

**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  
)

**INITIAL COMMENTS OF THE  
MARYLAND OFFICE OF PEOPLE’S COUNSEL**

In its March 21, 2019, Notice of Inquiry<sup>1</sup> (“ROE NOI” or “NOI”), the Federal Energy Regulatory Commission (“Commission” or “FERC”) initiated an examination of its policies for determination of return on equity for regulated utilities. The Maryland Office of People’s Counsel (“MdOPC”), as the statutory representative of the interests of Maryland residential consumers in utility cases,<sup>2</sup> provide these initial comments on certain of the questions raised for comment in the NOI.

## COMMENTS

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

The allowed return on equity (“ROE”) is a key component in investment decision making. However, the allowed ROE is not the only component. The allowed ROE, as supplied by market actions and interpreted by FERC, provides management with an expected rate of return that can be attained with prudent actions.

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

<sup>2</sup> Maryland Public Utilities Code Annotated, §2-205(b)(2016) (the People’s Counsel “may appear before any federal or state agency as necessary to protect the interests of residential...users of [gas, electricity or other regulated services].”

The *Hope*<sup>3</sup> and *Bluefield*<sup>4</sup> cases have been the standard guidance for setting ROEs across the country for many years. MdOPC maintains that utility management must earn the allowed ROE by always acting in the best interest of stockholders and utility customers alike. No rate of return should be guaranteed but, instead, utilities should only be given the opportunity to earn their rate of return.

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?*

As set out in the NOI, FERC has followed a long road to its current reliance on the Discounted Cash Flow (“DCF”) model. Coakley and MISO would have the Commission change its long-reliance on the DCF to give equal weight to the DCF, the Capital Asset Pricing Model (“CAPM”), the Risk Premium (“RP”) model, and the Comparable Earnings (“CE”) model. In giving equal weight to these three other models, the FERC is opening the debate on the merits of each of these models. Assuredly, debate on the nuances of each of these four models will involve numerous hearings, numerous court cases, and years upon years of debate.

MdOPC questions the need and wisdom of such analyses on each of the above-stated ROE methods. The FERC has already been through a long debate on the merits of the DCF and concluded it was the best model for use in ROE analyses. That long history raises the question: what has changed to merit the need for such a change? MdOPC posits that nothing has changed. The DCF is working fine whereas the other models are not.

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<sup>3</sup> *Fed. Power Comm’n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

<sup>4</sup> *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm’n*, 262 U.S. 679 (1923).

Equity investors will consider any change in the FERC ROE methodology to involve a measure of regulatory risk that, heretofore, has not been present with the FERC's reliance on the DCF. This extra risk will cost consumers through higher rates as investors will incorporate the higher risk in the prices they are willing to pay for these utility equities. It is the position of MdOPC that market reaction to a change as noted in the Coakley and MISO briefing orders will be negative and cause unnecessary risk to be reflected in market prices, thereby driving up the capital cost of utility projects.

*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?*

The use of four ROE models instead of only the DCF involves more judgment and more complexity. Investors will grapple with the details of four models and, as such, predictability of FERC actions would be left open, thereby creating additional risk and higher costs for consumers.

Forecasting allowed ROEs is already a difficult process. Adding three additional models will only increase the risk with no guarantee of additional accuracy in the allowed ROE. With an increase in risk, investors will demand a corresponding increase in the return. The end result will be an increase in the cost of utility capital projects.

*A3. Currently, public utilities in different Independent System Operators (ISOs) or RTOs may receive different ROEs, despite all using national proxy groups, due primarily to differences in when FPA section 205 or 206 proceedings were initiated. Are such variations justified, and, if not, should the Commission consider applying the same ROE to all utilities in RTOs/ISOs based on the most recent proceeding?*

No. ROEs are dynamic and company-specific. Setting a single ROE across an entire ISO/RTO would confuse the concept of risk and return in matters of time and risk pertinent to the specific utility in question.

A company with a low risk profile would earn the same ROE as a company with a high risk profile. Such a situation is simply illogical and would create additional risk for investors. Furthermore, to the extent that investments in a high-risk venture are assigned a lower risk ROE due to the requirement that the entire ISO/RTO have the same ROE, investors will ultimately choose not to make the investment because the allowed ROE will not be enough to warrant the added risk of a special project. As a result, utility projects will be at-risk of not being undertaken if the return does not match the corresponding risk of the project/utility.

In addition, setting the ROE across the entire ISO/RTO could incentivize utilities to change the timing of rate base investment such that plant construction is completed at a time when a more risky utility is expected to receive an allowed ROE from the FERC.

The task of the FERC is not to make decisions that influence investment decisions. Instead, the task of the FERC is to interpret market sentiments on a particular investment or utility and apply an ROE based on that particular risk and expected return. Any actions taken by the FERC to apply a ISO/RTO system-wide ROE would inject additional risk into the marketplace and alter the dynamics of decisions involving plant investment.

Lastly, based on the comments above, it is also clear that setting a single ROE for application across the entire ISO/RTO would be in violation of the comparability standard as set forth in Hope and Bluefield.

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?*

As noted in the MdOPC comments in A3 above, the allowed ROE should be based on a specific utility at a specific point in time. For the reasons stated above, varying the ROE in any other manner has the potential for a misalignment of return requirements with risk parameters thereby increasing costs for consumers.

A.4.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?*

MdOPC does not believe a “vintage approach” should be adopted by the Commission. Such an approach could lead to erratic investments in that investors, if they believe returns will increase in the future, may delay making critical infrastructure improvements so they could lock in relatively high returns for the life of the asset.

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?*

No. Setting an allowed ROE should be done at a specific time for a specific company. Applying a national ROE set on an annual basis and having that ROE set for the life of the asset will only add additional risk in the marketplace. Specifically, setting an ROE for the life of an asset creates a measure of uncertainty as to future market changes. If the cost of capital increases in future year but the ROE is set for a specific project, the utility will under-earn relative to its current market

requirements. Similarly, the reverse is true if the cost of capital decreases in future years as the utility will then over-earn relative to market requirements.

### **C. Performance of the DCF**

- 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?*

Sudden geopolitical movements can stoke fear in the market and cause all stock prices to act erratically causing DCF results that could be considered questionable. However, sudden movements in stock prices simply reflects ongoing risk as noted in the marketplace. If a situation arises in the marketplace that frightens or encourages the market, a change in stock prices simply reflects the reality at that particular moment in time. A sudden movement in the marketplace does not imply a flaw in the DCF. To the contrary, a sudden movement in the marketplace reflects the risk/return paradigm at that time.

An effective analyst can temper short-term price movements by examining a company over an extended timeframe. A short-term (one-week, for example) dividend yield analysis can be combined with similar analyses from longer time periods, such as 4-weeks, 13-weeks, or 26-weeks. Examination of short-term dividend yields as well as long-term dividend yields provides a robust analysis that is ideally suited to capture the entire market sentiments.

The DCF, unlike the CAPM, CE, or RP, can reflect sudden market movements. None of the other three models can capture a quick change in risk of a particular security or even the marketplace. Clearly, the DCF has no match in terms of capturing sudden stock price movements and the corresponding change in risk and return.

*C2. Have current and projected proxy company earnings over the last 10 to 20 years increased in a manner that would justify any increases in their stock prices over the same period, consistent with DCF model assumptions?*

Earnings have risen for utilities over the past 10-20 years and, likewise, stock prices have also risen. However, there has also been a flight to high quality yields due to the fact that interest rates have decreased over, at least, the past 10 years. When the impact of lower interest rates is combined with an increase in utility earnings, it is easy to understand why utility stock prices have risen.

It is also important to note that allowed ROEs have been declining at a slower pace than is warranted by the results of various ROE analyses. Realistically, the average allowed ROEs should be in the range of 8.0% to 9.0% in today market so as to reflect lower interest rates and higher stock valuations. The fact that allowed ROEs are at higher levels than warranted are the reason why stock prices have increased at a pace slightly higher than earned returns on equity. Hence, there is no violation of the DCF model assumptions. Instead, the higher-than-warranted allowed ROEs have created higher stock value multiples.

*C3. How does the DCF perform over a wide range of interest rate scenarios?*

The DCF model works well in both high and lower interest rate scenarios. The DCF model contains a dividend yield, which investors compare to interest rates. As such, investors bid up and bid down utility stocks in comparison to interest rate levels. Neither the CAPM, the RP, nor the Expected Earnings model are capable of quickly incorporating interest rate movements into ROE analyses.

*C3a. What specific assumptions of the DCF model, if any, do not work well in low or high interest rate environments?*

As explained above, the DCF work well in both a low and high interest rate environments.

C3b. *Is there evidence that the volatility of price-to-earnings ratios over the last 10 to 20 years, assumed to be constant in the DCF methodology, has been driven by the wide swings in interest rates over this period? If so, would the constant P/E assumption impact the award of reasonable ROEs?*

Regulatory commissions have been slow to recognize the lower cost of capital over the past ten years. As a result, as interest rates have fallen, utility P/Es have risen to reflect the allowed ROEs that have been set at higher levels than market-required ROEs derived from the DCF model. As an example, Exelon had a Value Line reported P/E of 11.5 in 2009 whereas its P/E in 2018 was an astonishing 20.1. In 2009, the average allowed ROE in 2009 was 10.52% versus the average 2008 allowed ROE of 9.60%. The average yield for a 30-year US Treasury bond was 4.08% in 2009 as compared to 3.11% in 2018.

Investors have reacted to lower interest rates and not to wide swings in interest rates. Specifically, investors are searching for yields in a low interest rate environment. In its May 17, 2019 edition, Value Line states the following in its Electric Utility (East) Industry section:

Most electric utility stocks have performed well in 2019. The majority of issues have risen in price by more than 10%. The market's expectation of a more-sanguine interest-rate environment has benefited these issues. The average dividend yield of stocks in this industry is 3.3%. This is low, by historical standards, but still compares favorably with the median yield of all dividend-paying stocks. Thus, equities in this industry are still attracting investors who are "reaching for yield." (underline added)

## **E. Financial Model Choice**

E1. *What models do investors use to evaluate utility equities?*

The DCF model is, by far, the most valued and the most trusted model in use by investment professionals. One need only look so far as investment reports such as *The Value Line Investment*



*Survey* (“Value Line”) to see the importance investors place on growth rates and dividend yields, both of which are central to the DCF model. Investment reports such as IBES and CFRA also contain similar information such as dividend yields and growth rates. However, such investment reports do not, universally, report items such as beta and risk premiums, both of which are needed in either the CAPM or the RP models.

The fact that utility and consumer witnesses all universally use the DCF model is another indicator of the importance that analysts and regulators around the country place on the model. Such weight is not afforded to the CAPM, RP, or CE models as these models are rarely given the same weight by regulators in assessing the proper ROE to use in ratemaking.

One of the strengths of the DCF model is its simplicity. Investors, large and small, are all capable of adding a dividend yield to a growth rate and arriving at an ROE. The same cannot be said of the CAPM, RP, or CE models. Indeed, the ease of use of the DCF is clearly one of the primary reasons why the DCF is the most trusted model by investors around the United States and the world. The CAPM, RP, and CE models are best used to assess DCF range estimates and are not used as stand-alone models by investors.

## E.2 *What role do current capital market conditions play in the choice of model used by investors to evaluate utility equities?*

The Commission must be wary of the phrase: this time is different. Utility witnesses that can no longer use the DCF model to justify double-digit returns are using this phrase to argue that current market conditions invalidate DCF results. Nothing could be farther from the truth. If a model worked during “normal” market times, a definition of which is highly debatable by itself, the model works in periods that are on the periphery of “normal” times.

OPC notes the following quote from then-Federal Reserve Chairperson Margaret Yellen in 2016 when she commented on the “new normal” In a press conference after the Federal Reserve held policy steady, Yellen spoke of a sense that rates may be depressed by “factors that are not going to be rapidly disappearing, but will be part of the new normal.”<sup>5</sup>

If the United States has, indeed, entered into a sustained period of low interest rates, it would be unwise to change models now simply because the current times are not “analogous” to past market times.

E.3. *Are any models thought to be superior or inferior to others? If so, why?*

The DCF is superior to the CAPM, RP, and CE models for the reasons stated in item E1 above.

E.4. *How are alternative models redundant or complementary with each other and/or the DCF model?*

Other models, such as the CAPM, RP, and CE models, are complementary to the DCF. These other models are, contrary to the DCF, incapable of being company-specific coupled with up-to-date financial data.

Among the CAPM, RP, and CE models, only the CAPM uses data that is related to the specific company being analyzed. In the CAPM, one must use a beta variable in which systematic risk is analyzed. However, sudden changes in a particular stock cannot be measured by the CAPM as the beta coefficient uses historical data to measure systematic risk.

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<sup>5</sup> <https://www.bloomberg.com/news/articles/2016-06-15/yellen-seems-to-sign-on-to-summers-view-of-lingering-low-rates>

The RP model cannot measure company-specific variables nor can it assess up-to-date information. The RP, like the CAPM, depends on historical information and, as such, cannot accurately determine, on its own, current market conditions.

The CE model measures expected returns on book value, but it does not measure expected returns on market value and, as such, is not, by itself, a suitable guide for market expectations.

Because of the inherent flaws in the CAPM, RP, and CE models, as stated above, the best use of these models is the use of them as complements to the DCF. To be specific, these models can help locate the range of results most accurate within the DCF.

E.5. *To what extent do alternative models avoid any deficiencies of the DCF model and/or operate better in diverse capital market conditions?*

The CAPM, RP, and CE models have material flaws, as described above, that, when used alone, are inferior to the DCF. Therefore, those models do not avoid any deficiencies of the DCF.

E.6 *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?*

Investors may use different ROE models, but MdOPC maintains the DCF is the superior model, and should be used in all market conditions. As noted in MdOPC’s comments to E2 above, a model that has worked well in “normal” conditions will also work well in conditions (current low interest rate environment) rarely seen in modern times.

E.7. *If the Commission were to consider multiple models, how should it weigh them?*

If the Commission were to consider using multiple models, the vast majority of the weight must go to the model that can react fastest to market and company specific movements. That model is clearly the DCF. As a result, DCF results should receive a majority of weighting, with other models, such as the CAPM, RP, and CE, receiving a combined minority weighting to the DCF model.

E.8. *To what extent is it reasonable for the Commission to use a simplified version of a model that does not reflect all the variables that investors consider?*

According to the Efficient Market Hypothesis, all the variables considered by investors are embedded in current market prices. Since market prices are an underlying component of the DCF model through the dividend yield, the DCF does capture all market variables that investors consider.

E8.a. *Is the use of a simplified model justified for ease of administration and predictability of result? If the Commission were to consider multiple models, how should it weigh them?*

OPC maintains that a model should not be used solely for its simplicity. While ease of administration and predictability are important variables, investor determination of the market required return should not be diluted for ease of use in the model.

E.9 *How, if at all, should the Commission consider state ROEs?*

Investors consider allowed state ROEs in the determination of the market required rate of return. Indeed, MdOPC maintains a primary reason why market valuations are so much greater than book valuations is that state regulatory bodies have been slow to react to lower capital market conditions. MdOPC posits that state allowed ROEs should be considered as part of the CE analysis

that, in turn, should be used to assist in the determination of the proper ROE range from the DCF model.

- E.10 *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?*

The FERC regulates transmission assets. MdOPC believes the proper comparison should be only to state ROEs that applies to utilities with only distribution and transmission companies. Generation is, generally, riskier than transmission and distribution. As such, to be comparable, the Commission should examine only state returns for transmission and distribution.

- E.11. *To what extent, if any, should the Commission exercise judgment in using financial models to set ROEs under various capital market conditions?*

Setting a market required ROE is, undoubtedly, an exercise in judgment. Judgment is used in the selection of the components of each model and judgment is used in the actual calculation details of the various models. Investors use judgment in the application of any cost of capital model in ROE analyses and so should this Commission. Doing so would be a disservice to investors as well as to consumers.

## **F. Mismatch between Market-based ROE and Book Value Rate Base**

- F1. *Does the mismatch between market-based ROE determinations and a book value rate base support current market values? Is this mismatch a problem?*

Investors are aware that market prices reflect a market ROE applied to a book value rate base. As a result, there is no mismatch. The mismatch often comes when witnesses in regulatory proceedings misapply the CE model and equate market value to book value in the determination of the proper ROE.

At present, market values of utility equities are, in general, well above book value of the underlying securities. A return on book value that is much less than market value will, by pure math, produce a higher return on book value than a return on market value. Analysts should make this representation to regulators who, in turn, should continue to set a ROE on book value rate base.

F2. *Why have most or all utility market-to-book ratios consistently exceeded one?*

As stated previously, investors are engaged in a chase for yields. As interest rates have fallen, investors are looking at alternative investments that provide yields. In addition to the chase for yield, regulatory bodies around the United States have been slow to recognize lower capital costs. The chase for yields and the high allowed ROEs have combined to cause market valuations to be much greater than book valuations.

F3. *How should the ROE level be set relative to the cost of equity?*

The ROE is the cost of equity for the underlying security. The Commission should continue to derive the ROE that represents the cost of equity for the Company being analyzed.

F4. *Should the Commission revise our use of these models to account for the mismatch between market-based ROE determinations and book-value rate base? If so, how? For example, should the Commission adjust the dividend yield used in the DCF model to represent a yield on book value rather than a yield on stock price?*

No. If the DCF has worked well in the past, it works well today. The DCF is not invalidated simply because interest rates have fallen. To the contrary, market valuations today completely reflect all known variables in the marketplace and accurately portray the market required ROE.

The task of the Commission is not to make the market but, instead, to assess the market required ROE and apply that ROE to rate base. Adjusting market valuations will create uncertainty in the marketplace that will, eventually, cause the cost of capital to increase and prices for consumers to, likewise, increase.

F5. *Should the Commission consider adjusting ROEs to account for market-to-book ratios above or below one? Would doing so introduce circularity into Commission ROEs by setting the ROE at whatever level of earnings the market expected, rather than making an independent assessment of the appropriate ROE?*

As discussed in the response to F4 above, the Commission should never set the market but should assess the market required return and set the allowed ROE at that level.

## **H. Model- Specific Issues**

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

H.1.1. *Are IBES data a good proxy for “investor consensus?”*

Yes, IBES is a good proxy for investor consensus, but IBES should not be used by itself. IBES provides only earnings estimates. Other data, such as dividend and book value growth rates should also be considered in assessing a company’s market required ROE.

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

MdOPC encourages the Commission to use a wide range of data sources. Doing so provides a more robust review of the entire marketplace. In particular, MdOPC encourages the Commission to consider the use of Value Line as this source is the most complete source of all company data. Specifically, Value Line provides historical and forecasted earnings, dividends, and book value growth rates. It also provides information on returns on book value and written explanations of anticipated activities that may drives the equity price in the near term.

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

As noted in the response immediately above in H.1.1., MdOPC recommends the FERC use a wide range of data sources so as to incorporate as many market expectations as possible.

*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?*

To the extent the Commission believes the source is a good source and investors use the information from the source in investment decisions, the Commission should afford that source its proper weight. MdOPC has previously recognized the Commission must exercise judgment in its determination of the market required ROE. The Commission can use its judgment as to the accuracy of each data source simply by reading the estimate provided by the source, the reasons cited by the source for the estimate, and how that estimate and associated reasons compare to other sources.

*H.1.2. To what extent does model risk affect all ROE methodologies?*



OPC maintains there is an element of risk in any cost of capital method. However, as discussed in response to questions above, there is significantly more risk of inaccurately assessing the market required ROE when using the CAPM, RP, and CE than when the DCF is employed.

*H.1.3. The DCF model incorporates data at the parent/holding company level (e.g., stock price). The Commission adjudicates cases at the operating company level, for which there is no public data like stock prices, growth rates, and betas. What impact does this disparity have on the results of the DCF and other models?*

If a company has a mix of low-risk regulated and higher risk unregulated companies, using holding company data will, by itself, result in a higher ROE being assigned to the lower risk utility operations. However, it is the task of the analyst to recognize the higher risk that may exist within holding companies and make a recommendation at a lower ROE to reflect the lower risk of regulated operations. The Commission, itself, can use its own judgment to recognize the lower risk of regulated operations and adjust the ROE accordingly.

*H.1.4. Should the Commission continue to rely on the efficient market hypothesis, which underlies the DCF and CAPM models? Why or why not?*

Yes. The efficient market hypothesis (“EMH”) assumes that investment decisions are based on all known market information available at that time. The EMH has been central to investment decision making for decades and is, generally, accepted by investors to be an accurate understanding of how the market operates.

At a time of instant information in the hands of investors, the EMH, if anything, is more accurate today than in years past.

H.1.4.a. *If yes, should the Commission continue to employ outlier screens, M&A screens, etc., for the DCF and CAPM models since these models need to incorporate all relevant information?*

Outlier screens are more for comparability standards than as a critique for the EMH. To the extent an equity is being influenced by factors other than the utility operating duties of a company, such as when a company is being valued for a merger, a screen is necessary to negate these other issues.

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

Growth rates for use in the DCF and CAPM should be derived from a variety of sources including, but not limited to, Value Line, IBES, Schwab, and CFRA. Investors do not limit their analyses to a single source of growth rates and neither should the Commission. Of the growth rate sources listed above, MdOPC opines Value Line to be the most complete source as it provides a wide range of historical and forecasted growth rates.

H.1.6 *Should the same growth rate sources be used across models, if more than one model is used to determine the ROE?*

As stated above, MdOPC maintains it is proper to use a wide range of growth rates from several sources. Investors use a wide range of resources, and the Commission should use these same resources across all models. There is no academic or practical reason why the same growth rate sources should be used for all models to determine the ROE.

## 2. **Model-Specific Issues**

### a. **DCF**

H.2.a.1 *Should the Commission continue to use a dividend DCF model or should the Commission use a different DCF model, for example, one based on free cash flow?*

A cash flow DCF model is identical to a dividend DCF model with one exception. The cash flow DCF model assumes a future value for some cash flow other than the payment of a dividend. As such, the cash flow model will inject an amount of uncertainty assumed from the marketplace that does not exist in the dividend DCF model. In most circumstances, the cash flow DCF will assume a terminal stock valuation. The determination of the terminal stock valuation will depend on a future Price-to-Earnings (“P/E”) multiple or, perhaps, a cash flow valuation. Regardless of exactly how the future valuation is determined, an element of risk and unknown subjectivity will become part of the valuation process. This extra level of risk will not provide any assurance of greater accuracy of the DCF results. In fact, it is highly possible, if not likely, that the extra level of risk associated with determining the terminal stock valuation will have the exact opposite effect and make the DCF model less reliable.

*H.2.a.2. Could terminal stock value be used in place of long-term growth projections? If so, how should terminal stock value be determined?*

Terminal stock values cannot be used in place of long-term growth rates, but terminal stock valuations could be used in conjunction with long-term growth rates. Long-term growth rates, as produced by Value Line, could be used to determine expected dividends to be paid in the years prior to the payment of the terminal stock value. The terminal stock value as noted in Issue H.2.a.1. could be calculated using a P/E ratio or a cash flow ratio.

*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?*

MdOPC is not aware of any source that forecasts earnings/dividend growth beyond five years. MdOPC assumes the reason for the lack of forecasts beyond five years is the difficulty in

assessing such long-term growth. It is also assumed that, for practical reasons, investors understand that a five-year forecast is a reasonable approximation for any long-term growth rate.

MdOPC also maintains, as previously stated, that analysts assessing the market required ROE should provide the most information available and then provide reasons for the selection of such a forecast (five years) as a proxy for long-term growth.

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

MdOPC recommends the Commission rely primarily on long-term growth rates. The DCF is predicated on the long-term growth of dividends. To be consistent with the fundamental basis for the model, we believe long-term earnings/dividends growth rates forecasts should be used in the DCF analysis. However, given that short-term factors may impact earnings and dividend growth rates in various manners, MdOPC maintains that analysts presenting witness testimony before the Commission should present information, and then provide specific reasons for their recommendations.

*H.2.a.5. The Commission uses a constant growth DCF model. Should the Commission consider using a multi-stage DCF model? If so, how would the Commission determine the length of each stage of a proxy company's growth?*

No. The multi-state DCF may require a terminal stock valuation. Per the comments above, calculating a terminal stock valuation is subject to highly debatable pricing estimates that will, in all likelihood, not add material value to the ROE estimate.

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

A period of six months of high/low monthly stock prices is an acceptable time period for use in the dividend yield of the DCF model. However, MdOPC believes that it would be more appropriate to use weekly stock prices as opposed to high/low monthly stock prices. The reason for this preference is that weekly prices would smooth out price variations and be more reflective of long-term investor expectations.

**b. CAPM**

*H.2.b.1. If the market risk premium is determined by applying the DCF methodology to a representative market index, should a long-term growth rate be used, as in the Commission's two-step DCF methodology?*

This approach should not be used because it would result in an inappropriate mixing of two different models.

*H.2.b.2. Beta is a measure of a security's risk relative to the broader market, such as the S&P 500, not of its absolute risk. Do CAPM's assumptions break down if both utility stocks and the broader market become riskier over time on an absolute basis, but the relative increase in risk in utility stocks rises more slowly?*

No. Beta measures risk relative to the total market. If the market gets riskier, beta would not necessarily shift relative to the market. Furthermore, if beta does change, it is also likely that the risk premium used in the CAPM would change, and thereby possibly offset the calculated ROE.

*H.2.b.3. What are appropriate data sources for the beta value?*

As stated previously, MdOPC posits that Value Line is the most detailed and most trusted investment source currently available in the industry. The Value Line beta is calculated over a

long-term time period that dampens volatility and, as such, is the most representative source now available in the marketplace.

*H.2.b.4. Should the Commission employ more sophisticated versions of the CAPM model that consider more variables instead of only beta, such as the Fama- French Model?*

MdOPC is not aware of a more sophisticated version of the CAPM that is in widespread use by the investment community. As a result, we do not believe it is appropriate to use a more complicated version of the CAPM. If a more sophisticated/complicated version of the CAPM model is used by the FERC, the market will react by driving up the market required ROEs to offset the risk of the unknowns associated with the new CAPM.

**c. Expected Earnings**

*H.2.c.1. Should the use of utilities in the proxy group for the Expected Earnings model be predicated on the Expected Earnings analysis being forward looking?*

MdOPC believes that historical earned returns should be used in conjunction with forecasted earned returns. MdOPC is reminded by the old adage that “Those that do not learn from history are bound to repeat it.” Analysts should present as much data as possible and then provide the Commission with a recommendation for his/her specific recommendation.

*H.2.c.2. What, if any, concerns regarding circularity are there with using the Expected Earnings analysis to determine the base ROE, as opposed to using the analysis for corroborative purposes?*

MdOPC agrees that Expected Earnings can lead to circularity problems. Furthermore, Expected Earnings can be misleading unless the analyst fully recognizes and explains that the

model is based on book value and not market value. When market values exceed book values, such as in current times, reliance Expected Earnings can lead to excessive ROEs. For these reasons, Expected Earnings should be used only for assistance in choosing a ROE range from DCF results.

**c. Risk Premium**

*H.2.d.1 – Should the analysis be historical or forward-looking?*

MdOPC posits that the derivation of the risk premium for use in the Risk Premium model should contain an examination of both historical and forward-looking analyses. However, as stated previously, it is incumbent on the analyst performing the ROE analysis to provide a full explanation for the basis of his/her decision as to the proper risk premium for use in the model.

*H.2.d.2. Is a Risk Premium analysis compatible with a finding of anomalous capital market conditions? Why or why not?*

The answer to this question depends on whether the analyst uses historical or future looking risk premiums. If the analyst uses a historical risk premium but maintains that current market times represent anomalous capital market conditions, the analyst has mixed apples and oranges. Utility witnesses often criticize the use of the DCF model by citing anomalous market conditions. However, these same utility witnesses will then use historical market premiums in the RP and CAPM, thereby contradicting their own analyses.

*H.2.d.3.i. Is there a method by which the Risk Premium ROE could be adjusted upward for an above average utility or downward for a below average risk utility? If not, is it reasonable to consider the results of a Risk Premium analysis when determining the ROE of an above or below average risk utility?*

This question is an indicator of the inherent problem with the RP model. This model simply cannot be used as a stand-alone model for a particular single company to determine the market-required ROE for that particular company. The RP model is only suitable to assist in the determination of a ROE through other models, such as the DCF.

H.2.d.3.ii. *Is it appropriate to use a Risk Premium analysis when conducting the first prong of the section 206 evaluation?*

As discussed in the response to H.2.d.3.i, the RP model should only be used as a secondary measure for determination of the market-required ROE. This model should not be used as a stand-alone mode.

## CONCLUSION

For the reasons discussed in MdOPC's comments above, the DCF model should remain the primary model for determining the required ROE for a public utility. Reliance on other models, which have significant limitations, either primarily or in a weighting with the DCF, will lead to inaccurate results, uncertainty among investors, and unnecessarily higher costs for ratepayers.

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