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BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION)	CASE NO. AVU-E-15-05
OF AVISTA CORPORATION FOR THE)	CASE NO. AVU-G-15-01
AUTHORITY TO INCREASE ITS RATES)	
AND CHARGES FOR ELECTRIC AND)	DIRECT TESTIMONY
NATURAL GAS SERVICE TO ELECTRIC)	OF
AND NATURAL GAS CUSTOMERS IN THE)	ADRIEN M. MCKENZIE
STATE OF IDAHO)	
)	

FOR AVISTA CORPORATION

(ELECTRIC AND NATURAL GAS)

DIRECT TESTIMONY OF ADRIEN M. MCKENZIE

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1 **I. INTRODUCTION**

2 **Q. Please state your name and business address.**

3 A. Adrien M. McKenzie, 3907 Red River, Austin, Texas,
4 78751.

5 **Q. In what capacity are you employed?**

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

9 **Q. Please describe your educational background and**
10 **professional experience.**

11 A. A description of my background and qualifications,
12 including a resume containing the details of my experience,
13 is attached as Exhibit No. 3, Schedule 1.

14 **C. Overview**

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

16 A. The purpose of my testimony is to present to the
17 Idaho Public Utility Commission (the "Commission" or "IPUC")
18 my independent evaluation of the fair rate of return on
19 equity ("ROE") for the jurisdictional electric and gas
20 utility operations of Avista Corp. ("Avista" or "the
21 Company"). In addition, I also examined the reasonableness

1 of Avista's capital structure, considering both the specific
2 risks faced by the Company and other industry guidelines.

3 **Q. Please summarize the information and materials you**
4 **relied on to support the opinions and conclusions contained**
5 **in your testimony.**

6 A. To prepare my testimony, I used information from a
7 variety of sources that would normally be relied upon by a
8 person in my capacity. I am familiar with the organization,
9 finances, and operations of Avista from my participation in
10 prior proceedings before the IPUC, the Washington Utilities
11 and Transportation Commission ("WUTC") and the Oregon Public
12 Utility Commission. In connection with the present filing, I
13 considered and relied upon corporate disclosures, publicly
14 available financial reports and filings, and other published
15 information relating to Avista. I have also visited the
16 Company's corporate headquarters and had discussions with
17 management in order to better familiarize myself with
18 Avista's utility operations. My evaluation also relied upon
19 information relating to current capital market conditions and
20 investor perceptions, requirements, and expectations for
21 utilities. These sources, coupled with my experience in the
22 fields of finance and utility regulation, have given me a
23 working knowledge of the issues relevant to investors'

1 required return for Avista, and they form the basis of my
2 analyses and conclusions.

3 **Q. How is your testimony organized?**

4 A. After first summarizing my conclusions and
5 recommendations, my testimony reviews the operations and
6 finances of Avista and industry-specific risks and capital
7 market uncertainties perceived by investors. With this as a
8 background, I present the application of well-accepted
9 quantitative analyses to estimate the current cost of equity
10 for a reference group of comparable-risk utilities. These
11 included the discounted cash flow ("DCF") model, the
12 empirical form of Capital Asset Pricing Model ("ECAPM"), and
13 an equity risk premium approach based on allowed ROEs for
14 electric utilities, which are all methods that are commonly
15 relied on in evaluating investors' required rate of return.
16 Based on the cost of equity estimates indicated by my
17 analyses, the Company's ROE was evaluated taking into account
18 the specific risks and potential challenges for Avista's
19 utility operations in Idaho, as well as other factors (e.g.,
20 flotation costs) that are properly considered in setting a
21 fair ROE for the Company.

22 In addition, I tested my recommendations for Avista
23 against the results of alternative ROE benchmarks, including
24 reference to applications of the traditional Capital Asset

1 Pricing Model ("CAPM") and expected rates of return for
2 electric utilities. Further, I corroborated my utility
3 quantitative analyses by applying the DCF model to a group of
4 low risk non-utility firms. Finally, my testimony addresses
5 the impact of regulatory mechanisms on an evaluation of a
6 fair ROE for Avista.

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

9 A. The ROE is the cost of attracting and retaining
10 common equity investment in the utility's physical plant and
11 assets. This investment is necessary to finance the asset
12 base needed to provide utility service. Investors commit
13 capital only if they expect to earn a return on their
14 investment commensurate with returns available from
15 alternative investments with comparable risks. Moreover, a
16 fair and reasonable ROE is integral in meeting sound
17 regulatory economics and the standards set forth by the U.S.
18 Supreme Court in the *Bluefield*¹ and *Hope*² cases, which state
19 that a utility's allowed ROE should be sufficient to: 1)
20 fairly compensate the utility's investors, 2) enable the
21 utility to offer a return adequate to attract new capital on

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 reasonable terms, and 3) maintain the utility's financial
2 integrity. These standards should allow the utility to
3 fulfill its obligation to provide reliable service while
4 meeting the needs of customers through necessary system
5 replacement and expansion, but they can only be met if the
6 utility has a reasonable opportunity to actually earn its
7 allowed ROE.

8 **D. Summary of Conclusions**

9 **Q. Please summarize the results of your analyses.**

10 A. The results of my analyses are presented on page 1
11 of Exhibit No. 3, Schedule 3, and in Table 1, below:

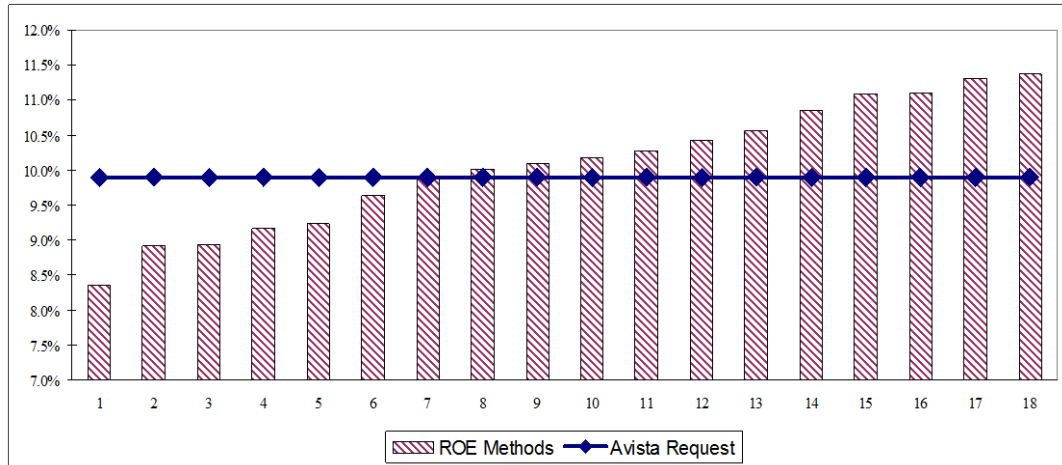
1
2

TABLE 1
SUMMARY OF RESULTS

<u>DCF</u>	<u>Average</u>	<u>Midpoint</u>
Value Line	9.9%	10.6%
IBES	9.2%	8.9%
Zacks	8.9%	9.2%
Internal br + sv	8.4%	9.6%
<u>Empirical CAPM - Historical Bond Yield</u>		
Unadjusted	10.0%	10.2%
Size Adjusted	11.1%	10.9%
<u>Empirical CAPM - Projected Bond Yield</u>		
Unadjusted	10.3%	10.4%
Size Adjusted	11.4%	11.1%
<u>Utility Risk Premium</u>		
Historical Bond Yields	10.1%	
Projected Bond Yields	11.3%	
<u>Cost of Equity Recommendation</u>		
Cost of Equity Range	9.4% -- 10.8%	
<u>Flotation Cost Adjustment</u>		
Dividend Yield	3.6%	
Flotation Cost Percentage	3.6%	
Adjustment	0.10%	
<u>ROE Recommendation</u>		
	9.5% -- 10.9%	

1 Figure 1, below, presents the 18 cost of equity estimates
2 presented in Table 1 in rank order, and compares them with
3 Avista's 9.9% ROE request:

4 **FIGURE 1**
5 **RESULTS OF ANALYSES VS. AVISTA REQUEST**



6

7 **Q. What are your findings regarding the 9.9 percent**
8 **ROE requested by Avista?**

9 A. Based on the results of my analyses and the
10 economic requirements necessary to support continuous access
11 to capital under reasonable terms, I determined that 9.9
12 percent is a fair and reasonable estimate of investors'
13 required ROE for Avista. The bases for my conclusion are
14 summarized below:

- 15 • In order to reflect the risks and prospects associated with Avista's jurisdictional utility operations, my
16 analyses focused on a proxy group of 19 other utilities with comparable investment risks.
- 17 • Because investors' required return on equity is unobservable and no single method should be viewed in
18
- 19
- 20

McKenzie, Di 7
Avista Corporation

1 isolation, I applied the DCF, ECAPM, and risk premium
2 methods to estimate a fair ROE for Avista;

- 3 • Based on the results of these analyses, and giving
4 less weight to extremes at the high and low ends of
5 the range, I concluded that the cost of equity for the
6 proxy group of utilities is in the **9.4 percent to 10.8**
7 **percent** range, or **9.5 percent to 10.9 percent** after
8 incorporating an adjustment to account for the impact
9 of common equity flotation costs; and,
- 10 • As reflected in the testimony of Mark T. Thies, Avista
11 is requesting an ROE of **9.9 percent**, which falls below
12 the **10.2 percent** midpoint of my recommended range.
13 Considering capital market expectations, the exposures
14 faced by Avista, and the economic requirements
15 necessary to maintain financial integrity and support
16 additional capital investment even under adverse
17 circumstances, it is my opinion that 9.9 percent
18 represents a conservative ROE for Avista.

19 **Q. What other evidence did you consider in evaluating**
20 **your ROE recommendation in this case?**

21 A. My recommendation is reinforced by the following
22 findings:

- 23 • The reasonableness of a 9.9 percent ROE for Avista is
24 supported by the need to consider the challenges to
25 the Company's credit standing:
 - 26 ○ The pressure of funding significant capital
27 expenditures of approximately \$375 million planned
28 for 2015, and over \$1.8 billion during the next
29 five years heighten the uncertainties associated
30 with Avista, especially given that the Company's
31 existing rate base is approximately \$2.6 billion;
 - 32 ○ Because of Avista's reliance on hydroelectric
33 generation and increasing dependence on natural
34 gas fueled capacity, the Company is exposed to
35 relatively greater risks of power cost volatility,
36 even with the power cost adjustment ("PCA");
 - 37 ○ Widespread expectations for higher interest rates
38 emphasize the implication of considering the
39 impact of projected bond yields in evaluating the
40 results of the ECAPM and risk premium methods;
41 and,

1 o My conclusion that a 9.9 percent ROE for Avista is
2 a reasonable estimate of investors' required
3 return is also reinforced by the greater
4 uncertainties associated with Avista's relatively
5 small size.

6 • Sensitivity to financial market and regulatory
7 uncertainties has increased dramatically and investors
8 recognize that constructive regulation is a key
9 ingredient in supporting utility credit standing and
10 financial integrity;

11 • Providing Avista with the opportunity to earn a return
12 that reflects these realities is an essential
13 ingredient to support the Company's financial
14 position, which ultimately benefits customers by
15 ensuring reliable service at lower long-run costs;

16 • Continued support for Avista's financial integrity,
17 including a reasonable ROE, is imperative to ensure
18 that the Company has the capability to maintain or
19 enhance its credit standing while confronting
20 potential challenges associated with funding
21 infrastructure development necessary to meet the needs
22 of its customers.

23 • Regulatory mechanisms, including Avista's requested
24 Fixed Cost Adjustment Mechanism ("FCA") are viewed as
25 supportive by investors, but they do not warrant a
26 downward adjustment to the Company's ROE:

27 ▪ The implications of regulatory mechanisms,
28 including measures comparable to the FCA, are
29 fully reflected in Avista's credit ratings, which
30 are comparable to those of the proxy group used
31 to estimate the cost of equity;

32 ▪ Because the utilities in my proxy group operate
33 under a wide variety of regulatory mechanisms,
34 including provisions akin to Avista's requested
35 FCA, the effects of the Company's approved and
36 proposed regulatory mechanisms are already
37 reflected in the results of my analyses, and no
38 separate adjustment to Avista's electric or gas
39 ROE is necessary or warranted.

40 These findings indicate that the 9.9 percent ROE requested by

41 Avista is reasonable and should be approved.

1 Q. What did the results of alternative ROE benchmarks
 2 indicate with respect to your evaluation?

3 A. The results of alternative ROE benchmarks are
 4 presented on page 2 of Exhibit No. 3, Schedule 3, and in
 5 Table 2, below:

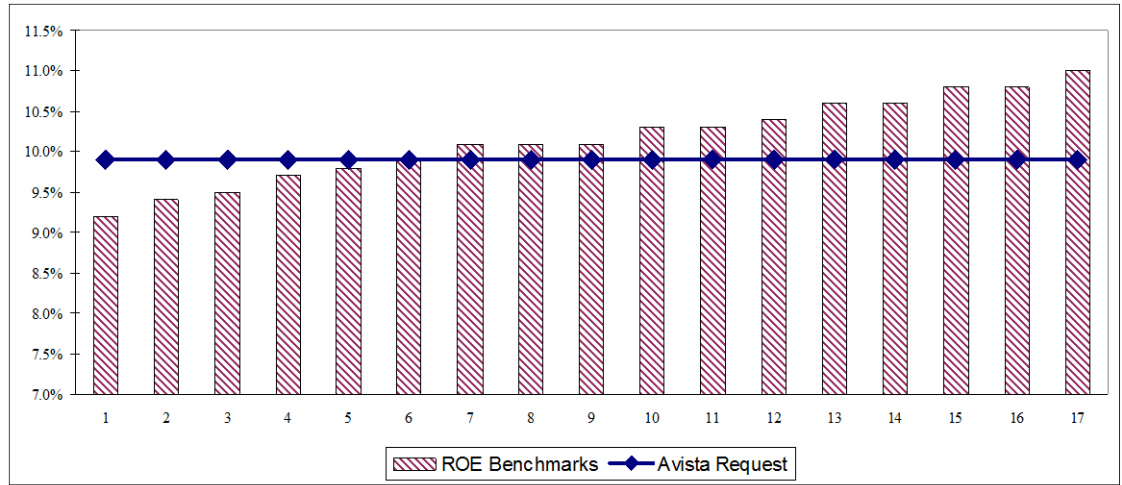
6 **TABLE 2**
 7 **SUMMARY OF ROE BENCHMARKS**

	<u>Average</u>	<u>Midpoint</u>
<u>CAPM - Historical Bond Yield</u>		
Unadjusted	9.5%	9.7%
Size Adjusted	10.6%	10.4%
<u>CAPM - Projected Bond Yield</u>		
Unadjusted	9.9%	10.1%
Size Adjusted	11.0%	10.8%
<u>Expected Earnings</u>		
Industry	10.6%	
Proxy Group	10.3%	10.8%
<u>Non-Utility DCF</u>		
Value Line	10.1%	10.3%
IBES	9.4%	9.2%
Zacks	9.8%	10.1%

8
 9 Figure 2, below, presents these 17 alternative benchmark
 10 results presented in Table 2 in rank order, and compares them
 11 with Avista's 9.9% ROE request:

1
2

FIGURE 2
ALTERNATIVE BENCHMARKS VS. AVISTA REQUEST



3

4 As summarized below, these results confirm the conclusion
5 that the 9.9 percent ROE requested for Avista is reasonable:

6

- Applying the traditional CAPM approach implied a current cost of equity on the order of 9.5 percent to 11.0 percent;

7

8

9

- Expected returns for electric utilities suggested an ROE range of 10.3 percent to 10.8 percent, excluding any adjustment for flotation costs;

10

11

12

- DCF estimates for a low-risk group of non-utility firms resulted in average ROE values in the range of 9.4 percent to 10.1 percent.

13

14

15

These tests of reasonableness confirm that a 9.9 percent ROE falls in the lower end of the reasonable range to maintain Avista's financial integrity, provides a return commensurate with investments of comparable risk, and supports the Company's ability to attract capital.

16

17

18

19

1 **Q. Would any adjustment to Avista's ROE be warranted**
2 **due to the Company's proposed FCA mechanism?**

3 A. No. Investors recognize that Avista is exposed to
4 significant risks associated with rising costs and stagnant
5 sales volumes, and concerns over these risks have become
6 increasingly pronounced in the industry. Avista's proposed
7 FCA mechanism represents an important means of mitigating
8 those risks, but it does not eliminate them. The addition of
9 the FCA mechanism would contribute towards leveling the
10 playing field and serves to address factors that could
11 otherwise impair Avista's opportunity to earn its authorized
12 return, as required by established regulatory standards.

13 Reflective of this industry trend, the companies in the
14 Utility Group operate under a wide variety of cost adjustment
15 mechanisms, which range from riders to recover bad debt
16 expense and post-retirement employee benefit costs to revenue
17 decoupling and adjustment clauses designed to address the
18 rising costs of environmental compliance measures.
19 Similarly, the firms in the Non-Utility Group also have the
20 ability to alter prices in response to rising production
21 costs, with the added flexibility to withdraw from the market
22 altogether. As a result, the mitigation in risks associated
23 with the proposed FCA mechanism is already reflected in the

1 cost of equity range determined earlier, and no separate
2 adjustment to Avista's ROE is necessary or warranted.

3 **Q. What other factors should be considered in**
4 **evaluating the ROE requested by Avista in this case?**

5 A. Apart from the results of the quantitative methods
6 summarized above, it is crucial to recognize the importance
7 of supporting the Company's financial position so that Avista
8 remains prepared to respond to unforeseen events that may
9 materialize in the future. Recent challenges in the economic
10 and financial market environment highlight the imperative of
11 continuing to build the Company's financial strength in order
12 to attract the capital needed to secure reliable service at a
13 reasonable cost for customers; these challenges include
14 interest rate risk and capital market volatility. The
15 reasonableness of the Company's requested ROE is reinforced
16 by the operating risks associated with Avista's reliance on
17 hydroelectric generation, the higher uncertainties associated
18 with Avista's relatively small size, and the fact that, due
19 to broad-based expectations for higher bond yields, current
20 cost of capital estimates are likely to understate investors'
21 requirements at the conclusion of this proceeding and beyond.

1 **Q. Does an ROE of 9.9 percent represent a reasonable**
2 **cost for Avista's customers to pay?**

3 A. Yes. Investors have many options competing for
4 their money. They make investment capital available to
5 Avista only if the expected returns justify the risk.
6 Customers will enjoy reliable and efficient service so long
7 as investors are willing to make the capital investments
8 necessary to maintain and improve Avista's utility system.
9 Providing an adequate return to investors is a necessary cost
10 to ensure that capital is available to Avista on reasonable
11 terms now and in the future. If regulatory decisions
12 increase risk or limit returns to levels that are
13 insufficient to justify the risk, investors will look
14 elsewhere to invest capital.

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

17 A. Based on my evaluation, I concluded that a common
18 equity ratio of 50.0 percent represents a reasonable basis
19 from which to calculate Avista's overall rate of return.
20 This conclusion was based on the following findings:

- 21 • Avista's requested capitalization is consistent with
22 the Company's need to maintain its credit standing and
23 financial flexibility as it seeks to raise additional
24 capital to fund significant system investments and
25 meet the requirements of its service territory;

1 more costly thermal generating capacity to meet its resource
2 needs. As S&P has observed:

3 A reduction in hydro generation typically increases
4 an electric utility's costs by requiring it to buy
5 replacement power or run more expensive generation
6 to serve customer loads. Low hydro generation can
7 also reduce utilities' opportunity to make off-
8 system sales. At the same time, low hydro years
9 increase regional wholesale power prices, creating
10 potentially a double impact - companies have to buy
11 more power than under normal conditions, paying
12 higher prices.³

13 Investors recognize that the potential for energy market
14 volatility, unpredictable stream flows, and Avista's reliance
15 on wholesale purchases to meet a significant portion of its
16 resource needs can expose the Company to the risk of reduced
17 cash flows and unrecovered power supply costs.

18 S&P has noted that Avista, along with Idaho Power
19 Company, "face the most substantial risks despite their PCAs
20 and cost-update mechanisms,"⁴ and concluded that Avista's
21 "Northwest hydropower has been subject to significant
22 volatility in recent years, so [Avista] is exposed to
23 purchased power costs."⁵

24 Similarly, Moody's Investors Service ("Moody's") has
25 recognized that, "Avista's high dependency on hydro resources

³ Standard & Poor's Corporation, "Pacific Northwest Hydrology And Its Impact On Investor-Owned Utilities' Credit Quality," *RatingsDirect* (Jan. 28, 2008).

⁴ *Id.*

⁵ Standard & Poor's Corporation, "Industry Report Card," *RatingsDirect* (Apr. 19, 2013).

1 (approximately 50% of its production comes from hydro fueled
2 electric generation resources) is viewed as a supply
3 concentration risk . . . especially since hydro levels, due
4 to weather, is a factor outside of management's control."⁶
5 More recently, S&P affirmed the importance of constructive
6 regulation in light of the potential need "to purchase power
7 for customers when hydro power is unavailable."⁷ Avista's
8 reliance on purchased power to meet shortfalls in
9 hydroelectric generation magnifies the importance of
10 strengthening financial flexibility.

11 **Q. Do financial pressures associated with Avista's**
12 **planned capital expenditures also impact investors' risk**
13 **assessment?**

14 A. Yes. Avista will require capital investment to
15 meet customer growth, provide for necessary maintenance and
16 replacements of its natural gas utility systems, as well as
17 fund new investment in electric generation, transmission and
18 distribution facilities. Utility capital additions are
19 expected to total approximately \$375 million for 2015, and
20 \$350 million for each of the years 2016 through 2019. This

⁶ Moody's Investors Service, "Credit Opinion: Avista Corp.," *Global Credit Research* (Mar. 17, 2011).

⁷ Standard & Poor's Corporation, "Avista Corp.," *RatingsDirect* (May 9, 2014).

1 represents a substantial investment given Avista's current
2 rate base of approximately \$2.6 billion.

3 Continued support for Avista's financial integrity and
4 flexibility will be instrumental in attracting the capital
5 necessary to fund these projects in an effective manner.
6 Investors are aware of the challenges posed by burdensome
7 capital expenditure requirements, especially in light of
8 ongoing capital market and economic uncertainties, and
9 Moody's has noted that increasing capital expenditures are a
10 primary credit concern for Avista.⁸

11 **Q. Would investors consider Avista's relative size in**
12 **their assessment of the Company's risks and prospects?**

13 A. Yes. A firm's relative size has important
14 implications for investors in their evaluation of alternative
15 investments, and it is well established that smaller firms
16 are more risky than larger firms. With a market
17 capitalization of approximately \$2.0 billion, Avista is one
18 of the smallest publicly traded utility holding companies
19 followed by Value Line, which have an average capitalization
20 of approximately \$12.6 billion.⁹

⁸ Moody's Investors Service, "Credit Opinion: Avista Corp.," *Global Credit Research* (Mar. 28, 2014).

⁹ www.valueline.com (retrieved May 5, 2015).

1 actions in the aftermath of the Great Recession, and are not
2 representative of what investors expect in the future.
3 Investors have had to contend with a level of economic
4 uncertainty and capital market volatility that has been
5 unprecedented in recent history. The ongoing potential for
6 renewed turmoil in the capital markets has been seen
7 repeatedly, with common stock prices exhibiting the dramatic
8 volatility that is indicative of heightened sensitivity to
9 risk. In response to heightened uncertainties in recent
10 years, investors have repeatedly sought a safe haven in U.S.
11 government bonds. As a result of this "flight to safety,"
12 Treasury bond yields have been pushed significantly lower in
13 the face of political, economic, and capital market risks.
14 In addition, the Federal Reserve has implemented measures
15 designed to push interest rates to historically low levels in
16 an effort to stimulate the economy and bolster employment.

17 **Q. How do current yields on public utility bonds**
18 **compare with what investors have experienced in the past?**

19 A. The yields on utility bonds remain near their
20 lowest levels in modern history. Figure 3, below, compares
21 the April 2015 average yield on long-term, triple-B rated
22 utility bonds with those prevailing since 1968:

1
2

FIGURE 3
BBB UTILITY BOND YIELDS - CURRENT VS. HISTORICAL



3 As illustrated above, prevailing capital market conditions,
4 as reflected in the yields on triple-B utility bonds, are an
5 anomaly when compared with historical experience. Similarly,
6 while 10-year Treasury bond yields may reflect a modest
7 increase from all-time lows of less than 2.0 percent, they
8 are hardly comparable to historical levels.¹² Federal Reserve
9 President Charles Plosser recently observed that U.S.
10 interest rates are unprecedentedly low, and "outside
11 historical norms."¹³

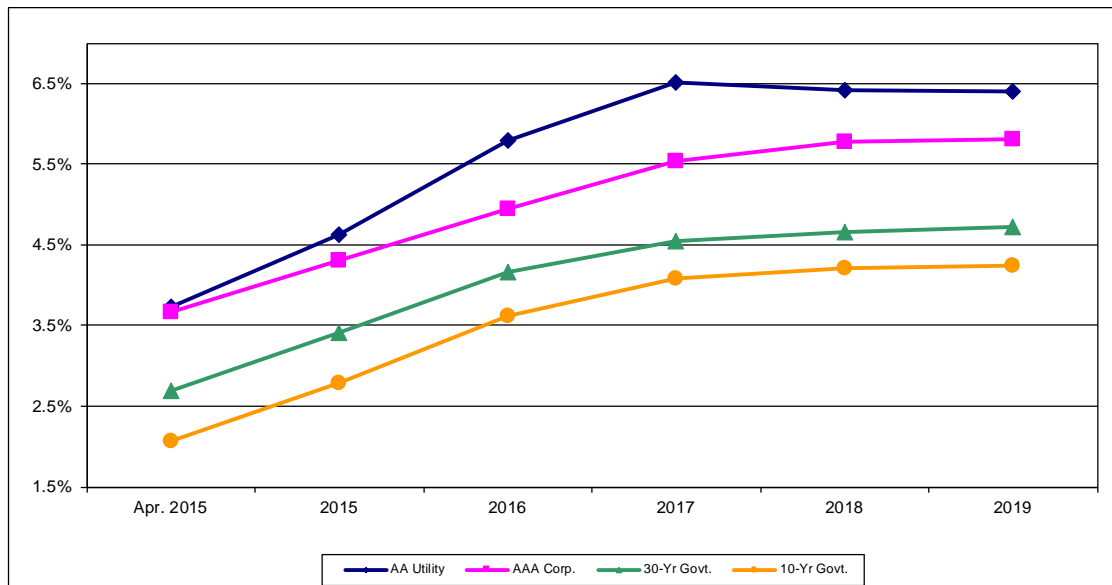
¹² The average yield on 10-year Treasury bonds for the six-months ended April 2015 was 2.06 percent. Over the 1968-2015 period illustrated on Figure 2, 10-year Treasury bond yields averaged 6.71 percent.

¹³ Barnato, Katy, "Fed's Plosser: Low rates 'should make us nervous'," CNBC (Nov. 11, 2014).

1 Q. Are these very low interest rates expected to
2 continue?

3 A. No. Investors continue to anticipate that interest
4 rates will increase significantly from present levels.
5 Figure 4 below compares current interest rates on 30-year
6 Treasury bonds, triple-A rated corporate bonds, and double-A
7 rated utility bonds with near-term projections from Value
8 Line, IHS Global Insight, Blue Chip Financial Forecasts
9 ("Blue Chip"), and the Energy Information Administration
10 ("EIA"):

11 **FIGURE 4**
12 **INTEREST RATE TRENDS**



Source:

Value Line Investment Survey, Forecast for the U.S. Economy (Feb. 20, 2015)
IHS Global Insight, The U.S. Economy: The 30-Year Focus (Third-Quarter 2014)
Energy Information Administration, Annual Energy Outlook 2015 (April 2015)
Blue Chip Financial Forecasts, Vol. 33, No. 12 (Dec. 1, 2014)

13 These forecasting services are highly regarded and
14 widely referenced, with FERC incorporating forecasts from IHS

1 Global Insight and the EIA in its preferred DCF model for
2 natural gas and oil pipelines, as well as for electric
3 transmission utilities. As evidenced above, there is a clear
4 consensus in the investment community that the cost of long-
5 term capital will be significantly higher over the 2015-2019
6 period.

7 **Q. Do recent actions of the Federal Reserve support**
8 **the contention that current low interest rates will continue**
9 **indefinitely?**

10 A. No. Citing improvement in the outlook for the
11 labor market and increasing strength in the broader economy,
12 the Federal Reserve elected to discontinue further purchases
13 under its bond-buying program at its October 2014 meeting.
14 While the Federal Reserve continues to express support for
15 maintaining a highly accommodative monetary policy and an
16 exceptionally low target range for the federal funds rate,
17 elimination of additional bond purchases under the Federal
18 Reserve's program of "Quantitative Easing" should ultimately
19 exert upward pressure on long-term interest rates. As *The*
20 *Wall Street Journal* observed:

21 The Fed's decision to begin trimming its \$85
22 billion monthly bond-buying program is widely
23 expected to result in higher medium-term and long-
24 term market interest rates. That means many

1 borrowers, from home buyers to businesses, will be
2 paying higher rates in the near future.¹⁴

3 While the Federal Reserve's conclusion of new asset
4 purchases has moderated uncertainties over just when, and to
5 what degree, the stimulus program would be altered, investors
6 continue to face ongoing uncertainties over future
7 modifications that could ultimately affect how quickly and by
8 how much interest rates are affected.

9 **Q. Does the cessation of further asset purchases by**
10 **the Federal Reserve mark a return to "normal" in capital**
11 **markets?**

12 A. No. The Federal Reserve continues to exert
13 considerable influence over capital market conditions through
14 its massive holdings of Treasuries and mortgage-backed
15 securities. Prior to the initiation of the stimulus program
16 in 2009, the Federal Reserve's holdings of U.S. Treasury
17 bonds and notes amounted to approximately \$400 - \$500
18 billion. With the implementation of its asset purchase
19 program, balances of Treasury securities and mortgage backed
20 instruments climbed steadily, and their effect on capital
21 market conditions became more pronounced. Table 3 below

¹⁴ Jon Hilsenrath, "Fed Dials Back Bond Buying, Keeps a Wary Eye on Growth," *The Wall Street Journal* at A1 (Dec. 19, 2013).

1 charts the course of the Federal Reserve's asset purchase
2 program:

3 **TABLE 3**
4 **FEDERAL RESERVE BALANCES OF**
5 **TREASURY BONDS AND MORTGAGE-BACKED SECURITIES**
(Billion \$)

2008	\$ 410
2009	\$ 1,618
2010	\$ 1,939
2011	\$ 2,423
2012	\$ 2,512
2013	\$ 3,597
2014	\$ 4,097

6 Far from representing a return to normal, the Federal
7 Reserve's holdings of Treasury bonds and mortgage-backed
8 securities now amount to more than \$4 trillion,¹⁵ which is an
9 all-time high.

10 For now, the Federal Reserve is maintaining its policy
11 of reinvesting principal payments from these securities -
12 about \$16 billion a month - and rolling over maturing
13 Treasuries at auction. As the Federal Reserve recently
14 noted:

15 The Committee is maintaining its existing policy of
16 reinvesting principal payments from its holdings of
17 agency debt and agency mortgage-backed securities
18 in agency mortgage-backed securities and of rolling
19 over maturing Treasury securities at auction. This
20 policy, by keeping the Committee's holdings of

¹⁵ Federal Reserve Statistical Release, "Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks," H.4.1.

1 longer-term securities at sizable levels, should
2 help maintain accommodative financial conditions.¹⁶
3

4 This continued investment maintains the downward
5 pressure on interest rates that is the hallmark of the
6 stimulus program and the anomalous conditions currently
7 characterizing capital markets.

8 Of course, the corollary to these observations is that
9 changes to this policy of reinvestment would further reduce
10 stimulus measures and could place significant upward pressure
11 on bond yields, especially considering the unprecedented
12 magnitude of the Federal Reserve's holdings of Treasury bonds
13 and mortgage-backed securities. The International Monetary
14 Fund noted, "A lack of Fed clarity could cause a major spike
15 in borrowing costs that could cause severe damage to the U.S.
16 recovery and send destructive shockwaves around the global
17 economy," adding that, "[a] smooth and gradual upward shift
18 in the yield curve might be difficult to engineer, and there
19 could be periods of higher volatility when longer yields jump
20 sharply—as recent events suggest."¹⁷ As a Financial Analysts
21 Journal article noted:

22 Because no precedent exists for the massive
23 monetary easing that has been practiced over the

¹⁶ *Press Release*, Board of Governors of the Federal Reserve System, (Mar. 18, 2015), <http://www.federalreserve.gov/newsevents/press/monetary/20150318a.htm>.

¹⁷ Talley, Ian, "IMF Urges 'Improved' U.S. Fed Policy Transparency as It Mulls Easy Money Exit," *The Wall Street Journal* (July 26, 2013).

1 past five years in the United States and Europe,
2 the uncertainty surrounding the outcome of central
3 bank policy is so vast. . . . Total assets on the
4 balance sheets of most developed nations' central
5 banks have grown massively since 2008, and the
6 timing of when the banks will unwind those
7 positions is uncertain.¹⁸

8
9 These developments highlight continued concerns for
10 investors and support expectations for higher interest rates
11 as the economy and labor markets continue to recover. With
12 the Federal Reserve curtailing the expansion of its enormous
13 portfolio of Treasuries and mortgage bonds, ongoing concerns
14 over political stalemate in Washington, the threat of renewed
15 recession in the Eurozone, and political and economic unrest
16 in Ukraine, the Middle East, and emerging markets, the
17 potential for significant volatility and higher capital costs
18 is clearly evident to investors.

19 **Q. Have other regulators recognized the importance of**
20 **considering the implications of current capital market**
21 **conditions when evaluating a fair ROE for a utility?**

22 A. Yes. In its June 19, 2014 order in Docket No.
23 EL11-66-001, FERC explicitly noted the need to "consider the
24 extent to which economic anomalies may have affected the
25 reliability of DCF analyses in determining where to set a
26 public utility's ROE within the range of reasonable

¹⁸ Poole, William, "Prospects for and Ramifications of the Great Central Banking Unwind," Financial Analysts Journal (November/December 2013).

1 returns.”¹⁹ FERC ultimately determined that due to
2 unrepresentative capital market conditions, an upward
3 adjustment to the 9.39 percent midpoint of its DCF range was
4 required in order to meet the regulatory standards
5 established by *Hope* and *Bluefield*. Based on its examination
6 of alternatives to the DCF approach, FERC authorized an ROE
7 from the upper end of its DCF range, or 10.57 percent.²⁰

8 **Q. What do these events imply with respect to the ROE**
9 **for Avista more generally?**

10 A. Current capital market conditions continue to
11 reflect the impact of unprecedented policy measures taken in
12 response to recent dislocations in the economy and financial
13 markets. As a result, current capital costs are not
14 representative of what is likely to prevail over the near-
15 term future. As FERC recently concluded:

16 [W]e also understand that any DCF analysis may be
17 affected by potentially unrepresentative financial
18 inputs to the DCF formula, including those produced
19 by historically anomalous capital market
20 conditions. Therefore, while the DCF model remains
21 the Commission’s preferred approach to determining
22 allowed rate of return, the Commission may consider
23 the extent to which economic anomalies may have
24 affected the reliability of DCF analyses ...²¹

¹⁹ *Martha Coakley et al., v. Bangor Hydro-Electric Company, et al.*, Opinion No. 531, 147 FERC ¶ 61,234 at P 41 (2014) (“Opinion No. 531”).

²⁰ *Id.* at PP 145, 146, 148, & 152.

²¹ Opinion No. 531, 147 FERC ¶ 61,234 at P 41 (2014).

1 This conclusion is supported by comparisons of current
2 conditions to the historical record and independent
3 forecasts. As demonstrated above, recognized economic
4 forecasting services project that long-term capital costs
5 will increase from present levels.

6 To address the reality of current capital markets, the
7 IPUC should consider forecasts for higher public utility bond
8 yields in assessing the reasonableness of individual cost of
9 equity estimates and in evaluating a fair ROE for Avista from
10 within the range of reasonableness. As discussed in Exhibit
11 No. 3, Schedule 2, this result is supported by economic
12 studies that show that equity risk premiums are higher when
13 interest rates are at very low levels.

14 **Q Do ongoing economic and capital market**
15 **uncertainties also influence the appropriate capital**
16 **structure for Avista?**

17 A Yes. Financial flexibility plays a crucial role in
18 ensuring the wherewithal to meet funding needs, and utilities
19 with higher financial leverage may be foreclosed from
20 additional borrowing, especially during times of stress. As
21 a result, the Company's capital structure must maintain an
22 equity "cushion" that preserves the flexibility necessary to
23 maintain continuous access to capital even during times of
24 unfavorable market conditions.

1 **C. Support for Avista's Credit Standing**

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

3 A. S&P has assigned Avista a corporate credit rating
4 of "BBB", while Moody's has set Avista's Issuer Rating at
5 "Baa1".

6 **Q. What considerations impact investors' assessment of**
7 **the firms in the utility industry?**

8 A. Numerous factors have the potential to impact
9 investors' perceptions of the relative risks inherent in the
10 utility industry and have implications for the financial
11 standing of the utilities themselves. These include the
12 possibility of volatile fuel or purchased power costs,
13 uncertain environmental mandates and associated costs, the
14 implications of declining demand associated with economic
15 weakness or structural changes in usage patterns, and
16 increased reliance on distributed generation or other
17 alternatives to the incumbent utility. Apart from these
18 considerations, utilities may face increasing costs of
19 operating their systems, as well as the financial pressures
20 associated with large capital expenditure programs, which are
21 magnified during periods of turmoil in capital markets.

1 **Q. What are the implications for Avista, given the**
2 **potential for further dislocations in the capital markets?**

3 A. The pressures of significant capital expenditure
4 requirements reinforce the importance of supporting continued
5 improvement in Avista's credit standing. Investors
6 understand from past experience in the utility industry that
7 large capital needs can lead to significant deterioration in
8 financial integrity that can constrain access to capital,
9 especially during times of unfavorable capital market
10 conditions. Considering the uncertain state of financial
11 markets, competition with other investment alternatives, and
12 investors' sensitivity to the potential for market
13 volatility, greater credit strength is a key ingredient in
14 maintaining access to capital at reasonable cost. As Mr.
15 Thies confirms in his testimony, continued regulatory support
16 will be a key driver in continuing to build Avista's
17 financial health.

18 **Q. What role does regulation play in ensuring that**
19 **Avista has access to capital under reasonable terms and on a**
20 **sustainable basis?**

21 A. Investors recognize that constructive regulation is
22 a key ingredient in supporting utility credit ratings and
23 financial integrity, particularly during times of adverse
24 conditions. As Moody's noted, "the regulatory environment is

1 the most important driver of our outlook because it sets the
2 pace for cost recovery,"²² With respect to Avista
3 specifically, the major bond rating agencies have explicitly
4 cited the potential that adverse regulatory rulings could
5 compromise the Company's credit standing. S&P observed that
6 management of Avista's regulatory relationships "is a
7 critical underpinning of its investment-grade credit
8 quality."²³, and concluded that "greater borrowing or
9 increased rate lag, a large deferral, or adverse regulatory
10 decisions" could lead to a downgrade. Similarly, Moody's
11 concluded that "Avista's ratings could be negatively impacted
12 if the level of regulatory support wanes."²⁴ Further
13 strengthening Avista's financial integrity is imperative to
14 ensure that the Company has the capability to maintain an
15 investment grade rating while confronting large capital
16 expenditures and other potential challenges.²⁵

²² Moody's Investors Service, "Regulation Will Keep Cash Flow Stable As Major Tax Break Ends," *Industry Outlook* (Feb. 19, 2014).

²³ Standard & Poor's Corporation, "Avista Corp.," *RatingsDirect* (May 9, 2014).

²⁴ Moody's Investors Service, "Credit Opinion: Avista Corp.," *Global Credit Research* (Mar. 28, 2014).

²⁵ As noted in the testimony of Mr. Thies, continued regulatory support will be instrumental in achieving Avista's objective of a BBB+ rating, which is consistent with the average credit standing in the electric utility industry.

1 higher debt ratio means that there are proportionately more
2 investors ahead of them, thereby increasing the uncertainty
3 as to the amount of cash flow that will remain.

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

6 A. Avista's capital structure is presented in the
7 testimony of Mr. Thies. As summarized in his testimony, the
8 proposed common equity ratio used to compute Avista's overall
9 rate of return is 50.0 percent in this filing.

10 **Q. What was the average capitalization maintained by**
11 **the Utility Group?**

12 A. As shown on Exhibit No. 3, Schedule 4, for the 19
13 firms in the Utility Group, common equity ratios at December
14 31, 2014 ranged between 30.2 percent and 54.8 percent and
15 averaged 48.3 percent.

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

18 A. As shown on Exhibit No. 3, Schedule 4, Value Line
19 expects an average common equity ratio for the proxy group of
20 utilities of 49.7 percent for its three-to-five year forecast
21 horizon, with the individual common equity ratios ranging
22 from 34.5 percent to 58.0 percent.

1 **Q. How does Avista's common equity ratio compare with**
2 **those maintained by the reference group of utilities?**

3 A. The 50.0 percent common equity ratio requested by
4 Avista is consistent with the range of equity ratios
5 maintained by the firms in the Utility Group and is in-line
6 with the 48.3 percent and 49.7 percent average equity ratios
7 at year-end 2014 and Value Line's near-term expectations,
8 respectively.

9 **Q. What implication do the uncertainties inherent in**
10 **the utility industry have for the capital structures**
11 **maintained by utilities?**

12 A. As discussed earlier, utilities are facing rising
13 costs, the need to finance significant capital investment
14 plans, uncertainties over accommodating economic and
15 financial market uncertainties, and ongoing regulatory risks.
16 Coupled with the potential for turmoil in capital markets,
17 these considerations warrant a financial profile that
18 accommodates the need to deal with an increasingly uncertain
19 environment and to maintain the continuous access to capital
20 under reasonable terms that is required to fund operations
21 and necessary system investment, including times of adverse
22 capital market conditions.

23 Moody's has repeatedly warned investors of the risks
24 associated with debt leverage and fixed obligations and

1 advised utilities not to squander the opportunity to
2 strengthen the balance sheet as a buffer against future
3 uncertainties.²⁶ Similarly, S&P noted that, "we generally
4 consider a debt to capital level of 50% or greater to be
5 aggressive or highly leveraged for utilities."²⁷

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

8 A. Depending on their specific attributes, contractual
9 agreements or other obligations that require the utility to
10 make specified payments may be treated as debt in evaluating
11 Avista's financial risk. Power purchase agreements ("PPAs"),
12 leases, and pension obligations typically require the utility
13 to make specified minimum contractual payments akin to those
14 associated with traditional debt financing and investors
15 consider a portion of these commitments as debt in evaluating
16 total financial risks. Because investors consider the debt
17 impact of such fixed obligations in assessing a utility's
18 financial position, they imply greater risk and reduced

²⁶ Moody's Investors Service, "Storm Clouds Gathering on the Horizon for the North American Electric Utility Sector," *Special Comment* (Aug. 2007); "U.S. Electric Utility Sector," *Industry Outlook* (Jan. 2008); "U.S. Electric Utilities Face Challenges Beyond Near-Term," *Industry Outlook* (Jan. 2010); Moody's Investors Service, "U.S. Electric Utilities: Uncertain Times Ahead; Strengthening Balance Sheets Now Would Protect Credit," *Special Comment* (Oct. 28, 2010).

²⁷ Standard & Poor's Corporation, "Ratings Roundup: U.S. Electric Utility Sector Maintained Strong Credit Quality In A Gloomy 2009," *RatingsDirect* (Jan. 26, 2010).

1 financial flexibility. In order to offset the debt
2 equivalent associated with off-balance sheet obligations, the
3 utility must rebalance its capital structure by increasing
4 its common equity in order to restore its effective
5 capitalization ratios to previous levels.

6 These commitments have been repeatedly cited by major
7 bond rating agencies in connection with assessments of
8 utility financial risks.²⁸ The capital structure ratios
9 presented earlier do not include imputed debt associated with
10 power purchase agreements or the impact of other off-balance
11 sheet obligations.

12 **Q. What does this evidence indicate with respect to**
13 **the Company's capital structure?**

14 A. Based on my evaluation, I concluded that Avista's
15 requested capital structure represents a reasonable mix of
16 capital sources from which to calculate the Company's overall
17 rate of return. While industry averages provide one
18 benchmark for comparison, each firm must select its
19 capitalization based on the risks and prospects it faces, as

²⁸ See, e.g., Standard & Poor's Corporation, "Standard & Poor's Methodology For Imputing Debt For U.S. Utilities' Power Purchase Agreements," *RatingsDirect* (May 7, 2007); Standard & Poor's Corporation, "Implications Of Operating Leases On Analysis Of U.S. Electric Utilities," *RatingsDirect* (Jan. 15, 2008); Standard & Poor's Corporation, "Top 10 Investor Questions: U.S. Regulated Electric Utilities," *RatingsDirect* (Jan. 22, 2010); Standard & Poor's Corporation, "Utilities: Key Credit Factors For The Regulated Utilities Industry," *RatingsDirect* (Nov. 19, 2013).

1 well its specific needs to access the capital markets. A
2 public utility with an obligation to serve must maintain
3 ready access to capital under reasonable terms so that it can
4 meet the service requirements of its customers. Financial
5 flexibility plays a crucial role in ensuring the wherewithal
6 to meet the needs of customers, and utilities with higher
7 leverage may be foreclosed from additional borrowing under
8 reasonable terms, especially during times of stress.

9 Avista's capital structure is consistent with industry
10 benchmarks and reflects the challenges posed by its resource
11 mix, the burden of significant capital spending requirements,
12 and the Company's ongoing efforts to strengthen its credit
13 standing and support access to capital on reasonable terms.

14 **III. CAPITAL MARKET ESTIMATES**

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

16 A. This section presents capital market estimates of
17 the cost of equity. The details of my quantitative analyses
18 are contained in Exhibit No. 3, Schedule 2, with the results
19 being summarized below.

1 **A. Overview**

2 **Q. What fundamental economic principle underlies any**
3 **evaluation of investors' required return on equity?**

4 A. The fundamental economic principle underlying the
5 cost of equity concept is the notion that investors are risk
6 averse. In capital markets where relatively risk-free assets
7 are available (e.g., U.S. Treasury securities), investors can
8 be induced to hold riskier assets only if they are offered a
9 premium, or additional return, above the rate of return on a
10 risk-free asset. Since all assets compete with each other
11 for investor funds, riskier assets must yield a higher
12 expected rate of return than safer assets to induce investors
13 to hold them.

14 Given this risk-return tradeoff, the required rate of
15 return (k) from an asset (i) can be generally expressed as:

16
$$k_i = R_f + RP_i$$

17 where: R_f = Risk-free rate of return, and
18 RP_i = Risk premium required to hold
19 riskier asset i .

20 Thus, the required rate of return for a particular asset at
21 any point in time is a function of: 1) the yield on risk-free
22 assets, and 2) its relative risk, with investors demanding
23 correspondingly larger risk premiums for assets bearing
24 greater risk.

25 **Q. Is there evidence that the risk-return tradeoff**
26 **principle actually operates in the capital markets?**

1 A. Yes. The risk-return tradeoff can be readily
2 documented in segments of the capital markets where required
3 rates of return can be directly inferred from market data and
4 where generally accepted measures of risk exist. Bond
5 yields, for example, reflect investors' expected rates of
6 return, and bond ratings measure the risk of individual bond
7 issues. Comparing the observed yields on government
8 securities, which are considered free of default risk, to the
9 yields on bonds of various rating categories demonstrates
10 that the risk-return tradeoff does, in fact, exist.

11 **Q. Does the risk-return tradeoff observed with fixed**
12 **income securities extend to common stocks and other assets?**

13 A. Yes. It is widely accepted that the risk-return
14 tradeoff evidenced with long-term debt extends to all assets.
15 Documenting the risk-return tradeoff for assets other than
16 fixed income securities, however, is complicated by two
17 factors. First, there is no standard measure of risk
18 applicable to all assets. Second, for most assets -
19 including common stock - required rates of return cannot be
20 directly observed. Yet there is every reason to believe that
21 investors exhibit risk aversion in deciding whether or not to
22 hold common stocks and other assets, just as when choosing
23 among fixed-income securities.

1 **Q. Is this risk-return tradeoff limited to differences**
2 **between firms?**

3 A. No. The risk-return tradeoff principle applies not
4 only to investments in different firms, but also to different
5 securities issued by the same firm. The securities issued by
6 a utility vary considerably in risk because they have
7 different characteristics and priorities. As noted earlier,
8 long-term debt is senior among all capital in its claim on a
9 utility's net revenues and is, therefore, the least risky.
10 The last investors in line are common shareholders. They
11 receive only the net revenues, if any, remaining after all
12 other claimants have been paid. As a result, the rate of
13 return that investors require from a utility's common stock,
14 the most junior and riskiest of its securities, must be
15 considerably higher than the yield offered by the utility's
16 senior, long-term debt.

17 **Q. What does the above discussion imply with respect**
18 **to estimating the cost of common equity for a utility?**

19 A. Although the cost of common equity cannot be
20 observed directly, it is a function of the returns available
21 from other investment alternatives and the risks to which the
22 equity capital is exposed. Because it is unobservable, the
23 cost of equity for a particular utility must be estimated by
24 analyzing information about capital market conditions

1 generally, assessing the relative risks of the company
2 specifically, and employing various quantitative methods that
3 focus on investors' current required rates of return. These
4 various quantitative methods typically attempt to infer
5 investors' required rates of return from stock prices,
6 interest rates, or other capital market data.

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

9 A. No. In my opinion, no single method or model
10 should be relied upon to determine a utility's cost of equity
11 because no single approach can be regarded as wholly
12 reliable. Therefore, I used the DCF, CAPM, and risk premium
13 methods to estimate the cost of common equity. In addition,
14 I also evaluated a fair ROE using an earnings approach based
15 on investors' current expectations in the capital markets.
16 In my opinion, comparing estimates produced by one method
17 with those produced by other approaches ensures that the
18 estimates of the cost of equity pass fundamental tests of
19 reasonableness and economic logic.

20 **Q. Are you aware that the IPUC has traditionally**
21 **relied primarily on the DCF and comparable earnings methods?**

22 A. Yes, although the Commission has also evidenced a
23 willingness to weigh alternatives in evaluating an allowed

1 ROE. For example, while noting that it had not focused on
2 the CAPM for determining the cost of equity, the IPUC
3 recognized in Case No. IPC-E-03-13, Order No. 29505 that
4 "methods to evaluate a common equity rate of return are
5 imperfect predictors" and emphasized "that by evaluating all
6 the methods presented in this case and using each as a check
7 on the other," the Commission had avoided the pitfalls
8 associated with reliance on a single method.²⁹

9 **B. Results of Primary Methods**

10 **Q. What specific proxy group of utilities did you rely**
11 **on for your analysis?**

12 A. In estimating the cost of equity, the DCF model is
13 typically applied to publicly traded firms engaged in similar
14 business activities or with comparable investment risks. As
15 described in detail in Exhibit No. 3, Schedule 2, I applied
16 the DCF model to a utility proxy group composed of those
17 dividend-paying companies included by Value Line in its
18 Electric Utilities Industry groups with:

- 19 1. S&P corporate credit ratings of "BBB-" to "BBB+;"
20 2. Moody's issuer ratings of Baa2, Baa1, or A3,
21 3. Value Line Safety Rank of "2" or "3";

²⁹Case No. IPC-E-03-13, Order No. 29505 at 38 (2004).

1 Avista are generally comparable to those of the firms in the
2 Utility Group.

3 **Q. What cost of equity is implied by your DCF results**
4 **for the Utility Group?**

5 A. My application of the DCF model, which is discussed
6 in greater detail in Exhibit No. 3, Schedule 2, considered
7 three alternative measures of expected earnings growth, as
8 well as the sustainable growth rate based on the relationship
9 between expected retained earnings and earned rates of return
10 ("br+sv"). As shown on page 3 of Exhibit No. 3, Schedule 5
11 and summarized below in Table 5, after eliminating illogical
12 values,³⁰ application of the constant growth DCF model
13 resulted in the following cost of equity estimates:

³⁰ I provide a detailed explanation of my DCF analysis, including the evaluation of individual estimates, in Exhibit No. 3, Schedule 2.

1
2

TABLE 5
DCF RESULTS - UTILITY GROUP

<u>Growth Rate</u>	<u>Cost of Equity</u>	
	<u>Average</u>	<u>Midpoint</u>
Value Line	9.9%	10.6%
IBES	9.2%	8.9%
Zacks	8.9%	9.2%
br + sv	8.4%	9.6%

3

4 **Q. How did you apply the ECAPM to estimate the cost of**
5 **equity?**

6 A. Like the DCF model, the ECAPM is an *ex-ante*, or
7 forward-looking model based on expectations of the future.
8 As a result, in order to produce a meaningful estimate of
9 investors' required rate of return, the ECAPM is best applied
10 using estimates that reflect the expectations of actual
11 investors in the market, not with backward-looking,
12 historical data. Accordingly, I applied the ECAPM to the
13 Utility Group based on a forward-looking estimate for
14 investors' required rate of return from common stocks.
15 Because this forward-looking application of the ECAPM looks
16 directly at investors' expectations in the capital markets,
17 it provides a more meaningful guide to the expected rate of
18 return required to implement the ECAPM.

19 Empirical research indicates that the ECAPM does not
20 fully account for observed differences in rates of return
21 attributable to firm size. The need for an adjustment to

1 account for relative market capitalization arises because
2 differences in investors' required rates of return that are
3 related to firm size are not fully captured by beta.
4 Accordingly, my ECAPM analyses incorporated an adjustment to
5 recognize the impact of size distinctions, as developed by
6 Morningstar.

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

9 A. As shown on page 1 of Exhibit No. 3, Schedule 7, my
10 forward-looking application of the ECAPM model indicated an
11 ROE of 10.0 percent for the Utility Group. Adjusting the
12 10.0 percent theoretical ECAPM result to incorporate the size
13 adjustment results in an indicated cost of common equity of
14 11.1 percent.

15 **Q. Did you also apply the ECAPM using forecasted bond**
16 **yields?**

17 A. Yes. As discussed earlier, there is widespread
18 consensus that interest rates will increase materially as the
19 economy continues to strengthen. Accordingly, in addition to
20 the use of current bond yields, I also applied the CAPM based
21 on the forecasted long-term Treasury bond yields developed
22 based on projections published by Value Line, IHS Global
23 Insight and Blue Chip. As shown on page 2 of Exhibit No. 3,

1 Schedule 7, incorporating a forecasted Treasury bond yield
2 for 2015-2019 implied a cost of equity of approximately 10.3
3 percent for the Utility Group, or 11.4 percent after
4 adjusting for the impact of relative size.

5 **Q. How did you implement the risk premium method?**

6 A. I based my estimates of equity risk premiums for
7 electric utilities on surveys of previously authorized rates
8 of return on common equity, which are frequently referenced
9 as the basis for estimating equity risk premiums. My
10 application of the risk premium method also considered the
11 inverse relationship between equity risk premiums and
12 interest rates, which suggests that when interest rate levels
13 are relatively high, equity risk premiums narrow, and when
14 interest rates are relatively low, equity risk premiums
15 widen.

16 **Q. What cost of equity was indicated by the risk**
17 **premium approach?**

18 A. As shown on page 1 of Exhibit No. 3, Schedule 8,
19 adding an adjusted risk premium of 5.51 percent to the
20 average yield on triple-B utility bonds for April 2015 of
21 4.55 percent resulted in an implied cost of equity of
22 approximately 10.1 percent. As shown on page 2 of Exhibit
23 No. 3, Schedule 8, incorporating a forecasted yield for 2015-

1 2019 and adjusting for changes in interest rates since the
2 study period implied a cost of equity of approximately 11.3
3 percent.

4 **C. Flotation Costs**

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

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

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

21 A. No. While debt flotation costs are recorded on the
22 books of the utility, amortized over the life of the issue,
23 and thus increase the effective cost of debt capital, there

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

18 **Q. Is there a theoretical and practical basis to**
19 **include a flotation cost adjustment in this case?**

20 A. Yes. First, an adjustment for flotation costs
21 associated with past equity issues is appropriate, even when
22 the utility is not contemplating any new sales of common
23 stock. The need for a flotation cost adjustment to
24 compensate for past equity issues has been recognized in the

1 financial literature. In a *Public Utilities Fortnightly*
2 article, for example, Brigham, Aberwald, and Gapenski
3 demonstrated that even if no further stock issues are
4 contemplated, a flotation cost adjustment in all future years
5 is required to keep shareholders whole, and that the
6 flotation cost adjustment must consider total equity,
7 including retained earnings.³¹ Similarly, *New Regulatory*
8 *Finance* contains the following discussion:

9 Another controversy is whether the flotation cost
10 allowance should still be applied when the utility
11 is not contemplating an imminent common stock
12 issue. Some argue that flotation costs are real
13 and should be recognized in calculating the fair
14 rate of return on equity, but only at the time when
15 the expenses are incurred. In other words, the
16 flotation cost allowance should not continue
17 indefinitely, but should be made in the year in
18 which the sale of securities occurs, with no need
19 for continuing compensation in future years. This
20 argument implies that the company has already been
21 compensated for these costs and/or the initial
22 contributed capital was obtained freely, devoid of
23 any flotation costs, which is an unlikely
24 assumption, and certainly not applicable to most
25 utilities. ... The flotation cost adjustment cannot
26 be strictly forward-looking unless all past
27 flotation costs associated with past issues have
28 been recovered.³²

³¹ Brigham, E.F., Aberwald, D.A., and Gapenski, L.C., "Common Equity Flotation Costs and Rate Making," *Public Utilities Fortnightly*, May, 2, 1985.

³² Morin, Roger A., "New Regulatory Finance," *Public Utilities Reports, Inc.* (2006) at 335.

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

3 A. While there are a number of ways in which a
4 flotation cost adjustment can be calculated, one of the most
5 common methods used to account for flotation costs in
6 regulatory proceedings is to apply an average flotation-cost
7 percentage to a utility's dividend yield. Based on a review
8 of the finance literature, *New Regulatory Finance* concluded:

9 The flotation cost allowance requires an estimated
10 adjustment to the return on equity of approximately
11 5% to 10%, depending on the size and risk of the
12 issue.³³

13 Alternatively, a study of data from Morgan Stanley regarding
14 issuance costs associated with utility common stock issuances
15 suggests an average flotation cost percentage of 3.6
16 percent.³⁴

17 Issuance costs are a legitimate consideration in setting
18 the ROE for a utility, and applying these expense percentages
19 to the average dividend yield for the Utility Group of 3.6

³³ Roger A. Morin, "New Regulatory Finance," *Public Utilities Reports, Inc.*
at 323 (2006).

³⁴ 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 percent.

1 percent implies a flotation cost adjustment on the order of
2 10 basis points.³⁵

3 **Q. Has the IPUC Staff previously considered flotation**
4 **costs in estimating a fair ROE?**

5 A. Yes. For example, in Case No. IPC-E-08-10, IPUC
6 Staff witness Terri Carlock noted that she had adjusted her
7 DCF analysis to incorporate an allowance for flotation
8 costs.³⁶

9 **Q. Have other regulators previously recognized that**
10 **flotation costs are properly considered in setting the**
11 **allowed ROE?**

12 A. Yes. For example, in Docket No. UE-991606 the WUTC
13 concluded that a flotation cost adjustment of 25 basis points
14 should be included in the allowed return on equity:

15 The Commission also agrees with both Dr. Avera and
16 Dr. Lurito that a 25 basis point markup for
17 flotation costs should be made. This amount
18 compensates the Company for costs incurred from
19 past issues of common stock. Flotation costs
20 incurred in connection with a sale of common stock
21 are not included in a utility's rate base because
22 the portion of gross proceeds that is used to pay
23 these costs is not available to invest in plant and
24 equipment.³⁷

³⁵ Calculated as the product of the 3.6 percent average dividend yield and a flotation cost percentage of 3.6 percent. $3.6\% \times 3.6\% = 0.1\%$
³⁶ Case No. IPC-E-08-10, *Direct Testimony of Terri Carlock* at 12-13 (Oct. 24, 2008).
³⁷ *Third Supplemental Order*, WUTC Docket No. UE-991606, et al., p. 95 (September 2000).

1 **D. Other ROE Benchmarks**

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

4 A. As indicated earlier, I also conducted alternative
5 tests to demonstrate that the end results of the analyses
6 discussed above are reasonable and do not exceed a fair ROE.
7 The first test is based on applications of the traditional
8 CAPM analysis using current and projected interest rates.
9 The second test is based on expected earned returns for
10 electric utilities. Finally, I present a DCF analysis for a
11 low risk group of non-utility firms, with which Avista must
12 compete for investors' money.

13 **Q. What cost of equity estimates were indicated by the**
14 **traditional CAPM?**

15 A. My applications of the traditional CAPM were based
16 on the same forward-looking market rate of return, risk-free
17 rates, and beta values discussed earlier in connections with
18 the ECAPM. As shown on page 1 of Exhibit No. 3, Schedule 9,
19 applying the forward-looking CAPM approach to the firms in
20 the Utility Group results in an average cost of equity
21 estimate of 9.5 percent prior to adjusting for firm size, or
22 10.6 percent after incorporating the size adjustment
23 corresponding to the market capitalization of the individual
24 utilities.

1 As shown on page 2 of Exhibit No. 3, Schedule 9,
2 incorporating a forecasted Treasury bond yield for 2015-2019
3 implied a cost of equity of approximately 9.9 percent for the
4 Utility Group, or 11.0 percent after adjusting for the impact
5 of relative size.

6 **Q. Please summarize the results of the expected**
7 **earnings approach.**

8 A. Reference to rates of return available from
9 alternative investments of comparable risk can provide an
10 important benchmark in assessing the return necessary to
11 assure confidence in the financial integrity of a firm and
12 its ability to attract capital. This expected earnings
13 approach is consistent with the economic underpinnings for a
14 fair rate of return established by the U.S. Supreme Court.
15 Moreover, it avoids the complexities and limitations of
16 capital market methods and instead focuses on the returns
17 earned on book equity, which are readily available to
18 investors.

19 **Q. What rates of return on equity are indicated for**
20 **utilities based on the expected earnings approach?**

21 A. Value Line's projections imply an average rate of
22 return on common equity for the electric utility industry of

1 10.6 percent over its 2018-2020 forecast horizon.³⁸ As shown
2 on Exhibit No. 3, Schedule 10, Value Line's projections for
3 the Utility Group suggest an average ROE of approximately
4 10.3 percent, with a midpoint value of 10.8 percent.

5 **Q. What other proxy group did you consider in**
6 **evaluating a fair ROE for Avista?**

7 A. Under the regulatory standards established by *Hope*
8 and *Bluefield*, the salient criterion in establishing a
9 meaningful benchmark to evaluate a fair ROE is relative risk,
10 not the particular business activity or degree of regulation.
11 With regulation taking the place of competitive market
12 forces, required returns for utilities should be in line with
13 those of non-utility firms of comparable risk operating under
14 the constraints of free competition. Consistent with this
15 accepted regulatory standard, I also applied the DCF model to
16 a reference group of low-risk companies in the non-utility
17 sectors of the economy. I refer to this group as the "Non-
18 Utility Group".

19 **Q. Do utilities have to compete with non-regulated**
20 **firms for capital?**

21 A. Yes. The cost of capital is an opportunity cost
22 based on the returns that investors could realize by putting

³⁸ The Value Line Investment Survey (Feb. 20, Mar. 20, & May 1, 2015). Value Line reports return on year-end equity so the equivalent return on average equity would be higher.

1 their money in other alternatives. Clearly, the total
2 capital invested in utility stocks is only the tip of the
3 iceberg of total common stock investment, and there are a
4 plethora of other enterprises available to investors beyond
5 those in the utility industry. Utilities must compete for
6 capital, not just against firms in their own industry, but
7 with other investment opportunities of comparable risk.
8 Indeed, modern portfolio theory is built on the assumption
9 that rational investors will hold a diverse portfolio of
10 stocks, not just companies in a single industry.

11 **Q. Is it consistent with the *Bluefield* and *Hope* cases**
12 **to consider required returns for non-utility companies?**

13 A. Yes. Returns in the competitive sector of the
14 economy form the very underpinning for utility ROEs because
15 regulation purports to serve as a substitute for the actions
16 of competitive markets. The Supreme Court has recognized
17 that it is the degree of risk, not the nature of the
18 business, which is relevant in evaluating an allowed ROE for
19 a utility. The *Bluefield* case refers to "business
20 undertakings attended with comparable risks and
21 uncertainties."³⁹ It does not restrict consideration to other
22 utilities. Similarly, the *Hope* case states:

³⁹ *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679 (1923).

1 By that standard the return to the equity owner
2 should be commensurate with returns on investments
3 in other enterprises having corresponding risks.⁴⁰

4 As in the *Bluefield* decision, there is nothing to restrict
5 "other enterprises" solely to the utility industry.

6 **Q. Does consideration of the results for the Non-**
7 **Utility Group make the estimation of the cost of equity using**
8 **the DCF model more reliable?**

9 A. Yes. The estimates of growth from the DCF model
10 depend on analysts' forecasts. It is possible for utility
11 growth rates to be distorted by short-term trends in the
12 industry or the industry falling into favor or disfavor by
13 analysts. The result of such distortions would be to bias
14 the DCF estimates for utilities. Because the Non-Utility
15 Group includes low risk companies from many industries, it
16 diversifies away any distortion that may be caused by the ebb
17 and flow of enthusiasm for a particular sector.

18 **Q. What criteria did you apply to develop the Non-**
19 **Utility Group?**

20 A. My comparable risk proxy group of non-utility firms
21 was composed of those U.S. companies followed by Value Line
22 that:

- 23 1) pay common dividends;
24 2) have a Safety Rank of "1";

⁴⁰ *Federal Power Comm'n v. Hope Natural Gas Co.* (320 U.S. 391, 1944).

- 3) have a Financial Strength Rating of "B++" or greater;
- 4) have a beta of 0.70 or less; and
- 5) have investment grade credit ratings from S&P.

Q. How do the overall risks of this Non-Utility Group compare with the Utility Group and Avista?

A. Table 6 compares the Non-Utility Group with the Utility Group and Avista across the four key risk measures discussed earlier:

**TABLE 6
COMPARISON OF RISK INDICATORS**

<u>Proxy Group</u>	<u>S&P</u>	<u>Moody's</u>	<u>Value Line</u>		
			<u>Safety Rank</u>	<u>Financial Strength</u>	<u>Beta</u>
Non-Utility	A	A2	1	A++	0.66
Electric Group	BBB+	Baa1	2	B++	0.77
Avista	BBB	Baa1	2	A	0.80

As shown above, the average credit ratings, Safety Rank, Financial Strength Rating, and beta for the Non-Utility Group suggest less risk than for Avista and the proxy group of utilities. These objective indicators suggest that investors would likely conclude that the overall investment risks for the Utility Group and Avista are greater than those of the firms in the Non-Utility Group.

1 Q. What were the results of your DCF analysis for the
2 Non-Utility Group?

3 A. As shown on Exhibit No. 3, Schedule 11, I applied
4 the DCF model to the non-utility companies using the same
5 analysts' EPS growth projections described earlier for the
6 Utility Group. As summarized below in Table 7, after
7 eliminating illogical values, application of the constant
8 growth DCF model resulted in the following cost of equity
9 estimates:

10 TABLE 7
11 DCF RESULTS - NON-UTILITY GROUP

<u>Growth Rate</u>	<u>Cost of Equity</u>	
	<u>Average</u>	<u>Midpoint</u>
Value Line	10.1%	10.3%
IBES	9.4%	9.2%
Zacks	9.8%	10.1%

12
13 Considering that the investment risks of the Non-Utility
14 Group are lower than those of the Utility Group and Avista,
15 these results understate investors' required rate of return
16 for the Company.

17 IV. IMPACT OF REGULATORY MECHANISMS

18 Q. Does the fact that Avista is requesting an FCA in
19 this case warrant any adjustment in your evaluation of a fair
20 ROE?

21 A. No. As discussed earlier, investors recognize that
22 Avista is exposed to significant risks associated with the

1 ability to recover rising costs and investment on a timely
2 basis, and concerns over these risks have become increasingly
3 pronounced in the industry. While the regulatory mechanisms
4 approved and proposed for Avista would contribute towards
5 leveling the playing field, this only serves to address
6 factors that could otherwise impair the Company's opportunity
7 to earn its authorized return, as required by established
8 regulatory standards.

9 **Q. Is there any evidence that approval of the FCA**
10 **would result in a measureable change to Avista's relative**
11 **investment risks?**

12 A. No. There is no evidence to suggest that
13 implementation of the FCA would alter the relative risk of
14 Avista enough to warrant any adjustment to its ROE. As noted
15 earlier, the investment community and the major credit rating
16 agencies in particular, pay close attention to the regulatory
17 framework, including cost adjustment mechanisms. Based
18 largely on the expanded use of ratemaking mechanisms such as
19 revenue decoupling and cost-recovery riders, Moody's upgraded
20 most regulated utilities in January 2014.⁴¹ Recognizing this
21 industry trend, Moody's premised its assessment of Avista's
22 risks on the expectation that "similar treatment will be

⁴¹ Moody's Investors Service, "US utility sector upgrades driven by stable and transparent regulatory frameworks," *Sector Comment* (Feb. 3, 2014).

1 afforded to Avista and that the company will have improved
2 cost recovery mechanisms (e.g., decoupling)."⁴² In other
3 words, the implications of the FCA and other regulatory
4 mechanisms are already fully reflected in Avista's credit
5 ratings, which are comparable to those of the proxy group
6 used to estimate the cost of equity.

7 **Q. Would approval of the FCA set Avista apart from**
8 **other firms operating in the utility industry?**

9 A. No. Adjustment mechanisms and cost trackers have
10 been increasingly prevalent in the utility industry in recent
11 years. In response to the increasing risk sensitivity of
12 investors to uncertainty over fluctuations in costs and the
13 importance of advancing other public interest goals such as
14 reliability, energy conservation, and safety, utilities and
15 their regulators have sought to mitigate some of the cost
16 recovery uncertainty and align the interest of utilities and
17 their customers through a variety of adjustment mechanisms.

18 Reflective of this trend, the companies in the electric
19 and gas utility industries operate under a wide variety of
20 cost adjustment mechanisms, which range from riders to
21 recover bad debt expense and post-retirement employee benefit
22 costs to revenue decoupling and adjustment clauses designed

⁴² Moody's Investors Service, "Avista Corp.," *Global Credit Research* (Mar. 28, 2014).

1 to address rising capital investment outside of a traditional
2 rate case and increasing costs of environmental compliance
3 measures. As Regulatory Research Associates concluded in its
4 recent review of adjustment clauses, "some form of decoupling
5 is in place in the vast majority of jurisdictions."⁴³
6 Similarly, the majority of gas utilities benefit from
7 mechanisms analogous to the Company's proposed FCA, along
8 with a variety of other provisions that enhance their ability
9 to recover operating and capital costs on a timely basis.⁴⁴
10 The firms in the Non-Utility Group also have the ability to
11 alter prices in response to rising production costs, with the
12 added flexibility to withdraw from the market altogether. As
13 a result, the mitigation in risks associated with utilities'
14 ability to adjust revenues and attenuate the risk of cost
15 recovery is already reflected in the cost of equity range
16 determined earlier, and no separate adjustment to Avista's
17 ROE is necessary or warranted.

18 **Q. Have you summarized the various tracking mechanisms**
19 **available to the other firms in the Utility Group?**

20 A. Yes. I evaluated the regulatory mechanisms
21 approved for the other utilities in the Utility Group using

⁴³ Regulatory Research Associates, "Adjustment Clauses, A State-by-State Overview," *Regulatory Focus* (Jul. 1, 2014).

⁴⁴ See, e.g., American Gas Association, *Innovative Rates, Non-Volumetric Rates, and Tracking Mechanisms: Current List* (Jan. 2015).

1 data reported in the most recent Form 10-K reports filed with
2 the Securities and Exchange Commission, which is publicly
3 available and free of charge to investors. Reflective of
4 industry trends, the companies in the Utility Group operate
5 under a variety of regulatory adjustment mechanisms.⁴⁵ As
6 summarized on Exhibit No. 3, Schedule 12, these mechanisms
7 are ubiquitous and wide ranging. For example, apart from
8 Avista, twelve of the firms benefit from some form of FCA or
9 decoupling mechanism or operate in jurisdictions that allow
10 the use of future test years. Many of these utilities
11 operate under mechanisms that allow for cost recovery of
12 infrastructure investment outside a formal rate proceeding,
13 as well as the ability to implement periodic rate adjustments
14 to reflect changes in a diverse range of operating and
15 capital costs, including expenditures related to
16 environmental mandates, conservation programs, transmission
17 costs, and storm recovery efforts.

18 **Q. Have other regulators recognized that approval of**
19 **adjustment mechanisms do not warrant an adjustment to the**
20 **ROE?**

21 A. Yes. For example, the Staff of the Kansas State
22 Corporation Commission concluded that no ROE adjustment was

⁴⁵ Because this information is widely referenced by the investment community, it is also directly relevant to an evaluation of the risks and prospects that determine the cost of equity.

1 justified in the case of certain tariff riders because the
2 impact of similar mechanisms is already accounted for through
3 the use of a proxy group:

4 Those mechanisms differ from company to company and
5 jurisdiction to jurisdiction. Regardless of their
6 nuances, the intent is the same; reduce cash-flow
7 volatility year to year and place recent capital
8 expenditures in rates as quickly as possible.
9 Investors are aware of these mechanisms and their
10 benefits are a factor when investors value those
11 stocks. Thus, any risk reduction associated with
12 these mechanisms is captured in the market data
13 (stock prices) used in Staff's analysis.⁴⁶

14 Similarly, the effects of Avista's existing and proposed
15 regulatory mechanisms are already reflected in the results of
16 the quantitative methods presented in my testimony.

17 **Q. What does this imply with respect to the evaluation**
18 **of a fair ROE for Avista?**

19 A. While investors would consider approval of the FCA
20 and Avista's regulatory mechanisms to be supportive of the
21 Company's financial integrity and credit ratings, there is
22 certainly no evidence to suggest that these mechanisms alone
23 would alter Avista's relative risk enough to warrant an ROE
24 adjustment. The purpose of regulatory mechanisms is to
25 better match revenues to the underlying costs of providing
26 service. This levels the playing field and improves Avista's

⁴⁶ *Direct Testimony Prepared by Adam H. Gatewood, State Corporation Commission of the State of Kansas, Docket No. 12-ATMG-564-RTS, pp. 8-9 (June 8, 2012). This proceeding was ultimately resolved through a stipulated settlement.*

1 ability to attract capital and actually earn its authorized
2 ROE, but it does not result in a "windfall" or otherwise
3 penalize customers. Utilities across the U.S. that Avista
4 competes with for new capital are increasingly availing
5 themselves of similar adjustments. As a result, the impact
6 of utilities' ability to mitigate the risk of cost recovery
7 is already reflected in the cost of equity estimates
8 determined in this case, and no separate adjustment to
9 Avista's ROE is necessary or warranted.

10 Q. Does this conclude your pre-filed direct testimony?

11 A. Yes.