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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 RATES ) CASE NO. IPC-E-08-10  
AND CHARGES FOR ELECTRIC SERVICE. )  

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IDAHO POWER COMPANY  
DIRECT REBUTTAL TESTIMONY  
OF  
WILLIAM E. AVERA

DIRECT REBUTTAL TESTIMONY OF WILLIAM E. AVERA

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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 A. The purpose of my testimony is to respond to  
10 the direct testimony of Terri Carlock, submitted on behalf  
11 of the Staff of the Idaho Public Utilities Commission  
12 ("IPUC"). In addition, I will also rebut the  
13 recommendations contained in the direct testimony of Matthew  
14 I. Kahal, on behalf of the United States Department of  
15 Energy, and Dennis E. Peseau, on behalf of Micron  
16 Technology, Inc., concerning the return on equity ("ROE")  
17 for the jurisdictional utility operations of Idaho Power  
18 Company ("Idaho Power" or "the Company").

19 Q. Please summarize the conclusions of your  
20 testimony.

21 A. With respect to the testimony of Ms. Carlock,  
22 I concluded that her recommendations were understated  
23 because of her failure to consider the implications of  
24 current capital market conditions, as well as the fact that  
25 her discounted cash flow ("DCF") analysis focused primarily

1 on a single firm and her evaluation ignored the results of  
2 other accepted methods of estimating the cost of equity.  
3 Additionally, Ms. Carlock's assessment of relative risks  
4 focused exclusively on Idaho Power's relatively low rates,  
5 while ignoring the substantial uncertainties and higher  
6 investment risks that investors must bear to provide the  
7 benefits of lower electricity costs to customers. The  
8 dramatic increase in the cost of long-term capital, the  
9 upward shift in investors' risk perceptions, and the results  
10 of the Capital Asset Pricing Model ("CAPM") all support a  
11 rate of return above the upper end of Ms. Carlock's  
12 recommended ROE range.

13 Similarly, Mr. Kahal's recommendations are biased  
14 downward because he failed to reflect current capital market  
15 conditions or exclude illogical estimates in evaluating the  
16 results of his analyses. Similarly, there is no basis for  
17 Mr. Kahal's criticisms of my proxy group and his alternative  
18 application of the CAPM is flawed and should be rejected.  
19 Meanwhile, Dr. Peseau mischaracterized the implications of  
20 bond yield trends and - like Ms. Carlock and Mr. Kahal -  
21 ignored the higher risks now associated with Idaho Power.  
22 Considering the adverse conditions in today's capital  
23 markets, the ROE recommendations of Ms. Carlock, Mr. Kahal,  
24 and Dr. Peseau portend further deterioration in Idaho  
25 Power's finances if adopted.



1           A.       Considering investors' heightened awareness  
2 of the risks associated with the electric power industry and  
3 the implications of ongoing volatility in the markets for  
4 long-term capital, supportive regulation remains crucial in  
5 preserving Idaho Power's access to capital. Capital markets  
6 recognize that constructive regulation is a key ingredient  
7 in supporting utility credit ratings and financial  
8 integrity, particularly during times of adverse conditions.  
9 Moreover, considering the magnitude of the events that have  
10 recently occurred, investors' sensitivity to market and  
11 regulatory uncertainties has increased dramatically.

12           Q.       Is it widely accepted that a utility's  
13 ability to attract capital must be considered in  
14 establishing a fair rate of return?

15           A.       Yes. Ms. Carlock and I agree that the  
16 authorized rate of return should be competitive with returns  
17 available to investors from investments of corresponding  
18 risk, as directed by landmark Supreme Court decisions. Ms.  
19 Carlock also recognized that the opportunity to earn a  
20 return at least equal to those expected in the capital  
21 markets for comparable investments is required if a utility  
22 is to be able to attract capital. Ms. Carlock also noted  
23 the importance of testing any cost of equity estimate  
24 against applicable standards:

1 . . . three standards have evolved for  
2 determining a fair and reasonable rate  
3 of return: (1) the Financial Integrity  
4 or Credit Maintenance Standard; (2) the  
5 Capital Attraction Standard; and (3) the  
6 Comparable Earnings Standard.<sup>1</sup>  
7

8 This is absolutely correct. If Idaho Power's return  
9 on equity does not fully reflect the level of investment  
10 risks that investors perceive, it will violate the risk-  
11 return tradeoff, breach applicable standards, and impair the  
12 Company's ability to attract necessary capital.

13 Q. What benchmarks are useful in evaluating the  
14 extent to which the ROE recommendations meet this  
15 fundamental regulatory requirement?

16 A. The comparable earnings standard recognizes  
17 that Idaho Power must compete for capital with all firms in  
18 the capital markets generally, and against firms in its own  
19 industry specifically. The Value Line Investment Survey  
20 ("Value Line") reports that electric utilities as a whole  
21 are anticipated to earn a return of 11.5 percent in 2008,  
22 2009, and over its 2011-2013 forecast horizon.<sup>2</sup> A return  
23 that is significantly below the level that Value Line  
24 expects for electric utilities generally would undermine  
25 confidence in the financial integrity of the firm and its  
26 ability to attract capital.

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<sup>1</sup> Carlock Direct at 5.

<sup>2</sup> The Value Line Investment Survey at 2230 (Nov. 7, 2008).

1           Q.       What are the potential consequences of  
2 authorizing a rate of return less than what is required to  
3 meet the financial end-result test?

4           A.       Considering the risks faced by Idaho Power,  
5 the need to fund substantial investment in utility  
6 infrastructure, and the imperative of maintaining access to  
7 capital during times of adversity, setting an ROE that fails  
8 to provide investors with an opportunity to earn returns  
9 commensurate with companies of comparable risk would weaken  
10 Idaho Power's financial integrity, violate the capital  
11 attraction standard, and send the wrong signal to investors  
12 at a time when access to capital markets is crucial for the  
13 Company.

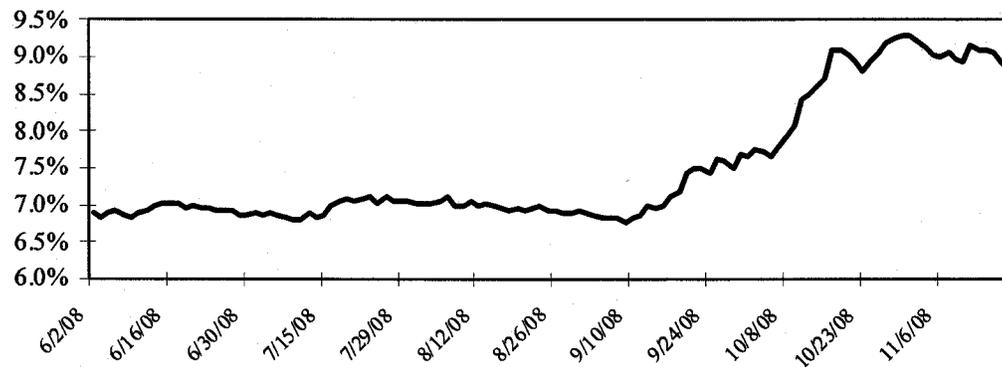
14                   **III. CHANGES IN CAPITAL MARKET CONDITIONS**

15           Q.       What are the implications of recent capital  
16 market conditions?

17           A.       Recent volatility in the debt and equity  
18 markets linked to the ongoing financial crisis and the  
19 weakening economy evidences investors' trepidation to commit  
20 capital and marks a significant upward revision in their  
21 perceptions of risk and required returns. Bloomberg  
22 reported that the CBOE Volatility Index, commonly know as  
23 the VIX, recently surged 26 percent to almost triple its  
24 average during the past year, indicating unprecedented price

1 fluctuations and uncertainty.<sup>3</sup> With respect to utilities  
2 specifically, as of November 14, 2008, the Dow Jones Utility  
3 Average stock index has declined over 28 percent since June  
4 2008, while yields on utility bonds have increased  
5 precipitously. Figure 1 below plots the yields on triple-B  
6 utility bonds reported by Moody's Investors Service  
7 ("Moody's") from June 2008 through November 20, 2008:

8 **FIGURE 1**  
9 **MOODY'S TRIPLE-B PUBLIC UTILITY BOND YIELDS**



10  
11 At the time my direct testimony was prepared, the average  
12 yield on triple-B rated utility bonds was 6.9 percent, or  
13 approximately 6.8 percent in May 2004, when the IPUC issued  
14 its decision in Case No. IPC-E-03-13. Meanwhile, Moody's  
15 reported that for the month of October 2008, the average  
16 yield on triple-B utility bonds had climbed to 8.6 percent,  
17 with the month-average yield as of November 20, 2008 being  
18 approximately 9.0 percent.

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<sup>3</sup> Kearns, Jeff, "VIX 'Exploding' as Stocks Plunge on Growing Recession Concern," *Bloomberg* (Oct. 15, 2008).

1 Q. What does this evidence indicate with respect  
2 to establishing a fair ROE for Idaho Power?

3 A. The recent sell-off in common stocks and  
4 sharp increase in utility bond yields are indicative of  
5 higher costs for long-term capital, and the ongoing credit  
6 crisis has spilled over into the utility industry. For  
7 example, utilities have been forced to draw on short-term  
8 credit lines to meet debt retirement obligations because of  
9 uncertainties regarding the availability of long-term  
10 capital.<sup>4</sup> As the *Edison Electric Institute* ("EEI") noted in  
11 a recent letter to congressional representatives, the  
12 financial crisis has serious implications for utilities and  
13 their customers:

14 In the wake of the continuing upheaval  
15 on Wall Street, capital markets are all  
16 but immobilized, and short-term  
17 borrowing costs to utilities have  
18 already increased substantially. If the  
19 financial crisis is not resolved  
20 quickly, financial pressures on  
21 utilities will intensify sharply,  
22 resulting in higher costs to our  
23 customers and, ultimately, could  
24 compromise service reliability.<sup>5</sup>

25 Similarly, an October 1, 2008, *Wall Street Journal*  
26 report confirmed that dislocations in credit markets were  
27 also impacting the utility sector:

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<sup>4</sup> Riddell, Kelly, "Cash-Starved Companies Scrap Dividends, Tap Credit,"  
Pittsburgh Post-Gazette (Oct. 2, 2008).

<sup>5</sup> *Letter to House of Representatives*, Thomas R. Kuhn, President, Edison  
Electric Institute (Sep. 24, 2008).

1 Disruptions in credit markets are  
2 jolting the capital-hungry utility  
3 sector, forcing companies to delay new  
4 borrowing or come up with different-  
5 often more costly-ways of raising cash.<sup>6</sup>

6 An October 2008 report on the implications of credit  
7 market upheaval for utilities noted that, while high-quality  
8 companies can still issue debt, "they now have to pay an  
9 unusually high risk premium over Treasuries."<sup>7</sup> Meanwhile, a  
10 Managing Director with Fitch Ratings, Ltd. ("Fitch")  
11 recently observed that with debt costs at present levels,  
12 "significantly higher regulated returns will be required to  
13 attract equity capital."<sup>8</sup> As Fitch concluded:

14 The collapse in secondary market debt  
15 pricing and in equity valuations is  
16 worrisome. We see new debt now priced at  
17 around 9% or higher pushing up against  
18 average authorized ROEs for utilities of  
19 around 10.25% to 10.50%. Thus, raising  
20 new equity, which is now priced close to  
21 book value, is likely to be dilutive.<sup>9</sup>

22 Q. Do the recommendations of Ms. Carlock and Mr.  
23 Kahal reflect these economic realities?

24 A. No. While Ms. Carlock and Mr. Kahal both  
25 touch on conditions in the capital markets, they either seek  
26 to diminish the importance of the recent financial crisis or

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<sup>6</sup> *Wall Street Journal* "Turmoil in Credit Markets Send Jolt to Utility Sector" (Oct. 1, 2008), p. B4.

<sup>7</sup> *Rudden's Energy Strategy Report* (Oct. 1, 2008).

<sup>8</sup> Fitch Ratings Ltd., "EEI 2008 Wrap-Up: Cost of Capital Rising," *Global Power North America Special Report* (Nov. 17, 2008).

<sup>9</sup> Fitch Ratings Ltd., "Investing In An Unpredictable World," *Fitch Ratings' 20<sup>th</sup> Annual Global Power Breakfast* (Nov. 10, 2008).

1 mischaracterize the implications of the resulting economic  
2 threats. For example, Ms. Carlock noted (p. 10) that  
3 current market trends "are making capitalization difficult  
4 for all," but her assessment of short-term interest rate  
5 trends leaves the false impression that capital costs have  
6 somehow decreased.

7 For his part, Mr. Kahal grants (p. 9) that  
8 "financial markets distress and equity market volatility has  
9 increased drastically, with credit markets beginning in last  
10 September freezing up," but nevertheless concludes that the  
11 implications are "difficult to predict." Rather than  
12 account for the economic realities facing today's investors,  
13 he simply asserts that "cost of capital data in this case  
14 have not changed substantially,"<sup>10</sup> and that the present  
15 crisis "likely will be temporary".<sup>11</sup> As a result, he  
16 recommends ignoring it altogether.

17 Q. Do the interest rate benchmarks cited by Ms.  
18 Carlock and Mr. Kahal accurately reflect the current  
19 expectations and requirements of Idaho Power's equity  
20 investors?

21 A. No. In evaluating trends in interest rates,  
22 Ms. Carlock concluded in her testimony that interest rates  
23 have decreased, based solely on her observation that the

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<sup>10</sup> Kahal Direct at 6.

<sup>11</sup> Kahal Direct at 10.

1 prime rate and the federal funds rate have declined.<sup>12</sup> Of  
2 course, the decline in the federal funds rate and prime  
3 lending rate are a function of the Federal Reserve's actions  
4 to increase liquidity in the face of a profound crisis in  
5 credit markets. Moreover these interest rate benchmarks  
6 have virtually no relevance in an evaluation of long-term  
7 capital costs for a utility such as Idaho Power.

8 While Mr. Kahal grants that trends in long-term  
9 interest rates are indicative of the cost of equity,<sup>13</sup> he  
10 concludes that "favorable trends" in long-term debt cost  
11 rates support his recommendation.<sup>14</sup> As documented above,  
12 however, Mr. Kahal's conclusion is directly at odds with the  
13 capital market realities faced by investors. Yields on  
14 triple-B utility bonds are on the order of at least 200  
15 basis points higher than those prevailing at the time the  
16 IPUC issued its decision in Idaho Power's last litigated  
17 rate proceeding. In contrast to the recommendations of Ms.  
18 Carlock and Mr. Kahal, this implies a significant increase  
19 the ROE for Idaho Power.

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<sup>12</sup> In response to IPC Request No. 22, which asked if Ms. Carlock had evaluated trends in public utility bond yields from the time of Idaho Power's last rate case until the present, she indicated that "Public Utility bond yields floated within a closer range (versus prime rate), decreasing at times and increasing at others. With the market uncertainty this fall, they increased."

<sup>13</sup> Kahal Direct at 9.

<sup>14</sup> Kahal Direct at 10.

1           Q.       What increase in ROE is indicated by the  
2 upward trend in long-term utility bond yields?

3           A.       While the cost of equity generally moves in  
4 the same direction as interest rates, it is widely accepted  
5 that the cost of equity does not increase or decrease in  
6 lockstep with changes in bond yields.  Indeed, there is  
7 substantial evidence that equity risk premiums tend to move  
8 inversely with interest rates.  In other words, when  
9 interest rate levels are relatively high, equity risk  
10 premiums narrow, and when interest rates are relatively low,  
11 equity risk premiums widen.  This inverse relationship has  
12 been recognized in the financial literature and by  
13 regulators.  Based on a review of the financial literature,  
14 *Regulatory Finance: Utilities Cost of Capital* concluded  
15 that:  "These studies imply that the cost of equity changes  
16 only half as much as interest rates change."<sup>15</sup>

17           Considering this inverse relationship and the fact  
18 that triple-B utility bond yields have increased at least  
19 200 basis points since the IPUC issued its decision in Case  
20 No. IPC-E-03-13 implies a minimum upward adjustment to the  
21 approved ROE of 100 basis points.

22           Q.       Does it make sense to ignore current capital  
23 market conditions, as Mr. Kahal recommends?

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<sup>15</sup> Morin, Roger A., "Regulatory Finance: Utilities' Cost of Capital,"  
Public Utilities Reports, Inc. (1994) at 292.

1           A.           Absolutely not. Mr. Kahal may have gazed  
2 into his crystal ball and determined that the demonstrable  
3 increase in long-term capital costs "will be temporary," but  
4 his personal opinions have no bearing on the realities that  
5 Idaho Power faces in raising capital. In fact, most of the  
6 investment community are far less sanguine than Mr. Kahal  
7 and there is very little indication that the dire conditions  
8 confronting the economy and financial markets will be  
9 resolved quickly. In contrast to Mr. Kahal's rosy outlook,  
10 in a review of the impact of the financial crisis for  
11 utilities, a Managing Director for Fitch recently concluded,  
12 "I do not believe that borrowing costs will come down from  
13 current levels."<sup>16</sup> Even Mr. Kahal was forced to grant that  
14 "it is difficult to predict when normal conditions . . .  
15 will return to financial markets."<sup>17</sup>

16           As noted earlier, the standards underlying a fair  
17 rate of return require that Idaho Power's authorized ROE  
18 reflect a return competitive with other investments of  
19 comparable risk and preserve the Company's ability to  
20 maintain access to capital on reasonable terms. This  
21 standard can only be met by considering the requirements of  
22 investors in today's capital markets. Past trends in

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<sup>16</sup> Grabelsky, Glen, "Surviving the Present, Preparing for the Future,"  
*Fitch Ratings' 20<sup>th</sup> Annual Global Power Breakfast* (Nov. 10, 2008).

<sup>17</sup> Kahal Direct at 9.

1 interest rates or Mr. Kahal's vague sense that conditions  
2 may soon return to "normal" are irrelevant.

3 Similarly, contrary to Mr. Kahal's contention,<sup>18</sup> the  
4 fact that the current crisis may complicate the application  
5 of the DCF model or CAPM to estimate the cost of equity  
6 provides no basis to ignore the dramatic upward shift in  
7 investors' risk perceptions and required rates of return for  
8 long-term capital. Moreover, the fact that yields on long-  
9 term utility bonds have increased over 200 basis points  
10 since the IPUC's decision in Case No. IPC-E-03-13 is  
11 directly observable in the capital markets. This evidence  
12 alone - which does not depend on the DCF or CAPM approaches  
13 - demonstrates that Idaho Power's ROE must be increased  
14 substantially if the Supreme Court's standards underlying a  
15 fair rate of return are to be met in today's economic  
16 environment.

17 Q. What other evidence supports a finding that  
18 Idaho Power's cost of equity capital has increased?

19 A. Apart from the dramatic upward shift in  
20 investors' required rates of return generally, the  
21 investment risks specific to Idaho Power have also  
22 increased. Ms. Carlock's recommended ROE of 10.25 percent  
23 is equal to that authorized by the IPUC in Case No. IPC-E-

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<sup>18</sup> Kahal Direct at 10.

1 03-13, which Mr. Kahal cites as a benchmark. What both  
2 these witnesses fail to address is the fact that Idaho  
3 Power's bond ratings have declined since that time,  
4 indicating higher risks and a higher required rate of return  
5 on equity.

6 Based in large part on concerns stemming from the  
7 outcome of Idaho Power's past rate proceedings and the  
8 pressures of ongoing capital requirements, Standard & Poor's  
9 Corporation ("S&P") lowered the Company's corporate credit  
10 rating from "A-" to "BBB+" in November 2004,<sup>19</sup> and again  
11 from "BBB+" to "BBB" in January 2008.<sup>20</sup>

12 Q. Is there any direct capital market evidence  
13 regarding the amount of the premium investors require from a  
14 firm that is rated triple-B, versus one with Idaho Power's  
15 former single-A rating?

16 A. Although rates of return on equity cannot be  
17 directly observed, the observed yields on long-term bonds  
18 provide direct evidence of the additional return that  
19 investors require to bear the risks associated with weaker  
20 credit ratings. Moody's recently reported an average yield  
21 on single-A rated public utility bonds for October 2008 of  
22 7.56 percent, versus an average yield of 8.58 percent for

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<sup>19</sup> Standard & Poor's Corporation, "IDACORP and Unit Ratings Lowered, Removed From CreditWatch Negative," *RatingsDirect* (Nov. 29, 2004).

<sup>20</sup> Standard & Poor's Corporation, "IDACORP, Idaho Power Co. Ratings Lowered One Notch To 'BBB'; Outlook Stable," *RatingsDirect* (Jan. 31, 2008).

1 bonds rated triple-B. Based on this evidence, the debt  
2 markets would now require approximately 100 basis points in  
3 additional return in order to compensate for the greater  
4 risks associated with Idaho Power's current triple-B rating.  
5 Equity investors would undoubtedly require a significantly  
6 greater premium for bearing the higher risk associated with  
7 the more junior common stock of a utility with a triple-B  
8 rated company, versus one that is rated single-A.

9 Coupled with the significant increase in long-term  
10 capital costs discussed earlier, the higher risks that  
11 investors associate with Idaho Power provide further  
12 evidence that the ROE recommendations of Ms. Carlock and Mr.  
13 Kahal are inadequate. Since the 1930s, there has not been a  
14 time when the domestic and global financial markets have  
15 experienced as much turmoil and uncertainty as they are now  
16 undergoing. For a utility with an obligation to provide  
17 reliable service, investors' increased reticence to supply  
18 additional capital during times of crisis highlights the  
19 necessity of preserving the flexibility necessary to  
20 overcome periods of adverse capital market conditions. The  
21 investment risks faced by utilities and their investors have  
22 only been exacerbated in this uncertain environment. In  
23 turn, the need for supportive regulation and an adequate ROE  
24 may never have been greater.

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

4 A. If the greater risks associated with Idaho  
5 Power's weakened credit standing are not incorporated in the  
6 allowed rate of return on equity, the results will fail to  
7 meet the comparable earnings standard that Ms. Carlock  
8 agrees is fundamental in determining the cost of capital.  
9 From a more practical perspective, failing to provide  
10 investors with the opportunity to earn a rate of return  
11 commensurate with Idaho Power's risks will only serve to  
12 further weaken its financial integrity, while hampering the  
13 Company's ability to attract the capital needed to meet the  
14 economic and reliability needs of its service area.

15 Q. Does the importance of an adequate return to  
16 attract investors' capital diminish if the utility is not  
17 planning to issue new equity?

18 A. Not at all. First, it is not always within  
19 the utility's control when it will have to access equity  
20 markets. Due to its obligation to serve, a utility may have  
21 to invest new capital even during adverse market conditions  
22 and its ability to withstand such periods of stress depends  
23 to a large degree on investors' confidence in supportive  
24 regulation, including an adequate ROE.

1           In the current crisis there has been much discussion  
2 of the problems created for homeowners who were induced into  
3 buying too much house by "teaser" interest rates that were  
4 very low at the outset, but then reset to higher rates after  
5 the first few years of the mortgage. Many problems could  
6 have been avoided if, at the outset, homeowners and lenders  
7 had looked beyond the low initial payments and focused on  
8 the long-term costs and implications of their mortgage  
9 terms. The long-term perspective is similarly important for  
10 regulators. The cost to customers in the long-term may be  
11 much higher if the allowed return in the near term limits  
12 the financial resiliency of the utility and renders it  
13 unable to raise capital on reasonable terms to fund crucial  
14 infrastructure investments, especially in times of financial  
15 stress.

16           If regulators opportunistically approve inadequate  
17 returns when the utility seems to be financially sound, then  
18 investor confidence is lost. As the western energy crisis  
19 of 2000-2001 demonstrated, it cannot be easily or quickly  
20 regained by simply granting higher returns in later years.  
21 It would be both unfair to Idaho Power and against the long-  
22 term interest of customers to adopt a downward-biased ROE,  
23 such as those proposed by Ms. Carlock and Mr. Kahal.

1 IV. TERRI CARLOCK

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

4 A. Ms. Carlock estimated the cost of equity by  
5 applying the constant growth DCF model to Idaho Power's  
6 parent, IDACORP, Inc. ("IDACORP").<sup>21</sup> She concluded that the  
7 results of this DCF application indicated a cost of equity  
8 in the 8.9 percent to 9.8 percent range. Ms. Carlock also  
9 conducted a comparable earnings analysis, which resulted in  
10 an indicated cost of equity in the 9.5 percent to 10.5  
11 percent range. Based on these two analyses, Ms. Carlock  
12 concluded that the cost of equity was in the 9.5 to 10.5  
13 percent range, selecting 10.25 percent as her point estimate  
14 ROE recommendation for Idaho Power.

15 Q. Do you believe it is reasonable to rely on  
16 the DCF results for a single company in evaluating a fair  
17 ROE for Idaho Power?

18 A. No. Even for a firm with publicly traded  
19 stock, such as IDACORP, the cost of equity is inherently  
20 unobservable and can only be inferred indirectly by  
21 reference to available capital market data. As a result,  
22 applying quantitative models using observable market data  
23 only produces an estimate that inherently includes some

---

<sup>21</sup> In response to IPC Request No. 27, Ms. Carlock noted that, in addition to her independent DCF analysis for IDACORP, she also reviewed my DCF results.

1 degree of observation error. Because any form of analysis  
2 that depends on estimates is subject to measurement error,  
3 the accepted approach to increase confidence in the results  
4 is to apply the DCF model and other quantitative methods to  
5 a proxy group of publicly traded companies that investors  
6 regard as risk comparable. The results of the analysis on  
7 the sample of companies are relied upon to establish a range  
8 of reasonableness for the cost of equity for the specific  
9 company at issue.

10 To the extent that the data used to apply the DCF  
11 model does not capture the expectations that investors have  
12 incorporated into current stock prices, the resulting cost  
13 of equity estimate will be biased and unreliable.  
14 Conceptually, the issue of proxy group size is directly  
15 analogous to the use of sampling in statistical analyses.  
16 In statistics, a "true" value is often estimated by  
17 reference to sample observations, with the analyst having  
18 greater confidence in the applicability of the estimated  
19 results as the size of the sample increases. As Mr. Kahal  
20 noted, "I believe that an appropriately selected proxy group  
21 (preferably one reasonable in size) is likely to be more  
22 reliable than a single company study."<sup>22</sup> By relying on a  
23 single DCF value for IDACORP, Ms. Carlock unnecessarily

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<sup>22</sup> Kahal Direct at 18.

1 compromises the ability of the DCF analysis to reflect  
2 investors' actual expectations and requirements.

3 Q. Is there evidence of bias in Ms. Carlock's  
4 DCF analysis for IDACORP?

5 A. Yes. Despite the fact that common equity is  
6 considerably more risky than an investment in long-term  
7 debt, the low end of Ms. Carlock's DCF range falls below  
8 current yields on triple-B rated utility bonds. Similarly,  
9 with triple-B utility bond yields averaging above 9 percent  
10 so far in November 2008, the top end of her DCF range  
11 implies an equity risk premium of less than 80 basis points.  
12 In light of the risks that investors presently associate  
13 with long-term capital generally and utilities specifically,  
14 an equity risk premium of 80 basis points is far below what  
15 is necessary to ensure Idaho Power's ability to attract  
16 capital.<sup>23</sup>

17 In addition, while Ms. Carlock contended that her  
18 DCF conclusions were based in part on a review of my  
19 analyses,<sup>24</sup> as noted in my direct testimony, all but one of  
20 the average DCF estimates resulting for my proxy group  
21 exceeded 11 percent.

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<sup>23</sup> At the time the IPUC authorized a 10.25 percent ROE for Idaho Power in Case No. IPC-E-03-13, the six-month average single-A utility bond yield was approximately 6.25 percent. This implies a risk premium of 400 basis points.

<sup>24</sup> Response to IPC Request No. 27.

1 Q. Did you have the opportunity to review the  
2 details of the comparable earnings analysis that underlie  
3 Ms. Carlock's conclusions?

4 A. No. Ms. Carlock's testimony contains no  
5 schedules or exhibits presenting the results of her  
6 comparable earnings analyses. In response to Idaho Power  
7 Company's production Request No. 25, Ms. Carlock asserted  
8 that the "returns are for utility companies shown in Company  
9 witness Avera exhibits and workpapers."

10 Q. Does Ms. Carlock's comparable earnings range  
11 correspond to the returns investors are anticipating for the  
12 companies in your proxy group?

13 A. No. As indicated on my Exhibit No. 25,  
14 expected earned rates of return for the firms in my proxy  
15 group result in an average implied return on equity of 11.1  
16 percent, which is considerably higher than the 9.5 percent  
17 to 10.5 percent range cited in her testimony. In addition,  
18 as noted earlier, Value Line expects that electric utilities  
19 as a whole are anticipated to earn a return of 11.5 percent.  
20 A return that is significantly below the level that Value  
21 Line expects for electric utilities generally would  
22 undermine confidence in Idaho Power's financial integrity  
23 and its ability to attract capital.

24 Q. Do historical allowed rates of return support  
25 Ms. Carlock's ROE recommendations?

1           A.       No. While I have no basis to dispute Ms.  
2 Carlock's observation that authorized ROEs during 2007 and  
3 the first quarter of 2008 may have ranged from 9.8 percent  
4 to 11.25 percent, these historical figures completely ignore  
5 the significant changes in capital market conditions since  
6 the record in these various proceedings was established. As  
7 indicated earlier, the increase in utility bond yields  
8 translates to an upward adjustment in the cost of equity on  
9 the order of 100 basis points. As a result, adjusting the  
10 stale, historical figures underlying Ms. Carlock's analysis  
11 of authorized returns would suggest a current range on the  
12 order of 10.5 percent to 11.5 percent. As noted earlier,  
13 this is consistent with the investment community's view that  
14 "significantly higher regulated returns will be required to  
15 attract equity capital."<sup>25</sup>

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

18           A.       No. While Ms. Carlock stated that "much of  
19 the theoretical approach" that she used was consistent with  
20 my testimony, Ms. Carlock did not use the CAPM to estimate  
21 the cost of equity. As I explained in my direct testimony,  
22 the CAPM method is widely recognized as a meaningful  
23 approach to estimate investors' required rate of return.

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<sup>25</sup> Fitch Ratings Ltd., "EEI 2008 Wrap-Up: Cost of Capital Rising,"  
*Global Power North America Special Report* (Nov. 17, 2008).

1 Unlike the comparable earnings method, which depends on  
2 earned returns derived from accounting information, the CAPM  
3 approach is based on capital market data indicative of  
4 investors' current expectations. The IPUC has noted the  
5 importance of "evaluating all the methods" and "using each  
6 as a check on the other when setting the allowed rate of  
7 return."<sup>26</sup>

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

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

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<sup>26</sup> Idaho Public Utilities Commission, Order No. 29505 (May 25, 2004) at 38.

1 Regulators have customarily considered the results  
2 of alternative approaches in determining allowed returns.<sup>27</sup>  
3 It is widely recognized that no single method can be  
4 regarded as a panacea; all approaches have advantages and  
5 shortcomings. For example, a publication of the Society of  
6 Utility and Financial Analysts (formerly the National  
7 Society of Rate of Return Analysts), concluded that:

8 Each model requires the exercise of  
9 judgment as to the reasonableness of the  
10 underlying assumptions of the  
11 methodology and on the reasonableness of  
12 the proxies used to validate the theory.  
13 Each model has its own way of examining  
14 investor behavior, its own premises, and  
15 its own set of simplifications of  
16 reality. Each method proceeds from  
17 different fundamental premises, most of  
18 which cannot be validated empirically.  
19 Investors clearly do not subscribe to  
20 any singular method, nor does the stock  
21 price reflect the application of any one  
22 single method by investors.<sup>28</sup>

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

25 A. Yes. I am aware that in the past the IPUC  
26 has expressed concerns over the measurement and proper use  
27 of the beta value necessary to apply the CAPM and has not

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<sup>27</sup> 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).

<sup>28</sup> Parcell, David C., "The Cost of Capital - A Practitioner's Guide," *Society of Utility and Regulatory Financial Analysts* (1997) at Part 2, p. 4.

1 routinely focused on the results of this method.<sup>29</sup>  
2 Nevertheless, the CAPM is a rigorous conceptual framework at  
3 the heart of modern financial theory and it is widely used  
4 and referenced in the investment community. Indeed,  
5 evidence suggests that reliance on the DCF model as a tool  
6 for estimating investors' required rate of return has  
7 declined outside the regulatory sphere, with the CAPM being  
8 "the dominant model for estimating the cost of equity."<sup>30</sup>  
9 Of course, the CAPM is based on restrictive assumptions and  
10 does not describe security returns perfectly and there are  
11 controversies surrounding the measurement of key variables,  
12 such as beta. But then exactly the same could be said for  
13 the constant growth DCF model, which assumes a single,  
14 static growth rate into perpetuity that has no observable  
15 proxy in the capital markets. Moreover, I have used Value  
16 Line as the source of my betas, a reference cited by Ms.  
17 Carlock in her data responses.

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

20 A. As discussed in detail in my direct testimony  
21 and show on Table 4, the results of the CAPM approach  
22 implied cost of equity estimates ranging from 10.2 percent

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<sup>29</sup> See, e.g., Order No. 29505 at 38.

<sup>30</sup> See, e.g., Bruner, R.F., Eades, K.M., Harris, R.S., and Higgins, R.C., "Best Practices in Estimating Cost of Capital: Survey and Synthesis," Financial Practice and Education (1998).

1 to 11.9 percent, with the average of the individual values  
2 being 11.0 percent. This result is consistent with my  
3 finding that present capital market conditions imply an ROE  
4 significantly above the 10.25 percent approved in Idaho  
5 Power's last litigated rate case.

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

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

11 The competitive risks for electric  
12 utilities have changed with increasing  
13 non-utility generation, deregulation in  
14 some states, open transmission access,  
15 and changes in electricity markets.<sup>31</sup>

16 Ms. Carlock concluded that, because of these greater  
17 uncertainties, the difference in the risk between industrial  
18 firms operating in the competitive market and electric  
19 utilities "is not as great as it used to be."<sup>32</sup>

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

22 A. No. Ms. Carlock ignored the implications of  
23 this trend in investment risks for utilities, asserting  
24 instead that Idaho Power's "competitive risks" are lower  
25 because of its "low-cost source of power" and "low retail

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<sup>31</sup> Carlock Direct at 8.

<sup>32</sup> *Id.*

1 rates."<sup>33</sup> Ms. Carlock also asserted that the Power Cost  
2 Adjustment ("PCA") and Fixed Cost Adjustment ("FCA") reduce  
3 Idaho Power's risks relative to other electric utilities.<sup>34</sup>

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

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

15 Reduced hydroelectric generation due to below-  
16 average water conditions forces Idaho Power to rely on less  
17 efficient thermal generating capacity and purchased power to  
18 meet its resource needs. As the IPUC has noted, "there are  
19 no guarantees about future stream flows or market prices,"<sup>35</sup>  
20 and in light of the recent past, this dependence on  
21 wholesale markets entails significant risk in the minds of  
22 investors, especially for a utility located in the West.

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<sup>33</sup> *Id.* at 9.

<sup>34</sup> *Id.*

<sup>35</sup> *Idaho Power Granted \$256 million deferral, but bond plan denied,*  
Idaho Public Utilities Commission (May 13, 2002).

1 Investors recognize that volatile markets, unpredictable  
2 stream flows, and Idaho Power's dependence on wholesale  
3 purchases to meet the needs of its customers expose the  
4 Company to the risk of reduced cash flows, increased need  
5 for financing, and unrecovered power supply costs.

6 Apart from exposure to market uncertainties, Idaho  
7 Power also confronts the complexities associated with  
8 maintaining the necessary licenses to operate its  
9 hydroelectric stations. The process of relicensing is  
10 prolonged and involved and often includes the implementation  
11 of various studies and measures to address environmental and  
12 stakeholder concerns.<sup>36</sup> These measures can impose  
13 significant additional costs and/or lead to reduced  
14 generating capacity and flexibility.

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

18 A. No. The fact that Idaho Power had been  
19 granted a PCA does not translate into lower risk *vis-à-vis*  
20 other electric utilities. First, adjustment mechanisms to  
21 account for changes in power supply costs are the rule,  
22 rather than the exception in the utility industry, so that

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<sup>36</sup> The current license for the Hells Canyon Complex, which accounts for 68 percent of Idaho Power's hydroelectric generating capacity, expired in July 2005. Apart from significant ongoing expenditures associated with proposed environmental measures, the relicensing process is complex, protracted, and expensive.

1 the Company's PCA merely moves its risks closer to those of  
2 other utilities. Second, the PCA does not prevent the lag  
3 between the time that Idaho Power actually incurs power  
4 supply expenses and when those expenses are recovered from  
5 ratepayers. As S&P noted:

6           The Company's PCA does not currently  
7           fully insulate it under very poor or  
8           persistently low hydro conditions. In  
9           exceptionally low water years, deferrals  
10          materially weakened cash flows and credit  
11          metrics . . .<sup>37</sup>

12           Investors are well aware that the significant  
13          reduction in cash flows associated with mounting deferrals  
14          can have a debilitating impact on a utility's financial  
15          position. Moreover, investors are aware that the PCA does  
16          not apply to 100 percent of the difference between the  
17          actual cost of purchased power and the amount collected  
18          through rates, with Idaho Power's shareholders remaining at  
19          risk for a portion of any discrepancy.<sup>38</sup> As documented in  
20          my direct testimony, investors recognize that uncertainties  
21          over water conditions are a persistent operational risk  
22          associated with Idaho Power.

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<sup>37</sup> Standard & Poor's Corporation, "Summary: Idaho Power Co.,"  
*RatingsDirect* (Aug. 29, 2008).

<sup>38</sup> While the stipulation filed in October 2008 would improve Idaho  
Power's PCA mechanism by allowing the Company to collect 95 percent of  
under-collected power costs and providing a better match between actual  
expenses and revenues, S&P concluded that, while positive, these  
revisions would not result in an improvement to Idaho Power's credit  
ratings. Standard & Poor's Corporation, "Bulletin: Proposed PCA Changes  
Should Help Idaho Power Co. Recoup Costs, No Rating Change,"  
*RatingsDirect* (Oct. 16, 2008).

1 Q. Is there any merit to Ms. Carlock's position  
2 that the FCA implies lower risks for Idaho Power than for  
3 other electric utilities?

4 A. No. As explained in my direct testimony,  
5 while adjustment mechanisms such as the FCA help to preserve  
6 Idaho Power's opportunity to earn its authorized return by  
7 allowing the Company to recover reasonable and necessary  
8 expenditures, they also address the investment community's  
9 heightened concerns over the risks associated with rising  
10 costs. Of particular concern to investors is the impact of  
11 regulatory lag and cost-recovery on the utility's ability to  
12 earn its authorized ROE. For example, Moody's has  
13 emphasized the need for regulatory support "in an era of  
14 broadly rising costs," noting that as cost pressures have  
15 escalated for electric utilities, so too has the importance  
16 of timely recovery through the regulatory process and the  
17 risks associated with regulatory lag.<sup>39</sup>

18 While the FCA attenuates Idaho Power's exposure to  
19 attrition in an era of rising costs, this leveling of the  
20 playing field will only serve to preserve the Company's  
21 opportunity to earn its authorized return, as required by  
22 established regulatory standards. Indeed, S&P recently

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<sup>39</sup> Moody's Investors Service, "Regulatory Pressures Increase For U.S. Electric Utilities," *Special Comment* (March 2007).

1 observed that its risk analysis focuses on the utility's  
2 ability to consistently earn a reasonable return:

3 Notably, the analysis does not revolve  
4 around "authorized" returns, but rather  
5 on actual earned returns. We note the  
6 many examples of utilities with healthy  
7 authorized returns that, we believe,  
8 have no meaningful expectation of  
9 actually earning that return because of  
10 rate case lag, expense disallowances,  
11 etc.<sup>40</sup>

12 Since before the IPUC's 2004 decision authorizing Idaho  
13 Power an ROE of 10.25 percent, the Company's actual earned  
14 returns have fallen in the single digits, with Value Line  
15 projecting an earned return on equity for IDACORP of 7.5  
16 percent in 2008.<sup>41</sup>

17 Moreover, utilities increasingly benefit from a wide  
18 variety of mechanisms designed to mitigate against the risks  
19 associated with fluctuations in costs and regulatory lag.  
20 While these mechanisms are not always directly analogous to  
21 the specific provisions of Idaho Power's FCA, the objective  
22 is similar; namely, to allow the utility an opportunity to  
23 earn a fair rate of return and partially attenuate exposure  
24 to attrition in an era of rising costs. Reflective of this  
25 industry trend, the companies in my proxy group operate  
26 under a variety of cost adjustment mechanisms, which range

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<sup>40</sup> Standard & Poor's Corporation, "Assessing U.S. Regulatory Environments," *RatingsDirect* (Nov. 7, 2008).

<sup>41</sup> The Value Line Investment Survey (Nov. 7, 2008).

1 from riders to recover bad debt expense and post-retirement  
2 employee benefit costs to adjustment clauses designed to  
3 address the rising costs of environmental compliance  
4 measures.

5 For example, apart from revenue decoupling and other  
6 attrition rate adjustments, Pacific Gas and Electric Company  
7 benefits from a number of other balancing account mechanisms  
8 that cover a significant portion of its revenue  
9 requirements. Similarly, Xcel Energy, Inc., also benefits  
10 from a transmission cost recovery adjustment that allows the  
11 utility to recover incremental transmission investments  
12 between rate cases, as well as an adjustment clause to  
13 account for the impact of demand side management programs.  
14 Moreover, in response to the heightened risk associated with  
15 utilities' exposure to substantial costs for environmental  
16 remediation, adjustment mechanisms designed to allow for  
17 recovery of these costs outside a general rate case have  
18 become increasingly prevalent. Considering that the impact  
19 of various adjustment mechanisms is already reflected in the  
20 cost of equity estimates for the proxy firms, there is no  
21 basis for Ms. Carlock's contention that Idaho Power's risks  
22 are lower than for other electric utilities.

23 Q. Does reference to objective risk measures  
24 confirm your conclusion that Idaho Power's investment risks  
25 are comparable to the utilities in your proxy group?

1           A.       Yes. As discussed in my direct testimony,  
2 Idaho Power is rated "BBB" by S&P, which is identical to the  
3 average for the firms in the Utility Proxy Group.  
4 Meanwhile, Value Line has assigned IDACORP a Safety Rank of  
5 "3" and a Financial Strength Rating of "B+", which are also  
6 the same as the proxy group average. These criteria, which  
7 reflect objective, published indicators that incorporate  
8 consideration of a broad spectrum of risks, including the  
9 impact of regulatory adjustment clauses, financial and  
10 business position, relative size, and exposure to company  
11 specific factors, demonstrate that investors regard this  
12 group as having comparable risks to Idaho Power.

13           Q.       Do you believe that investment community risk  
14 indicators, such as S&P's credit ratings, may not reflect an  
15 informed assessment of regulatory risks?

16           A.       No. Ms. Carlock indicated that in assigning  
17 credit ratings "regulatory risks may not be fully analyzed,"  
18 and she asserted that "regulatory mechanisms for example may  
19 not be completely understood and may not be adequately  
20 reflected."<sup>42</sup> In fact, however, the investment community  
21 clearly recognizes that an accurate evaluation of regulatory  
22 climate, including the specific adjustment mechanisms  
23 affecting a utility's cash flows, is critical in any

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<sup>42</sup> Response to IPC Request No. 23.

1 assessment of investment risk. For example, S&P noted in a  
2 recent publication entitled "Assessing U.S. Utility  
3 Regulatory Environments " that, "The assessment of  
4 regulatory risk is perhaps the most important factor in  
5 Standard & Poor's Ratings Services' analysis of a U.S.  
6 regulated, investor-owned utility's business risk."<sup>43</sup>  
7 Credit rating agencies such as S&P devote considerable  
8 resources towards their analyses of a utility's credit  
9 risks, including the impact of regulation and related  
10 adjustment mechanisms.

11 With respect to Idaho Power specifically, Moody's  
12 concluded, "A key consideration in order for [Idaho Power]  
13 to stabilize its rating outlook and maintain its Baal senior  
14 unsecured rating will be the extent to which the IPUC is  
15 supportive in any future regulatory filings."<sup>44</sup> Similarly,  
16 Fitch noted that "[m]eaningful price increases will be  
17 required to recover planned capital expenditures to meet  
18 infrastructure and growth requirements,<sup>45</sup> while S&P cited  
19 "[r]egulatory challenges in meeting rising costs and a large

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<sup>43</sup> Standard & Poor's Corporation, "Assessing U.S. Regulatory Environments," *RatingsDirect* (Nov. 7, 2008).

<sup>44</sup> Moody's Investors Service, "Credit Opinion: Idaho Power Company," *Global Credit Research* (June 4, 2008).

<sup>45</sup> Fitch Ratings, Ltd., "Idaho Power Company," *Global Power U.S. and Canada Credit Analysis* (Apr. 10, 2008).

1 capital expenditure program" as a key risk exposure.<sup>46</sup> The  
2 investment community is aware of the impact that regulatory  
3 decisions can have on Idaho Power's risks, and there is no  
4 basis to conclude that their risk assessment is somehow  
5 lacking.

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

9 A. As noted earlier, the outcome of Idaho  
10 Power's last rate proceeding in Case No. IPC-E-03-13 was  
11 instrumental in S&P's decision to downgrade Idaho Power's  
12 corporate credit rating from "A-" to "BBB+" in November  
13 2004. In explaining that action, S&P noted:

14 Following the IPUC staff's 3.1% rate  
15 increase recommendation in February  
16 2004, Standard & Poor's said that "a  
17 final decision by the commission that  
18 adopted a rate increase akin to that  
19 proposed by the staff could have an  
20 adverse effect on bondholder protection  
21 measures." The final IPUC ruling is  
22 indeed substantially closer to the  
23 staff's position than the company's, and  
24 will weaken credit protection  
25 measures.<sup>47</sup>

26 Similarly, Moody's also downgraded the Company's issuer  
27 rating from "A3" to "Baa1", citing the risks associated with

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<sup>46</sup> Standard & Poor's Corporation, "Idaho Power Co.," *RatingsDirect* (Feb. 1, 2008).

<sup>47</sup> Standard & Poor's Corporation, "IDACORP and Unit Ratings Lowered, Removed From CreditWatch Negative," *RatingsDirect* (Nov. 29, 2004).

1 hydroelectric power and ongoing capital commitments, as well  
2 as the need for additional regulatory support as key factors  
3 leading to lower credit ratings for Idaho Power:

4           The downgrade of IPC's ratings reflects:  
5           1) expected weaker cash flow coverage of  
6           interest and debt; 2) the likelihood for  
7           continued negative free cash flow over  
8           the next few years, with internally  
9           generated funds falling short of meeting  
10          the dividend requirements of IDACORP and  
11          significant utility-related capital  
12          spending; 3) persistent drought  
13          conditions that are likely to result in  
14          higher supply costs, not all of which  
15          are recoverable under the utility's  
16          power cost adjustment mechanism; 4) the  
17          final resolution this fall of the  
18          company's rate case, which resulted in a  
19          revenue increase of a little more than  
20          half of the company's updated request;  
21          and 5) the likely need for additional  
22          support from the Idaho Public Utility  
23          Commission (IPUC) in future rate  
24          proceedings as IPC adds new generation  
25          and transmission infrastructure to help  
26          meet customer and load growth and ensure  
27          reliability of service.<sup>48</sup>

28          Citing similar concerns over deteriorating financial  
29          metrics, S&P again lowered Idaho Power's corporate credit  
30          rating from "BBB+" to "BBB" in January 2008,<sup>49</sup> with Moody's

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<sup>48</sup> Moody's Investors Service, "Ratings Action: IDACORP, Inc.," *Global Credit Research* (Dec. 3, 2004).

<sup>49</sup> Standard & Poor's Corporation, "IDACORP, Idaho Power Co. Ratings Lowered One Notch To 'BBB'; Outlook Stable," *RatingsDirect* (Jan. 31, 2008).

1 and Fitch presently maintaining a "negative" outlook for  
2 Idaho Power's credit standing.<sup>50</sup>

3           Considering these successive downgrades and the fact  
4 that Moody's and Fitch have already assigned a "negative"  
5 outlook to Idaho Power, the perception of lack of regulatory  
6 support would undoubtedly place further downward pressure on  
7 current ratings. Such an outcome would be inconsistent with  
8 the IPUC's stated desire to maintain Idaho Power's credit  
9 ratings and lends further support for a return on equity  
10 above the top of Ms. Carlock's recommended range.<sup>51</sup>

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

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

20                   Regulatory risk remains a recurring  
21                   theme in Fitch's 2008 outlook. For  
22                   regulated electric utilities, there is  
23                   continuing event risk related to state

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<sup>50</sup> Moody's Investors Service, "Moody's Changes Outlook Of Idacorp And Sub To Negative," *Press Release* (June 3, 2008); Fitch Ratings Ltd., "Idaho Power Company," *Global Power U.S. and Canada Credit Analysis* (Apr. 10, 2008).

<sup>51</sup> Idaho Public Utilities Commission, Order No. 29505 (May 25, 2004) at 43.

1 regulatory and political reactions to  
2 higher energy bills. . . . The risk is  
3 heightened by the convergence of rising  
4 costs for fuel, equipment and  
5 maintenance materials, pension and  
6 medical benefits, and infrastructure  
7 investments.<sup>52</sup>

8 More recently, S&P concluded "the quality of regulation is  
9 at the forefront of our analysis of utility  
10 creditworthiness."<sup>53</sup> Accordingly, it is critical to assure  
11 investors' confidence in a balanced approach if reasonable  
12 access to capital is to be maintained.

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

17 A. In my opinion, Ms. Carlock's recommended  
18 10.25 percent cost of equity falls well short of the rate of  
19 return that investors require from Idaho Power. In order to  
20 maintain and expand utility infrastructure, it is both  
21 reasonable and necessary that the Company be provided the  
22 opportunity to maintain its credit standing and ability to  
23 attract capital. To meet these challenges successfully and  
24 economically - particularly during times of capital market  
25 adversity - it is crucial that Idaho Power receive adequate

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<sup>52</sup> Fitch Ratings, Ltd., "U.S. Utilities, Power & Gas 2008 Outlook," at 5 (Dec. 11, 2007).

<sup>53</sup> Standard & Poor's Corporation, "Assessing U.S. Utility Regulatory Environments," *RatingsDirect* (Nov. 7, 2008).

1 support for its credit standing. Ms. Carlock's  
2 recommendation is inadequate to meet this goal.

3 At the very least, the IPUC should consider the  
4 dramatic upward shift in long-term capital costs and the  
5 deterioration in Idaho Power's credit ratings since it  
6 approved a 10.25 percent ROE for the Company in Case No.  
7 IPC-E-03-13. Ms. Carlock granted that, in selecting a point  
8 estimate from within a range, "any point within [the] range  
9 is reasonable."<sup>54</sup> Coupled with the higher returns demanded  
10 by investors, the ongoing risks associated with Idaho  
11 Power's continued exposure to wholesale power markets, and  
12 the downward pressures on its credit standing, this would  
13 suggest a minimum cost of equity at the very top of Ms.  
14 Carlock's 9.5 percent to 10.5 percent range.

15 **V. MATTHEW I. KAHAL**

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

18 A. Mr. Kahal recommended a 10.5 percent ROE for  
19 Idaho Power based primarily on the results of the constant  
20 growth DCF model applied to alternative groups of electric  
21 utilities. Mr. Kahal developed his proxy groups based on  
22 the companies included in Value Line's Electric Utility  
23 (West) industry group, as well as a subset of the comparable

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<sup>54</sup> Carlock Direct at 15.

1 utilities developed in my direct testimony that Mr. Kahal  
2 characterized as operating in "non-restructured" states. In  
3 addition to the DCF model, Mr. Kahal also examined  
4 historical and projected earned rates of return for his  
5 reference groups. Based on the results of his analyses, Mr.  
6 Kahal concluded that a reasonable cost of equity would fall  
7 in the range of 9.4 percent to 10.4 percent, although the  
8 DCF results for his two proxy groups suggested a range of  
9 9.9 percent to 10.4 percent and 9.6 percent to 10.6 percent,  
10 respectively. In explaining his recommended ROE of 10.5  
11 percent for Idaho Power, Mr. Kahal noted that it was "toward  
12 the upper end" of his DCF range.<sup>55</sup>

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

16 A. No. Apart from passing reference to the  
17 comparable earnings approach, which I address subsequently,  
18 Mr. Kahal ignored the results of other methods, such as the  
19 CAPM, to check or validate his results. As I explained  
20 earlier, however, no single method or model should be relied  
21 upon to determine a utility's cost of equity because no  
22 single approach can be regarded as wholly reliable.  
23 Considering the results of alternative methods and

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<sup>55</sup> Kahal Direct at 42.

1 approaches provides greater confidence that the end result  
2 is reflective of investors' required rate of return.

3 *Regulatory Finance: Utilities' Cost of Capital* concluded  
4 that:

5 When measuring equity costs, which  
6 essentially deal with the measurement of  
7 investor expectations, no one single  
8 methodology provides a foolproof  
9 panacea. If the cost of equity  
10 estimation process is limited to one  
11 methodology, such as DCF, it may  
12 severely bias the results.<sup>56</sup>

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

16 A. No. There is every indication that Mr.  
17 Kahal's results are biased downward and fail to reflect  
18 investors' required rate of return. As Mr. Kahal correctly  
19 observed, the "g" component of the DCF model should be  
20 prospective and must reflect the growth "*expected by*  
21 *investors.*"<sup>57</sup> But as he went on to note, the environment  
22 presumed by the constant growth DCF approach he employed  
23 does not exist in reality. Mr. Kahal granted the  
24 significant dislocations recently faced by electric  
25 utilities, noting that:

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<sup>56</sup> Morin, Roger, "Regulatory Finance: Utilities' Cost of Capital,"  
Public Utilities Reports, Inc. at 238 (1994).

<sup>57</sup> Kahal Direct at 17 (emphasis original).

1 [M]y experience in recent years with  
2 utilities has been that these historic  
3 measures have been very volatile and are  
4 not reliable as long-run prospective  
5 measures. This may be due in part to  
6 extensive corporate restructuring in the  
7 energy industry.<sup>58</sup>

8 And while Mr. Kahal noted that his projected growth rates  
9 "warrants substantial emphasis," he also recognized that  
10 "[t]here are a number of reasons why investor expectations  
11 of long-run growth could differ from the limited, five-year  
12 projections from security analysts."<sup>59</sup> Considering that  
13 investors' expectations could differ substantially from the  
14 growth rates he relied on, Mr. Kahal concluded that the  
15 resulting cost of equity estimates "should be subject to a  
16 reasonableness test and corroboration."<sup>60</sup> If the growth  
17 projections used to apply the DCF model do not fully reflect  
18 the long-term expectations investors have built into stock  
19 prices, the resulting cost of equity estimates will be  
20 biased downward.

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

24 A. No. Mr. Kahal's mechanical application of  
25 the constant growth DCF model contradicts his own

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<sup>58</sup> Kahal Direct at 21.

<sup>59</sup> Kahal Direct at 22-23.

<sup>60</sup> Kahal Direct at 23.

1 admonishment to avoid simply plugging alternative growth  
2 rates into the DCF formula with no consideration for the  
3 reasonableness of the end results. In fact, many of the  
4 growth measures embodied in Mr. Kahal's constant growth DCF  
5 application make no economic sense.

6 For example, consider the fact that four of the  
7 Value Line growth rates reported on page 4 of Mr. Kahal's  
8 Exhibit No. 604 were 2.0 percent or less. A growth rate of  
9 2.0 percent, when combined with Mr. Kahal's average dividend  
10 yield of approximately 3.9 percent,<sup>61</sup> suggests a DCF cost of  
11 equity estimate of approximately 5.9 percent. Indeed, one  
12 of the growth values that Mr. Kahal referenced was less than  
13 zero,<sup>62</sup> implying that the utility's cost of equity is below  
14 its dividend yield. Similarly, almost one-third of the  
15 individual growth rates contained on page 5 of Mr. Kahal's  
16 Exhibit No. 604 were 3.0 percent or less, implying a cost of  
17 equity of at most 6.9 percent. These implied cost of equity  
18 estimates fall far below the average yield on triple-B  
19 public utility bonds reported by Moody's for October 2008 of  
20 approximately 8.6 percent.<sup>63</sup> Clearly, the risks associated  
21 with an investment in public utility common stocks exceed

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<sup>61</sup> Exhibit No. 604, p. 1. This actually overstates the dividend yield, which Mr. Kahal has adjusted for one-half years' growth.

<sup>62</sup> Exhibit No. 604, p. 4.

<sup>63</sup> Moody's Investors Service, *CreditTrends.com* (retrieved Nov. 14, 2008).

1 those of long-term bonds, and Mr. Kahal's growth measures  
2 result in a built-in downward bias to his DCF conclusions,  
3 which provide no meaningful information regarding the  
4 expectations and requirements of investors.

5 Q. What other evidence indicates that Mr.  
6 Kahal's DCF analysis fails to reflect the current  
7 requirements of investors?

8 A. As indicated earlier, Mr. Kahal made no  
9 attempt to reflect the impact of the ongoing financial  
10 crisis on investors' required returns. Considering the  
11 dramatic upward trend in long-term capital costs, this  
12 omission virtually ensures that Mr. Kahal's recommendations  
13 are downward biased. Consider the dividend yield component  
14 of Mr. Kahal's DCF analysis, for example. While Mr. Kahal  
15 noted a "slight upward trend" in dividend yields over the  
16 six-month period ending September 2008,<sup>64</sup> he nonetheless  
17 elected to base his analysis "on market conditions during  
18 the second and third calendar quarters of 2008,"<sup>65</sup> rather  
19 than relying on the most recent information available to  
20 him.

21 Q. How do current dividend yields for Mr.  
22 Kahal's proxy groups compare with the values used in his DCF  
23 analysis?

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<sup>64</sup> Kahal Direct at 20.

<sup>65</sup> Kahal Direct at 24.

1           A.       Since September 2008, utility stock prices  
2 have continued to decline sharply in response to the upward  
3 revision in investors' required returns. As a result,  
4 dividend yields have also increased significantly. As shown  
5 on Exhibit No. 81, based on average closing prices in  
6 November 2008, the expected dividend yield for Mr. Kahal's  
7 West Region proxy group is now approximately 4.7 percent,  
8 versus the 3.9 percent calculated in his direct testimony.  
9 Similarly, the indicated dividend yield for Mr. Kahal's  
10 Restricted West Region proxy group is now on the order of  
11 5.1 percent, which is 50 basis points higher than the 4.6  
12 percent figure used in his analysis.

13           Q.       What cost of equity is indicated if current  
14 dividend yields are incorporated into Mr. Kahal's DCF  
15 analysis?

16           A.       As shown on Exhibit No. 82, incorporating a  
17 dividend yield for Mr. Kahal's proxy groups based on average  
18 closing stock prices in November 2008 results in midpoint  
19 cost of equity estimates for the West Region and Restricted  
20 West Region groups of 10.95 percent and 10.61 percent,  
21 respectively. Because these estimates rely on Mr. Kahal's  
22 growth rate ranges, which incorporate the impact of  
23 illogical values discussed earlier, these results continue  
24 to be downward biased. Nevertheless, they confirm my  
25 earlier conclusion that a fair ROE for Idaho Power should be

1 established above the 10.5 percent upper end of Ms.  
2 Carlock's ROE range.

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

6 A. No. Mr. Kahal simply asserted (p. 30) that,  
7 because the objective in this case was to determine an ROE  
8 for Idaho Power's regulated utility operations, data for  
9 unregulated companies have "no value at all." Although he  
10 provides no detailed explanation for his position, Mr. Kahal  
11 apparently contends that the investment risks of my non-  
12 utility group were not comparable to Idaho Power or the  
13 utility proxy group I developed in my testimony. In fact,  
14 however, participation in competitive markets says nothing  
15 at all about the overall investment risks perceived by  
16 investors, which is the very basis for a fair rate of  
17 return.

18 For example, consider (1) an electric utility  
19 operating in regulated markets that has experienced an  
20 inability to recover the costs incurred to provide service,  
21 and (2) Wal-Mart Stores, Inc. ("Wal-Mart"), which faces  
22 competition on numerous fronts. Despite its lack of a  
23 regulated monopoly, with a double-A bond rating, the highest  
24 Value Line Safety Rank, and a beta of 0.70, the investment  
25 community would undoubtedly regard Wal-Mart as the less

1 risky alternative. In fact, my review of objective  
2 indicators of investment risk - which consider the impact of  
3 competition and market share - demonstrated that, if  
4 anything, the non-utility proxy group is less risky in the  
5 minds of investors than the common stock of electric  
6 utilities, including Idaho Power.<sup>66</sup>

7           Meanwhile, Mr. Kahal's contention (p. 27) that an  
8 estimate of the required return for firms in the competitive  
9 sector of the economy "is not reasonable for use in this  
10 case" is wrong. In fact, returns in the competitive sector  
11 of the economy form the very underpinning for utility ROEs  
12 because regulation purports to serve as a substitute for the  
13 actions of competitive markets. The Supreme Court has  
14 recognized in the *Bluefield* and *Hope* cases that it is the  
15 degree of risk, not participation in particular business  
16 activities, which is relevant in evaluating an allowed ROE  
17 for a utility.

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

21           A.       No. Mr. Kahal argued for the elimination of  
22 companies based on an assessment of the degree of regulatory  
23 restructuring at the retail level or participation in non-

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<sup>66</sup> As shown in Table 2 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.

1 utility operations. However, he failed to demonstrate how  
2 his subjective criteria translate into differences in the  
3 investment risks perceived by investors. As I amply  
4 demonstrated in my direct testimony,<sup>67</sup> a comparison of  
5 objective indicators demonstrates that investment risks for  
6 the firms in my proxy groups are relatively homogeneous and  
7 comparable to Idaho Power. Moreover, there are significant  
8 errors and inconsistencies associated with Mr. Kahal's  
9 approach that justify rejecting his alternative proxy groups  
10 altogether.

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

14 A. No. Under the regulatory standards  
15 established by *Hope* and *Bluefield*, the salient criteria in  
16 establishing a meaningful proxy group to estimate investors'  
17 required return is relative risk, not the degree of  
18 regulatory restructuring. Mr. Kahal presented no evidence  
19 to demonstrate a connection between the subjective criteria  
20 that he employed and the views of real-world investors in  
21 the capital markets.

22 Q. What objective evidence can be evaluated to  
23 confirm the conclusion that these subjective criteria are

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<sup>67</sup> Pages 36-38 and 50-52.

1 not synonymous with comparable risk in the minds of  
2 investors?

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

11 Concrete evidence supporting the  
12 relationship between bond ratings and  
13 the quality of a security is abundant  
14 . . . . The strong association between  
15 bond ratings and equity risk premiums is  
16 well documented in a study by Brigham  
17 and Shome (1982).<sup>68</sup>

18 While credit ratings provide the most widely  
19 referenced benchmark for investment risks, other quality  
20 rankings published by investment advisory services and  
21 rating agencies also provide relative assessments of risk  
22 that are considered by investors in forming their  
23 expectations. For example, Mr. Kahal considered Value  
24 Line's Safety Rank, beta, and Financial Strength Rating in  
25 evaluating his reference group.<sup>69</sup>

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<sup>68</sup> Morin, Roger A., "Regulatory Finance: Utilities' Cost of Capital,"  
*Public Utility Reports* (1994) at 81.

<sup>69</sup> Exhibit No. 603.

1           As I noted in my direct testimony (p. 38), my proxy  
2 group of 27 electric utilities had an average corporate  
3 credit rating of triple-B. Similarly, credit ratings  
4 assigned to the eleven utilities excluded by Mr. Kahal based  
5 on his subjective tests ranged from "BBB-" to "BBB+" and  
6 were entirely comparable to those assigned to the remainder  
7 of the companies in my utility proxy group. Considering  
8 that credit ratings provide one of the most widely  
9 referenced benchmarks for investment risks, a comparison of  
10 this objective risk indicator demonstrates that the range of  
11 risks for the companies eliminated under the subjective  
12 criteria proposed by Mr. Kahal are virtually identical to  
13 the remaining companies that he accepted as comparable. A  
14 review of the key Value Line risk indicators discussed in my  
15 direct testimony also confirm the conclusion that the firms  
16 excluded by Mr. Kahal are entirely comparable to the  
17 remainder of my utility proxy group. In fact, PG&E  
18 Corporation, which was one of my proxy companies deemed by  
19 Mr. Kahal to be "less useful and appropriate,"<sup>70</sup> was  
20 included in his own West Region proxy group.

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

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<sup>70</sup> Kahal Direct at 28.

1           A.           While Mr. Kahal proposes to eliminate  
2 companies based on his assessment of the proportion of  
3 revenues from regulated utility operations, he presented no  
4 explanation or evidence supporting his "test." Apart from  
5 the fact that it is often impossible to accurately apportion  
6 financial measures between utility and non-utility sources,  
7 Mr. Kahal's subjective assessment is inconsistent with the  
8 companies he accepted in his own reference group of western  
9 utilities. For example, while Mr. Kahal argued to exclude  
10 companies with "substantial unregulated operations," he  
11 included Black Hills Corporation ("Black Hills") in his  
12 reference group. Black Hills reported in its most recent  
13 Form 10-K Report that its utility operations accounted for  
14 44 percent of operating revenues, with other operations -  
15 including oil and gas and coal mining, making up the  
16 remaining 55 percent. Similarly, in addition to its  
17 electric utility operations, Hawaiian Electric Industries,  
18 Inc. ("Hawaiian Electric") also owns and operates American  
19 Savings Bank, which is the third largest financial  
20 institution in Hawaii. Despite the fact that competitive  
21 banking activities accounted for approximately 41 percent of  
22 operating income in 2007, Mr. Kahal elected to include  
23 Hawaiian Electric in his proxy group. Thus, Mr. Kahal's  
24 evaluation of my proxy companies is totally at odds with his  
25 own evaluation and analyses.

1           Similarly, Mr. Kahal's assertions concerning the risks  
2 associated with restructuring are ill-defined and  
3 inconsistent with his arguments over the implications of  
4 competition. For example, while Mr. Kahal argues that  
5 CenterPoint Energy should be excluded because it operates in  
6 restructured power markets, CenterPoint Energy is engaged  
7 almost exclusively in providing regulated electric and gas  
8 distribution and transmission services.<sup>71</sup> As CenterPoint  
9 Energy noted:

10                   It is a transmission and distribution  
11                   electric utility that operates wholly  
12                   within the state of Texas. Neither  
13                   CenterPoint Houston nor any other  
14                   subsidiary of CenterPoint Energy makes  
15                   sales of electric energy at retail or  
16                   wholesale, or owns or operates any  
17                   electric generating facilities.<sup>72</sup>

18           While CenterPoint Energy does not participate in  
19 restructured wholesale power markets, Avista Corp. - one of  
20 the companies included in Mr. Kahal's reference group -  
21 specifically informed investors of its exposure to the risks  
22 of energy commodity markets and reported that wholesale  
23 power market purchases accounted for almost 30 percent of  
24 total energy needs.<sup>73</sup> Again, the circumstances faced by the

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<sup>71</sup> 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.

<sup>72</sup> CenterPoint Energy 2007 Form 10-K Report at 2.

<sup>73</sup> Avista Corp. 2007 Form 10-K Report at 11.

1 utilities in Mr. Kahal's own proxy group are inconsistent  
2 with the subjective "tests" he proposes.

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

5 A. While Mr. Kahal declined to consider the  
6 results of the CAPM in arriving at his recommendation, he  
7 relied on a market risk premium of 6.0 percent, which he  
8 apparently derived from a single journal article and two  
9 selected studies reported in a finance textbook.<sup>74</sup>

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

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

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<sup>74</sup> Kahal Direct at 35-36.

1           The cost of capital is always an  
2           expectational or forward-looking  
3           concept. While the past performance of  
4           an investment and other historical  
5           information can be good guides and are  
6           often used to estimate the required rate  
7           of return on capital, the expectations  
8           of future events are the only factors  
9           that actually determine cost of  
10          capital.<sup>75</sup>

11         By failing to look directly at the returns investors are  
12         currently requiring in the capital markets, as I did on  
13         Exhibit No. 21, Mr. Kahal's CAPM estimate significantly  
14         understates investors' required rate of return.

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

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

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<sup>75</sup> Morningstar, *Ibbotson SBBI, 2008 Valuation Yearbook* at 23.

1 The debate surrounding the equity risk  
2 premium arises because theoretically  
3 such premia are concerned with the  
4 extent to which risky stocks are  
5 "expected" to outperform a (relatively)  
6 safe investment, whereas excess returns  
7 are estimated values of this  
8 outperformance derived from observed  
9 data. The lack of consensus regarding  
10 the true value of the equity risk  
11 premium arises from the fact that  
12 expectations are unobservable hence can  
13 only be estimated, and that such  
14 estimates will vary over time depending,  
15 in part at least, on the sample period  
16 used.<sup>76</sup>

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

25 Moreover, even if historical studies were relevant  
26 in this context, there are other such studies of equity risk  
27 premiums published in academic journals that imply required  
28 rates of return considerably in excess of those selected by  
29 Mr. Kahal. For example, a study reported in the *Financial*  
30 *Analysts' Journal* noted that the real risk premium for U.S.

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<sup>76</sup> 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.

1 stocks averaged 6.9 percent over the period 1889 through  
2 2000 and concluded that:

3 Over the long term, the equity risk  
4 premium is likely to be similar to what  
5 it has been in the past and returns to  
6 investment in equity will continue to  
7 substantially dominate returns to  
8 investments in T-bills for investors  
9 with a long planning horizon.<sup>77</sup>

10 Similarly, based on a study of *ex-ante* expected returns for  
11 a sample of S&P 500 firms over the 1983-1998 period, a 2003  
12 article in *Financial Management* found an expected market  
13 risk premium of 7.2 percent.<sup>78</sup>

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

19 The above discussion suggests that the  
20 equity premium debate is far from over,  
21 and that the use of excess returns as a  
22 proxy for such premia, while convenient,  
23 may capture a substantial amount of  
24 noise and be uncorrelated with equity  
25 risk premia particularly over the short-  
26 run.<sup>79</sup>

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<sup>77</sup> Mehra, Ranjnish, "The Equity Premium: Why Is It a Puzzle?", *Financial Analysts' Journal* (January/February 2003).

<sup>78</sup> 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.

<sup>79</sup> 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.

1 In fact, no selected historical study, or group of studies,  
2 is a substitute for an analysis of investors' current  
3 expectations in the capital markets, such as that  
4 incorporated in my CAPM analysis shown on Exhibit No. 21.

5 Q. Do the "real world" risk premiums relied on  
6 by Mr. Kahal make economic sense?

7 A. No. As noted on page 36 of Mr. Kahal's  
8 testimony, the historical surveys included in his assessment  
9 found market equity risk premiums of 5.5 percent and 3.8  
10 percent. But multiplying these market equity risk premiums  
11 by Mr. Kahal's beta of 0.83, and combining the resulting  
12 risk premiums with his 4.5 percent risk-free rate, results  
13 in indicated cost of equity estimates of approximately 7.7  
14 percent and 9.1 percent. These returns fall at or below  
15 current yields on triple-B utility bonds and are  
16 dramatically lower than the earnings Value Line expects  
17 utilities to achieve in coming years. By any objective  
18 measure, such results fall woefully short of required  
19 returns from an investment in Idaho Power's common equity  
20 and confirm that the inputs to Mr. Kahal's CAPM cost of  
21 equity have little relation to the expectation of real-world  
22 investors.

23 Q. Is there anything wrong with the approach  
24 that you employed to determine the equity risk premium for  
25 your forward-looking CAPM analysis (Exhibit No. 21)?

1           A.       No. As explained in my direct testimony, I  
2 estimated the current equity risk premium by first applying  
3 the DCF model to estimate investors' current required rate  
4 of return for the firms in the S&P 500 and then subtracting  
5 the yield on government bonds. Mr. Kahal contends that this  
6 CAPM analysis is flawed because of an alleged upward bias in  
7 the market risk premium. In fact, however, the use of  
8 forward-looking expectations in estimating the market risk  
9 premium is well accepted in the financial literature. For  
10 example, in "The Market Risk Premium: Expectational  
11 Estimates Using Analysts' Forecasts" [*Journal of Applied*  
12 *Finance*, Vol. 11 No. 1, 2001], Robert S. Harris and Felicia  
13 C. Marston employed the DCF model and earnings growth  
14 projections from IBES - just as I did in Exhibit No. 21.

15           Mr. Kahal's complaint about my forward-looking CAPM  
16 approach seems to hinge on the fact that this method  
17 produces an equity risk premium for the S&P 500 that is  
18 considerably higher than the unrealistic benchmarks he  
19 cites. But as I explained earlier, estimating investors'  
20 required rate of return by reference to current, forward-  
21 looking data, as I have done, is entirely consistent with  
22 the theory underlying the CAPM methodology, which is an ex-  
23 ante, or forward-looking model based on expectations of the  
24 future. As a result, in order to produce a meaningful  
25 estimate of required rates of return, the CAPM is best-

1 applied using data that reflects the expectations of actual  
2 investors in the market. Rather than look backwards to risk  
3 premiums based on historical literature articles or surveys,  
4 my analysis appropriately focused on the expectations of  
5 actual investors in today's capital markets.

6 Q. Is there any merit to Mr. Kahal's contention  
7 that the CAPM analysis should consider alternative beta  
8 values?

9 A. No. Application of any quantitative  
10 technique to estimate the cost of equity is an attempt to  
11 determine the expectations and requirements of real-world  
12 investors in the capital markets. In this regard, the Value  
13 Line beta values I used to apply the CAPM are perhaps the  
14 best indicator of the risks investors are likely to  
15 associate with electric utilities such as Idaho Power. As  
16 noted in *Regulatory Finance: Utilities' Cost of Capital:*

17 Value Line betas are computed on a  
18 theoretically sound basis using a  
19 broadly-based market index, and they are  
20 adjusted for the regression tendency of  
21 betas to converge to 1.00. . . . Value  
22 Line is the largest and most widely  
23 circulated independent investment  
24 advisory service, and exerts influence  
25 on a large number of institutional and  
26 individual investors and on the  
27 expectations of these investors.<sup>80</sup>

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<sup>80</sup> Morin, Roger A., "Regulatory Finance: Utilities' Cost of Capital,"  
Public Utilities Reports (1994) at 65.

1 In my experience, Value Line is the most widely referenced  
2 source for beta in regulatory proceedings and Mr. Kahal has  
3 presented no evidence that would call these values into  
4 question.

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

7 A. By failing to evaluate the economic logic of  
8 the individual returns for the companies in his reference  
9 group, Mr. Kahal's comparable earnings analysis suffers from  
10 the same flaw explained earlier in connection with his DCF  
11 application. For example, Mr. Kahal's comparable earnings  
12 results included a number of values that fall below current  
13 yields on public utility bonds.<sup>81</sup> Indeed, almost one-half  
14 of the individual returns included in Mr. Kahal's comparable  
15 earnings approach for his West Region proxy group (Exhibit  
16 No. 606, p. 1) were equal to 8.5 percent or less. With  
17 triple-B public utility bonds yielding 8.6 percent in  
18 October 2008, these values provide no meaningful guide to  
19 investors' expected rate of return. As a result, Mr.  
20 Kahal's comparable earnings analysis is woefully understated  
21 and should be ignored.

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<sup>81</sup> See, e.g., the 4.2 percent and 5.5 percent returns for Avista Corp. and Black Hills Corp., respectively, included on page 1 of Exhibit No. 606.

1           Q.       Is there any merit to Mr. Kahal's admonition  
2 (p. 38) that market-to-book ratios for electric utilities  
3 should be considered in establishing Idaho Power's allowed  
4 rates of return?

5           A.       No. Underlying Mr. Kahal's argument is the  
6 supposition that regulators should set a required rate of  
7 return to produce a market-to-book value of approximately  
8 1.0. This is fallacious. For example, *Regulatory Finance:  
9 Utilities Cost of Capital* noted that:

10                   The stock price is set by the market,  
11                   not by regulators. The M/B ratio is the  
12                   end result of regulation, and not its  
13                   starting point. The view that  
14                   regulation should set an allowed rate of  
15                   return so as to produce a M/B of 1.0,  
16                   presumes that investors are masochistic.  
17                   They commit capital to a utility with a  
18                   M/B in excess of 1.0, knowing full well  
19                   that they will be inflicted a capital  
20                   loss by regulators. This is not a  
21                   realistic or accurate view of  
22                   regulation.<sup>82</sup>

23                   Indeed, while Mr. Kahal's example supposes that  
24 investors expect an earned return of 11.0 percent on the  
25 common equity of his hypothetical utility, he suggests that  
26 regulators only need to allow the utility an ROE of 7.3  
27 percent. In other words, Mr. Kahal apparently believes that  
28 regulators should establish equity returns that will cause  
29 share prices to fall. Given the regulatory imperative of

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<sup>82</sup> *Id.* at 256.

1 preserving a utility's ability to attract capital, this  
2 would be a truly nonsensical result.

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

7 A. No. Mr. Kahal cites the 10.25 percent ROE  
8 approved for Idaho Power in Case No. IPC-E-03-13, presumably  
9 as support for the reasonableness of his 10.5 percent ROE  
10 recommendation here. But as discussed earlier in response  
11 to Ms. Carlock, this ignores the dramatic changes in capital  
12 market conditions and the fact that the Company's investment  
13 risks have increased. Because the record in Case No. IPC-E-  
14 03-13 was predicated on Idaho Power's former single-A credit  
15 rating, the 10.25 percent ROE awarded by the IPUC does not  
16 consider the higher risks that investors now associate with  
17 the Company. Nor does it consider the significant increase  
18 in investors' required return on long-term capital, as  
19 evidenced by sharply higher yields on public utility bonds.

20 Q. Do you agree with Mr. Kahal (p. 10) that  
21 changes in dividend taxation enacted in 2003 have led to a  
22 significant decline in investors' required rate of return on  
23 equity?

24 A. No. In light of the unprecedented capital  
25 market events of this year and the uncertainties associated

1 with the incoming administration's policy responses, it is  
2 ironic that Mr. Kahal would choose to focus on 2003 tax  
3 legislation as support for his recommendations.<sup>83</sup> While  
4 dividend taxation is certainly one factor that may be  
5 considered by investors, the impact of changes in dividend  
6 taxation on the cost of equity for Idaho Power is unclear.  
7 First, the important role that pension funds and tax  
8 deferred accounts play in the capital markets dilutes any  
9 effect that tax rate changes might have on investors'  
10 required rate of return. This is because the reduction in  
11 the taxation of dividends has no impact on the returns for  
12 tax-free investors.

13 Moreover, using current capital market data to  
14 estimate the cost of equity, such as my DCF and forward-  
15 looking CAPM approaches, already incorporate any effects of  
16 changes in tax policies. While Mr. Kahal implies that  
17 changes in dividend taxation suggest a lower cost of equity  
18 than in the past, this ignores other significant factors  
19 that influence required returns. In particular, risk  
20 perceptions in general, and for electric utilities  
21 specifically, have shifted sharply upward, which would more  
22 than offset any decline in the equity risk premium due to  
23 changes in dividend taxation. Finally, investors are

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<sup>83</sup> 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.

1 forward-looking and recognize that there is no guarantee  
2 that the reduction in dividend taxation will continue.

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

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

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

10 A. No. The need for a flotation cost adjustment  
11 to compensate for past equity issues is recognized in the  
12 financial literature. In a *Public Utilities Fortnightly*  
13 article, for example, Brigham, Aberwald, and Gapenski  
14 demonstrated that even if no further stock issues are  
15 contemplated, a flotation cost adjustment in all future  
16 years is required to keep shareholders whole, and that the  
17 flotation cost adjustment must consider total equity,  
18 including retained earnings.<sup>84</sup> Similarly, *Regulatory*  
19 *Finance: Utilities' Cost of Capital* contains the following  
20 discussion:

21 Another controversy is whether the  
22 underpricing allowance should still be  
23 applied when the utility is not  
24 contemplating an imminent common stock  
25 issue. Some argue that flotation costs

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<sup>84</sup> Brigham, E.F., Aberwald, D.A., and Gapenski, L.C., "Common Equity Flotation Costs and Rate Making," *Public Utilities Fortnightly*, May, 2, 1985.

1 are real and should be recognized in  
2 calculating the fair rate of return on  
3 equity, but only at the time when the  
4 expenses are incurred. In other words,  
5 the flotation cost allowance should not  
6 continue indefinitely, but should be  
7 made in the year in which the sale of  
8 securities occurs, with no need for  
9 continuing compensation in future years.  
10 This argument implies that the company  
11 has already been compensated for these  
12 costs and/or the initial contributed  
13 capital was obtained freely, devoid of  
14 any flotation costs, which is an  
15 unlikely assumption, and certainly not  
16 applicable to most utilities. . . . The  
17 flotation cost adjustment cannot be  
18 strictly forward-looking unless all past  
19 flotation costs associated with past  
20 issues have been recovered. (p. 175)

21 Q. Do you agree with Mr. Kahal's position your  
22 testimony failed to support an adjustment for flotation  
23 costs?

24 A. No. The rationale underlying an adjustment  
25 for past flotation costs was discussed in detail in my  
26 direct testimony at pages 59-61. Further, while Mr. Kahal  
27 asserts (p. 12) that I did not calculate a flotation cost  
28 adder, this is incorrect. As noted in my direct testimony  
29 (p. 61), my evaluation indicated that the flotation cost  
30 allowance requires an estimated adjustment to the return on  
31 equity of approximately 3.6 percent to 10 percent, which  
32 translated into a flotation cost adder of approximately 14  
33 to 39 basis points at the time my testimony was prepared.



1 world borrowing costs are in a different universe from  
2 Treasury yields and Fed rates."<sup>85</sup> The fact that the prices  
3 of Treasury bonds have been driven sharply higher is the  
4 mirror image of higher, not lower returns for more risky  
5 asset classes, such as the common stock of utilities like  
6 Idaho Power. Moreover, as discussed in detail earlier, Dr.  
7 Peseau's conclusion that yields for utilities such as  
8 IDACORP "have been essentially flat" is not true.<sup>86</sup> The  
9 average triple-B utility bond yield during 2007 was  
10 approximately 6.3 percent, versus 9.0 percent in November  
11 2008, or an increase of 270 basis points.

12 Second, while Dr. Peseau speculates about the  
13 potential impact of changes in beta values and the implied  
14 market risk premium, he completely ignores the ramifications  
15 of this market data. As documented in Exhibit No. 21 to my  
16 direct testimony, employing current beta values and a  
17 forward-looking estimate of the current market risk premium  
18 implies a cost of equity for my Utility Proxy Group of 11.9  
19 percent, which considerably exceeds Dr. Peseau's artificial  
20 10.25 percent "ceiling."

21 Third, Dr. Peseau - like Ms. Carlock and Mr. Kahal -  
22 entirely ignores the fact that Idaho Power's risks have

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<sup>85</sup> Gongloff, Mark, "Ahead of the Tape: The Shocks Are Getting A Workout," *The Wall Street Journal* at C1 (Sep. 17, 2008).

<sup>86</sup> Peseau Direct at 26.

1 increased, as exemplified by the decline in the Company's  
2 credit rating. The fact is that while the Commission  
3 professed a goal of maintaining Idaho Power's bond ratings  
4 at or above the single-A level in 2004,<sup>87</sup> the authorized  
5 return has been inadequate to achieve this objective and the  
6 Company has consistently been unable to earn an ROE above  
7 the single digits. Unsurprisingly, the associated decline  
8 in financial metrics has pushed Idaho Power's S&P credit  
9 rating to "BBB", while Moody's and Fitch maintain a  
10 "negative" outlook, warning investors of the potential for  
11 yet another downgrade. Considering these trends and the  
12 adverse conditions in today's capital markets, the ROE  
13 recommendations of Ms. Carlock, Mr. Kahal, and Dr. Peseau  
14 are inadequate and portend further deterioration in Idaho  
15 Power's finances if adopted.

16 Q. Does this conclude your rebuttal testimony?

17 A. Yes.

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<sup>87</sup> Idaho Public Utilities Commission, Order No. 29505 (May 25, 2004) at 43.

RECENT DIVIDEND YIELD

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Exhibit No. 81

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KAHAL PROXY GROUPS

IDAHO PUBLIC  
UTILITIES COMMISSION  
(a) (b)

<u>West Region</u>	<u>Stock Price</u>	<u>Dividend</u>	<u>Dividend Yield</u>
1 Avista	\$ 18.44	\$ 0.75	4.07%
2 Black Hills	\$ 25.12	\$ 1.44	5.73%
3 Edison International	\$ 33.46	\$ 1.29	3.86%
4 Hawaiian Electric	\$ 26.45	\$ 1.24	4.69%
5 IDACORP	\$ 28.12	\$ 1.20	4.27%
6 MDU Resources	\$ 18.46	\$ 0.62	3.36%
7 PG&E Corp.	\$ 29.24	\$ 1.62	5.54%
8 Pinnacle West	\$ 29.65	\$ 2.10	7.08%
9 Portland General	\$ 18.06	\$ 1.00	5.54%
10 Puget Energy	\$ 25.40	\$ 1.02	4.02%
11 Semptra Energy	\$ 42.15	\$ 1.55	3.68%
12 UniSource Energy	\$ 25.40	\$ 0.96	3.78%
13 Xcel Energy	\$ 17.72	\$ 0.97	5.47%
<b>Average</b>			<b>4.70%</b>

Restricted West Region

1 Avista	\$ 18.44	\$ 0.75	4.07%
2 Black Hills	\$ 25.12	\$ 1.44	5.73%
3 Hawaiian Electric	\$ 26.45	\$ 1.24	4.69%
4 IDACORP	\$ 28.12	\$ 1.20	4.27%
5 Pinnacle West	\$ 29.65	\$ 2.10	7.08%
6 Portland General	\$ 18.06	\$ 1.00	5.54%
7 Puget Energy	\$ 25.40	\$ 1.02	4.02%
8 Xcel Energy	\$ 17.72	\$ 0.97	5.47%
<b>Average</b>			<b>5.11%</b>

(a) Average closing price for November 3-24, 2008 from [www.finance.yahoo.com](http://www.finance.yahoo.com).

(b) Estimated dividend for next 12 mos. from The Value Line Investment Survey, Summary and Index (Nov. 28, 2008).

West Region

Adjusted Yield (a)		4.70%
DCF Growth Rate (b)	6.00%	-- 6.50%
Implied Cost of Equity	<u>10.70%</u>	-- <u>11.20%</u>
Midpoint		10.95%

Restricted West Region

Adjusted Yield (a)		5.11%
DCF Growth Rate (c)	5.00%	-- 6.00%
Implied Cost of Equity	<u>10.11%</u>	-- <u>11.11%</u>
Midpoint		10.61%

(a) Exhibit 12.

(b) Kahal Exhibit No. 604, p. 1.

(c) Kahal Exhibit No. 604, p. 2.