

**UNITED STATES OF AMERICA  
BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION**

Inquiry Regarding the Commission's Policy for )  
Determining Return on Equity )

Docket No. PL19-4-000

**COMMENTS OF SOUTHERN CALIFORNIA EDISON COMPANY  
IN RESPONSE TO THE COMMISSION'S MARCH 21, 2019  
NOTICE OF INQUIRY**

Pursuant to Ordering Paragraph 39 of the Federal Energy Regulatory Commission's ("Commission") March 21, 2019 *Notice of Inquiry*,<sup>1</sup> Southern California Edison Company ("SCE") submit these comments. The Commission seeks information and stakeholder views regarding whether, and if so how, it should modify its policies concerning the determination of the return on equity ("ROE") to be used in designing jurisdictional rates charged by electric utilities. Specifically, the Commission seeks comment on questions addressing a broad range of issues, including: (1) the role of the Commission's base ROE in investment decision-making and what objectives should guide the Commission's approach; (2) performance of the DCF model; (3) proxy groups; (4) financial model choice; and (5) model mechanics and implementation.

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<sup>1</sup> Inquiry Regarding the Commission's Policy for Determining Return On Equity, 166 FERC ¶ 61,207 (2019) ("ROE NOI").

SCE, a wholly owned subsidiary of Edison International, is an investor-owned utility, subject to the Commission's jurisdiction. The policies developed in this Notice of Inquiry concerning the determination of the ROE used in designing jurisdictional rates will have a direct effect on SCE. Thus, SCE submits these comments to assist the Commission with its evaluation of existing ROE policies as well as the development of stable, predictable, and beneficial policies to support transmission investment. In these comments, SCE responds to the questions set out in the Notice of Inquiry.

## **I. COMMUNICATIONS**

SCE requests that all notices, orders, correspondence, and other communications related to this proceeding be directed to the following individuals:

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## **II. EXECUTIVE SUMMARY**

It is the role of the Commission to establish just and reasonable ROEs. Consistent with this, SCE supports the steps taken by the Commission in the recent Coakley and MISO Briefing Orders to expand the methodologies that the Commission will use to determine the zone of reasonableness and the ROE within that zone. This an advance in the Commission's approach to ROE determination for electric utilities provides a more robust and reasonable methodology consistent with investor expectations. This NOI asks

many meaningful questions to help the Commission further refine its methodology.

However, at times the questions within the NOI appear to focus on process and the need to streamline litigation. SCE suggests that the Commission should continue to focus on establishing a correct just and reasonable ROE under various market and risk conditions.<sup>2</sup>

The more robust the methodology, the more these other issues will naturally resolve themselves.<sup>3</sup>

In order to aid the Commission, SCE provides answers to select questions contained in the NOI and addresses the following matters:

- The Commission should use the same midpoint measures for group-filers and single-filers when determining base ROE for a utility.
- The ROE should not be fixed at the cost of capital at the time of an investment or vintage because common equity is not a fixed contract or expectation with investors in the way that bonds or incentives are.

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<sup>2</sup> As this Commission recently recognized, it is critical to examine the “particular circumstance[]” and unique risks of an electric utility when determining whether an ROE meets the capital attraction standard that underlies the Commission’s ROE policies. *See, e.g.,* Martha Coakley *et al.* v. Bangor Hydro-Electric Co. *et al.*, Order Directing Briefs, 165 FERC ¶ 61,030, at PP 21, 24 (2018) (“Coakley Briefing Order”). As set forth by the Supreme Court in a series of legal decisions, including *Hope* and *Bluefield*, the ROE authorized for a regulated utility must (1) be sufficient to ensure confidence in the financial soundness of the utility, (2) be adequate to permit the utility to be creditworthy, (3) allow the utility to attract capital, and (4) be comparable with returns on investments of similar risk. *See Federal Power Comm’n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) (“*Hope*”); *Bluefield Water Works and Improvement Co. v. Public Service Commission of the State of West Virginia*, 262 U.S. 679, 692 (1923) (“*Bluefield*”).

<sup>3</sup> That said, the Commission should continue to consider ways in which it can address complaints that are filed without fully litigating each complaint when the complaint does not meet the burden of proof to establish that an ROE is unjust and unreasonable.

- The Commission must ensure a robust proxy group size and permit proxy group expansion as necessary to ensure the proxy group captures comparable risk.
- The Commission should incorporate multiple methodologies—including CAPM, DCF, Expected Earnings and Risk Premium—to ensure a robust analysis when determining just and reasonable ROEs and reflect the breadth of resources investors use in analyzing their investment opportunities.
- To reflect current market conditions, the low-end threshold should be estimated by using a risk premium formula based on the CAPM model.
- The Commission’s methodology for determining ROE must permit it to exercise discretion and judgement to address the particular facts and circumstances related to a company and the prevailing market conditions, rather than systematically following a formula. Therefore, the Commission should use its regulatory judgment to identify “anomalous” market conditions and to recognize circumstances specific to a company that create increased risk and require modifications to existing methodologies.

To reduce repetition, SCE has grouped relevant questions together and answered them in one response. The order of the questions is not necessarily consistent with the Commission’s ordering but SCE identifies the question number for each question.

### III. RESPONSE TO QUESTIONS

#### A. Role and Objectives of the Commission's Base ROE Policy

1. **A1. To what extent would the ROE methodology described in the Coakley and MISO Briefing Orders impact the predictability of ROE determinations and the costs for market participants of making or intervening in such proceedings**

**A2. How would using the ROE methodology described in the Coakley and MISO Briefing Orders affect an investor's ability to forecast the ROE the Commission would establish in a litigated proceeding and the ability of participants to propose, contest, and settle base ROEs as compared to using only the DCF methodology**

**D10. The Commission currently uses midpoints to determine the central tendency of the zone of reasonableness when determining RTO-wide ROEs. Should the Commission adopt a policy of using medians for this purpose?**

**G4. In single utility rate cases, the Commission determines the central tendency of the zone of reasonableness based on the median of the proxy group ROEs. Is the approach outlined in the *Coakley* and MISO briefing orders appropriate in single utility rate cases given that the proxy company ROEs tend to cluster near the center of the zone of reasonableness, making the middle quartile relatively narrow?**

**G4.a. Would it be reasonable to determine the central tendencies of the upper and lower halves of the zone of reasonableness for single utilities based on a midpoint analysis, so as to produce approximately equal ranges of presumptively just and reasonable ROEs for below average, average, and above average risk utilities?**

The Commission's role and objective should be to develop a robust methodology for ensuring a just and reasonable ROE for the market and risk conditions contained in each individual case. At times dramatic changes in market or risk conditions in short time frames may require ROEs to be "unpredictable" in order to maintain just and

reasonable rates. Therefore, SCE suggests that these questions should be reframed to focus less on predictability and cost to participants, and more on achieving an ROE that properly compensates investors and follows the principles found in *Hope* and *Bluefield*.<sup>4</sup> The Commission's methodology in the Coakley and MISO Briefing Orders is a significant step forward in this regard. As the Briefing Order itself explains, good practice in ROE determination involves using multiple models and methods.<sup>5</sup> SCE also appreciates the Commission's proposal to include consideration of the relative riskiness of a utility within its proxy group when determining a utility's ROE within the zone of reasonableness, as this fact is considered by equity investors. That said, as SCE noted in its briefing on the Coakley Briefing Order<sup>6</sup> and discusses more below, there are discrete areas where the new methodology can be further improved to provide a just and reasonable ROE that is consistent with investor expectations.

The first and most critical of these improvements is to eliminate discrimination between single-filing and group-filing utilities when determining ROEs for below or above average risk utilities. Specifically, for group-filers, the Commission proposes to use midpoints of the lower and upper halves of the zone of reasonableness, while for single-filers, the Commission proposes to use medians.<sup>7</sup> The difference in resulting

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<sup>4</sup> See *Hope*, 320 U.S. 591; *Bluefield*, 262 U.S. 679.

<sup>5</sup> Coakley Briefing Order, at PP 33-38.

<sup>6</sup> SCE filed a Motion for Leave to Intervene Out-of-Time to file an Initial Brief on the Coakley Briefing Order in Docket Nos. EL11-66-001 *et al.* As of the date of these Comments, that motion remains pending.

<sup>7</sup> Coakley Briefing Order at pp. 17-32.

ROE's for utilities of above average risk based filing status as either single- or group-filers can be significant and unjustifiable. Given that the Coakley and MISO Briefing Orders did not fully examine the single utility rate case situation, they present no analysis or reason for the different treatment. In fact, different treatment would result in two assets of equal risk being awarded a different level of return on equity, which is contrary to the notion that the allowed ROE should be commensurate with that of entities of similar risk. According to finance theory, the cost of capital for an entity depends on the use of funds not the source of funds.<sup>8</sup> Consequently, there is no finance or economic reason to treat single-filers and group-filers differently.

Table 1 shows, by credit rating group, the often significant and serious injury that can be caused to single-filing utilities of above average risk by use of the median of the upper half of the zone of reasonableness over the midpoint.<sup>9</sup>

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<sup>8</sup> Brealey, Myers and Allen, "Principles of Corporate Finance," 11th Edition, 2014, p. 219.

<sup>9</sup> SCE used the proxy group selection process in the Coakley Briefing Order to estimate the four-model average of the upper half midpoint and median ROEs for several proxy groups based on Moody's and Standard & Poor's bond ratings. SCE also uses a low-end outlier test that is based on the Moody's Public Utility Bond Yield Average for Baa utility bonds (consistent with Commission precedent as discussed below) but keeps the 100 basis point spread to be as consistent as possible with the Coakley Briefing Order, although SCE disagrees with that spread, as discussed below.

**Table 1**

<b>Upper Half Midpoint Estimate (Four Models, Median) by Credit Rating Category</b>							
S&P Rating (Down)	Moody's Rating (Across)						
	A1	A2	A3	Baa1	Baa2	Baa3	
A	#N/A	9.51%	10.49%	10.58%			
A-		9.52%	11.34%	11.37%	11.46%		
BBB+		9.52%	11.28%	11.36%	11.75%	10.64%	
BBB			11.36%	11.32%	11.36%	10.35%	
BBB-			9.48%	9.97%	9.97%	10.22%	
<b>Upper Half Median Estimate (Four Models, Median) by Credit Rating Category</b>							
S&P Rating (Down)	Moody's Rating (Across)						
	A1	A2	A3	Baa1	Baa2	Baa3	
A	#N/A	9.51%	9.93%	10.17%			
A-		9.69%	10.39%	10.45%	10.53%		
BBB+		9.69%	10.32%	10.45%	10.64%	10.70%	
BBB			10.36%	10.36%	10.67%	10.22%	
BBB-			9.31%	9.90%	9.90%	10.17%	
<b>Upper Half Midpoint Estimate Minus Upper Half Median Estimate</b>							
S&P Rating	Moody's Rating (Across)						
	A1	A2	A3	Baa1	Baa2	Baa3	
A	#N/A	0.00%	0.56%	0.40%			
A-		-0.17%	0.95%	0.92%	0.93%		
BBB+		-0.17%	0.96%	0.90%	1.10%	-0.06%	
BBB			1.00%	0.96%	0.69%	0.13%	
BBB-			0.17%	0.06%	0.06%	0.06%	

These data indicate that even with the more robust Coakley Briefing Order methodology, using median when determining ROE significantly disadvantages high risk companies when compared to companies using the midpoint. In many cases, the ROE for the



median calculation is lower by more than 90 basis points. The Commission must correct the defects in the Coakley Briefing Order methodology as it applies to and discriminates against single-filing utilities. Specifically, the Commission should modify the methodology to use midpoints of the lower and upper halves of the zone of reasonableness to respectively determine ROE for below and above average risk utilities, to ensure that the ROE provided to single filing utilities is just and reasonable and non-discriminatory.

**2. A4. Should the ROE reflect the cost of capital at the time of the investment or be subject to adjustment to reflect the contemporary ROE required by investors?**

**A4.a. Should the Commission consider a “vintage approach,” with ROE fixed for the life of the asset at the time that each asset was completed?**

**A4.b. Would such a “vintage approach” need to be coupled with an annual national default ROE for investments made in that year, so as to minimize the need for numerous annual litigated ROE proceedings for each public utility that made an investment during that year? What procedure should be used to determine such a default ROE?**

The ROE should not be fixed at the cost of capital at the time of an investment or vintage because common equity is not a fixed contract or expectation with investors in the way that a bond or an incentive are. Rather, the cost of equity floats over time in accordance with underlying economic and financial conditions, as well as the relative riskiness of the utility. Moreover, fixing the ROE at the time of investment may result at times in underinvestment because, as market or risk conditions change, the ROE for a company may be insufficient to attract equity investors. Finally, such vintaging of ROE

for the life of an asset would be administratively burdensome for transmission owners as each asset in a portfolio of assets would have a different ROE vintage at a different rate, thus resulting in significant calculation and tracking. Therefore, ROE should continue be subject to adjustment to reflect the current cost of capital.

However, as discussed more in SCE's comments on the incentives NOI,<sup>10</sup> project-specific incentives should be durable and receive "vintage" treatment, because the utility's investment in the corresponding projects will have been premised on the durability of those incentives.

## **B. Performance of the DCF Model**

### **1. C1. The DCF model assumes stock prices are equal to the present value of projected future cash flows. Is there evidence of situations when these assumptions are inaccurate?**

To respond to this question, one needs to distinguish between the validity of the DCF assumptions for the members of a proxy group and the applicability of the proxy group estimate to the target company. The Commission's approach to proxy group selection, particularly the requirements that a dividend is paid currently and the dividend is expected to continue, will generally ensure that the DCF assumptions hold for members of the proxy group. On the other hand, if the target company is in financial distress, at risk of financial distress, and/or has reduced or suspended its common equity dividend, it may be the case that the proxy group estimate is no longer valid for the target company. SCE's current situation with respect to wildfire risk is an example where the

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<sup>10</sup> Docket No. PL19-3-000.

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proxy group estimate is no longer valid.<sup>11</sup> In SCE's case, wildfires present an asymmetric risk that on average will prevent investors from earning their expected return on equity. Financial models such as DCF do not capture asymmetric risks like megafires in California, in part because such risks are typically unrelated to market conditions. Asymmetric risks such as megafires in California are a risk of loss that reduces value and impairs the opportunity to earn the normal return on the prudently incurred rate base investments, with no financial market adjustment for recapturing that loss exposure from future appreciation.<sup>12</sup>

Stock prices and other data from which ROE is inferred reflect statistically expected outcomes for future cash flows and market outcomes (*i.e.*, weighting the possibilities that actual outcomes could be worse or better). However, traditional utility regulation allows for very limited upside in realized returns, which means that ROEs are awarded as if there was very limited chance of an asymmetric loss. A utility earns its normal cost of capital if its assets are as or more valuable than expected but may earn less if its assets perform below expectations and are penalized, or if additional penalty costs

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<sup>11</sup> SCE addresses this issue in detail in its recent formula rate filing with the Commission. *See* Docket No. ER19-1553-000.

<sup>12</sup> Docket No. ER19-1553-000, Exhibit SCE-22, p. 3. This is not even a risk that is arising from the usefulness of the utility assets or investments in ratebase but is a potential unplanned/unrecovered operating cost. For example, if there was a (perhaps temporary) purchased power policy dispute that said SCE cannot recover from customers anything above \$x/MWh, regardless of market circumstances causing power prices to exceed this threshold—as was the case during the California energy crisis—there would be no doubt that some kind of additional cost/risk compensation was needed, above and beyond conventional ROE. Wildfires present an analogous but more extreme type of risk.

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arise for independent reasons (like wildfires). This is unlike an unregulated firm which can earn more than its cost of capital if it happens to have assets and products that are more valuable than expected, *i.e.*, more valuable to customers than they cost (including their ROE) to provide. Thus, a utility's opportunity to earn its allowed ROE is impaired by asymmetric risks, violating *Hope* and *Bluefield* unless additional consideration is given to address the asymmetric risk.<sup>13</sup> To offset that risk and give investors a reasonable opportunity to earn their expected return, the ROE that is authorized in rates must be increased correspondingly.

### **C. Proxy Groups**

#### **1. D1. Should proxy groups for electric utilities, as well as natural gas and oil pipelines, consist only of companies with corresponding regulated businesses?**

**D1.a. For companies with a combination of regulated and unregulated businesses, should a company be required to derive a certain percentage of its revenues from the applicable regulated business in order for that company to be included in the proxy group that is used to determine an ROE for a company in that regulated business?**

**D1.b. Are the corresponding proxy groups sufficiently large given the continued consolidation in the industries?**

**D2. Should risk be considered both in the proxy group selection and in the placement within the zone of reasonableness?**

**D3. Should the Commission consider non-energy companies when selecting proxy groups?**

**D6. What would be the impact of the Commission modifying the credit rating screen to include all investment-grade utilities in the proxy group?**

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<sup>13</sup> *Hope*, 320 U.S. 591; *Bluefield*, 262 U.S. 679.

**D9. What circumstances or factors, if any, warrant an adjustment from the midpoint/median to other points within the zone of reasonableness (*e.g.*, lower or upper midpoint/median)?**

To produce just and reasonable results, the Commission's ROE methodology must ensure robust proxy groups that are reflective of the types of companies that electric utilities compete with for capital and appropriately place the target utility within the zone of reasonableness created by that proxy group.

The Commission's current approach of creating proxy groups that are plus-or-minus one notch from the target company's issuer credit rating (and utilizing the intersection of selections using both the Moody's and Standard & Poor's ratings) often creates proxy groups that are too small due to both this restrictive screening criterion and the continuing consolidation of the electric utility industry.<sup>14</sup> This suggests that electric utility proxy groups should at a minimum include all investment grade utilities (a broad risk category) which will increase the likelihood, at least in the short term, of a larger proxy group. This also would recognize the reality that utilities compete for capital nationally against all investment grade utilities. Further, limiting proxy group inclusion to one credit rating notch above or below that subject company's credit rating fails to adequately consider the interests of equity holders. There is no direct relationship

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<sup>14</sup> This decrease results both from the decrease in the number of electric utilities deemed comparable, and the removal of any companies while they are in merger discussions that may affect their DCF calculation.

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between credit ratings and the cost of equity.<sup>15</sup> The credit rating metric is specific to debt holders whose concerns are about a company's ability to repay its debt. It does not capture equity investors concerns of whether a company will provide an adequate return and the risks to that return.

SCE suggests that the Commission permit proxy groups for electric utilities that are not limited to corresponding regulated businesses. Electric utilities with regulated subsidiaries do not compete for capital only with other electric utilities with regulated subsidiaries. Proxy groups should allow for additional companies of commensurate risk from the same, and possibly different, industries as needed to ensure a robust proxy group and to reflect companies with similar risk levels. For example, in its recent formula rate filing,<sup>16</sup> SCE identified a proxy group of companies from Capital-Intensive Network Industries ("CINI") whose risk profiles are more comparable to SCE (versus an electric utility proxy group) when considering California's unique, asymmetrical and significant wildfire risks. Like regulated utilities, these industries are capital intensive<sup>17</sup> and operate

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<sup>15</sup> *Transmission Investment: Revisiting the Federal Energy Regulatory Commission's Two-Step DCF Methodology for Calculating Allowed Returns on Equity*, Edison Electric Institute, December 2017, at p. 20, available at <http://www.eei.org/issuesandpolicy/transmission/Documents/ROE%20White%20Paper.pdf>

<sup>16</sup> Docket No. ER19-1553-000.

<sup>17</sup> "Capital intensive" means that these industries have high capital-to-output ratios; they employ more units of capital per unit of output than most industries in the United States. Financial analysts commonly calculate the so-called asset turnover ratio, which is revenue per dollar investment thus capital intensity equals 1 divided by the asset turnover ratio. See, e.g., Ross, Westerfield & Jaffe, "Corporate Finance," 10<sup>th</sup> edition, 2013, pp. 52-53. In SCE's formula rate filing, SCE required a company to have an asset turnover ratio of less than 1.60 to be included in its CINI sample. In addition to electric utilities, the following industries were  
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networks of assets. Because of these characteristics, companies in these industries generate a relatively small amount of annual revenue per unit of capital and their assets are not readily re-deployed to a different use. As reflected in SCE's recent formula rate case addressing wildfire risk,<sup>18</sup> a non-utility proxy group is particularly relevant when a target utility is below investment grade or has a high risk of non-recovery of a very large cost, atypical for regulated utilities in the United States. This will ensure larger proxy groups and more appropriately address the issue of comparable risk.

Moreover, the Commission's current approach often results in ROE estimates for different proxy groups that are not logically consistent: namely that companies with *higher* risk are awarded *lower* ROE's than companies of *lower* risk. Table 2 indicates ROEs for proxy groups organized by credit rating group.<sup>19</sup>

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included as network industries: water, natural gas distribution, oil and natural gas pipelines, pipeline master limited partnerships ("MLPs"), telecom services, telecom utility, cable TV, trucking, railroads, and air transport. *See* Docket No. ER15-1553-000, SCE Exhibit-25 at pp. 43-44.

<sup>18</sup> Docket No. ER19-1553-000.

<sup>19</sup> As explained in footnote 9, SCE used the proxy group selection process in the Coakley Briefing Order to estimate the four-model average of the median ROEs for several proxy groups based on Moody's and Standard & Poor's bond ratings. SCE also uses a low-end outlier test that is based on the Moody's Public Utility Bond Yield Average for Baa utility bonds (consistent with Commission precedent as discussed below) but keeps the 100 basis point spread to be as consistent as possible with the Coakley Briefing Order, although SCE disagrees with that spread, as discussed below.

**Table 2**

<b>NETO Average Estimate (Four Models, Median) by Credit Rating Category</b>						
S&P Rating (Down)	Moody's Rating (Across)					
	A1	A2	A3	Baa1	Baa2	Baa3
A	#N/A	9.43%	9.77%	9.78%		
A-		<b>9.33%</b>	9.81%	9.85%	9.98%	
BBB+		<b>9.33%</b>	<b>9.71%</b>	<b>9.83%</b>	<b>9.96%</b>	<b>9.52%</b>
BBB			9.84%	<b>9.77%</b>	<b>9.83%</b>	<b>9.49%</b>
BBB-			<b>9.07%</b>	<b>9.29%</b>	<b>9.29%</b>	<b>9.67%</b>

Table 3 shows the size of each proxy group identified in Table 2.

**Table 3**

<b>Average Proxy Group Size (Rounded) by Credit Rating Category</b>						
S&P Rating (Down)	Moody's Rating (Across)					
	A1	A2	A3	Baa1	Baa2	Baa3
A	0	3	9	11		
A-		5	18	22	19	
BBB+		5	20	27	24	9
BBB			13	18	17	7
BBB-			3	6	6	4

As indicated by the tables, this problem is particularly prevalent when the proxy groups are very small. The Commission must rectify this problem by establishing criteria that permit a robust proxy group of companies with comparable risk.

The Commission should then consider risk when placing the target company's ROE within the zone of reasonableness established by this robust proxy group. The Commission must review the totality of the circumstances related to the target company's



risk when determining where to place a company within the zone of reasonableness and whether a finding of above average risk or below average risk is warranted. There is no bright-line answer to this question and such a determination must be made on a case-by-case basis based upon the circumstances and risk profile of the electric utility.

**2. D4. What, if any, are appropriate high- and low-end outlier tests?**

**D4.a. The Commission currently excludes from the proxy group companies whose ROE fails to exceed the average 10-year bond yield by approximately 100 basis points. Should the low-end outlier test continue to be based on a fixed value relative to the costs of debt or (a) should it be based on its value relative to the median (*i.e.*, less than 50 percent of the median); or (b) still reflect the cost of debt but vary based on interest rates?**

The question, also addressed in the Coakley and MISO Briefing Orders, describes the low-end outlier test as excluding “from the proxy group companies whose ROE fails to exceed the average 10-year bond yield by approximately 100 basis points.” The Coakley briefing order cites Opinion 531 for this proposition.<sup>20</sup> Inspection of Opinion 531 reveals that, consistent with Commission precedent prior to Opinion 531,<sup>21</sup> the interest rate used in the test is the Moody’s Baa average with an average of 4.61 percent

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<sup>20</sup> Coakley Briefing Order at P 51.

<sup>21</sup> For example, in *Southern California Edison Company*, Opinion No. 445, the Commission applied an outlier test based a Moody’s public utility bond yield (92 FERC ¶ 61,070 (2000) at 61,266) and in *Kern River Transmission*, Opinion No. 486, the Commission excluded ROE estimates that were less than 126 basis points above the six-month average yield for public utility debt (117 FERC ¶ 61, 077 (2006) at P 140).

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for the period ending in March 2013. The relevant page from the Mergent Bond Record<sup>22</sup> that shows this 4.61 percent average is an average of the Moody's Public Utility Bond Yield Average for Baa utility bonds and that the bonds comprising this average "have maturities as close as possible to 30 years"<sup>23</sup> rather than 10 years. Use of this input is appropriate for estimation of ROE because common equity is perpetual, therefore the bond yield used should be the longest maturity that is in common use.

Moreover, the spread above the Moody's Bond Yield Average that is incorporated in the low-end outlier test, which the Coakley Briefing Order sets at 100 basis points, should be adjusted. In the Coakley Briefing Order, the Commission states a low-end outlier test which excludes ROE estimates less than 100 basis points above a reference bond rate. The practice of setting the low-end threshold 100 basis points above the utility bond yield does not contemplate that the spread between utility bond yields and the cost of utility equity can change over time, and thus the 100 basis point spread may be too low. To reflect current market conditions, the low-end threshold should be estimated by using a risk premium formula based on the CAPM model. The calculation can be summarized as follows:

$$r_{\text{UTILITY}} - r_{\text{BONDS}} = (\beta_{\text{UTILITY}} - \beta_{\text{BONDS}}) \times \text{market risk premium}$$

$r$  is the return on the asset and  $\beta$  is the CAPM beta for each asset category.

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<sup>22</sup> *Mergent Bond Record*, January 2015, p. 213, available at [https://psc.ky.gov/pscecf/2014-00372/mkurtz%40bkllawfirm.com/04062015050516/Corporate\\_Bond\\_Yield\\_Averages\\_%28January\\_2015%29.pdf](https://psc.ky.gov/pscecf/2014-00372/mkurtz%40bkllawfirm.com/04062015050516/Corporate_Bond_Yield_Averages_%28January_2015%29.pdf) (last accessed on January 7, 2019).

<sup>23</sup> *Id.*

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SCE's analysis submitted in Docket No. ER18-169-000 used beta values of 0.50 and 0.26 for utility equities and corporate bonds,<sup>24</sup> respectively, and 9.62% for the market risk premium, resulting in a spread of 231 basis points.<sup>25</sup>

**3. D7. To what extent do credit ratings correspond to the ROE required by investors?**

Credit ratings reflect risk to creditors and are therefore useful when determining what ROE is required by creditors. But, credit ratings do not adequately capture the risk to equity holders, who face more risk than bond holders, particularly in the case of bankruptcy caused by very large asymmetric risks (such as the wildfire risks that California utilities face). Credit ratings and comparison of credit ratings between utilities are directionally correct but weak indicators of relative equity exposure to large cost variances.<sup>26</sup> Relying upon credit ratings as a proxy for comparable risk fails to capture the magnitude of compensation that equity holders require for the cost variances themselves. Accordingly, credit ratings should not serve as the sole or primary method to determine ROE for investors.

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<sup>24</sup> Elton, E. J., M. J. Gruber, D. Agrawal, and C. Mann, "Explaining the Rate Spread on Corporate Bonds," *The Journal of Finance*, February 2001, p. 270, fn. 32.

<sup>25</sup> The market risk premium has increased since the time of that filing.

<sup>26</sup> If the exposure is not large enough to swing a utility across a ratings boundary, models based solely on credit ratings won't capture any of this information, although equity holders are still impacted.

- 4. D8. The Commission excludes from the proxy group companies with merger activity during the six-month study period that is significant enough to distort study inputs. Should the Commission continue using our existing merger screen?**

**D8.a. If so, should the Commission revise its standards for what conduct constitutes merger and acquisition activity?**

SCE recommends that the Commission refine its merger screen to exclude mergers and acquisitions that are relatively small when compared to the total assets of the merging or acquiring company. SCE proposes that the Commission merger screen exclude merger and acquisition activity where the specific assets involved in the merger or acquisition comprise less than 25 percent of the merging or acquiring company's assets preceding the merger. A more sophisticated way to approach this would be to trace the stock price activity relative to an industry index during the pending period of the merger and exclude companies for which the stock price varies more than 10 percent relative to the industry index.

## **D. Financial Model Choice**

1. **E3. Are any models thought to be superior or inferior to others? If so, why?**

**E4. How are alternative models redundant or complementary with each other and/or the DCF model?**

**E5. To what extent do alternative models avoid any deficiencies of the DCF model and/or operate better in diverse capital market conditions?**

**E6. To the extent that investors use multiple models, should the Commission combine them in its analysis or use the “best” one that would apply in all market conditions?**

**E7. If the Commission were to consider multiple models, how should it weigh them?**

**E9. How, if at all, should the Commission consider state ROEs?**

**E10. If the Commission considers state ROEs, how should it compare FERC jurisdictional transmission ROEs with state ROEs that apply to utilities that are (a) distribution and transmission companies; or (b) distribution, generation, and transmission companies?**

All the models proposed in the Coakley Briefing Order complement each other. The Capital Asset Pricing Model (“CAPM”) is the premier model for analyzing the cost of equity capital. It is a risk-based model that was developed more than 50 years ago and it has been widely used in academic research. The biggest advantage of CAPM is that it is an explicitly risk-based model, unlike DCF which is a dividend growth model that only indirectly accounts for risk. Cost of capital practitioners generally employ multiple models to estimate required return on equity and DCF has a place in their toolbox. Moreover, the risk-based models (*e.g.*, CAPM and Risk Premium) complement the DCF

as they look at risk in different way than DCF and may under normal circumstances do a better job of incorporating risk than the DCF.

The Expected Earnings model, because it is based on book value data and not market data, complements all the other models as described above. The prevailing approach is to determine ROE using market data as market data are expected to provide the clearest indication of investors' expectations at any point in time. However, Expected Earnings estimates represent investor expectations (from equity analysts) for earnings and earnings growth as related to the underlying investment itself, *i.e.*, book value of assets and therefore offer a needed complement to market-based methodologies to account for market perturbations that can impact CAPM and Risk Premium methodologies. Expected Earnings is very similar to the Comparable Earnings method used by some cost of capital practitioners. Roger Morin writes the following about the Comparable Earnings method:

The Comparable Earnings approach is far more meaningful in the regulatory arena than in the sphere of competitive firms. Unlike industrial companies, the earnings requirement of utilities is determined by applying a percentage rate of return to the book value of a utility's investment, and not on the market value of that investment. Therefore, it stands to reason that a different percentage rate of return than the market cost of capital be applied when the investment base is stated in book value terms rather than market value terms. ... If regulation's role was to duplicate the competitive result perfectly, the market cost of capital would be applied to the current market value of rate base employed by utilities to provide service. But because the investment base for ratemaking purposes is expressed in book value terms, a rate of return on book value, as is the case with Comparable Earnings, is highly meaningful.<sup>27</sup>

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<sup>27</sup> Morin, "New Regulatory Finance," 2006, pp. 394-395.

The Commission should maintain the multiple model methodology it proposed in the Coakley and MISO Briefing Orders, weighing each model equally to come up with a company's ROE that is specific to its circumstances and prevailing market conditions.

**2. E11. To what extent, if any, should the Commission exercise judgment in using financial models to set ROEs under various capital market conditions?**

As discussed above, the Commission's role is to determine what a just and reasonable ROE is for a given company to meet the following criteria: (1) be sufficient to ensure confidence in the financial soundness of the utility; (2) be adequate to permit the utility to be creditworthy; (3) allow the utility to attract capital; and (4) be comparable with returns on investments of similar risk.<sup>28</sup> To achieve this, the Commission must be permitted to exercise its discretion and judgement to address the particular facts and circumstances related to a company and the prevailing market conditions, rather than systematically following a formula. Therefore, the Commission should avoid a pure formulaic approach and leverage its regulatory judgment to identify "anomalous" market conditions and recognize circumstances specific to a company that create increased risk and therefore necessitate modifications to existing methodologies.

**E. Model Mechanics and Implementation**

**1. 1. General issues/issues that affect multiple models**

**(1) H.1.1. Are IBES data a good proxy for "investor consensus?"**

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<sup>28</sup> See *Hope*, 320 U.S. at 603; *Bluefield*, 262 U.S. at 692.

**H.1.1.a. If not, are there better alternatives, such as Bloomberg, Zacks, S&P Capital, Morningstar, and Value Line?**

**H.1.1.b. Should the Commission combine data from multiple sources?**

**H.1.1.c. What weight, if any, should be given to an estimate if the number and identity of analysts contributing to the estimate is not available?**

**H.1.5. Should growth rates be based on Value Line, IBES, or alternative estimates?**

IBES data are incomplete. Investors have a wide range of expectations for the market and IBES alone is not necessarily representative of their different prospects of utility common stocks. While IBES can be used as one source to estimate investors' expectations, Bloomberg, Morningstar, S&P Capital IQ, Value Line, and Zacks are other credit sources that can be used to reflect the diverse range of investors' expectations. It reduces the subjectivity of using only one source for the short-term growth rate. In Opinion 531, the Commission reaffirmed that "there may be more than one valid source of growth rate estimates."<sup>29</sup> This is particularly important because there is evidence that of these six candidate growth rates, IBES may be the lowest of the group and thus not representative of investors' expectations. Using data as of the end of September 2018, SCE computed average and median growth rates for all of the Value Line utilities and found the following data:

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<sup>29</sup> Opinion 531, P 90.



<b>Average and Median Growth Rates</b>		
Service	Average	Median
IBES	4.88%	4.70%
Value Line	5.18%	5.46%
Bloomberg	5.26%	5.36%
Morningstar	5.13%	5.40%
S&P Capital IQ	5.01%	5.10%
Zacks	5.37%	5.55%

Thus, including six growth rates often relied upon by investors in their analyses would further increase the robustness of the Commission's proposed methodology. Using additional sources for short-term growth rate also makes the zone of reasonableness more robust by increasing relevant data points that reflect the full range of investors' return expectation. Using growth rate projections from multiple sources also increases the sample size, which makes the range of estimated ROEs more reliable. Moreover, the Commission should include all estimates even if the number and identity of analysts contributing to the estimate is not available. By significantly increasing and diversifying the estimates included in its analysis, any individual anomalies have less of an impact overall.

SCE proposes that in addition to a DCF model with IBES growth rates, the Commission should expand its DCF method to include growth rates from Bloomberg, Morningstar, S&P Capital IQ, Value Line, and Zacks.

## **2. Model-Specific Questions**

### **a. DCF**

- (1) H.2.a.3. Do investment analysts project earnings/dividends growth beyond five years, and if**

**not, why not, and is GDP an appropriate proxy for long-term growth?**

**H.2.a.4 How should the Commission weight short-term and long-term earnings/dividend growth projections?**

GDP is not an appropriate proxy for long-term growth. Using a forecast of GDP growth for the long-term earnings growth rate assumption in the Commission's two-step DCF model understates the growth that public utilities are expected to achieve, as seen historically in the difference between the growth rate of the economy generally and that of utilities. Theoretical and empirical evidence supports the notion that utilities' productivity (and in turn their earnings) grow at different rates than the economy does. Public utilities grow based upon the rate of rate base growth, not GDP growth.

The Commission's one-third weighting of GDP growth in the two-step DCF model was adopted by Opinion 531 from this Commission's approach to ROE for pipelines. However, the Commission's rationale in originally deciding to give GDP growth a one-third weighting for pipelines does not apply to electric utilities, and the Commission's original reasoning suggests that the long-term growth rate should be given less weight in any two-step DCF model applied to electric utilities. The Commission also found in Opinion 531 that "earnings forecasts made by investment analysts are considered to be the best available estimates of short-term dividend growth because they are likely relied on by investors when making investment decisions."<sup>30</sup> However, to the

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<sup>30</sup> Order 531 at P 17.

extent that security analysts' forecasts cannot be extrapolated using EPS estimates, analysts may be taking into account long-term growth levels beyond five years to develop their short-term estimates, thus blurring the lines between short and long-term growth rates and suggesting that less weight be given to the Commission's measure of long-term growth rate.

The Commission previously decided to not weigh long-term growth rates and apply a long-term growth rate due to industry restructuring and "investors would be unlikely to place much weight on long-term forecasts because the uncertainties regarding the future were so great."<sup>31</sup> Today, the electric industry is in a state of continued transition and consolidation. Because of this consolidation and transition, and in light of the issues relating to the weighting of long-term growth rate, the Commission should return to a one-step DCF that does not consider long-term growth levels.

**(2) H.2.a.6. Are six months of average high/low historical monthly stock prices an appropriate measure for the current stock price "P"?**

No. The Commission should evaluate a shorter period of time, perhaps three months, for average high/low historical monthly stock prices in order to more appropriately capture sudden significant events.

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<sup>31</sup> ROE NOI at P 11.

#### IV. CONCLUSION

SCE respectfully requests that the Commission modify its ROE framework as described in these comments.

Respectfully submitted,

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Dated: June 26, 2019

## **CERTIFICATE OF SERVICE**

I hereby certify that I have this day served the foregoing **COMMENTS OF SOUTHERN CALIFORNIA EDISON COMPANY IN RESPONSE TO THE COMMISSION'S MARCH 21, 2019 NOTICE OF INQUIRY** upon each person designated on the official service lists compiled by the Secretary in this proceeding.

Dated at Rosemead, California, this 26<sup>th</sup> day of June, 2019.

/s/ Norman Goss

Norman Goss

Legal Administrative Assistant

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