BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION OF IDAHO POWER COMPANY FOR AUTHORITY TO INCREASE ITS RATES AND CHARGES FOR ELECTRIC SERVICE TO ELECTRIC CUSTOMERS IN THE STATE OF IDAHO.	CASE NO. IPC-E-07-8

IDAHO POWER COMPANY

REBUTTAL TESTIMONY

OF

WILLIAM E. AVERA

REBUTTAL TESTIMONY OF WILLIAM E. AVERA

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I. INTRODUCTION

Q. Please state your name and business address.

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

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

A. Yes, I am.

Q. What is the purpose of your rebuttal?

A. The purpose of my testimony is to respond to the direct testimony of Ms. Terri Carlock, submitted on behalf of the staff of the Idaho Public Utilities Commission ("IPUC"). In addition, I will also rebut the recommendations contained in the direct testimony of Mr. Matthew I. Kahal, on behalf of the United States Department of Energy, concerning the cost of equity for the jurisdictional utility operations of Idaho Power Company ("Idaho Power" or "the Company").

Q. Please summarize the conclusions of your testimony.

A. With respect to the testimony of Ms. Carlock, I concluded that her recommendations were understated because of her failure to consider the results of other accepted methods of estimating the cost of equity.[1] Additionally, Ms. Carlock's assessment of relative risks focused exclusively on

[1] As I note subsequently, I was unable to review or evaluate the details of the analyses supporting Ms. Carlock's conclusions because she provided no schedules, workpapers, or other documentary support for her testimony.

Idaho Power's relatively low rates, while ignoring the substantial uncertainties and higher investment risks that investors must bear to provide the benefits of lower electricity costs to customers. At a minimum, considering the results of the Capital Asset Pricing Model ("CAPM") approach, investors' risk perceptions, and correcting Ms. Carlock's flotation adjustment would support a rate of return from the upper end the range of her results.

Meanwhile, Mr. Kahal's recommendations are biased downward because he failed to exclude illogical estimates in evaluating the results of his analyses. Similarly, there is no basis for Mr. Kahal's criticisms of my proxy group and his alternative application of the CAPM is flawed and should be rejected.

II. TERRI CARLOCK

Q. How did Ms. Carlock arrive at her 10.25 percent cost of equity recommendation for Idaho Power?

A. Ms. Carlock estimated the cost of equity by applying the constant growth DCF model to a group of other utilities. She concluded that the results of this DCF application indicated a cost of equity in the 7.7 to 11.7 percent range. Ms. Carlock also conducted a comparable earnings analysis, which resulted in an indicated cost of equity in the 10.0 to 11.0 percent range. Based on these two analyses, Ms. Carlock concluded that the cost of equity was in the 9.5 to 10.5

percent range, selecting 10.25 percent as her point estimate and recommendation for Idaho Power.

Q. Did you have the opportunity to review the details of the analyses that underlie Ms. Carlock's conclusions?

A. No. Ms. Carlock's testimony contains no schedules or exhibits presenting the results of her analyses. Ms. Carlock's testimony does not identify the composition of the proxy group of utilities she relied on to apply her methods or the data inputs used in her calculations. Ms. Carlock has not provided copies of workpapers or electronic worksheet files that she relied on in developing her conclusions. As a result, I was unable to verify the accuracy of Ms. Carlock's calculations or otherwise review the details of her analyses and my ability to respond to Ms. Carlock's testimony is greatly limited.

Q. Did Ms. Carlock apply the CAPM to estimate the cost of equity for Idaho Power?

A. No. While Ms. Carlock stated that "much of the theoretical approach" that she used was consistent with my testimony, Ms. Carlock did not use the CAPM to estimate the cost of equity. As I explained in my direct testimony, the CAPM method is widely recognized as a meaningful approach to estimate investors' required rate of return. Unlike the comparable earnings method, which depends on earned returns derived from accounting information, the CAPM approach is

based on capital market data indicative of investors' current expectations. The IPUC has noted the importance of "evaluating all the methods" and "using each as a check on the other when setting the allowed rate of return."[2]

Q. Why is the use of multiple methods so important when estimating the cost of equity?

A. Investors' expectations are unobservable, and there is no methodology that provides a foolproof guide to their required rate of return. Each method provides another facet of examining investor behavior, with different assumptions and premises. Investors do not necessarily subscribe to any one method, and no model can conclusively determine or estimate the required return for an individual firm. If the cost of equity estimation is restricted to certain methodologies, while the results of other approaches are ignored, it may significantly bias the outcome. Rather, all relevant evidence should be weighed and evaluated in order to minimize the potential for error.

Regulators have customarily considered the results of alternative approaches in determining allowed returns.[3] It is widely recognized that no single method can be regarded as a

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

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

panacea; all approaches have advantages and shortcomings. For example, a publication of the Society of Utility and Financial Analysts (formerly the National Society of Rate of Return Analysts), concluded that:

> Each model requires the exercise of judgment as to the reasonableness of the underlying assumptions of the methodology and on the reasonableness of the proxies used to validate the theory. Each model has its own way of examining investor behavior, its own premises, and its own set of simplifications of reality. Each method proceeds from different fundamental premises, most of which cannot be validated empirically. Investors clearly do not subscribe to any singular method, nor does the stock price reflect the application of any one single method by investors.[4]

Q. Has the IPUC expressed reluctance to consider the results of the CAPM approach?

A. Yes. I am aware that in the past the IPUC has expressed concerns over the measurement and proper use of the beta value necessary to apply the CAPM and has not routinely focused on the results of this method.[5] Nevertheless, the CAPM is a rigorous conceptual framework at the heart of modern financial theory and it is widely used and referenced in the investment community. Indeed, evidence suggests that reliance on the DCF model as a tool for estimating investors' required

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

[5] See, *e.g.*, Order No. 29505 at 38.

rate of return has declined outside the regulatory sphere, with the CAPM being "the dominant model for estimating the cost of equity."[6] Of course, the CAPM is based on restrictive assumptions and does not describe security returns perfectly and there are controversies surrounding the measurement of key variables, such as beta. But then exactly the same could be said for the constant growth DCF model, which assumes a single, static growth rate into perpetuity that has no observable proxy in the capital markets. Moreover, I have used The Value Line Investment Survey ("Value Line") as the source of my betas, a reference cited by Ms. Carlock in her data responses.

Q. What cost of equity is implied if the CAPM method is used to check Ms. Carlock's conclusions?

A. As discussed in detail in my direct testimony (pp. 54-58), the results of the CAPM approach implied a cost of equity on the order of 11.5 percent to 12.8 percent, which is consistent with a rate of return from the top of Ms. Carlock's DCF range.

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

Q. What other evidence indicates that a return from the top end of Ms. Carlock's range of results is warranted?

A. While Ms. Carlock did not provide the analyses underlying her 10.0 to 11.0 percent comparable earnings range, this method is typically implemented based on a review of historical earned rates of return on book equity for the companies or industry in question. But earned rates of return based on historical information are not necessarily indicative of investors' long-run perceptions of risk and expectations for return going forward. Alternatively, reference to earned rates of return expected from firms of comparable risk, which I referenced in my direct testimony, can also provide a useful guide that may better reflect the ongoing returns necessary to assure financial integrity and attract capital.

The most recent projections from Value Line, which is the largest and most widely circulated independent investment advisory service, indicate that its analysts anticipate an average rate of return on common equity for the electric utility industry of 11.5 percent in 2007, 2008, and over its three-to-five year forecast horizon.[7] Based on Value Line's estimates, investors would anticipate a return on equity from the average electric utility above Ms. Carlock's DCF and comparable earnings ranges.

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[7] The Value Line Investment Survey (Nov. 30, 2007) at 154.

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

A. Yes. We agree that the authorized rate of return should be competitive with returns available to investors from investments of corresponding risk, as directed by landmark Supreme Court decisions. Ms. Carlock also correctly noted that the opportunity to earn a return at least equal to those expected in the capital markets for comparable investments is required if a utility is to be able to attract capital. As stated by Ms. Carlock:

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

Ms. Carlock also noted the importance of testing any cost of equity estimate against applicable standards:

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

This is absolutely correct. If Idaho Power's return on equity does not fully reflect the level of investment risks that

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[8] Carlock Direct at 6.

[9] *Id.* at 4-5.

investors perceive, it will violate the risk-return tradeoff, breach applicable standards, and impair the Company's ability to attract necessary capital.

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

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

> The competitive risks for some electric utilities and the industry as a whole have changed with increasing non-utility generation, deregulation in some states, open transmission access, and changes in electricity markets.[10]

Ms. Carlock concluded that, because of these greater uncertainties, the difference in the risk between industrial firms operating in the competitive market and electric utilities "is not as great as it used to be."[11]

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

A. No. Ms. Carlock ignored the implications of this trend in investment risks for utilities, asserting instead that Idaho Power's "competitive risks" are lower because of its "low-cost source of power" and "low retail rates."[12] Ms. Carlock also asserted that the Power Cost Adjustment ("PCA")

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

and Fixed Cost Adjustment ("FCA") reduce Idaho Power's risks relative to other electric utilities.[13]

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

A. No. While I agree with Ms. Carlock that relatively low rates provide benefits to customers, this narrow view ignores the substantial uncertainties that Idaho Power's investors assume to realize these benefits. As explained in detail in my direct testimony, because a high proportion of the Company's energy needs is provided by hydroelectric facilities, Idaho Power is exposed to a level of uncertainty not faced by other utilities, which are less dependent on hydro generation.

Reduced hydroelectric generation due to below-average water conditions forces Idaho Power to rely on less efficient thermal generating capacity and purchased power to meet its resource needs. As the IPUC has noted, "there are no guarantees about future stream flows or market prices,"[14] and in light of the recent past, this dependence on wholesale markets entails significant risk in the minds of investors, especially for a utility located in the West. Investors recognize that volatile markets, unpredictable stream flows,

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[13] *Id.*

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

and Idaho Power's dependence on wholesale purchases to meet the needs of its customers expose the Company to the risk of reduced cash flows, increased need for financing, and unrecovered power supply costs.

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

Q. Does the fact that Idaho Power has a PCA absolve investors from risk of volatility, as Ms. Carlock seems to imply?

A. No. The fact that Idaho Power had been granted a PCA does not translate into lower risk *vis-à-vis* other electric utilities. First, adjustment mechanisms to account for changes in power supply costs are the rule, rather than the exception in the utility industry, so that the Company's PCA merely moves its risks closer to those of other utilities.

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[15] In 2004, for example, a federal court ordered the Federal Energy Regulatory Commission to respond to a request for a formal review of Idaho Power's Hells Canyon hydroelectric complex under the Endangered Species Act. "Court orders FERC to answer seven-year-old request for study of Idaho dams' fish impact," *Electric Utility Week* (Jun. 28, 2004) at 14.

Second, the PCA does not prevent the lag between the time that Idaho Power actually incurs power supply expenses and when those expenses are recovered from ratepayers. Investors are well aware that the significant reduction in cash flows associated with mounting deferrals can have a debilitating impact on a utility's financial position.

Moreover, investors are aware that the PCA does not apply to 100 percent of the difference between the actual cost of purchased power and the amount collected through rates, with Idaho Power's shareholders remaining at risk for 10 percent of any discrepancy. Indeed, the Company and its investors have already experienced the impact that chaotic market conditions can have when the utility is forced to rely on wholesale purchases to meet the gap in its resource needs created by reduced hydro generation. As documented in my direct testimony, investors cannot afford to discount the continuing prospect of further turmoil in western power markets, with the FERC Commission Staff recognizing the ongoing potential for market disruption in a 2007 market assessment report:

> Prices are likely to remain a concern. Last year we monitored transactions above the $400 per megawatt hour Western soft cap due to scarcity at peak. Given the likelihood of higher-priced natural gas in the West this year, extreme weather could easily

raise prices to the peak level again in summer 2007.[16]

Q. What other evidence indicates the importance of reasonable regulatory decisions on Idaho Power's ability to maintain its financial integrity?

A. Citing concerns over the impacts of a sustained drought, the pressures of ongoing capital requirements, and the outcome of Idaho Power's last rate proceeding in Case No. IPC-E-03-13, Standard & Poor's Corporation ("S&P") lowered Idaho Power's corporate credit rating from "A-" to "BBB+" in November 2004.[17] In explaining this action, S&P noted:

> Following the IPUC staff's 3.1% rate increase recommendation in February 2004, Standard & Poor's said that "a final decision by the commission that adopted a rate increase akin to that proposed by the staff could have an adverse effect on bondholder protection measures." The final IPUC ruling is indeed substantially closer to the staff's position than the company's, and will weaken credit protection measures.[18]

Similarly, Moody's Investors Service ("Moody's) also downgraded the Company's issuer rating from "A3" to "Baa1", citing the risks associated with hydroelectric power and ongoing capital commitments, as well as the need for

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[16] Federal Energy Regulatory Commission, Office of Market Oversight and Investigations, "Summer Energy Market Assessment 2007," (May 17, 2007) at 14.

[17] Standard & Poor's Corporation, "IDACORP and Unit Ratings Lowered, Removed From CreditWatch Negative," *RatingsDirect* (Nov. 29, 2004).

[18] *Id.*

additional regulatory support as key factors leading to lower credit ratings for Idaho Power:

> The downgrade of IPC's ratings reflects: 1) expected weaker cash flow coverage of interest and debt; 2) the likelihood for continued negative free cash flow over the next few years, with internally generated funds falling short of meeting the dividend requirements of IDACORP and significant utility-related capital spending; 3) persistent drought conditions that are likely to result in higher supply costs, not all of which are recoverable under the utility's power cost adjustment mechanism; 4) the final resolution this fall of the company's rate case, which resulted in a revenue increase of a little more than half of the company's updated request; and 5) the likely need for additional support from the Idaho Public Utility Commission (IPUC) in future rate proceedings as IPC adds new generation and transmission infrastructure to help meet customer and load growth and ensure reliability of service. [19]

Considering the fact that S&P has already has assigned a "negative" outlook to Idaho Power, warning investors of the potential for further deterioration in the Company's credit standing going forward, the perception of lack of regulatory support would undoubtedly place further downward pressure on current ratings. Such an outcome would be inconsistent with the IPUC's stated desire to maintain Idaho Power's credit ratings "at or above the current level"[20] and lends further support for a return on equity at the very top of the range of Ms. Carlock's results.

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[19] Moody's Investors Service, "Ratings Action: IDACORP, Inc.," *Global Credit Research* (Dec. 3, 2004).

[20] Idaho Public Utilities Commission, Order No. 29505 (May 25, 2004) at 43.

Q. Is there evidence regarding the importance of regulatory support in determining a utility's financial integrity?

A. Yes. Investment publications and the trade press are replete with examples that highlight the critical role that a constructive regulatory environment plays in investors' assessment of a utility's credit quality. In discussing the outlook for the utility industry, for example, Fitch Ratings, Ltd. recently noted that:

> Regulatory risk remains a recurring theme in Fitch's 2008 outlook. For regulated electric utilities, there is continuing event risk related to state regulatory and political reactions to higher energy bills. … The risk is heightened by the convergence of rising costs for fuel, equipment and maintenance materials, pension and medical benefits, and infrastructure investments.[21]

Accordingly, it is critical to assure investors' confidence in a balanced approach if reasonable access to capital is to be maintained. This is particularly true in this case for Idaho Power since the IPUC has such a significant role in this utility's prospects. Staff witness Donn English is incorrect at page 26 of his testimony when he suggests that Idaho Power has less regulatory risk because its service territory is concentrated in Idaho. Just as a diversified investment portfolio reduces risk to an investor, so also does exposure

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[21] Fitch Ratings, Ltd., "U.S. Utilities, Power & Gas 2008 Outlook," at 5 (Dec. 11, 2007).

to diversified regulatory authorities attenuate the risk of one jurisdiction adopting regulatory policies viewed as unconstructive by investors.

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

A. Partially. Ms. Carlock incorporated flotation costs by increasing the dividend yield component of her DCF analysis. While Ms. Carlock concluded that direct flotation costs would warrant an adjustment equal to 2 percent of the dividend yield component, she provided no support or explanation for this figure. As documented in my direct testimony, a review of related studies supports an adjustment on the order of 3.6 percent to 10 percent.[22] In addition, Ms. Carlock apparently did not adjust the results of her comparable earnings approach to incorporate flotation costs.

Q. In light of the shortfalls in Ms. Carlock's analysis and her failure to present a balanced assessment of Idaho Power's relative investment risks, what is your conclusion regarding her recommendations in this case?

A. In my opinion, Ms. Carlock's recommended 10.25 percent cost of equity falls well short of the rate of return that investors require from Idaho Power. In order to maintain

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[22] In prior testimony, Ms. Carlock has stated that direct flotation costs equate to an adjustment factor of 4 percent applied to a utility's dividend yield. Direct Testimony of Terri Carlock, Case Nos. AVU-E-04-1 & AVU-G-04-1, at 11 (June 21, 2004).

and expand utility infrastructure, it is both reasonable and necessary that the Company be provided the opportunity to maintain its credit standing and ability to attract capital. To meet these challenges successfully and economically, it is crucial that Idaho Power receive adequate support for its credit standing. Ms. Carlock's recommendation is inadequate to meet this goal.

At the very least, the IPUC should consider the results of the CAPM, along with Ms. Carlock's approaches, in evaluating the cost of equity. Ms. Carlock granted that, in selecting a point estimate from within a range, "any point within [the] range is reasonable."[23] Coupled with the ongoing risks associated with Idaho Power's continued exposure to wholesale power markets and the downward pressures on its credit standing, this would suggest a minimum cost of equity from the upper end of Ms. Carlock's DCF and comparable earnings ranges.

III. MATTHEW I.KAHAL

Q. Briefly describe how Mr. Kahal arrived at his recommended cost of equity for Idaho Power.

A. Mr. Kahal recommended a 10.25 percent ROE for Idaho Power based primarily on the results of the constant growth DCF model applied to alternative groups of electric utilities.

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[23] Carlock Direct at 12-13.

Mr. Kahal developed his proxy groups based on the companies included in Value Line's Electric Utility (West) industry group, as well as a subset of the comparable utilities developed in my direct testimony that Mr. Kahal characterized as operating in "non-restructured" states. In addition to the DCF model, Mr. Kahal also examined historical and projected realized rates of return for his reference groups. Based on the results of his analyses, Mr. Kahal concluded that a reasonable "baseline" cost of equity would fall in the range of 9.5 percent to 10.5 percent. In explaining his recommended ROE of 10.25 percent for Idaho Power, Mr. Kahal claimed to include "a small return premium for IPC."

Q. Did Mr. Kahal adequately recognize the importance associated with reliance on multiple methods and approaches in estimating the cost of equity?

A. No. Apart from passing reference to the comparable earnings approach, which I address subsequently, Mr. Kahal ignored the results of other methods, such as the CAPM, to check or validate his results. As I explained in my direct testimony, however, no single method or model should be relied upon to determine a utility's cost of equity because no single approach can be regarded as wholly reliable. Considering the results of alternative methods and approaches provides greater confidence that the end result is reflective of investors' required rate of return. *Regulatory Finance: Utilities' Cost*

of Capital (Public Utilities Reports, Inc., 1994) concluded that:

> When measuring equity costs, which essentially deal with the measurement of investor expectations, no one single methodology provides a foolproof panacea. If the cost of equity estimation process is limited to one methodology, such as DCF, it may severely bias the results. (p. 238)

Q. Do you believe that the results of Mr. Kahal's constant growth DCF analyses mirror investors' long-term expectations in the capital markets?

A. No. There is every indication that Mr. Kahal's results are biased downward and fail to reflect investors' required rate of return. Historical and short-term projected growth rates used to apply the DCF model may be colored by lingering economic uncertainties and the numerous challenges faced in the utility industry. The impact of this short-term focus is exemplified by Value Line, which has assigned its Utilities sector the lowest ranking of all 10 sectors it covers for year-ahead stock price performance,[24] while noting, "We don't totally discount the possibility that the industry will be accorded higher sustainable valuations going forward."[25] In other words, while Value Line does not anticipate substantial near-term gains for investors, they

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[24] The Value Line Investment Survey, Selection & Opinion (Jan. 26, 2007) at 4910.

[25] The Value Line Investment Survey (Mar. 2, 2007) at 153.

recognize that investors' long-term view may be different. As a result, while a cautious short-term outlook may be indicative of relatively low near-term growth projections, it does not necessarily reflect investors' long-term expectations for the industry.

As Mr. Kahal correctly observed, the "*g*" component of the DCF model should be prospective and must reflect "investor expected future growth."[26] But as he went on to note, environment presumed by the constant growth DCF approach he employed does not exist in reality. Mr. Kahal granted the significant dislocations recently faced by electric utilities, noting that:

> [M]y experience in recent years with utilities has been that these historic measures have been very volatile and are not reliable as long-run prospective measures. This may be due in part to extensive corporate restructuring in the energy industry.[27]

And while Mr. Kahal noted that his projected growth rates "should be considered and given substantial weight," he also recognized that "[t]here are a number of reasons why investor expectations of long-run growth could differ from the limited, five-year projections from security analysts."[28] Considering that investors' expectations could differ substantially from

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[26] Kahal Direct at 19.
[27] Kahal Direct at 19.
[28] Kahal Direct at 20.

the growth rates he relied on, Mr. Kahal concluded that the resulting cost of equity estimates "should be subject to a reasonableness test and corroboration."[29] If the growth projections used to apply the DCF model do not fully reflect the long-term expectations investors have built into stock prices, the resulting cost of equity estimates will be biased downward.

Q. Did Mr. Kahal test the reasonableness of the individual growth estimates he relied on to reach his recommended ROE for Idaho Power?

A. No. Mr. Kahal's mechanical application of the constant growth DCF model contradicts his own admonishment to avoid simply plugging alternative growth rates into the DCF formula with no consideration for the reasonableness of the end results. In fact, many of the growth measures embodied in Mr. Kahal's constant growth DCF application make no economic sense.

For example, consider the fact that three of the Value Line growth rates reported on page 4 of Mr. Kahal's Exhibit No. 604 were equal to 2.0 percent or less. A growth rate of 2.0 percent, when combined with Mr. Kahal's average dividend yield of approximately 3.65 percent,[30] suggests a DCF cost of equity estimate of approximately 5.7 percent. Meanwhile,

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[29] *Id.*

[30] Exhibit No. 604, p. 3.

several of the alternative growth values that Mr. Kahal referenced were equal to or less than zero,[31] implying that the utility's cost of equity is equal to or below its dividend yield. Considering the risk-return tradeoff principle fundamental to financial theory, it is clear that such results violate economic logic and clearly tell us nothing about investors' actual return requirements.

Q. Did Mr. Kahal offer any evidence to support his contention that DCF results for your non-utility proxy group should be rejected?

A. No. Mr. Kahal simply asserted (p. 26) that, because the objective in this case was to determine an ROE for Idaho Power's regulated utility operations, data for unregulated companies have "no value at all." Although he provides no detailed explanation for his position, Mr. Kahal apparently contends that the investment risks of my non-utility group were not comparable to Idaho Power or the utility proxy group I developed in my testimony. In fact, however, participation in competitive markets says nothing at all about the overall investment risks perceived by investors, which is the very basis for a fair rate of return. For example, consider 1) an electric utility operating in regulated markets that has experienced an inability to recover the costs incurred to

[31] Exhibit No. 604, p. 5.

provide service, and 2) United Parcel Service (UPS), which faces competition on numerous fronts. Despite its lack of a regulated monopoly, with a triple-A bond rating, the highest Value Line Safety Rank, and a beta of 0.75, the investment community would undoubtedly regard UPS as the less risky alternative. In fact, my review of objective indicators of investment risk - which consider the impact of competition and market share - demonstrated that, if anything, the non-utility proxy group is less risky in the minds of investors than the common stock of electric utilities, including Idaho Power.[32]

Meanwhile, Mr. Kahal's contention (p. 24) that an estimate of the required return for firms in the competitive sector of the economy "is not reasonable for use in this case" is wrong. In fact, returns in the competitive sector of the economy form the very underpinning for utility ROEs because regulation purports to serve as a substitute for the actions of competitive markets. The Supreme Court has recognized in the *Bluefield* and *Hope* cases that it is the degree of risk, not participation in particular business activities, which is relevant in evaluating an allowed ROE for a utility.

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[32] As shown in Table 3 of my direct testimony, the non-utility proxy group was less risky than Idaho Power and the utility proxy group across the four major indicators of investment risk.

Q. Do you agree with Mr. Kahal's assertions regarding the elimination of certain companies in analyzing the cost of equity for Idaho Power?

A. No. Mr. Kahal argued for the elimination of companies based on an assessment of the degree of regulatory restructuring at the retail level or participation in non-utility operations. However, he failed to demonstrate how his subjective criteria translate into differences in the investment risks perceived by investors. As I amply demonstrated in my direct testimony,[33] a comparison of objective indicators demonstrates that investment risks for the firms in my proxy groups are relatively homogeneous and comparable to Idaho Power. Moreover, there are significant errors and inconsistencies associated with Mr. Kahal's approach that justify rejecting his alternative proxy groups altogether.

Q. Did Mr. Kahal demonstrate a nexus between the subjective criteria he used to define his proxy groups and objective measures of investment risk?

A. No. Under the regulatory standards established by *Hope* and *Bluefield*, the salient criteria in establishing a meaningful proxy group to estimate investors' required return is relative risk, not the degree of regulatory restructuring.

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[33] Pages 36-38 and 51-53.

Mr. Kahal presented no evidence to demonstrate a connection between the subjective criteria that he employed and the views of real-world investors in the capital markets.

Q. What objective evidence can be evaluated to confirm the conclusion that these subjective criteria are not synonymous with comparable risk in the minds of investors?

A. Bond ratings are perhaps the most objective guide to utilities' overall investment risks and they are widely cited in the investment community and referenced by investors. While the bond rating agencies are primarily focused on the risk of default associated with the firm's debt securities, bond ratings and the risks of common stock are closely related. As noted in Regulatory Finance: Utilities' Cost of Capital:

> Concrete evidence supporting the relationship between bond ratings and the quality of a security is abundant. … The strong association between bond ratings and equity risk premiums is well documented in a study by Brigham and Shome (1982).[34]

While credit ratings provide the most widely referenced benchmark for investment risks, other quality rankings published by investment advisory services and rating agencies also provide relative assessments of risk that are considered by investors in forming their expectations. For example, Mr.

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[34] Morin, Roger A., "Regulatory Finance: Utilities' Cost of Capital," *Public Utility Reports* (1994) at 81.

Kahal considered Value Line's Safety Rank, beta, and Financial Strength Rating risk measured in evaluating his reference group.[35]

As I noted in my direct testimony (p. 36), my proxy group of 21 electric utilities had an average corporate credit ratings of triple-B, with ratings for the individual utilities ranging from "BBB" to "A-". Similarly, credit ratings assigned to the eight utilities excluded by Mr. Kahal based on his subjective tests ranged from "BBB" to "BBB+" and were entirely comparable to those assigned to the remainder of the companies in my utility proxy group. Considering that credit ratings provide one of the most widely referenced benchmarks for investment risks, a comparison of this objective risk indicator demonstrates that the range of risks for the companies eliminated under the subjective criteria proposed by Mr. Kahal are virtually identical to the remaining companies that he accepted as comparable. A review of the key Value Line risk indicators discussed in my direct testimony also confirm the conclusion that the firms excluded by Mr. Kahal are entirely comparable to the remainder of my utility proxy group.

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[35] Exhibit No. 603.

Q. What inconsistencies are associated with the alternative tests proposed by Mr. Kahal?

A. While Mr. Kahal proposes to eliminate companies based his assessment the proportion of revenues from regulated utility operations, he presented no explanation or evidence supporting his "test". Apart from the fact that it is often impossible to accurately apportion financial measures between utility and non-utility sources, Mr. Kahal's subjective assessment is inconsistent with the companies he accepted in his own reference group of western utilities. For example, while Mr. Kahal argued to exclude companies with "substantial unregulated operations," he included Black Hills Corporation ("Black Hills") in his reference group. Black Hills reported in its most recent Form 10-K Report that its utility operations accounted for 41 percent of operating revenues, with other operations - including oil and gas and coal mining, making up the remaining 59 percent. Similarly, in addition to its electric utility operations Hawaiian Electric Industries, Inc. ("Hawaiian Electric") also owns and operates American Savings Bank, which is the third largest financial institution in Hawaii. Despite the fact that competitive banking activities accounted for approximately 37 percent of operating income in 2006, Mr. Kahal elected to include Hawaiian Electric in his proxy group. Thus, Mr. Kahal's evaluation of my proxy companies is totally at odds with his own evaluation and analyses.

Similarly, Mr. Kahal's assertions concerning the risks associated with restructuring are ill-defined and inconsistent with his arguments over the implications of competition. For example, while Mr. Kahal argues that CenterPoint Energy should be excluded because it operates in restructured power markets, CenterPoint Energy is engaged almost exclusively in providing regulated electric and gas distribution and transmission services.[36] As CenterPoint Energy noted:

> Neither CenterPoint Energy Houston nor any other subsidiary of CenterPoint Energy make sales of electric energy at retail or wholesale or owns any electric generating facilities.[37]

While CenterPoint Energy does not participate in restructured wholesale power markets, Avista Corp. - one of the companies included in Mr. Kahal's reference group - specifically informed investors of its exposure to the risks of energy commodity markets and reported that wholesale power market purchases accounted for almost 30 percent of total energy needs.[38] Again, the circumstances faced by the utilities in Mr. Kahal's own proxy group are inconsistent with the subjective "tests" he proposes.

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[36] In Texas, where Centerpoint's operations are concentrated, utilities providing transmission and distribution service are regulated by the Public Utility Commission of Texas on a rate of return basis essentially the same as the IPUC regulation of Idaho Power. Wholesale and retail sales are subject to competitive markets.

[37] CenterPoint Energy 2006 Form 10-K Report at 2.

[38] Avista Corp. 2006 Form 10-K Report.

Q. What market risk premium did Mr. Kahal use to apply the CAPM?

A. While Mr. Kahal declined to consider the results of the CAPM in arriving at his recommendation, he relied on a market risk premium of 6.0 percent, which he derived from a single journal article and two selected studies reported in a finance textbook.[39]

Q. What is the fundamental problem associated with the approach underlying Mr. Kahal's suggested application of the CAPM?

A. Like the DCF model, the CAPM is an *ex-ante,* or forward-looking model based on expectations of the future. As a result, in order to produce a meaningful estimate of investors' required rate of return, the CAPM must be applied using data that reflects the expectations of actual investors in the market. However Mr. Kahal's application of the CAPM method was premised only on *historical* - not projected - rates of return. The primacy of current expectations was recognized by Ibbotson Associates:

> The cost of capital is always an expectational or forward-looking concept. While the past performance of an investment and other historical information can be good guides and are often used to estimate the required rate of return on capital, the

[39] Kahal Direct at 32.

> expectations of future events are the only factors that actually determine cost of capital.[40]

By failing to look directly at the returns investors are currently requiring in the capital markets, as I did on Exhibit 6, Mr. Kahal's CAPM estimate significantly understates investors' required rate of return.

Q. Are the selected references cited by Mr. Kahal representative of investors' expectations?

A. No. Mr. Kahal claims that "real world" data suggests that the market risk premium is significantly lower than the values relied on in my analyses. First, Mr. Kahal's selected surveys from 2001 and 2003 do not examine the forward-looking expectations of today's investors to estimate the required market rate of return in current capital markets. These studies reflect historical data, not the current expectations of the future that form the basis of investors' required returns today. This critical distinction was recognized in a recent survey of risk premium research:

> The debate surrounding the equity risk premium arises because theoretically such premia are concerned with the extent to which risky stocks are "expected" to outperform a (relatively) safe investment, whereas excess returns are estimated values of this outperformance derived from observed data. The lack of consensus regarding the true value of the equity risk premium arises from the fact that expectations are unobservable hence can only be estimated, and that such estimates will vary over

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[40] Ibbotson Associates, *2003 Yearbook, Valuation Edition* at 23.

> time depending, in part at least, on the sample period used.[41]

In other words, instead of directly considering requirements in today's capital markets, Mr. Kahal is implicitly asserting that events and expectations for the time periods covered by his two surveys are more representative of what is likely to occur going forward. This assertion runs counter to the assumptions underlying the use of the CAPM to estimate investors' required return, which is a purely forward-looking model.

Moreover, even if historical studies were relevant in this context, there are other such studies of equity risk premiums published in academic journals that imply required rates of return considerably in excess of those selected by Mr. Kahal. For example, a study reported in the *Financial Analysts' Journal* noted that the real risk premium for U.S. stocks averaged 6.9 percent over the period 1889 through 2000 and concluded that:

> Over the long term, the equity risk premium is likely to be similar to what it has been in the past and returns to investment in equity will continue to substantially dominate returns to investments in T-bills for investors with a long planning horizon.[42]

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[41] Oyefeso, Oluwatobi, "Would There Ever Be Consensus Value and Source of the Equity Risk Premium? A Review of the Extant Literature," International Journal of Theoretical and Applied Finance, Vol. 9, No. 2 (2006) 199-215.

[42] Mehra, Ranjnish, "The Equity Premium: Why Is It a Puzzle?", *Financial Analysts' Journal* (January/February 2003).

Similarly, based on a study of *ex-ante* expected returns for a sample of S&P 500 firms over the 1983-1998 period, a 2003 article in *Financial Management* found an expected market risk premium of 7.2%.[43]

In contrast to the conclusions that Mr. Kahal draws from his review of selected studies, other researchers are less sanguine and recognize that the shortcomings of academic methods can produce results that deviate from investors' actual expectations and requirements:

> The above discussion suggests that the equity premium debate is far from over, and that the use of excess returns as a proxy for such premia, while convenient, may capture a substantial amount of noise and be uncorrelated with equity risk premia particularly over the short-run.[44]

In fact, no selected historical study, or group of studies, is a substitute for an analysis of investors' current expectations in the capital markets, such as that incorporated in my CAPM analysis shown on Exhibit 6.

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[43] Harris, R.S., Marston, F. C., Mishra, D. R., and O'Brian, T. J., "Ex Ante Cost of Equity Estimates of S&P 500 Firms: The Choice Between Global and Domestic CAPM," *Financial Management* (Autumn 2003) at Table I.

[44] Oyefeso, Oluwatobi, "Would There Ever Be Consensus Value and Source of the Equity Risk Premium? A Review of the Extant Literature," International Journal of Theoretical and Applied Finance, Vol. 9, No. 2 (2006) 199-215.

Q. Is there anything wrong with the approach that you employed to determine the equity risk premium for your forward-looking CAPM analysis (Exhibit 6)?

A. No. While Mr. Kahal criticizes historical risk premium data published by Ibbotson Associates (now Morningstar),[45] I did not reference this data whatsoever in my forward-looking CAPM analysis. As explained in my direct testimony, I estimated the current equity risk premium by first applying the DCF model to estimate investors' current required rate of return for the firms in the S&P 500 and then subtracting the yield on government bonds. Mr. Kahal contends that this CAPM analysis is flawed because of an alleged upward bias in the market risk premium. In fact, however, the use of forward-looking expectations in estimating the market risk premium is well accepted in the financial literature. For example, in "The Market Risk Premium: Expectational Estimates Using Analysts' Forecasts" [*Journal of Applied Finance*, Vol. 11 No. 1, 2001], Robert S. Harris and Felicia C. Marston employed the DCF model and earnings growth projections from IBES - just as I did in Exhibit 6.

Mr. Kahal's complaint about my forward-looking CAPM approach seem to hinge on the fact that this method produces an equity risk premium for the S&P 500 that is considerably higher than the unrealistic benchmarks he cites. But as I

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[45] Kahal Direct at pp. 30-31.

explained earlier, estimating investors' required rate of return by reference to current, forward-looking data, as I have done, is entirely consistent with the theory underlying the CAPM methodology, which is an *ex-ante*, or forward-looking model based on expectations of the future. As a result, in order to produce a meaningful estimate of required rates of return, the CAPM is best-applied using data that reflects the expectations of actual investors in the market. Rather than look backwards to risk premiums based on historical literature articles or surveys, my analysis appropriately focused on the expectations of actual investors in today's capital markets.

Q. Is there any merit to Mr. Kahal's contention that the alternative beta values he references are "more plausible" that those reported by Value Line?

A. None whatsoever. Application of any quantitative technique to estimate the cost of equity is an attempt to determine the expectations and requirements of real-world investors in the capital markets. In this regard, the Value Line beta values I used to apply the CAPM are perhaps the best indicator of the risks investors are likely to associate with electric utilities such as Idaho Power. As noted in *Regulatory Finance: Utilities' Cost of Capital*:

> Value Line betas are computed on a theoretically sound basis using a broadly-based market index, and they are adjusted for the regression tendency of betas to converge to 1.00. …Value Line is the largest and most widely circulated independent investment advisory service, and exerts influence on

> a large number of institutional and individual investors and on the expectations of these investors.[46]

In my experience, Value Line betas are widely used, without adjustment, to estimate the cost of equity in regulatory proceedings.

Q. Did Mr. Kahal present any meaningful evidence to support his claim (p. 29) that certain Value Line's beta values are "clearly unreasonable"?

A. No. After noting that beta values for my proxy group and IDACORP imply risks comparable to the stock market as a whole," Mr. Kahal simply asserts, "This is clearly unreasonable."[47] Missing from Mr. Kahal's testimony is any evidence to support his view that higher beta values for utility stocks are somehow not reflective of underlying investment risks. Moreover, it is the expectations and requirement of investors that determine the relative fluctuations in share prices on which Value Line's beta values are based. But rather than view increased stock price volatility relative to the market as a sign of increased risk, as would be consistent with financial theory, Mr. Kahal offers his unsupported assertion that this trend is "unreasonable."

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[46] Morin, Roger A., "Regulatory Finance: Utilities' Cost of Capital," Public Utilities Reports (1994) at 65.

[47] Kahal Direct at 29.

In fact, increasing beta values for the electric utility industry are entirely consistent with the higher risks perceived by investors, as described in my direct testimony.[48] Moreover, the greater risk implied by higher beta values are also consistent with the general downward trend in utility credit ratings. In my experience, Value Line is the most widely referenced source for beta in regulatory proceedings and Mr. Kahal has presented no evidence that would call these values into question.

Q. What is the most telling indication that the data Mr. Kahal cites in applying the CAPM do not reflect investors' expectations?

A. The results of the CAPM method applied using the data reported by Mr. Kahal do not make economic sense. The surveys cited as support for Mr. Kahal's conclusions implied market equity risk premiums of 5.5 percent and 3.8 percent, with his alternative beta values averaging 0.74 for his proxy group.[49] But multiplying market equity risk premiums of 5.5 percent and 3.8 percent by Mr. Kahal's beta of 0.74 for his reference group, and combining the resulting 4.1 percent and 2.8 percent risk premiums with a 4.8 percent risk-free rate, results in indicated costs of equity of approximately 8.9

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[48] As noted earlier, Ms. Carlock also comments on investors' perceptions of the increasing risk of the electric utility industry.

[49] Kahal Direct at pp. 30 & 31.

percent to 7.6 percent. These returns are barely above the yields on utility bonds and dramatically lower than the earnings Value Line expects utilities to earn in coming years. By any objective measure, such results fall woefully short of required returns from an investment in common equity. Mr. Kahal's interpretation has little relation to the expectations of actual investors and no value as a benchmark in applying the CAPM or evaluating the reasonableness of his DCF recommendations.

Q. Please comment on Mr. Kahal's application of the comparable earnings approach.

A. By failing to evaluate the economic logic of the individual returns for the companies in his reference group, Mr. Kahal's comparable earnings analysis suffers from the same flaw explained earlier in connection with his DCF application. Indeed, while Mr. Kahal suggested that a 17.5 percent return on equity for Dominion Resources should be excluded as implausible, he retained low-end estimates that are clearly illogical. For example, Mr. Kahal's comparable earnings results included a number of values that fall below current yields on public utility bonds,[50] while others are far below any reasonable estimate of investors' required rate of

[50] See, *e.g.*, the 5.3 percent and 5.8 percent returns for Portland Energy included on page 1 of Exhibit No. 606.

return.[51] Thus, the results of Mr. Kahal's comparable earnings approach are understated and should be ignored.

Q. Does Mr. Kahal's reference to the ROE authorized by the IPUC in Idaho Power's last rate proceeding support his recommendations in this in proceeding?

A. No. Mr. Kahal argues that the IPUC should "reaffirm and continue" the 10.25 percent ROE that it found to be reasonable for Idaho Power in Case No. IPC-E-03-13, but this ignores the fact that the Company's investment risks have increased. As discussed earlier in response to Ms. Carlock, Idaho Power was downgraded from single-A to triple-B following the conclusion of the Company's last litigated rate proceeding. Apart from the uncertainties associated with Idaho Power's reliance on hydro generation and the financial pressures attributable to increased capital requirements, S&P and Moody's also noted the Company's weakened financial standing in light of the IPUC's ruling. Because the record in Case No. IPC-E-03-13 was predicated on Idaho Power's former single-A credit rating, the 10.25 percent ROE awarded by the IPUC does not consider the higher risks that investors now associate with the Company.

Q. Is there any direct capital market evidence regarding the amount of the premium investors require from a

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[51] See, *e.g.*, the 7.5 percent and 7.0 percent rates of return for DTE Energy and NiSource Inc.

firm that is rated triple-B, versus one with Idaho Power's former single-A rating?

A. Although rates of return on equity cannot be directly observed, the observed yields on long-term bonds provide direct evidence of the additional return that investors require to bear the risks associated with weaker credit ratings. Moody's recently reported an average yield on single-A rated public utility bonds for November 2007 of 5.97 percent, versus an average yield of 6.27 percent for bonds rated triple-B. Based on this evidence, the debt markets would require approximately 30 basis points in additional return in order to compensate for the greater risks associated with Idaho Power's current triple-B rating. Equity investors would undoubtedly require a significantly greater premium for bearing the higher risk associated with the more junior common stock of a utility with a triple-B rated company, versus one that is rated single-A. As a result, reference to the IPUC's findings in Idaho Power's last litigated rate proceeding confirms that Mr. Kahal's recommended ROE is inadequate to compensate for the level of investment risk that investors now associate with Idaho Power.

Q. What are the implications of disregarding the Company's higher investment risks in setting the allowed rate of return on equity?

A. If the greater risks associated with Idaho Power's weakened credit standing are not incorporated in the allowed

rate of return on equity, the results will fail to meet the comparable earnings standard that Ms. Carlock agrees is fundamental in determining the cost of capital. From a more practical perspective, failing to provide investors with the opportunity to earn a rate of return commensurate with Idaho Power's risks will only serve to further weaken its financial integrity, while hampering the Company's ability to attract the capital needed to meet the economic and reliability needs of its service area.

Q. Do you agree with Mr. Kahal (p. 8) that changes in dividend taxation enacted in 2003 have led to a significant decline in investors' required rate of return on equity?

A. No. While dividend taxation is certainly one factor that may be considered by investors, the impact of changes in dividend taxation on the cost of equity for Idaho Power is unclear. First, the important role that pension funds and tax deferred accounts play in the capital markets dilutes any effect that tax rate changes might have on investors' required rate of return. This is because the reduction in the taxation of dividends has no impact on the returns for tax-free investors.

Moreover, using current capital market data to estimate the cost of equity, such as my forward-looking CAPM approach (Exhibit 6), already incorporates any effects of changes in tax policies. While Mr. Kahal implies that changes in dividend taxation suggest a lower cost of equity than in the

past, this ignores other significant factors that influence required returns. In particular, as a result of events during the past several years, investors' risk perceptions for electric utilities shifted sharply upward, which would more than offset any decline in the equity risk premium due to changes in dividend taxation. Finally, investors recognize that ballooning federal budget deficits are apt to force changes in fiscal policy and that there is no guarantee that the reduction in dividend taxation will continue.[52]

Q. Did Mr. Kahal incorporate an allowance for flotation costs?

A. No. Based on his assertion that IDACORP has no plans to issue common stock, Mr. Kahal rejected an allowance for issuance costs.

Q. Is Mr. Kahal's position consistent with financial realities and the views of other practitioners?

A. No. The need for a flotation cost adjustment to compensate for past equity issues is recognized in the financial literature. In a *Public Utilities Fortnightly* article, for example, Brigham, Aberwald, and Gapenski demonstrated that even if no further stock issues are contemplated, a flotation cost adjustment in all future years is required to keep shareholders whole, and that the flotation

[52] The reduction in dividend taxation in the Jobs and Growth Tax Relief and Reconciliation Act of 2003 will expire at the end of 2008 unless renewed by Congress.

cost adjustment must consider total equity, including retained earnings.[53] Similarly, *Regulatory Finance: Utilities' Cost of Capital* contains the following discussion:

> Another controversy is whether the underpricing allowance should still be applied when the utility is not contemplating an imminent common stock issue. Some argue that flotation costs are real and should be recognized in calculating the fair rate of return on equity, but only at the time when the expenses are incurred. In other words, the flotation cost allowance should not continue indefinitely, but should be made in the year in which the sale of securities occurs, with no need for continuing compensation in future years. This argument implies that the company has already been compensated for these costs and/or the initial contributed capital was obtained freely, devoid of any flotation costs, which is an unlikely assumption, and certainly not applicable to most utilities. … The flotation cost adjustment cannot be strictly forward-looking unless all past flotation costs associated with past issues have been recovered. (p. 175)

Q. Do you agree with Mr. Kahal's assessment of a reasonable flotation cost percentage?

A. No. As noted in my direct testimony, a review of the finance literature indicated that the flotation cost allowance requires an estimated adjustment to the return on equity of approximately 5% to 10%, not the 3% advocated by Mr. Kahal. Moreover, the purpose of the flotation cost adjustment is not to amortize flotation costs over a predetermined

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

schedule. While this is one approach to cost recovery that has been adopted for the financial reporting of debt issuance costs, an equity flotation cost adjustment recognizes that investors are unable to earn a rate of return on the portion of their capital paid out as flotation costs on an ongoing basis.

Q. Does this conclude your rebuttal testimony?

A. Yes.