BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

WUTC V. AVISTA CORPORATION d/b/a AVISTA UTILITIES

DOCKET NOS. UE-050482 AND UG-050483

REBUTTAL TESTIMONY OF STEPHEN G. HILL (SGH-18T)

ON BEHALF OF

PUBLIC COUNSEL

September 22, 2005

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1 **I. INTRODUCTION/SUMMARY**

2 **Q. Please state your name, occupation and address.**

3 A. My name is Stephen G. Hill. I am self-employed as a financial consultant, and
4 principal of Hill Associates, a consulting firm specializing in financial and economic
5 issues in regulated industries. My business address is P.O. Box 587, Hurricane, West
6 Virginia, 25526 (e-mail: sghill@compuserve.com).

7 **Q. Are you the same Stephen Hill who testified previously in this proceeding on**
8 **behalf of the Public Counsel section of the Attorney General's Office (Public**
9 **Counsel) on the subjects of capital structure and cost of capital?**

10 A. Yes, I am.

11 **Q. What is the purpose of your testimony at this time?**

12 A. I will respond to the Settlement Agreement (Settlement) proposed by the Commission
13 Staff and Avista with regard to my issues of expertise: capital structure and the cost
14 of common equity capital. I will also comment, briefly, on the cost of capital
15 testimony submitted by Mr. Michael Gorman on behalf of the Industrial Customers of
16 Northwest Utilities (ICNU). While Mr. Gorman and I are in agreement that the return
17 on common equity included in the Settlement is excessive, his recommended return,
18 9.8%, overstates the Company's current cost of common equity due primarily to his
19 use of projected bond yields in his risk premium methodologies.

20 **Q. What are the issues included in the Settlement that you wish to address?**

21 A. I believe the return on equity included in the Settlement, 10.4%, substantially exceeds
22 the Company's cost of common equity capital, is not supported by reliable evidence

1 in the record in this proceeding and does not take into account other ratemaking
2 factors that work to shift risks to ratepayers. I will discuss the cost of common equity
3 issues initially.
4 Second, the Settlement contains a hypothetical ratemaking capital structure that is
5 almost identical to that recommended for ratemaking purposes in my direct
6 testimony, and, for that reason, I will not address the percentages of equity and debt
7 included in the Settlement. However, the Settlement does not recognize that there are
8 substantial ratepayer subsidies included in that capital structure, as I noted at page 47
9 of my direct testimony. Also, there are aspects of the testimony supporting the capital
10 structure settlement that are incorrect, in my opinion, and should be clarified. Finally,
11 although the Settlement contains some utility-only common equity ratio targets as
12 well as penalties for not reaching those targets—an "equity building" mechanism—
13 they are not sufficient, in my view, to ensure that by the time Avista files for
14 increased rates in Washington, ratepayer subsidization of the Company's financial
15 position will no longer be an issue.
16
17 **II. RETURN ON EQUITY**

18 **Q. Is the allowed return on equity of 10.4% included in the Settlement fair to**
19 **ratepayers?**
20 A. No, it is not. The allowed return on equity included in the Settlement is substantially
21 higher than the Company cost of equity capital, which I show in my direct testimony
22 is currently more than 100 basis points lower at 9.25%. That equity cost estimate is

1 based on an analysis of a sample group of similar-risk combination gas and electric
2 companies and the application of four different econometric models to the market
3 data of those Companies. My Discounted Cash Flow (DCF) result was corroborated
4 by the other three methodologies and a range of equity costs for combination utilities
5 similar in risk to Avista of 8.75% to 9.50% was established. Within that range, and
6 taking into account Avista's higher-than-average investment risk, I determined that an
7 appropriate point-estimate of the cost of equity for Avista was 9.25%, above the mid-
8 point of the reasonable range.

9 I also point out in my direct testimony that if Avista is allowed and earns a 9.25%
10 return on equity, the Company would be able to substantially improve its pre-tax
11 interest coverage ratios and, thereby, improve its financial position. Therefore, a
12 9.25% equity return is sufficient to attract capital (it equals the return investors
13 require in the marketplace) and it maintains or improves the financial position of the
14 Company. An equity return higher than 9.25% would unfairly enrich shareholders at
15 ratepayer expense.

16 It is important to note also that Avista's own rate of return witness, Dr. William
17 Avera, testified that the DCF cost of equity for his sample group of Companies was
18 9.8%—below the 10.4% included in the settlement. As I show at pages 77 through
19 82 of my direct testimony, updating Dr. Avera's DCF analysis and selecting the
20 highest growth rates produces an equity cost estimate of 9.3%. In other words, even
21 the Company's witness's most reliable equity cost estimation methodology, the DCF,
22 when updated to employ current market data, produces a maximum cost of equity

1 estimate more than 100 basis points below the equity return included in the
2 settlement.
3 I also show that one of Dr. Avera's Risk Premium analyses produces a current
4 equity cost estimate of 9.45% (Hill Direct, p. 87). Also, Dr. Avera's CAPM analysis,
5 when corrected for errors that overstate the cost of equity, indicates a current equity
6 cost of 9.2% (Hill Direct, p. 93).
7 **Q. ICNU cost of capital witness Gorman estimates the Company's cost of equity to**
8 **be 9.8%. Do you believe that estimate is also overstated to some degree?**
9 A. Yes I do. Mr. Gorman's DCF estimate is somewhat below my equity cost estimate in
10 this proceeding but within a reasonable range. His risk premium methods, a bond
11 yield-plus-risk premium method and a CAPM, are, I believe, overstated due to his
12 reliance on projected bond yields. As I noted in my critique of Dr. Avera's cost of
13 equity analysis (the Company witness also utilized bond yield projections in his cost
14 of equity analysis), the use of projected bond yields is unnecessary.
15 Investors are aware of the state of capital markets, including the expectations for
16 interest rates in the future. Those expectations are incorporated into current security
17 prices and are reflected in current bond yields. Therefore using projected bond yields
18 effectively double-counts those expectations and causes the equity cost estimate to be
19 overstated. Mr. Gorman doesn't use projected stock prices in his DCF analysis and,
20 for the same reason in my view, he should not use projected bond yields in his risk
21 premium cost of equity estimates.
22 In addition, bond yield projections are often wrong. As I note at page 83 of my

1 direct testimony, Blue Chip economists (the forecasting service on which Mr.
2 Gorman relies) has, for the past two years, consistently forecast interest rate increases
3 that have not materialized. In fact, interest rates have fallen over that time period.
4 Absent the use of projected bond yields in his risk premium and CAPM analyses,
5 Mr. Gorman's equity cost estimates for those methods would be 9.3% and 10%—
6 roughly 70 basis points lower than the equity cost estimates included in his direct
7 testimony. Mr. Gorman also notes, at page 25 of his direct testimony that "current
8 CAPM returns are at unusually high levels."
9 Even if we give his current-yield CAPM (10%) equal weight with Mr. Gorman's
10 DCF (8.8%) and current-yield Risk Premium (9.3%) results, the average equals
11 9.36%. This result, based on current yields and current investor expectations, is very
12 similar to my recommendation in this proceeding—9.25%—and roughly 100 basis
13 points below the 10.4% return on equity included in the Settlement.
14
15 **III. RATEPAYER SUBSIDY RESULTING FROM THE HYPOTHETICAL**
16 **CAPITAL STRUCTURE**
17 **Q. Are there other factors to consider when determining the fairness of the equity**
18 **return to be determined in this proceeding?**
19 A. Yes. One primary factor the Commission should weigh in its attempt to balance
20 ratepayer and stockholder interests is that the 40% equity ratio contained in the
21 ratemaking capital structure does not represent the manner in which the Company
22 actually capitalizes its utility assets. The ratemaking capital structure contains a

1 substantial ratepayer subsidy to shore up the utility's financial strength. Setting rates
2 with an equity return that overstates the Company's actual equity cost would shift an
3 even greater burden unnecessarily to ratepayers.
4 As the Settlement correctly reports, at year-end 2004, the Company's utility
5 operations were capitalized with approximately 30% common equity capital. By
6 setting rates with a 40% equity ratio, ratepayers will be required to provide an equity
7 return on approximately 10% of Avista's rate base (40% hypothetical equity – 30%
8 actual equity), which is actually financed with debt. Therefore, on that 10% of rate
9 base, the difference between the cost of equity that ratepayers must provide in rates
10 and the cost of debt will fall straight to Avista's bottom line in the form of a ratepayer
11 subsidy.
12 As shown in Table 1 below, the difference between the overall cost of capital
13 produced by the settlement capital structure and that produced by Avista Utilities
14 actual capital structure, times the Company's rate base, indicates an annual ratepayer
15 subsidy of about $7 Million, at the stipulated 10.4% return on common equity.
16 //
17 ///
18 ////
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20 //////
21 ///////
22 ////////

1 **TABLE 1**

2 **Annual Rate Impact of Hypothetical Capital Structure**

Settlement Capital Structure

Type of Capital	Percent	Cost Rate	Wt. Average Cost Rate	Pre-tax Cost Rate (t=35%)
Common Equity	40.00%	10.40%	4.16%	6.40%
Preferred Securities	1.42%	7.39%	0.10%	0.10%
Trust Preferred Securities	5.18%	6.60%	0.34%	0.34%
Debt	53.40%	8.44%	4.51%	4.51%
Total	100.00%		9.11%	**11.35%**

Utility Only Capital Structure

Type of Capital	Percent	Cost Rate	Wt. Average Cost Rate	Pre-tax Cost Rate (t=35%)
Common Equity	30.00%	10.40%	3.12%	4.80%
Preferred Securities	1.42%	7.39%	0.10%	0.10%
Trust Preferred Securities	5.18%	6.60%	0.34%	0.34%
Debt	63.40%	8.44%	5.35%	5.35%
Total	100.00%			**10.60%**

Overall Cost of Capital Differential = **0.76%**
Original Cost Rate Base (Gas & Electric) = **$0.926 Billion**
Annual Rate Impact of Hypothetical Capital Structure = **$7,004,816**

3

4 Considering the ratepayer subsidy included in rates in a different context provides
5 another assessment of the degree to which Avista's Washington ratepayers are
6 helping to shore up the Company's financial position. If the Company is allowed and
7 earns an overall return of 9.11%, as recommended in the Settlement, and that overall
8 return is applied to the Company's actual utility-only capital structure, the Company

1 is actually afforded an opportunity to earn a return on equity of 11.04%. That is
2 because the hypothetical ratemaking capital structure allows the Company to earn an
3 equity return on a portion of rate base actually financed with debt.

4 **Q. Mr. Hill, isn't it true that Public Counsel also recommended a capital structure**
5 **with a 40% common equity ratio—one that contains the very same ratepayer**
6 **subsidy?**

7 A. Yes, and I believe that that subsidy, at the current time, is reasonable as long as the
8 Company makes a firm commitment to shore up its actual utility-only common equity
9 ratio and eliminate the necessity for any such subsidy in the future. If the same
10 calculation shown above in Table 1 is performed using Public Counsel's
11 recommended 9.25% return on equity, the annual rate impact of the difference
12 between a 40% hypothetical common equity ratio and the Company's actual 30%
13 common equity ratio is about $5.3 Million, annually.

14 However, the issue on point here is that in my ratemaking recommendation to the
15 Commission I point out that such a subsidy exists, even with a 40% common equity
16 ratio. Neither the Settlement nor the testimony supporting it mentions that fact. I
17 mention it here to underscore the fact that the substantial ratepayer subsidies that are
18 built into the use of a hypothetical ratemaking capital structure call for the
19 Commission to be additionally sensitive about allowing a return on equity for Avista
20 that is excessive. In monetary terms, I believe it is appropriate to ask ratepayers to
21 provide a $5.3 Million annual subsidy through the use of a hypothetical ratemaking
22 capital structure due to the weak financial nature of Avista—as long as the Company

1 will rectify that capital structure difference before the next rate case. However, what
2 is unfair is the additional $2 Million that would be required from ratepayers to
3 provide a return on equity capital above the Company's actual cost.
4
5 **IV. JOINT TESTIMONY ARGUMENTS ON RETURN ON EQUITY**
6 **Q. What evidence is offered in the joint testimony supporting the 10.4% return on**
7 **common equity?**
8 A. The joint testimony refers only to equity return awards by other regulatory bodies in
9 other cases. The joint testimony does not refer to the current level of directly
10 observable capital costs (interest rates) or how that current interest rate level relates to
11 capital costs generally in recent years. The joint testimony does not discuss similar
12 risk companies, market prices, dividend growth rates, bond yields or any factors
13 relevant to the determination of the return investors currently require in order to
14 invest in combination gas and electric firms similar in risk to Avista Utilities.
15 No other portion of the Settlement or joint testimony reviews the actions of other
16 regulatory bodies and recommends that a consensus of other regulatory opinion be a
17 guide to regulatory action in this proceeding. Should a fuel adjustment clause in
18 Washington approximate the average of what is being done in other jurisdictions?
19 Amortization of historically high debt costs is an unusual regulatory practice—should
20 it be discontinued in Washington because it is not done in other parts of the U.S.?
21 Setting rates for one utility based on the average actions of other regulatory bodies is

1 reserved for only one aspect of the Settlement entered into by Avista and the Staff in
2 this proceeding—rate of return.
3 The joint testimony cites Regulatory Research Associates reported equity returns
4 during the first half of 2005 as support for the reasonableness of a 10.4% equity
5 return recommendation. However, with equal authority, one could cite as a
6 benchmark of reasonability the average overall return allowed electric utilities in the
7 first half of 2005 reported by the same publication—8.18%. That average allowed
8 return is almost 100 basis points below the 9.11% overall return recommended in the
9 Settlement, indicating the overall return included in the Settlement is excessive. That
10 8.18% is the return being allowed other regulated electric utilities in other parts of the
11 U.S., so why wouldn't it be reasonable for Avista?
12 The reason why allowing an overall return for Avista equal to the average overall
13 return being allowed other electric utilities is not a reasonable regulatory strategy is
14 the same reason why setting Avista's equity return based on average returns allowed
15 other electrics is not reasonable. The particular factors pertinent to the setting of
16 allowed returns to other companies in other jurisdictions are not necessarily pertinent
17 to either Avista Utilities or to the determination of the current cost of common equity
18 capital based on the facts in the record in this proceeding.
19 In a very recent rate decision, the Arkansas Public Service Commission
20 recognized the problems of basing the allowed return in one regulatory jurisdiction on
21 returns allowed in other jurisdictions for other companies:
22
23

1 Several parties present as evidence information on recent allowed returns
2 for LDC's in other states (T. 837-841, 911-913, 940-942(, (Hadaway
3 Exhibits SCH-11 and SCH-12), (T. 135, 209, 243, 1888) This
4 Commission gives no weight to such data for three reasons. First, there is
5 an element of circularity involved if this Commission, as well as other
6 state Commissions, rely upon rate of return determinations in other states
7 for determining the appropriate allowed return for utilities in their states.
8 Second, neither this Commission nor the parties have had an opportunity
9 to probe the factors that made up the allowed return determinations in the
10 other states. This Commission must make determinations based upon the
11 evidence presented in testimony and hearings before this Commission,
12 pursuant to the laws of the State of Arkansas. Third, this sort of
13 comparison is akin to piecemeal ratemaking and is unacceptable. For
14 example, we do not know the other state commissions' policies regarding
15 rate base, expenses, depreciation, etc. As noted by CEUG witness Staley:
16 '[E]very natural gas utility has different needs, different risks, different
17 load profiles, and different performance levels. Consequently, every
18 natural gas utility should have a uniquely determined ROE.' (T. 1302)
19 (Docket No. 04-121-U, Centerpoint Energy Arkla, Arkansas Public
20 Service Commission, Order No. 16, September 19, 2005, pp. 45, 46)
21
22 **Q. Are there other factors in the Settlement that work to reduce risks and should**
23 **also be considered in the Commission's determination of the reasonableness of a**
24 **10.4% return on equity for Avista?**
25 A. Yes. There are two points to note in that regard. First, the Settlement reduces the
26 Energy Recovery Mechanism (ERM) deadband from $9 Million to $3 Million. The
27 "deadband" is the amount of under- or over-earnings related to power costs the
28 Company must absorb before those under- or over-earnings are shared 90%/10% with
29 customers. Changing the size of the deadband does not change the power cost risks
30 to which the Company is subject, it merely shifts those risks to ratepayers.
31 With a narrowing of the deadband, Avista's operating risk is reduced and passed
32 on to customers. If the Commission accepts the Settlement's recommendations with
33 regard to this additional risk-shifting by the Company, that incrementally lower risk

1 would provide additional rationale to set the rate of return on equity below the 10.4%
2 suggested by Avista and Commission Staff. In that light my recommendation of a
3 9.25% return on equity is conservative.
4 Second, as I note at page 52 of my direct testimony, the Company's current debt
5 costs, which are included in the Settlement's ratemaking capital structure, are very
6 high. Moreover, mechanisms (rate swaps) are in place that will, following the
7 adjudication of this proceeding, lower the debt cost responsibility of Avista below the
8 level that will be included in rates. Therefore, monies included in rates that are
9 earmarked for debt service will be able to be used for other purposes (hopefully, for
10 debt reduction), or will fall to the bottom line increasing the Company's return on
11 equity. This future reduction in debt costs is another reason the Commission should
12 be conservative in setting the allowed return in this proceeding and not allow rates to
13 be based on a return on common equity that is higher than the Company's cost of that
14 form of capital.
15
16 **V. JOINT TESTIMONY ARGUMENTS ON CAPITAL STRUCTURE**
17 **Q. What are your comments regarding the Company's capital structure?**
18 A. As I noted at the outset of this testimony, the percentages of equity and debt in the
19 ratemaking capital structure included in the Settlement are virtually the same as those
20 that I recommended in my direct testimony and I believe they are reasonable.
21 However, in their joint testimony the parties make the following statement:
22 Investors look at the consolidated capital structure in
23 assessing the risk and their required return on Avista's

1 common stock and debt financing. Furthermore, the credit
2 rating agencies issue ratings for the company's securities
3 based on the consolidated capital structure of the Company.
4 Similarly, equity investors can only invest in Avista Corp.
5 stock, not the utility alone. Therefore, for the purposes of
6 the Settlement and under the circumstances of this case the
7 Settling Parties have agreed that the consolidated capital
8 structure is the relevant capital structure in determining a
9 fair rate of return for Avista's equity investors and bond
10 investors. (Joint Testimony, pp. 12, 13).
11
12 There are important distinctions that need to be made in regard to that statement.
13 There are two Avista entities. One is Avista Corporation, which is a diversified
14 company that contains a regulated utility as well as a group of unregulated companies
15 including, primarily, energy marketing operations. Those unregulated operations are
16 higher-risk operations than the regulated utility operations, making the consolidated
17 entity, Avista Corporation, a higher-risk entity than a pure-play utility operation. The
18 other Avista—the one before the Commission for an assessment of the adequacy of
19 its rates—is Avista Utilities.
20 When investors consider the purchase of Avista Corporation shares, as correctly
21 noted in the joint testimony cited above, investors must necessarily consider the
22 risk/return matrix presented by the all of the operations owned by Avista
23 Corporation—regulated and unregulated. For those investors, the consolidated
24 capital structure is, indeed, a consideration. However, the Commission is not setting
25 rates for the consolidated operations of Avista Corporation, it is setting rates for a
26 division of Avista Corporation—Avista Utilities. The risk/return matrix of concern to
27 the Commission in that task is that of the electric and gas utility. It follows then, that
28 the capital structure of concern is the capital structure of the utility, and Avista

1 Corporation management makes very clear to all concerned that only a portion of the
2 common equity that appears on its consolidated balance sheet is invested in utility
3 operations (see Hill Direct, p. 40, citing Avista S.E.C. Form 10-K).
4 For that reason, the consolidated capital structure is not the "relevant capital
5 structure" for determining an appropriate return to be allowed in this proceeding. As
6 it happens, the consolidated capital structure ratios are near the level appropriate for a
7 hypothetical capital structure which is appropriate for ratemaking in this instance. It
8 is important that the Commission does not set rates for Avista—no matter what the
9 choice of equity return—with the assumption that the 40% equity ratio is based on the
10 consolidated equity ratio of Avista Corporation, it just happens to be similar to it.
11 As I noted at page 46 of my direct testimony, if the utility operations of this
12 Company were more safely capitalized (i.e. with more equity capital), then the
13 consolidated capital structure of Avista Corporation would be approximately 50% of
14 total capital. For a diversified company with a substantial presence in energy
15 marketing, that would be a reasonable capital structure and would account for the
16 additional risk of Avista Corporation's unregulated operations. However, that would
17 not be an economically efficient capital structure for the regulated utility, which has
18 substantially less risk and which should have a much lower common equity ratio.
19 Therefore, the Commission's capital structure decision in this proceeding should not
20 be related in any way to Avista Corporation's consolidated capital structure. The
21 relevant capital structure in the instant proceeding is the appropriate ratemaking
22 capital structure for Avista Utilities.

1

2 ## VI. EQUITY BUILDING MECHANISM

3 **Q. With regard to the equity building portion of the Settlement, what are your**
4 **comments?**

5 A. First, I acknowledge that the Company has made a reasonable effort to address the
6 ratepayers' concerns that its utility operations are undercapitalized, and appears
7 willing to address those problems in the future. However, the progress toward the
8 goal of eliminating the ratepayers subsidies that are now necessary is, I believe, too
9 slow.

10 The joint testimony indicates that Avista Utilities agrees to reach a common
11 equity ratio of 35% by December 2007 and 38% by December 2008. The Company
12 wishes to adjust those targets depending on their ability to recover future power
13 supply or purchased gas costs within a time frame of their choosing. Also, the
14 Company agreed to a one percent reduction in base rates, implemented the following
15 April (i.e., the end of the heating season) if the common equity targets are not met.

16 The common equity ratio targets I set out in my direct testimony at pages 49 and
17 50 are slightly higher than those included in the Settlement (36% in 2007 and 39% in
18 2008). My recommendation also has a target equity percentage at the end of 2006,
19 which the Settlement does not. Finally, the revenue reduction penalty I recommend if
20 the targets are not met is 2% of revenues, not 1%. As I noted in my direct testimony,
21 those targets and penalty levels were patterned after the Commission's Order in
22 Docket Nos. UE-011570 and UG-011571 (Puget Sound Energy).

1 I believe that ratepayers, who are currently being asked to provide financial
2 support to Avista, would be better served by having regular step-wise common equity
3 ratio targets for the Company to meet. That would include an improved common
4 equity ratio by the end of 2006. An equity ratio of 33% by year-end 2006 would be
5 reasonable in that regard.

6 In addition, the 36% and 39% equity ratio targets I recommend go further than
7 those contained in the Settlement toward getting the utility to a point where the
8 ratepayers will be paying for the actual levels of common equity that finance utility
9 plant, not hypothetical levels. Thirty-nine percent common equity is closer to forty
10 percent than is thirty-eight percent, and closer to the elimination of ratepayer
11 subsidies.

12 It is important to understand also, that improving Avista Utilities' common equity
13 ratio is beneficial to the Company and its investors as well as to ratepayers. The
14 utility will be on firmer financial footing and it will have a much better opportunity to
15 improve its bond rating and lower its debt costs. Therefore, I believe it is reasonable
16 to subject Avista to the same rate penalty risk as was assigned Puget when the
17 Commission ordered that company to rebalance its capital structure. The two percent
18 across-the-board rate reduction was never realized by Puget and its capital structure
19 ratio targets were met early. I see no reason for the Commission to "soft-pedal" its
20 approach with Avista by utilizing penalties only half as large. The risk/reward
21 framework included in the Puget recapitalization plan worked very well and I believe

1 the Commission should continue to rely on a ratemaking strategy that has been
2 successful in the past.
3 Finally, on the point of the equity building guidelines and the size of the penalties
4 for non-compliance, I would like to underscore a point raised in the direct testimony
5 of ICNU witness Gorman. Mr. Gorman points out, correctly, that after keeping its
6 annual dividend constant at $0.48 since 1999, Avista management raised the dividend
7 three times in the last two years, as shown in Table 2 below.
8
9 **TABLE 2**
10 **Avista Dividends**

2003	Mar.	14	$0.12
	Jun.	13	$0.12
	Sept.	15	$0.125
	Dec.	15	$0.125
2004	Mar.	15	$0.125
	Jun.	15	$0.13
	Sept.	15	$0.13
	Dec.	15	$0.13
2005	Mar.	15	$0.135
	Jun.	15	$0.135
	Sept.	15	$0.135

11 Data from Avista website.
12
13 Clearly, one way to increase common equity in a corporation is to increase the
14 earnings retained within the firm, and just as clearly, Avista management has recently
15 elected to do the opposite—pay out a larger portion of earnings in dividends to its
16 stockholders. While Public Counsel did not originally make a recommendation that
17 an equity recapitalization plan include a restriction on dividend increases, it was

1 assumed that not increasing the dividend would be one sure way of improving the
2 common equity ratio. That retention of earnings along with the amortization of debt
3 costs enabling the buy-down of existing debt would enable Avista Utilities to improve
4 its common equity ratio. I believe Mr. Gorman makes a good point of concern with
5 regard to Avista's dividend policy. At the very least, concern over management's
6 dividend policy should provide the Commission additional incentive to maintain the
7 2% rate penalty requirement so that, if Avista Corporation management elects to pay
8 out more of its earnings in lieu of meeting its utility capital structure targets, it does
9 so at its own detriment. If the Company can meet its recapitalization targets for
10 Avista Utilities and increase dividends, fine, but it should have sufficient incentive to
11 meet those utility equity ratio targets.

12 **Q. Mr. Hill, your reference to what the Commission did with Puget's**
13 **recapitalization as appropriate for Avista begs the question of why the common**
14 **equity return recently allowed Puget would not also be appropriate for Avista?**

15 A. The answer to that is simple: 1) capital costs are lower now that they were last year
16 and 2) in my opinion, the equity return allowed Puget early this year exceeded that
17 Company's cost of common equity capital. In the 2004 Puget proceeding, my
18 estimate of the cost of common equity ranged from 9.00% to 10.00%. In the instant
19 proceeding, the cost of common equity of combination gas and electric utilities has
20 declined to a range of 8.75% to 9.50%. In other words, the mid-point of my range for
21 the cost of equity has declined about 40 basis points since last year. With regard to
22 the Commission's ultimate determination of the allowed return in the 2004 Puget

1 proceeding, I would simply note that my equity cost estimate in that proceeding was
2 9.75% and Staff's equity cost estimate was 9.00%, which I believe framed the cost of
3 equity more accurately than did the Commission's ultimate choice of allowed return
4 in that proceeding.

5 **Q. Does this conclude your rebuttal testimony, Mr. Hill?**

6 A. Yes, it does.