarize your return on equity recommendations.

A: Based on my proposed capital structure, I recommend the Washington Utilities & Transportation Commission (WUTC or the Commission) award Avista a return on common equity of 10.10%, which is the midpoint of my estimated range of 9.70% to 10.50%. I recommend an overall rate of return of 8.18% for Avista, as shown in Exhibit No. ___ (MPG-3), page 1, for both electric and gas operations without a decoupling program. If a decoupling program is approved for gas operations, I recommend a rate of return of 8.06% as shown on page 2 of Exhibit No. ___ (MPG-3).

I demonstrate that my recommended return on equity and proposed capital structure will provide Avista with an opportunity to realize cash flow financial coverages and balance sheet strength that conservatively support Avista's current bond rating. Consequently, my recommended return on equity represents fair compensation for Avista's investment risk, and it will preserve the Company's financial integrity and credit standing.

I will also respond to Avista witness Dr. William Avera's proposed return on equity of 11.00%. For the reasons discussed below, Dr. Avera's recommended return on equity for Avista is excessive and should be rejected.

Q: How did you estimate Avista's current market cost of equity?

A: I did this by development of a comparable proxy investment group of publicly traded utility companies that have investment risk similar to Avista. I then performed three versions of the Discounted Cash Flow (DCF) model, Risk Premium (RP) study, and

Capital Asset Pricing Model (CAPM) analysis. Based on these assessments, and as discussed in more detail below, I estimate Avista's current market cost of equity to be 10.10%.

Q: Are you proposing any adjustments to Avista's proposed capital structure?

A: Yes. As set forth below, Avista's proposed capital structure reflects an increased common equity ratio that is largely attributable to a planned equity infusion for the fourth quarter of 2009. This equity infusion raises the Company's capital structure common equity ratio to over 47%, relative to approximately 45% to 46% common equity ratio this Company has maintained since 2006. I recommend the common equity infusion adjustment to Avista's actual capital structure at December 31, 2008, be rejected. Instead, I recommend Avista's actual capital structure at year-end 2008 be used to set rates. This includes a common equity ratio of 45.6% rather than the Company's proposed 47.5% common equity ratio based on its projected year-end 2009 capital structure.

Q: What is the revenue requirement impact of your return on equity and capital structure adjustments?

A: The revenue impact from reducing Avista's return on equity from 11.0% down to 10.1% and reducing its common equity ratio from 47.5% to 45.6% lowers its claimed Washington jurisdictional revenue deficiency by $10.4 million.

Q: How does your recommended return on equity compare to Avista's current authorized return on equity in Washington?

A: My recommended return on equity for Avista is slightly lower than the 10.2% return on equity previously authorized to Avista in 2008, in Docket Nos. UE-080416 &

UG-080417. My estimate of Avista's current authorized return on equity of 10.1% is still reasonable given the circumstances and market changes that have occurred since Avista's last rate case.

Specifically, while capital markets and the economy have gone through significant distress since Avista's last rate filing, capital markets have improved since the end of 2008/beginning of 2009, continue to strengthen and are returning to more normal capital market conditions. Further, the economy has dipped into a recession, but now appears to be picking up strength, and a full economic recovery is projected to start to take effect at the end of this year and through 2010.[1] Hence, the rates determined in this proceeding will be in effect during a period which will reflect a recovery of the capital market and the U.S. economy.

It would be prudent and reasonable for the Commission to mitigate unnecessary price pressure on Avista's retail customers. Mitigating any increases in prices is critical in supporting the Avista service territory's recovery through this economic downturn, and also this fair compensation that will preserve Avista's financial integrity during this downturn and through an improvement in capital markets and the service area economy. For all these reasons, Avista's authorized return on equity should be set at 10.1%.

Q: If the Commission continues with the Avista gas decoupling pilot program, do you recommend an adjustment to your proposed return on equity?

A: Yes. If Avista's decoupling mechanism for its gas operations continues, then I recommend Avista's return on equity for its gas operations be reduced to reflect this

[1] *Blue Chip Financial Forecasts*, July 1, 2009, p. 2.

risk reduction created by the decoupling mechanism. If the Commission approves the decoupling mechanism, then I recommend Avista's return on equity to develop an overall rate of return for its gas utility operations be reduced by 25 basis points, or from 10.1% to 9.85%. This return on equity is still within my recommended range for Avista, but reflects the significant risk reduction to Avista created by the revenue decoupling mechanism.

B. *Gas Revenue Decoupling*

Q: Please describe Avista's gas decoupling pilot plan.

A: The report of the independent evaluator for Avista's decoupling pilot program described decoupling as follows:

> Decoupling is a ratemaking and regulatory tool intended to break the link between a utility's recovery of fixed costs and a consumer's energy consumption by reducing the impact of energy consumption on the utility's recovery of its fixed costs.[2]

As the report discusses, the pilot program allows for the deferral of 90% of the margin difference (either positive or negative) for subsequent recovery in later rates (deferral balance). The deferral recovery would be subject to an earnings test, which would prevent Avista from recovering the deferral only if its actual earnings are more than its authorized return on equity. Avista is also instructed to pursue demand-side management programs, and recovery on any deferral balance amount would be subject to Avista achieving specific conservation targets. If the deferrals are subject to recovery from customers, Avista is then allowed to earn interest on the

[2] "Evaluation of Avista Natural Gas Decoupling Mechanism Pilot," Titus Final Report to Avista and the Stakeholder Advisory Group, March 30, 2009, p. 7.

unamortized balance. Deferral amounts are also being amortized to customers over a three-year period.[3]

Q: Why do you believe that this decoupling plan will lower Avista's operating risk associated with providing gas service?

A: The gas decoupling mechanism will lower Avista's operating risk for providing gas service to its small commercial and residential customers. This deferral mechanism provides a safety net to ensure that Avista will more likely earn its authorized return on equity. As such, this gas decoupling margin deferral mechanism mitigates Avista's operating risk, and will strengthen its earnings and cash flow in support of its gas utility operations. Indeed, as noted below in the description of Avista's current operating investment risk, credit rating agencies have noted that this decoupling pilot program mitigates Avista's operating risk.

Q: Have other jurisdictions reflected a reduction in risk and a lower return on equity by implementation of a decoupling mechanism?

A: Yes. Other jurisdictions have recognized that decoupling mechanisms do reduce risk to investors. Importantly, these same regulatory commissions recognize that a decoupling mechanism does not eliminate risk, but simply shifts risk from investors to customers. Other commissions that have made return on equity adjustments to reflect reduced operating risk by the implementation of decoupling programs include the following:

- In an order concerning Portland General Electric Company (PGE), the Public Utility Commission of Oregon, in Order No. 09-020, January 22, 2009, approved a sales normalization adjustment (SNA) which created a balancing account applied to residential and non-residential customers. The SNA compared actual

[3] *Id.*, p. 8.

weather adjusted distribution, transmission and fixed generation revenues with those that would be collected with a fixed per customer charge. The difference was accumulated in a balancing account. In that order, the Oregon Commission found that the regulatory mechanisms did shift risk to customers and reduced risk to investors. The Oregon Commission found it appropriate to reduce PGE's return on equity by 10 basis points for this risk shift.

A similar finding was made by the Connecticut Department of Public Utility Control (DPUC) in a Decision in Docket No. 08-12-06. In that case, the Connecticut DPUC concluded that a decoupling mechanism should not be approved; however, it did note that such a mechanism would shift the risk of cost under-recovery from the company to its customers and noted that if such a risk did take place a return on equity adjustment would be appropriate. The DPUC ultimately concluded that the decoupling proposal should be denied, and that it would be difficult to determine the appropriate level of return on equity adjustment if one were adopted.[4]

Q: How did you determine an appropriate return on equity adjustment to reflect the risk reduction created by the decoupling mechanism?

A: I approximated an appropriate return on equity return risk reduction by reviewing the difference in market-required return available for an investment that produces a higher probability of cost recovery. This market evidence is produced by the normal bond yield spread between an "A" rated utility bond and a "Baa" rated utility bond. A utility bond rate of "A" has a greater probability of full cost recovery and meeting its debt service obligations compared to a "Baa" utility bond. For this greater cost recovery assurance, the market prices "A" rated utility bonds to produce a lower yield relative to the yield on "Baa" utility bonds. This yield spread represents fair compensation for greater cost recovery assurance.

Because of current market conditions, the yield spread between an "A" rated utility bond and a "Baa" rated utility bond is abnormally wide. This yield spread is

[4] Connecticut Department of Public Utility Control, Decision in Docket No. 08-12-06, pp. 75-76, June 30, 2009.

caused by current economic circumstances unrelated to utility cost recovery risk but rather, reflects a temporary flight to quality that has caused an abnormally large yield spread.

I estimated a more normal yield spread using the typical yield spreads that prevailed during the calendar years 2004 through 2007, a period of more normal economic activity. As shown below in Table 1, the average yield spread during the period 2004 through 2007 is approximately 25 basis points.

TABLE 1

Utility Bond Yield Spreads

Year	"A"	"Baa"	Spread
2004	6.16%	6.40%	0.24%
2005	5.65%	5.93%	0.28%
2006	6.07%	6.32%	0.25%
2007	6.07%	6.33%	0.26%
Avg.			0.25%

Source: Exhibit No. ___ (MPG-18).

Based on the typical spread for "A" rated utility bonds versus "Baa" utility bonds, I believe an appropriate return on equity adjustment for implementing regulatory mechanisms to provide greater assurance of full cost recovery, would be appropriate to lower the authorized return on equity by 25 basis points.

II. RATE OF RETURN

Q: Please summarize this section of your testimony.

A: In this section of my testimony:

1. I will review the current electric utility industry market outlook.

2. I will review the investment risk of Avista.

3. I will propose a capital structure that will maintain Avista's financial integrity.

4. I will estimate a fair return on equity for Avista.

5. I will show that my recommended rate of return will support Avista's financial integrity and investment grade bond rating.

6. Finally, I will respond to Avista witness Dr. William Avera's recommended return on equity range of 11.3% to 13.3% and explain why it is excessive and unreasonable.

A. *Electric Utility Industry Market Outlook*

Q: Please describe this section of your testimony.

A: I will review the credit rating and investment return performance of the electric utility industry. Based on the assessments below, I find the credit rating outlook of the industry to be strong and supportive of the industry's financial integrity. Further, electric utilities' stocks have exhibited strong return performance and are again characterized as a safe investment.

Q: Please describe the electric utilities' credit rating outlook.

A: Standard & Poor's (S&P) provided an assessment of the credit rating of U.S. electric utilities for the first quarter 2009. S&P's commentary included the following:

> Against a strong headwind in the credit markets, the regulated U.S. electric utility sector performed well during the first quarter of 2009. Highlights include continued capital market access with robust debt issuance by operating companies in this quarter. March 2009 issuance volume exceeded the combined first two months of 2009; through the first quarter of 2009 issuance exceeded $16 billion, about 25% more than the same 2008 period. Several companies have proactively prefunded issuance in advance of maturities, taking advantage of investor appetite and favorable spreads as compared to investment-grade issuers in other sectors.
>
> In response to recessionary pressures and slowing demand, many companies have pared back discretionary spending and growth plans.

This moderating of capital expenditure programs should ease some balance sheet and liquidity burden.

* * *

Our forecast for the electric sector is for a stable ratings trend for the balance of 2009. Currently, more than three-quarters of rated entities have stable outlooks with the average rating at 'BBB'. The depth of the recession in certain pockets of the U.S. economy, combined with weaker cash flow measures and ballooning debt balances, may cause credit deterioration on the margin for some, but we expect the majority of electric companies to maintain current ratings in 2009. Our forecast incorporates expectations of responsive regulatory decision making, continued demand by investors for utility operating company debt, ample liquidity access provided by bank lines, and moderate capital expenditures. On the horizon, future capital needs to improve reliability, integrated renewable resources, and potentially address carbon emissions limit upward rating momentum for the near term.[5]

Further, Moody's also acknowledges the following for the electric utility industry in its report. Moody's states:

Overview

The U.S. investor-owned electric utility sector enjoys solid credit metrics and the fundamental credit outlook remains stable. In general, state regulators continue to let the utilities recover prudently incurred operating costs and capital expenditures relatively quickly, and with reasonable rates of return. Moreover, we believe state regulators would otherwise prefer to regulate financially healthy companies.

The sector is also well positioned relative to many other corporate/industrial sectors, primarily due to the fundamental business plan: providing monopolistic electric service within a designated service territory in exchange for oversight and limitations on profitability. However, we are increasingly concerned with business and operating risks, which are not new but appear to be accelerating faster than previously understood. These business and operating risks include potential environmental legislation from the Obama Administration; the continued capital investment needs for

[5] Standard & Poor's RatingsDirect: "Industry Report Card: U.S. Electric Utility Sector Performed Well In First Quarter Of 2009," March 30, 2009 (emphasis added).

> refurbishing aging infrastructure; and a potentially more contentious regulatory relationship amid a protracted or severe recession.[6]

Similarly, Fitch states:

> The utilities segment is not immune to the economic challenges facing corporate America, but is relatively well positioned. Providing essential services and largely regulated, utilities benefit from investor perceptions as a defensive group. For the most part, electric utilities reduced debt and focused on improving their core business over the past four years. Consequently, while many industries and companies have recently been shut out of the capital markets, stronger utilities have accessed both secured and unsecured markets. However, investor "flight to quality" is selective within the sector, favoring companies at higher rating levels, with a marked preference for secured debt and lending at the operating, rather than parent, company.[7]

As noted by S&P, Moody's and Fitch above, the regulated electric utility industry is maintaining strong investment grade credit and is well positioned to weather the current economic downturn. Therefore, reasoned and rational adjustments to Avista's rates would be appropriate to provide fair compensation, but not excessive compensation, in an effort to improve Avista's competitive position and support its credit quality.

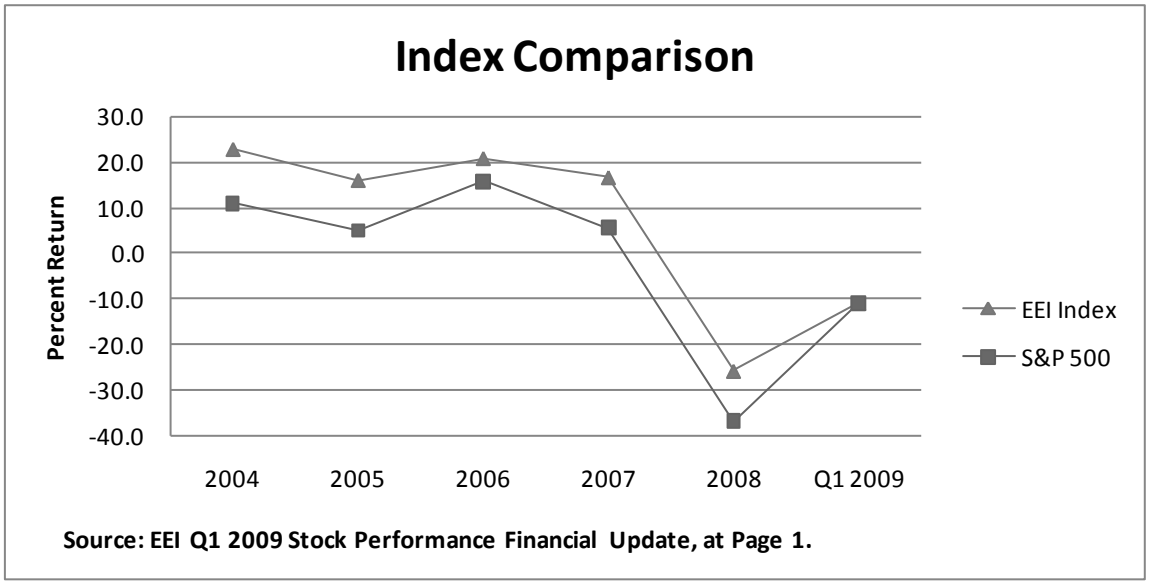
Q: Please describe the electric utility stock price performance over the last five years.

A: As shown in Figure 1 below, Edison Electric Institute (EEI) has recorded electric utility stock price performance compared to the market. The EEI data show that its Electric Utility Index has outperformed the market in every year over the last five years. Again, this strong stock performance indicates commission-authorized

[6] Moody's Investors Service Industry Outlook: "U.S. Investor-Owned Electric Utilities," January 2009 (emphasis added).
[7] Fitch Ratings: "U.S. Utilities, Power and Gas 2009 Outlook," December 22, 2008.

returns on equity over the last several years have been positively received by the market.

FIGURE 1:



Source: EEI Q1 2009 Stock Performance Financial Update, at Page 1.

Q: For 2008, the electric utility stock and the overall market price performance has been significantly negative. Does this time period also support your position that regulated electric utility stock performance has been strong relative to the market?

A: Yes. While clearly the market performance for all securities was poor throughout 2008, one positive signal from the market performance is the fact that electric utility stocks and bonds have continued to be perceived by the market as "safe" investments. Indeed, during times of market duress, the market generally exhibits a "flight to quality," and lower-risk securities generally perform better than the overall market and higher-risk securities. This has happened throughout the last year. For example, EEI noted the following concerning electric utility stock performance in 2008:

Flight to Safety

> The relatively stronger performance of utility stocks in both the quarter and the year offers a classic illustration of their traditional role as a defensive investment in times of market stress. In a weakening economy, investors are drawn to the relative stability offered by utilities' dividend yields and more predictable earnings (in comparison with other sectors of the economy), made possible by the essential role that electricity plays in the lives of Americans at work and at home compared to other, more optional products and services.
>
> Indeed, the comparative category returns shown in Charts II and VIII highlight the theme that dividend stability and earnings predictability – generally most associated with the regulated utility business model – translated into better stock market performance in 2008. The Regulated group's -5.9% return in the fourth quarter was about 8 percentage points better than the Mostly Regulated group's -14.0% return, which in turn was slightly better than the Diversified group's -17.0% return. The Regulated group, with a -15.6% return for the year as a whole, also outperformed the Mostly Regulated group's -27.0% return and the Diversified group's -33.9% return for the year.[8]

This stock price performance again supports the notion that regulated electric utilities are perceived by the market as safe haven investments, which will help support their access to capital during difficult financial times. This is clearly evident through a review of their stable credit outlook and stable stock prices, relative to the securities of non-regulated companies.

B. *Avista Investment Risk*

Q: Please provide a brief overview of Avista and its investment characteristics.

A: Avista's current senior secured bond ratings from S&P and Moody's are "BBB+" and "Baa2," respectively. Avista's corporate credit ratings from S&P and Moody's are "BBB-" and "Baa3," respectively.[9]

[8] "Stock Performance," EEI *Q4 2008 Financial Update*, pp. 4-5.
[9] Exhibit No. ___ (MTT-2), p. 1 of 5.

Specifically, S&P states the following:

> **Rationale**
> The rating on Avista Corp. reflects a strong business profile supported by stable, geographically diverse regulated electric and gas utility operations. The company's chief risk is the electric utility's exposure to replacement power costs, particularly in low water years, which its fuel and purchased power mechanisms in Idaho and Washington partially mitigate.
>
> The company's consolidated financial performance in 2008 improved from a poor 2007, when trading losses from its now-divested marketing arm Avista Energy, below-average hydroelectric generation, and out-of-date test years in Washington and Idaho weakened financials. While the company has not yet filed its 10K for 2008, based on its earnings release earlier this month, Standard & Poor's Ratings Services would expect cash flows to be significantly stronger in 2008, due largely to rate increases in Washington and Idaho; close to normal hydro conditions, which resulted in modest though continued reductions in the company's deferred power balances; and continued stable performance from Advantage IQ, a small, unregulated business that audits large customers' energy bills.[10]

Similarly, Moody's confirms Avista's supportive regulatory treatment:

> **Rating Rationale**
> Avista's Baa3 senior unsecured rating reflects the improvement in its business risk profile, following the sale of Avista Energy; the supportive regulatory treatment provided in recent decisions in all three jurisdictions; and conservative financing strategies that together with the supportive regulation have fostered improvement in credit metrics previously pressured by debt added to fund energy cost deferrals during times of persistent drought, higher interest costs, some regulatory lag, and disappointing results from Avista Energy. Avista's liquidity has been generally sufficient, with committed bank credit and an accounts receivable sales program supplementing internally generated cash flow. Key concerns going forward relate to executing a fairly large capital program, managing the pressures of rising pension costs due to declining performance of invested funds, and maintaining sufficient liquidity and currently good regulatory relationships during a time of frequent rate case activity.

* * *

[10] Standard & Poor's RatingsDirect Summary: "Avista Corp.," February 27, 2009, Avista's Response to Public Counsel's Data Request No. 150, Attachment B, pp. 1-3.

Improved Business Risk Profile

Avista's back to basics strategy was reinforced by the sale of substantially all of the contracts and ongoing operations of Avista Energy to Coral Energy Holding, L.P. and certain of its subsidiaries (Coral Energy), a subsidiary of Shell. Avista Energy paid a $169 million cash dividend to Avista Capital for the net assets sold to Coral Energy; Avista Capital then paid a $155 million cash dividend to Avista Corp. The transaction removed the risk of earnings and cash flow volatility associated with energy and marketing trading operations (i.e., Avista Energy had comprised about 40% of Avista's total assets at June 30, 2007).

* * *

Generally Supportive Regulatory Environment

Avista has historically met some difficulty in earning its allowed rate of return in its various jurisdictions, but is addressing this through more frequent rate cases after a history of staying out of the rate arena for lengthy periods of time. Avista benefits from credit supportive ratemaking practices in all three of its jurisdictions, which include periodic adjustment mechanisms to account for variations in the power and natural gas costs incurred as compared to the levels included in rates. Also, management fosters collaborative working relationships with key constituents in all three jurisdictions, which have often led to more favorable settlements and faster resolution of base rate case proceedings than might otherwise have been the case with a litigated decision. We especially note strengthened regulatory relations in Washington, given support for substantial recovery of deferred energy costs, approval of a trial natural gas decoupling mechanism, favorably settled outcomes in the two most recently concluded base rate cases, and good prospects to achieve a similar result in the currently pending base electric and gas cases before the WUTC.

* * *

Stronger Financial Metrics

As anticipated, Avista's financial performance improved in 2008 compared to 2007, as the general rate increases effective January 1, 2008 contributed to improved gross margins, which were only partially offset by below average hydro conditions and increased utility related operating and other expenses. Also, the 2008 period benefited from reduced interest expense due to refinancing of high

cost debt at a lower interest rate and the absence of one-time items related to the sale of Avista Energy.[11]

Q: What do you recommend the WUTC take from this credit report review of the regulatory treatment Avista is receiving?

A: Credit analysts consider the regulatory treatment for Avista to be constructive and supportive of Avista's strong business risk profile and stable investment grade credit standing.

C. *Avista's Proposed Capital Structure*

Q: What capital structure is the Company requesting to use to develop its overall rate of return for electric operations in this proceeding?

A: Avista's proposed capital structure, as supported by Avista witness Mr. Mark T. Thies, is shown below in Table 2.

TABLE 2
Avista's Proposed Capital Structure
(December 31, 2009)

Description	Percent of Total Capital
Total Debt	52.49%
Common Equity	47.51%
Total Regulatory Capital Structure	100.00%

Source: Exhibit No. ___ (MTT-1T), p. 31.

/ / /

/ / /

/ / /

[11] Moody's Investors Service Credit Opinion: "Avista Corp.," December 3, 2008, pp. 2-5, (emphasis added).

Q: How did the Company develop its proposed capital structure?

A: The Company is proposing a projected December 31, 2009 capital structure. This capital structure reflects an expected significant common equity infusion in the fourth quarter of 2009.

Q: Do you believe the Company's proposed capital structure is reasonable?

A: No. The Company's projected equity infusion at the end of calendar year 2009 results in an increase in the common equity ratio of total capital relative to actual year-end capital structures actually achieved by the Company since 2006. My Exhibit No. ___ (MPG-4), p. 1, shows the Company's actual end-of-year utility capital structure for 2006, 2007 and 2008. As shown in this exhibit, the Company has maintained common equity ratios of 45.1%, 46.3% and 45.6% for 2006, 2007 and 2008, respectively. While the Company's projection for an equity infusion at year-end 2009 may occur, it is not yet certain, and is not known and measurable. Therefore, I reject the Company's year-end projected 2009 capital structure being used to set rates.

Q: What capital structure do you propose be used to set rates in this proceeding?

A: I propose the Company's actual year-end 2008 capital structure be used to set rates. As shown in Exhibit No. ___ (MPG-4), this capital structure reflects a reasonably consistent amount of debt and equity weights over the last three years. Further, the 2008 year-end actual is comparable to Mr. Thies' projected year-end 2009 capital structure if the forecasted equity infusion is removed, as shown in p. 2 of Exhibit No. ___ (MPG-4). I recommend the capital structure weights shown below in Table 3 be used to develop Avista's overall rate of return.

TABLE 3
Gorman Proposed Capital Structure

Description	Percent of Total Capital
Total Debt	54.4%
Common Equity	45.6%
Total Regulatory Capital Structure	100.0%

Source: Exhibit No. ___ (MPG-3).

Q: Will this capital structure and your return on equity support Avista's financial integrity and access to capital?

A: Yes. I provide a full review of my recommended rate of return, including return on equity and proposed capital structure and its ability to support credit metrics consistent with Avista's strong investment grade credit rating. As shown below, my proposed overall rate of return will support Avista's financial integrity and access to capital.

D. *Return on Common Equity*

Q: Please describe what is meant by a "utility's cost of common equity."

A: A utility's cost of common equity is the return investors expect, or require, in order to make an investment. Investors expect to achieve their return requirement from receiving dividends and stock price appreciation.

Q: Please describe the framework for determining a regulated utility's cost of common equity.

A: In general, determining a fair cost of common equity for a regulated utility has been framed by two decisions of the U.S. Supreme Court: *Bluefield Water Works &*

Improvement Co. v. Public Serv. Commission of West Virginia, 262 U.S. 679 (1923) *and Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

These decisions identify the general standards to be considered in establishing the cost of common equity for a public utility. Those general standards provide that the authorized return should: (1) be sufficient to maintain financial integrity; (2) attract capital under reasonable terms; and (3) be commensurate with returns investors could earn by investing in other enterprises of comparable risk.

Q: Please describe the methods you have used to estimate the cost of common equity for Avista.

A: I have used several models based on financial theory to estimate Avista's cost of common equity. These models are: (1) a constant growth Discounted Cash Flow (DCF) model; (2) a sustainable growth DCF model; (3) a multi-stage growth DCF model; (4) a Risk Premium model; and (5) a Capital Asset Pricing Model (CAPM). I have applied these models to a group of publicly traded utilities that I have determined reflect investment risk similar to Avista.

Q: How did you select a utility proxy group similar in investment risk to Avista to estimate its current market cost of equity?

A: I relied on the same utility proxy group used by Avista witness Dr. Avera to estimate Avista's return on equity.

Q: How does this proxy group's investment risk compare to the investment risk of Avista?

A: The proxy group is shown in Exhibit No. ___ (MPG-5). This proxy group has an average senior secured credit rating from S&P of "BBB+," which is identical to

Avista's senior secured credit rating from S&P. The proxy group's senior secured credit rating from Moody's is "Baa1," which is also reasonably comparable to Avista's senior secured credit rating from Moody's of "Baa2". Therefore, my proxy group has comparable total investment risk to Avista.

The proxy group has an average common equity ratio of 46.2% (including short-term debt) from AUS and 47.6% (excluding short-term debt) from *Value Line* in 2008. This proxy group's common equity ratio is comparable to my proposed common equity of 45.6%. A comparable common equity ratio demonstrates that Avista's financial risks are comparable or lower than my proxy group.

I also compared Avista's business risk to the business risk of my proxy group based on S&P's ranking methodology. Avista has a business risk profile of "Strong," which is identical to the risk profile of my proxy group. S&P's profile score methodology is discussed later in my testimony.

E. *Discounted Cash Flow Model*

Q: Please describe the DCF model.

A: The DCF model posits that a stock price is valued by summing the present value of expected future cash flows discounted at the investor's required rate of return or cost of capital. This model is expressed mathematically as follows:

$$P_0 = \frac{D_1}{(1+K)^1} + \frac{D_2}{(1+K)^2} \ldots . \frac{D_\infty}{(1+K)^\infty} \text{ where} \qquad \text{(Equation 1)}$$

P_0 = Current stock price
D = Dividends in periods 1 - ∞
K = Investor's required return

This model can be rearranged in order to estimate the discount rate or investor-required return, "K." If it is reasonable to assume that earnings and dividends will grow at a constant rate, then Equation 1 can be rearranged as follows:

$$K = D_1/P_0 + G \qquad \text{(Equation 2)}$$

K = Investor's required return
D_1 = Dividend in first year
P_0 = Current stock price
G = Expected constant dividend growth rate

Equation 2 is referred to as the annual "constant growth" DCF model.

Q: Please describe the inputs to your constant growth DCF model.

A: As shown under Equation 2 above, the DCF model requires a current stock price, expected dividend, and expected growth rate in dividends.

Q: What stock price and dividend have you relied on in your constant growth DCF model?

A: I relied on the average of the weekly high and low stock prices over a 13-week period ended July 17, 2009. An average stock price is less susceptible to market price variations than a spot price. Therefore, an average stock price is less susceptible to aberrant market price movements, which may not be reflective of the stock's long-term value.

A 13-week average stock price is still short enough to contain data that reasonably reflect current market expectations, but is not so short a period as to be susceptible to market price variations that may not be reflective of the security's long-term value. In my judgment, a 13-week average stock price is a reasonable balance between the need to reflect current market expectations and the need to capture sufficient data to smooth out aberrant market movements.

I used the most recently paid quarterly dividend, as reported in *The Value Line Investment Survey*. This dividend was annualized (multiplied by 4) and adjusted for next year's growth to produce the D_1 factor for use in Equation 2 above.

Q: What dividend growth rates have you used in your constant growth DCF model?

A: There are several methods one can use in order to estimate the expected growth in dividends. However, for purposes of determining the market-required return on common equity, one must attempt to estimate investors' consensus about what the dividend or earnings growth rate will be, and not what an individual investor or analyst may use to form individual investment decisions.

Security analysts' growth estimates have been shown to be more accurate predictors of future returns than growth rates derived from historical data because they are more reliable estimates.[12] Assuming the market generally makes rational investment decisions, analysts' growth projections are more likely the growth estimates considered by the market that influence observable stock prices than are growth rates derived from only historical data.

For my constant growth DCF analysis, I have relied on a consensus, or mean, of professional security analysts' earnings growth estimates as a proxy for the investor consensus dividend growth rate expectations. I used the average of three sources of analysts' growth rate estimates: Zacks, SNL Financial and Thomson Financial (or First Call). All consensus analysts' projections used were available on July 24, 2009, as reported online.

[12] *See, e.g.*, David Gordon, Myron Gordon, and Lawrence Gould, "Choice Among Methods of Estimating Share Yield," *The Journal of Portfolio Management*, Spring 1989.

Each consensus growth rate projection is based on a survey of security analysts. The consensus estimate is a simple arithmetic average, or mean, of surveyed analysts' earnings growth forecasts. A simple average of the growth forecasts gives equal weight to all surveyed analysts' projections. It is problematic as to whether any particular analyst's forecast is more representative of general market expectations. Therefore, a simple average, or arithmetic mean, of analyst forecasts is a good proxy for market consensus expectations.

Q: What is the growth rate you used in your constant growth DCF model?

A: The growth rates I used in my DCF analysis are shown in Exhibit No. ___ (MPG-6). The average growth rate for my proxy group is 6.35%.

Q: What are the results of your constant growth DCF model?

A: As shown in Exhibit No. ___ (MPG-7), the average and median constant growth DCF returns for the proxy group are 12.00% and 11.44%, respectively.

Q: Do you have any comments concerning the results of your constant growth DCF analysis?

A: Yes. The constant growth DCF return is not reasonable and represents an inflated return for Avista at this time. The constant growth DCF result is unreliable and inflated because it is based on a dividend yield of 5.65%, which has increased significantly due to current constrained market conditions, and a growth rate of 6.35% that reflects abnormally high growth that is not sustainable indefinitely as required by this DCF model.

I believe the dividend and growth components of the constant growth model are producing irrational results because they appear to reflect completely

contradictory outlooks for the utility industry. Specifically, the dividend yield for utility stocks has been higher recently, caused by drops in the stock price. These utility stock price declines have been caused by concerns about the economy, utility sales, and reductions to capital programs which will slow rate base growth. These factors would limit future earnings and dividend growth. In contrast, the growth component in the DCF result still reflects extraordinarily robust growth outlooks. Therefore, the current market assessments for growth for utilities appear to contradict those growth outlooks reflected in security analysts' projections.

Further, the growth rate included in the DCF model is also not sustainable over an indefinite period of time. Therefore, reliability of the constant growth DCF model is at very best, problematic. Therefore, I do not recommend relying on the results of the constant growth DCF study in this case.

Q: Why do you believe that the current dividend yield is abnormally high relative to historical standards?

A: As shown in Exhibit No. ___ (MPG-8), the historical dividend yield over the last five years (2004-2008) is in the range of 3.47% to 4.46%, with an average of 3.87%. This is significantly lower than the current dividend yield of 5.53%.

The current dividend yield is driven by the current market uncertainty. The stock prices of the proxy group companies have decreased recently, which in turn have increased the proxy group dividend yield. Part of the cause for the decline in utility stock price relates to the expectation of reduced growth, or more uncertain future growth. Future growth is impacted by the current economic environment, which has impacted customer sales growth and caused many utilities to reduce

capital programs to conserve cash. For example, the Edison Electric Institute has projected that the current economic recession will cause utilities to reduce capital expenditure budgets over at least the next two years by as much as 10%.[13] These factors result in a reduction to growth in rate base and the related growth in earnings and dividends.

Indeed, *Value Line* observed this in its most recent comment on the electric utility industry. *Value Line* recognized utility stocks' deterioration based on economic conditions as follows:

> Since our last review, electric utility stocks as a whole have continued to struggle, based on share-price performance. Many utilities have been hampered by higher capital costs and weaker generation margins stemming from lower demand and a sharp decline in energy prices. Within the Eastern utility group, top losers included *Central Vermont* (-32%), Washington, DC.-based *Pepco Holdings* (-26%), and Ohio-based *First Energy Group* (-22%). Notable gainers included Florida-based *FPL Group* (15%) and New Jersey-based *Public Service Enterprise Group* (10%).[14]

Value Line also has recognized that dividend growth will likely slow after a rather robust pace that took place through calendar year 2008. *Value Line* also stated as follows:

> Dividends have been increasing at a rapid pace since 2002, reflecting relatively healthy balance sheets throughout the industry. In fact, last year 61% of electric utilities raised their dividend, 33% reported no change, 2% reinstated theirs, 2% lowered them, and only 2% are not paying them at all. In any industry these statistics would be viewed as quite favorable. <u>But, 2008 actually marked the slowing of a trend for the electric utility industry, in which the percentage of dividend increases declined. The reversal is attributable to deteriorating economic conditions, elevated capital spending, and higher debt-to-</u>

[13] Edison Electric Institute, "Electricity: Power The Change That America Needs," February 12, 2009.
[14] *The Value Line Investment Survey Ratings & Reports*, "Electric Utility (East) Industry," May 29, 2009, p. 148.

capitalization ratios. Despite this, many utilities are still sporting attractive yields.[15]

Q: How do the proxy group's projected growth rates compare to historical actual growth and contemporary projected nominal gross domestic product (GDP) growth and inflation rates?

A: As shown in Exhibit No. ___ (MPG-9), the historical growth of the proxy group's dividend (columns 1 and 2) is lower than the historical nominal GDP growth (columns 7 and 8). Over the last 5 and 10 years, my proxy group's dividend growth was lower than the actual inflation growth (columns 4 and 5) and well beneath the actual growth of nominal GDP (columns 7 and 8).

This historical perspective confirms the robust outlook for earnings growth over the next three to five years and supports my contention that current three- to five-year earnings growth projections are not reasonable estimates of sustainable long-term growth.

Q: Why do you believe the proxy group's three- to five-year growth rate is in excess of a long-term sustainable growth?

A: The three- to five-year growth rate of the proxy group exceeds the growth rate of the overall U.S. economy. As developed below, the consensus of published economists projects that the U.S. GDP will grow at a rate of no more than 5.1% over the next 5 to 10 years. A company cannot grow, indefinitely, at a faster rate than the market in which it sells its products. The U.S. economy, or GDP, growth projection represents a ceiling, or high-end, sustainable growth rate for a utility over an indefinite period of time.

[15] *Id.* (emphasis added).

Q: Why is the GDP growth projection considered a ceiling growth rate for a utility?

A: Utilities cannot indefinitely sustain a growth rate that exceeds the growth rate of the overall economy. Utilities' earnings/dividend growth is created by increased utility investment or rate base. Utility plant investment, in turn, is driven by service area economic growth and demand for utility service. In other words, utilities invest in plant to meet sales demand growth, and sales growth in turn is tied to economic growth in their service areas. The Energy Information Administration (EIA) has observed that utility sales growth is less than U.S. GDP growth, as shown in Exhibit No. ___ (MPG-10). Utility sales growth has lagged behind GDP growth. Hence, nominal GDP growth is a very conservative, albeit overstated, proxy for electric utility sales growth, rate base growth, and earnings growth. Therefore, GDP growth is a reasonable proxy for the highest sustainable long-term growth rate of a utility.

Q: Is there research that supports your position that, over the long term, a company's earnings and dividends cannot grow at a rate greater than the growth of the U.S. GDP?

A: Yes. This concept is supported in both published analyst literature and academic work. Specifically, in a textbook entitled *Fundamentals of Financial Management*, published by Eugene Brigham and Joel F. Houston, the authors state as follows:

> The constant growth model is most appropriate for mature companies with a stable history of growth and stable future expectations. Expected growth rates vary somewhat among companies, but dividends for mature firms are often expected to

grow in the future at about the same rate as nominal gross domestic product (real GDP plus inflation).[16]

Also, Morningstar's *Stocks, Bonds, Bills and Inflation 2009 Yearbook Valuation Edition* tracked dividends of the stock market in comparison to GDP growth over the period 1926 through the end of 2008.[17] Based on that study, the authors found that earnings and dividends for the market have historically grown in tandem with the overall economy. It is important to note that the growth of companies included in the overall market will normally be higher than that of utility companies. These non-utility companies achieve a higher level of growth because they retain a larger percentage of their earnings and pay out a much smaller percentage of their earnings as dividends. Retaining higher percentages of total earnings fuels stronger growth for these non-utility companies. Since the market in general grows at the overall GDP growth rate, it is very conservative to assume that utility companies could achieve this same level of sustained growth without a material reduction in their dividend payout ratios. As such, using the GDP as a maximum sustainable growth rate is a very conservative and high-end estimate for utility companies.

F. *Sustainable Growth DCF*

Q: Is there a way of developing a DCF estimate using a sustainable long-term growth rate?

A: Yes. This can be developed using an internal growth rate or sustainable growth for the companies included in the proxy group using *Value Line*'s three- to five-year

[16] *Fundamentals of Financial Management* Eugene F. Brigham and Joel F. Houston, Eleventh Edition 2007, Thomson South-Western, a Division of Thomson Corporation, p. 298.
[17] *Stocks, Bonds, Bills and Inflation 2009 Yearbook Valuation Edition* (Morningstar, Inc.), p. 67.

earnings and dividends projections and estimated earned return on equity. An internal growth rate methodology estimates the sustainable growth rate based on the percentage of the utility's earnings that are retained in the company and reinvested in utility plant and equipment. These reinvested earnings increase the earnings base and will increase the earned return on equity when those additional earnings are put into service, and the company is allowed to earn its authorized return on the additional investment.

The internal growth methodology is tied to the percentage of earnings retained in the company and not paid out as dividends. The earnings retention ratio is 1 minus the dividend payout ratio. As the payout ratio declines, the earnings retention ratio increases. An increased earnings retention ratio will fuel stronger growth because the business funds more investments with retained earnings. As shown in Exhibit No. ___ (MPG-11), *Value Line* projects the proxy group to have a declining dividend payout ratio over the next three to five years. These dividend payout ratios and earnings retention ratios can then be used to develop a sustainable long-term earnings retention growth rate to help gauge whether analysts' current three- to five-year growth rate projections can be sustained over an indefinite period of time.

As shown in Exhibit No. ___ (MPG-12), the average sustainable growth rate for the proxy group using this internal growth rate model is 4.81%.

Using the proxy group average growth rate of 6.35% and a three- to five-year projected dividend payout ratio of 57.10% would require an earned return on book

equity of 14.80%[18] to support a long-term sustainable growth rate of 6.35%. In comparison, *Value Line* is projecting a group average return on book equity of 10.91%.[19] This information supports my conclusion that current analysts' three- to five-year earnings growth projections are not sustainable and will decline over time.

Q: What is a constant growth DCF estimate using this sustainable long-term growth rate?

A: A DCF estimate based on this sustainable growth rate is developed in Exhibit No. ___ (MPG-13). As shown there, the proxy group average and median sustainable growth DCF average is 10.57% and 10.35%, respectively.

The sustainable growth DCF result is based on the dividend and price data used in my constant growth DCF study (using analyst growth rates) and the sustainable growth rate discussed above and developed in Exhibit No. ___ (MPG-12).

G. *Multi-Stage Growth DCF Model*

Q: Have you conducted any other DCF studies?

A: Yes. My first constant growth DCF is based on consensus analysts' growth rate projections, so it is a reasonable reflection of rational investment expectations over the next three to five years. The limitation on the constant growth DCF model is that it cannot reflect a rational expectation that a period of high/low short-term growth can be followed by a change in growth to a rate that is more reflective of long-term sustainable growth. Hence, I performed a multi-stage growth DCF analysis to reflect this outlook of changing growth expectations.

[18] 6.35% ÷ (1 – 57.10%).
[19] *Id*.

Q: Please describe your multi-stage growth DCF model.

A: The multi-stage growth DCF model reflects the possibility of non-constant growth for a company over time. The multi-stage growth DCF model reflects three growth periods: (1) a short-term growth period, which consists of the first five years; (2) a transition period, which consists of the next five years (6 through 10); and (3) a long-term growth period, starting in year 11 through perpetuity.

For the short-term growth period, I relied on the consensus analysts' growth projections described above in relationship to my constant growth DCF model. For the transition period, the growth rates were reduced or increased by an equal factor, which reflects the difference between the analysts' growth rates and the GDP growth rate. For the long-term growth period, I assumed each company's growth would converge to the maximum sustainable growth rate for a utility company as proxied by the consensus analysts' projected growth for the U.S. GDP of 4.9%, starting in 10 years.

Q: What do you believe is a reasonable sustainable long-term growth rate?

A: A reasonable growth rate that can be sustained in the long run should be based on consensus analysts' projections. *Blue Chip Economic Indicators* publishes consensus GDP growth projections twice a year. Based on its latest issue, the consensus economists published a GDP growth rate of 4.9% projected for 10 years out.[20]

Therefore, I propose to use the consensus economists' projected 10-year GDP consensus growth rate of 4.9%, as published by *Blue Chip Economic Indicators,* as

[20] *Blue Chip Economic Indicators*, March 10, 2009, p. 15.

an estimate of sustainable long-term growth. This consensus GDP growth forecast represents the most likely views of market participants because it is based on published economist projections.

Q: What stock price, dividend and growth rates did you use in your multi-stage growth DCF analysis?

A: I relied on the same 13-week stock price and the most recent quarterly dividend payment discussed above. For stage one growth, I used the consensus analysts' growth rate projections discussed above in my constant growth DCF model. The transition period begins in year 6 and ends in year 10. For the long-term sustainable growth rate starting in year 11, I used 4.9%, the consensus economists' projected nominal GDP growth rate.

Q: What are the results of your multi-stage growth DCF model?

A: As shown in Exhibit No. ___ (MPG-14), the average and median multi-stage growth DCF returns on equity for the proxy group are 10.88% and 11.04%, respectively.

Q: Please summarize the results from your DCF analyses.

A: The results from my DCF analyses are summarized in the table below:

TABLE 4

Summary of DCF Results

Description	Group Average	Group Median
Constant Growth DCF Model (Analysts' Growth)	12.00%	11.44%
Constant Growth DCF Model (Sustainable Growth)	10.57%	10.35%
Multi-Stage Growth DCF Model	10.88%	11.04%
DCF Return[21]	10.73%	10.70%

[21] (10.57% + 10.88%) / 2, and (10.35% + 11.04%) / 2.

My DCF studies produce a return on equity of 10.70%. I excluded the analysts' growth result for the reasons discussed above.

For the reasons set forth above, I believe the DCF return produces abnormally high results given the market data supporting the DCF estimate at this time. As noted above, the dividend yield component of the DCF model reflects significant declines to stock prices over the last few months that were largely caused by the economic downturn and financial distress caused by recent capital markets. The economic downturn and these stock price declines have together contributed to the market's expectations of uncertain sales growth outlooks and reduced capital expenditure programs, which will limit utilities' earnings and dividend growth. In significant contrast, the growth component of the DCF model still reflects robust growth outlooks that are considerably higher than historical achieved growth for utility dividends and earnings over the last five and ten years.

The major components of the DCF reflect opposite outlooks: (1) the dividend yield component reflects constrained growth outlooks; and (2) the growth component reflects robust growth outlooks. Because of these uncertain and apparent contradictory outlooks, I recommend the Commission place minimal weight on the results of the DCF study at this time.

H. *Risk Premium Model*

Q: Please describe your bond yield plus risk premium model.

A: This model is based on the principle that investors require a higher return to assume greater risk. Common equity investments have greater risk than bonds because bonds have more security of payment in bankruptcy proceedings than common

equity and the coupon payments on bonds represent contractual obligations. In contrast, companies are not required to pay dividends on common equity, or to guarantee returns on common equity investments. Therefore, common equity securities are considered to be more risky than bond securities.

This risk premium model is based on two estimates of an equity risk premium. First, I estimated the difference between the required return on utility common equity investments and Treasury bonds. The difference between the required return on common equity and the bond yield is the risk premium. I estimated the risk premium on an annual basis for each year over the period 1986 through first quarter of 2009. The common equity required returns were based on regulatory commission-authorized returns for electric utility companies. Authorized returns are typically based on expert witnesses' estimates of the contemporary investor required return.

The second equity risk premium method is based on the difference between regulatory commission-authorized returns on common equity and contemporary "A" rated utility bond yields. This time period was selected because over the period 1986 through the first quarter of 2009, public utility stocks have consistently traded at a premium to book value. This is illustrated in Exhibit No. ___ (MPG-15), where the market to book ratio since 1986 for the electric utility industry was consistently above 1.0. Over this time period, regulatory authorized returns were sufficient to support market prices that at least exceeded book value. This is an indication that regulatory authorized returns on common equity supported a utility's ability to issue additional common stock, without diluting existing shares. It further demonstrates

that utilities were able to access equity markets without a detrimental impact on current shareholders.

Based on this analysis, as shown in Exhibit No. ___ (MPG-16), the average indicated equity risk premium over U.S. Treasury bond yields has been 5.17%. Of the 24 observations, 18 indicated risk premiums fall in the range of 4.40% to 6.08%. Since the risk premium can vary depending upon market conditions and changing investor risk perceptions, I believe using an estimated range of risk premiums provides the best method to measure the current return on common equity using this methodology.

As shown in Exhibit No. ___ (MPG-17), the average indicated equity risk premium over contemporary Moody's utility bond yields was 3.69% over the period 1986 through the first quarter of 2009. The indicated equity risk premium estimates based on this analysis primarily fall in the range of 3.03% to 4.39% over this time period.

Q: Do you believe that this risk premium is based on a time period that is too long or too short to draw accurate results concerning contemporary market conditions?

A: No. Contemporary market conditions can change dramatically during the period that rates determined in this proceeding will be in effect. Therefore, relying on a relatively long period of time where stock valuations reflect premium to book value is an indication that the authorized returns on equity and the corresponding equity risk premiums were supportive of investors' return expectations and provided utilities access to the equity markets under reasonable terms and conditions. Further,

this time period is long enough to smooth abnormal market movement that might distort equity risk premiums. While market conditions and risk premiums do vary over time, this historical time period is a reasonable period to estimate contemporary risk premiums.

The time period I use in this risk premium is a generally accepted period to develop a risk premium study using "expectational" data. Conversely, studies have recommended that use of "actual achieved return data" should be based on very long historical time periods. The studies find that achieved returns over short time periods may not reflect investors' expected returns due to unexpected and abnormal stock price performance. However, these short-term abnormal actual returns would be smoothed over time and the achieved actual returns over long time periods would approximate investors' expected returns. Therefore, it is reasonable to assume that averages of annual achieved returns over long time periods will generally converge on the investors' expected returns.

My risk premium study is based on expectational data, not actual returns, and, thus, need not encompass very long time periods.

Q: Based on historical data, what risk premium have you used to estimate Avista's cost of equity in this proceeding?

A: The equity risk premium should reflect the relative market perception of risk in the utility industry today. I have gauged investor perceptions in utility risk today in Exhibit No. ___ (MPG-18). On that exhibit, I show the yield spread between utility bonds and Treasury bonds over the last 29 years. As shown in this exhibit, the 2008 utility bond yield spreads over Treasury bonds for "A" rated and "Baa" rated utility

bonds are 2.23% and 2.93%, respectively. The utility bond spreads over Treasury bonds for "A" and "Baa" rated utility bonds for the first quarter of 2009 are 2.92% and 4.43%, respectively. These utility bond yield spreads over Treasury bond yields are much higher than the 29-year average spreads of 1.64% and 2.05%, respectively.

While the yield spreads for 2008 and first quarter 2009 reflect unusually large spreads, the market has started to improve and these spreads have started to decline to more normal levels. For example, the 13-week average "A" rated utility bond yield has subsided relative to the end of 2008 and beginning of 2009, down to around 6.3%. This utility bond yield when compared to the projected Treasury bond yield of 5.0%, implies a yield spread of around 1.3% which is lower than the 29-year average spread of 1.64% for "A" utility bonds over Treasury bond yields. This suggests a full bond market recovery over the next year or two.

Q: How did you estimate Avista's cost of common equity with this risk premium model?

A: I added a projected long-term Treasury bond yield to my estimated equity risk premium over Treasury yields. *Blue Chip Financial Forecasts* projects the 30-year Treasury bond yield to be 5.0%, and a 10-year Treasury bond yield to be 4.4%.[22] The 30-year Treasury bond yield averaged 4.17% in the second quarter of 2009.[23] Using the projected 30-year bond yield of 5.00% and a Treasury bond risk premium of 4.40% to 6.08%, as developed above, produces an estimated common equity return in the range of 9.40% to 11.08%, with a midpoint of 10.24%.

[22] *Blue Chip Financial Forecasts*, July 1, 2009, p. 2.
[23] Federal Reserve Bank of St. Louis.

I next added my equity risk premium over utility bond yields to a current 13-week average yield on "Baa" rated utility bonds for the period ending July 17, 2009 of 7.42%. Exhibit No. ___ (MPG-19). Adding the utility equity risk premium of 3.03% to 4.39%, as developed above, to a "Baa" rated bond yield of 7.42%, produces a cost of equity in the range of 10.45% to 11.81%, with a midpoint of 11.13%. As shown in page 2 of Exhibit No. ___ (MPG-19), "Baa" rated utility bond yields reached very high levels during late October through December 2008, but they have started to decline to more normal non-distressed levels. Indeed, the most recent "Baa" bond yield over the last five weeks has fallen to an average of 6.97%. This more current yield indicates a risk premium return in the range of 10.0% to 11.36%, with a midpoint of 10.68%.

Recognizing the significant decline in "Baa" utility bond yields over the last six months, and the significant decline in risk yield spreads between "A" and "Baa" utility bond yields, as shown on page 3 of Exhibit No. ___ (MPG-19), I recommend a return on equity at the low end of the range reflecting both a 13-week average and 5-week average utility bond yield. This would indicate a return on equity using this methodology in the range of 10.0% to 10.45% with a midpoint estimate of approximately 10.25%.

My risk premium analyses produce a return estimate in the range of 10.24% to 10.25%, with a midpoint estimate of 10.25%.

/ / /

/ / /

/ / /

I. *Capital Asset Pricing Model (CAPM)*

Q: Please describe the CAPM.

A: The CAPM method of analysis is based upon the theory that the market required rate of return for a security is equal to the risk-free rate, plus a risk premium associated with the specific security. This relationship between risk and return can be expressed mathematically as follows:

$R_i = R_f + B_i \times (R_m - R_f)$ where:

R_i = Required return for stock i
R_f = Risk-free rate
R_m = Expected return for the market portfolio
B_i = Beta - Measure of the risk for stock

The stock-specific risk term in the above equation is beta. Beta represents the investment risk that cannot be diversified away when the security is held in a diversified portfolio. When stocks are held in a diversified portfolio, firm-specific risks can be eliminated by balancing the portfolio with securities that react in the opposite direction to firm-specific risk factors (e.g., business cycle, competition, product mix, and production limitations).

The risks that cannot be eliminated when held in a diversified portfolio are nondiversifiable risks. Nondiversifiable risks are related to the market in general and are referred to as systematic risks. Risks that can be eliminated by diversification are regarded as non-systematic risks. In a broad sense, systematic risks are market risks, and non-systematic risks are business risks. The CAPM theory suggests that the market will not compensate investors for assuming risks that can be diversified away. Therefore, the only risk that investors will be compensated for are systematic

or non-diversifiable risks. The beta is a measure of the systematic or non-diversifiable risks.

Q: Please describe the inputs to your CAPM.

A: The CAPM requires an estimate of the market risk-free rate, the company's beta, and the market risk premium.

Q: What did you use as an estimate of the market risk-free rate?

A: As previously noted, *Blue Chip Financial Forecasts*' projected 30-year Treasury bond yield is 5.00%.[24] The current 30-year bond yield is 4.00%. I used *Blue Chip Financial Forecasts*' projected 30-year Treasury bond yield of 5.00% for my CAPM analysis.

Q: Why did you use long-term Treasury bond yields as an estimate of the risk-free rate?

A: Treasury securities are backed by the full faith and credit of the United States government. Therefore, long-term Treasury bonds are considered to have negligible credit risk. Also, long-term Treasury bonds have an investment horizon similar to that of common stock. As a result, investor-anticipated long-run inflation expectations are reflected in both common stock required returns and long-term bond yields. Therefore, the nominal risk-free rate (or expected inflation rate and real risk-free rate) included in a long-term bond yield is a reasonable estimate of the nominal risk-free rate included in common stock returns.

Treasury bond yields, however, do include risk premiums related to unanticipated future inflation and interest rates. A Treasury bond yield is not a risk-

[24] *Blue Chip Financial Forecasts*, July 1, 2009, p. 2.

free rate. Risk premiums related to unanticipated inflation and interest rates are systematic or market risks. Consequently, for companies with betas less than 1.0, using the Treasury bond yield as a proxy for the risk-free rate in the CAPM analysis can produce an overstated estimate of the CAPM return.

Q: What beta did you use in your analysis?

A: As shown in Exhibit No. ___ (MPG-20), the proxy group average *Value Line* beta estimate is 0.74.

Q: How did you derive your market risk premium estimate?

A: I derived two market risk premium estimates, a forward-looking estimate and one based on a long-term historical average.

The forward-looking estimate was derived by estimating the expected return on the market (as represented by the S&P 500) and subtracting the risk-free rate from this estimate. I estimated the expected return on the S&P 500 by adding an expected inflation rate to the long-term historical arithmetic average real return on the market. The real return on the market represents the achieved return above the rate of inflation.

Morningstar's *Stocks, Bonds, Bills and Inflation 2009 Yearbook* publication estimates the historical arithmetic average real market return over the period 1926 to 2008 as 8.5%. A current consensus analysts' inflation projection, as measured by the Consumer Price Index, is 2.0%.[25] Using these estimates, the expected market return

[25] *Blue Chip Financial Forecasts*, July 1, 2009, p. 2.

is 10.67%.[26] The market premium then is the difference between the 10.67% expected market return, and my 5.0% risk-free rate estimate, or 5.67%.

The historical estimate of the market risk premium was also estimated by Morningstar in *Stocks, Bonds, Bills and Inflation 2008 Yearbook*. Over the period 1926 through 2008, Morningstar's study estimated that the arithmetic average of the achieved total return on the S&P 500 was 11.70%, and the total return on long-term Treasury bonds was 6.10%. The indicated equity risk premium is 5.60% (11.70% - 6.10% = 5.60%).

Q: How does your estimated market risk premium range compare to that estimated by Morningstar?

A: Morningstar estimates a forward-looking market risk premium based on actual achieved data from the historical period of 1926 through year-end 2008. Using this data, Morningstar estimates a market risk premium derived from the total return on large company stocks (S&P 500), less the income return on Treasury bonds. The total return includes capital appreciation, dividend or coupon reinvestment returns, and annual yields received from coupons and/or dividend payments. The income return, in contrast, only reflects the income return received from dividend payments or coupon yields. Morningstar argues that the income return is the only true risk-free rate associated with Treasury bonds and is the best approximation of a truly risk-free rate. While I disagree with this assessment from Morningstar, because it does not reflect a true investment option available to the marketplace and therefore does not produce a legitimate estimate of the expected premium of investing in the stock

[26] { [(1 + 0.085) ∗ (1 + 0.020)] – 1] } ∗ 100.

market versus that of Treasury bonds. Nevertheless, I will use Morningstar's conclusion to show the reasonableness of my market risk premium estimates.

Morningstar's analysis indicates that a market risk premium falls somewhere in the range of 5.7% to 6.5%. This range is based on several methodologies. First, Morningstar estimates a market risk premium of 6.5% based on the difference between the total market return on common stocks (S&P 500) less the income return on Treasury bond investments. Second, Morningstar found that if the New York Stock Exchange (the NYSE) was used as the market index rather than the S&P 500, that the market risk premium would be 6.3% and not 6.5%. Third, if only the two deciles of the largest companies included in the NYSE were considered, the market risk premium would be 5.8%.[27]

Finally, Morningstar found that the 6.5% market risk premium based on the S&P 500 was impacted by an abnormal expansion of price-to-earnings (P/E) ratios relative to earnings and dividend growth during the period 1980 through 2001. Morningstar believes this abnormal P/E expansion is not sustainable. Therefore, Morningstar adjusted this market risk premium estimate to normalize the growth in the P/E ratio to be more in line with the growth in dividends and earnings. Based on this alternative methodology, Morningstar published a long-horizon supply-side market risk premium of 5.7%.[28]

[27] Morningstar observes that the S&P 500 and the NYSE Decile 1-2 are both large capitalization benchmarks. Morningstar, Inc. *Ibbotson SBBI 2009 Valuation Yearbook*, pp. 56-57.
[28] *Id.*, pp. 67-69.

Thus, based on all of Morningstar's estimates, the market risk premium falls somewhere in the range of 5.7% to 6.5%. This range supports my use of a 5.7% market risk premium in my CAPM study.

Q: What are the results of your CAPM analysis?

A: As shown in Exhibit No. ___ (MPG-21), based on my historical market risk premium of 5.6% and prospective market risk premium of 5.67%, a risk-free rate of 5.0%, and a beta of 0.74, my CAPM analysis produces a return in the range of 9.14% to 9.20%, with a midpoint of 9.17%, rounded up to 9.20%.

Q: Do you have any general comments on the results of your CAPM analysis?

A: Yes. I believe my CAPM study is also impacted by the distressed financial market. The impact on the financial market has resulted in a decline in the market risk premium that was largely caused by a significant decline in stock market valuations and increase in Treasury bond valuations at the end of 2008. The historical market risk premium has been around 6.5% over the last several years, but declined to 5.6% at year-end 2008. I do not believe this reduced market risk premium is sustainable. Therefore, I recommend minimal weight be placed on the CAPM return estimate at this time.

/ / /

/ / /

/ / /

/ / /

/ / /

/ / /

J. *Return on Equity Summary*

Q: Based on the results of your rate of return on common equity analyses described above, what return on common equity do you recommend for Avista?

A: Based on my analyses, I estimate Avista's current market cost of equity to be 10.1%.

TABLE 5

Return on Common Equity Summary

Description	Results
DCF	10.70%
Risk Premium	10.25%
CAPM	9.20%

My recommended return on equity range is 9.7% to 10.5%. The upper end of my range is the average of my DCF and risk premium studies ((10.70% + 10.25%) ÷ 2) and the lower end of my range is the average of my risk premium and CAPM studies ((10.25% + 9.20%) ÷ 2). For the reasons set forth above, based on the unstable market conditions that exist today, I believe the DCF results are abnormally high, and the CAPM return estimate is abnormally low. Therefore, I have developed a range based on a method of mitigating the extreme high and low return on equity estimates. I believe this is necessary in order to approximate a reasonable return on equity that provides fair compensation for investment risk over time and is not distorted by the abnormal and depressed market conditions.

The high end of the range was based on the approximate midpoint DCF and risk premium range, and the low end was based on the approximate midpoint of the DCF and CAPM range. The midpoint is equal to the risk premium estimate.

K. *Financial Integrity*

Q: Will your recommended overall rate of return support an investment grade bond rating for Avista?

A: Yes. I have reached this conclusion by comparing the key credit rating financial ratios for Avista at its proposed capital structure and my return on equity to S&P's benchmark financial ratios using S&P's new credit metric ranges. In addition, I compared Avista's key credit financial ratios to S&P benchmark financial ratios, the old S&P credit metric ranges for an "A" rated utility, and a "BBB" rated utility with a business profile score (BPS) of '5,' Avista's rating under S&P's old credit metric benchmarks.

Q: Why are you comparing your credit metric calculations to S&P's new and old credit metric guidelines?

A: S&P's new credit metrics are not as transparent and do not clearly identify utility-specific credit metric guidance ranges based on S&P business risk assessment. Specifically, S&P has not published a range, that I am aware of, where it sets out specific credit metric ranges for a utility with an "Aggressive" financial risk rating, and a business risk rating score of "Strong," Avista's current rating. However, S&P has published guidelines which appear to be generally reflective of credit metrics at various credit rating levels. In order to more clearly identify credit metric ranges that are appropriate to support Avista's credit ratings, I will use both S&P's old and new credit metric benchmarks.

/ / /

Q: Please describe S&P's use of the financial benchmark ratios in its credit rating review.

A: S&P evaluates a utility's credit rating based on an assessment of its financial and business risks. A combination of financial and business risks equates to the overall assessment of Avista's total credit risk exposure. S&P publishes a matrix of financial ratios that defines the level of financial risk as a function of the level of business risk.

S&P publishes ranges for three primary financial ratios that it uses as guidance in its credit review for utility companies. The three primary financial ratio benchmarks it relies on in its credit rating process include: (1) funds from operations (FFO) to debt interest expense, (2) FFO to total debt, and (3) total debt to total capital.

Q: How did you apply S&P's financial ratios to test the reasonableness of your rate of return recommendations?

A: I calculated each of S&P's financial ratios based on Avista's cost of service for its electric and gas retail operations. While S&P would normally look at total parent company consolidated financial ratios in its credit review process, my investigation in this proceeding is to judge the reasonableness of my proposed cost of capital for rate setting in Avista's utility operations. Hence, I am attempting to determine whether the rate of return and related cash flow generation opportunity reflected in my proposed utility rates for Avista will support its investment grade bond ratings and financial integrity.

/ / /

Q: Did you include any off-balance sheet debt for Avista's jurisdictional financial ratios based on its electric operations?

A: Yes. As shown in Exhibit No. ___ (MPG-22), p. 3, I estimated off-balance sheet debt equivalents of $29.6 million attributed to Avista's trade accounts receivable, operating leases and purchased power agreements (PPA).

Q: How did you estimate Avista's off-balance sheet debt?

A: The off-balance sheet debt is shown in page 3 of Exhibit No. ___ (MPG-22). First, I developed an Avista electric allocator, which is the ratio of Avista's Washington rate base as of September 2008 divided by total Company rate base for the same period.

Second, Avista's total Company off-balance sheet debt and associated imputed interest and amortization expenses were provided in Avista's Response to Public Counsel Data Request No. 265. Then, I applied Avista's allocator to Avista's total Company off-balance sheet debt and associated imputed interest and amortization expense.

Q: Did you calculate the credit metrics that support electric and gas operations separately?

A: Yes. I offer two different sets of financial ratio projections. First, I assume the pilot decoupling proposal is not continued, and my 10.1% return on equity and proposed capital structure are adopted for both Avista's electric and gas operations. Second, if the decoupling program is approved, then I developed the credit metrics using a composite return on equity of 10.06%, which is composed of a 10.1% equity return for electric operations and a 9.85% equity return for gas operations. In both

instances, the jurisdictional allocated off-balance sheet debt equivalents and accounts receivable financing are considered in the development of the credit metrics.

Q: Please describe the results of this credit metric analysis based on your proposed capital structure and a 10.1% return on equity (without decoupling).

A: The S&P financial metric calculations for Avista are developed on Exhibit No. ___ (MPG-22), p. 1. As shown in this exhibit, based on an equity return of 10.1%, Avista will be provided an opportunity to produce an FFO to debt interest expense of 3.6x. This FFO to interest coverage ratio is at the high end of S&P's old benchmark ratio guideline of 2.8x to 3.8x[29] for a "BBB" rated utility company with a business profile score of '5,' and is slightly above S&P's new guideline range of 2.0x to 3.5x.[30] This ratio supports a credit rating of a strong "BBB" credit rating.

Avista's retail operations FFO to total debt coverage at a 10.1% equity return would be 18%, which is within S&P's old credit metric guideline range of 15% to 22% for a "BBB" bond rating and within the new metric guideline range of 10% to 30%. The FFO/total debt ratio will support a "BBB" rated investment grade bond rating.

Finally, Avista's total debt ratio to total capital is 55%. This ratio is within S&P's "BBB" rated utility old guideline range of 50% to 60%, which supports a "BBB" credit rating.

With my proposed capital structure and return on equity of 10.1%, Avista's financial credit metrics are supportive of a "BBB" utility bond rating. Therefore, my

[29] Standard & Poor's: "Assessing U.S. Vertically Integrated Utilities? Business Risk Drivers," September 14, 2006.
[30] Standard & Poor's: "U.S. Utilities Rating Analysis Now Portrayed in the S&P Corporate Ratings Matrix," November 30, 2007.

recommended return on equity is consistent with the overall financial and business risk underlying Avista's current bond rating, will fairly compensate Avista's investors, and will support the Company's financial integrity.

Q: Please describe the results of this credit metric analysis based on a 10.06% composite return on equity (with decoupling).

A: The S&P financial metric calculations for Avista are developed on Exhibit No. ___ (MPG-23), p. 1. As shown in this exhibit, based on an equity return of 10.06%, Avista will be provided an opportunity to produce an FFO to debt interest expense of 3.6x. This FFO to interest coverage ratio is at the high end of S&P's old benchmark ratio guideline of 2.8x to 3.8x[31] for a "BBB" rated utility company with a business profile score of '5,' and is slightly above S&P's new guideline range of 2.0x to 3.5x.[32] This ratio supports a credit rating of a strong "BBB" credit rating.

Avista's retail operations FFO to total debt coverage at a 10.06% equity return would be 18%, which is within S&P's old credit metric guideline range of 15% to 22% for a "BBB" bond rating and within the new metric guideline range of 10% to 30%. The FFO/total debt ratio will support a "BBB" rated investment grade bond rating.

Finally, Avista's total debt ratio to total capital is 55%. This ratio is within S&P's "BBB" rated utility old guideline range of 50% to 60%, which supports a "BBB" credit rating.

/ / /

[31] Standard & Poor's: "Assessing U.S. Vertically Integrated Utilities? Business Risk Drivers," September 14, 2006.
[32] Standard & Poor's: "U.S. Utilities Rating Analysis Now Portrayed in the S&P Corporate Ratings Matrix," November 30, 2007.

With my proposed capital structure and return on equity of 10.06%, Avista's financial credit metrics are supportive of a "BBB" utility bond rating. Therefore, my recommended return on equity is consistent with the overall financial and business risk underlying Avista's current bond rating, will fairly compensate Avista's investors, and will support the Company's financial integrity.

L. *Response to Avista Witness Dr. William Avera*

Q: What is Avista's return on equity recommendation?

A: Avista's rate of return witness, Dr. Avera, recommends a return on equity in the range of 11.3% to 13.3%. However, Avista is requesting a return on equity of 11.0%, below Dr. Avera's recommended range, because it believes that this return will allow the Company to continue improving its financial conditions.

Q: How did Dr. Avera develop his return on equity range?

A: Dr. Avera developed his return on equity recommendation by applying the DCF model, and the CAPM, as well as an alternative Comparable Earnings Model (CEM) applied to utility and non-utility proxy groups. He arrived at his recommendations by reviewing Avista's business operations, the market conditions and utility industry trends at the time of his filing.

Q: Please summarize Dr. Avera's proposed return on equity for Avista.

A: Dr. Avera estimated Avista's cost of equity using DCF and risk premium analyses. As shown below in Table 6, Dr. Avera's analyses produced a return on equity in the range of 11.3% to 13.3%.

However, as I will discuss in more detail below, making reasonable adjustments to Dr. Avera's DCF and risk premium studies produces a return on equity for Avista of less than the 10.1% I am recommending.

TABLE 6

Avista's ROE Analysis

Model	Avera Proposed	Adjusted*
DCF	11.5%-13.4%	10.7%
CAPM	11.2%	8.3%
Comparable Earnings	11.4%	Reject
Range	**11.3%-13.3%**	**8.3%-10.8%**
Recommended ROE	**11.0%**	**9.5%**

Source: Exhibit No. ___ (WEA-1T), p. 43, Utility Proxy Group.
*Exhibit No. ___ (MPG-24) and Exhibit No. ___ (MPG-25).

Q: Please describe Dr. Avera's DCF analysis.

A: Dr. Avera applied the traditional DCF model to two proxy groups, which he concludes have reasonably comparable risk to Avista. Based on his utility group, the DCF results yield a return in the range of 11.5% to 13.4%. Dr. Avera's non-utility group included companies operating in various industries, which are followed by Value Line. Based on this non-utility group, his DCF analysis produced a return on equity in the range of 13.1% to 13.5%.

/ / /

/ / /

Q: Do you take issues with Dr. Avera's DCF analyses?

A: I have two major issues concerning Dr. Avera's DCF analysis. First, his use of a non-utility proxy group is flawed and his results produced by this study should be rejected. Second, Dr. Avera's constant growth DCF analyses produce excessive return estimates for the same reasons discussed above concerning my DCF studies. That is, Dr. Avera's analysts' growth DCF study is based on abnormally high dividend yields and growth rate estimates that are not sustainable in the long run.

Q: Why do you consider Dr. Avera's non-utility group unreasonable?

A: The companies included in Dr. Avera's non-utility proxy group are subject to different risk characteristics in comparison to the risk factors affecting Avista's utility operations. As noted by the major credit rating agencies, the electric utility industry has relatively low risk in comparison with the market. Further, the regulatory process itself provides an effective mechanism to mitigate some of the market risks influencing the U.S. economy. Therefore, using Dr. Avera's non-utility proxy group, which is much riskier than the utility industry, will produce an inflated return on equity for Avista. Hence, the Commission should disregard the results of Dr. Avera's non-utility group.

Q: You stated that Dr. Avera applied his DCF analysis without prudent consideration of current trends of the utility dividend yields and growth rates. Please explain.

A: In his DCF analysis, Dr. Avera used growth rate estimates published by *Value Line*, I/B/E/S, First Call, Zacks and his internal growth rate based on *Value Line* estimates. His utility-group growth rate estimates fall in the range of 5.5% to 7.9%, which is

significantly higher than the projected long-term growth rate of the U.S. economy of 4.9% over the next 10 years. Dr. Avera's projected growth rate estimates are unreasonably high and cannot be sustained indefinitely. Even though Dr. Avera excludes some of his results producing abnormally high and abnormally low DCF returns, his growth rate and dividend yield estimates are still upwardly biased and unreasonably inflate the return on equity for Avista.

Further, Dr. Avera's utility-group return is based on an abnormally high dividend yield of 4.9%. Dr. Avera's DCF studies, like mine, represent contradictory market growth outlooks as discussed above. Therefore, the Commission should give little weight to Dr. Avera's DCF analyses.

Q: How will Dr. Avera's DCF return change if a multi-stage model is applied?

A: I have applied a multi-stage DCF model to Dr. Avera's utility proxy group, by using the average of his five growth rate estimates for the first stage, which includes the period from year 1 to year 5. The second stage is the transition stage from year 6 to year 10. For the third growth rate stage, which starts in year 11 to perpetuity, I used the projected 10-year GDP growth rate of 4.9%. Applying the multi-stage DCF version to Dr. Avera's utility group yields a DCF return of 10.7% as shown in my Exhibit No. ___ (MPG-24). Again, considering the current market growth rate outlook, I caution the Commission placing significant weight on the DCF model.

Q: Please describe Dr. Avera's forward-looking risk premium CAPM analysis.

A: Dr. Avera estimates a forward-looking return on the market of 13.2%. From this market return estimate he subtracts his risk-free rate, a long-term Treasury bond yield of 3.2%, to arrive at a market risk premium of 10.0%. He relies on the utility

beta for each company included in his comparable group, which averages at approximately 0.80 to produce an implied cost of equity for his utility group of 11.2%.[33]

Q: Is Dr. Avera's forward-looking CAPM analysis reasonable?

A: No. Dr. Avera's 13.2% projected return on the market is highly inflated and unreliable. This market return estimate is based on a DCF analysis that includes a growth rate projection of 9.6% and a dividend yield of 3.6%. Dr. Avera's risk premium is dramatically overstated because it is based on a DCF return on the market that is based on irrationally high growth outlooks, and is, therefore, not reliable.

It is simply irrational to expect that the securities market capital appreciation and growth will be 9.6% for an indefinite period of time. This is important because the DCF model requires a sustainable long-term growth rate, not simply a growth rate that might be appropriate for the next five years. The growth rate for the overall securities market must reflect the economy in which the companies operate, and the earnings and dividend paying ability of those companies. Companies produce earnings and dividends by selling goods and services in the marketplace. Hence, companies' earnings growth and sales growth opportunities cannot be substantially in excess of the expected growth in the overall economy. It is simply not a rational expectation to believe that the growth rate of companies will exceed the growth of the overall economy in which they sell their goods and services, and produce earnings to pay dividends for an extended period of time. As I mentioned above,

[33] Exhibit No. ___ (WEA-9).

Blue Chip Economic Forecasts projects a five- to 10-year nominal growth in the GDP, or overall U.S. economy, of 5.1%.[34] Hence, expecting a growth rate of 9.6% is in essence assuming the securities market can grow at a rate almost twice the growth rate of the overall U.S. economy. This is simply not a rational expectation.

Q: What would a market return be using a reasonable estimate of sustainable growth?

A: Ibbotson's data estimates that over the period 1926 through 2008 the arithmetic average growth rate of the S&P 500 has been 7.3%.[35] Using this historical growth projection of a long-term sustainable growth rate that should be used in a DCF analysis, along with the current S&P 500 unadjusted dividend yield of 2.2%, implies a forward-looking return on the S&P 500 of 9.7%.

Q: How would Dr. Avera's forward-looking CAPM return estimate change if a reasonable forward-looking market risk premium is used?

A: Applying a market risk premium estimate of 5.2%.[36] I have updated Dr. Avera's risk-free rate to reflect the 20-year Treasury yield as of June 2009. The updated risk-free rate is 4.5%.

As shown at my Exhibit No. ___ (MPG-25), Dr. Avera's forward-looking CAPM return would be reduced from 11.2% to 8.3%, using a market risk premium of 5.1%, an updated risk-free rate of 4.5%, and an updated beta of 0.74. [37]

/ / /

/ / /

[34] Blue Chip Economic Indicators, March 10, 2009.
[35] Morningstar 2009 Classic Yearbook, p. 100.
[36] 9.7% - 4.5% = 5.2%.
[37] 4.5% + 0.74 (5.1%) = 8.3%.

Q: Please describe Dr. Avera's comparable earnings analysis.

A: Dr. Avera's comparable earnings analysis was based on an assessment of the earned return on book equities for his utility proxy group. Based on a review of projected earnings over the next three to five years, Dr. Avera estimated a return on equity for Avista using this methodology to be 11.4%.[38]

Q: Is the comparable earnings analysis a reasonable method for estimating a fair return on equity for Avista?

A: No. A comparable earnings analysis does not measure the return an investor requires in order to make an investment. Rather, it measures the earned return on book equity companies have experienced in the past, or are projected to achieve in the future. The returns investors require in order to assume the risk of an investment are measured from prevailing stock market prices. A comparable earnings analysis measures an accounting return on book equity. Therefore, the return is not developed from observable market data. The return estimated from a comparable earnings analysis can be significantly different than returns investors currently require. Therefore, Dr. Avera's comparable earnings approach should be rejected.

Q: Does this conclude your testimony?

A: Yes, it does.

[38] Exhibit No. ___ (WEA-1T), p. 42.