Exhibit No.___(MPG-1T)
Docket Nos. UE-110876/UG-110877/UE-120436/UG-120437
Witness: Michael P. Gorman

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant,	)	Docket No. UE-110876
	)	Docket No. UG-110877
v.	)	Docket No. UE-120436
	)	Docket No. UG-120437
AVISTA CORPORATION d/b/a AVISTA UTILITIES, Respondent.	)	*(consolidated)*

RESPONSIVE TESTIMONY OF MICHAEL P. GORMAN

ON BEHALF OF

THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

September 19, 2012

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. WHAT IS YOUR OCCUPATION?

A. I am a consultant in the field of public utility regulation and a managing principal of Brubaker & Associates, Inc., energy, economic and regulatory consultants.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A. These are set forth in Exhibit No.___(MPG-2).

Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A. I am appearing on behalf of the Industrial Customers of Northwest Utilities ("ICNU").

Q. WHAT IS THE SUBJECT OF YOUR TESTIMONY?

A. I will comment on Avista Corporation d/b/a Avista Utilities' ("Avista" or the "Company") proposed attrition year cost of service adjustment, and I will recommend a fair return on common equity and overall rate of return for Avista.

I. SUMMARY

Q. PLEASE SUMMARIZE YOUR TESTIMONY CONCERNING AVISTA'S ATTRITION YEAR COST OF SERVICE ADJUSTMENT.

A. Avista's proposed attrition year cost of service adjustment should be rejected. This attrition year cost of service adjustment is inappropriate and should not be used to develop a revenue deficiency for Avista in this case for the following reasons:

1. Avista proposes an attrition year adjustment to its cost of service in order to reduce the number of rate cases to calibrate its rates to its cost of service. However, Avista's proposal accomplishes this goal by setting prices above its cost of service. A process that produces excessive prices will materially erode customer protections in the ratemaking process.

2. Avista's proposed attrition year adjustment to its cost of service proposed by Avista witness Andrews in this case is an inexact measurement of costs, and unreliable method of estimating a revenue deficiency. Her adjustment produces an excessive cost of service and substantial overstatement of Avista's cost of service and revenue deficiency.

3. Avista's proposed trending methodology in support of its attrition year adjustment is materially flawed, and a wholly inexact method of estimating costs, revenue deficiency and rate-setting trends. Therefore, it should not be relied upon to develop rate-setting policy in Washington.

Q. PLEASE SUMMARIZE YOUR RETURN ON EQUITY RECOMMENDATIONS.

A. Based on my proposed capital structure, I recommend the Washington Utilities and Transportation Commission (the "Commission") award Avista a return on common equity of 9.40% and an overall rate of return of **7.48%**, as shown in Exhibit No.___(MPG-3).

If Avista's proposed modifications to its rate mechanisms and attrition year cost of service adjustments are approved, then I recommend the Commission award a return on equity at the low end of my estimated return on equity range, or 9.1%. Avista's proposed changes to its regulatory mechanisms will substantiate reduce its operating risk, and shift significant sales and operating risks to its retail customers. This shift in risk justifies a reduction in the authorized return on equity to mitigate Avista's rate increase and compensate customers for taking more of shareholders' operating risk for utility operations.

My recommended return on equity range and the Company's actual capital structure will provide Avista with an opportunity to realize cash flow financial coverages and balance sheet strength that support Avista's current investment grade bond rating. Consequently, my recommended return on equity range represents fair

compensation given Avista's investment risk, and it will preserve the Company's financial integrity and credit standing.

Further, I recommend adjustments to Avista's proposed ratemaking capital structure. I recommend the common equity supporting Avista's non-regulated operations be removed from the capital structure used to develop the overall rate of return for regulated operations. This adjustment is necessary in order to eliminate any subsidies between regulated and non-regulated operations, and is a better estimate of the true cost of capital supporting Avista's utility business. My proposed adjustments to Avista's capital structure would reduce the common equity ratio from the 48.4% proposed by Avista down to 47.3%.

I will also respond to Avista witness Dr. William E. Avera's proposed return on equity of 10.90%. For the reasons discussed below, Dr. Avera's recommended return on equity is excessive and should be rejected.

Q. HOW DID YOU ESTIMATE AVISTA'S CURRENT MARKET COST OF EQUITY?

A. I performed analyses using three Discounted Cash Flow ("DCF") models, a Risk Premium ("RP") study, and a Capital Asset Pricing Model ("CAPM"). These analyses used a proxy group of publicly traded companies that have investment risk similar to Avista. Based on these assessments, I estimate Avista's current market cost of equity to be 9.40%.

Q. WHAT IS THE REVENUE IMPACT OF YOUR RETURN ON EQUITY AND CAPITAL STRUCTURE ADJUSTMENTS?

A. The revenue impact from reducing Avista's return on equity from 10.90% to 9.40% and reducing the common equity ratio from 48.4% to 47.4% lowers the Company's Washington jurisdictional revenue requirements by $15.5 million.

II. ATTRITION REVENUE REQUIREMENT ADJUSTMENT

Q. DID AVISTA INCLUDE AN ATTRITION REVENUE REQUIREMENT ADJUSTMENT IN ITS COST OF SERVICE?

A. Yes. As shown in the schedules attached to Avista witness Elizabeth M. Andrews' testimony, the Company increased its claimed revenue deficiency from $20.99 million to $41.5 million to reflect an attrition year adjustment to its traditional cost of service.[1/] The principle underlying the Company's claim for an attrition year cost of service adjustment is described in Avista witness Mark Lowry's testimony.[2/] The actual application of the attrition year adjustment to Avista's cost of service in this case is included in Avista witness Ms. Andrews' testimony and exhibits.

Q. IS THE COMPANY'S PROPOSED ATTRITION YEAR COST OF SERVICE ADJUSTMENT FAIR AND REASONABLE?

A. No. The Company's proposed attrition year cost of service adjustment outlined in Mr. Lowry's testimony is severely flawed and is not a fair method of setting rates in a way that balances the interests of investors and ratepayers. Further, the actual application of the attrition year adjustment outlined in Ms. Andrews' testimony is not the same as that advocated by Mr. Lowry. Mr. Lowry's cost trend study represents a material break from traditional cost of service. Traditional cost of service provides a transparent and verifiable revenue requirement using standard accounting rules, and a clear measure of fair compensation and cost of service. In significant contrast, Mr. Lowry's trending methodology is a highly inexact and flawed method of estimating a utility's cost of providing service. Therefore, Mr. Lowry's trending methodology cannot be relied on to ensure that rates are set at a just and reasonable level.

1/ Exh. No. ___ (EMA-2) at 9 (Andrews).
2/ Exh. No. ___ (MNL-1T) (Lowry).

Mr. Lowry's trending assumptions ignore management's obligation to manage costs and mitigate cost escalation by improving productivity, pursuing cost reduction opportunities and enhancing system efficiency. Indeed, Mr. Lowry's analysis simply ignores the benefits that can be created by effective utility management, a productive/efficient work force, and technological advances.

Q. WHY DOES MR. LOWRY BELIEVE AN ATTRITION YEAR ADJUSTMENT TO AVISTA'S COST OF SERVICE IS APPROPRIATE?

A. Mr. Lowry believes that Avista has an under-earning problem because the traditional rate-setting mechanisms in Washington do not fully capture Avista's increasing cost of service. He references the Company's elevated and sustained capital expenditure program, which is causing rate base growth and limiting Avista's ability to recover its cost of service (earn its authorized return on equity) when rates are in effect.

He notes that Avista's Washington electric operations have under-earned for at least the last five years.[3/] Mr. Lowry believes that mitigating the under-earning problem will allow utilities to attract capital under more reasonable terms, and benefit customers because rate cases would be filed less frequently. He also believes that mitigation of under-earnings will send customers better price signals about cost that will help them make better consumption decisions.

Q. IS MR. LOWRY'S PROPOSED ATTRITION MECHANISM IN AVISTA'S WASHINGTON RETAIL COST OF SERVICE APPROPRIATE?

A. No. There are material flaws to Mr. Lowry's proposed attrition adjustment to cost of service. These flaws include the following:

Customers' interests are not protected, and they do not receive better price signals if the utility rates are not based on a revenue requirement that reflects efficient

[3/] Exh. No. ___ (MNL-1T) at 10-12.

cost management. If prices are set too high, a utility could earn more than its allowed return on equity, and file fewer rate cases, but customers are not better off if prices are set above the utility's cost of service.

By setting prices too high, Mr. Lowry would erode utility management's economic incentive to aggressively manage costs in order to achieve its earnings target. Using Mr. Lowry's trending methodologies to project future cost ignores productivity cost enhancements, competitive procurement of service to reduce cost escalation, and overall demands on employees to enhance productivity to mitigate cost escalation. Mr. Lowry's analysis is completely devoid of the customers' right to expect utility management to produce achievable cost efficiencies and productivity gains.

Mr. Lowry's attrition trending methodology produces a wildly inexact and unreliable cost of service in this case. His projections are internally inconsistent and his trending methodology would perpetuate a grossly mismanaged utility.

Q. PLEASE EXPLAIN WHY CUSTOMERS ARE NOT BETTER OFF WITH THE COMPANY'S PROPOSED ATTRITION YEAR COST OF SERVICE ADJUSTMENT.

A. The Company's attrition year cost of service in this proceeding would double its claimed revenue deficiency in this case—$20.99 million up to $41.5 million. The effect of increasing the cost of service in this proceeding would be to substantially increase the Company's earned rate of return, likely to well above the authorized rate of return during at least the first year the rates will be in effect. Specifically, the Company's proposed two-year attrition period will result in rates that are designed to produce over-earnings in the first year the rates are in effect, and earn the authorized return in the second year the rates are in effect. This proposal to produce an excessive

cost of service over the two-year attrition period and will cause customers to pay excessive rates, on average over the two-year period.

The existence of the cost pressures and the desire of management to earn the target return on equity are the very basis of the economic incentives which drive management to be as efficient as possible in minimizing its escalation of its costs, and to realize revenue that provides it an opportunity to earn its authorized return on equity. Using an attrition year cost of service methodology which produces rates that reflect an elevated cost of service level based on projected future cost increases will reduce management's incentive and need to limit escalation of its cost of service. As such, under the Company's proposed attrition year cost of service adjustment, earning the target return on equity will be a function of trending methodologies and other economic studies used to inflate the cost of service in rate case filings, rather than keeping the burden on management to control its cost of service while the rates are in effect in order to realize the profit opportunities provided in the last rate case. The Company's attrition year adjustment will simply eliminate the incentive for management to be as efficient as possible.

Q. ARE CUSTOMERS BETTER OFF WITH FEWER RATE CASES?

A. Not necessarily. It is far more efficient and cost competitive for customers to pay for more frequent rate cases and the related rate case expense than to pay rates that are inflated by $21 million to reflect projected cost increases that may be incurred while the rates are in effect. Therefore, customers are far better off under traditional ratemaking practices than they are under the Company's proposed attrition year cost of service principles, even if rate cases are filed annually.

Q. PLEASE EXPLAIN WHY UTILITY MANAGEMENT'S ECONOMIC INCENTIVE TO MANAGE COSTS WOULD BE ERODED UNDER MR. LOWRY'S ATTRITION YEAR COST OF SERVICE ADJUSTMENTS.

A. Managing cost of service to realize earnings targets based on a prescribed efficient pricing structure is critical to create an economic incentive for management to be as efficient as possible. Non-regulated companies are forced to manage their cost structures to achieve profit targets while taking prices set by the market. In contrast, a regulated entity must also pursue every opportunity to manage its cost of service in order to realize its profit targets at a pricing structure that is just and reasonable.

Modifying the traditional ratemaking practices to simply increase cost of service to inflate rates—that is, to provide an easier road for the Company to realize its earnings target—reduces management's incentive to be efficient.

MR. LOWRY'S ATTRITION STUDY

Q. PLEASE EXPLAIN WHY MR. LOWRY'S ATTRITION COST TRENDING METHODOLOGY PRODUCES A FLAWED AND UNRELIABLE COST OF SERVICE PROJECTION.

A. Mr. Lowry's attrition year trending analysis is unreliable for the following reasons:

The accuracy of his projected revenue growth is problematic. His projected billing unit growth reflects an increase in the number of customers, an increase in the volume billing units (kWh), but a decrease in the billing demand units for all rate classes.[4/] The effect of Mr. Lowry's billing unit changes suggests there will be a material increase in the load factors for all rate classes—General Service, Large General Service, and Extra Large General Service customers. This would, of course, be desirable because it would increase the utilization of utility assets. However, this increase in the load characteristics of all customers is material and will impact

[4/] Exh. No.___(MNL-4).

Avista's cost of providing service. Such a material change to load characteristics should not be based on a simple trending analysis, but should rather be based on more detailed assessment of the actual load characteristics of customers.

Further, the trending period relied on by Mr. Lowry includes one of the worst economic recessions the U.S. has ever experienced. Hence, the trending study may reflect changes in load characteristics and consumption that were caused by a distressed economy and not by changes to normal customer consumption patterns. As such, Mr. Lowry's analysis simply is unreliable.

Mr. Lowry's trending study includes a projected escalation for operating expenses of 9.71% during the period 2011 through 2013, a two-year period. This projected escalation of operating expenses represents an escalator that is more than twice the expected level of inflation over the same time period. Hence, Mr. Lowry's operations and maintenance ("O&M") expense projections reflect a complete failure of management to control operating expenses. Indeed, it is reasonable to expect that management would maintain operating expense escalation at a rate equal to or less than the rate of inflation. The escalation could be lower than the rate of inflation if management achieves productivity gains in managing costs.

Also, the trend in the study relied on by Mr. Lowry likely did reflect the existence of recent non-recurring, abnormal, and unpredictable O&M expense escalation. For example, pension expense has been driven by changes in the valuation of the pension trust fund asset. Also, increases in employee benefits costs may not trend forward in the same level as in the past, due to changes in health care insurance. Mr. Lowry's trending study is not reliable.

Further, Mr. Lowry's projected increase in depreciation expense (15.38% escalation) and rate base growth (12.95%) are internally inconsistent. Depreciation expense will increase with the level of growth in utility gross plant investment. If gross plant investment increases at a 12.95% rate, then depreciation expense should also increase at a 12.95% rate. Mr. Lowry's assumption for a faster depreciation expense escalation than gross plant investment escalation can only be accomplished by changing depreciation rates each year. Mr. Lowry's trending study is not reliable because his projected growth rate for depreciation expense is inconsistent with his expected growth rate of gross plant investment.

Further, his buildup of accumulated depreciation will change with the level of growth in depreciation expense. Again, Mr. Lowry's projected increase in accumulated depreciation of 12.95% is inconsistent with his projected growth rate of depreciation expense (15.38%). Mr. Lowry simply is not accumulating additional depreciation expense increases to offset gross plant additions in calculating net plant in his attrition year forecast. These inconsistencies result in a misstatement of rate base, and an overstatement of Avista's cost of service.

Mr. Lowry has also ignored changes in the utility's cost of capital. The Company's own evidence[5/] indicates that the Company is refinancing existing debt instruments at lower interest rates, which is lowering its cost of capital. This reduction in the cost of capital and the overall rate of return are ignored by Mr. Lowry in his trending attrition year cost projections. Therefore, he is again overstating Avista's cost of service.

[5/] Exh. No.___(MTT-1T) at 5 (Thies).

Further, had Mr. Lowry trended changes in utilities' operating income he would show a significant decline in that trend caused by declines in the cost of capital, offset by growth in rate base. Hence, his capital market costs have been steadily declining over the last three to five years (declining capital costs are referenced later in my testimony). This capital cost decline offsets the increasing cost caused by rate base growth. This offsetting trend was ignored in Mr. Lowry's trending analysis.

Ms. Andrews' Attrition Adjustment

Q. PLEASE DESCRIBE HOW MS. ANDREWS INCLUDES THE ATTRITION ADJUSTMENT IN HER ESTIMATE OF AVISTA'S COST OF SERVICE IN THIS CASE.

A. Ms. Andrews developed the Company's claimed revenue deficiency on her Exhibit EMA-2. As shown on pages 5 through 8 of that exhibit, she includes the Company's 2011 results of operations, describes certain adjustments to the cost of service and produces a restated amount on page 7, and then proposes several pro forma adjustments to year-end 2011 cost of service. She adds alternative attrition year adjustments by adding the revenue requirement effect of planned capital additions for calendar year 2012, and 13-month average capital additions for calendar year 2013, plus demand-side management ("DSM") and other adjustments.

Q. DOES MS. ANDREWS' PROPOSED ATTRITION YEAR ADJUSTMENT TO AVISTA'S COST OF SERVICE PRODUCE A BALANCED AND REASONABLE REVENUE REQUIREMENT USED TO SET RATES IN THIS PROCEEDING?

A. No. Ms. Andrews' attrition year cost of service adjustment is a one-sided self-serving exercise that inflates the Company's cost of service. She intentionally inflates the Company's cost of service for a 2011 test year for cost increases projected out through 2013. However, she ignores revenue growth at current rates produced through

increasing customers and sales growth through 2013. As such, she has designed a methodology that escalates some cost of service but ignores cost decreases and revenue growth. The Commission cannot rely on this attrition adjustment to set just and reasonable rates.

Q. WHY IS MS. ANDREWS' PROPOSED ATTRITION YEAR COST OF SERVICE NOT REASONABLE?

A. There is a substantial mismatch between the calendar year revenues (2011) and the calendar year rate base costs (2013). Ms. Andrews ignores growth in revenues in her attrition year projections. Mr. Lowry's billing growth projects growth in base revenues of $11.197 million between 2011 and 2013. Although I have concerns that Mr. Lowry understated sales growth revenue because of his optimistic projections of demand unit declines, this projected revenue growth largely offsets the increase in revenue requirement for rate base growth ($16.25 million) projected by Ms. Andrews.

To her credit, Ms. Andrews did not include the highly unreliable and flawed O&M expense projection methodology proposed by Mr. Lowry. However, she also did not consider the projected decrease in cost of capital likely to be realized by Avista as it refinances its existing embedded debt at lower interest rates, and increases its outstanding debt at marginal interest rates that are below the embedded interest rates. These cost of capital savings will offset the revenue requirement increase caused by rate base growth. Ms. Andrews' attrition study ignores cost reductions.

Q. HOW DO YOU INTERPRET THE ATTRITION YEAR ADJUSTMENT PROPOSED BY MS. ANDREWS?

A. The Company's revenue growth projections of $11.2 million through 2013 (at current rates) will largely offset the increased revenue requirement for the two-year rate base growth estimated by Ms. Andrews of $16.3 million. Again, however, Ms. Andrews'

revenue requirement adjustment does not include an expectation of lower cost of capital as Avista embedded debt costs decline. As such, the revenue growth at current rates will largely offset the increase in the Company's cost of service produced through rate base growth.

Ms. Andrews' projection for a DSM cost of service increase is based on lost sales revenue. This outlook simply is not justified. Conservation may mitigate growth in sales, but Ms. Andrews has provided no evidence that it would actually result in lower sales. If conservation results in a lower growth in Avista's sales, then revenues will not decline—they simply would not go up as high as they otherwise would. Ms. Andrews' DSM adjustment attempts to compensate the Company for lost sales rather than cost changes. This is inappropriate because it provides compensation for more than a fair return on invested capital based on projected sales levels for 2011.

The Company's claim that it will under-earn its return because its rate base is growing is not as material as it asserts. As clearly noted in Ms. Andrews' projections for calendar year 2013, Avista's rate base will actually decline despite $39 million of new capital improvements.[6/] In 2013, the Company's accumulated depreciation will grow by $60 million, which more than offsets the new plant additions. The bottom line is that rate base declines in 2013 over 2012.

Further, the percent growth in rate base will start to slow over time even if Avista maintains an elevated capital spending program. The growth in rate base will slow because Avista will be growing a larger rate base which will mean a smaller percent change in rate base assuming a relatively constant capital improvement program. Capital improvement levels cannot increase indefinitely because Avista has

[6/] Exh. No. ___ (EMA-2) at 9.

limited resources to engineer, plan and manage capital improvements to its system. Over time, increases in rate base will start to slow as a percentage of embedded rate base, and elevated additions level off. As a result, the percent increase in Avista's cost of service will start to slow, which will mitigate its under-earning risk associated with a growing rate base. Thus, rate case frequency may start to slow naturally over time as changes in rate base result in a slower growth to rate base.

Q. WOULD CUSTOMERS BE EXPOSED TO EXCESSIVE PRICING IF THE COMPANY'S PROPOSED ATTRITION YEAR COST OF SERVICE METHODOLOGY IS ADOPTED?

A. Yes. The primary determinant underlying the cost justification of the Company's attrition year projections is that it actually goes forward with and increases its rate base in line with its projections. If the Company's projected increases in rate base are lower than it is projecting, then its attrition year cost of service adjustment would be highly flawed. Further, if the Company sales revenue grows at current rates, then the Company's attrition year adjustment will overstate its need for a rate increase. The only way to accurately measure whether or not existing rates are producing adequate revenues is to consider all cost of service—revenues, expenses and invested capital—at the same point in time.

III. ENERGY RECOVERY MECHANISM ("ERM")

Q. PLEASE DESCRIBE AVISTA'S CURRENT ERM.

A. The Company's current and proposed ERM are described on pages 11-12 of William Johnson's direct testimony. Avista's current ERM is subject to a deadband of $4 million. However, if the Company's power supply costs are higher than the costs authorized to be recovered in base rates within the range of $4 million to $10 million, a 50% (Avista)/50% (Customers) sharing mechanism is applied. Conversely, if the

costs are less than expected the Company is subject to 25% (Avista)/75% (Customers). Finally, all costs above $10 million are recovered on the basis of 10% (Avista)/90% (Customers).

Q. HOW IS THE COMPANY PROPOSING TO MODIFY THE EXISTING ERM.

A. Avista is proposing to remove the existing $4 million deadband and sharing bands, $4 million to $10 million, and strictly recover all costs on the basis of 10% (Avista)/90% (Customers), which will reduce the Company's risk and will further stabilize its earnings and cash flows, while exposing the customers to greater volatility.

Q. WHY DO YOU BELIEVE THAT THESE MODIFICATIONS TO THE ERM WILL LOWER AVISTA'S OPERATING RISK?

A. The proposed modifications to the ERM represent a deferral mechanism that provides a safety net to ensure that Avista will more likely earn its authorized return on equity. As such, this mechanism mitigates Avista's operating risk and will strengthen its earnings and cash flow in support of its utility operations. Indeed, as noted on page 13 of Mr. Johnson's testimony, removing the deadband and sharing bands will be viewed positively by credit and security analysts.

Q. DOES THE CURRENT ERM BALANCE COMMODITY COST RECOVERY RISK BETWEEN THE COMPANY AND ITS CUSTOMERS?

A. To a significant extent, yes. Indeed, the Company is able to implement hedging strategies with suppliers to help manage its commodity cost recovery risk. Mr. Johnson describes at pages 15 and 16 of his testimony how the Company implements hedging strategies to manage the full cost recovery of commodity costs, but notes that these recovery mechanisms typically do not close all open positions while rates are in effect. Hedging mechanisms reduce the risk of major increases in power supply costs due to significant increases in natural gas prices, power prices, or low hydro

conditions requirements for reliance on higher cost energy resources. While the Company does have some means to mitigate its commodity procurement risk, customers do not have these risk management options. Therefore, it is a reasonable balance to include a deadband in the implementation of an ERM because it provides the Company with the incentive to aggressively manage power supply costs within that deadband, for the benefit of itself and its customers. This deadband in turn provides the Company with clear parameters around its projected power costs to implement its hedging strategies and provides customers with stable ERM costs within the deadband.

Q. HAVE OTHER JURISDICTIONS EXPERIENCED A REDUCTION IN RISK AND A LOWER RETURN ON EQUITY BY IMPLEMENTATION OF SIMILAR MECHANISM?

A. Yes. Other jurisdictions have recognized that such earnings stabilization mechanisms do reduce risk to investors. Importantly, these same regulatory commissions recognize that a recovery 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 similar programs include the following:

- In an order concerning Portland General Electric Company ("PGE"), the Oregon Public Utility Commission ("OPUC"), 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 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 OPUC found

that the regulatory mechanisms did shift risk to customers and reduced risk to investors. The OPUC 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.[7/]

Q. IF THE COMMISSION MODIFIES AVISTA'S CURRENT ERM, DO YOU RECOMMEND AN ADJUSTMENT TO YOUR PROPOSED RETURN ON EQUITY?

A. Yes. If Avista's ERM mechanism is modified as proposed by the Company, then I recommend Avista's return on equity be reduced to reflect this risk reduction created by the modified ERM. If the Commission approves the proposed modifications, then I recommend Avista's return on equity to develop an overall rate of return for its electric utility operations be reduced by 30 basis points, or from 9.40% to 9.10%. This return on equity is at the low end of my recommended range for Avista, but reflects the significant risk reduction to Avista created by the proposed modifications to the existing ERM.

[7/] Application of Conn. Natural Gas Corp. for a Rate Increase, DPUC Docket No. 08-12-06, Decision at 75-76 (June 30, 2009).

Q. HOW DID YOU DETERMINE AN APPROPRIATE RETURN ON EQUITY ADJUSTMENT TO REFLECT THE RISK REDUCTION CREATED BY THE PROPOSED MODIFICATIONS TO THE CURRENT ERM?

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.

As described later in my testimony and as shown on Exhibit No.___(MPG-15), page 1, the average annual spread between an "A" and "Baa" utility bond yield over the last 32 years has been 42 basis points, and the spread between an "Aaa" and "Baa" corporate bond yield has been approximately 22 basis points. I think this reasonably approximates an adjustment to market-required return to reflect improved cost recovery and reduced risk.

However, I do not recommend the Commission approve a return on equity that is outside of my estimated range for Avista. The range between my midpoint (9.4%) and the low-end of my estimated range of 9.1% is 30 basis points. This is generally consistent with the lower risk and return indicated by utility and corporate bonds' yield spreads, but also ensures Avista's approved return is fair and reasonable.

If the Commission adopts the regulatory mechanisms proposed by Avista in this case, and substantially decreases its cost recovery risk, then I recommend its return on equity be awarded at the low-end of my estimated range, or 9.1%.

IV. RATE OF RETURN

Q. HOW DOES YOUR RECOMMENDED RETURN ON EQUITY RANGE COMPARE TO AVISTA'S LAST AUTHORIZED RETURN ON EQUITY?

A. On December 16, 2011, the Commission approved a settlement and issued a final order in Docket Nos. UE-110876/UG-110877. However, the settlement and the order were silent with respect to rate of return or any capital cost components, but authorized Avista to utilize a 7.62% overall rate of return for the purpose of calculating allowance for funds used during construction ("AFUDC") and compliance filings.[8/]

On November 19, 2010, the Commission issued its final order in Avista's rate case (Washington Utilities and Transportation Commission, Docket Nos. UE-100467/UG-100468), which included a return on equity of 10.20%.[9/]

My recommended return on equity range is lower in this case than the return on equity included in Avista's rate case from November 2010. However, this lower return on equity is justified based on clear evidence that capital market costs today are much lower than they were in 2010 when Avista's rates were approved.

Q. WHY DO YOU BELIEVE MARKET COSTS OF CAPITAL ARE LOWER TODAY THAN THEY WERE IN AVISTA'S PRIOR RATE CASE?

A. Market costs of capital have declined since Avista's UE-100467 rate case. This is illustrated by a comparison of bond yields in this case and the last case, and is evident

8/ WUTC v. Avista Corp., Docket Nos. UE-110876/UG-110877, Order 06 ¶¶ 12, 68 (Dec. 16, 2011).
9/ WUTC v. Avista Corp., Docket Nos. UE-100467/UG-100468, Order 07 ¶¶ 8, 58 (Nov. 19, 2010).

from cost of capital estimates in this case versus the last case. In Table 1 below, I show the change in utility bond yields.

TABLE 1

Capital Costs – Avista Rate Cases

Description	Current Case[1]	Docket No. UE-100467	Yield Change
"A" Rated Utility Bond Yields	4.03%	5.15%	1.12%
"Baa" Rated Utility Bond Yields	4.89%	5.67%	0.78%
13-Week Period Ending	08/10/2012	11/19/2010	

Source:
[1]Exhibit No.___(MPG-16), page 1.

As shown in Table 1 above, the current market cost of debt for "A" and "Baa" rated utility bond yields has decreased in this case relative to Avista's last rate case. The current "A" rated utility bond yield is approximately 1.10 percentage points lower now than it was in Avista's last rate case. Also, the current "Baa" utility bond yield is approximately 0.80 percentage points lower than during Avista's last rate case.

Utility bond yields have declined by approximately 0.80 to 1.10 basis points since Avista's last rate case. This decline in utility bond yields suggests that Avista's cost of capital is lower now than it was in its last rate case.

Electric Utility Industry Market Outlook

Q. PLEASE DESCRIBE THIS SECTION OF YOUR TESTIMONY.

A. I begin my estimate of a fair return on equity for Avista by reviewing the market's assessment of electric utility industry investment risk, credit standing, and stock price performance in general. I used this information to get a sense of the market's

perception of the risk characteristics of electric utility investments in general, which is then used to produce a refined estimate of the market's return requirement for assuming investment risk similar to Avista's utility operations.

Based on the assessments described below, I find the credit rating outlook of the industry to be strong and supportive of the industry's financial integrity, and electric utilities' stocks have exhibited strong price performance over the last several years.

Based on this review of credit outlooks and stock price performance, I conclude that the market has again embraced the electric utility industry as a safe-haven investment, and views utility equity and debt investments as low-risk securities.

Q. PLEASE DESCRIBE THE ELECTRIC UTILITIES' CREDIT RATING OUTLOOK.

A. Electric utilities' credit rating outlook has improved over the recent past and is now stable. Standard &Poor's ("S&P") recently provided an assessment of the credit rating of U.S. electric utilities. S&P's commentary included the following:

> Standard & Poor's Ratings Services' believes the outlook for credit quality in the U.S. investor-owned regulated electric, gas, and water utility sectors for the remainder of 2012 and into 2013 will remain stable. These companies have weathered the challenging economic environment of the past few years with little lasting effect on their financial risk profiles. The essential service that utilities provide and the rate-regulated nature of the business enable them to generate reasonably steady and predictable cash flows through timely recovery of their costs from ratepayers, despite economic conditions and ongoing heavy investment needs. As a result, we expect their credit quality to remain stable.
>
> * * *

Industry Credit Outlook

> Liquidity is adequate for most utilities. Investor appetite for utility debt remains healthy, with deals continuing to be oversubscribed. The companies' near-term debt maturities appear manageable and we think they will likely refinance these with new debt or borrowings under revolving credit facilities. Credit fundamentals indicate that most, if not all, utilities should continue to have ample access to funding sources and credit. Some have issued common stock to partly fund construction expenditures, which has helped to support capital structure balance. Additionally, many companies are accessing short-term credit markets through commercial paper programs at very low rates. Liquidity is an industry strength and has been improving, and banks are indicating a willingness to lengthen the terms of credit facilities out as far as five years in more and more cases. U.S. regulated utilities have not been significantly hurt by turbulence in the global financial markets.[10/]

Similarly, Fitch states:

Electric Utilities: Stable

> Fitch's Outlook for the electric utility sector in 2012 remains stable. The sector benefits from low interest rates, modest inflationary pressures, open capital markets, and low natural gas and power prices. Fitch expects these conditions to persist into 2013.
>
> The favorable funding environment helps to offset any stress that would otherwise result during an extended period of high projected capital investment. Capex is expected to remain elevated, increasing 5%–6% over 2011 levels.[11/]

Value Line also continues to characterize utility stock investments as a safe haven, even though it notes that investors are now willing to accept more risk:

Conclusion

> The broader market averages have significantly outperformed the Electric Utility Industry thus far in 2012. This represents quite a reversal from last year when investors flocked to utility stocks, seeking safe havens from heightened volatility in other sectors. As economic fears have subsided, the investment community has appeared to

[10/] *Standard & Poor's RatingsDirect on the Global Credit Portal*: "Industry Economic And Ratings Outlook: U.S. Regulated Utilities Will Likely Stay On A Stable Trajectory For The Rest Of 2012 And Into 2013," July 17, 2012 at 2, 5-6 (emphasis added).

[11/] *FitchRatings*: "2012 Outlook: Utilities, Power, and Gas," December 5, 2011 at 10.

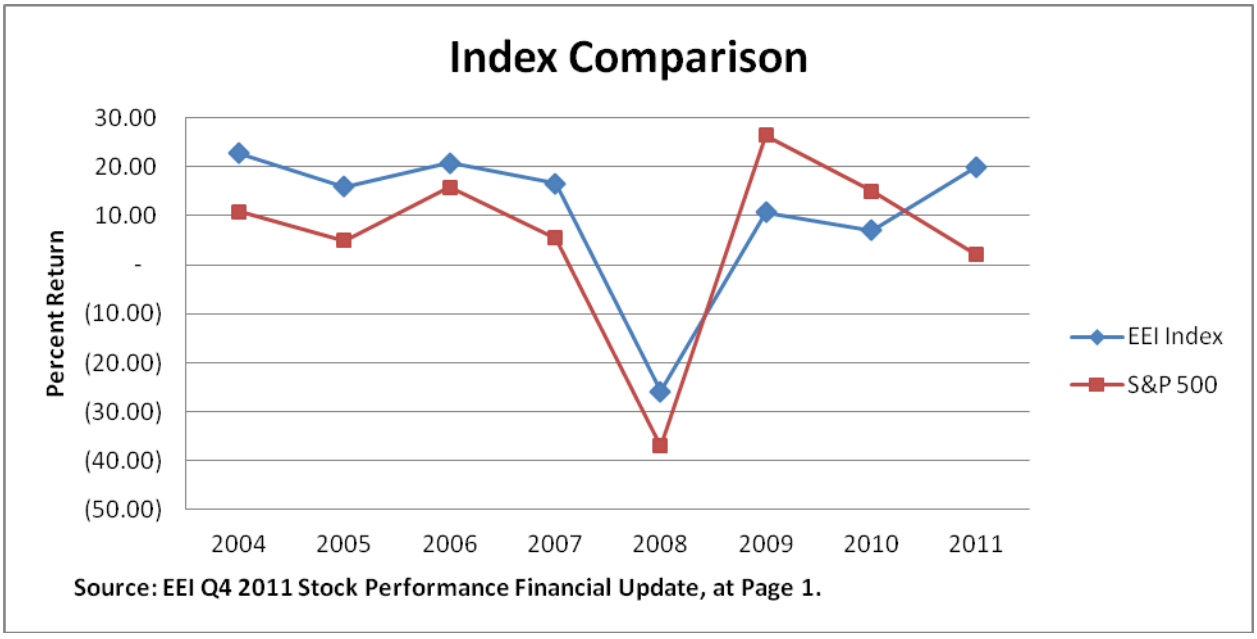
become more venturesome with its stock picks, which may be contributing to the utility underperformance.[12/]

The Edison Electric Institute ("EEI") also opined as follows:

> There was little change during 2011 in the industry's long-term outlook. Many regulated utilities are engaged in capital spending programs that should, according to Wall Street analysts, help drive slow but steady earnings growth over the next several years. New EPA regulations may boost capex by 30% in the years ahead, relative to EEI's latest capex survey estimates.[13/]

Q. PLEASE DESCRIBE ELECTRIC UTILITY STOCK PRICE PERFORMANCE OVER THE LAST SEVERAL YEARS.

A. As shown in the graph below, the EEI has recorded electric utility stock price performance compared to the market. The EEI data shows that its Electric Utility Index has outperformed the market, with a few exceptions, triggered by the recent state of the economic environment.



Source: EEI Q4 2011 Stock Performance Financial Update, at Page 1.

12/ *Value Line Investment Survey*, May 25, 2012 at 137 (emphasis added).
13/ *EEI Q4 2011 Stock Performance* at 1.

During 2009 and 2010, the EEI Index underperformed the market, which is not unusual for stocks that are considered "safe havens" during periods of market turbulence.

In 2011, the EEI Index outperformed the market. EEI states the following:

> **Commentary**
>
> The EEI Index produced a positive 20% return during 2011, its strongest annual gain since 2006, outperforming the broad market after two consecutive years of underperformance as stocks rebounded from the lows reached during 2008 financial crisis.
>
> * * *
>
> The strength of the EEI Index in 2011 is no surprise, highlighting the industry's traditional role as a defensive investment following its reemphasis in recent years of core regulated businesses with slow but predictable earnings growth and steady dividends. In fact, the industry's average dividend yield exceeded 4% during the year, leading that of all other U.S. business sectors.[14/]

Avista Investment Risk

Q. PLEASE DESCRIBE THE MARKET'S ASSESSMENT OF THE INVESTMENT RISK OF AVISTA.

A. The market assessment of Avista's investment risk is best described by credit rating analysts' reports. Avista's current senior secured credit ratings from S&P and Moody's are "A-" and "A3," respectively. The Company's corporate credit ratings from S&P and Moody's are "BBB" and "Baa2," respectively.

S&P specifically stated:

> **Rationale**
>
> The 'BBB' rating on Spokane, Wash.-based Avista Corp. reflects an "excellent" business risk profile and an "aggressive" financial risk profile under Standard & Poor's Ratings Services' corporate risk profile matrix. The business risk profile reflects our view of Avista's stable

[14/] Id. at 1, 4-5.

regulated electric and gas utility operations with low rates. Regulated businesses operate in the near absence of competition with regulated authorized returns. The company's primary risks are the electric utility's exposure to replacement power costs (particularly in low-water years for its hydrogeneration, when it requires more power, which becomes more expensive) and recovery of utility spending in a timely manner; its fuel and purchased-power mechanisms allow it to mitigate the former. The company's management of regulatory relationships in its three jurisdictions, in addition to its strategic focus on regulated utility operations, is a crucial tenet of the excellent business profile.[15/]

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, 2012)

Description	**Percent of Total Capital**
Total Debt	51.6%
Common Equity	48.4%
Total Regulatory Capital Structure	100.0%

Source: Exh. No. (MTT-1T) at 26 (Thies).

Q. HOW DID THE COMPANY DEVELOP ITS PROPOSED CAPITAL STRUCTURE?

A. The Company is proposing a projected December 31, 2012 capital structure. This capital structure is based on the Company's actual 2011 capital structure as filed in

[15/] *Standard & Poor's RatingsDirect on the Global Credit Portal*: "Avista Corp.," July 19, 2012 at 2 (emphasis added).

Avista's 10-K, adjusted for projected equity issuance and debt related to subsidiary transactions.

Q. IS THE COMPANY'S PROPOSED CAPITAL STRUCTURE REASONABLE?

A. No. Avista's proposed capital structure reflects common equity investments supporting non-utility assets. Avista's balance sheet reflects significant investments in subsidiary companies and non-utility investments. Avista removed the short-term debt and some common equity capital related to its subsidiary companies from its proposed capital structure. However, it did not remove all of the common equity capital supporting its non-regulated investments from its regulatory capital structure.

Avista did remove approximately $35 million of common equity to coincide with its removal of affiliate short-term debt. However, Avista has significantly more common equity invested in non-regulated affiliates than $35 million. Hence, as shown on my Exhibit No.___(MPG-3), I removed all common equity associated with net non-utility property and investments in subsidiary companies. This resulted in common equity allocated in non-regulated operations of approximately $90.4 million. $35 million of this was already included by Avista in its adjustments to common equity in Mr. Thies's testimony. Hence, my common equity adjustment removes another $55.4 million from the common equity supporting utility operations.

Q. PLEASE DESCRIBE YOUR PROPOSED ADJUSTMENT TO AVISTA'S CAPITAL STRUCTURE.

A. I propose to remove the common equity supporting non-utility investments from Avista's proposed capital structure as recorded on Avista's FERC Form 3-Q balance sheet as of March 31, 2012, that are non-utility related. These non-utility investments include net non-utility property and investments in subsidiary companies, and other

investments. The amount of these investments has been relatively stable through the last several years, and I assume that they will continue to be stable through the end of the test year. Removing this amount of equity investments from the Company's proposed capital structure, will reduce the amount of common equity to total capital ratio for the ratemaking capital structure.

Q. WHAT CAPITAL STRUCTURE DO YOU PROPOSE BE USED TO SET RATES IN THIS PROCEEDING?

A. As shown in Exhibit No.___(MPG-4), my proposed capital structure reflects Avista's debt and equity capital supporting its regulated operations. The capital structure is consistent with Avista's capital structure approved in Docket No. UE-100467.[16/]

I recommend the capital structure weights shown below in Table 3 be used to develop Avista's overall rate of return.

TABLE 3
ICNU Proposed Capital Structure

Description	Percent of Total Capital
Total Debt	52.7%
Common Equity	47.3%
Total Regulatory Capital Structure	100.0%

Source: Exh. 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

16/ WUTC Docket Nos. UE-100467/UG-100468, Order 07 ¶¶ 8, 58; Settlement Stipulation at 5.

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.

Return on 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 require on an investment in the utility. 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 hallmark decisions of the U.S. Supreme Court: Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n of W. Va., 262 U.S. 679 (1923) and Fed. Power Comm'n 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 using consensus analysts' growth rate projections; (2) a constant growth DCF using sustainable growth rate estimates; (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 share investment risk similar to Avista's.

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. William Avera to estimate Avista's return on equity. However, I excluded Ameren Corp. because its consensus analyst growth rate was negative, likely due to concern at the merchant generation units.

Q. HOW DOES THE PROXY GROUP INVESTMENT RISK COMPARE TO AVISTA'S INVESTMENT RISK?

A. The proxy group is shown in Exhibit No.___(MPG-4). This proxy group has an average corporate credit rating from S&P of "BBB," which is identical to S&P's corporate credit rating for Avista. The proxy group's corporate credit rating from Moody's is "Baa2," which is also identical to Avista's corporate credit rating from Moody's. The proxy group has comparable investment risk to Avista.

The proxy group has an average common equity ratio of 46.4% (including short-term debt) from SNL Financial ("SNL") and 49.4% (excluding short-term debt) from *Value Line* in 2011. The proxy group's common equity ratio is almost identical to my proposed common equity ratio of 47.3%, including short-term debt.

I also compared Avista's business risk to the business risk of the proxy group based on S&P's ranking methodology. Avista has an S&P business risk profile of "Excellent," which is identical to the S&P business risk profile of the proxy group.

The S&P business risk profile score indicates that Avista's business risk is comparable to that of the proxy group.[17/]

Based on these proxy group selection criteria, I believe that my proxy group reasonably approximates the investment risk of Avista, and can be used to estimate a fair return on equity for Avista.

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

[17/] S&P ranks the business risk of a utility company as part of its corporate credit rating review. S&P considers total investment risk in assigning bond ratings to issuers, including utility companies. In analyzing total investment risk, S&P considers both the business risk and the financial risk of a corporate entity, including a utility company. S&P's business risk profile score is based on a six-notch credit rating starting with "Vulnerable" (highest risk) to "Excellent" (lowest risk). The business risk of most utility companies falls within the lowest risk category, "Excellent," or the category one notch lower (more risk), "Strong." *Standard & Poor's:* "Criteria Methodology: Business Risk/Financial Risk Matrix Expanded," May 27, 2009.

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

Q. WHAT STOCK PRICE HAVE YOU RELIED ON IN YOUR CONSTANT GROWTH DCF MODEL?

A. I relied on the average of the weekly high and low stock prices of the utilities in the proxy group over a 13-week period ending on August 10, 2012. 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 reflects a period that is still short enough to contain data that reasonably reflect current market expectations, but the period is not so short as to be susceptible to market price variations that may not reflect the stock'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.

Q. WHAT DIVIDEND DID YOU USE IN YOUR CONSTANT GROWTH DCF MODEL?

A. I used the most recently paid quarterly dividend, as reported in *The Value Line Investment Survey*.[18/] 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.

[18/] *The Value Line Investment Survey*, May 25, June 22, and August 3, 2012.

Q. WHAT DIVIDEND GROWTH RATES HAVE YOU USED IN YOUR CONSTANT GROWTH DCF MODEL?

A. There are several methods that can be used to estimate the expected growth in dividends. However, regardless of the method, 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 make individual investment decisions.

As predictors of future returns, security analysts' growth estimates have been shown to be more accurate than growth rates derived from historical data.[19/] That is, assuming the market generally makes rational investment decisions, analysts' growth projections are more likely to influence observable stock prices than growth rates derived only from 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 investor consensus dividend growth rate expectations. I used the average of analysts' growth rate estimates from three sources: Zacks, SNL, and Reuters. All such projections were available on August 14, 2012, and all were reported online.

Each consensus growth rate projection is based on a survey of security analysts. It is problematic as to whether any particular analyst's forecast is more representative of general market expectations. 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'

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

projections. Therefore, a simple average, or arithmetic mean, of analyst forecasts is a good proxy for market consensus expectations.

Q. WHAT ARE THE GROWTH RATES YOU USED IN YOUR CONSTANT GROWTH DCF MODEL?

A. The growth rates I used in my DCF analysis are shown in Exhibit No.___(MPG-5). The average growth rate for my proxy group is 4.43%.

Q. WHAT ARE THE RESULTS OF YOUR CONSTANT GROWTH DCF MODEL?

A. As shown in Exhibit No.___(MPG-6), the average and median constant growth DCF returns for my proxy group are 8.75% and 8.50%, respectively.

Q. DO YOU HAVE ANY COMMENTS ON THE RESULTS OF YOUR CONSTANT GROWTH DCF ANALYSIS?

A. Yes. The three- to five-year growth rates are in line with the long-term sustainable growth rate. Therefore, I believe my constant growth DCF analysis using analysts' three- to five-year growth rates reflects reasonable growth outlooks and the DCF results are also reasonable. However, I also considered other DCF methodologies in order to enhance the information available to accurately estimate Avista's current market return on common equity.

Sustainable Growth DCF

Q. PLEASE DESCRIBE HOW YOU ESTIMATED A SUSTAINABLE LONG-TERM GROWTH RATE FOR YOUR SUSTAINABLE GROWTH DCF MODEL.

A. A sustainable growth rate is based on the percentage of the utility's earnings that is retained and reinvested in utility plant and equipment. These reinvested earnings increase the earnings base (rate base). Earnings grow when plant funded by reinvested

earnings is put into service, and the utility is allowed to earn its authorized return on such additional rate base 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. The payout ratios of the proxy group are shown on my Exhibit No.___(MPG-7). These dividend payout ratios and earnings retention ratios then can be used to develop a sustainable long-term earnings retention growth rate. A sustainable long-term retention ratio will help gauge whether analysts' current three- to five-year growth rate projections can be sustained over an indefinite period of time.

The data used to estimate the long-term sustainable growth rate is based on the Company's current market to book ratio and on *Value Line's* three- to five-year projections of earnings, dividends, earned returns on book equity, and stock issuances.

As shown in Exhibit No.___(MPG-8), page 1, the average sustainable growth rate for the proxy group using this internal growth rate model is 4.78%.

Q. WHAT IS THE DCF ESTIMATE USING THESE SUSTAINABLE LONG-TERM GROWTH RATES?

A. A DCF estimate based on these sustainable growth rates is developed in Exhibit No.___(MPG-9). As shown there, a sustainable growth DCF analysis produces proxy group average and median DCF results of 9.12% and 8.52%, respectively.

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.

Q. WHEN DO YOU BELIEVE SHORT-TERM GROWTH RATES CHANGE OVER TIME?

A. Analyst projected growth rates over the next three to five years will change as utility earnings growth outlooks change. Utility companies typically go through cycles in making investments in their systems. When utility companies are making large investments, their rate base grows rapidly, which accelerates their earnings growth. Once a major construction cycle is completed or levels off, growth in the utility rate base slows, and its earnings slow from an abnormally high three- to five-year growth rate period to a lower sustainable growth rate.

As major construction cycles extend over longer periods of time, even with an accelerated construction program, the growth rate of the utility will slow simply because it is adding to a larger rate base, and the utility has limited human and capital resources available to expand its construction program. Hence, the three- to five-year growth rate projection should be used as a long-term sustainable growth rate but not without making a reasonable informed judgment to determine whether it considers the

current market environment, the industry, and whether the three- to five-year growth outlook is sustainable.

Q. CAN A UTILITY'S ELEVATED THREE- TO FIVE-YEAR GROWTH RATE CONTINUE INDEFINITELY IF ITS CAPITAL PROGRAM CONTINUES OVER AN INDEFINITE PERIOD OF TIME?

A. No, because the growth rate will slow over time, even if the utility's capital program remains at an elevated level. This is illustrated in Table 4 below. Consider a hypothetical company with a beginning plant-in-service of $1 million and an elevated capital expenditure program of $100,000 (10% of total capital). Capital expenditures stay elevated but also grow at the rate of inflation of 2% over the next 10 years. This company has depreciation expense based on a rate of gross plant of 3.0%.

In this example, the first year, the capital expenditures less depreciation expense will grow plant-in-service from $1 million up to $1,070,000—a 7% plant growth. In this example, earnings in the year would begin at an assumed 10% rate of return on investment, or $103,500. This represents a 10% return on average plant investment for the year. Now assume that the capital improvement program continues, and plant-in-service increases from the initial $1 million up to $1,139,900 by the end of year 2. In this second year, earnings would increase to $110,495, a 6.8% growth in earnings relative to year 1. Each year, the embedded plant-in-service increases by capital improvements less depreciation expense. As a result, the growth in earnings slows because a percent change in plant-in-service starts to slow as the beginning of the year plant-in-service number increases. That is, the denominator in the growth equation increases with a relatively flat but elevated level of capital improvements resulting in a decreasing growth in earnings. With this continued level of elevated capital improvement offset by depreciation expense, the growth rate of

earnings starts at around 6.8% in the beginning of the growth period, declines to around 5.3% after five years of growth, and further declines to around 4.2% after 10 years of elevated capital investment spending. Hence, while the company maintains an elevated level of capital spending throughout the forecast period, the earnings growth rate nevertheless declines from 6.8% at the beginning of the spending period, down to 4.2% after 10 years of elevated capital spending. Again, this occurs because the denominator in the growth equation increases as plant investment is made and plant-in-service increases. As a result, elevated capital expenditures have a lower growth impact on a larger capital base after years of elevated capital spending relative to the beginning of the capital spending program.

TABLE 4

Growth in Plant In-Service and Earnings

Year	Beginning of Year Plant-in-Service (1)	Capital Improvement (2)	Depreciation Expense (3)	End of Year Plant-in-Service (4)	Avg Year Plant (5)	ROE (6)	Earnings (7)	Annual Earnings Growth Rate (8)
0	$1,000,000	$100,000	$30,000	$1,070,000	$1,035,000	10.0%	$103,500	
1	$1,070,000	$102,000	$32,100	$1,139,900	$1,104,950	10.0%	$110,495	6.8%
2	$1,139,900	$104,040	$34,197	$1,209,743	$1,174,822	10.0%	$117,482	6.3%
3	$1,209,743	$106,121	$36,292	$1,279,572	$1,244,657	10.0%	$124,466	5.9%
4	$1,279,572	$108,243	$38,387	$1,349,428	$1,314,500	10.0%	$131,450	5.6%
5	$1,349,428	$110,408	$40,483	$1,419,353	$1,384,390	10.0%	$138,439	5.3%
6	$1,419,353	$112,616	$42,581	$1,489,388	$1,454,371	10.0%	$145,437	5.1%
7	$1,489,388	$114,869	$44,682	$1,559,575	$1,524,482	10.0%	$152,448	4.8%
8	$1,559,575	$117,166	$46,787	$1,629,954	$1,594,765	10.0%	$159,476	4.6%
9	$1,629,954	$119,509	$48,899	$1,700,565	$1,665,259	10.0%	$166,526	4.4%
10	$1,700,565	$121,899	$51,017	$1,771,447	$1,736,006	10.0%	$173,601	4.2%

Notes:
Column 2: Escalation Rate 2.00%.
Column 3: Depr Rate 3.00%.
Column 4 = Column 1 plus Column 2 less Column 3.
Column 5 = (Column 1 + Column 4)/2.
Column 7 = Column 5 ∗ Column 6.
Column 8 = Column 7 N ÷ Column 7 N-1 (N is the Year) less 1.

Q. IS THE USE OF A MULTI-STAGE DCF MODEL SUPPORTED IN ACADEMIC AND INDUSTRY LITERATURE?

A. Yes. In his book *New Regulatory Finance*, Dr. Roger Morin states the following:

> Dividends need not be, and probably are not, constant from period to period. Moreover, there are circumstances where the standard DCF model cannot be used to assess investor return requirements. For example, if a utility company is in the process of altering its dividend payout policy and dividends are not expected to grow at the same rate as earnings during the transition period, the standard DCF model is inapplicable. This is because the expected growth in stock price has to be different from that of dividends, earnings, and book value if the market price is to converge toward book value.
>
> * * *

> A Non-Constant Growth DCF model is appropriate whenever the growth rate is expected to change, and the only way to produce a change in the forecast payout ratio is by introducing an intermediate growth rate that is different from the long-term growth rate, as in the previous example.[20/]

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 United States Gross Domestic Product ("U.S. 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%.

Q. WHY IS THE GDP GROWTH PROJECTION A REASONABLE PROXY FOR THE MAXIMUM SUSTAINABLE 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. Such investment, in turn, is driven by service area economic growth and demand for utility service. In other words, utilities invest in plant to meet

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[20/] *New Regulatory Finance*, Roger A. Morin, PhD, 2006 Public Utilities Reports, Inc., Vienna, Virginia, pp. 264 and 267.

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 for more than a decade. As a result, 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 conservative 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).[21/]

Q. HOW DID YOU DETERMINE A SUSTAINABLE LONG-TERM GROWTH RATE THAT REFLECTS THE CONSENSUS OF THE MARKET?

A. I relied on the consensus analysts' projections of long-term GDP growth. *The Blue Chip Financial Forecasts* publishes consensus economists' GDP growth projections twice a year. These consensus analysts' GDP growth outlooks are the best available measure of the market's assessment of long-term GDP growth. These analyst

[21/] "Fundamentals of Financial Management," Eugene F. Brigham and Joel F. Houston, Eleventh Edition 2007, Thomson South-Western, a Division of Thomson Corporation at 298.

projections reflect all current outlooks for GDP, as reflected in analyst projections, and are likely the most influential on investors' expectations of future growth outlooks. The consensus economists' published GDP growth rate outlook is 5.1% to 4.7% over the next 10 years.[22/]

Therefore, I propose to use the consensus economists' projected 5- and 10-year average GDP consensus growth rate of 4.9%, as published by *Blue Chip Financial Forecasts,* as an estimate of long-term sustainable growth. *Blue Chip Financial Forecasts'* projections provide real GDP growth projections of 2.8% and 2.5%, and GDP inflation of 2.2% and 2.1%[23/] over the 5-year and 10-year projection periods, respectively. This consensus GDP growth forecast represents the most likely views of market participants because it is based on published consensus economist projections.

Q. DO YOU CONSIDER OTHER SOURCES OF PROJECTED LONG-TERM GDP GROWTH?

A. Yes, and these sources corroborate my consensus analysts' projections. The U.S. EIA in its Annual Energy Outlook projects real GDP out until 2035. In its 2011 Annual Report, the EIA projects real GDP through 2035 to be in the range of 2.1% to 3.2%, with a midpoint or reference case of 2.7%.[24/]

Also, the Congressional Budget Office ("CBO") makes long-term economic projections. The CBO is projecting real GDP growth of 3.3% to 2.4% during the next 5 and 10 years, respectively, with GDP price inflation of 1.9% to 2.0%.[25/] The CBO's real GDP projections are higher than the consensus, but its GDP inflation is lower than the consensus economists.

[22/] *Blue Chip Financial Forecasts*, June 1, 2012 at 14.
[23/] GDP growth is the product of real and inflation GDP growth.
[24/] *DOE/EIA Annual Energy Outlook 2011 With Projections to 2035*, April 2011 at 58.
[25/] *CBO: The Budget and Economic Outlook: Fiscal Years 2012 to 2022*, January 2012 at 128.

The real GDP and nominal GDP growth projections made by the U.S. EIA and those made by the CBO support the use of the consensus analyst 5-year and 10-year projected GDP growth outlooks as a reasonable market assessment of long-term prospective GDP growth.

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 data 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 average of the consensus economists' 5-year and 10-year projected nominal GDP growth rates.

Q. WHAT ARE THE RESULTS OF YOUR MULTI-STAGE GROWTH DCF MODEL?

A. As shown in Exhibit No.___(MPG-11), the average and median DCF returns on equity for my proxy group are 9.12% and 9.23%, respectively.

Q. PLEASE SUMMARIZE THE RESULTS FROM YOUR DCF ANALYSES.

A. The results from my DCF analyses are summarized in Table 5 below:

TABLE 5

Summary of DCF Results

Description	Estimates
Constant Growth DCF Model (Analysts' Growth)	8.75%
Constant Growth DCF Model (Sustainable Growth)	9.12%
Multi-Stage Growth DCF Model	9.12%
Average	9.00%

I conclude that a DCF return for Avista in this case is 9.10%.

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 or 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 U.S. Treasury bonds. The difference between the required return on common equity and the Treasury bond yield is the risk premium. I estimated the risk premium on an annual basis for each year over the period 1986 through June 2012. 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 estimate is based on the difference between regulatory commission-authorized returns on common equity and contemporary "A" rated utility bond yields. I selected the period 1986 through June 2012 because public utility stocks consistently traded at a premium to book value during that period. This is illustrated in Exhibit No.___(MPG-12), which shows that the market to book ratio since 1986 for the electric utility industry was consistently above 1.0. Over this 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-13), the average indicated equity risk premium over U.S. Treasury bond yields has been 5.31%. Of the 27 observations, 21 indicated risk premiums fall in the range of 4.41% to 6.18%. 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-14), the average indicated equity risk premium over contemporary Moody's utility bond yields was 3.89% over the period 1986 through June 2012. The indicated equity risk premium estimates based on this analysis primarily fall in the range of 3.03% to 4.88% over this time period.

Q. DO YOU BELIEVE THAT THESE EQUITY RISK PREMIUM ESTIMATES ARE BASED ON A TIME PERIOD THAT IS TOO LONG OR TOO SHORT TO DRAW ACCURATE CONCLUSIONS 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. A relatively long period of time where stock valuations reflect premiums 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 study 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 COMMON 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-15). On that schedule, I show the yield spread between utility bonds and Treasury bonds over the last 32 years and the first six months of 2012. As shown in this schedule, the 2011 utility bond yield spreads over Treasury bonds for "A" rated and "Baa" rated utility bonds are 1.13% and 1.65%, respectively. The utility bond yield spreads over Treasury bonds for "A" and "Baa" rated utility bonds

for the first six months of 2012 are 1.27% and 2.00%, respectively. The current "A" rated utility bond yield spread over Treasury bond yields is now lower than the 32-year average spreads of 1.57%. However, the "Baa" rated utility spread of 2.00% is slightly higher, even though comparable to the 32-year average spread of 1.98%.

A current 13-week average "A" rated utility bond yield of 4.03%, when compared to the current Treasury bond yield of 2.69% as shown in Exhibit No.___(MPG-16), page 1 implies a yield spread of around 1.34%. This current utility bond yield spread is lower than the 32-year average spread for "A" utility bonds of 1.57%. The current spread for the "Baa" utility yields of 2.20% is slightly higher than, although comparable to, the 32-year average spread of 1.98%.

These utility bond yield spreads are clear evidence that the market considers the utility industry to be a relatively low risk investment and demonstrates that utilities continue to have strong access to capital.

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. The 13-week average 30-year Treasury bond yield, ending August 10, 2012 was 2.69%, as shown in Exhibit No.___(MPG-16), page 1. *Blue Chip Financial Forecasts* projects the 30-year Treasury bond yield to be 3.40%, and a 10-year Treasury bond yield to be 2.40%.[26/] Using the projected 30-year bond yield of 3.40%, and a Treasury bond risk premium of 4.41% to 6.18%, as developed above, produces an estimated common equity return in the range of 7.81% (3.40% + 4.41%) to 9.58% (3.40% + 6.18%). I recommend an equity risk premium of 9.58%,

[26/] *Blue Chip Financial Forecasts*, August 1, 2012 at 2.

rounded to 9.60%, which is at the high end of the range. I believe this is appropriate given the unusually large yield spreads between Treasury bond and utility bond yields.

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 August 10, 2012 of 4.89%. Adding the utility equity risk premium of 3.03% to 4.88%, as developed above, to a "Baa" rated bond yield of 4.89%, produces a cost of equity in the range of 7.92% (4.89% + 3.03%) to 9.77% (4.89% + 4.88%). Again, recognizing the unusually wide Treasury to utility bond yield spreads, I recommend a risk premium of 9.77%, rounded to 9.75%.

My risk premium analyses produce a return estimate in the range of 9.60% to 9.75%, with a midpoint estimate of approximately 9.70%.

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 non-diversifiable risks. Non-diversifiable 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 3.40%.[27/] The current 30-year Treasury bond yield is 2.69%, as shown in Exhibit No.___(MPG-16), page 1. I used *Blue Chip Financial Forecasts*' projected 30-year Treasury bond yield of 3.40% for my CAPM analysis.

[27/] Id.

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, so 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-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-17), 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 2012 Classic Yearbook* publication estimates the historical arithmetic average real market return over the period 1926 to 2011 as 8.6%.[28/] A current consensus analysts' inflation projection, as measured by the Consumer Price Index, is 2.2%.[29/] Using these estimates, the expected market return is 10.99%.[30/] The market risk premium then is the difference between the 10.99% expected market return, and my 3.40% risk-free rate estimate, or approximately 7.60%.

The historical estimate of the market risk premium was also estimated by Morningstar in *Stocks, Bonds, Bills and Inflation 2012 Classic Yearbook*. Over the period 1926 through 2011, Morningstar's study estimated that the arithmetic average of the achieved total return on the S&P 500 was 11.8%,[31/] and the total return on long-term Treasury bonds was 6.1%.[32/] The indicated market risk premium is 5.7% (11.8% - 6.1% = 5.7%). The average of my market risk premium estimates is 6.7% (7.6% to 5.7%).

Q. HOW DOES YOUR ESTIMATED MARKET RISK PREMIUM RANGE COMPARE TO THAT ESTIMATED BY MORNINGSTAR?

A. Morningstar's analysis indicates that a market risk premium falls somewhere in the range of 5.9% to 6.6%. My market risk premium falls in the range of 5.7% to 7.6%.

28/ *Morningstar, Inc. Ibbotson SBBI 2012 Classic Yearbook* at 84.
29/ *Blue Chip Financial Forecasts*, August 1, 2012 at 2.
30/ { [(1 + 0.086) ∗ (1 + 0.022)] – 1 } ∗ 100.
31/ *Morningstar, Inc. Ibbotson SBBI 2012 Classic Yearbook* at 83.
32/ Id.

My average market risk premium of 6.7% is toward the high end of Morningstar's range.

Morningstar estimates a forward-looking market risk premium based on actual achieved data from the historical period of 1926 through 2011. 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. 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 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 range is based on several methodologies. First, Morningstar estimates a market risk premium of 6.6% 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 6.4%, not 6.6%. Third, if only the two deciles of the largest

companies included in the NYSE were considered, the market risk premium would be 5.9%.[33/]

Finally, Morningstar found that the 6.6% market risk premium based on the S&P 500 was influenced 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 6.1%.[34/]

Q. WHAT ARE THE RESULTS OF YOUR CAPM ANALYSIS?

A. As shown in Exhibit No.___(MPG-18), based on my high-end market risk premium of 6.7%, a risk-free rate of 3.40%, and a beta of 0.74, my CAPM analysis produces a return of 8.36% (rounded to 8.40%).

Return on Equity Summary

Q. BASED ON THE RESULTS OF YOUR 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 9.40%.

[33/] Morningstar observes that the S&P 500 and the NYSE Decile 1-2 are both large capitalization benchmarks. *Morningstar, Inc. Ibbotson SBBI 2012 Valuation Yearbook* at 54.

[34/] Id. at 66.

TABLE 6

Return on Common Equity Summary

Description	Results
DCF	9.10%
Risk Premium	9.70%
CAPM	8.40%

My recommended return on equity is the midpoint of my range of 9.10% to 9.70%, based on my DCF and Risk Premium results.

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's retail cost of service in this case, adjusted for my proposed return on equity and the Company's actual capital structure, to S&P's benchmark financial ratios using S&P's new credit metric ranges.

Q. PLEASE DESCRIBE THE MOST RECENT S&P FINANCIAL RATIO CREDIT METRIC METHODOLOGY.

A. S&P publishes a matrix of financial ratios that correspond to its assessment of the business risk of the utility company and related bond rating. On May 27, 2009, S&P expanded its matrix criteria[35/] by including additional business and financial risk categories. Based on S&P's most recent credit matrix, the business risk profile categories are "Excellent," "Strong," "Satisfactory," "Fair," "Weak," and "Vulnerable." Most electric utilities have a business risk profile of "Excellent" or

[35/] S&P updated its original 2007 credit metric guidelines in 2009, and incorporated utility metric benchmarks with the general corporate rating metrics. *Standard & Poor's*: "Criteria Methodology: Business Risk/Financial Risk Matrix Expanded" at 2, May 27, 2009.

"Strong." The financial risk profile categories are "Minimal," "Modest," "Intermediate," "Significant," "Aggressive," and "Highly Leveraged." Most of the electric utilities have a financial risk profile of "Aggressive." Avista has an "Excellent" business risk profile and an "Aggressive" financial risk profile.[36/]

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) Total Debt to Total Capital; (2) Debt to Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA"); and (3) Funds From Operations ("FFO") to Total Debt.[37/]

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 Washington jurisdictional electric operations. While S&P would normally look at total consolidated Avista financial ratios in its credit review process, my investigation in this proceeding is not the same as S&P's. I am attempting to judge the reasonableness of my proposed cost of capital for rate-setting in Avista's regulated

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[36/] *Standard & Poor's RatingsDirect on the Global Credit Portal*: "Avista Corp.," July 19, 2012 at 2 (emphasis added).

[37/] Id. at 4.

utility operations. Hence, I am attempting to determine whether my proposed rate of return will in turn support cash flow metrics, balance sheet strength, and earnings that will support an investment grade bond rating and Avista's financial integrity.

Q. DID YOU INCLUDE ANY OFF-BALANCE SHEET DEBT ("OBSD")?

A. Yes. As shown in Exhibit No.___(MPG-19), page 3, the Company estimated off-balance sheet debt equivalents of $86.8 million attributed to Avista's operating leases and purchase power agreements, which were provided in response to ICNU data request 2.5. Avista includes other off-balance sheet debt adjustments which I did not include in my analysis. Pension benefit obligations and asset retirement obligations were not included in my analysis. This factor is either reflected in Avista's cost of service, or I could not find evidence that it relates to regulated utility operations. As such, I did not include it in the metrics to judge the reasonableness of my rate of return for retail operations in Washington in this proceeding.

Q. PLEASE DESCRIBE THE RESULTS OF THIS CREDIT METRIC ANALYSIS FOR AVISTA AT A 9.40% RETURN ON EQUITY.

A. The S&P financial metric calculations for Avista at a 9.40% return are developed on Exhibit No.___(MPG-19), page 1.

Avista's adjusted total debt ratio is approximately 54%. This is within the "Aggressive" utility guideline range of 50% to 60%. This total debt ratio will support an investment grade bond rating.

As shown on Exhibit No.___(MPG-19), page 1, column 1, based on an equity return of 9.40%, Avista will be provided an opportunity to produce a debt to EBITDA ratio of 4.3x. This is within S&P's "Aggressive" range of 4.0x to 5.0x. This ratio also supports an investment grade credit rating.

Finally, Avista's retail operations FFO to total debt coverage at a 9.40% equity return would be 14%, which is within the "Aggressive" metric guideline range of 12% to 20%. The FFO/total debt ratio will support an investment grade bond rating.

At my recommended return on equity of 9.40% and the Company's actual capital structure, Avista's financial credit metrics are supportive of an investment grade bond rating.

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 of 10.9%, which is the midpoint of his recommended range of 10.2% to 11.6% after his 20 basis point adjustment for flotation costs.[38/]

Q. HOW DID DR. AVERA DEVELOP HIS RETURN ON EQUITY RANGE?

A. Dr. Avera developed his return on equity recommendation by applying the DCF, CAPM and RP models to a utility proxy group and a non-utility proxy group. He also used a Comparable Earnings Model ("CEM"). Dr. Avera arrived at his recommendations by reviewing Avista's business operations, market conditions, and utility industry trends at the time of his analysis.

Q. PLEASE SUMMARIZE DR. AVERA'S PROPOSED RETURN ON EQUITY FOR AVISTA.

A. As shown below in Table 7, Dr. Avera estimates a return on equity in the range of 10.0% to 11.4%. Dr. Avera increased his proxy group estimated return range by 0.20% to account for flotation costs. However, as I will discuss in more detail below, making reasonable adjustments to Dr. Avera's DCF, CAPM and RP studies reduces

[38/] Exh. No. ___(WEA-1T) at 4 (Avera).

his return on equity estimate for Avista to less than 9.5%. Dr. Avera's flotation cost return on equity adder should be rejected.

TABLE 7

Dr. Avera's ROE Analysis

Model	Avera Proposed	Adjusted
DCF (Utility)	9.0% - 10.3%	9.5%
DCF (Non-Utility)	10.9% - 13.2%	Reject
CAPM (Current)		
Unadjusted	10.9%	8.0%
Size Adjusted	11.8%	Reject
CAPM (Projected)		
Unadjusted	11.2%	9.4%
Size Adjusted	12.1%	Reject
Risk Premium		
Current	10.3%	9.4%
Projected	11.3%	Reject
Expected Earnings		
2014-16	10.5%	Reject
Utility Proxy Group	10.0%	Reject
Range	10.0% - 11.4%	8.0% - 9.5%
Flotation Cost Adder	0.20%	–
Range Including Adder	10.2% - 11.6%	8.0% - 9.5%
Recommended ROE	10.9%	

Sources:
Exh. No. ___(WEA-1T) at 53 (Avera).

Q. WHY IS DR. AVERA'S FLOTATION COST ADJUSTMENT FLAWED?

A. Dr. Avera's proposed 0.20% flotation cost adjustment is not based on the recovery of prudent and reasonable Avista flotation cost expenses. Rather, as discussed at pages 50-52 of Dr. Avera's direct testimony, he derives a flotation cost adjustment based on

published academic literature. Because he does not show that his adjustment is based on Avista's actual and verifiable flotation expenses, however, there simply are no means of verifying whether Dr. Avera's proposal is reasonable or appropriate.

Q. PLEASE DESCRIBE DR. AVERA'S DCF ANALYSIS.

A. Dr. Avera applied the traditional DCF model to two proxy groups that he concludes have reasonably comparable risk to Avista. Based on his utility group, the DCF results yield a return in the range of 9.0% to 10.3%. Dr. Avera's non-utility group includes companies operating in various industries followed by *Value Line*. Based on this non-utility group, his DCF analysis produces a return on equity in the range of 10.9% to 13.2%[39/]

Q. DO YOU TAKE ISSUE WITH DR. AVERA'S DCF ANALYSES?

A. Yes. I have several issues concerning his DCF analysis. First, his use of a non-utility proxy group does not reliably estimate a fair return for Avista. Therefore, the DCF results produced by his non-utility proxy group should be rejected.

Second, Dr. Avera simply manipulated his selection of his utility proxy group DCF estimates in order to derive the return estimates he shows for this proxy group on his Exhibit No.___(WEA-5). Dr. Avera excluded many low-end cost of equity estimates that would have been retained in the study but retained the majority of his high-end estimates.

Third, excluding the negative growth rates, the average growth rate included in his proxy group ranged from 4.3% for the sustainable growth to 5.7% for *Value Line*. The high end of these growth rates exceed a reasonable estimate of long-term sustainable growth, and therefore inflate his DCF return estimates.

[39/] Id. at 53.

Fourth, Dr. Avera also presented the midpoint of his results, which is another way to manipulate his results and a poor attempt to misguide the Commission's effort to award a fair return on equity for Avista that will balance the interests of shareholders and ratepayers.

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 risks that are different from those affecting Avista's utility operations. As noted by the major credit rating agencies, the utility industry has relatively low risk in comparison with the market. Indeed, 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 unreliable and inflated return on equity for a low-risk utility like Avista. Therefore, the Commission should disregard the results of Dr. Avera's non-utility group.

Q. CAN YOU PROVIDE AN EXAMPLE OF WHY DR. AVERA'S NON-UTILITY GROUP IS NOT A REASONABLE RISK PROXY GROUP FOR AVISTA?

A. Yes. One criterion that Dr. Avera uses to select a comparable risk non-utility group in order to estimate Avista's return on equity, is to compare Avista's bond rating to that of the non-regulated group (see Table 2-2). While this is a reasonable method of estimating and identifying comparable proxy groups within the industry, doing it across industries is not as straightforward and not as reliable. For example, if bond ratings alone would adequately help to identify comparable risk companies across industries, then there should not be any observable clear differences in the investment cost for securities that had different bond ratings. However, the industry or

circumstances behind the security have a material role in the market's assessment of a fair compensation. For example, long-term U.S. Treasury bonds have a bond rating from Moody's of "Aaa." The current yield on a U.S. Treasury bond is around 2.90%. In comparison, corporate bonds with a "AAA" rating currently have costs of approximately 3.80%.[40/] A corporate bond is approximately 0.90% more expensive than a Treasury bond, despite the fact that it has the same bond rating.

While "Aaa" corporate bonds and U.S. Treasury bonds have comparable bond ratings, the risk differential is significant largely because of the operating risk differences between the securities. The U.S. government has virtually minimal default risk on its bond issuances, whereas even a "Aaa" rated corporate bond has measurable default risk. Similarly, regulated utility operations and the ability to adjust prices to cost of service provide far less default risk than that of non-regulated companies. A regulated company simply has a franchise to a monopolistic service territory, the ability to set prices based on reasonable and prudent costs, and minimal competition. In significant contrast, a non-regulated entity does not have a franchised or monopolistic customer base, must price its services consistent with what the market will permit, and has far more uncertainty of selling products that produce cash flows that support financial obligations.

Q. WHAT WOULD BE THE RESULTS OF DR. AVERA'S DCF RETURN ESTIMATE IF THE AVERAGE WAS TAKEN OF HIS PROXY GROUP DCF RETURN ESTIMATES, RATHER THAN SUBJECTIVELY EXCLUDING CERTAIN DCF RETURN ESTIMATES?

A. As shown on my Exhibit No.___(MPG-20), excluding only the utility proxy group DCF returns produced by negative growth rates, the average DCF return ranges from

[40/] *Blue Chip Financial Forecasts*, August 1, 2012 at 2.

approximately 8.6% to 9.7%. As such, considering all the companies in his utility proxy group DCF return studies, Dr. Avera's own DCF return estimates support a return on equity in the range of 8.6% to 9.7%.

Q. HOW WILL DR. AVERA'S DCF RETURN CHANGE IF A MULTI-STAGE MODEL IS APPLIED?

A. As I discussed above, the high end of his growth rate range estimates of 4.3% to 5.7% cannot be sustained indefinitely. I have applied a multi-stage DCF model to Dr. Avera's utility proxy group by using the average of his four 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 average 5- to 10-year GDP growth rate of 4.9%. Applying the multi-stage DCF version to Dr. Avera's utility group yields average and median DCF returns of 9.4% and 9.5%, respectively, as shown in Exhibit No.___(MPG-21).

Q. PLEASE DESCRIBE YOUR CONCERN WITH DR. AVERA'S MIDPOINT ESTIMATES.

A. Presenting midpoint DCF estimates is just another way to manipulate the results of Dr. Avera's DCF studies. Similar to his average estimates, his midpoint estimates are upward biased because Dr. Avera does not include all of his results, but again he excludes the lowest results, without excluding the highest ones, which unreasonably inflates his midpoint estimate.

In fact, this practice of subjectively excluding some illogical estimates but not others completely contradicts the Federal Energy Regulatory Commission's ("FERC") position. FERC has found that using median results is more accurate in a skewed distribution.

Specifically, FERC states:

> Protesters state that in *Northwest Pipeline Corp*., [footnote omitted] the Commission determined that the median best represented the central tendency in a skewed distribution and is therefore preferable to the midpoint. The Commission stated that since the midpoint is the average of the highest and lowest numbers in the group, it is clearly subject to distortion by extremely high or low values.[41/]

Therefore, Dr. Avera's midpoint results should not be relied upon by the Commission when establishing a fair return for Avista.

Q. PLEASE DESCRIBE DR. AVERA'S FORWARD-LOOKING MARKET RISK PREMIUM CAPM ANALYSES.

A. Dr. Avera developed two CAPM analyses based on current and projected Treasury bond yields. Dr. Avera estimates a forward-looking return on the market of 13.5%. From this market return estimate he subtracts his risk-free rate, the current and projected long-term Treasury bond yields of 3.0% and 4.4%, respectively, to arrive at a market risk premium of 10.5% and 9.1%.[42/] He relies on the average utility beta of 0.75 for the companies included in his proxy group to produce an implied cost of equity for his utility group in the range of 10.8% to 11.2%.[43/] He then adds a size adjustment to his CAPM return estimate of 0.94% to arrive at his implied cost of equity for the utility proxy group in the range of 11.8% to 12.1%.[44/]

Q. IS DR. AVERA'S FORWARD-LOOKING CAPM ANALYSIS REASONABLE?

A. No. Dr. Avera's CAPM analysis is based on a market risk premium in the range of 9.1% to 10.5%.[45/] This market risk premium is significantly higher than the historical

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41/ Potomac-Appalachian Transmission Highline, L.L.C., 122 FERC ¶ 61,188; Docket No. ER08-386-000, Order Accepting and Suspending Formula Rates, Subject to Conditions, and Establishing Hearing and Settlement Procedures, February 29, 2008 at 23-24.

42/ Exh. No. ___(WEA-9) at 2.

43/ Exh. No. ___(WEA-1T) at 53 (Avera).

44/ Exh. No.___(WEA-9) at 2.

45/ Id. at 1-2.

market risk premium of 6.6%. Dr. Avera's 13.5% projected market return used to derive the market risk premium of 9.1% to 10.5% is highly inflated and unreliable. This market return estimate is based on a DCF analysis that includes a growth rate projection of 10.9% and a dividend yield of 2.6%. Dr. Avera's risk premium is dramatically overstated because it is based on a DCF return produced by irrationally high growth outlooks, and is, therefore, not reliable.

Specifically, it is simply irrational to expect that securities market capital appreciation and growth will be at 10.9% for an indefinite period of time, as reflected in Dr. Avera's market study. 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 its 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, for an extended period of time, the growth rate of companies will both exceed the growth of the overall economy in which they sell their goods and services. As I mentioned above, *Blue Chip Financial Forecasts* projects an average 5- to 10-year nominal growth in the GDP, or overall U.S. economy, of 4.9%.[46/] Hence, expecting a growth rate of 10.9%, in essence, assumes that the securities market can grow at a rate more than twice that of the overall U.S. economy. This is simply not a rational expectation.

[46/] *Blue Chip Financial Forecasts*, June 1, 2012 at 14.

Q. IS DR. AVERA'S PROPOSAL TO INCREASE HIS CAPM RETURN ESTIMATE BY 0.94% TO REFLECT A SIZE ADJUSTMENT APPROPRIATE?

A. No. Dr. Avera's size adjustment is based on estimates made by Morningstar in its *Ibbotson SBBI 2012 Valuation Yearbook*. In that publication, Morningstar estimates various size adjustments based on differentials in utility beta estimates tied to the size of a company. The size adjustment recommended by Dr. Avera reflects companies that have beta estimates in excess of 1.00.[47/] These beta estimates are substantially higher than the beta estimates of 0.75 for the proxy utility group used by Dr. Avera as reflective of Avista's investment risk. Therefore, his beta estimates produce a CAPM return estimate that is not risk comparable to Avista and therefore, is not reasonable for setting a fair return for Avista.

Q. HOW WOULD DR. AVERA'S FORWARD-LOOKING CAPM RETURN ESTIMATE CHANGE IF A REASONABLE FORWARD-LOOKING MARKET RISK PREMIUM WERE USED?

A. Applying a market risk premium estimate of 6.6%, a beta of 0.75 and using Dr. Avera's current and projected risk-free rates of 3.0% and 4.4%, respectively, will produce a CAPM return in the range of 7.95% to 9.35%, rounded to 8.0% and 9.4%.

Q. PLEASE DESCRIBE DR. AVERA'S UTILITY RISK PREMIUM ANALYSIS.

A. Dr. Avera's utility bond yield versus authorized return on common equity risk premium is shown in Exhibit No.___(WEA-10). As shown on page 3 of this exhibit, Dr. Avera estimated an annual equity risk premium by subtracting Moody's average bond yield from the electric utility regulatory commission authorized return on common equity over the period 1974 through 2011. Based on this analysis, Dr. Avera

47/ *2012 SBBI Valuation Yearbook* at 89.

estimates an average indicated equity risk premium over current utility bond yields of 3.41%.

Dr. Avera then adjusts this average equity risk premium using a regression analysis based on an expectation that there is an ongoing inverse relationship between interest rates and equity risk premiums. Based on this regression analysis, Dr. Avera increases his equity risk premium from 3.41%, up to 5.23% and 4.55% relative to the current and projected average bond yields. He then adds these inflated equity risk premiums to the current and projected "BBB" rated utility bond yields of 5.06% and 6.69%, respectively, to produce a return on equity of 10.29% and 11.24%, respectively.

Q. ARE DR. AVERA'S UTILITY RISK PREMIUM ANALYSES REASONABLE?

A. No. Dr. Avera develops a forward-looking risk premium model, relying on forecasted interest rates and volatile utility yield spreads, which are highly uncertain and prone to inaccurate results. Further, Dr. Avera's proposal to adjust the actual equity risk premium of 3.41% to 5.23% and 4.55% to reflect an inverse relationship between interest rates and utility equity risk premiums is flawed and not reliable. This adjustment is inappropriate and not consistent with academic literature that finds that this relationship should change with risk changes and not simply changes to interest rates.

Q. DO YOU HAVE ANY COMMENTS CONCERNING DR. AVERA'S FORECASTED UTILITY YIELD OF 6.7%?

A. Yes. Dr. Avera develops his forecasted utility yield based on the 6-month historical spread of BBB-AA rated utility bond yields of 1.00% added to his projected "AA" utility bond yield of 5.72%. Exhibit No.___(WEA-3) at 24, Table 2. This approach is

unreasonable, because Dr. Avera relies exclusively on projected interest rates. The accuracy of his projections is highly problematic. Indeed, while interest rates have been projected to increase over the last several years, those increased interest rate projections have turned out to be wrong.

Q. WHY DO YOU BELIEVE THAT THE ACCURACY OF FORECASTED INTEREST RATES IS HIGHLY PROBLEMATIC?

A. Over the last several years, observable current interest rates have been a more accurate predictor of future interest rates than economists' consensus projections. Exhibit No.___(MPG-22) illustrates this point. On this exhibit, under Columns 1 and 2, I show the actual market yield at the time a projection is made for Treasury bond yields two years in the future. In Column 1, I show the actual Treasury yield and, in Column 2, I show the projected yield two years out.

As shown in Columns 1 and 2, over the last several years, Treasury yields were projected to increase relative to the actual Treasury yields at the time of the projection. In Column 4, I show what the Treasury yield actually turned out to be two years after the forecast. Under Column 5, I show the actual yield change at the time of the projections relative to the projected yield change.

As shown in this exhibit, over the last several years, economists consistently have been projecting that interest rates will increase. However, as demonstrated under Column 5, those yield projections have turned out to be overstated in virtually every case. Indeed, actual Treasury yields have decreased or remained flat over the last five years, rather than increase as the economists' projections indicated. As such, current observable interest rates are just as likely to predict future interest rates as are economists' projections.

Q. WHY IS DR. AVERA'S USE OF A SIMPLE INVERSE RELATIONSHIP BETWEEN INTEREST RATES AND EQUITY RISK PREMIUMS NOT REASONABLE?

A. Dr. Avera's belief that there is a simplistic, inverse relationship between equity risk premiums and interest rates is not supported by academic research. While academic studies have shown that, in the past, there has been an inverse relationship with these variables, researchers have found that the relationship changes over time and is influenced by changes in perception of the risk of bond investments relative to equity investments, and not simply changes to interest rates.[48/]

In the 1980s, equity risk premiums were inversely related to interest rates, but that was likely attributable to the interest rate volatility that existed at that time. Interest rate volatility currently is much lower than it was in the 1980s.[49/] As such, when interest rates were more volatile, the relative perception of bond investment risk increased relative to the investment risk of equities. This changing investment risk perception caused changes in equity risk premiums.

In today's marketplace, interest rate variability is not as extreme as it was during the 1980s. Nevertheless, changes in the perceived risk of bond investments relative to equity investments still drive changes in equity premiums. However, a relative investment risk differential cannot be measured simply by observing nominal interest rates. Changes in nominal interest rates are highly influenced by changes to inflation outlooks, which also change equity return expectations. As such, the relevant

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48/ "The Market Risk Premium: Expectational Estimates Using Analysts' Forecasts," Robert S. Harris and Felicia C. Marston, *Journal of Applied Finance*, Volume 11, No. 1, 2001 and "The Risk Premium Approach to Measuring a Utility's Cost of Equity," Eugene F. Brigham, Dilip K. Shome, and Steve R. Vinson, *Financial Management*, Spring 1985.

49/ *Morningstar SBBI, 2009 Yearbook* at 95-96.

factor needed to explain changes in equity risk premiums is the relative changes to the risk of equity versus debt securities investments, not simply changes to interest rates.

Importantly, Dr. Avera's analysis simply ignores investment risk differentials. He bases his adjustment to the equity risk premium exclusively on changes in nominal interest rates. This is a flawed methodology and does not produce accurate or reliable risk premium estimates. His results should be rejected by the Commission.

Q. CAN DR. AVERA'S RISK PREMIUM ANALYSES BASED ON CURRENT AND PROJECTED YIELDS BE MODIFIED TO PRODUCE MORE REASONABLE RESULTS?

A. Yes. Eliminating the inverse relationship adjustment to the equity risk premium of 3.41% and relying on Dr. Avera's current "BBB" rated utility yield of 5.06% will result in a return on equity risk premium of 8.47%, rounded to 8.5%. Using Dr. Avera's 2011 equity risk premium of 5.09% as shown on page 3 of his Exhibit No.___(WEA-10) and his current "BBB" rated utility yield of 5.06% will result in a return of 10.15%, rounded to 10.2%. Therefore, Dr. Avera's risk premium will be in the range of 8.5% to 10.2%, with a midpoint of 9.4%.

Q. PLEASE DESCRIBE DR. AVERA'S COMPARABLE EARNINGS ANALYSIS.

A. Dr. Avera's comparable earnings analysis is based on *Value Line*'s projected earned return on book equities for his utility proxy group, adjusted to reflect average year equity returns. Based on a review of *Value Line* projected earnings for the electric and gas industry over the next three to five years, Dr. Avera estimates a return on equity for Avista of 10.5%. Based on *Value Line*'s earnings projections for the proxy group, Dr. Avera estimates the return on equity for Avista to be 10.0%. Exhibit No. ___(WEA-1T) at 49.

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 that 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, such a return is not developed from observable market data. A return estimate using a comparable earnings analysis can differ significantly from the return investors currently require. Therefore, Dr. Avera's comparable earnings approach should be rejected.

Q. DOES THIS CONCLUDE YOUR RESPONSIVE TESTIMONY?

A. Yes, it does.