Exhibit No. ___(MPG-1T)
Docket Nos. UE-050482 and UG-050483
Witness: Michael Gorman

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, vs. AVISTA CORPORATION, Respondent.	**Docket No. UE-050482** **Docket No. UG-050483** *(consolidated)*

DIRECT TESTIMONY OF MICHAEL GORMAN

ON BEHALF OF

THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

August 26, 2005

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Michael Gorman and my business address is 1215 Fern Ridge Parkway, Suite 208, St. Louis, MO 63141-2000.

Q. WHAT IS YOUR OCCUPATION?

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

Q. PLEASE SUMMARIZE 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 PURPOSE OF YOUR TESTIMONY?

A. I will make comments related to the proposed settlement ("Settlement Agreement") filed by Avista Corp. ("Avista" or the "Company"), the Staff of the Washington Utilities and Transportation Commission ("WUTC" or the "Commission"), the Northwest Industrial Gas Users, and the Energy Project, which are jointly referred to as the "Signing Parties."

1. THE SETTLEMENT AGREEMENT

Q. WHAT ASPECTS OF THE SETTLEMENT AGREEMENT ENTERED INTO BY THE SIGNING PARTIES WILL YOU ADDRESS IN THIS TESTIMONY?

A. I will respond to the overall rate of return included in the Settlement Agreement and the Equity Building Mechanism provision.

Q. PLEASE SUMMARIZE YOUR RECOMMENDATIONS CONCERNING THE PROPOSED SETTLEMENT AGREEMENT.

A. If the Commission elects to approve the Settlement Agreement, it should condition approval on the Signing Parties accepting a more reasonable common equity return. I recommend a return on common equity of 9.8%. This common equity return is reflective of the current low cost capital market for utilities with minimum investment grade senior corporate credit ratings.

I also find it is not in the public interest to enhance Avista's earnings above current market levels to increase its ability to accelerate the pay down of debt and increase its common equity ratio. Based on its public statements, it appears that Avista is attempting to increase its equity ratio by paying down debt from internal funds, but it has not attempted to maximize its retained earnings. Indeed, Avista informed investors that it has increased its dividend payments three times in the last 18 months.[1/] These dividend increases reduced the amount of earnings retained in the Company, reduced its internal funds available to pay down debt, and lowered Avista's common equity ratio.

Significantly a portion of Avista's internal funds are derived from the amortization of purchased power costs incurred but not recovered during the wholesale market activities in calendar years 2000 and 2001. Avista maintains that the build up of its debt balance and reduction of its common equity ratio is primarily a result of the extraordinary purchased power cost that has not yet been recovered.[2/] Avista Utilities has been permitted to defer these costs and amortize

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[1/] Avista's 2004 Annual Report at 13.
[2/] Exhibit No. ____(MKM-1T) at 4.

them to customers.[3/] Cash flow produced through this amortization of costs is helping to fund debt reduction and increase Avista's common equity ratio. Hence, regulatory mechanisms are already in place to provide ratepayer assistance to pay down the debt that has caused an erosion to Avista's common equity ratio. It is unreasonable to provide Avista an above-average market return on common equity in order to enhance its earnings entitlement as an additional means to fund debt reduction, especially since it is very likely these excess earnings will be used to support dividend payments and possibly dividend increases, but not debt reduction.

Q. PLEASE BRIEFLY DESCRIBE THE SETTLEMENT AGREEMENT.

A. The Signing Parties have agreed to an electric rate increase of $22.1 million, and a gas increase of $968,000. This revenue deficiency is based on an overall ROR of 9.11%, and a return on common equity ("ROE") of 10.4%.

Q. HAVE THE SIGNING PARTIES FULLY SUPPORTED THE REVENUE REQUIREMENT INCLUDED IN THE SETTLEMENT AGREEMENT?

A. No. The Settlement Agreement provides no details that demonstrate whether the overall rate of return, or the return on common equity, are just and reasonable. Indeed, a review of various aspects of the Settlement Agreement clearly indicates that the true return on common equity opportunity for Avista is over 11.14%, which is excessive. Hence, the rates produced under the Settlement Agreement have not been shown to be fair, just, reasonable, and in the public interest.

3/ Avista 2004 SEC 10K at 77.

Q. DO YOU BELIEVE THE SETTLEMENT AGREEMENT'S PROPOSED OVERALL RATE OF RETURN OF 9.11% IS REASONABLE?

A. No. This return is overstated for at least two reasons. First, the Settlement Agreement's authorized ROE of 10.4% is excessive in today's low cost capital market environment. I have estimated that Avista's current cost of common equity in today's capital market is 9.8%, as described below. Hence, the Commission should not approve the stipulated revenue requirement without full evidence on a fair cost of equity.

Second, the Settlement Agreement sets rates to actually provide Avista an opportunity to earn a true return on equity of at least 11.14%. This additional equity return opportunity is created because the stipulated capital structure is based on an artificially inflated ratio of common equity and an artificially reduced debt ratio. Inflating the amount of common equity in the capital structure increases the true equity return opportunity reflected in the Settlement Agreement, because Avista is permitted to earn an equity return on equity capital that has not been invested in the utility operations. Stated differently, under the Settlement Agreement, Avista will be permitted to earn an equity return on some portion of debt capital. Since, the equity return is higher than Avista's cost of debt, the amount of return above its debt cost will increase its return on the actual equity invested in utility operations.

Q. WHY HAVE YOU CONCLUDED THAT THE SETTLEMENT CAPITAL STRUCTURE IS BASED ON A COMMON EQUITY RATIO THAT EXCEEDS AVISTA'S ACTUAL COMMON EQUITY INVESTED IN UTILITY PLANT?

A. This is apparent from the Settlement Agreement. Specifically, the stipulated revenue requirement and rates are developed using a capital structure that is

composed of a percentage of common equity to total capital of 40%. Settlement Agreement at 3 (Aug. 12, 2005). However, in Section 8 of the Settlement Agreement, the "Equity Building Mechanism," the Signing Parties have agreed that the Company will increase its actual common equity ratio to total capital to 35% by year-end 2007, and to 38% by year-end 2008. Id. Hence, this clearly indicates that the Signing Parties have agreed that the Company's actual capital structure today supporting utility operations contains a common equity ratio to total capital that is less than the 40% ratio used to develop the stipulated revenue requirement.

Q. HAVE ALL THE SIGNING PARTIES CONSISTENTLY TAKEN THE POSITION THAT IT IS APPROPRIATE TO SET RATES BASED ON HYPOTHETICAL CAPITAL STRUCTURES

A. No. In another recent proceeding, Staff opposed setting rates with imputed common equity. WUTC v. Puget Sound Energy, Inc., ("PSE") WUTC Docket Nos. UG-040640, UE-040641, UE-031471, and UE-032043, Order No. 06 at ¶ 22 (Feb. 18, 2005). In the PSE case, the Order identified Staff's position as:

> [S]etting rates based on the basis of PSE's proposed 45% equity ratio, rather than the Company's actual expected equity ratio over the course of the rate year, would require ratepayers to pay for 'phantom equity costs' amounting to millions of dollars per year.

Id. In that case, Staff recommended rates be set at the Company's actual balance of common equity capital. Staff does not appear to be providing the same ratepayer protections to Avista's customers that it extended to PSE's customers.

Q. DOES THE SETTLEMENT AGREEMENT PROVIDE ADEQUATE INFORMATION THAT ALLOWS YOU TO DETERMINE WHAT AVISTA'S ACTUAL EARNING ENTITLEMENT WILL BE UNDER THE PROPOSED SETTLEMENT RATES?

A. No. While the Settlement Agreement claims to have identified a revenue deficiency, that revenue deficiency is not transparently developed in the Settlement Agreement. Indeed, the Settlement Agreement does not clearly identify the electric and gas rate base used by the Signing Parties to produce the claimed stipulated revenue requirement, among other cost items. Hence, the stipulated revenue deficiency calculations are not transparent, and it is not possible to accurately validate the Signing Parties' claimed revenue deficiency.

Q. IS THERE ANY WAY TO APPROXIMATE THE POTENTIAL EARNINGS ENTITLEMENT FOR AVISTA UNDER THE PROPOSED SETTLEMENT AGREEMENT?

A. Only loosely. If one relies on the electric and gas rate base from the Company's filing, and assumes that the actual capital structure supporting utility operations has a common equity ratio of no higher than 35%, one can estimate the minimum enhanced return on equity that the Settlement Agreement provides Avista during the rate period.

As developed on my Exhibit No.___(MPG-3), under these parameters, Avista will be provided an opportunity to earn an 11.14% return on common equity, assuming a common equity ratio of no higher than 35% of total capital. This minimum equity return enhancement is significantly higher than that awarded to utilities in most recent rate cases based on today's low cost capital market. Hence, the revenue requirement increase provided for in the Settlement Agreement is excessive and not just and reasonable.

Q. ARE THERE OTHER ASPECTS OF THE SETTLEMENT AGREEMENT THAT ARE TROUBLING?

A. Yes. While the Settlement Agreement is clearly based on a hypothetical capital structure with imputed (i.e., phantom) common equity, the Settlement Agreement appears to ignore the significant above-market cost of debt Avista is currently carrying on its books and records. At a minimum, the Settlement Agreement, if it is to impute common equity, should reduce the embedded debt cost down to assume that near-term embedded debt retirement of Avista will be refinanced at today's lower capital market costs. Indeed, approximately $300 million of high cost debt will be retired in calendar years 2007 and 2008. Avista witness Malyn Malquist testified that Avista has already purchased financial swap positions to lock in interest rate reductions amounting to over $900,000 per year in interest savings. Exhibit No.___(MKM-1T) at 21. Hence, the embedded debt used in the overall rate of return in the Settlement Agreement should be reduced to reflect the expected debt cost reduction when the imputed higher equity ratio is expected to be achieved.

Q. ARE THERE ANY ASPECTS OF THE PROPOSED SETTLEMENT AGREEMENT THAT WOULD REDUCE AVISTA'S OPERATING RISK AND THUS JUSTIFY A REDUCED RETURN ON EQUITY?

A. Yes. In Paragraph 13 of the proposed Settlement Agreement, the Energy Recovery Mechanism ("ERM") would be modified to provide greater assurance that Avista will fully recover its fuel and purchased power costs. The Settlement Agreement provides for a change to the ERM to reduce the deadband to $3 million, from $9 million, after calendar year 2005. Reducing the deadband will

provide Avista greater flexibility to increase deferrals and/or charges to recover volatile fuel and purchased power energy charges.

Importantly, while this proposed modification to the ERM reduces Avista's risk, it doesn't eliminate the risk. Rather, it simply transfers the volatile fuel and purchased power costs to customers and away from Avista. ICNU does not support reducing the deadband; however, if the Commission approves this approach it is appropriate to compensate customers for assuming a larger amount of the risk associated with fuel and purchased power cost recovery. This customer compensation should come in the form of reduced rates via a reduced ROE.

2. THE EQUITY BUILDING MECHANISM

Q. DOES THE EQUITY BUILDING MECHANISM BENEFIT CUSTOMERS AS OUTLINED IN THE SETTLEMENT AGREEMENT?

A. Not as structured. The Equity Building Mechanism appears to be designed to encourage Avista to increase its common equity ratio of total utility capital. Presumably the objective appears to be to incent Avista to improve its credit rating and financial integrity, thus enhancing its ability to attract capital at a more reasonable cost. Unfortunately, the Equity Building Mechanism is structured too loosely to provide real ratepayer assurances that Avista will use the excessive earnings provided in the Settlement Agreement to improve its financial condition rather than simply enhance its return to shareholders.

Q. PLEASE DESCRIBE THE DEFICIENCIES IN THE EQUITY BUILDING MECHANISM.

A. Simply stated, there is no true commitment by Avista to retain the excessive earnings produced via the Settlement Agreement to increase its common equity

capital and/or accelerate the pay down of debt during the rate period. Importantly, building up the equity capital in Avista should be an obligation and burden of its common shareholders, not ratepayers. Hence, the concept of setting rates to produce excessive earnings to build up utility equity capital places the considerable burden of making Avista utility equity investments on ratepayers rather than on investors. This concept is patently unjust to customers.

Setting this important principle aside, the Equity Building Mechanism should require Avista to agree to suspend dividend payments until the 40% utility equity ratio target is met. At a minimum, the Settlement Agreement should require Avista to agree not to increase dividends during the term of this rate settlement, and the suspension on dividend increases should remain in effect until Avista achieves the 40% common equity ratio of total utility capital.

In addition, the Company should be required to disclose to the Commission, Staff, and all interested stakeholders its plan to increase its common equity utility capital. Some options available include the public issuance of common equity stock where the proceeds will be used to reduce debt, or to fund utility cash requirements, excluding dividend payments. Avista should make a firm commitment to execute the plan to enhance its common equity, strengthen its balance sheet, and attempt to improve its credit rating.

The Settlement Agreement simply does not provide any assurance from Avista that it is committed to achieve the equity ratio targets reflected in the Settlement Agreement.

Q. BUT DOESN'T THE EQUITY BUILDING MECHANISM INCLUDE REFUND PENALTIES IN THE EVENT AVISTA FAILS TO MEET THE EQUITY RATIO TARGETS?

A. Yes. However, these revenue adjustments simply do not provide adequate penalties for failing to meet these equity ratio improvements. The Settlement Agreement provides for prospective rate adjustment and Avista will be permitted to keep all excessive earnings from prior periods. Hence, the Settlement Agreement does not provide assurance that the excessive earnings provided in the Settlement Agreement will be used by Avista to strengthen its utility balance sheet rather than be used to enhance its return to investors.

Q. WHY SHOULD AVISTA BE REQUIRED TO PROVIDE CUSTOMERS WITH A PLAN TO IMPROVE ITS EQUITY RATIO UNDER THE SETTLEMENT AGREEMENT?

A. Customers are, in effect, making equity investments in Avista by being required to pay rates that are equivalent to well-above-market required returns on low risk utility investments. If the Commission agrees that customers should be a source of Avista equity capital, then Avista should be obligated to make a firm commitment to build up its common equity by eliminating its dividend or, at a minimum, suspending growth to its dividend until the equity ratio targets are met, and until its target credit rating is achieved.

3. MARKET COST OF EQUITY

Q. PLEASE DESCRIBE THE FRAMEWORK FOR DETERMINING A REGULATED COMPANY'S COST OF COMMON EQUITY.

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

& Improvement Co. v. Pub. Serv. Comm'n of West Virginia, 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 are 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 WHAT IS MEANT BY THE "UTILITY'S COST OF COMMON EQUITY."

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

Q. PLEASE DESCRIBE THE METHODS YOU HAVE USED TO ESTIMATE THE COST OF COMMON EQUITY FOR AVISTA.

A. I have used several models derived from financial theory to estimate Avista's cost of common equity. These models are: 1) the constant growth discounted cash flow ("DCF") model; 2) the bond yield plus equity risk premium model; and 3) a capital asset pricing model ("CAPM"). I have applied these models to a proxy risk group of publicly traded utilities that I have determined to be reasonably comparable to Avista in terms of investment risk.

Q. HOW DID YOU SELECT YOUR PROXY RISK GROUP OF PUBLICLY TRADED UTILITIES IN ESTIMATING A FAIR RETURN FOR AVISTA?

A. I selected a group of electric utility companies followed by The Value Line Investment Survey that met the following selection criteria:

1. A minimum investment grade bond rating from S&P and Moody's of BBB or Baa;

2. Common equity ratios no greater than 60%;

3. Have paid dividends consecutively over the last two years; and

4. Have published consensus analysts' growth rate estimates.

Based on these selection criteria, the companies included in my comparable group are shown on my Exhibit No.____(MPG-4).

Q. IS YOUR PROXY GROUP REASONABLY RISK COMPARABLE TO AVISTA?

A. Yes. The proxy group's senior secured corporate credit rating from Standard & Poor's is BBB and from Moody's is Baa2. These ratings are only slightly higher than Avista's senior secured credit rating from Standard & Poor's of BBB- and from Moody's of Baa3. The group has a comparable business profile score from Standard & Poor's indicating comparable business risk.[4/]

Finally, Avista's Settlement Agreement common equity ratio of 40% is somewhat lower than the average equity ratio of 43%, when short-term debt is included in the calculation (Column 5). This group is a reasonable risk proxy for Avista.

4. THE 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 ("ROR") or cost of capital. This model is expressed mathematically as follows:

$$Po = \frac{D1}{(1+K)^1} + \frac{D2}{(1+K)^2} \ldots . \frac{D\infty}{(1+K)\infty} \quad \text{where} \qquad \text{(Equation 1)}$$

Po= 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:

$$K = D1/Po + G \qquad \text{(Equation 2)}$$

K = Investor's required return
D1 = Dividend in first year
Po = Current stock price
G = Expected constant dividend growth rate

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

Q. PLEASE DESCRIBE THE INPUTS TO YOUR CONSTANT GROWTH DCF MODEL.

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

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

A. I relied on the average of the weekly high and low stock prices over a 13-week period ending August 5, 2005. 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.

[4/] Standard & Poor's rates utilities' business risk based on a profile scale ranging from 1 (lowest risk) to 10 (highest risk). Integrated utility companies normally have business profile scores in the range of 4 to 6. Hence, Avista's business risk is at the high end of this range.

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

I used the most recently paid quarterly dividend, as reported in the Value Line Investment Survey. This dividend was annualized (multiplied by 4) and adjusted for next year's estimated growth to produce the D1 factor for use in Equation 2 above.

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

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

Security analysts' growth estimates have been shown to be more accurate predictors of future returns than growth rates derived from historical data.[5/] Because they are more reliable estimates, and assuming the market generally makes rational investment decisions, analysts' growth projections are the most likely growth estimates that are built into stock prices.

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

For my constant growth DCF analysis, I have relied on a consensus, or mean, of professional security analysts' earnings growth estimates as a proxy for the investor consensus dividend growth rate expectations. I used the average of three published sources of customer growth rate estimates, including Zack's Detailed Analyst Estimates, Reuters, and Thomson Financial. All consensus analyst projections used were available on August 19, 2005, as reported on-line. Each consensus growth rate projection is based on a survey of security analysts. The consensus estimate is a simple arithmetic average of surveyed analysts' earnings growth forecasts. A simple average of the growth forecasts gives equal weight to all surveyed analysts' projections. It is problematic as to whether any particular analyst's forecast is most representative of general market expectations. Therefore, a simple average, or arithmetic mean, of analysts' forecasts is a good proxy for market consensus expectations. The growth rates I used in my DCF analysis are shown on my Exhibit No. ____(MPG-5).

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

A. The result of my DCF analysis is shown on my Exhibit No.____(MPG-6). My DCF cost of common equity estimates for the proxy utility group is 8.8%.

Q. DO YOU HAVE ANY COMMENTS CONCERNING THE RESULTS OF YOUR DCF ANALYSIS?

A. Yes. I believe my DCF results exhibit sound investment and economic fundamentals. Indeed, both the growth and yield components of my DCF return reflect sound company financial fundamentals that support investment returns that reasonably reflect prevailing low cost and low inflation capital markets.

Specifically, the consensus analysts' growth rate for my proxy utility group is 4.57%. This growth rate is reasonable, if not highly conservative, for several reasons. First, the growth rate is reasonably consistent with the consensus of economists' five and ten-year projected GDP growth rate of 5.3%.[6/] Growth rates that approximate the long-term projected GDP growth rate represent the maximum sustainable growth rate for electric utility companies. This is true because electric utility companies cannot

grow indefinitely at a growth rate that is faster than the economy in which they sell their services. A utility's earnings are tied to its investment in utility plant, and utility plant is typically made to meet growing customer demands. Growing customer demand is, in turn, a function of the growth in the service area economy. Hence, growth in the service area economy represents the maximum sustainable long-term growth for utility plant investment and earnings. I would note, however, the Energy Information Administration has tracked historical GDP growth in utility earnings and has noted that utility sales growth lags the overall economy; EIA concludes that "demand for electricity has been related to economic growth, that positive relationship is expected to continue."[7/]

Accordingly, the nominal GDP growth rate is a conservative high end, i.e., should be considered the maximum, sustainable growth for electric utility companies in the DCF model. Hence, the growth rates used in my DCF analysis are conservatively high.

[6/] Blue Chip Economic Forecast, March 10, 2005.
[7/] EIA Annual Energy Outlook 2004 at 80.

Second, I conclude the growth rate is conservative in comparison to the GDP growth rate because the growth rate in utility dividends historically has been dramatically lower than the nominal GDP growth rate. See Exhibit No. ____(MPG-7). In fact, this exhibit shows that the proxy group's historical dividend growth rate has been closer to the rate of inflation. Currently, inflation projections over the next five and ten years by a consensus of economists, as published in the Blue Chip Financial Forecast, is 2.5%. (August 1, 2005 at 2).

Third, the fundamental factors supporting growth for these companies indicates that they are at payout ratios and dividend to book ratios that would support the sustainable dividend growth as projected by security analysts. For example, the payout ratio for the proxy utility group in 2004 is around 72%, and is projected to be around 63% three to five years out. This percentage payout allows the companies to retain adequate earnings to fund growth going forward. Retaining approximately 35% of their earnings would support moderate growth, again, growth that likely does not exceed the growth of the economy in which they sell their services.

Also, the current and projected dividend to book ratios of my proxy utility group is approximately 6.9% to 6.4%, respectively. Hence, a DCF return on equity of 9.8% will support the current and projected dividend and allow earnings retention to fund future growth.

Finally, the group yield of 4.24% is reflective of the market interest rates of long-term investments, thus indicating it is reasonably reflective of today's low cost capital market.

5. THE 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 ROR to assume greater risk. Common equity investments have greater risk than bonds because bonds have more security of payment in bankruptcy proceedings than common equity, and the coupon payments on bonds represent contractual obligations. In contrast, companies are not required to pay dividends on common equity, or to guarantee returns on common equity investments. Therefore, common equity securities are considered to be more risky than bond securities.

This risk premium model is based on two estimates of an equity risk premium. The difference between the required return on common equity and the yield on a bond is the risk premium. I estimated the risk premium on an annual basis for each year over the period 1986 through 2004. The common equity required returns were based on regulatory commission-authorized returns for electric utility companies. These authorized returns are typically based on expert witnesses' estimates of the contemporary investor required return.

The 1986-2004 time period was selected because over this period public utility equities have consistently traded at a premium to book value. This is illustrated on my Exhibit No. _____(MPG-8), where the market to book ratio since 1986 for the electric utility industry was consistently above 1.0. Therefore, over this time period, authorized returns were sufficient to support market prices that exceeded book value. This is an indication that authorized returns on common equity supported a utility's ability to issue additional common stock,

without diluting existing shares and having a detrimental impact on current shareholders.

The first estimate uses the difference between the required return on utility common equity investments and Treasury bond yields. Based on this analysis, as shown on my Exhibit No. ____(MPG-9), the average indicated equity risk premium of authorized electric utility common equity returns over U.S. Treasury bond yields was 4.96%. Of the 19 observations, 12 indicated risk premiums fall in the range of 4.4% to 5.7%. Since the risk premium can vary depending upon market conditions and changing investor risk perceptions, I believe using an estimated range of risk premiums is the best method to measure the current required return on common equity under this methodology.

The second equity risk premium method is based on the difference between regulatory commission authorized returns on common equity and contemporary A-rated utility bond yields. As shown on my Exhibit No. ____(MPG-10), the average indicated equity risk premium of authorized electric utility common equity returns over contemporary Moody's utility bond yields was 3.54% over the period 1986-2004. The equity risk premium estimates based on this analysis primarily fall in the range of 3.0% to 4.0% over this time period.

Q. HOW DID YOU ESTIMATE AVISTA'S COST OF COMMON EQUITY WITH THIS MODEL?

A. I added my estimated equity risk premium over Treasury yields to a projected long-term Treasury bond yield. Blue Chip Financial Forecasts projects the 20-year Treasury bond yield to be 5.2%, and the 10-year Treasury bond yield to be 5.1%. Blue Chip Financial Forecast, Aug. 1, 2005 at 2. Using the projected 20-

year bond yield of 5.2% and an equity risk premium of 4.4% to 5.7% produces an estimated common equity return in the range of 9.6% to 10.9%, with a mid-point estimate at 10.3%.

I next added my equity risk premium over utility bond yields to the current 13-week average yield on "Baa" rated utility bonds for the period ending July 1, 2005 of 5.79%. This current "Baa" utility bond yield is developed on my Exhibit No.____(MPG-11). Adding the utility bond equity premium of 3.0% to 4.0% to the "A" rated bond yield of 5.8% produces a cost of equity in the range of 8.8% to 9.8%, with a mid-point of 9.3%. Using the Baa yield would produce an average return of 9.3%.

My risk premium analyses therefore produce a common equity return estimate in the range of 9.3% to 10.3%, with a mid-point of 9.8%.

6. THE CAPITAL ASSET PRICING MODEL

Q. PLEASE DESCRIBE THE CAPM.

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

Ri = Rf + Bi x (Rm - Rf) where:

Ri = Required return for stock i
Rf = Risk-free rate
Rm = Expected return for the market portfolio
Bi = Beta - Measure of the risk for stock

The stock specific risk term in the above equation is beta. Beta represents the investment risk that cannot be diversified away when the security is held in a

diversified portfolio. When stocks are held in a diversified portfolio, firm-specific risks can be eliminated by balancing the portfolio with securities that react in the opposite direction to firm-specific risk factors (e.g., business cycle, competition, product mix, and production limitations).

The risks that cannot be eliminated when held in a diversified portfolio are nondiversifiable risks. Nondiversifiable risks are related to the market in general and are referred to as systematic risks. Risks that can be eliminated by diversification are regarded as nonsystematic risks. In a broad sense, systematic risks are market risks, and nonsystematic 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 risks that investors will be compensated for are systematic or nondiversifiable risks. The beta is a measure of the systematic or nondiversifiable 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. I used Blue Chip Financial Forecast's projected 20-year Treasury bond yield of 5.2%. Blue Chip Financial Forecast, Aug. 1, 2005 at 2.

Q. WHY DID YOU USE LONG-TERM TREASURY BOND YIELDS AS AN ESTIMATE OF THE RISK-FREE RATE?

A. Treasury securities are backed by the full faith and credit of the United States government. Therefore, long-term Treasury bonds are considered to have negligible credit risk. Also, long-term Treasury bonds have an investment

horizon similar to that of common stock. As a result, investor-anticipated long-run inflation expectations are reflected in both common stock required returns and long-term bond yields. Therefore, the nominal risk-free rate (or expected inflation rate and real risk-free rate) included in a long-term bond yield is a reasonable estimate of the nominal risk-free rate included in common stock returns.

Treasury bond yields, however, do include risk premiums related to unanticipated future inflation and interest rates. Therefore, 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 one, 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. I relied on the group average beta estimate for the comparable group. Group average beta is more reliable than a single company beta. A group average beta has stronger statistical parameters that better describe the systematic risk of the group than an individual company beta. For this reason, a group average beta will produce a more reliable return estimate.

I relied on The Value Line Investment Survey published beta for each of the companies in my comparable group. The average beta for my proxy utility group is 0.86 as shown on my Exhibit No. ____(MPG-12).

Q. HOW DID YOU DERIVE YOUR MARKET PREMIUM ESTIMATE?

A. I derived two market 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 (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.

The Ibbotson and Associates' Stocks, Bonds, Bills and Inflation 2005 Year Book publication estimates the historical arithmetic average real market return over the period 1926-2004 as 9.2%. A current five-year consensus analyst inflation projection, as measured by the Consumer Price Index, is 2.5%. Blue Chip Financial Forecasts, Mar. 10, 2005 at 15. Using these estimates, the expected market return is 11.9%. The market premium then is the difference between the 11.9% expected market return and my 5.2% risk-free rate estimate, or 6.7%.

The historical estimate of the market risk premium was also estimated by Ibbotson and Associates in the Stock, Bonds, Bills and Inflation, 2005 Year Book. Over the period 1926 through 2004, Ibbotson's study estimated that the arithmetic average of the achieved total return on the S&P 500 was 12.4%, and the total return on long-term Treasury bonds was 5.8%, producing an indicated equity risk premium of 6.6% (12.4% - 5.8% = 6.6%).

Q. WHAT ARE THE RESULTS OF YOUR CAPM ANALYSIS?

A. As shown on my Exhibit No.____(MPG-13), my CAPM estimate is 10.9%.

7. RETURN ON EQUITY SUMMARY

Q. BASED ON THE RESULTS OF YOUR RATE OF RETURN ON COMMON EQUITY ANALYSES DESCRIBED ABOVE, WHAT RETURN ON COMMON EQUITY DO YOU RECOMMEND FOR AVISTA?

A. Based on my analyses, I estimate an appropriate return on equity for Avista to be 9.8%.

TABLE 1

Return on Common Equity Summary

Description	Percent
Constant Growth DCF	8.8%
Risk Premium	9.8%
CAPM	10.9%

My recommended return on equity of 9.8% is at the mid-point of my estimated return on equity range for Avista of 9.0% to 10.3%. The high end of my estimated range is based on the average of my risk premium and CAPM analyses, and the low end of my estimated range is based on my DCF analysis, rounded up to 9.0%.

Q. WHY IS IT IMPORTANT TO ADOPT AN OVERALL ROE BASED ON THE MIDPOINT OF THE THREE MODELS?

A. Avista's ROE should not be established based on only one of the models because using a complete ROE analysis provides the most reliable estimate of a utility's current cost of common equity. The most accurate estimate of a utility's ROE will balance the competing interest of investors and customers, and is thus the most fair to both stakeholders. Indeed, arbitrarily selecting one model's results or

another's will tilt the regulatory balance in favor of investors at the expense of customers or vice versa. Hence, a balanced approach to developing the ROE should be followed in setting just and reasonable utility prices.

In addition, it is particularly inappropriate to set a utility's ROE on only the CAPM analysis. Specifically, the CAPM return is depended on the estimated utility beta. Utility betas over the last few years have been extremely volatile ranging from as low as 0.5 to as high recently as 0.9. Hence, current CAPM returns are at unusually high levels. Further, since the utility betas are calculated from five years of historical data, they are heavily impacted by the utility industry risk over the last five years. The utility industry risk during this time period was plagued by extremely volatile and uncertain wholesale markets, bankruptcies, and accounting irregularities and other factors that eroded investor's confidence in utility management and increased the market volatility of energy company stocks

These risk factors are no longer a significant concern, because the utility industry has reverted to a "back to basics" business model that concentrates on low risk regulated utility operations. Hence, the CAPM return in particular is not an appropriate method to develop a stand alone ROE estimate.

8. RESPONSE TO AVISTA WITNESS DR. WILLIAM AVERA

Q. DOES AVISTA WITNESS DR. AVERA'S RETURN ON EQUITY STUDY AND RECOMMENDATIONS SUPPORT THE 10.4% RETURN ON EQUITY INCLUDED IN THE STIPULATION?

A. No. Dr. Avera proposes an 11.5% equity return. His return on equity is supported by analyses that contain significant deficiencies and overstate a fair return on equity for Avista. By removing overstated cost estimates and adjusting

his assumptions to reflect current market costs, Dr. Avera's own studies support a return on equity for Avista of 9.8%.

Q. HOW DID DR. AVERA DEVELOP HIS 11.5% RETURN ON EQUITY?

A. Dr. Avera estimated a return for his comparable utility group of 11.2% and then added 30 basis points for common stock flotation expense. Hence, Dr. Avera is proposing an authorized return on equity for Avista of 11.5%.

Q. DO YOU BELIEVE THAT DR. AVERA'S 30 BASIS POINT FLOTATION COST ADDER TO AVISTA'S RETURN ON EQUITY IS REASONABLE?

A. No. Dr. Avera's 30 basis point return on equity adder is based on issuance expense studies performed on other utility companies. Common stock issuance expense is an item that can be properly accounted for and tracked by utility companies. If it is properly accounted for, the expense can be audited and confirmed, and the amount of the expense can be shown to be just and reasonable. Since Dr. Avera's flotation cost adjustment is not based on Avista-specific costs, it is not a known and measurable expense and should not be reflected in Avista's cost of service.

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

A. Dr. Avera estimated Avista's cost of equity using DCF and risk premium analyses. As shown below in Table 2, Dr. Avera's analyses produced returns on equity in the range of 10.0% to 11.9%.

However, as I will discuss in more detail below, making reasonable adjustments to Dr. Avera's DCF and risk premium studies indicate that a return on equity of 9.8% is fair for Avista based on today's marketplace.

TABLE 2

Avista's ROE Analysis

Model	Avera Proposed	Adjusted
DCF	9.8%	9.0%
RP: Authorized Return	10.8%-11.5%	9.8%
RP: Realized Return	9.8%-11.1%	Reject
CAPM: Forward	12.5%-12.6%	10.6%
CAPM: Historical	10.6%-11.8%	10.4%
Range		9.0%-10.6%
Midpoint		9.8%

Q. PLEASE SUMMARIZE DR. AVERA'S ARGUMENT THAT THE DCF RESULT IS CURRENTLY UNRELIABLE.

A. Dr. Avera argues that the DCF model should be used in conjunction with other models to estimate a fair return. He believes that the DCF model results may reflect a hangover associated with lingering economic and industry uncertainties. Consequently, he appears to assert that the DCF analysis does not produce reasonable results.

Q. DO YOU AGREE WITH DR. AVERA'S CONCLUSION THAT THE DCF ANALYSIS DOES NOT PRODUCE REASONABLE RESULTS AT THIS TIME?

A. Absolutely not. Indeed, as described in detail above, the fundamental characteristics of the industry and proxy group support the DCF model premise.

As discussed earlier in my testimony, the DCF dividend yields right now are consistent with low capital market interest rates. Also, the growth

components of the DCF analysis are at historically high levels approximating the projected growth of the overall U.S. economy.

From a company fundamental standpoint, the dividends are affordable and can permit reinvestment of adequate earnings to sustain targeted growth.

All of these factors demonstrate that the DCF results are logical in relationship to today's very low capital market costs, and appear fundamentally sound based on a review of the companies' ability to earn their dividends and retain sufficient earnings after dividend payments to fund future growth.

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

A. Using the same comparable group that I used to estimate Avista's return on equity, Dr. Avera estimated a current dividend yield of 4% and a growth rate estimate of 5.8% to produce a DCF return estimate of 9.8%.

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

A. Yes. Dr. Avera's DCF model is based on an unrealistically high growth rate of 5.8%. Dr. Avera estimates his proxy group's utility growth rates in the range of 4.3% to 5.7% with a midpoint of 5.0%. The 5.0% is based generally on analysts' projected growth, and also is corroborated by Dr. Avera's results of the utilities' own internal growth based on current utility fundamental data, which indicates a growth rate of 5.1%.

Using a 5.0% growth rate instead of a 5.8% growth rate that Dr. Avera used, would produce a DCF return of 9% (5% growth plus 4% yield).

Q. PLEASE DESCRIBE DR. AVERA'S RISK PREMIUM ANALYSIS USING COMMISSION AUTHORIZED RETURNS ON EQUITY.

A. Dr. Avera compares the Commission authorized returns over the period 1980 through 2004 relative to contemporary average utility bond yields. For the time period, he estimates an average risk premium of 3.17%. This states that over this 25-year time period, commission authorized returns have generally been 3.17 percentage points higher than the prevailing utility bond yield.

Dr. Avera then adjusted this historical equity risk premium for his belief that there is an inverse relationship between interest rates and equity risk premiums. Dr. Avera then increases the actual equity risk premium from 3.17% over this historical time period up to 4.8%. He then added this equity risk premium to the current "BBB" rated utility bond yield of 5.95% to produce a return on equity of 10.8%.

Next, he adjusted the historical 3.12% equity risk premium, based on a projected 2006 average utility bond yield of 7.0% to produce an adjusted equity risk premium of 4.29%. He then added the estimated equity risk premium of 4.29% to his projected "Baa" bond yield of 7.2% to produce a return on equity for Avista of 11.5%.

Dr. Avera's methodologies produce a return on equity for Avista in the range of 10.8% to 11.5%.

Q. DOES DR. AVERA'S RISK PREMIUM, BASED ON COMMISSION AUTHORIZED RETURNS, PRODUCE REASONABLE ESTIMATES?

A. No. Dr. Avera's proposal to increase the actual commission authorized equity risk premium over prevailing utility bond yields is inappropriate. Indeed, Dr. Avera has provided no credible support for the proposition that current equity risk

premiums will move inversely with interest rates. Equity risk premiums would logically be expected to change with expected changes in relative risk differentials between equity and bond investments. Equity risk premiums would not simply change based on changes to interest rates. Hence, Dr. Avera's proposed equity risk premium adjustment is based on a false financial premise.

Dr. Avera's schedule indicates the annual average equity risk premium seldom exceeds 4.0%. Exhibit No.___(WEA-2) at 6-7. This equity risk premium indicates a current return of approximately 9.8%, relative to current "Baa" yields of 5.8%.

Q. PLEASE DESCRIBE DR. AVERA'S REALIZED EQUITY RISK PREMIUM ANALYSIS.

A. Dr. Avera estimates the achieved return on the S&P electric stock index in comparison to the achieved total return on S&P's "A" rated utility bonds over the historical period of 1945 through end of calendar year 2003. Based on this review of historical achieved returns, Dr. Avera estimates an achieved equity risk premium on the S&P electric index relative to S&P's bond yields of 3.87%. Dr. Avera then adds this equity risk premium to the current and projected "Baa" utility bond yields of 5.95% and 7.2%, respectively. This produced an equity return within the range of 9.8% to 11.1%.

Q. DOES DR. AVERA'S HISTORICAL EQUITY RISK PREMIUM PRODUCE REASONABLE RESULTS?

A. No. There are several significant problems with Dr. Avera's historical equity risk premium analysis. First, his achieved return on utility stocks is based on end of year or December data. However, utility investments are traded throughout the year, not only at year end. Using data from the first three quarters of the year to

calculate the annual return on utility stocks would produce a lower achieved return on utility stocks than using the year-end data. Hence, he artificially selected a time period that produces the highest common equity return and thus inflates the equity risk premium estimate.

Second, the driving factor in this relatively short historical period reviewed by Dr. Avera (1952-2004) is the substantial decline in interest rates experienced over the last 25 years, and the dramatic changes in expectations of energy stock returns experienced over the last ten years.

Indeed, current interest rates are less than one-half the rates that existed in the early 1980s. This interest rate drop has dramatically impacted the achieved returns on both utility stocks and utility bonds. This interest rate drop is not likely to be repeated.

Further, the expected risk exposure of energy companies was impacted dramatically as the move to competition started in the early 1990s, and culminated in significant financial distress for many energy companies in the 2000-2002 time period. During that time period the market's expectation of substantial growth in energy company stocks substantially deviated from the relatively low risk nature of utility operations that currently exist, and have existed prior to this historical time period.

The bottom line effect of relative risk differentials between equity achieved returns and bond achieved returns is driven by factors that currently are not reflective of today's low risk, low interest rate capital market.

Consequently, this method is not a reasonable method of estimating Avista's equity risk premium required by investors today.

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

A. Dr. Avera estimates a forward-looking return on the market of 13.9%. From this market return estimate he then subtracts a long-term Treasury bond yield of 4.6% to arrive at a market risk premium of 9.3%. He relies on the utility beta of 0.84 to produce an implied cost of equity for his comparable group of 12.5%.

Dr. Avera then relies on a projected Treasury bond yield of 5.8% to produce a market risk premium of 6.8%. Using the same utility beta of 0.84, and this projected Treasury bond yield, produces a CAPM return of 12.6%.

As such, Dr. Avera's forward-looking application of the CAPM analysis produced a return on equity within the range of 12.5% to 12.6%.

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

A. No. Dr. Avera's 13.9% projected return on the market is highly inflated and unreliable. This market return estimate is based on a DCF analysis that includes a growth rate projection of 12.1% and a dividend yield of 1.8%. Dr. Avera's risk premium is dramatically overstated because it is based on a DCF return on the market that is untenable.

A market growth projection of 12.1% is untenable for the following reasons. First, his method of estimating it is to take the average of IBES growth rates for all the companies included in the S&P 500. It isn't clear whether he made a market weighted average of these IBES growth rate projections, or if he took the simple average of these companies. The footnote to his testimony

implies a simple average. Hence, he is over-weighting relatively small companies that provide relatively small weight to the S&P 500 market index.

Second, his method of estimating a DCF return for the market is in itself flawed. Specifically, many of the individual companies comprising the S&P 500 do not pay dividends. Hence, relying on a current earnings growth projection as a DCF return estimate for those companies is erroneous. Specifically, a DCF model estimates the future return based on projected dividends. The current dividend yield would be zero, and to the extent they are not projected to pay dividends for a number of years, would imply a DCF return of zero percent, or close to it. It is wrong to set the DCF return equal to the growth rate estimate. Hence, Dr. Avera's method of calculating a DCF return is flawed and overstates the market required return.

Q. WHAT HAS BEEN THE HISTORICAL GROWTH RATE TO THE S&P 500 AND HOW DOES THAT COMPARE TO DR. AVERA'S PROJECTED GROWTH RATE OF 12.1%?

A. Ibbotson & Associates' data estimates that over the period 1929 through 2004 the arithmetic average growth rate of the S&P 500 has been 7.9%. SBBI 2005 Yearbook at 117. Using this historical growth projection of a long-term sustainable growth rate that should be used in a DCF analysis, along with the current S&P 500 dividend yield of 1.8%, implies a forward-looking return on the S&P 500 of 9.7%.

Q. HOW WOULD DR. AVERA'S FORWARD-LOOKING CAPM RETURN ESTIMATE CHANGE IF A REASONABLE FORWARD-LOOKING RETURN ON THE MARKET IS USED?

A. It is difficult to establish what a reasonable expected return on the market is. However, using an 11.8% expected return on the market, which is the midpoint

between Dr. Avera's 13.9% estimate and my 9.7% estimate, would produce a more evenhanded market risk premium estimate. At a market risk premium of 11.8%,[8/] Dr. Avera's forward-looking CAPM analysis would produce a return in the range of 10.6% at current Treasury rates, and 10.7% using a more recent Treasury yield projection of 5.2%.

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

A. Dr. Avera uses Ibbotson & Associates estimated historical market risk premium of 7.2%. Ibbotson & Associates estimates this is based on the achieved return on utility stocks relative to the prevailing income yield on Treasury bonds. For the period 1926 though 2003, Ibbotson & Associates estimates this market risk premium to be 7.2%.

Using this market risk premium, a utility beta of 0.76, and a current and projected Treasury bond yield of 4.6% and 5.8%, respectively, Dr. Avera estimates a CAPM return of 10.6% to 11.8%.

Q. IS DR. AVERA'S ESTIMATED HISTORICAL DERIVED MARKET RISK PREMIUM CAPM ANALYSIS REASONABLE?

A. Ibbotson & Associates' historical market risk premium estimate of 7.2% is overstated. Ibbotson & Associates estimates this by looking at the historical achieved total return on stocks, relative to the yield on utility bonds. This is not a proper application of historical data to estimate the actual return premium of investing in stocks relative to Treasury bonds. Indeed, Ibbotson & Associates looks at the actual achieved historical returns on stocks, relative to the forward-

[8/] Note that this market return is similar to the arithmetic historical return on the S&P 500 of 12.5% (1929 to 2004).

looking expected return on utility bonds. This methodology is simply inappropriate.

Using Ibbotson & Associates data, the historical achieved return on common stocks is 12.4%, and the historical total achieved return on Treasury bonds is 5.8%. This implies a historical achieved return premium on stocks, relative to bonds, of 6.6%. This is an apples-to-apples use of historical data to estimate the real achieved premium on equity investments relative to a nearly riskless investment or Treasury bond yield.

Q. HOW WOULD DR. AVERA'S HISTORICAL CAPM ANALYSIS CHANGE IF A MORE REASONABLE MARKET RISK PREMIUM ESTIMATE IS USED?

A. Using a market risk premium of 6.6%, and a utility beta of 0.84, and a current Treasury bond yield of 4.9% and current projected Treasury bond yield of 5.2% would produce a return on equity of approximately 10.1% to 10.7%, with a mid-point of 10.4%.

Q. PLEASE SUMMARIZE YOUR CONCLUSIONS REGARDING DR. AVERA'S PROPOSALS IN THIS CASE.

A. Dr. Avera's analysis, once properly adjusted, supports an overall midpoint ROE of 9.8%. Adjusting Dr. Avera's DCF analysis to exclude an unreasonably high growth rate would produce a DCF return of 9.0%. Correcting Dr. Avera's risk premium analysis, including the exclusion of an inappropriate equity risk premium adjustment, the utilization of data from the entire year rather than only the end of the year, and reflecting the substantial decline in interest rates, would produce a risk premium return of 9.8%. Adjusting Dr. Avera's highly inflated CAPM analysis to remove unrealistic growth rates and flawed analysis produces a

10.6% forward CAPM. These three analysis produce a recommended midpoint ROE of 9.8%.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.