BEFORE THE

IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION OF UNITED WATER IDAHO INC. FOR AUTHORITY TO INCREASE ITS RATES AND CHARGES FOR WATER SERVICE IN THE STATE OF IDAHO	)	**CASE NO. UWI-W-04-4**

DIRECT TESTIMONY OF CAROLEE HALL

IDAHO PUBLIC UTILITIES COMMISSION

APRIL 6, 2005

Q. Please state your name and business address.

A. My name is Carolee Hall and my business address is 472 West Washington, Boise, Idaho 83702.

Q. By whom are you employed and in what capacity?

A. I am employed by the Idaho Public Utilities Commission as a Telecommunications Analyst.

Q. Please describe your work experience and educational background.

A. I have been with the Commission since April 1997. I have completed a Regulatory Studies program offered through NARUC at Michigan State University. I have also attended National Exchange Carrier Association (NECA) training sessions where federal issues associated with the changing telecommunications industries were topics of discussion.

In October 2004 I completed an advanced Utilities Finance and Accounting seminar for Financial Professionals in New York. Seminar instruction was provided by the Financial Accounting Institute and covered various fields of study including Corporate accounting and auditing, taxation, management and cost of capital.

Prior to coming to work for the Commission, I worked for two years as a Financial Manager for a competitive long distance provider. I graduated from Boise State University in 1993 with a B.B.A. in Finance.

Q. What is the purpose of your testimony in this proceeding?

A. The purpose of my testimony is to present the Staff's recommendations for the overall cost of capital for United Water Idaho to be used in calculating the revenue requirement for this case. I will specifically address the overall capital structure with the cost of capital for debt, minority interest (preferred stock), and return on common equity as it pertains to the overall rate of return.

Q. Describe your testimony regarding the return on equity?

A. My testimony will focus primarily on the return on equity portion in general as it pertains to the capital structure of the Company. Staff witness Terri Carlock will be the primary cost of capital witness and address this issue in her testimony.

Q. Please summarize the parent/subsidiary relationship for United Water Idaho.

A. United Water Idaho's common stock is not traded. It is a wholly owned subsidiary of United Waterworks, Inc., which is owned by United Water Resources Inc., which all are ultimately owned by Suez Lyonnaise des Eaux, a French Corporation that holds many water companies, and other business endeavors, throughout the world.

OVERVIEW OF CAPITAL STRUCTURE AND RECOMMENDATIONS

Q. Will you please briefly summarize your recommendations?

A. Staff is recommending a cost of debt of 6.45% and a cost of Minority Interest (Preferred Stock) of 5%. Staff has used, and recommends, a point estimate of 10% for return on common equity. The recommended overall weighted cost of capital of 8.10% is used to calculate the revenue requirement. Please see Staff Exhibit No. 117.

Q. How many Exhibits will you be sponsoring with your testimony?

A. I have three Exhibits identified as Exhibit Nos. 117 through 119.

Q. Have you reviewed the testimony and exhibits of United Water's witness Ms. Pauline Ahern with AUS Consultants?

A. Yes I have.

Q. Please identify the relative time period used in your analysis.

A. The historical test year used in this case is August 1, 2003 - July 31, 2004. My testimony uses December 31, 2004 for the capital structure with proformed debt changes so current cost rates reflect financing costs that are relevant when rates are established in this case.

Q. Do you have any adjustments to the December 31,

2004 data?

A. Yes. On March 22, 2005, the Company notified Staff of two recent financial activities it was making to avoid interest rate creep. First, the Company repaid a $10 million medium term note that was to mature in February 2025. This note had a stated interest rate of 8.84%. The second event was to refinance an Idaho Water Resource tax-exempt revenue bond instrument that had an outstanding balance of $19,975,000 and a maturity date of October 2024. By refinancing this debt instrument, the Company reduced the interest rate from 6.4% to 4.7% resulting in a pre-tax savings to the total Company of approximately $280,000. By using the December 31, 2004 capital structure with the two stated adjustments, Staff is able to capture these known and measurable changes for ratemaking purposes. These activities also improved the Company's debt-to-equity ratio from 55.10% debt and 44.9% equity to 53.41% debt and 46.59% equity. In doing this, the Company was able to bring its overall debt-to-equity ratio closer in line to the composite statistics for water utilities listed in Value Line. Overall, this is beneficial to the Company and for Idaho customers as it will help maintain credit ratings.

Q. Would you please recap the capital structure of the Company reflecting the December 31, 2004 numbers?

A. Yes. Again Staff is proposing an overall rate of

return on rate base of 8.10% and a Return on Common Equity of 10% as reflected in Exhibit No. 117.

Q. Is the proposed capital structure consistent with the Company's current credit rating?

A. Yes. This capital structure allows the Company to fund its required capital expenditures while increasing the equity ratio contributing to maintaining credit ratios that support the continuance of its current 'A' credit rating.

Q. How does maintenance of a strong credit rating benefit customers?

A. The credit rating given to a company has a direct impact on the cost that a company will incur to obtain capital necessary to support its current and future operating needs. A strong credit rating directly benefits customers by reducing immediate and future borrowing costs related to the financing needed to support regulatory operations.

Q. Are there other benefits?

A. Yes. During periods of capital market disruptions, a company with a higher credit rating has an easier time accessing capital for various projects. This is not necessarily the case with lower rated companies, which often find themselves unable to obtain capital or, incurring increased costs associated with financing and/or collateral requirements. Such access to capital provides companies

with more alternatives when attempting to meet current and future capital projects to meet consumer demand.

DEBT

Financing Calculations

Q. How did the Company calculate the embedded debt cost?

A. As shown in Exhibit No. 118, the Company took the face value of the debt issuance (Column 4 "outstanding amount") and subtracted the unamortized net discount, premium and expense in Column 5. This calculation resulted in the current net proceeds value in column 6.

The second step in its calculations was to take the face value again in Column 4 and multiply it by the stated interest rate of the issuance in Column 7 resulting in the annual interest expense in Column 8. The annual interest expense was then added to Column 9 (Amortization of net discount premium and expenses) resulting in an annual cost number in Column 10.

The third and final step in the Company's embedded debt calculation was to take the annual interest and amortization costs (Column 10) divided by the Net Proceeds (Column 6). By doing this, the Company has reflected the issue costs in the unamortized cost figures and in the annual amortization. Staff believes that the Company has not reflected the discounting properly, thereby inflating

the embedded cost rate and the overall long-term debt cost.

Q. How did you calculate the Company's cost of long-term debt?

A. Also shown in Exhibit No. 118 I used the data provided by the Company to calculate the cost of debt for United Water. In order to calculate the long-term debt cost (the Company refers to this number as the embedded cost rate in Column 11) the annual cost of debt (column 10) comprised of the annual interest expense (column 8) plus the Amortization of Net Discount Premium and Expense (Column 9) were used. I took the Company's annual cost of debt (Column 10) and divided that by the amount of debt outstanding (Column 4). This accurately reflects the discounting of issuance costs to properly allow the Company to recover in rates the annual interest cost and the annual amortization of issuance costs.

Q. Please summarize the differences between your calculations and those of the Company's?

A. As mentioned earlier, in my calculations I used the annual interest and amortization costs (Column 10) divided by the face value or outstanding amount (Column 4). Please refer to Staff Exhibit No. 118. Given these calculations, a proper embedded cost rate of 6.45% was derived. The Company calculated its embedded cost rate to be 6.90% after it made its adjustments to debt previously

discussed. The Company's calculation differs from Staff's because the annual cost is divided by the unamortized net proceeds (column 6).

In other cases before the Commission, the Staff's proposed debt cost calculation has been utilized. Another method also accepted by the Commission reflects embedded cost of debt rate using the net proceeds at the time of issue but the interest cost only, not the interest plus amortization costs, as the numerator used to reflect the annual cost when calculating the embedded cost of debt rate.

Q. For calculating the cost of debt, did you use Idaho specific numbers or the consolidated numbers provided by the Company?

A. I ran various scenario analyses for calculating the cost of debt and capital structure. It is critical to assure that Idaho customers receive the benefit of the Department of Water Resource Revenue bonds in Idaho. Staff determined that by using the consolidated numbers provided by the Company, Idaho customers continue to receive this benefit with the Company-wide sponsored debt and capital structure.

MINORITY INTEREST (PREFERRED STOCK)

Q. Did you have any adjustments to the Company's costs for its minority interest (preferred) stock?

A. No, the minority interest has not changed from the

previously approved rate and is reasonable.

COMMON EQUITY

Q. What legal standards have been established for determining a fair and reasonable rate of return for the Company?

A. The legal test of a fair rate of return for a utility company was established in the Bluefield Water Works decision of the United States Supreme Court and is repeated specifically in the Hope Natural Gas case.

In Bluefield Water Works and Improvement Co. V West Virginia Public Service Commission, 262 U.S. 679, 692, 43S.Ct.675,67 L.Ed. 1176(1923), the Supreme Court stated:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally.

The Court stated in FPC v Hope Natural Gas Company

320 U.S. 591, 603, 64 S.CT. 281, 88 L.Ed.333 (1944):

> From the investor or Company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. (Citations omitted.)

The Supreme Court decisions in Bluefield Water Works and Hope Natural Gas have been affirmed in In re Permian Basin Area Rate Case, 390, U.S. 747, 88 S. Ct 1344, 20 L.Ed 2d 312 (1968) and Duquesne Light Co. V. Barasch, 488 U.S. 299, 109 S. Ct. 609, 102 L. Ed.2d.646 (1989); Hayden Pines Water Company v. IPUC, 122 ID 356, 834 P.2d 873 (1992). As a result of these United States and Idaho Supreme Court decisions, three standards have evolved for determining a fair and reasonable rate of return: (1) the Financial Integrity or Credit Maintenance Standard; (2) the Capital Attraction Standard; and, (3) the Comparable Earnings Standard. If the Comparable Earnings Standard is met, the Financial Integrity or Credit Maintenance Standard and the Capital Attraction Standard will also be met, as they are an integral part of the Comparable Earnings Standard.

Q. Did Staff consider these standards in its analysis and recommendations?

A. Yes. These standards were considered in all of Staff's return analysis upon which its recommendations are based. It is also noteworthy to recognize that the fair rate of return that allows the utility Company to maintain its financial integrity and to attract capital is established assuming efficient and economic management, as specified by the Supreme Court in Bluefield Water Works.

Q. Please define the term "cost of common equity capital" and provide an overview of the process to determine this cost.

A. The cost of common equity, or equity capital, is the profit that investors expect to receive. Equity investors expect a return on their capital commensurate with the risks they take and consistent with returns that might be available from other similar investments. This profit or return is paid to shareholders as dividends or retained by the Company to grow the equity investment and future returns. Unlike returns from debt and preferred stocks, however, the equity return is not directly observable in advance and therefore, it must be calculated or inferred from capital market data and trading activity.

Q. Would you please provide a narrative example to illustrate the cost of equity?

A. A very simplified example would be that I purchase a stock for $30 per share. If the stock's expected dividend during the year is $1.00, the expected dividend yield is 3 percent ($1.00 / $30 = 3 percent). Now, let's assume that the stock (being extremely stable) increases in value to $31.50 one year after purchase. I have then gained another 5 percent in the expected total rate of return ($1.5 / $30.00 = 5 percent). As a result of buying my stock at $30 per share, I should expect a total return of 8 percent: 3 percent dividend yield and 5 percent appreciation. Therefore, my total expected rate of return at 8 percent is the appropriate measure of the cost of equity capital, because it is this rate of return that caused me to commit the $30 of equity capital in the first place. Should the stock be riskier, I would have required a much higher return to be compensated for taking on that risk.

Q. Has Staff analyzed the cost of equity and established a range for United Water Idaho?

A. Yes, using the three Companies in Value Line, I calculated a water utilities industry cost of equity of 10% and recommend that this rate be authorized for United Water Idaho. Staff witness Terri Carlock will be providing testimony with respect to the cost of equity and she will support the equity ranges around the 10% point.

Q. In your opinion, do you believe that the 10%

Return on Equity is in line with the composite Value Line returns for the industry?

A. Yes. According to Value Line's composite statistics for water utilities industry (October, 2004 and January 2005) the return on shareholder's equity and common equity for 2004 and 2005 was 9.5%. For the years of 2007 - 2009 it is projected to be at 10%.

Q Did you review any recent Idaho rate cases where the Commission established the return on equity rate?

A. Yes. The Idaho Commission recently authorized Avista Utilities and Idaho Power Company rates of 10.4% and 10.25% respectively.

Q. Will a 10% return on equity provide the Company the opportunity to maintain its current bond ratings and borrowing ability in the capital markets?

A. Yes, Staff believes it will. According to Value Line, the Composite Water Utility Industry return on equity has been 8.8% in 2003 and 9.5% in 2004 and 2005.

Through its own actions, the Company's debt-to-equity ratios were improved with its debt retirement and refinancing. With these financial adjustments, the equity ratio was increased and the debt ratio decreased, thus maintaining the Company's ability to access the capital markets with a good bond rating. Staff believes that the projected 2007 - 2009 return rates of 10% will continue to

afford the Company this opportunity.

Q. The Company maintains that it needs a common equity cost rate of 11.2% given various risk factors presented by the Company. Would you please comment on these assertions?

A. Yes. Risk is the uncertainty or unpredictability of the future results of a company. The greater the range within which future results are likely to fall, the greater the risk associated with an investment in, or extension of credit to the company. Certain factors may include high rates of technological changes, such as is occurring in the telecommunications industry. Technological changes are not substantial for water utilities so this is not a significant risk issue for United Waterworks. Other risk factors may include uncertainty about demand. In the monopoly environment in which United Water Idaho currently operates this risk is minimal compared to competitive industries like Micron, Simplot or most local businesses in Idaho. The Company's request for a 11.2% return on equity is higher than needed given the environment in which it operates.

Q. The Company's consultant, witness Ahern, discussed the risks associated with United Water and a beta study. Do you agree with the Company's position?

A. No. Of the three Value Line companies used in the sample, two of the companies have betas of .7, and the third

Company has a beta of .75. These betas are all well under the market indicator of 1.0, therefore the sample presented by the Company reflects a lower than market risk for these water utilities.

Q. Did you perform any other equity analysis for the Company?

A. Yes, under the direction of Staff witness Terri Carlock, I prepared a discounted cash flow analysis (DCF). See Staff Exhibit No. 119.

Q. Were you able to calculate a DCF for United Water Idaho?

A. United Water Idaho's cost of equity cannot be directly calculated from its own market data because United Water Idaho is a subsidiary of United Waterworks Inc. United Waterworks Inc. is a wholly owned subsidiary of Suez, a French conglomerate, and, only Suez has publicly traded common stock. Independent market data required to determine cost of equity directly for the regulated water utility operations of United Water Idaho simply is not available. The DCF analysis shown on Exhibit No. 119 uses the three sample companies as listed in *Value Line Investment Survey*. Staff witness Carlock will expand upon this analysis in her testimony.

Q. Given the Staff analysis discussed in your testimony, would you please summarize your recommendations?

A. Yes, Staff recommends a set point of 10% as an appropriate return for Common Equity. For the cost of debt, the recalculated composite rate using the appropriate calculation derived a 6.45% cost. The Minority Interest rate of 5% did not change. Staff reflects the Company's recent debt changes as they improved the Company's debt-to-equity ratios, thereby benefiting the Company as well as Idaho customers. Finally, Staff recommends an overall rate of return of 8.10% as the point authorized for use in the revenue requirement calculation.

Q. Does this conclude your direct testimony in this proceeding?

A. Yes it does.

CERTIFICATE OF SERVICE

I HEREBY CERTIFY THAT I HAVE THIS 6Th DAY OF APRIL 2005, SERVED THE FOREGOING **DIRECT TESTIMONY OF CAROLEE HALL,** IN CASE NO. UWI-W-04-04, BY MAILING A COPY THEREOF, POSTAGE PREPAID, TO THE FOLLOWING:

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