
Allowed Return on Equity - Focus on Effective Regulation

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What are and are not goals of ROE?

- Goal is effective regulation
 - All about safe and reliable service at a reasonable cost.
 - Attract capital cost effectively.
 - Return should be commensurate with risk and encourage management efficiency.
- ROE is not:
 - A bottom line reconciliation tool.
 - A yard stick for external evaluation of PUC's by Wall Street.

Risks of setting ROE too high or too low

- Too high
 - Rates are too high. Hampers economy.
 - Less incentive for cost-effective management (too much cushion)
 - Tendency to over-invest in rate base (Averch-Johnson effect)
- Too Low
 - Lack of access to capital markets or dilution of equity
 - Service reliability and quality may suffer
 - Rates are too low and encourage usage.
- ROE must be looked at in context with other adjustments made and not made. Lowering ROE has same overall financial impact effect as equivalent imprudence disallowance.

Making sense of ROE

- How can reasonable people recommend ROEs that are hundreds of basis points different?
 - Not an exact science.
 - Many competing methods.
 - Sometimes seems like the blind men feeling an elephant.
 - No simple solution.
- Reveal some myths and discover reality.

Myth: The ROE granted to other utilities is a clear indicator of an appropriate ROE for my case

- Benchmarking between utilities is difficult.
 - Data available from Regulatory Research Associates.
 - EEI quarterly rate case reports tally average requested and allowed ROE, 10-year Treasury yield and regulatory lag and summarizes recent rate case decisions and requests.
- Other commissions may not have made good judgments. Best practice versus common practice.
- Peer groups are difficult to isolate.
- Lots of factual differences to consider.

Factual differences to consider

- When was the ROE set. Lots of old cases.
 - Utility characteristics
 - Capital Structure including off-balance sheet commitments and long-term power contracts
 - Growing or shrinking demand or customer base
 - Customer mix
 - Vertically integrated or restructured
 - Corporate structure: Size. Single utility or multiple services. Holding company. Single state.
 - Capex program
 - Generating mix
 - Regulatory risks
 - Project preapproval
 - CWIP in rate base
 - Decoupling and income volatility in rate structure
 - Depreciation rate
 - Inter-rate case cost recovery
 - Test year
 - Expense and revenue adjustments
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Myth: The riskier the utility, the higher the allowed return

- Assume two comparable utilities. One is well managed. One is not.
- Poor management leads to regulatory disallowances and poor financial performance.
- Which utility should get a higher allowed ROE?
- Must differentiate between legitimate exogenous risk and risk caused by management behavior.

Myth: Just add the same number of basis points to the utility's current long-term debt rate.

- Inferior management may be reflected in lower bond ratings and cost of long-term debt.
- Adding basis points to high cost of debt may just reward poor management.
- Double counts risk that bond market has already assessed.
- More general index like ten-year treasury note may provide a better basis.

Myth: Higher ROE means higher bond ratings and lower long-term total revenue requirements.

- Argument was popular in 1970s & 80s.
- Analyses showed revenues needed to support AAA ratings were more costly to ratepayers than the cost capital associated with an A rating.
- Note: according to 10/08 Public Utilities Fortnightly, since 2005, 9 of the Fortnightly 40 have had rating changes with 6 being upgrades.

Myth: Capital structure is unimportant compared to ROE.

- Changing capital structure from equity to debt often reduces WACC.
- Assume a 50/50 capitalization and a debt cost of 6.5% and ROE of 11% (18.3% including taxes at 40% tax rate)
- Move from a 50/50 capitalization to a 60/40
 - Assume debt 6.75% and ROE 11.25% (18.75% including taxes)
 - Old tax adjusted WACC = 12.42%
 - New tax adjusted WACC = 11.55%
 - On \$2B rate base change in revenue requirement = \$17.4M
 - Equivalent to more than 1.0% decrease in allowed ROE under 50/50, even with higher cost components.

Myth: ROE is just a number that makes a Commission's order hold together.

- Too often this myth is reality.
- ROE too important to be the result of a default calculation.
- Make explicit adjustments for risk factors where possible.
 - Vermont PSC reduced ROE by 0.50% to reflect annual operating cost adjustments
 - CT DPUC reduced ROE by 0.25% to reflect weather normalization adjustment (gas)
- Avoid the hand wave. “Taking all into consideration...”

Focus on reality

- Commissions have great deal of discretion in setting ROE, especially when witnesses offer recommendations 100s of basis points apart.
 - What others have done on ROE is often information without insights.
 - Stay focused on underlying role of ROE in effective regulation.
 - Cost effective access to capital.
 - Compensate for comparable risk and incent management.
 - Ask about the long-term impact of ROE on bond ratings and long-term revenue requirements.
 - Consider alternative financing options that create leverage.
 - Ask what is driving proposals for ROE.
 - Regulatory policies
 - Financial market conditions
 - Utility characteristics
 - What is cause of utility bond rating?
 - Ask about comparable risks such as missed dividends or bankruptcy.
 - Never reward poor management performance with higher ROE.
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