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BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION	)	CASE NO. AVU-E-04-01
OF AVISTA CORPORATION FOR THE	)	CASE NO. AVU-G-04-01
AUTHORITY TO INCREASE ITS RATES	)	
AND CHARGES FOR ELECTRIC AND	)	
NATURAL GAS SERVICE TO ELECTRIC AND	)	REBUTTAL TESTIMONY
NATURAL GAS CUSTOMERS IN THE STATE	)	OF
OF IDAHO	)	WILLIAM E. AVERA
	)	

FOR AVISTA CORPORATION

(ELECTRIC AND NATURAL GAS)

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CONTENTS

</div>

1

2   **Section**   **Page**

1   I.   INTRODUCTION

2   Q.   Please state your name and business address.

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

4   Q.   Are you the same William E. Avera that previously submitted direct

5   testimony in this case?

6   A.   Yes, I am.

7   Q.   What is the purpose of your rebuttal?

8   A.   The purpose of my testimony is to respond to the direct testimony of Ms. Terri

9   Carlock, submitted on behalf of the staff of the Idaho Public Utilities Commission ("IPUC").

10   In addition, I will also rebut the recommendations contained in the direct testimony of Dr.

11   Dennis E. Peseau and Mr. John S. Thornton, Jr., on behalf of Potlach Corporation, concerning

12   the cost of equity for the jurisdictional utility operations of Avista Corporation. ("Avista").

13   Q.   Please summarize the conclusions of your testimony.

14   A.   With respect to the testimony of Ms. Carlock, I concluded that her

15   recommendations were biased downward because of her failure to consider the results of

16   other accepted methods of estimating the cost of equity. Additionally, Ms. Carlock's

17   assessment of relative risks focused exclusively on Avista's relatively low rates, while

18   ignoring the substantial uncertainties and higher investment risks that investors must bear to

19   provide the benefits of lower electricity costs to Avista's customers. Finally, her flotation cost

20   adjustment understates the costs necessary to raise the equity capital invested in Avista's

21   jurisdictional utility operations in Idaho. At a minimum, considering the results of risk

22   premium approaches, investors' risk perceptions, and correcting Ms. Carlock's flotation

1 adjustment would support a rate of return at the very top of the range of her results, or 11.3

2 percent.

3   Meanwhile, Dr. Peseau did not conduct any independent analyses of the cost of equity

4 to Avista. Instead, his recommendations were based entirely on flawed "updates" and

5 "revisions" to my analyses, which should be rejected in their entirety. Similarly, Mr.

6 Thornton's recommended 8.5 percent cost of equity is woefully inadequate and, by any

7 reasonable benchmark, falls well short of investors' required rate of return from an electric

8 utility, especially considering Avista's unique risks and weakened credit standing. Mr.

9 Thornton's recommendations do not pass the financial end-result test fundamental to

10 regulation and would preclude Avista from restoring its financial integrity and attracting

11 capital on reasonable terms.

12   **Q.   Would you please summarize the principal shortcomings in the testimony**

13 **of Ms. Carlock, Dr. Peseau, and Mr. Thornton that you address in rebuttal?**

14   A.   Yes. The major issues addressed in my rebuttal testimony are as follows:

15 **<u>Ms. Carlock</u>**

16
17   • While the risks premium approach is widely recognized as a meaningful approach
      to estimate the cost of equity, Ms. Carlock did not use this method;

18
19
20   • No methodology provides a foolproof guide to investors' required rate of return,
      and it is important to consider alternative approaches and evaluate the results of
      accepted methods;

21
22   • The results of risk premium analyses are consistent with a rate of return at the top
      of Ms. Carlock's discounted cash flow ("DCF") and comparable earnings ranges;

23
24
25   • Ms. Carlock's recommendation does not fully reflect the investment risks
      associated with Avista's weakened credit profile and exposure to market
      uncertainties;

26
27   • The pre-tax coverage ratio implied by Ms. Carlock's recommendation is only
      marginally above the minimum benchmark for a triple-B bond rating;

28
29   • Ms. Carlock's flotation cost adjustment is biased downward and she failed to
      adjust the results of her comparable earnings approach to incorporate issuance

1	costs.

Dr. Peseau

- Dr. Peseau performed no independent analyses of the cost of equity;
- His decision to "update" my DCF analysis by ignoring historical growth trends is unsupported and contradicts the advise and conclusions of his own sources;
- In contrast to Dr. Peseau's allegations, there are no inconsistencies in my risk premium analyses and his use of single-A bond yields as a benchmark for Avista's investment risks understates investors' required return;
- Dr. Peseau did not update my application of the capital asset pricing model ("CAPM"); instead, he substituted a market risk premium that does not reflect expectations in today's capital markets; and,
- Dr. Peseau ignored Avista's greater investment risks and the need to adjust the cost of equity to account for flotation costs.

Mr. Thornton

- The extreme downward bias of Mr. Thornton's recommended cost of equity is illustrated when compared against the returns on equity authorized by regulators, including the IPUC;
- Mr. Thornton's recommendations are divorced from the requirements of real-world capital markets and the inputs to his analyses do not reflect the expectations of investors;
- Mr. Thornton's criticisms of my analyses lack any reasonable basis, as does his rejection of arithmetic mean returns and long-term bond yields in applying the CAPM;
- Like Dr. Peseau, Mr. Thornton ignored Avista's greater investment risks and the need to adjust the cost of equity to account for flotation costs; and,
- Correcting Mr. Thornton's flawed calculations results in a coverage ratio that falls below the minimum guidelines for an investment grade rating and demonstrate that his recommendations would not allow Avista the opportunity to maintain its financial integrity.

1	**II. TERRI CARLOCK**
2	**Q. First, does the capital structure proposed by Ms. Carlock provide a**
3	**reasonable basis on which to calculate an overall rate of return for Avista?**
4	A. Yes. Ms. Carlock recommended a capital structure composed of 50.08 percent
5	long-term debt, 5.57 percent trust preferred securities, 1.76 percent preferred stock, and 42.59
6	percent common equity based on Avista's actual capitalization at December 31, 2003. As
7	discussed in my direct testimony, the average capitalization for the firms in my comparable
8	group was composed of 44.7 percent common equity. Meanwhile, revised financial guideline
9	ratios published by Standard & Poor's Corporation ("S&P") imply a total equity ratio in the
10	range of 42 to 52 percent for Avista to qualify for a triple-B rating.[1] Accordingly, I concluded
11	that the capital structure used by Ms. Carlock is in-line with industry standards.
12	**Q. How did Ms. Carlock arrive at her 10.4 percent cost of equity**
13	**recommendation for Avista?**
14	A. Ms. Carlock estimated the cost of equity by applying the constant growth DCF
15	model directly to Avista. She concluded that the results of this single DCF application
16	indicated a cost of equity in the 8.8 to 11.3 percent range. Ms. Carlock also conducted a
17	comparable earnings analysis, which resulted in an indicated cost of equity in the 10.0 to 11.0
18	percent range. Based on these two analyses, Ms. Carlock concluded that the cost of equity
19	was in the 9.5 to 10.9 percent range, selecting 10.4 percent as her point estimate and
20	recommendation for Avista.

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[1] Standard & Poor's Corporation, "New Business Profile Scores Assigned for U.S. Utility and Power Companies; Financial Guidelines Revised," *RatingsDirect* (Jun. 2, 2004) at Table 1. For a utility with Avista's *business profile* ranking of "6", S&P reported a guideline total debt ratio ranging from 58 to 48 percent for a triple-B rating, which equates to a total equity ratio of 42 to 52 percent.

1 **Q.   Did Ms. Carlock apply the risk premium approach to estimate the cost of**

2 **equity for Avista?**

3   A.   No. While Ms. Carlock stated that "much of the theoretical approach" that

4 she used was consistent with my testimony, Ms. Carlock did not use the risk premium

5 method to estimate the cost of equity. The risk premium method is widely recognized as a

6 meaningful approach to estimate investors' required rate of return. Unlike the comparable

7 earnings method, which depends on earned returns derived from accounting information, the

8 risk premium approach is based on capital market data indicative of investors' current

9 expectations. The IPUC has noted the importance of "evaluating all the methods" and "using

10 each as a check on the other when setting the allowed rate of return."[2] This is especially the

11 case in light of the fact that Ms. Carlock's DCF range was based on the results of a single

12 company and her comparable earnings approach is not capital market oriented.

13   **Q.   Why is the use of multiple methods so important when estimating the cost**

14 **of equity?**

15   A.   Investors' expectations are unobservable, and there is no methodology that

16 provides a foolproof guide to their required rate of return. Each method provides another

17 facet of examining investor behavior, with different assumptions and premises. Investors do

18 not necessarily subscribe to any one method, and no model can conclusively determine or

19 estimate the required return for an individual firm. If the cost of equity estimation is

20 restricted to certain methodologies, while the results of other approaches are ignored, it may

21 significantly bias the outcome. Rather, all relevant evidence should be weighed and

22 evaluated in order to minimize the potential for error. The importance of considering the

---

[2] Idaho Public Utilities Commission, Order No. 29505 (May 25, 2004) at 38.

1   results of multiple methods has been widely noted in the financial literature, as evidenced in

2   this quote from two noted financial scholars:

> In practical work, it is often best to use all three methods – CAPM, bond yield
> plus risk premium, and DCF – and then apply judgement when the methods
> produce different results. People experienced in estimating capital costs
> recognize that both careful analysis and some very fine judgements are
> required. It would be nice to pretend that these judgements are unnecessary
> and to specify an easy, precise way of determining the exact cost of equity
> capital. Unfortunately, this is not possible.[3]

10   **Q.**   **Has the IPUC expressed reluctance to consider the results of the Capital**

11   **Asset Pricing Model ("CAPM") approach?**

12   **A.**   Yes. I am aware that the IPUC has continuing concerns over the measurement

13   and proper use of the beta value necessary to apply the CAPM and has not routinely focused

14   on the results of this method.[4] Nevertheless, the CAPM is a rigorous conceptual framework

15   at the heart of modern financial theory and it is widely used and referenced in the investment

16   community. Of course, the CAPM is based on restrictive assumptions and does not describe

17   security returns perfectly and there are controversies surrounding the measurement of key

18   variables, such as beta. But then exactly the same could be said for the constant growth DCF

19   model, which assumes a single, static growth rate into perpetuity that has no observable

20   proxy in the capital markets.

21   **Q.**   **What cost of equity is implied if the risk premium method is used to**

22   **check the results of Ms. Carlock's analyses?**

23   **A.**   Application of alternative risk premium approaches based on 1) surveys of

24   previously authorized rates of return on common equity for electric utilities, 2) realized rates

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[3] Brigham, E.F. and Gapenski, L.C., *Financial Management: Theory and Practice*, 6th ed., Dryden Press (1991) at 256, as referenced in "Regulatory Finance: Utilities' Cost of Capital" at 239-240.

Avera, Di - Reb   6
Avista Corporation

1   of return on electric utility common stocks, and 3) forward-looking applications of the

2   Capital Asset Pricing Model ("CAPM") were discussed in detail in my direct testimony (pp.

3   45-52). The results of these analyses, which are not adjusted to incorporate flotation costs,

4   are summarized in the following table:

Risk Premium Method	Cost of Equity Estimate
Authorized Returns	11.2%
Realized Rates of Return	10.5%
CAPM	11.7%

5   Taken together, applications of the risk premium approach to estimate the cost of equity for

6   an electric utility are consistent with a rate of return from the top of Ms. Carlock's DCF and

7   comparable earnings ranges.

8   **Q.   What other risk premium evidence confirms that Ms. Carlock's**

9   **recommendation is well below investors' required rate of return for Avista?**

10   A.   While the IPUC has expressed concern regarding the assumptions and inputs

11   necessary to apply certain forms of the risk premium approach (i.e., beta) it need look no

12   farther than its recent decision in Case No. IPC-E-03-13 involving Idaho Power Company

13   ("Idaho Power"). In that case, the IPUC approved a cost of equity of 10.25 percent and a

14   component cost of long-term debt of 5.769 percent.[5] Thus, the IPUC's findings imply an

15   equity risk premium for single-A rated Idaho Power of approximately 4.48 percent. Adding

16   this equity risk premium to Ms. Carlock's recommended long-term cost of debt of 8.68

17   percent suggests a cost of equity to Avista of 13.16 percent. Alternatively, combining the

18   4.48 percent risk premium from the IPUC's May 2004 decision with the average yield on

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[4] See, e.g., Order No. 29505 at 38.
[5] Idaho Public Utilities Commission, Order No. 29505 (May 25, 2004) at 43.

Avera, Di - Reb   7
Avista Corporation

1   triple-B public utility bonds for May 2004 of 6.75 percent[6] results in an implied cost of equity

2   for a utility with the lowest investment grade credit rating of 11.23 percent. This evidence

3   confirms the reasonableness of selecting a rate of return from the very top of Ms. Carlock's

4   DCF and comparable earnings ranges.

5   **Q.   What other evidence indicates that a return from the top end of Ms.**

6   **Carlock's range of results is warranted?**

7   A.   While Ms. Carlock did not provide the analyses underlying her 10.0 to 11.0

8   percent comparable earnings range, this method is typically implemented based on a review

9   of historical earned rates of return on book equity for the companies or industry in question.

10 But earned rates of return based on historical information are not necessarily indicative of

11 investors' long-run perceptions of risk and expectations for return going forward.

12 Alternatively, reference to earned rates of return expected from firms of comparable risk can

13 also provide a useful guide that may better reflect the ongoing returns necessary to assure

14 financial integrity and attract capital. The most recent projections from the Value Line

15 Investment Survey (Value Line), which is the largest and most widely circulated independent

16 investment advisory service, indicate that its analysts expect average earned rates of return on

17 book equity for the electric and natural gas utility industries over the next three to five years

18 of 11.0 percent.[7] Based on Value Line's estimates, investors would anticipate a return on

19 equity from the average electric and gas utility at the top of Ms. Carlock's comparable

20 earnings range.

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[6] Moody's Investors Service, *Credit Perspectives* (Jun. 14, 2004) at 49.
[7] The Value Line Investment Survey, Jun. 4, 2004 at 154, Jun. 18, 2004 at 458.

1   Q.   **Do you and Ms. Carlock agree on the benchmark for a fair rate of**

2   **return?**

3   A.   Yes. We agree that the authorized rate of return should be competitive with

4   returns available to investors from investments of corresponding risk, as directed by

5   landmark Supreme Court decisions. Ms. Carlock also correctly noted that the opportunity to

6   earn a return at least equal to those expected in the capital markets for comparable

7   investments is required if a utility is to be able to attract capital. As stated my Ms. Carlock:

8   ...if the return earned by a firm is not equal to the return being earned on other
9   investment of similar risk, the flow of funds will be toward those investments
10   earning the higher returns. Therefore, for a utility to be competitive in the
11   financial markets, it should be allowed to earn a return on equity equal to the
12   average return earned by other firms *of similar risk*.[8]

13   Ms. Carlock also noted the importance of testing any cost of equity estimate against

14   applicable standards:

15   ...three standards have evolved for determining a fair and reasonable rate of
16   return: (1) the Financial Integrity or Credit Maintenance Standard; (2) the
17   Capital Attraction Standard; and (3) the Comparable Earnings Standard.[9]

18   This is absolutely correct. If Avista's return on equity does not fully reflect the level of

19   investment risks that investors perceive, it will violate the risk-return tradeoff, breach

20   applicable standards, and impair Avista's ability to attract necessary capital.

21   Q.   **Did Ms. Carlock recognize that the investment risks associated with**

22   **electric utilities have increased?**

23   A.   Yes. Ms. Carlock noted that a plethora of changes have impacted investors

24   risk perceptions, observing that:

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[8] Carlock Direct at 6 (emphasis added).
[9] *Id.* at 5.

1 The competitive risks for electric utilities have changed with increasing non-
2   utility generation, deregulation in some states, open transmission access, and
3   changes in electricity markets.[10]

4 Ms. Carlock concluded that, because of these greater uncertainties, the difference in the risk

5 between industrial firms operating in the competitive market and electric utilities "is not as

6 great as it used to be."[11]

7   **Q.   Did Ms. Carlock consider this increase in risk in her analysis of the cost**

8 **of equity for Avista's jurisdictional utility operations?**

9   A.   No. Ms. Carlock ignored the implications of this trend in investment risks for

10 utilities, asserting instead that Avista's "competitive risks" are lower because of its "low-cost

11 source of power and the low retail rates."[12] Ms. Carlock also asserted that the Power Cost

12 Adjustment Mechanism ("PCA") reduces Avista's risks relative to other electric utilities.[13]

13   **Q.   Does this represent an accurate assessment of the investment risks**

14 **investors' associate with Avista?**

15   A.   No. While I agree with Ms. Carlock that relatively low rates provide benefits

16 to customers and may improve Avista's competitive position, this narrow view ignores the

17 substantial uncertainties that Avista's investors assume to realize these benefits. As explained

18 in detail in my direct testimony, because a high proportion of Avista's energy needs is

19 provided by hydroelectric facilities, Avista is exposed to a level of uncertainty not faced by

20 other utilities, which are less dependent on hydro generation.

21   Reduced hydroelectric generation due to below-average water conditions forces

22 Avista to rely on less efficient thermal generating capacity and purchased power to meet its

---

[10] *Id.* at 8.
[11] *Id.*
[12] *Id.* at 8-9.

1 resource needs. As the IPUC has noted, "there are no guarantees about future stream flows or

2 market prices,"[14] and in light of the recent past, this dependence on wholesale markets entails

3 significant risk in the minds of investors, especially for a utility located in the west. Investors

4 recognize that volatile markets, unpredictable stream flows, and Avista's dependence on

5 wholesale purchases to meet the needs of its customers expose Avista to the risk of reduced

6 cash flows, increased need for financing, and unrecovered power supply costs.

7   Apart from exposure to market uncertainties, Avista also confronts the complexities

8 associated with maintaining the necessary licenses to operate its hydroelectric stations. The

9 process of relicensing is prolonged and involved and often includes the implementation of

10 various studies and measures to address environmental and stakeholder concerns. For

11 example, a federal court recently ordered the Federal Energy Regulatory Commission

12 ("FERC") to respond to a request for a formal review of Idaho Power Company's ("Idaho

13 Power") Hells Canyon hydroelectric complex under the Endangered Species Act.15 These

14 measures can impose significant additional costs and/or lead to reduced generating capacity

15 and flexibility.

16   **Q.   Does the fact that Avista has a PCA absolve investors from risk of**

17 **volatility in wholesale power markets, as Ms. Carlock seems to imply?**

18   A.   No. The fact that Avista had been granted a PCA does not translate into lower

19 risk *vis-à-vis* other electric utilities. First, adjustment mechanisms to account for changes in

20 power supply costs are the rule, rather than the exception, so that Avista's PCA merely moves

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[13] *Id.* at 9.

[14] *Idaho Power Granted $256 million deferral, but bond plan denied*, Idaho Public Utilities Commission (May 13, 2002).

1   its risks closer to those of other utilities. Second, the PCA does not prevent the lag between

2   the time that Avista actually incurs power supply expenses and when it is actually recovered

3   from ratepayers. Investors are well aware that the significant reduction in cash flows

4   associated with mounting deferrals can have a debilitating impact on a utility's financial

5   position.

6   Moreover, investors are aware that the PCA does not apply to 100 percent of the

7   difference between the actual cost of purchased power and the amount collected through

8   rates, with Avista's shareholders remaining at risk for 10 percent of any discrepancy. Indeed,

9   Avista and its investors have already experienced the impact that chaotic market conditions

10 can have when the utility is forced to rely on wholesale purchases to meet the gap in its

11 resource needs created by reduced hydro generation. Investors cannot afford to discount the

12 continuing prospect of further turmoil in western power markets, with S&P recently

13 emphasizing the record high wholesale prices for both peak and off-peak power:

14   For 2003, record-high wholesale power prices were the defining feature of the
15   U.S. merchant power markets. ... Power prices in the western regions were
16   also the highest on record outside of the 2000-2001 California energy crisis.
17   ... Off-peak prices also rose about 50% across the U.S. and set record highs
18   along the way in most regions.[16].

19 Q.   Is Ms. Carlock's recommended cost of equity compatible with the level of

20 investment risks associated with Avista?

21 A.   No. Avista's weakened financial position, as evidenced by its below-

22 investment grade corporate credit ratings, place it on an altogether different risk plateau. The

---

[15] "Court orders FERC to answer seven-year-old request for study of Idaho dams' fish impact," *Electric Utility Week* (Jun. 28, 2004) at 14.

[16] Standard & Poor's Corporation, "Energy Commodity Report: U.S. Power Prices Record High in 2003," *RatingsDirect* (Jan. 15, 2004).

Avera, Di - Reb   12
Avista Corporation

1   speculative grade credit rating assigned to Avista confirms that investors perceive its

2   investment risks to be higher than for the average utility. Investors rely greatly on bond

3   ratings as a source of information regarding investment risk and bond ratings and the risk of

4   common stock investment are closely related. Indeed, the higher risk associated with Avista

5   is mirrored in its Value Line beta of 0.80. As Mr. Thornton recognized:

6   ...the average risk security has a capital asset pricing model beta of 1.0, while
7   the average electric utility from my sample has a *Value Line* beta of .72, which
8   is 28 percent less risky than the average-risk security.[17]

9   The corollary of Mr. Thornton's conclusion is that Avista's risk is higher than the average

10   utility and that its expected returns need to be correspondingly greater to attract investment.

11   **Q.   Does Ms. Carlock's recommended cost of equity adequately compensate**

12   **investors for Avista's greater risks?**

13   A.   No. While Ms. Carlock asserted that her recommendation considered the

14   "risk characteristics for Avista,"[18] she failed to look directly at other capital markets data to

15   assess the level of return investors require to compensate them for Avista's greater investment

16   uncertainties. Considering the IPUC's recent decision in Case No. IPC-E-03-13 to authorize

17   single-A rated Idaho Power a return on equity of 10.25 percent,[19] Ms. Carlock's proposed

18   10.4 percent cost of equity in this case implies an adjustment of 15 basis points to account for

19   Avista's below-investment grade credit rating. But as discussed in my direct testimony, the

20   dramatically greater investment risk imposed by a weakened credit standing implies a

21   significant premium for Avista above the return required for an investment grade utility.

22   Indeed, reference to bond yield spreads suggests that the capital markets would require a

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[17] Thornton Direct at 11.
[18] Carlock Direct at 14.

Avera, Di - Reb   13
Avista Corporation

1   minimum of 2.8 percent in additional return to compensate for the greater risk associated

2   with a speculative credit rating.

3   **Q.   What are the implications of disregarding Avista's investment risks in**

4   **setting the allowed rate of return on equity?**

5   A.   If the greater risks associated with Avista's speculative grade credit standing

6   are not incorporated in the allowed rate of return on equity, the results will fail to meet the

7   comparable earnings standard that Ms. Carlock agrees is fundamental in determining the cost

8   of capital. From a more practical perspective, failing to provide investors with the

9   opportunity to earn a rate of return commensurate with Avista's risks will only serve to

10   perpetuate its impaired financial integrity, while hampering Avista's ability to attract the

11   capital needed to meet the economic and reliability needs of its service area.

12   **Q.   How is a utility's financial integrity typically evaluated?**

13   A.   Bond ratings provide the most objective guide to a utility's financial integrity

14   and prospects for capital attraction. Bond ratings are assigned by independent agencies, such

15   as S&P and Moody's Investors Service ("Moody's"), for the purpose of providing investors

16   with an overall assessment of the creditworthiness of a firm. As discussed in my direct

17   testimony, an investment grade bond rating (*i.e.* triple-B or above) indicates that a utility has

18   some measure of financial integrity. A below-investment grade rating, such as the double-B

19   corporate ratings S&P has assigned to Avista, generally evidences a relative lack of

20   creditworthiness and an inability to attract capital except on more speculative terms.

---

[19] Idaho Public Utilities Commission, Order No. 29505 (May 25, 2004).

1   **Q.   How do the rating agencies decide what ratings to assign to a utility such**

2   **as Avista?**

3   A.   The ratings assigned to a utility by the rating agencies are based typically on

4   an evaluation of the utility's business and financial risks. One of the most important of the

5   qualitative factors in determining a utility's bond ratings is its pre-tax interest coverage ratio,

6   which is a measure of the protection available to pay interest expense from operational cash

7   flow. The financial ratio guidelines published by S&P specify a range for a utility's pre-tax

8   coverage ratio that corresponds to each specific bond rating. Widely cited in the investment

9   community, applicable ratios are determined by aligning the bond rating with the utility's

10   *business profile* ranking, which ranges from 1 (strong) to 10 (weak) depending on a utility's

11   relative business risks. Thus, S&P's guideline financial ratios for a given rating category

12   (*e.g.*, triple-B) vary with the business or operating risk of the utility. A firm with a *business*

13   *profile* of "2" (*i.e.*, relatively lower business risk) could presumably maintain lower coverage

14   ratios than a utility with a *business profile* assessment of "9" while maintaining the same

15   credit rating. S&P has currently assigned a business profile ranking of "6" to Avista.[20]

16   **Q.   What pre-tax coverage ratio would Avista require to qualify for the lowest**

17   **investment grade bond rating?**

18   A.   Consistent with Avista's *business profile* ranking of "6" and S&P's available

19   published guidelines, Avista would be required to achieve and maintain a pre-tax interest

20   coverage ratio in the range of 2.6 to 4.0 times to qualify for a triple-B bond rating.

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[20] Standard & Poor's Corporation, "New Business Profile Scores Assigned for U.S. Utility and Power Companies; Financial Guidelines Revised," *RatingsDirect* (Jun. 2, 2004).

1   **Q.**   **Is it clear that the coverage ratio implied by Ms. Carlocks's**

2 **recommendations would grant Avista the financial strength necessary to achieve an**

3 **investment grade bond rating?**

4   A.   No. As shown below, the pre-tax interest coverage implied by Ms. Carlock's

5 recommendations is 2.71 times:

Component	Percent	Cost Rate	Weighted Cost	Pre-tax Cost	Coverage
Debt	50.08%	8.68%	4.35%	4.35%	4.35%
Trust Preferred	5.57%	6.15%	0.34%	0.34%	
Preferred Stock	1.76%	7.35%	0.13%	0.20%	
Equity	42.59%	10.40%	4.43%	6.89%	
	100.00%		9.25%	11.78%	11.78%
Pre-tax Interest Coverage					**2.71 X**

6   This 2.71 times coverage is only marginally above the very bottom end of the 2.6 to 4.0 times

7 specified by S&P's financial benchmarks for a triple-B bond rating for a utility with Avista's

8 business risks. To restore a company's rating to a previous, higher level, rating agencies

9 generally require a company to maintain financial indicators above the minimum levels

10 required for the higher rating over a period of time. Considering Avista's already weakened

11 credit standing, it is unlikely that Ms. Carlock's proposed rate of return would be adequate to

12 allow Avista the opportunity, under efficient and economical management, to restore basic

13 financial integrity and implies a continuation of its current junk bond ratings.

1   **Q.   What other evidence indicates the importance of reasonable regulatory**

2   **decisions on Avista's ability to maintain its financial integrity?**

3   A.   Following the IPUC's decision in Case No. IPC-E-03-13, S&P placed the

4   utility' credit ratings on CreditWatch, indicating the potential for a future downgrades.[21] In

5   explaining this action, S&P noted:

6   Standard & Poor's Ratings Services today placed the corporate credit rating
7   and all long-term ratings on IDACORP Inc. ('A-/A-2') and subsidiary Idaho
8   Power Co. ('A-/A2') on CreditWatch with negative implications following the
9   May 25, 2004, Idaho Public Utilities Commission (IPUC) ruling authorizing
10   only a $25.3 million (5.2%) permanent electric base rate increase for the
11   utility, which had requested an $85.6 million (17.7%) increase. … Following
12   the IPUC staff's 3.1% rate increase recommendation in February 2004,
13   Standard & Poor's said that "a final decision by the commission that adopted a
14   rate increase akin to that proposed by the staff could have an adverse effect on
15   bondholder protection measures." The final IPUC ruling is indeed
16   substantially closer to the staff's position than the company's, and will weaken
17   credit protection measures.[22]

18   Considering the vastly greater investment risks implied by Avista's already weakened credit

19   profile, the perception of lack of regulatory support would undoubtedly place downward

20   pressure on current ratings, as is occurring for Idaho Power. Such an outcome would be

21   inconsistent with the IPUC's stated desire to maintain credit ratings "at or above the current

22   level"[23] and lends further support for a return on equity at the very top of the range of Ms.

23   Carlock's results.

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[21] Standard & Poor's Corporation, "IDACORP Ratings Placed on CreditWatch With Negative Implications Following IPUC Ruling," *RatingsDirect* (Jun. 15, 2004).
[22] *Id.*
[23] Idaho Public Utilities Commission, Order No. 29505 (May 25, 2004) at 43.

1   **Q.   Is there evidence regarding the importance of regulatory support in**

2   **determining a utility's financial integrity?**

3   A.   Yes. Investment publications and the trade press are replete with examples

4   that highlight the critical role that a constructive regulatory environment plays in investors'

5   assessment of a utility's credit quality. In discussing the criteria used to establish a

6   company's bond rating, S&P noted that:

7   The regulatory relationship can be a benign one – or it can be adversarial. It
8   affects virtually all corporates to one extent or another, and is obviously
9   critical in the case of utilities – where it is a factor in all assessments of
10   business risk.[24]

11   In light of challenges in the industry, investors have refocused attention on regulatory

12   policy. An article reporting on investment analysts' comments concerning the prolonged

13   financial slump in the electric utility industry noted the importance of "evenhanded

14   regulation," with one analyst concluding "uncertainty is the main obstacle to bolstering

15   energy utilities' capital."[25] Indeed, S&P noted that "one of the major challenges facing the

16   industry is the daunting task of restoring investor confidence" and recognized the importance

17   of regulatory support in its assessment of credit quality.[26] Accordingly, it is critical to assure

18   investors' confidence in a balanced approach if reasonable access to capital is to be

19   maintained.

20   **Q.   Did Ms. Carlock consider flotation costs in her DCF analysis?**

21   A.   Yes. Ms. Carlock incorporated flotation costs by increasing the dividend yield

22   component of her DCF analysis. While Ms. Carlock concluded that direct flotation costs

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[24] Standard & Poor's Corporation, *Corporate Ratings Criteria* (Nov. 13, 2003) at 42.
[25] Walsh, Campion, "Wall Street Seeks FERC's Help for Power Sector Slump", *Dow Jones Newswire* (January 16, 2003).
[26] Standard & Poor's Corporation, "Regulation and Credit Quality in the U.S. Utility Sector".

1   would warrant an adjustment equal to 4 percent of the dividend yield component, she reduced

2   this factor to 2 percent for Avista's jurisdictional utility operations, based on her belief that

3   "all subsidiaries of Avista Corp should be responsible for some of actual flotation costs."[27]

4   **Q.   Is there any merit to Ms. Carlock's logic?**

5   A.   No. While I do not disagree with Ms. Carlock that all of Avista's operations

6   should share the burden of flotation costs incurred to raise equity capital, no adjustment to the

7   cost factor is required to accomplish this objective. This is because the allowed return on

8   common equity, including the full 4 percent adjustment for direct flotation costs, is only

9   applied to the equity used to finance jurisdictional utility operations. Thus, the only flotation

10   costs that will be considered are those related specifically to the equity required to provide

11   utility service in Idaho. By adjusting the flotation cost factor downward to 2 percent, Ms.

12   Carlock is essentially assuming that the costs associated with raising equity invested in Idaho

13   jurisdictional utility operations are one-half as much as those incurred to finance Avista's

14   other operations. This is clearly not the case and results in a downward bias to Ms. Carlock's

15   recommendation.

16   In addition, Ms. Carlock apparently did not adjust the results of her comparable

17   earnings approach to incorporate flotation costs. Based on Ms. Carlock's representative

18   dividend yield of 3.4 percent and her 4 percent allowance for flotation costs, this would imply

19   an upward adjustment of approximately 10 basis points, or a comparable earnings range of

20   10.1 to 11.1 percent.

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[27] Carlock Direct at 11.

Avera, Di - Reb   19
Avista Corporation

1 **Q.   In light of the shortfalls in Ms. Carlock's analysis and her failure to**

2 **meaningfully address Avista's relative investment risks, what is your conclusion**

3 **regarding her recommendations in this case?**

4 A.   In my opinion, Ms. Carlock's recommended 10.4 percent cost of equity falls

5 well short of the rate of return that investors require from Avista. In order to maintain and

6 expand utility infrastructure, it is both reasonable and necessary that Avista be provided the

7 opportunity to strengthen its credit standing and enhance its ability to attract capital. To meet

8 these challenges successfully and economically, it is crucial that Avista receive adequate

9 support for its credit standing. Because of shortfalls in her analyses, Ms. Carlock's

10 recommendation is inadequate to meet this goal.

11 At the very least, the IPUC should consider the results of risk premium analyses,

12 along with Ms. Carlock's approaches, in evaluating the cost of equity. Ms. Carlock granted

13 that, in selecting a point estimate from within a range, "any point within [the] range is

14 reasonable."[28] Coupled with the ongoing risks associated with Avista's continued exposure

15 to wholesale power markets and its weakened credit standing, this would suggest a minimum

16 cost of equity from the very top of Ms. Carlock's DCF and comparable earnings ranges.

17 ### III.   DENNIS E. PESEAU

18 **Q.   How did Dr. Peseau evaluate the cost of equity for Avista?**

19 A.   It is important to note that Dr. Peseau's opinions were not based on any

20 independent analyses of the cost of equity for Avista. Rather, he arrived at his

21 recommendations based on a purported "update" of my analyses and by making revisions to

22 my methods.

1   Q.   What "updates" and modifications did Dr. Peseau make to your cost of
2   equity analyses?

3   A   Apart from conducting no analyses of his own, Dr. Peseau did not simply

4   update my analyses. Rather, he ignored historical trends in earnings growth in applying the

5   DCF model, used alternative bond yields to apply my risk premium approaches, and

6   substituted a lower market return in the CAPM. Finally, Dr. Peseau completely ignored the

7   flotation cost adjustment supported in my direct testimony.

8   Q.   What was the basis for Dr. Peseau's "revision" to exclude historical
9   growth rates from his "update" of your DCF analyses?

10   A.   In Idaho Power's recent general rate case, Dr. Peseau testified that historical

11 growth rates should be discarded because he did not approve of the composition of my proxy

12 group.[29] Now, Dr. Peseau argues that historical growth rates should be ignored because

13 investment analysts "have already taken that information into account."[30] While I agree with

14 Dr. Peseau that investment analysts may consider historical growth rates in arriving at their

15 near-term projections, this fact does not support his argument that such growth measures

16 should be ignored in applying the DCF model. Rather, the fact that professional analysts

17 consider historical growth rates in their analyses is strong evidence that such growth rates are

18 also of relevance to investors in assessing their expectations and required rate of return.

19 Indeed, Value Line and other investment advisory services routinely report historical growth

20 rates, along with near-term projections. If historical rates of growth were not of interest or

21 relevance to investors, there would be no need to compile such information and present it on

[28] Carlock Direct at 14.
[29] Direct Testimony of Dennis E. Peseau, Idaho Public Utilities Commission, Case No. IPC-E-03-13, at 16.
[30] Peseau Direct at 51.

1   an equivalent basis with near-term forecasts. Regulatory Finance: Utilities' Cost of Capital, a

2   source referenced by Dr. Peseau, concluded that:

> 3   Historical growth rates … are often used as proxies for investor expectations
> 4   in DCF analysis. Investors are certainly influenced to some extent by
> 5   historical growth rates in formulating their future growth expectations. In
> 6   addition, these historical growth indicators are widely used by analysts,
> 7   investors, and expert witnesses. …
>
> 8   Obviously, historical growth rates as well as analysts forecasts provide
> 9   relevant information to help the investor with regard to growth expectations.[31]

10   But instead of heeding the advice of his own source, Dr. Peseau advocates ignoring historical

11   information altogether and thereby introduces a downward bias to the DCF results.

12   **Q.   Is there anything "inexplicable" about your recommended 6.0 percent**

13   **growth rate, as Dr. Peseau contends?[32]**

14   A.   Not at all. The rationale underlying my use of a 6.0 percent growth rate in the

15   DCF model was fully explained in my testimony (pp. 42-45). As I noted there, based on

16   analysts' projections and historical growth rates, but giving little weight to Value Line's

17   projections, which deviated from consensus forecasts, I concluded that investors expect

18   growth in the 5.0 to 7.0 percent range for my proxy group. The 6.0 percent growth rate is the

19   midpoint of this range. As shown below, my 6.0 percent recommended growth rate is also

20   equal to the average of the remaining values after excluding Value Line's pessimistic earnings

21   growth projections:

Source	Growth Rate
IBES	5.1%
Value Line	*2.4%*
First Call	5.2%
Multex	5.4%

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[31] Morin, Roger A., "Regulatory Finance: Utilities Cost of Capital," Public Utility Reports (1994) at 140.
[32] Peseau Direct at 51.

Avera, Di - Reb   22
Avista Corporation

Historical 10 Yr.	7.3%
Historical 5 Yr.	8.1%
Value Line "bxr"	<u>4.6%</u>
Average	**6.0%**

1   Thus, the growth rate developed in my testimony is consistent with the recommendation of

2   Dr. Peseau's reference source, which notes that "equal weight should be accorded to DCF

3   results based on history and those based on analysts' forecasts."[33]

4   **Q.   What about Mr. Peseau's contention that your recommendation would**

5   **have been lower if you had applied a multi-stage DCF model (p. 53)?**

6   A.   Mr. Peseau's speculation is apparently based on his observation that dividend

7   growth in the electric utility industry is lagging behind earnings growth. As discussed in my

8   direct testimony, this observation only serves to illustrate the fact that near-term trends in

9   dividends are not representative of investors' long-term expectations. In any event, I

10   explained why there is presently no compelling arguments in favor of a multi-stage DCF

11   model and Mr. Peseau presented no evidence to support his remarks and candidly admitted

12   that "I have not presented such an analysis."[34]

13   **Q.   Is there any merit to Dr. Peseau's suggestion that there are inconsistencies**

14   **in your risk premium approaches that lead to an upward bias in your results (pp. 54-**

15   **56)?**

16   A.   No. The bond yields used in my applications of the risk premium method

17   were consistent with the underlying data sources used to compute equity risk premiums. In

18   developing risk premiums based on authorized rates of return on equity in Schedule WEA-5,

19   I matched allowed rates of return in each year with the average yield on public utility bonds

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[33] Morin, Roger A., "Regulatory Finance: Utilities Cost of Capital," Public Utility Reports (1994) at 157.
[34] Peseau Direct at 53.

1   reported by Moody's Investors Service ("Moody's"). This composite interest rate reflects the

2   risk profile of the electric utility generally over the 29 years covered by my analysis and there

3   is simply no basis for Dr. Peseau's insinuation that this somehow results in an upward bias.

4   Similarly, my analysis of realized rates of return reported on Schedule WEA-6 was based on a

5   consistent set of data, as reported by S&P. Because S&P does not publish an average public

6   utility bond yield, my analyses relied on the yield on single-A rated issues as a proxy for the

7   average risk profile of the industry over the study period.

8   **Q.   Was it "incorrect" to add the equity risk premium determined in your**

9   **studies to the yield on triple-B bonds, as Mr. Peseau claims (p. 54-55)?**

10   A.   No. The exercise at hand is to estimate investors' required rate of return from

11   Avista's jurisdictional utility operations, not for the average utility. Adding the risk premium

12   to a triple-B bond yield, as I did, reflects the investment risks of a utility with the lowest

13   investment grade credit rating.[35] Meanwhile, Mr. Peseau derives two of his "updated" risk

14   premium estimates by adding his revised equity risk premium to the yield on single-A bonds.

15   As a result, Mr. Peseau's "update" necessarily produces cost of equity estimate that falls

16   below investors' required rate of return for Avista, which has higher investment risks. As

17   shown in the table below, even accepting Mr. Peseau's flawed "updates," correcting his

18   calculation to incorporate the May 2004 average yield on triple-B bonds results in the

19   following cost of equity estimates:

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[35] In fact, this approach is likely to understate the return on equity because investors in common stock, the most junior and riskiest of a utility's securities, undoubtedly demand a greater premium to bear the higher risk of a triple-B bond rating than debtholders.

Method	Peseau "Updated" Risk Premium	Triple-B Yield[36]	Implied Cost of Equity
Allowed Returns –A Rated	4.72%	6.75%	11.5%
Allowed Returns – BBB Rated	4.35%	6.75%	11.1%
Realized Returns - Arithmetic	4.01%	6.75%	10.8%

1 This restatement clearly confirms the downward bias to the 9.2 to 10.8 percent cost of equity

2 estimates he recommends based on the same approach:

3   **Q.   Is your application of the realized rate of return approach based on the**

4 **assumption that "investors typically have holding periods of only one year," as Dr.**

5 **Peseau asserts (p. 56)?**

6   A.   No. My application of the risk premium method based on realized rates of

7 return makes no assumption regarding the holding period of the average investors, and Dr.

8 Peseau's assertion that the equity risk premium is a function of investors' holding period is

9 wrong. In estimating the cost of equity, the goal is to replicate what investors expect going

10 forward, not to measure the average performance of an investment over an assumed holding

11 period. Under the realized rate of return approach, investors consider the equity risk

12 premiums in each year independently, with the arithmetic average of these annual results

13 providing the best estimate of what investors might expect in future periods. Dr. Roger

14 Morin, who Dr. Peseau referenced in his testimony (p. 51), had this to say:

15   One major issue relating to the use of realized returns is whether to use the
16   ordinary average (arithmetic mean) or the geometric mean return. *Only*
17   *arithmetic means are correct for forecasting purposes and for estimating the*
18   *cost of capital.* When using historical risk premiums as a surrogate for the
19   expected market risk premium, the relevant measure of the historical risk

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[36] Moody's Investors Service, *Credit Perspectives* (Jun. 14, 2004) at 49.

1   premium is the arithmetic average of annual risk premiums over a long period
2   of time.[37]

3   Accordingly, Mr. Peseau's risk premium calculations using geometric means are properly

4   ignored and I have excluded them from the table above.

5   **Q.   How did Dr. Peseau "update" your application of the CAPM approach (p.**
6   **57)?**

7   A.   Dr. Peseau did not update or otherwise address my CAPM approach. Rather,

8   he ignored it entirely and instead substituted a market risk premium into my analysis that was

9   based on an entirely different method. As explained in my direct testimony, I applied the

10   CAPM based on a forward-looking estimate of the market risk premium that relied on

11   investors' current expectations in the capital markets. Meanwhile, Dr. Peseau simply asserted

12   that "[a]t this time, the indicated 'current market risk premium and the long-term average

13   market risk premium are both 7.2%."[38] But this 7.2 percent risk premium is based on

14   historical returns back to 1926, not on the forward-looking expectations that drive investors'

15   required rate of return in today's capital markets. The end result of Mr. Peseau's calculations

16   is not an "update" of my approach, but instead a CAPM cost of equity estimate that fails to

17   reflect investors' current required rate of return.

18   **Q.   Did Dr. Peseau address the need to adjust the cost of equity to reflect the**
19   **greater investment risks associated with Avista?**

20   A.   No. Dr. Peseau made no mention of Avista's below-investment grade credit

21   standing or the additional return investors require to compensate for this greater risk. Rather,

22   he simply observed that investors do not expect to be compensated for "non-market" or

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[37] Morin, Roger A., "Regulatory Finance: Utilities' Cost of Capital," Public Utility Reports (1994) at 275 (emphasis added).

1   "company-specific" risks.[39] While Dr. Peseau's comment may apply under the narrow

2   strictures of modern portfolio theory, it does not alter a fundamental premise of finance that

3   investors require higher returns to bear higher risks. The strong link between bond ratings

4   and equity risk premiums has been well documented, and there is no ambiguity that investors

5   require substantially higher rates of return to compensate them for the risks of speculative

6   securities, versus those with investment grade ratings. Moreover, the overall assumption that

7   investors care only about systemic risk and not company-specific risk is a substantial

8   simplification of reality. In fact, no investor is perfectly diversified and bondholders,

9   management, and other stakeholders have an intense interest in the fortunes of individual

10   companies. In the real world both macroeconomic risks (like the general economy) and

11   specific risks (like purchased power) absolutely factor into investors' risk perceptions.

12   **Q.   What about Dr. Peseau's allegation that such risks are "taken account by**

13   **investors" (p. 48)?**

14   A.   I agree wholeheartedly with Dr. Peseau that investors fully consider the

15   uncertainties and characteristics of Avista and that the observable share prices in the capital

16   markets reflect their consensus view of these risks and prospects. But stock prices are only

17   one component used to estimate investors' required rate of return through quantitative

18   analyses. To the extent that other assumptions embodied in the analysis (*e.g.*, market returns,

19   beta values, or growth rates) do not reflect the expectations that investors incorporated into

20   observed stock prices, the resulting cost of equity estimates will be flawed. For example, Dr.

21   Peseau's "update" of the CAPM is predicated solely on an historical study of equity risk

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[38] Peseau Direct at 58
[39] Peseau Direct at 48-49.

1   premiums, which does not contain *any* current market data. As I noted earlier, there is every

2   indication that the "updates" proposed by Dr. Peseau do not capture real-world expectations

3   or investors' requirements for Avista. These flawed approaches and logic do not absolve Dr.

4   Peseau of the need to consider qualitative indicators of investment risks, including the

5   business and regulatory uncertainties specific to Avista and the industry in which it operates.

6   **Q.   Did Dr. Peseau consider the need to account for past flotation costs?**

7   A.   No. Dr. Peseau did not take issue with my testimony that an adjustment for

8   flotation costs is reasonable in establishing a fair rate of return for Avista. However, Dr.

9   Peseau entirely ignored the issue of flotation costs in conducting his "updates" to my

10   analyses. As discussed in my direct testimony, flotation costs are legitimate and necessary,

11   and unless an adjustment is made to the cost of equity, investors will not have the opportunity

12   to earn their fair rate of return.

13   **IV.   JOHN S. THORNTON, JR.**

14   **Q.   Does Mr. Thornton recommend a "fair and reasonable" return on equity,**

15   **as his subtitle on page 4 would suggest?**

16   A.   No. His 8.50 percent recommendation fails all tests of reasonableness. Mr.

17   Thornton's claim that his return is adequate to maintain Avista's financial integrity is also

18   wrong because of mistakes in his coverage calculation presented on Exhibit JST-1 and his

19   reference to the wrong benchmarks to gauge how bond rating agencies evaluate adequacy.

20   Finally, Mr. Thornton's criticisms of my testimony miss the mark and are simply not credible.

1   **Q.   Do recently authorized returns for electric and gas utilities conclusively**
2   **demonstrate the extreme downward bias of Mr. Thornton's 8.5 percent cost of equity**
3   **recommendation?**

4   A.   Yes. This recommendation falls far short of the IPUC's recent finding of a

5   10.25 percent cost of equity for Idaho Power. Further, in contrast to the single-digit cost of

6   equity estimate proffered by Mr. Thornton, Regulatory Research Associates reported that

7   authorized rates of return on equity for electric and natural gas utilities averaged 11.0 percent

8   and 11.1 percent, respectively, for the first quarter of 2004.[40]

9   **Q.   What causes Mr. Thornton's analysis to fall so far from a fair and**
10   **reasonable result?**

11   A.   In rebutting Mr. Thornton, I will show that his views are contrary to empirical

12   evidence and common sense and at odds with recent reasoning by the IPUC and the opinions

13   of investors. The most fatal flaw in Mr. Thornton's approach is that he forgets that the

14   bottom line test of any rate of return recommendation is whether it is consistent with the

15   requirements of real world investors. Mr. Thornton's personal views and insights on risk and

16   return are simply irrelevant if investors don't agree.

17   **Q.   Is Mr. Thornton correct on page 31 when he claims that his 8.49 percent**
18   **recommended overall rate of return would maintain Avista's financial integrity?**

19   A.   Not at all. First, Mr. Thornton miscalculates the coverage ratio by ignoring the

20   fact that payments to holders of trust preferred securities are tax deductible. Second, he

21   compared Avista's projected financial parameters to other utilities' *actual* performance during

22   2000-2002, a period of unprecedented turmoil in the electric utility industry. Mr. Thornton

1   did not compare the projected coverage to the current criteria that the rating agencies apply in

2   their assessment of credit standing. Indeed, Mr. Thornton criticizes me for not recognizing

3   the improvements in the industry over the last year (pp. 33-34), yet he measures Avista's

4   prospective performance against those dark days for the industry.

5   **Q.   How does impact of Mr. Thornton's recommendations on Avista's**

6   **financial integrity compare with that implied by Ms. Carlock's proposals?**

7   A.   It is far worse. As shown on below, after properly accounting for the tax

8   deductibility of Avista's trust preferred securities, his recommendation really translates into a

9   coverage ratio of 2.52 times:

Component	Percent	Cost Rate	Weighted Cost	Pre-tax Cost	Coverage
Debt	48.19%	8.70%	4.19%	4.19%	4.19%
Trust Preferred	5.79%	7.01%	0.41%	0.41%	
Preferred Stock	1.726%	7.34%	0.13%	0.20%	
Equity	44.30%	8.50%	3.77%	5.86%	
	100.00%		8.49%	10.65%	10.65%
Pre-tax Interest Coverage					**2.54 X**

10   <u>This is well below the 2.6-times *minimum* threshold specified by S&P for an investment</u>

11   <u>grade credit rating.</u> A coverage ratio below the minimum guideline specified for a triple-B

12   bond rating is far below the level required to allow Avista to start down the road to rebuild its

13   creditworthiness. The continuation of junk bond ratings, as will result if Mr. Thornton's

14   recommendations are adopted, would fail to allow Avista an opportunity to maintain its

15   financial integrity or the ability to attract capital on reasonable terms on a prospective basis.

16   As a result, Mr. Thornton's proposals are clearly inconsistent with the financial integrity

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[40] Regulatory Research Associates, "Major Rate Case Decisions – January-March 2004", *Regulatory Focus*

1   "end-result" test and should be rejected. A speculative grade corporate credit rating does not

2   permit Avista to maintain its financial integrity or ability to attract capital on other than

3   speculative terms.

4   **Q.**   **Should it be relevant to this Commission that Mr. Thornton does not**

5   **share your "rather gloomy outlook" for electric utilities (p. 33) and has less pessimism**

6   **in his own views?**

7   **A.**   Neither my views nor those of Mr. Thornton are as relevant as the perceptions

8   of investors and their willingness to provide capital to Avista on reasonable terms. The

9   headline of the Fitch report included in Exhibit JST-1, pp. 20-21 indicates that at the end of

10   2003 there were finally prospects for stabilization in the industry. Stable is better than

11   deterioration, to be sure. This Fitch report, which Mr. Thornton referenced on page 34 of his

12   testimony, confirms that the industry is coming out of a bleak period that left many

13   participants weakened. Avista, with its double-B corporate rating is a prime example of a

14   company striving to stabilize its financial circumstances. Were this Commission to send a

15   disturbing signal, such as adopting an unreasonable return like that recommended by Mr.

16   Thornton, Avista and its customers would be denied the benefits of stabilization and the

17   opportunity to regain an investment grade credit rating.

18   **Q.**   **Is Mr. Thornton correct when he claims on page 8 that the arithmetic**

19   **mean is "spurious" so that the geometric mean should be the sole measure of average**

20   **rate of return?**

(Apr. 5, 2004).

1   A.   No, absolutely not. Both the arithmetic and geometric means are legitimate

2   measures of average return; they just provide different information. Each may be used

3   correctly or misused depending upon the inferences being drawn from the numbers. I am

4   particularly sensitive to Mr. Thornton's cavalier attitude toward these measures since my

5   Ph.D. dissertation dealt with the proper use of the geometric mean by investors.

6   The geometric mean of a series of returns measures the constant rate of return that

7   would yield the same change in the value of an investment over time. The arithmetic mean

8   measures what the expected return would have to be each period to achieve the realized

9   change in value over time. The observation on page 10 of Mr. Thornton's Exhibit JST-1

10   recognizes the legitimate role of the arithmetic mean:

11   Investors can be expected to realize geometric returns only over long
12   periods of time. The average geometric return is always less than the
13   arithmetic return except when all yearly returns are exactly equal. This
14   difference is related to the volatility of yearly returns.
15

16   As noted earlier in my rebuttal of Mr. Peseau, the arithmetic mean is the preferred

17   measure when using historical data for rate of return analyses. Yet, Mr. Thornton uses the

18   geometric mean exclusively and criticizes me for use of the arithmetic mean. One does not

19   have to get deep into finance theory to see why the arithmetic mean is more consistent with

20   the facts of this case. The IPUC is not setting a constant return that Avista is guaranteed to

21   earn over a long period. Rather, the exercise is to set an expected return based on test year

22   data. In the real world, Avista's yearly return will be volatile, depending on many economic

23   and weather factors, and investors do not expect to earn the same return each year.

24   **Q.   Did Mr. Thornton apply the conventional DCF model used by you, Ms.**

25   **Carlock, and Dr. Peseau?**

1   A.   No. Mr. Thornton used a multi-stage DCF model of his own design.

2 Although Mr. Thornton discusses his thoughts on why this model makes sense to him, he

3 presents no evidence that this model replicates the reasoning of real world investors. Mr.

4 Thornton's discussions of the record of stock market returns going back two centuries and

5 examination of a number of economic forecasts may be an intellectual exercise of sorts, but it

6 doesn't inform us of what real world investors expect when they invest in utilities like Avista.

7 Indeed, it is particularly telling that Mr. Thornton refers to "my growth estimates" on page 18

8 of his testimony. What matters are investors' estimates. Mr. Thornton gives us no credible

9 evidence that any investors share his expectations.

10 **Q.** **Do you agree with Mr. Thornton that dividend growth rates are likely to**

11 **provide a superior guide to investors' growth expectations?**

12   A.   No. Dividend policies in the electric utility industry have become increasingly

13 conservative as business risks in the industry have become more accentuated. Thus, while

14 earnings may be expected to grow significantly, dividends have remained largely stagnant as

15 companies conserve financial resources to provide a hedge against heightened uncertainties.

16 In this regard, the near-term dividend growth projections understate long-term expectations

17 for an industry in the midst of turmoil. S&P observed that, while over the past few years

18 "many utilities have frozen dividends or significantly lowered their growth rates" in order to

19 finance operations and pay down debt, "financially stronger companies may reconsider their

20 dividend policies."[41]

21 But in contrast to the assumptions Mr. Thornton builds into his DCF model, investors'

22 focus logically shifts from dividends to earnings as a measure of long-term growth as payout

1   ratios trend downward. As a result, growth in earnings, which ultimately supports future

2   dividends and the share price gains anticipated by investors, is likely to provide a more

3   meaningful guide to investors' long-term growth expectations. The fact that investment

4   advisory services, such as IBES and First Call focus on growth in earnings indicates that the

5   investment community regards this as superior to dividends as an indicator of future long-

6   term growth. Indeed, Financial Analysts Journal reported the results of a survey conducted to

7   determine what analytical techniques investment analysts actually use.[42] Respondents were

8   asked to rank the relative importance of earnings, dividends, cash flow, and book value in

9   analyzing securities. Of the 297 analysts that responded, only 3 ranked dividends first while

10   276 ranked it last. The article concluded:

11
12   > Earnings and cash flow are considered far more important than book value and
>   dividends.[43]

13   **Q.   Did you err in not using a larger sample of utilities as claimed by Mr.**

14   **Thornton at page 34?**

15   A.   No. Mr. Thornton's claim that a larger sample results in "a more efficient

16   estimator" is contrary to common sense. My selection of these companies was guided by

17   Value Line's classification of utilities for investors. I chose a sample of western utilities

18   because there was evidence that investors believe that these utilities share risks that are

19   unique to the region. Throwing in more utilities from other parts of the country does not

20   improve information if these companies are not comparable in investors' eyes.

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[41] Standard & Poor's Corporation, *Industry Surveys: Electric Utilities* (Aug. 7, 2003) at 8.
[42] Block, Stanley B., "A Study of Financial Analysts: Practice and Theory," *Financial Analysts Journal* (July/August 1999).
[43] *Id.* at 88.

1   Q.   Is there any validity to Mr. Thornton's claim at page 35 that your

2 dividend yield calculation mismatches price and dividends?

3   A.   No. The price is observed at the same time as the dividend expectations.

4 There is no reason to believe that the publication of the Value Line each week causes prices

5 to move systematically because the information in Value Line's *Summary & Index* causes

6 investors' to alter their expectations, as suggested by Mr. Thornton. If this were the case, then

7 investors would certainly seek more timely and uniform distribution of Value Line, rather

8 than relying on weekly deliveries by U.S. mail.

9   Q.   Mr. Thornton argues at page 36 that you unreasonably assume that

10 companies will "suddenly and forever increase dividends by 6 percent per year" which

11 is "tremendously optimistic to the point of incredible." Do you make any incredible

12 assumptions?

13   A.   No. I am attempting to replicate investor expectations, as reflected in IBES

14 and First Call and other publications. First, as explained earlier and in detail in my direct

15 testimony, investors focus on earnings, not dividends in projecting future growth. This view

16 is confirmed in the writings of Professor Siegal referenced by Mr. Thornton:

17   It does not matter how much is paid as dividends and how much is reinvested
18   *as long as* the firm earns the same return on its retained earnings that
19   shareholders demand on its stock. The reason for this is that dividends not
20   paid today are reinvested by the firm and paid as even larger dividends in the
21   future.[44]

22 Second, investors do not have an infinite horizon. Their projections of growth go out to the

23 foreseeable future. Few, if any, real world investors concern themselves with infinitely long

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[44] Exhibit JST-1, p. 11 (emphasis original).

1   horizons. As a practical matter, not only is it impossible to predict the distant future, it simply

2   doesn't matter. In terms of the DCF model, the present value of cash flows in far distant years

3   – beyond the foreseeable future – is so small as to have little effect on investment decisions

4   today.

5   **Q.   Is Mr. Thornton correct to argue (p. 36) that "one cannot conclude that**

6   **investors reasonably expect a 6 percent dividend growth in the near future (through**

7   **2009) much less infinity"?**

8   A.   No. Investors expect what they expect. If publications like IBES and Value

9   Line reflect what investors expect, and there is every indication they do, then it is reasonable

10 to conclude that what you see is what they expect. Mr. Thornton seems to think there is some

11 absolute benchmark for investor expectations other than what we see revealed in the

12 marketplace. This view is contrary to that found in Professor Siegal's words on page 10 of

13 Mr. Thornton's Exhibit JST-1:

14 However, the risk and return on stocks and bonds are not physical constants,
15 like the speed of light or gravitational force, waiting to be discovered in the
16 natural world. Historical values must be tempered with an appreciation of
17 how investors, attempting to take advantage of the returns from the past, can
18 alter those very returns in the future.

19 **Q.   Please respond to Mr. Thornton's contention that the analysts' growth**

20 **projections you used to apply the DCF model are "overly optimistic" (p. 36).**

21 A.   First, in contrast to Mr. Thornton's allegations, a study reported in "Analyst

22 Forecasting Errors: Additional Evidence" found no optimistic bias in earnings projections for

23 large firms (market capitalization of $500-$3,000 million), with data for the largest firms

1   (market capitalization > $3,000 million) demonstrating a *pessimistic* bias.[45] More

2   importantly, however, any bias in analysts' forecasts – whether pessimistic or optimistic – is

3   irrelevant if investors share analysts' views. The continued success of investment services

4   such as IBES, and the fact that projected growth rates from such sources are widely

5   referenced, provides strong evidence that investors give considerable weight to analysts'

6   earnings projections in forming their expectations for future growth. While the projections of

7   securities analysts may be proven optimistic or pessimistic in hindsight, this is irrelevant in

8   assessing the expected growth that investors have incorporated into current stock prices. As

9   an article in Journal of Applied Finance noted:

10   There is very little research on the properties of five-year growth forecasts, as
11   opposed to short-term predictions.
12   …Analysts' optimism, if any, is not necessarily a problem for the analysis in
13   this paper. If investors share analysts' views, our procedures will still yield
14   unbiased estimates of required returns and risk premia. [46]

15   Given the importance that investors place on estimates of earnings growth, there is no basis

16   to support Mr. Thornton's contention that securities analysts' earnings growth projections

17   should not be used in the DCF model.

18   **Q.**   **Does Mr. Thornton use conventional inputs to apply the CAPM?**

19   A.   No. Mr. Thornton rejects the use of Value Line betas and creates his own

20   (lower) adjusted betas. Similarly, he follows his own views about the appropriate risk-free

21   rate and market risk premiums. Again, Mr. Thornton tells us why he has convinced himself

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[45] Brown, Lawrence D.,"Analyst Forecasting Errors: Additional Evidence", *Financial Analysts Journal* (November/December 1997).
[46] Harris, Robert S. and Marston, Felicia C., "The Market Risk Premium: Expectational Estimates Using Analysts' Forecasts," *Journal of Applied Finance* 11 (2001) at 8.

1   of the rightness of these inputs, but does not offer any evidence that real world investors

2   would apply the model his way.

3   **Q.   Is there reason for the IPUC to be concerned about Mr. Thornton's low**

4   **betas?**

5   A.   Yes. His downward adjustment of the Value Line betas is a major driver of his

6   low CAPM estimates. In its recent decision in the Idaho Power case the IPUC noted the

7   concerns about the measurement and proper use of beta.[47] Mr. Thornton puts great emphasis

8   on beta not only in his CAPM analysis but as a basis for arguing that utilities have much less

9   risk than the average stock. To the extent that investors use betas in assessing risk, they are

10   more likely to reference the published betas in a widely circulated and authoritative source

11   like Value Line, rather than Mr. Thornton's self-developed adaptations to Value Line. Most

12   surprising, however, is that buried in Mr. Thornton's discourse on betas is evidence that

13   validates the IPUC's healthy skepticism.[48] The graph of betas presented by Mr. Thornton on

14   page 26 of his testimony reveals a sharp drop in "OLS betas" in the late 1970s and early

15   1980s. This was a period of turmoil in the electric utility industry as the second oil embargo

16   hit along with the Three Mile Island incident. To investors this was a time of great concern

17   about utilities with resulting dramatic drops in the prices of utility common stocks and

18   downgrades of utility bond ratings at a time when interest rates and inflation had been soaring

19   to new highs. As utilities were reeling in the aftermath of these changes, the stock market

20   generally was strong as inflation and interest rates began to fall and the economy shook off its

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[47] Idaho Public Utilities Commission, Order No. 29505 (May 25, 2004) at 38.
[48] While using the CAPM as his sole risk premium method in the face of the IPUC's reservations about this method, Mr. Thornton disparages the comparable earnings method favored by this Commission on page 37 calling it "an inferior approach to estimate a cost of equity."

1   malaise during the early years of President Reagan's administration. While investors almost

2   certainly regarded electric utilities to be increasing in relative risk, the unadjusted betas were

3   dropping because utility stock prices were going down while the market was rising. This

4   period was a statistical artifact that led most observers to understand that historical betas

5   should be interpreted with a prudent grain of salt.

6   **Q.   Are Mr. Thornton's criticisms of your allowed ROE risk premium**

7   **approach correct?**

8   A.   No, Mr. Thornton's criticisms of the allowed rates of return used in this

9   approach are without merit. First, he is incorrect to allege that the information regarding

10   average allowed rates of return in each year is unreliable simply because every item of

11   possible interest in each rate case is not also presented in my schedule. The allowed rates of

12   returns are taken from a recognized and widely-used publication from a firm with a long

13   history of accumulating and reporting the results of state regulatory commission decisions.

14   Mr. Thornton questions the potential for "upward bias," depending on the form of the DCF

15   model considered by regulators or whether they considered results of an "inferior approach,"

16   such as the comparable earnings method proposed by Ms. Carlock. But such criticisms miss

17   the point. Under this approach, it is not necessary to examine the actual tools and techniques

18   relied on by regulators to set allowed rates of return. Rather, what matters is that, after

19   reasoned consideration of the evidence presented by all participants to a rate proceeding,

20   regulators make an informed determination of investors' required rate of return at the time

21   they issue their decision. This determination is embodied in the authorized rates of return on

22   equity that I used to apply the risk premium approach.

1   With respect to his theoretical arguments, Mr. Thornton is wrong about the risk

2   premium in the regression not being an independent variable.[49] While the interest rate is

3   subtracted from the average allowed return each year, bond yields do not appear as an

4   independent variable in the analysis. Thus, if the risk premium had no association with the

5   level of interest rates, the regression equation would not show a statistically significant

6   relationship. In fact, the association found is highly significant using standard statistical

7   inference. Mr. Thornton also asserts that this study of authorized ROE's does not correct for

8   changes in industry risk. First, as explained in detail in my direct testimony, there is little

9   support for Mr. Thornton's contention that the risks associated with the electric power

10 industry have decreased over the period covered by my study. But irrespective of whether

11 risk was increasing or decreasing, this would be considered by regulators and captured in the

12 market data used to establish allowed rates of return. Mr. Thornton is also incorrect to claim

13 that declines in interest rates would lead to bias in the risk premiums. In fact, the average

14 interest rates used to apply this approach match the time period used to determine the average

15 allowed returns. Moreover, interest rates fluctuated considerable over the 29 years covered

16 by my study, which encompassed periods when interest rates were rising precipitously, as

17 well as times of moderating rates. And contrary to Mr. Thornton's allegation that my study is

18 "out of step" by "mismatching" allowed ROEs and interest rates, my study specifically

19 adjusted for the impact of changes in bond yields on the equity risk premium.[50] Mr.

20 Thornton's suppositions are simply lacking in factual basis.

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[49] Thornton Direct at fn. 19.
[50] Thornton Direct at 38.

1 **Q.   Is there any meaningful basis to Mr. Thornton's allegation that your risk**
2 **premium analysis based on realized rates of return is biased because it rewards**
3 **"unsystematic risk" (pp. 39-40)?**

4 A.   No. First, as I noted earlier in response to Dr. Peseau, the overall assumption

5 that investors care only about systemic risk and not company-specific risk is a substantial

6 simplification of reality. No investor is perfectly diversified and in the real world – as

7 distinct from Mr. Thornton's constructions – both macroeconomic risks and specific risks

8 affect investors' risk perceptions and return requirements.

9   Second, the assumption underlying the realized rate of return method is that historical

10 returns, measured over a sufficiently long time period, provide a surrogate for the forward-

11 looking rates of return required in the capital markets. This method does not depend on the

12 strict assumptions of the CAPM and avoids the controversy surrounding beta by looking

13 directly at returns for electric utilities. Nevertheless, these realized rates of return are a

14 function of actual prices in the capital markets, which are determined by real-world investors

15 that have the opportunity to "diversify into other industries."[51] Thus, following Mr.

16 Thornton's logic, to the extent that these investors can eliminate risk through diversification,

17 it would not be "priced in the market" or reflected in the values used to compute the realized

18 rates of return underlying my analysis. In other words, contrary to Mr. Thornton's assertions,

19 the only compensation priced into realized returns would be for systematic risks.[52]

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[51] Thornton Direct at 39.

[52] This can be demonstrated by way of example. Subtracting my 5.2% risk-free rate from my 10.6% cost of equity based on realized returns results in a risk premium for electric utilities of 5.4%. Dividing this premium by the average beta of 0.77 for the firms in my proxy group results in a market risk premium of 7.01%, which falls squarely within the 6.1 to 7.8 percent range advocated by Mr. Thornton (p. 27).

1   Third, Mr. Thornton again implies that declining risks may lead to an overstatement

2   of the cost of equity. Apart from the fact that his position is diametrically opposed to the

3   views of the investment community, as demonstrated in my direct testimony, it is also at odds

4   with the statistics he cites one paragraph previously, where he notes that the volatility of the

5   returns to electric utilities exceeded that for the S&P 500 over the 1994 to 2002 period.[53]

6   Under Mr. Thornton's theoretical paradigm, higher volatility of returns relative to the market

7   is indicative of higher, not lower, investment risks.

8   Fourth, as I noted earlier in response to Dr. Peseau, there is no "mismatch" (p. 40) in

9   using triple-B bond yields to develop a cost of equity estimate for Avista. Adding the risk

10   premium to a triple-B bond yield, as I did, reflects the investment risks of a utility with the

11   lowest investment grade credit rating and is more likely to understate, rather than overstate,

12   the returns required by equity investors.

13   Finally, the single academic study referenced by Mr. Thornton provides no meaningful

14   information to evaluate the realized rate of return approach or aid the IPUC in its

15   deliberations. As Mr. Thornton summarized, the final conclusion of this research was that

16   risk premiums for utilities "should be close to zero."[54] Of course, no reasonable analyst

17   would contend that the current risk premium for electric utilities should approach zero and

18   such a nonsensical result is even inconsistent with the meager returns recommended by Mr.

19   Thornton himself.

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[53] Thornton Direct at 39.
[54] Thornton Direct at 42.

1   **Q.   Is there any reason to believe that the market risk premiums and**

2   **expected returns are declining, as Mr. Thornton (p. 40) and Dr. Peseau (p. 58) assert?**

3   A.   No. Contrary to the assertions of these witnesses, a study reported in the

4   January/February 2003 edition of Financial Analysts Journal noted that the <u>real</u> risk premium

5   for U.S. stocks averaged 6.9 percent over the period 1889 through 2000 and concluded that:

6   Over the long term, the equity risk premium is likely to be similar to what it
7   has been in the past and returns to investment in equity will continue to
8   substantially dominate returns to investments in T-bills for investors with a
9   long planning horizon.[55]

10   Combining this real risk premium with an inflation rate of 3 percent suggests a market equity

11   risk premium well above the 8.5 percent used in my CAPM analysis that Mr. Thornton

12   characterized as "unrealistically high."[56]

13   **Q.   Please respond to Mr. Thornton's criticism of the long-term debt cost you**

14   **used to apply the CAPM (p. 43-45).**

15   A.   I agree with Mr. Thornton that:

16   The use of a long-term U.S. Treasury bond for the risk-free asset implies a
17   long-term holding period.[57]

18   Common equity is a perpetuity and as a result, the return that investors require is predicated

19   on their expectations for the firm's long-term risks and prospects. This does not mean that

20   every investor will buy and hold a particular common stock into perpetuity, but even an

21   investor with a relatively short holding period will consider the long-term because of its

22   influence on the price that he or she ultimately receives from the stock when it is sold.

23   Similarly, Mr. Thornton recognized that in applying the DCF model, the analyst must

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[55] Mehra, Ranjnish, "The Equity Premium: Why Is It a Puzzle?," *Financial Analysts Journal* (January/February 2003).
[56] Thornton Direct at 46.
[57] Thornton Direct at 43.

1   consider "the present value of all future dividends expected to be received by a share of

2   stock,"[58] not just the dividends to be paid during some shorter (*e.g.*, two-year), intermediate-

3   term holding period. Indeed, as Mr. Thornton observed in his Appendix, under the DCF

4   model "we assume that dividends are paid infinitely ($n \rightarrow \infty$)."[59]

5   In fact, credible sources unambiguously recognize that long-term Treasury bond yields

6   provide the preferred basis to compute a long-term cost of capital. Indeed, Roger Ibbotson,

7   whose firm Ibbotson Associates provided data relied on in Mr. Thornton's CAPM

8   application, made the same conclusion over a decade ago, explaining that while the CAPM

9   can be applied using short-term bill rates, the appropriate basis for a long-term cost of equity,

10   especially in the context of rate setting, is the yield on long-term Treasury bonds:

11   Q. Should the CAPM be used to estimate the short-term or the long-term cost
12   of capital?

13   A. The CAPM was originally formulated to measure the short-term cost of
14   capital, but it may be adapted to measure the long-term cost of capital by using
15   the expected return on a long-term government bond, instead of the risk risk-
16   free rate of return, as the riskless rate. ...

17   Q. When is it appropriate to use the long-term cost of capital?

18   A. It is necessary to use a long-term cost of capital when discounting cash
19   flows projected over a long period. Also, regulated ratesetting processes often
20   specify or suggest that the rate of return should allow the firm to attract and
21   retain debt and equity capital over the long term. Thus, the long-term cost of
22   capital is typically the appropriate cost of capital to use in regulated
23   ratesetting.[60]

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[58] Thornton Direct at 13 (emphasis added).
[59] Thornton Direct at 53.
[60] Ibbotson, Roger G. and Sinquefield, Rex A., "Stocks, Bonds, Bills, and Inflation: Historical Returns (126-1987)," Research Foundation of The Institute of Chartered Financial Analysts (1989) at 122-25.

1   More recently, Ibbotson Associates again emphasized the importance of using long-term bond

2   yields when applying the CAPM to estimate returns for long-term assets, such as common

3   stock:

> 4   The horizon of the chosen Treasury security should match the horizon of
> 5   whatever is being valued. ... Note that the horizon is a function of the
> 6   investment, not the investor. If an investor plans to hold a stock in a company
> 7   for only five years, the yield on a five-year Treasury note would not be
> 8   appropriate since the company will continue to exist beyond those five years.[61]

9   In applying the CAPM, Ibbotson Associates recognized that the cost of equity is a long-term

10   cost of capital and the appropriate interest rate to use is a long-term bond yield. Mr.

11   Thornton's criticism of the long-term bond yields that I used is simply without basis and his

12   use of a shorter, intermediate term bond yield is similarly unfounded.

13   **Q.   Did Mr. Thornton recognize that flotation costs are a necessary expense**

14   **that a utility must incur if it is to raise equity capital?**

15   A.   Yes. Mr. Thornton granted (p. 48) that "[f]lotation costs are a necessary cost

16   of business." Rather than recommend an upward adjustment to account for these costs,

17   however, Mr. Thornton recommended that Avista be allowed to recover flotation costs "as an

18   expense item" through an accounting treatment.[62]

19   **Q.   Do you have any objection to the IPUC adopting an accounting treatment**

20   **for the recovery of flotation costs?**

21   A.   No. Allowing recovery of flotation costs as an expense item is certainly one

22   acceptable way to address this issue going forward. On the other hand, such a treatment

23   would ignore the costs already incurred in connection with past stock issuances. The only

24   practicable means available to ensure that Avista has the opportunity to earn investors' cost of

1   capital is to include an allowance for past flotation costs in arriving at the fair rate of return,

2   as Ms. Carlock and I have recognized. Choosing to ignore a "necessary cost of business" is

3   yet another reason explaining the extreme downward bias of Mr. Thornton's recommended

4   cost of equity.

5   **Q.   Does financial theory preclude higher returns for higher risk, as Mr.**

6   **Thornton implies (p. 49-50)?**

7   A.   Of course not. Bond ratings are a widely recognized proxy for investment

8   risk. Mr. Thornton apparently is under the impression that investors would not necessarily

9   require a higher cost of equity from a "D" rated company whose debt is in default because

10   "investors can avoid risk by diversifying."[63] This shows just how far Mr. Thornton's analysis

11   departs from common sense in order to justify a below-market return on equity. Lower bond

12   ratings, such as Avista's double-B corporate credit rating, evidence investors' understanding

13   that there is greater uncertainties surrounding the firm's ability to successfully meet its

14   financial obligations, especially during adverse market conditions. In fact, this potential for

15   greater variability translates into Mr. Thornton's CAPM paradigm, with Avista's beta

16   exceeding those of the utilities in the proxy groups referenced by Mr. Thornton and me by a

17   significant margin. Further, while I agree with Mr. Thornton that the interest of bondholders

18   and stockholders may not always be aligned, the risks of investing in common stocks clearly

19   exceed those associated with bonds. Thus, reference to yield spreads between bonds of

20   various ratings is far more likely to *understate* the risk differential perceived by common

21   stockholders.

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[61] Ibbotson Associates, *2003 Yearbook* (Valuation Edition) at 53.
[62] Thornton Direct at 48.

1   **Q.   Does this conclude your rebuttal testimony?**

2   A.   Yes, it does.

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[63] Thornton Direct at 49.