

DAVID J. MEYER
VICE PRESIDENT, GENERAL COUNSEL, REGULATORY &
GOVERNMENTAL AFFAIRS
AVISTA CORPORATION
P.O. BOX 3727
1411 EAST MISSION AVENUE
SPOKANE, WASHINGTON 99220-3727
TELEPHONE: (509) 495-4316
FACSIMILE: (509) 495-8851

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IDAHO PUBLIC
UTILITIES COMMISSION

BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION)	CASE NO. AVU-E-08-01
OF AVISTA CORPORATION FOR THE)	CASE NO. AVU-G-08-01
AUTHORITY TO INCREASE ITS RATES)	
AND CHARGES FOR ELECTRIC AND)	DIRECT TESTIMONY
NATURAL GAS SERVICE TO ELECTRIC)	OF
AND NATURAL GAS CUSTOMERS IN THE)	WILLIAM E. AVERA
STATE OF IDAHO)	
)	

FOR AVISTA CORPORATION

(ELECTRIC AND NATURAL GAS)

DIRECT 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, Texas,
4 78751.

5 Q. In what capacity are you employed?

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

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

11 A. A description of my background and
12 qualifications, including a resume containing the details
13 of my experience, is attached as Schedule WEA-1.

14 A. Overview

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

17 A. The purpose of my testimony is to present to the
18 Idaho Public Utilities Commission (the "Commission" or
19 "IPUC") my independent evaluation of the fair rate of
20 return on equity ("ROE") for the jurisdictional electric
21 and gas utility operations of Avista Corp. ("Avista" or
22 "the Company"). In addition, I also examined the
23 reasonableness of Avista's capital structure, considering
24 both the specific risks faced by the Company and other
25 industry guidelines.

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

4 A. To prepare my testimony, I used information from
5 a variety of sources that would normally be relied upon by
6 a person in my capacity. I am familiar with the
7 organization, finances, and operations of Avista from my
8 participation in prior proceedings before the IPUC, the
9 Washington Utilities and Transportation Commission, and the
10 Oregon Public Utility Commission. In connection with the
11 present filing, I considered and relied upon corporate
12 disclosures, publicly available financial reports and
13 filings, and other published information relating to
14 Avista. I also reviewed information relating generally to
15 current capital market conditions and specifically to
16 current investor perceptions, requirements, and
17 expectations for Avista's utility operations. These
18 sources, coupled with my experience in the fields of
19 finance and utility regulation, have given me a working
20 knowledge of this issues relevant to investors' required
21 return for Avista, and they form the basis of my analyses
22 and conclusions.

23 **Q. What is the role of the rate of return on common**
24 **equity in setting a utility's rates?**

25 A. The ROE serves to compensate common equity
26 investors for the use of their capital to finance the plant

1 and equipment necessary to provide utility service.
2 Investors commit capital only if they expect to earn a
3 return on their investment commensurate with returns
4 available from alternative investments with comparable
5 risks. To be consistent with sound regulatory economics
6 and the standards set forth by the Supreme Court in the
7 *Bluefield*¹ and *Hope*² cases, a utility's allowed ROE should
8 be sufficient to: 1) fairly compensate the utility's
9 investors, 2) enable the utility to offer a return adequate
10 to attract new capital on reasonable terms, and 3) maintain
11 the utility's financial integrity.

12 **Q. How did you go about developing your conclusions**
13 **regarding a fair rate of return for Avista?**

14 A. I first reviewed the operations and finances of
15 Avista and the general conditions in the utility industry.
16 With this as a background, I conducted various well-
17 accepted quantitative analyses to estimate the current cost
18 of equity, including alternative applications of the
19 discounted cash flow ("DCF") model and the Capital Asset
20 Pricing Model ("CAPM"), as well as reference to expected
21 earned rates of return for utilities. Based on the cost of
22 equity estimates indicated by my analyses, the Company's
23 ROE was evaluated taking into account the specific risks

¹ *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679 (1923).

² *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

1 and potential challenges for Avista's utility operations in
2 Idaho.

3 **B. Summary of Conclusions**

4 **Q. What are your findings regarding the fair rate of**
5 **return on equity for Avista?**

6 A. Based on the results of my analyses and the
7 economic requirements necessary to support continuous
8 access to capital under reasonable terms, I determined that
9 a fair ROE for Avista falls in the range of 10.7 percent to
10 12.2 percent. The bases for my conclusion are summarized
11 below:

- 12 • In order to reflect the risks and prospects
13 associated with Avista's jurisdictional utility
14 operations, my analyses focused on a proxy group of
15 twenty other utilities with comparable investment
16 risks. Consistent with the fact that utilities
17 must compete for capital with firms outside their
18 own industry, I also referenced a proxy group of
19 comparable risk companies in the non-utility sector
20 of the economy;
- 21 • Because investors' required return on equity is
22 unobservable and no single method should be viewed
23 in isolation, I applied both the discounted cash
24 flow ("DCF") and capital asset pricing model
25 ("CAPM") methods, as well as the expected earnings
26 approach, to estimate a fair ROE for Avista:
 - 27 o My application of the constant growth DCF model
28 considered four alternative growth measures
29 based on projected earnings growth, as well as
30 the sustainable, "br+sv" growth rate for each
31 firm in the respective proxy groups;
 - 32 o After eliminating low- and high-end outliers,
33 my DCF analyses implied a cost of equity of
34 10.7 percent for the proxy group of utilities
35 and 12.6 percent for the group of non-utility
36 companies;

- 1 o Application of the CAPM approach using forward-
2 looking data that best reflects the underlying
3 assumptions of this approach implied a cost of
4 equity of 12.2 percent for the utility proxy
5 group and 11.4 percent for the firms in the
6 non-utility proxy group;
- 7 o Applying the CAPM method using historical
8 realized rates of return resulted in a cost of
9 equity of 10.7 percent for the utility proxy
10 group and 10.0 percent for the non-utility
11 proxy group;
- 12 o My evaluation of earned rates of return
13 expected for utilities suggested a cost of
14 equity on the order of 11.0 percent;
- 15 o Based on these results, I concluded that the
16 cost of equity for the proxy groups of electric
17 utilities and non-utility companies is in the
18 10.7 percent to 12.2 percent range.

19 Considering investors' expectations for capital
20 markets and the need to support financial integrity and
21 fund crucial capital investment even under adverse
22 circumstances, I concluded that Avista's requested ROE of
23 10.8 percent is reasonable. Based on my evaluation, I
24 determined that:

- 25 • Because Avista's requested ROE of 10.8 percent
26 barely exceeds the lower bound of my recommended
27 range, it represents a conservative estimate of
28 investors' required rate of return;
- 29 • The reasonableness of a 10.8 percent minimum ROE
30 for Avista is also supported by the need to
31 consider the Company's credit standing, which
32 remains relatively weak:
 - 33 o The pressures of funding significant capital
34 expenditures and increased operating risks
35 heighten the uncertainties associated with
36 Avista;
 - 37 o Because of Avista's reliance on hydroelectric
38 generation, the Company is exposed to
39 relatively greater risks of power cost
40 volatility;

- 1 o Investors view the Power Cost Adjustment
2 Mechanism ("PCA") as supportive of the
3 Company's financial integrity, but they
4 understand that the PCA does not apply to 100
5 percent of power costs; nor does it insulate
6 Avista from the need to finance accrued power
7 production and supply costs or shield the
8 Company from potential regulatory
9 disallowances;
- 10 o Given Avista's present credit ratings, an
11 inadequate rate of return imposed in this
12 proceeding would further pressure the Company's
13 financial flexibility and credit standing;
- 14 o My conclusion that a 10.8 percent ROE for
15 Avista is a conservative estimate of investors'
16 required return is also reinforced by the
17 Company's relatively greater risks as compared
18 with the proxy group, the greater uncertainties
19 associated with Avista's relatively small size,
20 and the fact that my recommended ROE range does
21 not consider flotation costs.

22

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

25 A. Based on my evaluation, I concluded that a common
26 equity ratio of 47.94 percent represents a reasonable basis
27 from which to calculate Avista's overall rate of return.
28 This conclusion was based on the following findings:

- 29 • Avista's requested capitalization is consistent
30 with the Company's need to strengthen its credit
31 standing and financial flexibility as it seeks to
32 raise additional capital to fund significant system
33 investments and meet the requirements of its
34 service territory;
- 35 • Avista's proposed common equity ratio is entirely
36 consistent with the 47.8 percent and 49.0 percent
37 average equity ratio maintained by the firms in my
38 utility proxy group, based on year-end 2007 data
39 and near-term expectations, respectively.

1 • My conclusion is reinforced by the investment
2 community's focus on the need for a greater equity
3 cushion to accommodate higher operating risks and
4 the pressures of funding significant capital
5 investments, as well as the impact of off-balance
6 sheet commitments such as purchased power
7 agreements.

8 **Q. What other evidence did you consider in**
9 **evaluating your recommendation in this case?**

10 A. My recommendation was reinforced by the following
11 findings:

- 12 • Sensitivity to regulatory uncertainties has
13 increased dramatically and investors recognize
14 that constructive regulation is a key ingredient
15 in supporting utility credit standing and
16 financial integrity;
- 17 • Providing Avista with the opportunity to earn a
18 return that reflects these realities is an
19 essential ingredient to strengthen the Company's
20 financial position, which ultimately benefits
21 customers by ensuring reliable service at lower
22 long-run costs;
- 23 • My conclusion is reinforced by the economic
24 reality that Avista's actual returns have fallen
25 systematically short of the allowed ROE; and the
26 financial impact of an ROE below the minimum level
27 requested by Avista would threaten the Company's
28 ability to maintain an investment grade credit
29 rating;
- 30 • Investors are aware of the near-term challenges
31 posed by upward pressure on costs and rising
32 capital expenditures. For Avista, these concerns
33 are magnified by the fact that financial metrics
34 continue to be anemic and its credit standing,
35 accordingly, remains relatively weak;
- 36 • Regulatory support, including a reasonable ROE,
37 will be a key driver in securing additional
38 progress towards restoring the Company's financial
39 health. Further strengthening Avista's financial
40 integrity is imperative to ensure that the Company
41 has the capability to maintain an investment grade
42 rating while confronting potential challenges

1 associated with funding infrastructure development
2 necessary to meet the needs of its customers.

3 **II. RISKS OF AVISTA**

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

5 A. As a predicate to my economic and capital market
6 analyses, this section examines the investment risks that
7 investors consider in evaluating their required rate of
8 return for Avista.

9 **A. Operations & Finances**

10 **Q. Briefly describe Avista.**

11 A. Avista is engaged primarily in the procurement,
12 transmission, and distribution of natural gas and electric
13 energy. Avista's generating facilities include 8
14 hydroelectric generating stations with a combined capacity
15 of approximately 980 megawatts ("MW") and the electrical
16 output of these plants, which has a significant impact on
17 total energy costs, is dependent on streamflows. Although
18 Avista estimates that hydroelectric generation is capable
19 of supplying approximately 50 percent of total system
20 requirements under normal conditions, the Company has
21 experienced prolonged periods of persistent below-normal
22 water conditions in the past.

23 Because close to one-half of Avista's total energy
24 requirements are provided by hydroelectric facilities, the
25 Company is exposed to a level of uncertainty not faced by
26 most utilities. While hydropower confers advantages in

