

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-10_____

DOCKET NO. UG-10_____

DIRECT TESTIMONY OF

WILLIAM E. AVERA

REPRESENTING AVISTA CORPORATION

DIRECT TESTIMONY OF WILLIAM E. AVERA

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Exhibit No.__(WEA-2) – Qualifications of William E. Avera

Exhibit No.__(WEA-3) – Description of Quantitative Analyses

Exhibit No.__(WEA-4) – Capital Structure

Exhibit No.__(WEA-5) – Constant Growth DCF Model – Utility Proxy Group

Exhibit No.__(WEA-6) – Sustainable Growth Rate – Utility Proxy Group

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Exhibit No.__(WEA-8) – Sustainable Growth Rate – Non-Utility Proxy Group

Exhibit No.__(WEA-9) – Forward-looking CAPM – Utility Proxy Group

Exhibit No.__(WEA-10) – Forward-looking CAPM – Non-Utility Proxy Group

Exhibit No.__(WEA-11) – Expected Earnings Approach

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I. INTRODUCTION

Q. Please state your name and business address.

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

Q. In what capacity are you employed?

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

Q. Please describe your educational background and professional experience.

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

A. Overview

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

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

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

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

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

18 A. The ROE serves to compensate common equity investors for the use of
19 their capital to finance the plant and equipment necessary to provide utility service.

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

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

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

¹ *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679 (1923).

² *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

1 the specific risks and potential challenges for Avista’s utility operations in
2 Washington.

3 **B. Summary of Conclusions**

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

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

- 10 • In order to reflect the risks and prospects associated with Avista’s
11 jurisdictional utility operations, my analyses focused on a proxy group of
12 seventeen other utilities with comparable investment risks. Consistent
13 with the fact that utilities must compete for capital with firms outside their
14 own industry, I also referenced a proxy group of comparable risk
15 companies in the non-utility sector of the economy;
- 16 • Because investors’ required return on equity is unobservable and no single
17 method should be viewed in isolation, I applied both the discounted cash
18 flow (“DCF”) and capital asset pricing model (“CAPM”) methods, as well
19 as the comparable earnings approach, to estimate a fair ROE for Avista;
- 20 • Based on my evaluation of the strength of the various methods, I concluded that
21 the cost of equity for the proxy groups of utilities and non-utility companies is in
22 the **10.9 percent to 12.5 percent** range, or **11.1 percent to 12.7 percent** after
23 incorporating an adjustment to account for the impact of common equity
24 flotation costs;
- 25 • Because Avista’s requested ROE of 10.9 percent falls at the very bottom of
26 my “bare bones” cost of equity range, it represents a conservative estimate
27 of investors’ required rate of return.

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

3 A. My recommendation is reinforced by the following findings:

- 4 • The reasonableness of a 10.9 percent minimum ROE for Avista is
5 supported by the need to consider the Company’s credit standing, which
6 remains relatively weak:
- 7 ○ The pressure of funding significant capital expenditures of \$420
8 million³ in the next two years, given that the Company’s rate base is
9 \$2.1 billion, coupled with increased operating risks, heighten the
10 uncertainties associated with Avista;
 - 11 ○ Because of Avista’s reliance on hydroelectric generation and
12 increasing dependence on natural gas fueled capacity, the Company
13 is exposed to relatively greater risks of power cost volatility, even
14 with the energy recovery mechanism (“ERM”);
 - 15 ○ Given that Avista’s credit ratings already fall at the very bottom of
16 the investment grade scale, and considering the potential for
17 continued regulatory lag, an inadequate rate of return imposed in
18 this proceeding would further pressure the Company’s financial
19 flexibility and credit standing;
 - 20 ○ My conclusion that a 10.9 percent ROE for Avista is a conservative
21 estimate of investors’ required return is also reinforced by the
22 Company’s relatively greater risks as compared with the proxy
23 groups, the greater uncertainties associated with Avista’s relatively
24 small size, and the economic reality that Avista’s actual returns have
25 fallen systematically short of the allowed ROE.
- 26 • Sensitivity to financial market and regulatory uncertainties has increased
27 dramatically and investors recognize that constructive regulation is a key
28 ingredient in supporting utility credit standing and financial integrity;
29 and,

³ Excluding investment for federal stimulus projects involving “smart grid”.

- 1 • Providing Avista with the opportunity to earn a return that reflects these
2 realities is an essential ingredient to support the Company's financial
3 position, which ultimately benefits customers by ensuring reliable service
4 at lower long-run costs.
- 5 • Regulatory support, including a reasonable ROE, will be a key driver in
6 securing additional progress towards continued improvement in the
7 Company's financial health. Further strengthening Avista's financial
8 integrity is imperative to ensure that the Company has the capability to
9 maintain an investment grade rating while confronting potential
10 challenges associated with funding infrastructure development necessary
11 to meet the needs of its customers.

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

14 A. Based on my evaluation, I concluded that a common equity ratio of
15 48.39 percent represents a reasonable basis from which to calculate Avista's overall
16 rate of return. This conclusion was based on the following findings:

- 17 • Avista's requested capitalization is consistent with the Company's need to
18 strengthen its credit standing and financial flexibility as it seeks to raise
19 additional capital to fund significant system investments and meet the
20 requirements of its service territory;
- 21 • Avista's proposed common equity ratio is entirely consistent with the
22 range of common equity ratios maintained by the proxy group of utilities.
23 It is also in-line with the 47.1 percent and 48.5 percent average equity
24 ratios for the proxy utilities, based on year-end 2009 data and near-term
25 expectations, respectively;
- 26 • My conclusion is reinforced by the investment community's focus on the
27 need for a greater equity layer to accommodate higher operating risks and
28 the pressures of funding significant capital investments. This is reinforced
29 by the need to consider the impact of uncertain capital markets conditions,

1 as well as off-balance sheet commitments such as purchased power
2 agreements, which carry with them some level of imputed debt.

3 **II. RISKS OF AVISTA**

4 **Q. What is the purpose of this section?**

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

8 **A. Operating Risks**

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

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

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

1 creating potentially a double impact – companies have to buy more
2 power than under normal conditions, paying higher prices.⁴

3 Investors recognize that volatile energy markets, unpredictable stream flows, and
4 Avista’s reliance on wholesale purchases to meet a significant portion of its resource
5 needs can expose the Company to the risk of reduced cash flows and unrecovered
6 power supply costs. S&P noted that Avista, along with Idaho Power Company, “face
7 the most substantial risks despite their PCAs and cost-update mechanisms,”⁵ and
8 concluded that Avista’s “chief risk is the electric utility’s exposure to replacement
9 power costs, particularly in low water years.”⁶ S&P recently confirmed that
10 deadbands in Avista’s ERM and a history of deferred power cost balances weaken
11 the Company’s credit standing.⁷ Similarly, Fitch Ratings Ltd. (“Fitch”) concluded,
12 “Avista’s earnings and cash flows are adversely affected when hydroelectric
13 generation production falls below levels factored into commission –approved rates
14 due to lower-than-projected streamflows.”⁸

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

⁴ Standard & Poor’s Corporation, “Pacific Northwest Hydrology And Its Impact On Investor-Owned Utilities’ Credit Quality,” *RatingsDirect* (Jan. 28, 2008).

⁵ Id.

⁶ Standard & Poor’s Corporation, “Avista Corp.,” *RatingsDirect* (Aug. 21, 2009).

⁷ Id.

⁸ Fitch Ratings, Ltd., “Avista Corp.,” *Global Power U.S. Credit Analysis* (Jul. 31, 2009).

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

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

5 A. Most definitely. Avista will require capital investment to meet
6 customer growth, provide for necessary maintenance and replacements of its natural
7 gas utility systems, as well as fund new investment in electric generation,
8 transmission and distribution facilities. As discussed by Company witness Mr.
9 Thies, planned capital additions for 2010-2011 alone total approximately \$420
10 million, with \$1.2 billion in expenditures being expected through 2014. This
11 represents a substantial investment given Avista's rate base was \$2.1 billion as of
12 year-end 2009.

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

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

3 A. Yes. In recent years utilities and their customers have had to contend
4 with dramatic fluctuations in energy costs due to ongoing price volatility in the spot
5 markets, and investors recognize the prospect of further turmoil in energy markets.
6 Moody's Investors Service ("Moody's") has warned investors of ongoing exposure to
7 "extremely volatile" energy commodity costs, including purchased power prices,
8 which are heavily influenced by fuel costs,⁹ and Fitch noted that rapidly rising
9 energy costs created vulnerability in the utility industry.¹⁰

10 For example, the utility industry and its customers have had to contend with
11 dramatic fluctuations in gas costs due to ongoing price volatility in the spot markets.
12 Fitch has highlighted the challenges that fluctuations in energy prices can have for
13 utilities and noted that:

14 The sharp run-up and subsequent collapse of natural gas prices in 2008
15 is emblematic of the extreme price volatility that characterizes the
16 commodity and is likely to persist in the future.¹¹

⁹ Moody's Investors Service, "Storm Clouds Gathering on the Horizon for the North American Electric Utility Sector," *Special Comment* at 6 (Aug. 2007).

¹⁰ Fitch Ratings Ltd., "Staying Afloat: Downstream Liquidity in the Energy and Power Sectors," *Oil & Gas / Global Power Special Report* (June 16, 2008).

¹¹ Fitch Ratings, Ltd., "U.S. Utilities, Power and Gas 2009 Outlook," *Global Power North American Special Report* (Dec. 22, 2008).

1 Moody's concluded that natural gas "remains highly volatile," and warned that such
2 price fluctuations "could have a significant impact on a utility's liquidity profile."¹²

3 While expectations for significantly lower energy prices reflect weaker
4 fundamentals affecting current load and fuel prices, investors recognize the potential
5 that such trends could quickly reverse. As Fitch recently noted, "uncertainty
6 regarding fuel prices, in particular natural gas costs, has made planning for the
7 future even more problematic."¹³ Besides discouraging potential customers from
8 choosing natural gas, causing certain existing users to substitute alternative fuels,
9 and leading to decreased customer usage, volatile natural gas prices have increased
10 the risks of investing in natural gas distribution utilities and placed additional
11 pressure on their bond ratings. The rapid rise in customers' bills that can result from
12 higher wholesale energy prices has also heightened investor concerns over the
13 implications for regulatory uncertainty. Moody's concluded that political risks
14 associated with "growing consumer intolerance for steadily increasing rates" was a

¹² Moody's Investors Service, "Carbon Risks Becoming More Imminent for U.S. Electric Utility Sector," *Special Comment* (March 2009).

¹³ Fitch Ratings, Ltd., "Electric Utility Capital Spending: The Show Will Go On," *Global Power U.S. and Canada Special Report* (Oct. 14, 2009).

1 key longer-term challenge for utilities that would be intensified by prolonged
2 unemployment.¹⁴

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

5 A. Investors are aware of the financial and regulatory pressures faced by
6 utilities associated with rising costs and the need to undertake significant capital
7 investments. As Moody's observed:

8 Utilities remain exposed to large, long-term capital investment
9 challenges, volatile commodity prices and legal judgments that can
10 wreak havoc on even the strongest liquidity profiles.¹⁵

11 Similarly, S&P noted that cost increases and capital projects, along with
12 uncertain load growth, were a significant challenge to the utility industry.¹⁶ Fitch
13 echoed this assessment, concluding:

14 The combination of high capital expenditures and relatively weak
15 electricity demand will continue to pressure credit quality and require
16 base rate increases in 2010 and beyond.¹⁷

¹⁴ Moody's Investors Service, "U.S. Electric Utilities Face Challenges Beyond Near-Term," *Industry Outlook* (Jan. 2010).

¹⁵ *Id.*

¹⁶ Standard & Poor's Corporation, "Industry Economic And Ratings Outlook," *RatingsDirect* (Feb. 2, 2010).

¹⁷ Fitch Ratings Ltd., "U.S. Utilities, Power, and Gas 2010 Outlook," *Global Power North America Special Report* (Dec. 4, 2009).

1 While providing the infrastructure necessary to meet the energy needs of
2 customers is certainly desirable, it imposes additional financial responsibilities on
3 Avista. As noted earlier, the Company's plans include electric utility capital
4 expenditures of approximately \$420 million just over the 2010-2011 period, and
5 Moody's has noted that Avista "is continuing its high level of investment."¹⁸
6 Investors are aware of the challenges posed by rising costs and burdensome capital
7 expenditure requirements, especially in light of Avista's relatively weak credit
8 standing and ongoing capital market and economic uncertainties.

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

10 A. Utilities are confronting increased environmental pressures that could
11 impose significant uncertainties and costs. In early 2007 S&P cited environmental
12 mandates, including emissions, conservation, and renewable resources, as one of the
13 top ten credit issues facing U.S. utilities.¹⁹ Similarly, Moody's noted that "the
14 prospect for new environmental emission legislation – particularly concerning

¹⁸ Moody's Investors Service, "Credit Opinion: Avista Corp.," *Global Credit Research* (Aug. 13, 2009).

¹⁹ Standard & Poor's Corporation, "Top Ten Credit Issues Facing U.S. Utilities," *RatingsDirect* (Jan. 29, 2007).

1 carbon dioxide – represents the biggest emerging issue for electric utilities,”²⁰ while
2 Fitch observed that “the structure, timing and implementation is still uncertain.”²¹

3 Compliance with evolving standards will undoubtedly require significant
4 capital expenditures, with S&P recently concluding, “Although we expect the cap-
5 and-trade program to be economywide and affect a variety of sectors, it will
6 disproportionately affect the power sector.”²² S&P recently emphasized that because
7 of uncertainty over the details and timing of future limits on CO₂ emissions, existing
8 ratings do not fully reflect the impact of carbon risks.²³

9 **Q. Would investors consider Avista’s relative size in their assessment of**
10 **the Company’s risks and prospects?**

11 A. Yes. A firm’s relative size has important implications for investors in
12 their evaluation of alternative investments, and it is well established that smaller
13 firms are more risky than larger firms. With a market capitalization of
14 approximately \$1.1 billion, Avista is one of the smallest publicly traded electric

²⁰ Moody’s Investors Service, “U.S. Investor-Owned Electric Utilities,” *Industry Outlook* (Jan. 2009).

²¹ Fitch Ratings, Ltd., “U.S. Utilities, Power and Gas 2009 Outlook,” *Global Power North America Special Report* (Dec. 22, 2008).

²² Standard & Poor’s Corporation, “The Potential Credit Impact Of Carbon Cap-And-Trade Legislation On U.S. Companies,” *RatingsDirect* (Sep. 14, 2009).

²³ *Id.*

1 utilities followed by Value Line, which have an average capitalization of
2 approximately \$6.7 billion.²⁴

3 The magnitude of the size disparity between Avista and other firms in the
4 utility industry has important practical implications with respect to the risks faced
5 by investors. All else being equal, it is well accepted that smaller firms are more
6 risky than their larger counterparts, due in part to their relative lack of
7 diversification and lower financial resiliency.²⁵ These greater risks imply a higher
8 required rate of return, and there is ample empirical evidence that investors in
9 smaller firms realize higher rates of return than in larger firms.²⁶ Common sense
10 and accepted financial doctrine hold that investors require higher returns from
11 smaller companies, and unless that compensation is provided in the rate of return
12 allowed for a utility, the legal tests embodied in the *Hope* and *Bluefield* cases cannot
13 be met.

²⁴ www.valueline.com (retrieved Mar. 5, 2010).

²⁵ It is well established in the financial literature that smaller firms are more risky than larger firms. See, e.g., Eugene F. Fama and Kenneth R. French, "The Cross-Section of Expected Stock Returns", *The Journal of Finance* (June 1992); George E. Pinches, J. Clay Singleton, and Ali Jahankhani, "Fixed Coverage as a Determinant of Electric Utility Bond Ratings", *Financial Management* (Summer 1978).

²⁶ See for example Rolf W. Banz, "The Relationship Between Return and Market Value of Common Stocks", *Journal of Financial Economics* (September 1981) at 16.

B. Implications of Attrition

1
2 **Q. What causes attrition?**

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

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

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

1 observed that its risk analysis focuses on the utility's ability to consistently earn a
2 reasonable return:

3 Notably, the analysis does not revolve around "authorized" returns,
4 but rather on actual earned returns. We note the many examples of
5 utilities with healthy authorized returns that, we believe, have no
6 meaningful expectation of actually earning that return because of rate
7 case lag, expense disallowances, etc.²⁷

8 Similarly, Moody's concluded, "we evaluate the framework and mechanisms that
9 allow a utility to recover its costs and investments and earn allowed returns. We are
10 less concerned with the official allowed return on equity, instead focusing on the
11 earned returns and cash flows."²⁸

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

14 A. Yes. As discussed in the testimony of Mr. Thies, for example, the
15 WUTC's most recent rate order limited recovery to costs associated with capital
16 additions placed in service through June 2009, even though new retail rates went
17 into effect on January 1, 2010. As a result, Avista is experiencing regulatory lag
18 associated with the return and depreciation on reasonable and necessary capital

²⁷ Standard & Poor's Corporation, "Assessing U.S. Utility Regulatory Environments," *RatingsDirect* (Nov. 7, 2008).

²⁸ Moody's Investors Service, "Electric Utilities Face Challenges Beyond Near-Term," *Industry Outlook* (Jan. 2010).

1 investment used to provide service for the last half of 2009 and all of 2010. S&P
2 confirmed that attrition has acted as a drag on Avista's finances:

3 Regulatory lag has been a consistent issue for Avista's utilities, with the
4 utility operations ... collectively unable to earn the company's
5 authorized return on equity (ROE) on a consolidated basis. On a
6 consolidated basis, average earned ROE over the past three years has
7 been just under 7%, based on Standard & Poor's Ratings Services'
8 calculations.²⁹

9 Similarly, Value Line recently noted that the Company "received a disappointing
10 rate order in Washington," and concluded, "Due to the effects of regulatory lag, it is
11 unlikely that Avista will earn its allowed ROE in Washington this year."³⁰ Value Line
12 informed investors that regulatory lag is expected to be an ongoing issue for the
13 Company, observing, "Any rate relief that Avista is granted won't come in time to
14 help earnings until 2011."³¹

15 **Q. What are the ways to deal with attrition?**

16 A. For many utilities, the widespread adoption of pass-through clauses
17 for fuel, purchased power, and other costs that were rising rapidly in the late 1970's
18 and early 1980's helped to partially offset the impact of attrition. The use of future
19 test years and other forward-looking adjustments and mechanisms is also useful in
20 ameliorating the impact of attrition, as is accelerated depreciation and inclusion of

²⁹ Standard & Poor's Corporation, "Summary: Avista Corp.," *RatingsDirect* (Feb. 18, 2010).

³⁰ The Value Line Investment Survey at 2232 (Feb. 5, 2010).

³¹ *Id.*

1 CWIP in rate base, particularly where financing an expensive generating plant
2 addition is undermining a utility's financial indicators. Many jurisdictions have
3 developed methods to attenuate regulatory lag, such as allowing interim rates,
4 putting rates into effect subject to refund, as well as accelerating the administrative
5 process to allow faster rate decisions.

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

8 A. Yes. Setting rates at a level that considers the impact of attrition and
9 allows the utility an opportunity to actually earn its authorized ROE is consistent
10 with fundamental regulatory principles. Central to the determination of reasonable
11 rates for utility service is the notion that owners of public utility properties are
12 protected from confiscation. The Supreme Court has reaffirmed that the end result
13 test must be applied to the actual returns that investors expect if they put their
14 money at risk to finance utilities.³² This end result can only be achieved for Avista if
15 the allowed return is sufficient to offset the impact of attrition. That end result
16 would maintain the utility's financial integrity, ability to attract capital and offer
17 investors fair compensation for the risk they bear. Given the Company's inability to

³² *Verizon Communications, et al v. Federal Communications Commission, et al*, 535 U.S. 467 (2002). While I cannot comment on the legal significance of this case, I found the economic wisdom of looking to the reasonable expectations of actual investors compelling. Economic logic and common sense confirm that a utility cannot attract capital on reasonable terms if investors expect future returns to fall short of those offered by comparable investments.

1 earn its authorized ROE in the past and the dynamics faced by Avista, there is every
2 reason to believe that attrition will continue to result in under-earning the allowed
3 ROE if the impact of regulatory lag and rising capital requirements are ignored.

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

15 **C. Impact of Capital Market Conditions**

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

17 A. The financial and real estate crisis that accelerated during the third
18 quarter of 2008 led to unprecedented price fluctuations in the capital markets as
19 investors dramatically revised their risk perceptions and required returns. As a

1 result of investors' trepidation to commit capital, stock prices declined sharply while
2 the yields on corporate bonds experienced a dramatic increase.

3 With respect to utilities specifically, as of December 2009, the Dow Jones
4 Utility Average stock index remained almost 30 percent below the level in June 2008.
5 This sell-off in common stocks and sharp fluctuations in utility bond yields reflect
6 the fact that the utility industry was not immune to the impact of financial market
7 turmoil and the ongoing economic downturn. As the Edison Electric Institute
8 ("EEI") noted in a letter to congressional representatives as the financial crisis
9 intensified, capital market uncertainties have serious implications for utilities and
10 their customers:

11 In the wake of the continuing upheaval on Wall Street, capital markets
12 are all but immobilized, and short-term borrowing costs to utilities
13 have already increased substantially. If the financial crisis is not
14 resolved quickly, financial pressures on utilities will intensify sharply,
15 resulting in higher costs to our customers and, ultimately, could
16 compromise service reliability.³³

17 Similarly, an October 1, 2008, *Wall Street Journal* report confirmed that utilities
18 had been forced to delay borrowing or pursue more costly alternatives to raise
19 funds.³⁴ In December 2008, Fitch confirmed "sharp repricing of and aversion to risk

³³ *Letter to House of Representatives*, Thomas R. Kuhn, President, Edison Electric Institute (Sep. 24, 2008).

³⁴ Smith, Rebecca, "Corporate News: Utilities' Plans Hit by Credit Markets," *Wall Street Journal* at B4 (Oct. 1, 2008).

1 in the investment community,” and noted that the disruptions in financial markets
2 and the fundamental shift in investors’ risk perceptions had increased the cost of
3 capital for utilities.³⁵:

4 More recently, Fitch concluded, “While utilities maintained relatively good
5 market access during the credit crisis, the cost of capital is higher than prior to the
6 credit crisis, and bank credit remains relatively tight.”³⁶ Similarly, S&P confirmed
7 that utilities are expected to maintain access to credit in 2010, “albeit at more
8 demanding terms than in the previous cycle,”³⁷ with Moody’s noting that “costs
9 associated with credit facilities have increased significantly.”³⁸

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

12 A. Table WEA-1 below compares current interest rates on 30-year
13 Treasury bonds, double-A rated utility bonds, and triple-A rated corporate bonds
14 with those projected for 2010 through 2014 by the Value Line Investment Survey

³⁵ Fitch Ratings Ltd., “U.S. Utilities, Power and Gas 2009 Outlook,” *Global Power North America Special Report* (Dec. 22, 2008).

³⁶ Fitch Ratings Ltd., “Electric Utility Capital Spending: The Show Will Go On,” *Global Power U.S. and Canada Special Report* (Oct. 14, 2009).

³⁷ Standard & Poor’s Corporation, “Industry Report Card: U.S. Regulated Electric Utilities Head Into 2010 With Familiar Concerns,” *RatingsDirect* (Dec. 28, 2009).

³⁸ Moody’s Investors Service, “U.S. Electric Utilities Face Challenges Beyond Near-Term,” *Industry Outlook* (Jan. 2010).

1 (“Value Line”), IHS Global Insight, the Energy Information Administration (“EIA”),
 2 a statistical agency of the U.S. Department of Energy (“DOE”):

3
 4

**TABLE WEA-1
 INTEREST RATE TRENDS**

| | 2010 | 2011 | 2012 | 2013 | 2014 | Feb. 2010 |
|-------------------------------|------|------|------|------|------|--------------|
| <u>30-Yr. Treasury</u> | | | | | | (a) |
| Value Line (a) | 4.6% | 4.9% | 5.3% | 5.8% | 6.3% | 4.6% |
| IHS Global Insight (b) | 4.6% | 4.6% | 4.9% | 5.2% | 5.8% | 4.6% |
| <u>AAA Corporate</u> | | | | | | |
| Value Line (b) | 5.8% | 6.0% | 6.4% | 6.7% | 7.0% | 5.4% |
| IHS Global Insight (c) | 5.3% | 5.5% | 5.9% | 6.2% | 6.7% | 5.4% |
| S&P (d) | 5.8% | 6.8% | 7.5% | 7.6% | -- | 5.4% |
| <u>AA Utility</u> | | | | | | |
| IHS Global Insight (c) | 5.6% | 5.8% | 6.3% | 6.6% | 7.2% | 5.7% |
| EIA (e) | 6.7% | 6.4% | 6.5% | 6.8% | 7.2% | 5.7% |

- (a) Based on monthly average bond yields for January 2010 reported at www.credittrends.moodys.com and <http://www.federalreserve.gov/releases/h15/data.htm>.
- (b) The Value Line Investment Survey, *Forecast for the U.S. Economy* (Feb. 26, 2010).
- (c) IHS Global Insight, *The U.S. Economy: The 30-Year Focus* (Third-Quarter 2009) at Table 34.
- (d) Standard & Poor’s Corporation, “U.S. Economic Forecast: To A Prosperous New Year,” *RatingsDirect* (Jan. 11, 2009).
- (e) Energy Information Administration, *Annual Energy Outlook 2010, Early Release* (Dec. 5, 2009) at Table 20.

5 As evidenced above, there is a clear consensus that the cost of permanent capital will
 6 be higher in the 2010-2014 timeframe than it is currently. As a result, current cost of
 7 capital estimates are likely to understate investors’ requirements at the time the
 8 outcome of this proceeding becomes effective and beyond.

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

2 A. No one knows the future of our complex global economy. We know
3 that the financial crisis had been building for a long time and few predicted that the
4 economy would fall as rapidly as it has, or that corporate bond yields would
5 fluctuate as dramatically as they did. While conditions in the economy and capital
6 markets appear to have stabilized, investors are apt to react swiftly and negatively to
7 any future signs of trouble in the financial system or economy. As the *Wall Street*
8 *Journal* recently noted:

9 Stocks pulled out of a 167-point hole with a late rally Friday, capping a
10 wild week reminiscent of the most volatile days of the credit crisis. ...
11 It was a return to the unusual relationships, or correlations, seen at
12 major flash points over the past two years when investors fled risky
13 assets and jumped into safe havens. This market behavior, which has
14 reasserted itself repeatedly since the financial crisis began, suggests
15 that investment decisions are still being driven more by government
16 support and liquidity concerns than market fundamentals.³⁹

17 Given the importance of reliable electric and gas utility service for customers and the
18 economy, it would be unwise to ignore investors' increased sensitivity to risk in
19 evaluating Avista's ROE.

³⁹ Gongloff, Mark, "Stock Rebound Is a Crisis Flashback – Late Surge Recalls Market's Volatility at Peak of Credit Difficulties; Unusual Correlations," *Wall Street Journal* at B1 (Feb. 6, 2010).

1 **D. Support For Avista's Credit Standing**

2 **Q. What credit ratings have been assigned to Avista?**

3 A. Avista has been assigned a corporate credit rating of "BBB-" by S&P
4 and an issuer default rating of "BBB-"by Fitch. Moody's has assigned the Company
5 an issuer rating of "Baa3". S&P and Moody's have revised their credit outlook on
6 Avista to "positive", indicating the potential for higher ratings going forward.⁴⁰ The
7 current ratings assigned by S&P, Moody's, and Fitch represent the lowest rung on
8 the ladder of the investment grade scale.

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

11 A. The past decade witnessed steady erosion in credit quality throughout
12 the utility industry, both as a result of revised perceptions of the risks in the industry
13 and the weakened finances of the utilities themselves. S&P recently reported that
14 the majority of the companies in the utility sector now fall in the triple-B rating
15 category.⁴¹ Going forward, S&P observed that:

16 Looming costs associated with environmental compliance, slack
17 demand caused by economic weakness, the potential for permanent

⁴⁰ Standard & Poor's Corporation, "Research Update: Outlook On Avista Corp. Credit Rating Revised To Positive; Ratings Affirmed," *RatingsDirect* (Aug. 10, 2009); Moody's Investors Service, "Ratings Action: Avista Corp.," *Global Credit Research Ratings Action* (Aug. 12, 2009).

⁴¹ Standard & Poor's Corporation, "Issuer Ranking: U.S. Regulated Electric Utilities, Strongest To Weakest," *RatingsDirect* (Mar. 2, 2010).

1 demand destruction caused by changes in consumer behavior and
2 closing of manufacturing facilities, and numerous regulatory filings
3 seeking recovery of costs are some of the significant challenges the
4 industry has to deal with.⁴²

5 **Q. How does Avista's relative credit standing compare with others in**
6 **the utility industry?**

7 A. Avista's credit ratings remain at the very bottom of the investment
8 grade scale, and in a recent report by S&P ranking U.S. regulated utilities from
9 strongest to weakest, Avista was ranked 145 out of the total 181 companies with
10 investment grade credit ratings.⁴³ Meanwhile, in a ranking of electric and gas utility
11 parent companies, Fitch placed Avista at 34th position out of 49 companies.⁴⁴

12 **Q. What are the implications of Avista's relative credit standing, given**
13 **the potential for further dislocations in the capital markets?**

14 A. As documented earlier and in the testimony of Mr. Mark Thies,
15 investors' concerns are magnified by the fact that its credit standing remains
16 relatively weak. The Company's efforts to regain investment grade credit ratings
17 have been successful, but Avista's finances remain pressured.

⁴² Standard & Poor's Corporation, "U.S. Regulated Electric Utilities Head Into 2010 With Familiar Concerns," *RatingsDirect* (Dec. 28, 2009).

⁴³ Standard & Poor's Corporation, "Issuer Ranking: U.S. Regulated Electric Utilities, Strongest To Weakest," *RatingsDirect* (Mar. 2, 2010).

⁴⁴ Fitch Ratings Ltd., "U.S. Utilities, Power, and Gas 2010 Outlook," *Global Power North America Special Report* (Dec. 4, 2009).

1 Fitch observed that when credit market conditions are unsettled, “flight to
2 quality’ is selective within the [utility] sector, favoring companies at higher rating
3 levels.”⁴⁵ Because Avista’s ratings are at the very bottom of the investment grade
4 barrel, there is no backstop in the event of a recurring capital market crisis and
5 reduced flexibility to respond to other challenges, such as a continuation of poor
6 hydro conditions or increased capital outlays. As Mr. Thies confirms in his
7 testimony, regulatory support will be a key driver in securing additional progress
8 towards restoring the Company’s financial health. Further strengthening Avista’s
9 financial integrity and continued progress in raising the Company’s credit standing
10 is imperative to ensure the capability to maintain an investment grade rating while
11 confronting potential challenges.

12 Moreover, the negative impact of declining credit quality on a utility's capital
13 costs and financial flexibility becomes more pronounced as debt ratings move down
14 the scale from investment to non-investment grade. As the Chairman of the New
15 York State Public Service Commission noted in his role as spokesman for the
16 National Association of Regulatory Utility Commissioners:

17 While there is a large difference between A and BBB, there is an even
18 brighter line between Investment Grade (BBB-/Baa3 bond ratings by
19 S&P/Moody’s, and higher) and non-Investment Grade (Junk) (BB+/Ba1

⁴⁵ *Id.*

1 and lower). The cost of issuing non-investment grade debt, assuming
2 the market is receptive to it, has in some cases been hundreds of basis
3 points over the yield on investment grade securities. To me this
4 suggests that you do not want to be rated at the lower end of the BBB
5 range because an unexpected shock could move you outside the
6 investment grade range.⁴⁶

7 The pressures of significant capital expenditure requirements reinforce the
8 importance of supporting continued improvement in Avista's credit standing.
9 Investors understand from past experience in the utility industry that large capital
10 needs can lead to significant deterioration in financial integrity that can constrain
11 access to capital, especially during times of unfavorable capital market conditions.
12 Considering the weakened state of financial markets, competition with other
13 investment alternatives, and investors' sensitivity to the potential for market
14 volatility, greater credit strength is a key ingredient in maintaining access to capital
15 at reasonable cost. With Avista's credit ratings poised on the precipice between
16 investment grade and junk bond status, the stakes associated with an inadequate
17 rate of return are increased dramatically. In turn, the need for supportive regulation
18 and an adequate ROE may never have been greater.

⁴⁶ Brown, George, "Credit and Capital Issues Affecting the Electric Power Industry," *Federal Energy Regulatory Commission Technical Conference* (Jan. 13, 2009).

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E. Capital Structure

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

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

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

A. Avista's capital structure is presented in the testimony of Mr. Thies. As summarized in his testimony, the pro-forma common equity ratio used to compute Avista's overall rate of return was 48.39 percent in this filing.

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

3 A. As shown on Exhibit No.__(WEA-4), for the 17 firms in the utility
4 proxy group, common equity ratios at December 31, 2009 ranged between 42.6
5 percent and 63.2 percent and averaged 47.1 percent.

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

8 A. As shown on Exhibit No.__(WEA-4), The Value Line Investment
9 Survey (“Value Line”) expects an average common equity ratio for the proxy group
10 of utilities of 48.5 percent for its three-to-five year forecast horizon, with the
11 individual common equity ratios ranging from 40.5 percent to 55.5 percent.⁴⁷ The
12 WUTC has previously observed that “[i]t is appropriate ... to afford more weight to
13 forward considerations than to historic conditions as we determine the appropriate
14 equity ratio to be embedded in prospective rates.”⁴⁸

⁴⁷ Because Value Line does not include short-term debt in its capital structure ratios, these projections were adjusted to include the same proportion of short-term debt outstanding at year-end 2009.

⁴⁸ *Order No. 06*, Docket Nos. UG-040640 and UE-040641 (consolidated) (Feb. 18, 2005) at P. 32.

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

3 A. The 48.39 percent common equity ratio requested by Avista is entirely
4 consistent with the range of equity ratios maintained by the firms in the Utility
5 Proxy Group and is in-line with the 47.1 percent and 48.5 percent average equity
6 ratios at year-end 2009 and based on Value Line’s near-term expectations,
7 respectively.

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

10 A. As discussed earlier, the average credit rating associated with firms in
11 the electric industry has fallen to triple-B, with Avista’s “BBB-“ rating occupying the
12 lowest rung on the ladder of the investment grade scale. At the same time, utilities
13 are facing uncertainties on a number fronts, including the need to finance significant
14 capital investment plans and ongoing regulatory risks. Coupled with the potential
15 for further turmoil in capital markets, these considerations warrant a stronger
16 balance sheet to deal with an increasingly uncertain environment. A more
17 conservative financial profile, in the form of a higher common equity ratio, is
18 consistent with increasing uncertainties and the need to maintain the continuous

1 access to capital that is required to fund operations and necessary system
2 investment, even during times of adverse capital market conditions.

3 Moody's has repeatedly warned investors of the risks associated with debt
4 leverage and fixed obligations and advised utilities not to squander the opportunity
5 to strengthen the balance sheet as a buffer against future uncertainties.⁴⁹ More
6 recently, Moody's concluded:

7 From a credit perspective, we believe a strong balance sheet coupled
8 with abundant sources of liquidity represents one of the best defenses
9 against business and operating risk and potential negative ratings
10 actions.⁵⁰

11 Similarly, S&P recently noted that, "we generally consider a debt to capital level of
12 50% or greater to be aggressive or highly leveraged for utilities."⁵¹ Fitch affirmed
13 that it expects regulated utilities "to extend their conservative balance sheet stance in
14 2010," and employ "a judicious mix of debt and equity to finance high levels of
15 planned investments."⁵² This is especially the case for Avista, which faces the dual

⁴⁹ Moody's Investors Service, "Storm Clouds Gathering on the Horizon for the North American Electric Utility Sector," *Special Comment* (Aug. 2007); "U.S. Electric Utility Sector," *Industry Outlook* (Jan. 2008).

⁵⁰ Moody's Investors Service, "U.S. Electric Utilities Face Challenges Beyond Near-Term," *Industry Outlook* (Jan. 2010).

⁵¹ Standard & Poor's Corporation, "Ratings Roundup: U.S. Electric Utility Sector Maintained Strong Credit Quality In A Gloomy 2009," *RatingsDirect* (Jan. 26, 2010).

⁵² Fitch Ratings Ltd., "U.S. Utilities, Power, and Gas 2010 Outlook," *Global Power North America Special Report* (Dec. 4, 2009).

1 challenge of financing significant capital expansion plans while at the same time
2 endeavoring to improve its credit standing.

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

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

1 These commitments have been repeatedly cited by major bond rating
2 agencies in connection with assessments of utility financial risks.⁵³ For example,
3 S&P reported that it adjusts Avista's capitalization to include approximately \$195
4 million in imputed debt from PPAs, leases, and postretirement benefit obligations.⁵⁴
5 Unless Avista takes action to offset this additional financial risk by maintaining a
6 higher equity ratio, the resulting leverage will weaken the Company's
7 creditworthiness, implying a higher required rate of return to compensate investors
8 for the greater risks.⁵⁵

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

11 A. Based on my evaluation, I concluded that Avista's requested capital
12 structure represents a reasonable mix of capital sources from which to calculate the
13 Company's overall rate of return. While industry averages provide one benchmark
14 for comparison, each firm must select its capitalization based on the risks and

⁵³ See, e.g., Standard & Poor's Corporation, "Standard & Poor's Methodology For Imputing Debt For U.S. Utilities' Power Purchase Agreements," *RatingsDirect* (May 7, 2007); Standard & Poor's Corporation, "Implications Of Operating Leases On Analysis Of U.S. Electric Utilities," *RatingsDirect* (Jan. 15, 2008); Standard & Poor's Corporation, "Top 10 Investor Questions: U.S. Regulated Electric Utilities," *RatingsDirect* (Jan. 22, 2010).

⁵⁴ Standard & Poor's Corporation, "Avista Corp.," *RatingsDirect* (Aug. 21, 2009).

⁵⁵ Apart from the immediate impact that the fixed obligation of purchased power costs has on the utility's financial risk, higher fixed charges also reduce ongoing financial flexibility, and the utility may face other uncertainties, such as potential replacement power costs in the event of supply disruption.

1 prospects it faces, as well its specific needs to access the capital markets. A public
2 utility with an obligation to serve must maintain ready access to capital under
3 reasonable terms so that it can meet the service requirements of its customers.

4 Avista's capital structure reflects the challenges posed by its resource mix, the
5 burden of significant capital spending requirements, and the Company's ongoing
6 efforts to strengthen its credit standing and support access to capital on reasonable
7 terms. Moody's observed that its ratings for Avista anticipate "conservative
8 financing strategies."⁵⁶ The need for access becomes even more important when the
9 company has capital requirements over a period of years, and financing must be
10 continuously available, even during unfavorable capital market conditions.

11 **III. CAPITAL MARKET ESTIMATES**

12 **Q. What is the purpose of this section?**

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

⁵⁶ Moody's Investors Service, "Credit Opinion: Avista Corp.," *Global Credit Research* (Aug. 13, 2009).

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A. Overview

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

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

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

A. No. In my opinion, no single method or model should be relied upon to determine a utility's cost of equity because no single approach can be regarded as

1 wholly reliable. For example, a publication of the Society of Utility and Financial
2 Analysts (formerly the National Society of Rate of Return Analysts), concluded that:

3 Each model requires the exercise of judgment as to the reasonableness
4 of the underlying assumptions of the methodology and on the
5 reasonableness of the proxies used to validate the theory. Each model
6 has its own way of examining investor behavior, its own premises, and
7 its own set of simplifications of reality. Each method proceeds from
8 different fundamental premises, most of which cannot be validated
9 empirically. Investors clearly do not subscribe to any singular method,
10 nor does the stock price reflect the application of any one single
11 method by investors.⁵⁷

12 Therefore, I used both the DCF and CAPM methods to estimate the cost of equity. In
13 addition, I also evaluated a fair ROE return using an earnings approach based on
14 investors' current expectations in the capital markets. In my opinion, comparing
15 estimates produced by one method with those produced by other approaches
16 ensures that the estimates of the cost of equity pass fundamental tests of
17 reasonableness and economic logic.

18 **Q. What was your conclusion regarding a fair rate of return on equity**
19 **for the proxy companies?**

20 A. Based on the results of my quantitative analyses, and my assessment of
21 the relative strengths and weaknesses inherent in each method, I concluded that the

⁵⁷ Parcell, David C., "The Cost of Capital – A Practitioner's Guide," *Society of Utility and Regulatory Financial Analysts* (1997) at Part 2, p. 4.

1 cost of equity for the proxy companies is in the 10.9 percent to 12.5 percent range, or
2 11.1 percent to 12.7 percent after including a minimum adjustment for flotation
3 costs.

4 **B. Results of Quantitative Analyses**

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

7 A. In estimating the cost of equity, the DCF model is typically applied to
8 publicly traded firms engaged in similar business activities or with comparable
9 investment risks. As described in detail in Exhibit No.__(WEA-3), I applied the
10 DCF model to a utility proxy group composed of those dividend-paying companies
11 included by Value Line in its Electric Utilities Industry groups with: (1) S&P
12 corporate credit ratings of "BBB-" or "BBB," (2) a Value Line Safety Rank of "2" or
13 "3", and (3) a Value Line Financial Strength Rating of "B+" to "B++".⁵⁸ I refer to this
14 group as the "Utility Proxy Group."

⁵⁸ In addition, I excluded two firms that otherwise would have been in the proxy group, but are not appropriate for inclusion because Value Line indicated the potential that common dividends may be cut (Hawaiian Electric Industries, Inc.), and another (Allegheny Energy, Inc.) that is in the process of being acquired.

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

3 A. Under the regulatory standards established by *Hope* and *Bluefield*, the
4 salient criteria in establishing a meaningful benchmark to evaluate a fair rate of
5 return is relative risk, not the particular business activity or degree of regulation. As
6 noted in *Regulatory Finance: Utilities' Cost of Capital*, "It should be emphasized that
7 the definition of a comparable risk class of companies does not entail similarity of
8 operation, product lines, or environmental conditions, but rather similarity of
9 experienced business risk and financial risk."⁵⁹ Utilities must compete for capital,
10 not just against firms in their own industry, but with other investment opportunities
11 of comparable risk. With regulation taking the place of competitive market forces,
12 required returns for utilities should be in line with those of non-utility firms of
13 comparable risk operating under the constraints of free competition. Consistent
14 with this accepted regulatory standard, I also applied the DCF model to a reference
15 group of comparable risk companies in the non-utility sectors of the economy. I
16 refer to this group as the "Non-Utility Proxy Group".

⁵⁹ Morin, Roger A., "Regulatory Finance: Utilities' Cost of Capital," *Public Utilities Reports, Inc.* at 58 (1994).

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

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

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

7 A. As shown below, Table WEA-2 compares the non-utility proxy group
8 with the utility proxy group and Avista across four key indicators of investment risk:

9 **TABLE WEA-2**
10 **COMPARISON OF RISK INDICATORS**

| | S&P Credit Rating | Value Line | | |
|---------------------|-------------------------|----------------|-----------------------|------|
| | | Safety Rank | Financial Strength | Beta |
| Non-Utility Group | A | 1 | A+ | 0.79 |
| Utility Proxy Group | BBB | 3 | B+ | 0.73 |
| Avista Corp. | BBB- | 3 | B+ | 0.80 |

11 Considered together, a comparison of these objective measures indicates that
12 Avista's investment risks exceed those of the two proxy groups. As a result, the cost
13 of equity estimates indicated by my analyses provide a conservative estimate of
14 investors' required rate of return for Avista.

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

3 A. My application of the DCF model, which is discussed in greater detail
4 in Exhibit No.__(WEA-3), considered four alternative measures of expected
5 earnings growth, as well as the sustainable growth rate based on the relationship
6 between expected retained earnings and earned rates of return (“br + sv”) and Value
7 Line’s projected growth in stock price. As shown on Exhibit No.__(WEA-5) and
8 summarized below in Table WEA-3, after eliminating illogical low- and high-end
9 values, application of the constant growth DCF model resulted in the following cost
10 of equity estimates:

11 TABLE WEA-3
12 DCF RESULTS – UTILITY PROXY GROUP

| <u>Growth Rate</u> | <u>Average Cost of Equity</u> |
|--------------------|-------------------------------|
| Value Line | 11.5% |
| IBES | 11.1% |
| First Call | 11.1% |
| Zacks | 10.6% |
| br+sv | 10.4% |
| Stock Price | 11.2% |

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

15 A. As shown on Exhibit No.__(WEA-7), I applied the DCF model to the
16 non-utility companies in exactly the same manner described earlier for the Utility

1 Proxy Group. As summarized below in Table WEA-4, after eliminating illogical low-
 2 and high-end values, application of the constant growth DCF model resulted in the
 3 following cost of equity estimates:

4 **TABLE WEA-4**
 5 **DCF RESULTS – NON-UTILITY GROUP**

| <u>Growth Rate</u> | <u>Average Cost of Equity</u> |
|--------------------|-------------------------------|
| Value Line | 11.9% |
| IBES | 12.6% |
| First Call | 12.8% |
| Zacks | 12.7% |
| br+sv | 12.2% |
| Stock Price | 13.7% |

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

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

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

2 A. As shown on Exhibit No.__(WEA-9), my forward-looking application
3 of the CAPM model indicated an ROE of 9.5 percent for the utility proxy group.
4 Applying the CAPM approach to the firms in the non-utility proxy group (Exhibit
5 No.__(WEA-10)) implied a cost of equity of 9.8 percent. As discussed in Exhibit
6 No.__(WEA-3), however, applying the CAPM is complicated by the impact of the
7 recent capital market turmoil and recession on investors' risk perceptions and
8 required returns, which may cause CAPM cost of common equity estimates to
9 understate investors' required returns for common stocks.

10 This is because relationships between risk-free Treasury bonds and the
11 required returns on common stock have been distorted by heightened uncertainties.
12 In addition, beta values, which are estimated based on historical stock prices, have
13 been impacted by the unprecedented market volatility experienced since the third
14 quarter of 2008. These distortions not only impact the absolute level of the CAPM
15 cost of equity estimate, but they affect estimated risk premiums. As the Staff of the
16 Florida Public Service Commission recently concluded:

17 [R]ecognizing the impact the Federal Government's unprecedented
18 intervention in the capital markets has had on the yields on long-term
19 Treasury bonds, staff believes models that relate the investor-required
20 return on equity to the yield on government securities, such as the

1 CAPM approach, produce less reliable estimates of the ROE at this
2 time.⁶⁰

3 As a result, there is every indication that CAPM approaches fail to fully reflect the
4 risk perceptions of real-world investors in today's capital markets, which would
5 violate the standards underlying a fair rate of return by failing to provide an
6 opportunity to earn a return commensurate with other investments of comparable
7 risk.

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

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

⁶⁰ *Staff Recommendation for Docket No. 080677-E1 - Petition for increase in rates by Florida Power & Light Company*, at p. 280 (Dec. 23, 2009).

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

3 A. Value Line reports that its analysts anticipate an average rate of return
4 on common equity for the electric utility industry of 11.0 percent in 2010 and 11.5
5 percent over its 2012-2014 forecast horizon.⁶¹ The capital structure corresponding
6 with this expected return reflects an equity ratio of 49 percent. Meanwhile, for the
7 gas utility industry Value Line expects returns on common equity of 10.5 percent in
8 2010 and 11.0 percent for the period 2012-2014.⁶² As shown on Exhibit No.__(WEA-
9 11), Value Line’s projections for the utility proxy group suggested an average ROE of
10 10.7 percent after eliminating potential outliers.⁶³

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

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

⁶¹ The Value Line Investment Survey at 2231 (Feb. 5, 2010).

⁶² The Value Line Investment Survey at 444 (Dec. 11, 2009).

⁶³ As highlighted on Exhibit No.__(WEA-11), I eliminated six extreme low- and high-end outliers. While these Value Line projections may accurately reflect expectations for actual earned rates of return on common equity over the forecast horizon, they are unlikely to be representative of investors’ required rate of return.

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TABLE WEA-5
SUMMARY OF QUANTITATIVE RESULTS

| <u>DCF</u> | <u>Utility</u> | <u>Non-Utility</u> |
|------------------------------|---------------------|--------------------|
| Value Line | 11.5% | 11.9% |
| IBES | 11.1% | 12.6% |
| First Call | 11.1% | 12.8% |
| Zacks | 10.6% | 12.7% |
| br+sv | 10.4% | 12.2% |
| Stock Price | 11.2% | 13.7% |
| <u>CAPM</u> | 9.5% | 9.8% |
| <u>Expected Earnings</u> | <u>Electric</u> | <u>Gas</u> |
| 2010 | 11.0% | 10.5% |
| 2012-14 | 11.5% | 11.0% |
| Utility Proxy Group | | 10.7% |

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As noted earlier, because the capital market crisis and ensuing recovery have created a number of problems in applying the CAPM, I largely disregarded the resulting cost of equity estimates. Based on my assessment of the relative strengths and weaknesses inherent in each method, and conservatively giving less emphasis to the upper- and lower-most boundaries of the range of results, I concluded that the cost of common equity indicated by my analyses is in the 10.9 percent to 12.5 percent range.

1 **C. Flotation Costs**

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

4 A. The common equity used to finance the investment in utility assets is
5 provided from either the sale of stock in the capital markets or from retained
6 earnings not paid out as dividends. When equity is raised through the sale of
7 common stock, there are costs associated with “floating” the new equity securities.
8 These flotation costs include services such as legal, accounting, and printing, as well
9 as the fees and discounts paid to compensate brokers for selling the stock to the
10 public. Also, some argue that the “market pressure” from the additional supply of
11 common stock and other market factors may further reduce the amount of funds a
12 utility nets when it issues common equity.

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

15 A. No. While debt flotation costs are recorded on the books of the utility,
16 amortized over the life of the issue, and thus increase the effective cost of debt
17 capital, there is no similar accounting treatment to ensure that equity flotation costs
18 are recorded and ultimately recognized. No rate of return is authorized on flotation
19 costs necessarily incurred to obtain a portion of the equity capital used to finance

1 plant. In other words, equity flotation costs are not included in a utility's rate base
2 because neither that portion of the gross proceeds from the sale of common stock used
3 to pay flotation costs is available to invest in plant and equipment, nor are flotation
4 costs capitalized as an intangible asset. Unless some provision is made to recognize
5 these issuance costs, a utility's revenue requirements will not fully reflect all of the
6 costs incurred for the use of investors' funds. Because there is no accounting
7 convention to accumulate the flotation costs associated with equity issues, they must
8 be accounted for indirectly, with an upward adjustment to the cost of equity being
9 the most logical mechanism.

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

12 A. There are any number of ways in which a flotation cost adjustment can
13 be calculated, and the adjustment can range from just a few basis points to more
14 than a full percent. One of the most common methods used to account for flotation
15 costs in regulatory proceedings is to apply an average flotation-cost percentage to a
16 utility's dividend yield. Based on a review of the finance literature, *Regulatory*
17 *Finance: Utilities' Cost of Capital* concluded:

1 The flotation cost allowance requires an estimated adjustment to the
2 return on equity of approximately 5% to 10%, depending on the size
3 and risk of the issue.⁶⁴

4 Alternatively, a study of data from Morgan Stanley regarding issuance costs
5 associated with utility common stock issuances suggests an average flotation cost
6 percentage of 3.6%.⁶⁵

7 Issuance costs are a legitimate consideration in setting the return on equity for
8 a utility, and applying these expense percentages to a representative dividend yield
9 of 4.5 percent implies a flotation cost adjustment on the order of 16 to 45 basis
10 points.

11 **Q. Has the WUTC previously recognized that flotation costs are**
12 **properly considered in setting the allowed ROE?**

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

16 The Commission also agrees with both Dr. Avera and Dr. Lurito that a
17 25 basis point markup for flotation costs should be made. This amount
18 compensates the Company for costs incurred from past issues of
19 common stock. Flotation costs incurred in connection with a sale of
20 common stock are not included in a utility's rate base because the

⁶⁴ Roger A. Morin, *Regulatory Finance: Utilities' Cost of Capital*, 1994, at 166.

⁶⁵ *Application of Yankee Gas Services Company for a Rate Increase*, DPUC Docket No. 04-06-01, Direct Testimony of George J. Eckenroth (Jul. 2, 2004) at Exhibit GJE-11.1. Updating the results presented by Mr. Eckenroth through April 2005 also resulted in an average flotation cost percentage of 3.6%.

1 portion of gross proceeds that is used to pay these costs is not available
2 to invest in plant and equipment.⁶⁶

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

5 A. After incorporating an adjustment for flotation costs of 20 basis points
6 to my “bare bones” cost of equity range, I concluded that my analyses indicate a fair
7 ROE in the 11.1 percent to 12.7 percent range.

8 **IV. RETURN ON EQUITY FOR AVISTA CORP.**

9 **Q. What is the purpose of this section?**

10 A. In addition to presenting the conclusions of my evaluation of a fair rate
11 of return on equity range for Avista, this section also discusses the relationship
12 between ROE and preservation of a utility’s financial integrity and the ability to
13 attract capital under reasonable terms on a sustainable basis.

14 **A. Implications for Financial Integrity**

15 **Q. Why is it important to allow Avista an adequate return on equity?**

16 A. Given the importance of the utility industry to the economy and
17 society, it is essential to maintain reliable and economical service to all consumers.
18 While Avista remains committed to provide reliable utility service, a utility’s ability
19 to fulfill its mandate can be compromised if it lacks the necessary financial

⁶⁶ *Third Supplemental Order*, WUTC Docket No. UE-991606, et al., p. 95 (September 2000).

1 wherewithal or is unable to earn a return sufficient to attract capital. Coupled with
2 the ongoing potential for energy market volatility, Avista's exposure to variations in
3 hydroelectric generation and natural gas price volatility, along with plans for
4 significant infrastructure investment, pose a number of potential challenges that
5 might require the relatively swift commitment of significant capital resources in
6 order to maintain the high level of service that customers have come to expect.
7 Investors' increased reticence to supply additional capital during times of crisis
8 highlights the necessity of preserving the flexibility necessary during a period of
9 uncertain economic and financial market conditions. These considerations heighten
10 the importance of allowing Avista an adequate return on the fair value of its
11 investment.

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

14 A. As documented earlier, the major rating agencies have warned of
15 exposure to uncertainties associated with political and regulatory developments.
16 Investors recognize that constructive regulation is a key ingredient in supporting
17 utility credit ratings and financial integrity, particularly during times of adverse
18 conditions.

19 With respect to Avista specifically, the major bond rating agencies have

1 explicitly cited the potential that adverse regulatory rulings could compromise the
2 Company's credit standing. Of particular concern to investors is the impact of
3 regulatory lag and cost-recovery on Avista's ability to earn its authorized ROE and
4 maintain its financial metrics, with Moody's concluding that:

5 Failure to obtain adequate and timely support for recovery of and
6 return on core utility investments through pending and expected
7 future regulatory proceedings ... could have negative ratings
8 implications.⁶⁷

9 S&P observed that rate relief will remain critical to Avista's credit outlook,⁶⁸ and
10 concluded that "regulatory lag will continue to be a drag on the company's ability to
11 earn its authorized ROE."⁶⁹

12 For Avista, these concerns are magnified by the fact that its credit standing is
13 poised on the precipice between investment and speculative grade ratings. While
14 the Company's efforts to regain an investment grade credit rating have been
15 successful, Avista's financial metrics remain pressured. As Mr. Thies confirms in his
16 testimony, regulatory support will be a key driver in securing additional
17 improvement in the Company's financial health. Further strengthening Avista's

⁶⁷ Moody's Investors Service, "Credit Opinion: Avista Corp.," *Global Credit Research* (Dec. 3, 2008).

⁶⁸ Standard & Poor's Corporation, "U.S. Electric Utility Credit Quality Remains Strong Amid Continuing Economic Downturn," *RatingsDirect* (Dec. 19, 2008).

⁶⁹ Standard & Poor's Corporation, "Avista Corp.'s Corporate Credit Rating Raised One Notch To 'BBB-', " *RatingsDirect* (Feb. 7, 2008).

1 financial integrity is imperative to ensure that the Company has the capability to
2 maintain an investment grade rating while confronting potential challenges.

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

4 A. Yes. While providing an ROE that is sufficient to maintain Avista's
5 ability to attract capital, even in times of financial and market stress, is consistent
6 with the economic requirements embodied in the U.S. Supreme Court's *Hope* and
7 *Bluefield* decisions, it is also in customers' best interests. Ultimately, it is customers
8 and the service area economy that enjoy the benefits that come from ensuring that
9 the utility has the financial wherewithal to take whatever actions are required to
10 ensure reliable service. By the same token, customers also bear a significant burden
11 when the ability of the utility to attract necessary capital is impaired and service
12 quality is compromised. As Moody's recently concluded:

13 Inadequate attention to these challenges could conceivably push much
14 of this sector into the non-investment grade category. For now, we
15 think this unlikely, since most utility companies, regulators and
16 politicians would prefer to see the industry remain financially healthy
17 and investment-grade—especially because increasingly expensive and
18 uncertain financing would have adverse consequences for customers.
19 The recent financial turmoil has underscored the benefits of strong
20 credit ratings.⁷⁰

⁷⁰ Moody's Investors Service, "Electric Utilities Face Challenges Beyond Near-Term," *Industry Outlook* (Jan. 2010).

1 **B. Return on Equity Recommendation**

2 **Q. What then is your conclusion as to a fair rate of return on equity**
3 **range for Avista?**

4 A. As explained above, based on the capital market oriented analyses for
5 the utility and non-utility proxy groups described in my testimony, I concluded that
6 the “bare bones” cost of equity range was 10.9 percent to 12.5 percent, or 11.1
7 percent to 12.7 percent after incorporating an allowance for flotation costs.
8 Considering capital market expectations, the potential exposures faced by Avista,
9 and the economic requirements necessary to maintain financial integrity and
10 support additional capital investment even under adverse circumstances, it is my
11 opinion that this represents a fair and reasonable ROE range for Avista.

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

14 A. My evaluation indicates that Avista’s requested ROE of 10.9 percent
15 represents a conservative estimate of investors’ required rate of return. Given the
16 fact that the Company’s requested ROE falls at the lower bound of “bare bones” cost
17 of equity range, it should be viewed as an absolute floor in establishing rates for
18 Avista. This conclusion is reinforced by the need to buttress the Company’s credit
19 standing, which remains relatively weak, as well as the pressures of funding

1 significant capital expenditures and meeting increased operating risks, including
2 those associated with Avista's reliance on hydroelectric generation and exposure to
3 volatility in natural gas and wholesale power markets. The reasonableness of a
4 minimum 10.9 percent ROE for Avista is also supported by the Company's relatively
5 greater risks as compared with the proxy groups, the higher uncertainties associated
6 with Avista's relatively small size, and the need to consider the implications of
7 regulatory lag.

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

9 A. Yes.