

RECEIVED
FILED

2004 MAR 19 PM 4:32

IDAHO PUBLIC
UTILITIES COMMISSION

BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION)
OF IDAHO POWER COMPANY FOR)
AUTHORITY TO INCREASE ITS INTERIM)
AND BASE RATES AND CHARGES FOR)
ELECTRIC SERVICE.)

CASE NO. IPC-E-03-13

IDAHO POWER COMPANY
DIRECT REBUTTAL TESTIMONY
OF
WILLIAM E. AVERA

1 I. INTRODUCTION

2 Q. Please state your name and business address.

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

5 Q. Are you the same William E. Avera that
6 previously submitted direct testimony in this case?

7 A. Yes, I am.

8 Q. What is the purpose of your rebuttal
9 testimony?

10 A. The purpose of my testimony is to respond to
11 the direct testimony of Ms. Terri Carlock, submitted on
12 behalf of the staff of the Idaho Public Utilities Commission
13 ("IPUC"). In addition, I will also rebut the
14 recommendations contained in the direct testimony of Mr.
15 Dennis E. Peseau testimony, on behalf of Micron Technology,
16 Inc., concerning the cost of equity for Idaho Power Company
17 ("Idaho Power" or "the Company").

18 Q. Please summarize the conclusions of your
19 rebuttal testimony.

20 A. With respect to the testimony of Ms. Carlock,
21 I concluded that her discounted cash flow ("DCF") results
22 were biased because of her exclusive reliance on IDACORP,
23 Inc. ("IDACORP"), whose recent dividend cut violates the
24 assumptions of this method. Additionally, Ms. Carlock's
25 approach ignored other accepted methods of estimating the

1 this single DCF application indicated a cost of equity in
2 the 7.4 to 8.8 percent range. Ms. Carlock also applied the
3 comparable earnings approach, which resulted in an indicated
4 cost of equity in the 10.0 percent to 11.0 percent range.
5 Based on these two analyses, Ms. Carlock concluded that the
6 cost of equity was in the 9.5 to 10.5 percent range,
7 selecting the 10.0 percent midpoint as her recommendations
8 for Idaho Power.

9 Q. Do the results of Ms. Carlock's DCF analysis
10 represent a reliable basis on which to establish Idaho
11 Power's rate of return on equity?

12 A. No. Because she restricted her DCF analysis
13 to a single company - IDACORP - Ms. Carlock's results are
14 extremely susceptible to measurement error and bias. As I
15 discussed at length in my direct testimony, estimating the
16 cost of equity is a stochastic process. In other words,
17 because the cost of equity is unobservable, it can only be
18 inferred by indirect reference to other available data in
19 the capital markets. But for any single cost of equity
20 estimate, there is always the potential that the data used
21 to apply the DCF model will not reflect the expectations and
22 required returns that investors considered in arriving at
23 the stock prices we can observe in the capital markets. As
24 a result, it is essential to insulate against this bias by
25 referencing a proxy group or electric utilities with

1 comparable risks.

2 Q. Why is this particularly critical in the case
3 of IDACORP?

4 A. As discussed in my direct testimony, Idaho
5 Power and, in turn, IDACORP recently elected to cut common
6 dividend payments significantly in order to improve cash
7 flow and help maintain the strong credit ratings necessary
8 to support the Company's capital expansion plan. Under the
9 DCF approach, observable stock prices are a function of the
10 cash flows that investors' expected to receive, discounted
11 at their required rate of return. Because dividend payments
12 are a key parameter required to apply DCF methods, this
13 approach is not well-suited for firms that do not pay common
14 dividends or have recently cut their payout. Indeed, Ms.
15 Carlock recognized in her testimony that "changes in the
16 markets and the dividend cut for IDACORP" complicated any
17 assessment of representative data for the DCF model.¹

18 Indeed, IDACORP's decision to reduce annual common
19 dividends by some 35 percent severely violates the
20 assumptions underlying the constant growth DCF model that
21 Ms. Carlock used to estimate the cost of equity. As
22 explained in my direct testimony, this approach is based on
23 the presumption of stable conditions, with earnings
24 dividends, and book value all growing at a constant rate.
25 Such is hardly the case for IDACORP in light of its decision

1 to substantially alter its dividend payout.

2 Ms. Carlock recognized the importance of matching
3 the growth rate with a consistent dividend yield "so that
4 investor expectations are accurately reflects."² But by
5 choosing to focus only on IDACORP in implementing the DCF
6 model, Ms. Carlock needlessly introduced significant
7 additional complexity into an already challenging process.
8 Indeed, the fact that the 8.1 percent midpoint of Ms.
9 Carlock's DCF range falls almost 200 basis points below the
10 lower bound of her comparable earnings analysis illustrates
11 the problems of bias associated with her limited DCF
12 analysis. The proxy group of western electric utilities
13 referenced in my analyses is consistent not only with the
14 shared circumstances of electric power markets in the west,
15 but also with the need to ensure against the potential that
16 a single cost of equity estimate may not reflect investors'
17 required rate of return.

18 Q. Did Ms. Carlock apply the risk premium
19 approach to estimate the cost of equity for Idaho Power?

20 A. No. While Ms. Carlock stated that "much of
21 the theoretical approach" that she used was consistent with
22 my testimony, Ms. Carlock did not use the risk premium
23 approach to estimate the cost of equity. The risk premium
24 method is widely recognized as a meaningful approach to
25 estimate the cost of equity. No single method or model

1 should be relied upon to determine a utility's cost of
2 equity because no single approach can be regarded as wholly
3 reliable. This is especially the case in light of the fact
4 that Ms. Carlock's DCF range was based on the results of a
5 single company. Indeed, as documented in my direct
6 testimony, applications of the risk premium approach provide
7 further evidence of the downward bias inherent in Ms.
8 Carlock's DCF results.

9 Q. Did Ms. Carlock recognize that the investment
10 risks associated with electric utilities have increased?

11 A. Yes. Ms. Carlock noted that a plethora of
12 changes have impacted investors' risk perceptions, observing
13 that:

14 The competitive risks for electric utilities have
15 changed with increasing non-utility generation, deregulation
16 in some states, open transmission access, and changes in
17 electricity markets.³

18 Ms. Carlock concluded that, because of these greater
19 uncertainties, the difference in risk between industrial
20 firms operating in a competitive market and electric
21 utilities "is not as great as it used to be."⁴

22 Q. Did Ms. Carlock consider this increase in
23 risk in her analysis of the cost of equity for Idaho Power?

24 A. No. Ms. Carlock ignored this trend in
25 investment risks for electric utilities, asserting instead

1 that Idaho Power's "competitive risks" are lower because of
2 its "low-cost source of power and the low retail rates."⁵
3 Ms. Carlock also asserted that the Power Cost Adjustment
4 mechanism ("PCA") reduces Idaho Power's risks relative to
5 other electric utilities.⁶

6 Q. Does this represent an accurate assessment of
7 the investment risks investors' associate with Idaho Power?

8 A. No. While I agree with Ms. Carlock that
9 Idaho Power's relatively low rates provide benefits to
10 customers and may improve the Company's competitive
11 position, this one-sided view ignores the substantial
12 uncertainties that Idaho Power assumes to realize these
13 benefits. As explained in detail in my direct testimony,
14 because approximately one-half of Idaho Power's total energy
15 requirements are provided by hydroelectric facilities, the
16 Company is exposed to a level of uncertainty not faced by
17 other utilities, which are less dependent on hydro
18 generation. While hydropower confers advantages in terms of
19 fuel cost savings and diversity, investors also associated
20 hydro facilities with risks that are not encountered with
21 other sources of generation.

22 Reduced hydroelectric generation due to below-
23 average water conditions forces Idaho Power to rely on less
24 efficient thermal generating capacity and purchased power to
25 meet its resource needs. As the Commission has noted,

1 "there are no guarantees about future stream flows or market
2 prices,"⁷ and in light of the recent past, this dependence
3 on wholesale markets entails significant risk in the minds
4 of investors, especially for a utility located in the west.
5 Investors recognize that volatile markets, unpredictable
6 stream flows, and Idaho Power's dependence on wholesale
7 purchases to meet the needs of its customers exposes the
8 Company to the risk of reduced cash flows and unrecovered
9 power supply costs.

10 Apart from exposure to market uncertainties, Idaho
11 Power also confronts the complexities associated with
12 obtaining the necessary licenses to operate its
13 hydroelectric stations. The process of relicensing is
14 prolonged and involved and often includes the implementation
15 of various measures to address environmental and stakeholder
16 concerns. These measures can impose significant additional
17 costs and/or lead to reduced generating capacity and
18 flexibility.

19 Q. Does the fact that Idaho Power has a PCA
20 absolve investors from risks of volatility in wholesale
21 power markets, as Ms. Carlock seems to imply?

22 A. No. The fact that Idaho Power has been
23 granted a PCA does not translate into lower risk *vis-à-vis*
24 other electric utilities. First, adjustment mechanisms to
25 account for changes in power supply costs are the rule,

1 rather than the exception, so that Idaho Power's PCA merely
2 moves its risks closer to those of other utilities. Second,
3 the PCA does not prevent the lag between the time Idaho
4 Power actually incurs power supply expenses and when it is
5 actually recovered from ratepayers. Investors are well
6 aware that the significant reduction in cash flows
7 associated with mounting deferrals can have a debilitating
8 impact on a utility's financial position.

9 Moreover, the PCA does not apply to 100 percent of
10 the difference between the actual cost of purchased power
11 and the amount collected through rates, with Idaho Power's
12 shareholders remaining at risk for 10 percent of any
13 discrepancy. Indeed, Idaho Power and its investors has
14 already experienced the impact that chaotic market
15 conditions can have when the Company is forced to rely on
16 wholesale purchases to meet the gap in its resource needs
17 created by reduced hydro generation. Investors cannot
18 afford to discount the continuing prospect of further
19 turmoil in western power markets. Ms. Carlock's focus on
20 "low retail rates" entirely ignores market realities and the
21 substantial risks that investors must assume to provide
22 customers with the resulting benefits.

23 Q. Did Ms. Carlock adjust the results of her
24 quantitative methods to reflect flotation costs?

25 A. No. Ms. Carlock entirely failed to address

1 the issue of flotation costs, which, as discussed in my
2 direct testimony are a necessary cost incurred in connection
3 with raising common equity capital. When equity is raised
4 through the sale of common stock, there are costs associated
5 with "floating" the new equity securities. Unlike debt
6 flotation costs, which are recorded on the books of the
7 utility, amortized over the life of the issue, there is no
8 established mechanism for a utility to recognize equity
9 issuance costs. Unless some provision is made to recognize
10 these issuance costs, a utility's revenue requirements will
11 not fully reflect all of the costs incurred for the use of
12 investors' funds and investors will not have the opportunity
13 to earn their required rate of return. Because there is no
14 accounting convention to accumulate the flotation costs
15 associated with equity issues, I recommended a minimum
16 upward adjustment to the cost of equity of 20 basis points.

17 Q. In light of the shortfalls in Ms. Carlock's
18 DCF approach and her failure to meaningfully address Idaho
19 Power's relative investment risks or the issue of flotation
20 costs, what is your conclusion regarding her recommendations
21 in this case?

22 A. In my opinion, Ms. Carlock's recommended 10.0
23 percent cost of equity significantly understates the rate of
24 return that investors require from Idaho Power. Idaho Power
25 plans to add significant plant investment, such as the

1 equity for Idaho Power?

2 A. It is important to note that Dr. Peseau's
3 opinions were not based on any independent analyses of the
4 cost of equity to Idaho Power. Rather, he arrived at his
5 recommendations based on a purported "update" of my analyses
6 by making "revisions" to my methods.⁹

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

9 A. Apart from conducting no analyses of his own,
10 Dr. Peseau did not actually update my analyses. Rather, he
11 "simply plugs in an updated figure for dividend yield"¹⁰ to
12 my DCF model. Thus, Dr. Peseau's "update" completely
13 ignored the other half of the constant growth DCF equation;
14 namely, the growth rate. To the extent that investors'
15 expectations for growth increase, this would serve to offset
16 any decline in dividend yields. Apart from this incomplete
17 "update", Dr. Peseau's remaining modifications consisted of
18 ignoring historical trends in earnings growth in applying
19 the DCF model, using alternative bond yields to apply my
20 risk premium approaches, and substituting a lower market
21 return in the CAPM. Finally, Dr. Peseau completely ignored
22 the flotation cost adjustment supported in my direct
23 testimony.

24 Q. What was the basis for Dr. Peseau's
25 "revision" to exclude historical growth rates from his

1 "update" of your DCF analyses?

2 A. While Dr. Peseau granted that my "methodology
3 is not unreasonable,"¹¹ he asserted that historical growth
4 rates should be discarded because I excluded firms rated
5 below investment grade from my comparable group.

6 Q. Does your decision to exclude utilities with
7 junk bond ratings from your proxy group represent an
8 "implementation flaw," as Dr. Peseau asserts (p. 15)?

9 A. Absolutely not. The purpose of employing a
10 proxy group to estimate the cost of equity is to avoid
11 potential bias by focusing on firms facing comparable risks
12 and prospects. As I noted in my direct testimony, the
13 financial stress and lack of stability that accompanies
14 below investment grade bond ratings greatly complicates any
15 determination of investors' long-term expectations required
16 to implement the DCF model. Moreover, the move from
17 investment grade to junk bond ratings implies a quantum
18 increase in investment risks. It is hypocritical for Dr.
19 Peseau to assert that my proxy group is "not representative"
20 of electric utilities in the west, while simultaneously
21 arguing that firms with junk bond ratings should be
22 considered comparable to Idaho Power.

23 Q. What about Dr. Peseau's contention that the
24 companies in your group "are not really a sample of electric
25 utilities" (p. 16)?

1 A. The fact that these firms may be engaged in
2 other lines of business is hardly remarkable, as the same
3 can be said about virtually every electric utility operating
4 in the U.S. Nevertheless, the fact that investors regard
5 these firms as electric utilities is evidenced by the fact
6 that The Value Line Investment Survey ("Value Line")
7 classifies them in its Electric Utility (West) industry
8 group. Moreover, the statistics cited by Dr. Peseau do not
9 convey an accurate portrayal of the importance of utility
10 operations to the firms in my proxy group. Consider Black
11 Hills, for example. While Dr. Peseau reports that
12 electricity sales accounted for 38 percent of total
13 revenues, he failed to report that Black Hills' electric
14 power generation and utility operations accounted for
15 approximately 84 percent and 65 percent of operating
16 earnings and total assets, respectively, for 2003. Contrary
17 to Dr. Peseau's assertions, the firms included in my proxy
18 group provide a reasonable basis on which to estimate the
19 cost of equity for an electric utility in the western
20 region.

21 Q. Does Dr. Peseau's reference to earnings
22 growth trends for PNM Resources ("PNM") provide any basis to
23 exclude historical growth rates from your DCF analysis?

24 A. No. Dr. Peseau simply notes that PNM's
25 earnings per share in 1987 of \$2.00 are equal to what Value

1 Line is projecting for 2004. But this observation says
2 nothing about what investors might reasonably expect for
3 future growth based on more recent historical trends. In
4 fact, Dr. Peseau's observation implies that investors would
5 anticipate zero growth, which would produce a cost of equity
6 for PNM equal to its dividend yield, or 3.2 percent. Of
7 course, this is clearly a nonsensical result that is
8 unrelated to a determination of investors' future
9 expectations. In fact, variability in historical earnings
10 serves to illustrate the increasing risks associated with an
11 investment in electric utility common stocks. But given the
12 unsettled conditions over the near-term direction of the
13 economy and the spate of challenges faced in the electric
14 power industry, the historical growth trends reported by
15 Value Line provide a meaningful benchmark in implementing
16 the DCF model. As a result, when assessing investors'
17 expectations of future growth it is entirely appropriate to
18 consider historical trends in earnings, along with
19 securities analysts' projections, as I have done.

20 Q. Is there any basis for Dr. Peseau's statement
21 that Idaho Power's requested 11.2 percent cost of equity is
22 "unreasonable on its face" (p. 18)?

23 A. No. Based on changes in bond yields, Dr.
24 Peseau implies that the cost of equity for Idaho Power has
25 dropped "by 200 basis points or more."¹² But Dr. Peseau's

1 observation is meaningless. First, he ignores the dramatic
2 increase in the level of risks that investors now associate
3 with electric utilities. As discussed in my direct
4 testimony, these uncertainties are heightened for a utility
5 operating in the western U.S., especially given Idaho
6 Power's ongoing exposure to potential volatility in
7 wholesale power markets. Moreover, as I also explained in
8 my direct testimony, there is considerable evidence that
9 when interest rates are relatively low, equity risk premiums
10 widen. Accordingly, the cost of equity does not move in
11 lockstep with interest rates. In fact, the only way to
12 assess the relative impact of changes in risks and capital
13 market conditions since the Commission's last decision in
14 1995 is to conduct an independent analysis of the cost of
15 equity - something Dr. Peseau did not even attempt.

16 Q. Is there any merit to Dr. Peseau's suggestion
17 that there are inconsistencies in your risk premium
18 approaches that lead to an upward bias in your results (pp.
19 13-14)?

20 A. No. The bond yields used in my applications
21 of the risk premium method were consistent with the
22 underlying data sources used to compute the equity risk
23 premiums, as well as with the investment risks corresponding
24 to Idaho Power's single-A grade credit rating. In
25 developing risk premiums based on authorized rates of return

1 on equity on Exhibit WEA-8, I matched the average allowed
2 rates of return in each year with the average yield on
3 public utility bonds reported by Moody's Investors Service
4 ("Moody's"). This composite interest rate reflects the
5 average risk profile of the electric utility industry, and
6 there is simply no basis for Dr. Peseau's insinuation that
7 this somehow results in upward bias. Similarly, my analysis
8 of realized rates of return reported on Exhibit WEA-9 was
9 based on a consistent set of data, as reported by Standard &
10 Poor's Corporation ("S&P"). Because S&P does not publish an
11 average public utility bond yield, my analyses relied on the
12 yield on single-A rated issues as a proxy for the average
13 risk of the industry. Moreover, the interest rates that Dr.
14 Peseau cites in his "update" to not correspond to other
15 published sources. For example, Moody's reported that the
16 average yield on single-A public utility bonds for February
17 2004 was 6.15 percent,¹³ considerably higher than the 5.7
18 percent rate cited by Dr. Peseau.¹⁴

19 Q. How did Dr. Peseau "update" your application
20 of the Capital Asset Pricing Model ("CAPM")?

21 A. Dr. Peseau did not update or otherwise
22 address my CAPM approach. Rather, he ignored it entirely
23 and instead substituted a market risk premium into my
24 analysis that was based on an entirely different method. As
25 explained in my direct testimony, I applied the CAPM based

1 on a forward-looking estimate of the market risk premium
2 that relied on investors' current expectations in the
3 capital markets. Meanwhile, Dr. Peseau simply asserted that
4 "[t]he correct market risk premium to use at this time" is
5 7.00 percent.¹⁵ In fact, however, this 7.00 percent risk
6 premium is based on historical realized returns, not on the
7 forward-looking expectations that drive investors' required
8 rate of return in today's capital markets. The end result
9 of Dr. Peseau's thinly veiled shell game is not an update or
10 revision to my analysis, but instead a CAPM cost of equity
11 that fails to reflect investors' current required rate of
12 return.

13 Q. Did Dr. Peseau consider the need to account
14 for past flotation costs?

15 A. No. Dr. Peseau does not take issue with my
16 testimony that an adjustment for flotation costs is
17 reasonable in establishing a fair rate of return for Idaho
18 Power. Like Ms. Carlock, however, Dr. Peseau entirely
19 ignored the issue of flotation costs in conducting his
20 "revisions" and "updates" to my analyses. As discussed
21 earlier and in my direct testimony, flotation costs are
22 legitimate and necessary, and unless an adjustment is made
23 to the cost of equity, investors will not have the
24 opportunity to earn their fair rate of return.

25 Q. Is there any merit to Dr. Peseau's contention

1 that your characterization of conditions within the electric
2 utility industry is "too bleak" (p. 11)?

3 A. No. It is curious that Dr. Peseau takes
4 issue with my description of the challenges that investors
5 have confronted in the electric power industry, while
6 simultaneously granting that "all of these observations are
7 accurate enough."¹⁶ Moreover, the simple fact that the
8 majority of utilities have "weathered the recent disasters"¹⁷
9 says nothing about the risks that investors now associate
10 with the industry. As I documented in my direct testimony,
11 observable measures such as bond ratings clearly illustrate
12 the revised perceptions of the risks in the industry and the
13 weakened finances of the utilities themselves. Moreover,
14 while Dr. Peseau suggests that this assessment just reflects
15 a pessimistic bias on my part, my personal opinions are
16 irrelevant and were not the basis of my analyses. What
17 matters are the opinions of investors, who, demonstrated in
18 my direct testimony, recognize that the risks inherent in
19 the electric utility industry have increased significantly.
20 Indeed, as noted earlier, Ms. Carlock also granted that
21 electric utilities now face greater uncertainties than in
22 the past.

23 Q. Does Dr. Peseau's reference to a single
24 earned rate of return (p. 11) provide any meaningful basis
25 to evaluate investors risk perceptions or their required

1 rate of return?

2 A. No. The fact that Idaho Power's shareholders
3 may have earned positive returns in a single, historical
4 period says nothing about their forward-looking assessment
5 of investment risks or their return requirements. In fact,
6 as Dr. Peseau grants, "the previous few years produced some
7 negative returns."¹⁸ Dr. Peseau's observations regarding the
8 seemingly high variability of returns to Idaho Power's
9 shareholders are more supportive of my contention that the
10 investment risks associated with electric utilities,
11 including Idaho Power, have increased. Indeed, Dr. Peseau
12 grants that the recent "boom and bust" has "produced wildly
13 erratic year to year results ... for most of the utilities in
14 the western United States."¹⁹ For investors, "wildly
15 erratic" is synonymous with a level of investment risk far
16 in excess of what Dr. Peseau presumes.

17 Q. Does this conclude your direct rebuttal
18 testimony in this case?

19 A. Yes, it does.

ENDNOTES

-
- ¹ Carlock Direct at 11.
² *Id.*
³ Carlock Direct at 8.
⁴ *Id.*
⁵ *Id.*
⁶ Carlock Direct at 8-9.
⁷ *Idaho Power granted \$256 million deferral, but bond plan denied*, Idaho Public Utilities Commission (May 13, 2002).
⁸ Carlock Direct at 13.
⁹ Peseau Direct at 13.
¹⁰ *Id.*
¹¹ Peseau Direct at 15.
¹² Peseau Direct at 18.
¹³ Moody's Investors Service, *Credit Perspectives* (Mar. 2004).
¹⁴ Peseau Direct at 14.
¹⁵ *Id.*
¹⁶ Peseau Direct at 11.
¹⁷ *Id.*
¹⁸ Peseau Direct at 11.
¹⁹ Peseau Direct at 16.