

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-07_____

DOCKET NO. UG-07_____

DIRECT TESTIMONY OF

WILLIAM E. AVERA

REPRESENTING AVISTA CORPORATION

DIRECT TESTIMONY OF WILLIAM E. AVERA

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I. INTRODUCTION

Q. Please state your name and business address.

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

Q. In what capacity are you employed?

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

Q. Please describe your educational background and professional experience.

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

A. Overview

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

A. The purpose of my testimony is to present to the Washington Utilities and Transportation Commission (the "Commission" or "WUTC") my independent evaluation of the fair rate of return on equity ("ROE") for the jurisdictional electric and gas utility operations of Avista Corp. ("Avista" or "the Company").

Q. Please summarize the basis of your knowledge and conclusions concerning the issues to which you are testifying in this case.

A. As is common and generally accepted in my field of expertise, I have accessed and used information from a variety of sources. I am familiar with the

1 organization, finances, and operations of Avista from my participation in prior
2 proceedings before the WUTC, the Idaho Public Utilities Commission (“IPUC”), and
3 the Oregon Public Utility Commission (“OPUC”). In connection with the present
4 filing, I considered and relied upon corporate disclosures and management
5 discussions, publicly available financial reports and filings, and other published
6 information relating to Avista. I also reviewed information relating generally to
7 current capital market conditions and specifically to current investor perceptions,
8 requirements, and expectations for Avista’s electric utility operations. These sources,
9 coupled with my experience in the fields of finance and utility regulation, have given
10 me a working knowledge of investors’ ROE requirements for Avista as it competes to
11 attract capital, and form the basis of my analyses and conclusions.

12 **Q. What is the role of ROE in setting a utility's rates?**

13 A. The rate of return on common equity serves to compensate investors
14 for the use of their capital to finance the plant and equipment necessary to provide
15 utility service. Investors only commit money in anticipation of earning a return on
16 their investment commensurate with that available from other investment
17 alternatives having comparable risks. Consistent with both sound regulatory

1 economics and the standards specified in the *Bluefield*¹ and *Hope*² cases, the return on
2 investment allowed a utility should be sufficient to: 1) fairly compensate capital
3 invested in the utility, 2) enable the utility to offer a return adequate to attract new
4 capital on reasonable terms, and 3) maintain the utility's financial integrity.

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

7 A. I first reviewed the operations and finances of Avista and the general
8 conditions in the utility industry and the economy. With this as a background, I
9 conducted various well-accepted quantitative analyses to estimate the current cost of
10 equity, including alternative applications of the discounted cash flow ("DCF") model
11 and the Capital Asset Pricing Model ("CAPM"), as well as reference to comparable
12 earned rates of return expected for utilities. Based on the cost of equity estimates
13 indicated by my analyses, the Company's ROE was evaluated taking into account
14 the specific risks and economic requirements for Avista consistent with restoration
15 and preservation of its financial integrity.

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

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

1 **B. Summary of Conclusions**

2 **Q. What are your findings regarding the fair rate of return on equity for**
3 **Avista?**

4 **A.** Based on the results of my analyses and the economic requirements
5 necessary to support continuous access to capital, I recommend that Avista be
6 authorized a fair rate of return on equity in the range of 11.3 percent to 12.3 percent.

7 The bases for my conclusion are summarized below:

- 8 • Considering investors' expectations for capital markets and the need to
9 support financial integrity and fund crucial capital investment even
10 under adverse circumstances, it is my opinion that an ROE in the 11.3
11 percent to 12.3 percent range is reasonable for Avista. Specifically, I
12 concluded that:
 - 13 ○ Applications of quantitative methods to alternative groups of proxy
14 companies implied a cost of equity range of 11.3 percent to 12.3
15 percent, with a midpoint of 11.8 percent;
 - 16 ○ Because of Avista's reliance on hydroelectric generation, the
17 Company is exposed to relatively greater risks of power cost
18 volatility;
 - 19 ○ Investors view the Energy Recovery Mechanism ("ERM") as
20 supportive of the Company's financial integrity, but they understand
21 that the ERM does not apply to 100 percent of power costs; nor does
22 it insulate Avista from the need to finance accrued power production
23 and supply costs or shield the Company from potential regulatory
24 disallowances;
 - 25 ○ The reasonableness of a 11.8 percent ROE for Avista is also
26 supported by the greater risks associated with the Company's
27 relatively small size and the need to consider flotation costs, with
28 both of these factors more than offsetting any impact attributable to
29 the modified ERM or the implementation of a Power Cost Only Rate
30 Case ("PCORC").

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

3 A. I strongly endorse Avista's requested capital structure, which is
4 consistent with the range of capitalization maintained by the firms in my utility
5 proxy group, especially when considering the impact of off-balance sheet
6 commitments and trends towards lower debt leverage going forward. In addition,
7 Avista's requested capitalization is consistent with the Company's progress in
8 strengthening its credit standing and financial flexibility as it seeks to raise
9 additional capital to fund system investments and refinance outstanding securities.

10 **Q. What other evidence did you consider in evaluating your**
11 **recommendation in this case?**

12 A. My recommendation was reinforced by the following findings:

- 13 • Sensitivity to regulatory uncertainties has increased dramatically and
14 investors recognize that constructive regulation is a key ingredient in
15 supporting utility credit standing and financial integrity;
- 16 • The announced sale of Avista's energy marketing and trading operations
17 has not significantly altered the Company's investment risks relative to
18 those of the proxy groups used to estimate the cost of equity;
- 19 • Avista must compete for investors' capital with other utilities and
20 businesses of comparable risk. If Avista is not provided an opportunity
21 to earn a return that is sufficient to compensate for the underlying risks,
22 investors will be unwilling to supply capital;
- 23 • Providing Avista with the opportunity to earn a return that reflects these
24 realities is an essential ingredient to strengthen the Company's financial
25 position, which ultimately benefits customers by ensuring reliable
26 service at lower long-run costs. The financial impact of an inadequate
27 ROE would forestall Avista's ability to achieve an investment grade

1 credit rating, which implies higher capital costs and reduced financial
2 flexibility;

- 3 • Avista must access the capital markets to fund significant capital
4 expenditures to maintain and enhance its utility system and is faced with
5 the near-term prospect of refinancing a significant portion of its total
6 debt outstanding;
- 7 • The challenges that have recently characterized the utility industry
8 illustrate the need to ensure that Avista has the ability to respond
9 effectively to unforeseen events.

10 **II. RELATIVE RISKS OF AVISTA**

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

12 A. As a predicate to my economic and capital market analyses, this
13 section examines the relative investment risks that investors consider in evaluating
14 their required rate of return for Avista. Further discussion of Avista's operations and
15 finances and the general conditions in the utility industry is contained in Exhibit
16 No.__(WEA-3).

17 **A. Operations & Finances**

18 **Q. Briefly describe Avista.**

19 A. As discussed in greater detail in Exhibit No.__(WEA-3), Avista is
20 engaged primarily in the procurement, transmission, and distribution of natural gas
21 and electric energy, as well as other energy-related businesses. Avista's generating
22 facilities include 8 hydroelectric generating stations and the electrical output of these
23 plants, which has a significant impact on total energy costs, is dependent on stream

1 flows. Although Avista estimates that hydroelectric generation is capable of
2 supplying 50 percent of total system requirements under normal conditions, the
3 Company has experienced prolonged periods of persistent below-normal water
4 conditions in the past.

5 Because close to one-half of Avista's total energy requirements are provided
6 by hydroelectric facilities, the Company is exposed to a level of uncertainty not faced
7 by most utilities. While hydropower confers advantages in terms of fuel cost savings
8 and diversity, reduced hydroelectric generation due to below-average water
9 conditions forces Avista to rely more heavily on purchased power or more costly
10 thermal generating capacity to meet its resource needs. Additionally, in recent years
11 utilities and their customers have also had to contend with dramatic fluctuations in
12 gas costs due to ongoing price volatility in the spot markets. In the minds of
13 investors, this dependence on wholesale markets entails significant risk, especially
14 for a utility located in the West.

15 **Q. How are fluctuations in Avista's operating expenses caused by**
16 **varying hydro and power market conditions accommodated in its rates?**

17 A. Beginning in July 2002, Avista implemented the ERM, under which
18 Washington jurisdictional rates are adjusted periodically to reflect changes in
19 variable power production and supply costs. When hydroelectric generation is
20 reduced and power supply costs rise above those included in base rates, the ERM

1 allows Avista to set aside a portion of these additional costs for the opportunity for
2 future recovery. Conversely, when increased hydroelectric generation leads to lower
3 power supply costs, the change in costs reduces the existing deferral balance or leads
4 to a reduction in rates.

5 Certain key terms of the ERM were modified pursuant to a settlement
6 agreement approved by the WUTC in June 2006.³ Specifically, whereas Avista
7 previously incurred the cost of, or received the benefit from, the first \$9.0 million in
8 annual power supply costs above or below the amount included in base retail rates,
9 this “deadband” was reduced to \$4.0 million.⁴ For supply cost variances between
10 \$4.0 million and \$10.0 million, Avista will now absorb 50 percent, with the remaining
11 50 percent being deferred for future surcharge or credit to customers. Finally, if the
12 annual power cost variance exceeds \$10 million, 90 percent of the deviation will be
13 deferred and Avista will incur the cost of, or receive the benefit from, the remaining
14 10 percent.

³ *Order Approving Settlement Agreement*, Docket No. UE-060181 (June 16, 2006).

⁴ Since the ERM was introduced in 2002, Avista expensed the entire amount of the \$9.0 million deadband each year through 2005. In 2006, the Company received a \$2.6 million benefit from the ERM deadband.

1 **Q. Are there other mechanisms that affect Avista’s rates for utility**
2 **service?**

3 A. Yes. With respect to Avista’s gas utility rates, the WUTC recently
4 approved a pilot decoupling mechanism.⁵ The decoupling program separates the
5 recovery of fixed costs from gas sales volumes by allowing deferred recovery of lost
6 margins due to changes in residential and commercial customers’ usage attributable
7 to natural gas conservation, energy efficiency, and price elasticity.

8 In addition, as part of this proceeding, Avista is proposing that the WUTC
9 approve the Company’s request for the ability to implement a PCORC. As described
10 in the testimony of Mr. Kelly O. Norwood, this mechanism would provide the
11 flexibility to adjust base production and transmission costs that are related to the
12 fixed and variable expenses included in the ERM. If implemented, Avista would
13 have the opportunity to reflect net changes in costs driven by load growth, including
14 fluctuations in operating expenses and capital costs driven by additional
15 investments in production and transmission infrastructure.

16 **Q. Does Avista anticipate the need to access the capital markets going**
17 **forward?**

18 A. Most definitely. Avista will require capital investment to meet
19 customer growth, provide for necessary maintenance and replacements of its natural

⁵ *Final Order Approving Decoupling Pilot Program*, Docket No. UG-060518 (Feb. 1, 2007).

1 gas utility systems, as well as fund new investment in electric generation,
2 transmission and distribution facilities. As discussed by Mr. Malyn Malquist,
3 planned capital expenditures for 2007 alone total \$183 million, with approximately
4 \$355 million anticipated for 2007-2008.

5 In addition to funding investment in utility infrastructure, Avista will also be
6 required to refinance a significant portion of its long-term debt outstanding. In
7 December 2006, Avista issued \$150.0 million of long-term bonds to defease debt that
8 was scheduled to mature in January 2007.⁶ Also in December 2006, Avista received
9 net proceeds of \$77.7 million from the sale of approximately 3.2 million shares of
10 common stock. The Company also entered into a sales agency agreement to issue
11 up to 2 million additional common shares, which it expects to sell over the next 2
12 years. Avista has \$370 million of long-term debt maturities and mandatory
13 preferred stock redemptions in 2007 and 2008 and will need to issue new securities
14 to fund a significant portion of these requirements.

15 Continued support for Avista's financial integrity and flexibility will be
16 instrumental in attracting the capital necessary to fund these projects in an effective
17 manner. Similarly, bolstering Avista's financial position will also support the
18 Company's efforts to refinance securities at favorable terms, thereby lowering costs

⁶ Avista's outstanding preferred stock will be redeemed in September 2007.

1 for customers in the future. Avista's reliance on purchased power to meet shortfalls
2 in hydroelectric generation magnifies the importance of strengthening financial
3 flexibility, which is essential to guarantee access to the cash resources and interim
4 financing required to cover inadequate operating cash flows, as well as fund
5 required investments in the utility system.

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

7 A. Avista is currently assigned a corporate credit rating of "BB+" by
8 Standard & Poor's Corporation ("S&P"), with Avista's senior secured debt being
9 rated "BBB-". Similarly, Moody's Investors Service ("Moody's") has assigned an
10 issuer credit rating of "Ba1" to Avista and rates the Company's first mortgage bonds
11 "Baa3", while Fitch Ratings, Ltd. ("Fitch") has assigned an issuer default rating of
12 "BB" and a senior secured debt rating of "BBB-". These corporate credit ratings
13 place Avista in the same category as speculative, or "junk," bond companies, with its
14 senior debt ratings occupying the bottom rung on the ladder of the investment grade
15 scale.

16 **Q. What does Avista's credit rating imply with respect to the rate of**
17 **return required by investors?**

18 A. Cost of equity estimates developed for the two benchmark groups
19 described subsequently are predicated on the investment risks associated with the
20 proxy firms, which have average corporate credit ratings of "BBB" and "A+".

1 Meanwhile, Avista’s below investment grade rating is indicative of an entirely
2 different risk class. Because investors require a higher rate of return to compensate
3 them for bearing more risk, the greater investment risk implied by Avista’s credit
4 ratings suggests that the cost of equity is correspondingly higher than for the proxy
5 groups.

6 **Q. What is the significance of “investment grade” versus “below**
7 **investment grade”?**

8 A. The term “investment grade” refers to a security having sufficient
9 quality, or relatively low risk, to be suitable for certain investment purposes. In
10 discussing this distinction, S&P noted that:

11 The term “investment grade” was originally used by various
12 regulatory bodies to connote obligations eligible for investment by
13 institutions such as banks, insurance companies, and savings and loan
14 associations. Over time, this term gained widespread usage
15 throughout the investment community. Issues rated in the four highest
16 categories, ‘AAA’, ‘AA’, ‘A’, ‘BBB’, are recognized as being investment
17 grade. Debt rated ‘BB’ or below generally is referred to as speculative
18 grade. The term “junk bond” is merely a more irreverent expression
19 for this category of more risky debt.⁷

20 There is a precipitous increase in risk associated with moving from
21 investment grade to below investment grade securities. S&P documented this in its

⁷ Standard & Poor’s, *Corporate Ratings Criteria* at 9, available at www.standardandpoors.com/ratings.

1 description of the risks associated with triple-B rated bonds and below investment
2 grade instruments:

3 An obligation rated 'BBB' exhibits adequate protection parameters.
4 However, adverse economic conditions or changing circumstances are
5 more likely to lead to a weakened capacity of the obligor to meet its
6 financial commitment on the obligation. Obligations rated 'BB', 'B',
7 'CCC', and 'C' are regarded as having significant speculative
8 characteristics. ... While such obligations will likely have some quality
9 and protective characteristics, these may be outweighed by large
10 uncertainties or major exposures to adverse conditions.⁸

11 A study conducted by Moody's indicated that default rates on double-B rated bonds
12 exceeded those for triple-B rated debt by a factor of 5.82 times over the period 1970
13 through 2002.⁹ Thus, bond ratings differences within the investment grade range
14 tend to reflect relatively modest gradations among fairly secure investments.
15 Meanwhile, moving to below investment grade implies an altogether different risk
16 plateau – one where the firm is regarded as a speculative investment.

17 **Q. Does the recently announced sale of Avista Energy, Inc. alter your**
18 **assessment of Avista's relative investment risks?**

19 **A.** No. On April 17, 2006, Avista announced that it had entered into an
20 agreement to sell substantially all of the assets and operations related to its energy
21 trading and marketing activities to Coral Energy Holdings, L.P., with the transaction

⁸ *Id.* at 8.

⁹ Moody's Investors Service, "Tracing the Origins of Investment Grade," *Special Comment* (Jan. 2004) at 6.

1 expected to close by the third quarter of 2007. The sale is based on a net book value
2 of approximately \$202 million, and will generate significant cash proceeds that will
3 be available for reinvestment in Avista's utility operations.

4 The investment community views the sale of Avista Energy Inc.'s trading and
5 marketing operations positively, but it does not result in a significant shift in Avista's
6 risks relative to the proxy companies used to estimate the cost of equity. For
7 example, Moody's concluded that while the sale implied a lower business risk
8 profile, the change was not sufficient to warrant any modification to Avista's credit
9 standing or ratings outlook.¹⁰ And while S&P revised its outlook on Avista from
10 "stable" to "positive" in response to the announced sale, it noted that any
11 improvement in Avista's credit standing is contingent on stronger financial
12 performance, which remains weak compared to benchmark levels.¹¹ Similarly,
13 Moody's noted the challenges posed by higher capital spending and the importance
14 of constructive regulation,¹² while Fitch and S&P both emphasized Avista's ongoing
15 exposure to variability in hydro conditions.

¹⁰ Moody's Investors Service, "Moody's comments on Avista Corp.'s plans for its subsidiary, Avista Energy, Inc.," *Global Credit Research, Issuer Comment* (Apr. 18, 2007).

¹¹ Standard & Poor's Corporation, "Avista Corp.'s Rating Outlook Revised to Positive On Announced Intent To Sell Avista Energy," *RatingsDirect* (Apr. 17, 2007).

¹² Moody's Investors Service, "Moody's comments on Avista Corp.'s plans for its subsidiary, Avista Energy, Inc.," *Global Credit Research, Issuer Comment* (Apr. 18, 2007).

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

3 A. Yes. As discussed further in Exhibit No.__(WEA-2), a firm’s relative
4 size has important implications for investors in their evaluation of alternative
5 investments, and it is well established that smaller firms are more risky than larger
6 firms. Because Avista is one of the smallest publicly traded electric utility holding
7 companies followed by Value Line, this implies a higher required rate of return.

8 **Q. What does this evidence suggest with respect to Avista’s cost of**
9 **equity relative to the proxy group results?**

10 A. Because of the additional investment risks associated with Avista’s
11 speculative grade corporate ratings, the Company’s weakened credit standing and
12 financial flexibility, and the heightened uncertainty associated with Avista’s reliance
13 on hydroelectric generation, investors’ required return for Avista exceeds that of the
14 proxy groups used to estimate the cost of equity. Competition for capital resources
15 is intense and investors are free to invest their funds wherever they choose. Denying
16 investors the opportunity to earn a return that is commensurate with Avista’s
17 investment risks would perpetuate the Company’s anemic credit standing and
18 hamper its future ability to attract capital, especially during periods of adverse
19 capital market conditions. From the standpoint of the capital markets, the West is
20 risky – and Avista’s weakened financial profile and continued exposure to wholesale

1 electric and natural gas markets in meeting shortfalls in hydroelectric generation
2 and other variations in resources and loads compound these uncertainties.

3 **B. Capital Structure**

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

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

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

16 A. Avista's capital structure is presented in the testimony of Mr. Malquist.
17 As summarized in his testimony, the common equity ratio used to compute Avista's
18 overall rate of return was 47.78 percent in this filing.

1 Companies that form growth plans and financial structures without
2 considering the potential for a shift in the capital market environment
3 or downturn in valuations can run into financial problems down the
4 road.¹³

5 This is especially the case for electric utilities that are exposed to the potential for
6 significant fluctuations in power supply costs, such as Avista.

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

9 A. As shown on Schedule WEA-1, The Value Line Investment Survey
10 (“Value Line”) expects that the average common equity ratio for the proxy group of
11 utilities will increase to 48.6 percent over the next three to five years, with the
12 individual common equity ratios ranging from 41.0 percent to 55.0 percent. The
13 WUTC has previously observed that “[i]t is appropriate ... to afford more weight to
14 forward considerations than to historic conditions as we determine the appropriate
15 equity ratio to be embedded in prospective rates.”¹⁴

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

18 A. The 47.78 percent common equity ratio requested by Avista falls well
19 within the range of capitalizations maintained by the firms in the proxy group at

¹³ Fitch Ratings, Ltd., “U.S. Power and Gas 2007 Outlook,” *Global Power/North America Special Report* (Dec. 15, 2006).

¹⁴ *Order No. 06*, Docket Nos. UG-040640 and UE-040641 (consolidated) (Feb. 18, 2005) at P. 32.

1 year-end 2006 and is entirely consistent with the 46.98 percent equity ratio based on
2 Value Line's near-term expectations for the utility proxy group.¹⁵

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

5 A. Depending on their specific attributes, contractual agreements or other
6 obligations that require the utility to make specified payments may be treated as
7 debt in evaluating Avista's financial risk. For example, S&P recently reaffirmed its
8 practice of adjusting reported results to reflect the debt equivalent impact of
9 operating leases, post-retirement benefit obligations, and asset retirement
10 obligations, among other factors.¹⁶ Additionally, because power purchase
11 agreements typically obligate the utility to make specified minimum contractual
12 payments akin to those associated with traditional debt financing, investors consider
13 a portion of these commitments as debt in evaluating total financial risks. Further,
14 changes in financial accounting standards also result in adjustments that have the
15 effect of further increasing financial leverage. Because bond ratings agencies and
16 investors adjust for these various commitments in assessing a utility's financial
17 position, they imply greater risk and reduced financial flexibility.

¹⁵ The 46.98 percent average reflects an adjustment for comparable short-term debt balances.

¹⁶ Standard & Poor's Corporation, "Credit FAQ: S&P Introduces Reconciliation Tables to Show Analytical Adjustments To Global Utilities' Financial Statements," *RatingsDirect* (Oct. 11, 2006).

1 **Q. What does this imply with respect to Avista’s capital structure?**

2 A. Absent financial policies that recognize the leverage implicit in off-
3 balance sheet obligations, the associated investment risks would place downward
4 pressure on utilities' creditworthiness and debt ratings and the greater leverage
5 implied by a lower common equity ratio would increase investors' required rate of
6 return for both debt and equity securities. As discussed in the testimony of witness
7 Malquist, including the impact of off-balance sheet debt equivalents results in
8 financial ratios that continue to fall short of established benchmarks for an
9 investment grade rating. Considering that both S&P and Moody’s have cited the
10 need for stronger financial metrics to avoid deterioration in the Company’s credit
11 standing, Avista must incorporate a higher equity component in the capital structure
12 to neutralize the implied leverage from off-balance sheet commitments.

13 **Q. What did you conclude with respect to the Company’s capital**
14 **structure?**

15 A. Based on my evaluation, I concluded that Avista’s requested capital
16 structure represents a reasonable mix of capital sources from which to calculate the
17 Company’s overall rate of return. While generally in line with industry standards,
18 Avista’s proposed capital structure continues to result in weak financial metrics after
19 adjusting for the debt equivalent associated with off-balance sheet obligations. The
20 continued need to moderate debt leverage through higher equity balances is

1 reinforced by the imperative of improving Avista’s credit standing while supporting
2 continued system investment. The Company’s proposed capital structure is just one
3 reflection of its ongoing efforts to enhance its financial integrity and maintain access
4 to capital on reasonable terms.

5 **III. CAPITAL MARKET ESTIMATES**

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

7 A. This section presents capital market estimates of the cost of equity. The
8 details of my quantitative analyses are contained in Exhibit No.__(WEA-4), with the
9 results being summarized below.

10 **A. Overview**

11 **Q. What role does the rate of return on common equity play in a utility’s**
12 **rates?**

13 A. The return on common equity is the cost of inducing and retaining
14 investment in the utility’s physical plant and assets. This investment is necessary to
15 finance the asset base needed to provide utility service. Investors will commit
16 money to a particular investment only if they expect it to produce a return
17 commensurate with those from other investments with comparable risks. Moreover,
18 the return on common equity is integral in achieving the sound regulatory objectives
19 of rates that are sufficient to: 1) fairly compensate capital investment in the utility, 2)
20 enable the utility to offer a return adequate to attract new capital on reasonable

1 terms, and 3) maintain the utility's financial integrity. Meeting these objectives
2 allows the utility to fulfill its obligation to provide reliable service while meeting the
3 needs of customers through necessary system expansion.

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

6 A. No. In my opinion, no single method or model should be relied upon
7 to determine a utility's cost of equity because no single approach can be regarded as
8 wholly reliable. As the Federal Communications Commission recognized:

9 Equity prices are established in highly volatile and uncertain capital
10 markets. ... Different forecasting methodologies compete with each
11 other for eminence, only to be superseded by other methodologies as
12 conditions change. ... In these circumstances, we should not restrict
13 ourselves to one methodology, or even a series of methodologies, that
14 would be applied mechanically. Instead, we conclude that we should
15 adopt a more accommodating and flexible position.¹⁷

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

¹⁷ Federal Communications Commission, Report and Order 42-43, CC Docket No. 92-133 (1995).

1 Under the regulatory standards established by *Hope* and *Bluefield*, the salient
2 criteria in establishing a meaningful benchmark to evaluate a fair rate of return is
3 relative risk, not the particular business activity or degree of regulation. Consistent
4 with this accepted regulatory standard, I also applied the DCF model to a reference
5 group of comparable risk companies in the non-utility sector of the economy. My
6 assessment of comparable risk relied on three objective benchmarks for the risks
7 associated with common stocks -- Value Line's Safety Rank, Financial Strength
8 rating, and beta. My non-utility proxy group was composed of those U.S.
9 companies followed by Value Line that 1) pay common dividends, 2) have a Safety
10 Rank of "1", 2) have a Financial Strength Rating of "A" or above, 3) have beta values
11 of 0.99 or less,¹⁸ and (4) have published growth estimates from Value Line, IBES, and
12 Reuters. Consistent with the development of my utility proxy group, I also
13 eliminated firms with below-investment grade credit ratings.

14 **Q. How do the overall risks of this non-utility comparable group**
15 **compare with those of the utility proxy group?**

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

¹⁸ A beta value of 0.99 corresponds to the average for the firms in the utility proxy group.

1 end values, application of the constant growth DCF model resulted in the following
 2 cost of equity estimates:

3 **TABLE 4**
 4 **DCF RESULTS – NON-UTILITY GROUP**

<u>Growth Rate</u>	<u>Average Cost of Equity</u>
I/B/E/S	12.5%
Value Line	11.8%
Reuters	12.4%
br+sv	12.9%

5 **Q. What did you conclude with respect to the cost of equity implied by**
 6 **the proxy groups using the constant growth DCF model?**

7 A. Taken together, I concluded that these DCF results for the two
 8 alternative proxy groups implied a cost of equity range of 10.3 percent to 12.3
 9 percent.

10 **Q. Do you believe the constant growth DCF model should be relied on**
 11 **exclusively to evaluate a reasonable ROE for Avista?**

12 A. No. Because the cost of equity is unobservable, no single method
 13 should be viewed in isolation. While the DCF model has been routinely relied on in
 14 regulatory proceedings as one guide to investors' required return, it is a blunt tool
 15 that should never be used exclusively. Regulators have customarily considered the

1 results of alternative approaches in determining allowed returns.¹⁹ It is widely
2 recognized that no single method can be regarded as a panacea; all approaches
3 having their own advantages and shortcomings. For example, a publication of the
4 Society of Utility and Financial Analysts (formerly the National Society of Rate of
5 Return Analysts), concluded that:

6 Each model requires the exercise of judgment as to the reasonableness
7 of the underlying assumptions of the methodology and on the
8 reasonableness of the proxies used to validate the theory. Each model
9 has its own way of examining investor behavior, its own premises, and
10 its own set of simplifications of reality. Each method proceeds from
11 different fundamental premises, most of which cannot be validated
12 empirically. Investors clearly do not subscribe to any singular method,
13 nor does the stock price reflect the application of any one single
14 method by investors.²⁰

15 Moreover, evidence suggests that reliance on the DCF model as a tool for
16 estimating investors' required rate of return has declined outside the regulatory
17 sphere.²¹ *Regulatory Finance: Utilities Cost of Capital* noted the inherent difficulties of
18 the DCF approach:

19 [C]aution and judgment are required in interpreting the results of DCF
20 models because of (1) the questionable applicability of the DCF model

¹⁹ For example, a NARUC survey reported that 26 regulatory jurisdictions ascribe to no specific method for setting allowed ROEs, with the results of all approaches being considered. "Utility Regulatory Policy in the U.S. and Canada, 1995-1996," National Association of Regulatory Utility Commissioners (December 1996).

²⁰ Parcell, David C., "The Cost of Capital – A Practitioner's Guide," *Society of Utility and Regulatory Financial Analysts* (1997) at Part 2, p. 4.

²¹ See, e.g., Bruner, R.F., Eades, K.M., Harris, R.S., and Higgins, R.C., "Best Practices in Estimating Cost of Capital: Survey and Synthesis," *Financial Practice and Education* (1998).

1 to utility stocks in certain market environments, (2) the effect of
2 declining earnings and dividends on financial inputs to the DCF model
3 and biases caused by the effect of changes in risk and growth, and (3)
4 the conceptual and practical difficulties associated with the growth
5 component of the DCF model.²²

6 The publication concluded, "If the cost of equity estimation process is limited to one
7 methodology, such as DCF, it may severely bias the results."²³

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

9 A. The CAPM is generally considered to be the most widely referenced
10 method for estimating the cost of equity among academicians and professional
11 practitioners, with the pioneering researchers of this method receiving the Nobel
12 Prize in 1990. Like the DCF model, the CAPM is an *ex-ante*, or forward-looking
13 model based on expectations of the future. As a result, in order to produce a
14 meaningful estimate of investors' required rate of return, the CAPM must be applied
15 using estimates that reflect the expectations of actual investors in the market, not
16 with backward-looking, historical data.

17 I applied the CAPM to the utility proxy group based on a forward-looking
18 estimate for investors' required rate of return from common stocks. In addition,
19 because it is frequently referenced in regulatory proceedings, I also applied the

²² Morin, Roger A., "Regulatory Finance: Utilities' Cost of Capital," *Public Utilities Reports, Inc.* (1994) at 238.

²³ *Id.*

1 CAPM using risk premiums based on historical realized rates of return published by
2 Ibbotson Associates. Reference to historical data represents one way to apply the
3 CAPM, but these realized rates of return reflect, at best, an indirect estimate of
4 investors' current requirements. As a result, forward-looking applications of the
5 CAPM that look directly at investors' expectations in the capital markets are apt to
6 provide a more meaningful guide to investors' required rate of return.

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

8 A. As shown on Schedule WEA-6, my forward-looking application of the
9 CAPM model indicated an ROE of approximately 13.2 percent for the utility proxy
10 group. My application of the CAPM using risk premiums based on historical
11 realized rates of return published by Ibbotson Associates is presented on Schedule
12 WEA-7. As shown there, adding the arithmetic mean historical equity risk premium
13 on common stocks to the yield on 20-year Treasury bonds resulted in an implied cost
14 of equity of 12.0 percent.

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

16 A. As I noted earlier, I also evaluated the cost of equity using the
17 comparable earnings method. Reference to rates of return available from alternative
18 investments of comparable risk can provide an important benchmark in assessing
19 the return necessary to assure confidence in the financial integrity of a firm and its
20 ability to attract capital. This comparable earnings approach is consistent with the

1 economic underpinnings for a fair rate of return established by the Supreme Court.
2 Moreover, it avoids the complexities and limitations of capital market methods and
3 instead focuses on the returns earned on book equity, which are readily available to
4 investors.

5 **Q. What rates of return on equity are indicated for utilities based on the**
6 **comparable earnings approach?**

7 A. Value Line reports that its analysts anticipate an average rate of return
8 on common equity for the electric utility industry of 11.5 percent over its forecast
9 horizon,²⁴ with natural gas distribution utilities expected to earn an average rate of
10 return on common equity of 11.5 percent to 12.0 percent.²⁵ For the utility proxy
11 group specifically, Value Line's projections suggested an average ROE of 10.8 percent
12 after eliminating two potential high-end outliers. Based on the results discussed
13 above, I concluded that the comparable earnings approach implies a fair rate of
14 return on equity of at least 11.0 percent.

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

17 A. The cost of equity estimates implied by my quantitative analyses are
18 summarized in Table 5, below:

²⁴ The Value Line Investment Survey (Feb. 9, 2007) at 1774.

²⁵ The Value Line Investment Survey (Dec. 15, 2006) at 459.

1
2

TABLE 5
SUMMARY OF QUANTITATIVE RESULTS

<u>Method</u>	<u>Cost of Equity Estimate</u>
DCF	10.3% -- 12.3%
CAPM	
Forward-looking	13.2%
Historical	12.0%
Comparable Earnings	11.0%

3 Based on the results of my quantitative analyses, and my assessment of the
4 relative strengths and weaknesses inherent in each method, I concluded that the cost
5 of equity is in the 11.3 percent to 12.3 percent range, with a midpoint of 11.8 percent.

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

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

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

12 **A. Implications for Financial Integrity**

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

14 A. Given the social and economic importance of the utility industry, it is
15 essential to maintain reliable and economical service to all consumers. While Avista

1 remains committed to provide reliable utility service, a utility's ability to fulfill its
2 mandate can be compromised if it lacks the necessary financial wherewithal.

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

4 A. Yes. While providing an ROE that is sufficient to maintain Avista's
5 ability to attract capital, even in times of financial and market stress, is consistent
6 with the economic requirements embodied in the Supreme Court's *Hope* and *Bluefield*
7 decisions, it is also in customers' best interests. Ultimately, it is customers and the
8 service area economy that enjoy the benefits that come from ensuring that the utility
9 has the financial wherewithal to take whatever actions are required to ensure
10 reliable service. By the same token, customers also bear a significant burden when
11 the ability of the utility to attract necessary capital is impaired and service quality is
12 compromised. To continue to meet potential challenges successfully and
13 economically, it is crucial that Avista receive adequate support for its credit standing.

14 **Q. What dangers does an inadequate rate of return pose to Avista?**

15 A. Given that Avista's corporate credit rating is already below investment
16 grade, the perception of a lack of regulatory support could lead to further
17 downgrades or, at a minimum, prolong Avista's efforts to achieve investment grade
18 ratings. At the same time, Avista's plans include refinancing a major portion of its
19 outstanding debt, as well as significant plant investment to ensure that the energy
20 needs of its service territory are met. While providing the infrastructure necessary

1 to meet the energy needs of customers is certainly desirable, it imposes additional
2 financial responsibilities on Avista. To continue to meet these challenges successfully
3 and economically, it is crucial that Avista receive adequate support to improve its
4 credit standing.

5 **Q. Do the potential exposures faced by Avista highlight the need for**
6 **ongoing support of the Company's financial strength and ability to attract capital?**

7 A. Most definitely. A number of potential challenges might require the
8 relatively swift commitment of capital resources in order to maintain the high level
9 of service to which its customers have become accustomed. Avista faces the
10 potential for fluctuating stream flows and significant volatility in wholesale fuel and
11 energy markets. Given utilities' lack of control over the timing of such events, the
12 Company must have the wherewithal to meet these challenges even when capital
13 and energy market conditions are unfavorable.

14 Experience demonstrates that, while investor confidence can evaporate
15 almost overnight, it is difficult to recover and the damage is not quickly or easily
16 reversed. Events in the Western U.S. provide a dramatic illustration of just how
17 swiftly unforeseen circumstances can lead to deterioration in a utility's financial
18 condition, and stakeholders have discovered first hand how difficult and complex it
19 can be to remedy the situation after the fact. For a utility with an obligation to
20 provide reliable service, investors' increased reticence to supply additional capital

1 during times of crisis highlights the necessity of preserving the flexibility necessary
2 to overcome periods of adverse capital market conditions.

3 **Q. What role does regulation play in ensuring a utility's access to**
4 **capital?**

5 A. Considering investors' heightened awareness of the risks associated
6 with the electric power industry and the damage that results when a utility's
7 financial flexibility is compromised, supportive regulation remains crucial in
8 preserving access to capital. Investors recognize that constructive regulation is a key
9 ingredient in supporting utility credit ratings and financial integrity, particularly
10 during times of adverse conditions. S&P noted that:

11 Regulatory rulings have returned to center stage as a dominant factor
12 in assessing companies' credit quality. These decisions will be critical
13 for an industry that in many jurisdictions is nearing the end of
14 extended transition periods and will be making significant capital
15 investment in infrastructure during the next several years.²⁶

16 Investors recognize the importance of financial flexibility, especially
17 considering the capital markets' ability to constrict access to capital when investors'
18 confidence is compromised. As S&P observed:

²⁶ Standard & Poor's Corporation, "Industry Report Card: U.S. Electric/Gas/Water," *RatingsDirect* (May 3, 2005) at 1.

1 When examining the quality of regulation, Standard & Poor's factors in
2 what level of support the utility might get in times of distress, when its
3 needs are most acute.²⁷

4 **Q. Are these concerns germane to Avista and its investors?**

5 A. Yes. While acknowledging that Washington's regulatory environment
6 has generally been supportive, the investment community recognizes that regulation
7 has its own risks. With respect to Avista, Moody's concluded that "[f]ailure to obtain
8 adequate and timely support for recovery of and return on core utility investments"
9 could have negative ratings implications.²⁸

10 Considering the magnitude of the events that have transpired since the third
11 quarter of 2000, investors' sensitivity to market and regulatory uncertainties has
12 increased dramatically. Investors have many alternatives and competition for capital
13 is intense. Lingering uncertainties from a prior era, as well as new challenges in the
14 utility industry, breed reluctance to make the long-term commitment of capital that
15 is required to ensure the reliable and economic supply of electricity and gas that
16 customers both demand and deserve. Thus, while customers might realize short-
17 term "savings" through a downward-biased ROE, these will prove illusory when the

²⁷ Standard & Poor's Corporation, "Regulation and Credit Quality in the U.S. Utility Sector,"
RatingsDirect (Jan. 30, 2003).

²⁸ *Id.*

1 utility is precluded from making investments that are consistent with providing
2 sustained, high quality service at the lowest possible price in the long run.

3 **B. Other Factors**

4 **Q. Do the modifications to the ERM approved in Docket No. UE-060181**
5 **warrant any adjustment in evaluating an ROE for Avista?**

6 A. No. The revisions to the ERM approved by the WUTC in June 2006, in
7 particular the reduction of the “deadband” from \$9 million to \$4 million, have been
8 favorably received by the investment community, but there is no indication that
9 these changes have led to any measurable decline in Avista’s overall investment risks
10 or ROE. For example, none of the major bond rating agencies elected to raise
11 Avista’s credit rating in response to approval of the modified ERM. While S&P
12 noted that Avista had routinely absorbed \$9 million under the previous formula, the
13 rating agency affirmed the Company’s existing credit ratings and noted its
14 assessment that the modifications would provide “modest cash flow protection.”²⁹
15 In addition to maintaining Avista’s debt ratings, S&P also made no change to its
16 *Business Profile* ranking for Avista, which remains at “6”.³⁰

²⁹ Standard & Poor’s Corporation, “BULLETIN: Changes In Recovery Of Energy Clause In WA Protective Of Avista’s Credit Quality,” *RatingsDirect* (June 19, 2006).

³⁰ The *Business Profile* ranking ranges from 1 (strong) to 10 (weak) depending on a utility’s relative business risks.

1 Moreover, adjustment mechanisms and contractual arrangements that enable
2 utilities to implement rate changes to pass-through fluctuations in fuel costs have
3 been widely prevalent in the industry. As a result, the mitigation in risks associated
4 with utilities' ability to attenuate the impact of power cost volatility is already
5 reflected in the 11.3 percent to 12.3 percent cost of equity range determined earlier.
6 Similarly, the firms in the non-utility proxy group also have the ability to alter prices
7 in response to rising production costs, with the added flexibility to withdraw from
8 the market altogether. Avista's exposure to potential power cost volatility is also
9 heightened because of its significant reliance on hydroelectric generation. As Fitch
10 reported to investors, this remains a "primary concern", notwithstanding the
11 modifications to the ERM:

12 The primary concern for [Avista's] fixed income investors continues to
13 be the potential impact of poor hydro conditions on utility cash flow,
14 credit metrics, and liquidity. While regulatory mechanisms are in place
15 to recover the majority of such prudently incurred fuel and purchased
16 power costs, the proportion absorbed by the company together with
17 regulatory lag in the recovery of large deferred energy cost balances
18 can be significant during poor water years, particularly during periods
19 of persistently high and volatile energy commodity prices.³¹

³¹ Fitch Ratings, Ltd., "Fitch Affirms AVA's IDR at 'BB'; Revises Outlook to Positive," *Press Release* (July 28, 2006).

1 **Q. What about the decoupling mechanism approved for Avista’s gas**
2 **utility operations?**

3 A. In recent years, significant and persistent declines in gas usage on the
4 part of residential and small commercial customers in Washington have hampered
5 Avista’s ability to recover the fixed costs associated with providing service. The
6 decoupling mechanism addresses the built-in revenue shortfall to the Company
7 associated with declining usage. Decoupling is supportive of Avista’s financial
8 integrity and the WUTC’s efforts to promote conservation and energy efficiency, but
9 it does not constitute a sea change in the investment risk that investors associate
10 with Avista’s gas utility operations.

11 As for the ERM, approval of the decoupling mechanism did not result in any
12 revision to Avista’s credit standing or outlook and utilities across the U.S. are
13 increasingly availing themselves of similar adjustments. Moreover, because
14 decoupling does not apply to large customers it does not insulate the Company from
15 changes in gas usage due general business and economic fluctuations. In addition,
16 unlike the vast majority of gas utilities, which benefit from a variety of mitigants,
17 Avista remains exposed to variability in customer usage associated with abnormal

1 weather.³² Thus, decoupling is an increasingly common mechanism that removes a
2 built-in bias preventing a utility from recovering its fixed costs when consumption is
3 declining, but it is only one of many factors considered by investors in evaluating a
4 gas distribution utility's total investment risks. There is certainly no evidence to
5 suggest that the existence or absence of a decoupling mechanism alone would alter
6 the risk of a gas utility enough to warrant a change in its ROE.

7 **Q. How does the PCORC relate to the risks perceived by investors?**

8 A. While the PCORC will help to preserve Avista's opportunity to earn its
9 authorized return by allowing the utility to recover reasonable and necessary
10 expenditures, it also addresses the investment community's heightened concerns
11 over the risks associated with rising costs. Of particular concern to investors is the
12 impact of regulatory lag and cost-recovery on the utility's ability to earn its
13 authorized ROE. S&P noted the importance of predictability and consistency, as
14 well as the need to reduce rate-case lag, in its assessment of a utility's operating
15 environment.³³ More recently, S&P emphasized that rising costs, including
16 escalating construction, operating, and maintenance expenses were one of the top

³² The majority of gas utilities have some form of weather mitigant, including adjustment clauses, insurance, or rate design features that make the utility less susceptible to variations in gas consumption due to weather.

³³ Standard & Poor's Corporation, "U.S. Regulation Returns to Center Stage," *RatingsDirect* (Apr. 14, 2005).

1 ten challenges to the credit standing of utilities.³⁴ Similarly, in a March 2007 report,
2 Moody's emphasized the need for regulatory support "in an era of broadly rising
3 costs."³⁵ Moody's noted that as cost pressures have escalated for electric utilities, so
4 too has the importance of timely recovery through the regulatory process and the
5 risks associated with regulatory lag.³⁶ While the PCORC will partially attenuate
6 Avista's exposure to attrition in an era of rising costs, this leveling of the playing
7 field will only serve to preserve the Company's opportunity to earn its authorized
8 return, as required by established regulatory standards.

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

11 A. The common equity used to finance the investment in utility assets is
12 provided from either the sale of stock in the capital markets or from retained
13 earnings not paid out as dividends. When equity is raised through the sale of
14 common stock, there are costs associated with "floating" the new equity securities.
15 These flotation costs include services such as legal, accounting, and printing, as well
16 as the fees and discounts paid to compensate brokers for selling the stock to the
17 public. Also, some argue that the "market pressure" from the additional supply of

³⁴ Standard & Poor's Corporation, "Top Ten Credit Issues Facing U.S. Utilities," *RatingsDirect* (Jan. 29, 2007).

³⁵ Moody's Investors Service, "Regulatory Pressures Increase For U.S. Electric Utilities," *Special Comment* (March 2007).

³⁶ *Id.*

1 common stock and other market factors may further reduce the amount of funds a
2 utility nets when it issues common equity.

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

5 A. No. While debt flotation costs are recorded on the books of the utility,
6 amortized over the life of the issue, and thus increase the effective cost of debt
7 capital, there is no similar accounting treatment to ensure that equity flotation costs
8 are recorded and ultimately recognized. Alternatively, no rate of return is
9 authorized on flotation costs necessarily incurred to obtain a portion of the equity
10 capital used to finance plant. In other words, equity flotation costs are not included in
11 a utility's rate base because neither that portion of the gross proceeds from the sale of
12 common stock used to pay flotation costs is available to invest in plant and equipment,
13 nor are flotation costs capitalized as an intangible asset. Unless some provision is
14 made to recognize these issuance costs, a utility's revenue requirements will not fully
15 reflect all of the costs incurred for the use of investors' funds. Because there is no
16 accounting convention to accumulate the flotation costs associated with equity issues,
17 they must be accounted for indirectly, with an upward adjustment to the cost of
18 equity being the most logical mechanism.

1 **Q. What is the magnitude of the adjustment to the “bare bones” cost of**
2 **equity to account for issuance costs?**

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

9 The flotation cost allowance requires an estimated adjustment to the
10 return on equity of approximately 5% to 10%, depending on the size
11 and risk of the issue.³⁷

12 Alternatively, a study of data from Morgan Stanley regarding issuance costs
13 associated with utility common stock issuances suggests an average flotation cost
14 percentage of 3.6%.³⁸ Applying these expense percentages to a representative
15 dividend yield for a utility of 3.6 percent implies a flotation cost adjustment on the
16 order of 13 to 36 basis points.

³⁷ Roger A. Morin, *Regulatory Finance: Utilities’ Cost of Capital*, 1994, at 166.

³⁸ *Application of Yankee Gas Services Company for a Rate Increase*, DPUC Docket No. 04-06-01, Direct Testimony of George J. Eckenroth (Jul. 2, 2004) at Exhibit GJE-11.1. Updating the results presented by Mr. Eckenroth through April 2005 also resulted in an average flotation cost percentage of 3.6%.

1 imply a level of investment risk and required return that exceeds that of the proxy
2 groups used to estimate the cost of equity.

3 Based on the various capital market oriented analyses described in my
4 testimony, I concluded that the fair rate of return on equity range was 11.3 percent to
5 12.3 percent. Considering capital market expectations, the potential exposures faced
6 by Avista, and the economic requirements necessary to maintain financial integrity
7 and support additional capital investment even under adverse circumstances, it is
8 my opinion that this range represents a fair and reasonable ROE for Avista.

9 As explained earlier, there is no indication that changes to the ERM or
10 implementation of decoupling for Avista's gas utility operations has resulted in a
11 measurable change in the Company's overall investment risks or ROE. Similarly,
12 Avista's proposed PCORC would only serve to preserve the Company's opportunity
13 to earn its allowed return by countering the attrition associated with a rising cost
14 environment. Nor has the announced sale of Avista's energy marketing and trading
15 operations significantly altered the Company's investment risks relative to the proxy
16 groups used to estimate the cost of equity. Moreover, any impact of these
17 considerations on investors required return would be more than offset by the greater
18 risks associated with the Company's relatively small size and flotation costs, neither
19 of which are considered in my 11.3 percent to 12.3 percent recommended ROE range
20 for Avista.

- 1 Q. Does this conclude your pre-filed direct testimony?
- 2 A. Yes.