NEW YORK STATE OF OPPORTUNITY. Department of Public Service

Public Service Commission
John B. Rhodes
Chair and
Chief Executive Officer

Diane X. Burman
James S. Alesi
Tracey A. Edwards
Commissioners

Thomas Congdon
Deputy Chair and
Executive Deputy

John J. Sipos
Acting General Counsel

Kathleen H. Burgess
Secretary

Three Empire State Plaza, Albany, NY 12223-1350
www.dps.ny.gov

June 26, 2019

SENT VIA ELECTRONIC FILING

Kimberly D. Bose, Secretary
Federal Energy Regulatory Commission
888 First Street, N.E.
Room 1-A209
Washington, D.C. 20426

Re: Docket No. PL19-4-000 – Inquiry Regarding the Commission's Policy for Determining Return on Equity

Dear Secretary Bose:

Attached, for filing in the above-referenced proceeding, please find the Comments of the New York State Public Service Commission. Should you have any questions regarding the attached, please feel free to contact me at (518) 402-1537.

Very truly yours,

/s/ S. Jay Goodman
S. Jay Goodman, Esq.
Assistant Counsel

Attachment

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 THE NEW YORK STATE PUBLIC SERVICE COMMISSION

Pursuant to the Notice of Inquiry ("NOI") issued by the Federal Energy Regulatory Commission ("Commission") on March 28, 2019,[1] the New York State Public Service Commission ("NYSPSC")[2] submits these comments regarding the methods and policies that should apply to the "determination of the return on equity (ROE) to be used in designing jurisdictional rates charged by public utilities."[3] The Commission also seeks comments on whether any changes to these policies and methods should be applied to interstate natural gas pipelines and/or oil pipelines.[4]

As described herein, the Commission should adopt policies and methodologies that establish ROEs using transparent, reliable, and consistent protocols that reflect actual market conditions. These policies and methodologies should be applied across industries to electric

---

1 166 FERC ¶61,207 (March 21, 2019); Fed. Reg. Vol. 84, No. 60, pp. 11769-11777.

2 The views expressed herein are not intended to represent those of any individual member of the NYSPSC. Pursuant to Section 12 of the New York State Public Service Law, the Chair of the NYSPSC is authorized to direct this filing on behalf of the NYSPSC.

3 Id., p. 11769.

4 Id.

transmission companies, natural gas pipeline companies, and oil pipeline companies. The Commission also should reduce reliance on "black box" settlements in natural gas pipeline cases.

I. THE COMMISSION SHOULD RELY ON THE TWO-STEP DISCOUNTED CASH FLOW MODEL TO ESTABLISH A RANGE OF JUST AND REASONABLE ROEs

The request for comments on the methods and policies to be used for ROE determinations follows the decision of the U.S. Court of Appeals for the District of Columbia Circuit ("D.C. Circuit") in *Emera Maine v. FERC*.[5] In *Emera Maine*, the D.C. Circuit held that the Commission failed to establish a "rational connection" between record evidence and its decision to set the utility's base ROE at the upper midpoint of a range of ROEs, rather than the midpoint of the range.[6] The Commission had selected the upper midpoint to address its concern that "anomalous" market conditions undermined the reliability of the ROE range indicated by its standard two-step Discounted Cash Flow ("DCF") analysis. In light of this ruling and Commission concerns that the DCF model might not yield ROEs that satisfy applicable capital attraction standards following the financial crisis of 2008-09,[7] the Commission initiated this proceeding to a take a fresh look at the policies and methods that should be used to determine whether ROEs for public utilities that are sufficient to attract capital, provide a reasonable return, and maintain just and reasonable rates.

This inquiry is examining whether the Commission should continue relying on the two-step DCF analysis adopted in Opinion No. 531 to determine the range of reasonable ROEs

---

5 854 F.3d 9 (DC Cir. 2017) (*Emera Maine*).

6 *Emera Maine*, 854 F.3d 30.

7 ROE NOI, P24.

or, in the alternative, adopt one or more alternative methods to determine this range.[8] The ROE NOI explains that the Commission has considered the Capital Asset Pricing Model ("CAPM"), Expected Earnings, and Risk Premium methodologies (collectively, the "Alternative Valuation Methodologies") as alternative financial models that may be combined with the DCF analysis for the purpose of determining a just and reasonable ROE. With one key exception, the two-step DCF analysis adopted in Opinion No. 531 continues to be the most reliable method for determining just and reasonable ROEs, and the Alternative Valuation Methodologies should not be used or considered when establishing utility ROEs.

The Commission's decision to depart from sole reliance on the two-step DCF method was driven largely by its concern that "anomalous market conditions" surrounding the financial crisis of 2008-09 weakened the reliability of DCF results.[9] Specifically, the low yields on bonds, including U.S. Treasury bonds, observed after the financial crisis undermined the Commission's confidence that the zone of reasonableness produced by the two-step DCF methodology would provide a risk-appropriate ROE and satisfy applicable capital attraction standards.[10] The Commission thus considered the Alternative Valuation Methodologies, and ROEs set by state utility commissions, to inform its review of the DCF results.[11]

The two-step DCF methodology remains the most reliable model to establish just and reasonable ROEs. Market conditions do not justify deviating from this precedent. Moreover, the Alternative Valuation Methodologies that have been proposed to supplement or

---

8 Docket No. EL11-66-001, Coakley et al. v. Bangor Hydro-Electric Co. et al., Opinion No. 531 – Order on Initial Decision (issued June 19, 2014) ("Opinion. No. 531").

9 ROE NOI, P18.

10 Id.

11 Id.

replace the two-step DCF analysis are flawed and cannot be used reliably to estimate a company's actual cost of equity.

The "anomalous market conditions" that were used to justify deviating from the two-step DCF methodology have persisted for approximately a decade and there is no indication that market conditions might revert to those present before the financial crisis. To the contrary, benchmarks indicate that the "anomalous" conditions actually are stable, long-term market trends. In June 2014, when a concern about potential "anomalous market conditions" led the Commission to issue Opinion No. 531 and deviate from utilizing the midpoint of an ROE range indicated by the two-step DCF analysis, the yields on ten-year treasury bonds and A-rated utility debt were approximately 2.60% and 4.29%, respectively. Now, approximately five years after Opinion No. 531 was issued and approximately three-and-a-half years after the Federal Reserve began to unwind the Quantitative Easing it adopted in response to the financial crisis, the yields on ten-year treasury bonds and A-rated utility debt are 2.36% and 3.9%, respectively (i.e., not significantly different). These data belie the concern that the two-step DCF analysis does not yield just and reasonable ROEs because the "anomalous market conditions" might revert to the market conditions present before the financial crisis. Base ROEs should be set on actual market conditions, which currently reflect long-term trends, and should not be set based on speculation that market conditions might change dramatically in the short-term.

The Commission should recognize that current market conditions are not "anomalous" precisely because they have persisted for many years. The Commission also should adjust its expectation of what constitutes a just and reasonable ROE to match the return implied by stable, long-term market trends. It would be irrational to ignore actual market conditions and deviate from established precedent in favor of alternative methodologies that are

unreliable but might yield results that are preferred for their consistency with outdated or unrealized expectations.

The Commission's decision in Opinion No. 531 also reflects concern that the two-step DCF methodology that it employed indicated ROE ranges with a midpoint that was below state-authorized returns. There, the Commission stated that "transmission entails unique risks that state-regulated electric distribution does not" and, therefore, according to the Commission, the ROE for electric transmission utilities should be set at the upper midpoint within a range of reasonable ROEs to reflect this risk premium.[12]

However, this conclusion is based on the false premise that state-authorized ROEs are representative of a utility's cost of equity capital. Many states do not rely on a defined and transparent methodology to establish distribution utility ROEs that are representative of corporate equity costs.[13] The lack of transparency makes it difficult to evaluate whether the established ROE is reasonable. Regardless, however, the Commission should not assume that the state-authorized ROE fails to accurately represent the utility's equity cost. Financial theory provides that, if regulators set ROEs at or very near the rate required by investors, then the ratio of utility market values to book values should not exceed 1.0x by a noticeable margin.[14] The NYSPSC has observed, however, that utility market-to-book ratios were approximately 1.7x in June 2014 and are now approximately 2.0x. Inflated market-to-book ratios have been prevalent

---

[12] Opinion No. 531, P148.

[13] New York State, in contrast, relies on a defined and transparent methodology to establish distribution utility ROEs so as to minimize the concerns described herein.

[14] The Financial Impacts of Declining Investment Opportunities on Electric Utility Shareholders, Berkeley Lab (dated July 2016) at 4-5 ("Berkeley Lab Report"), available at https://emp.lbl.gov/sites/all/files/lbnl-1005828.pdf.

for years and are likely to persist for years.[15] These data indicate that many state-authorized ROEs cannot serve as a reliable proxy for the cost of utility equity capital since the ROEs being set by many state commissions are higher than required by investors and driving market to book ratios ever higher than 1.0x. Thus, it would be arbitrary and capricious to inflate utility ROEs for the sole purpose of exceeding an average of certain state-authorized returns.

The Commission also incorrectly assumes that transmission utilities carry greater risk than state-regulated distribution utilities and, therefore, their ROEs should reflect a market risk premium. This error is confirmed by Moody's Investors Services ("Moody's") who reported in 2016 that electric transmission utilities have the lowest risk among types of electric utilities.[16] According to Moody's, the Commission's regulatory model utilizes "formula rates that adjust annually for forecasted cost of service and true-ups for variances allow for timely recoveries of expenditures, and the ability to earn premium incentive returns make these utilities highly predictable."[17] Moody's actually concluded that "electric distribution utilities [have] slightly higher risk" than electric transmission utilities because "their local and state regulation … brings closer regulatory scrutiny and the potential for political interference."[18]

For the foregoing reasons, the Commission should continue relying on the two-step DCF model to establish utility ROEs. The DCF model utilizes a transparent and well-reasoned methodology. It relies on readily-available data to make objective estimates of

---

[15] Id., p. 5 (concluding that "[o]ur analysis shows that electric utilities will likely continue to earn returns on equity … over the long-run in excess of the returns their equity investors require …, which has also been the case for decades").

[16] Utility Diversification Strategies Seek Growth While Limiting Risk, Moody's Investors Service (dated October 18, 2016) ("Moody's Report").

[17] Id., p. 9.

[18] Id.

investors' return requirements in current market conditions, which reflect long-term stability and not transient anomalies. Utilities, however, should retain the opportunity to present company-specific facts or circumstances that might justify a higher ROE than that indicated by the midpoint of a range generated by the two-step DCF analysis. The Commission also could take into account differences in financial risk between the transmission owner and its proxy group, particularly with respect to the differences in leverage between the transmission owner and the proxy group. This would recognize that, all else being equal, the higher the equity ratio then the lower the financial risk of the entity and the lower the equity return that should be required by investors.

Importantly, arguments favoring the two-step DCF model over any or all of the Alternative Valuation Methodologies apply with equal force to interstate natural gas and oil pipeline companies. These companies present a comparable risk profile to electric transmission companies that does not merit a general ROE adder.[19] The potential need for a risk premium may be justified upon a showing that differences in risk between the pipeline company and the proxy group warrant a deviation from the midpoint.

II. THE COMMISSION HSOULD ENSURE IT MEETS ITS OBLIGATION TO PROTECT CONSUMERS BY REQUIRING RETURN ON EQUITY ESTIMATES THAT ARE DERIVED FROM TRANSPARENT FINANCIAL MODELS WITH DATA THAT REFLECT CURRENT MARKET CONDITIONS

The Commission is charged with protecting the public interest by ensuring that electric and gas transmission rates are just and reasonable.[20] This responsibility is explicit under the NGA, which charges the Commission with providing "consumers a complete, permanent and

[19] Moody's Report, p. 3, Exh. 1.

[20] 18 U.S.C. §824e; Natural Gas Act ("NGA") Section 7.

effective bond of protection from excessive rates and charges."[21] The ROE is a key determinant of a utility's cost-of-service and, therefore, electric and gas transmission rates.

The method and inputs used to estimate ROEs must be selected with care to ensure that the model output reasonably reflects that utility's cost of equity. The data used for model inputs should reflect the utility's current financial condition and actual market conditions. Economic conditions change with time, and the ROE periodically must be updated or rates will be too high or too low because they are based on stale data.[22] The Commission itself has recognized that stale data should not be used.[23]

As discussed further herein, the financial model used to estimate ROE should rely on protocols that are transparent, reliable, and consistent. Further, because financial markets are intrinsically volatile, the Commission should allow ROEs to rise and fall along with changing market and economic conditions. Otherwise, the ratemaking process would be an exercise in preserving an arbitrary, historic level of profit, which lacks a rational connection to the utility's actual cost-of-service, including its cost of equity. Preserving an outdated ROE also would be an irrational process and the resulting rates likely would be unjust and unreasonable. The

---

[21] *W. Va. Pub. Servs. Comm'n v. U.S. Dep't of Energy*, 681 F.2d 847, 855 (D.C. Cir. 1982). See also *Pub. Serv. Comm'n of N.Y. v. FPC*, 329 F.2d 242, 249 (D.C. Cir. 1964 (holding that "[t]he basic purpose of the Natural Gas Act is consumer protection from unreasonable prices…").

[22] *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n of W.V.*, 262 U.S. 679, 693 (1923).

[23] *Midwest Indep. Transmission Sys. Operator*, 141 FERC ¶63,021, P667 (2012 (initial decision of presiding Administrative Law Judge), *aff'd in relevant part*, 156 FERC ¶61,202, P133 (2016) ("[T]he failure not only to submit, but to convincingly establish, the depreciation rate, return on equity, or capital structure that was used to calculate the revenue requirement [sought to be] recover[ed] … violates Commission policy prohibit the use of stale data to justify a rate of return"); *Cranberry Pipeline Corp.*, 112 FERC ¶61,268, P25 (2005)(rejecting pipeline's proposed ROE because it was based on "stale data" that was "more than three years old").

Commission should affirm its commitment to these principles, which are critical to protecting consumers by ensuring just and reasonable rates that reasonably reflect the utility's cost-of-service, including its cost of equity.

III. THE COMMISSION SHOULD ADDRESS THE FOLLOWING MATTERS IDENTIFIED BELOW IN RESPONSE TO QUESTIONS PRESENTED IN THE ROE NOI

The following are brief responses to select topics and questions presented in the ROE NOI. The NYSPSC may address issues raised by one or more of the remaining topics and/or questions in its response to the initial comments filed by other parties.

Question 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?***

Generally speaking, the ROE should reflect the cost of capital at the time a utility's rates are being reviewed by the Commission in order to ensure that the ROE reflects the marginal cost of equity capital needed to attract new equity capital.

Topic B: ***ROEs for Different Commission-Regulated Industries***

The vast majority of interstate gas pipeline rate cases are resolved by negotiated "black box" settlements that specify a cost-of-service, but not do not disclose key cost-of-service elements, including the ROE that is used to set rates. The expectation that gas pipeline rate cases will settle with a black box that hides the ROE is especially problematic for various reasons. Significantly, it eliminates transparency from regulatory processes, makes it impossible for customers to understand how their rates are derived, and undermines consumer protection. The black box encourages the partisan development of ROEs that bear little relation to the company's actual cost of equity but are used for posturing in negotiations. The successive use of black box settlements over a long period of time thus leads to rates that are designed around an ROE that

cannot be specified and for which there is no rational basis to demonstrate that it leads to just and reasonable rates. The ROE NOI acknowledges this deficiency,[24] In fact, settlements that specify a cost-of-service but hide most of the key cost-of-service elements in a black box enable different parties to reasonably claim that rates are based on different ROEs. This is irrational, and excessive reliance on this murky ratemaking process cannot lead to just and reasonable rates.

Further, recourse rates for gas expansion projects typically are set using the last ROE specified in a general rate case. The repetitive use of black box settlements means that rates for some expansion projects are based on a decades-old estimate of investor expectations that prevailed under significantly different market and economic conditions than exist presently. This practice similarly makes it difficult to demonstrate convincingly that expansion project rates are just and reasonable.

The NYSPSC respectfully urges the Commission to re-examine the habitual reliance on black box settlements in gas pipeline rate cases. Increasing the transparency of rate settlements and the ratemaking process generally is sound policy and also is necessary to draw a rational connection between record evidence and the Commission's approval of a rate case settlement agreement.

Question B4: ***What, if any, differences between public utilities on the one hand and natural gas and oil pipelines on the other would justify using different methodologies to determine their ROEs?***

The same DCF methodology should be utilized for electric transmission, gas pipeline, and oil pipeline companies. A uniform approach would serve the public interest

[24] ROE NOI, P32, B2 (questioning how "the Risk Premium methodology" could be "implemented in natural gas or oil pipeline rate cases where there is no history of ROE settlement from which to develop a risk premium study…").

because the DCF methodology is transparent and provides the most reliable estimate of equity costs. The differences in corporate and risk profiles between these industries are not great enough to justify the alternative use of a less transparent and/or reliable financial model. By employing a sufficiently-large proxy group of similarly-situated companies, the undesirable effects of bias, both upward and downward, or inaccurate estimates for any one company, can be minimized. The NYSPSC utilizes a two-stage DCF model which explicitly recognizes that a company's short-term growth expectations do not necessarily equal long-term expectations. The first stage uses analysts' near-term estimates to derive the short-term growth rate, while the second stage is based on a calculation of a sustainable growth rate. The primary reason why the DCF methodology continues to be the preferred approach for determining a company's cost of equity is that investors' immediate return requirements, as observed in current stock prices and recent dividends, are readily quantifiable. This methodology has been used for years to establish distribution utility ROEs in New York State. There has not been an ROE established in reliance on the DCF methodology that was deemed to be unjust and unreasonable when issued, or that was inadequate to attract capital.

Ideally, the DCF methodology should utilize a proxy group comprised entirely of companies that represent, as closely as possible, the risk profile characteristics of the subject utility. This is problematic for natural gas and oil pipeline companies because there are now virtually no such companies at this time that are publicly traded in the market. This makes it very difficult to complete the DCF analysis with a robust-sized proxy group. The Commission should address this development in the pipeline industry by modifying the proxy group selection criteria to include regulated utilities. If needed, adjustments to the proxy group can be made to account for differences in financial risk. For instance, if the proxy group has an average

common equity ratio of 46% and the subject pipeline will be financed with a 60% common equity ratio, the lower financial risk should be considered in combination with the higher perceived business risk when determining the recommended ROE.

Question 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?***

There is no evidence to contradict the veracity of the assumption that stock prices equal the present value of projected future cash flows is inaccurate. What is apparent, however, is that the low interest rate environment that has persisted for a long time has led many state commissions either to rely on unrealistic assumptions, or utilize inferior methodologies to produce an ROE that reflects a biased preference for market conditions that were prevalent before the financial crisis of 2008-09. Specifically, the current low interest rate environment has persisted for years and is the "new normal." These current market conditions, however, have been characterized as "anomalous." There is little evidence to suggest that interest rates will change materially in the near future and revert to levels realized before the financial crisis.

The DCF model is not flawed but, because many state commissions have not adhered to reasonably-constructed financial models to establish ROEs, they have provided ROEs that substantially exceed investors' requirements. The decisions of some state commissions suggest a policy decision that there is a floor below which ROEs will not be reduced despite market conditions. This artificial floor, in turn, has inflated market-to-book ratios to approximately 2.0x. At the same time, utilities have made record capital expenditures that reflect incentives to grow their rate bases so as to take advantage of the excessive ROE authorizations. Recent electric and gas merger activity over the past five years also has inflated

the market-to-book ratio and contributed to an average acquisition price-to-book ratio of more than 2.0x.

Question C3: ***How does the DCF methodology perform over a wide range of interest rate conditions?***

The current low interest rate environment has persisted for many years. Some state utility commissions have not adjusted to these market conditions and instead appear to be authorizing ROEs that exceed investor requirements. This leads to excessive utility earnings, provides utilities with an opportunity to increase dividend hikes, and promotes rate base growth which also provides additional earnings opportunities, all of which is collected through rates paid by utility customers.

Utility stocks generally are responsive to interest rates and, therefore, the DCF theoretically is responsive to interest rate conditions.[25] All else being equal, an increase in interest rates will increase a utility's cost of equity while a decrease in interest rates will decrease a utility's cost of equity. Lower interest rates normally increase utility stock prices, which reduce dividend yields and lower DCF results. Conversely, higher interest rates generally decrease utility stock prices and increase dividend yields, thus resulting in higher DCF results. Although a low interest rate environment may result in lower DCF results when estimating the cost of equity for a utility, the cost of debt will decrease as interest rates decrease. This relationship maintains an appropriate risk differential between the ROE and the cost of debt.

[25] See, e.g., NYSPSC Case 91-M-0509, Financial Regulatory Policies for New York State Utilities, Recommended Decision (issued July 19, 1994), App. C, p. 2.

Question C3.a: ***What specific assumptions of the DCF model, if any, do not work well in low or high interest rate environments?***

The following assumptions may not work well in low or high interest rate environment:

- Short-term dividend and earnings growth rates;
- Long-term dividend and earnings growth rates; and
- Market/Book Ratios.

The DCF model operates consistently and reliably in any interest rate environment. There is no evidence that the DCF model is not working under current market conditions.

Question C3.b: 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?

As a general matter, interest rates have not swung wildly over the last 10-20 years. Interest rates instead have exhibited, in general, a steady downward trend, but many regulators have been hesitant to follow declining interest rates with declining ROEs. It is possible that interest rates considered low by historical standards will persist for quite some time. The zone of reasonableness for ROEs, and the point within the zone that is selected as a utility's ROE, should reflect actual market conditions. The ROEs indicated by any Commission-approved methodology should not be adjusted to reflect preferred or historical market conditions.

Topic D. Proxy Groups: The Commission seeks comment on the appropriate guidelines for proxy group composition, elimination of outliers, and placement of base ROE within a zone of reasonableness.

An ideal proxy group should consist of companies with regulated businesses and risks that correspond to the target company. However, if a robust and sufficiently-sized proxy

group cannot be established with qualifying companies, then the selection criteria should be relaxed modestly to include other companies with similar risk characteristics. For instance, a proxy group of electric utilities, natural gas, and oil pipeline companies could be modeled when determining an ROE for natural gas and oil pipelines. For companies with a combination of regulated and unregulated businesses, proxy group companies should derive a minimum percentage of revenue from regulated utility businesses. New York, for example, requires a threshold that 70% of revenue be from regulated activities, but the Commission may desire to adjust that based on how it impacts the size of the proxy group when combined with other screens.

Over the past several years, for instance, New York State consistently has utilized proxy groups of approximately 25 to 30 companies when estimating the ROE for either natural gas, electric, or water utilities. Due to mergers and acquisitions, however, it is unlikely that the State will be able to rely solely on water or gas companies when determining an ROE for utilities in those industries. New York State addresses this issue by expanding the companies that may be included in the proxy group, provided that they have a risk profile similar to that of the subject utility. This may lead to the inclusion of distribution-oriented utilities that derive the vast majority of their revenue from delivery services. The result may be a fairly homogenous group of companies where differences in risk are difficult to measure with any degree of accuracy. Relaxing the selection criteria can improve the robustness of the proxy group while maintaining a consistent risk profile across the companies included in the group.

The proxy group selection criteria should not change based on which financial model is used. A consistent methodological approach provides transparency and reliability. If an appropriate proxy group selection criteria and screening process are in place, it should not be

necessary for the proxy group to include non-energy companies. If non-energy companies are included, however, their selection criteria should focus on regulated revenue and may include water utilities. The key selection criteria should focus on whether the company is a natural monopoly subject to rate regulation because providing an essential public service to captive customers subject to cost-of-service regulation is the defining feature that should be required for inclusion in the proxy group.

An outlier test, if used to eliminate certain ROE results, should exclude results that fall outside two standard deviations of the mean. This would provide a transparent and objective selection criterion that would be simple to implement. The exclusion should be based on ROE results only and not interest rates, which would decrease transparency while introducing more variables and subjectivity.

The Commission should continue excluding from the proxy group companies that are engaged in merger activity. Merger activity can distort stock prices in the near-term and impact the ROE results produced by financial models. Not all merger activity creates this distortion, however. For this reason, New York State applies a threshold criterion that a merger must be "transformative" to justify excluding a company engaged in merger activity from consideration for the proxy group. This standard is subjective but would provide flexibility to compile a reasonable proxy group where the number of potential companies is limited.

With respect to changing the point(s) within the zone of reasonableness that should be used to establish a company's ROE, the Commission should select the mean or median result. Because it is likely that any difference in risk between the subject company and the proxy group would be too small to measure with a reasonable degree of precision, any adjustment should be relatively modest.

Topic E: ***Financial Model Choice***

While the DCF should be the predominant determinant of the ROE, the CAPM may complement the DCF by capturing additional elements of utility equity evaluation. The CAPM includes factors such as beta, the market risk premium, and the risk-free rate which are important to estimating ROE but are not directly captured in the DCF model. It also incorporates current capital market conditions directly through the risk-free rate and the development of a market risk premium. Provided that most of the utility companies in the proxy group pay dividends, the actual market conditions should not dictate the choice of model utilized to estimate ROE. Nevertheless, the DCF methodology is a more reliable financial model for ROEs than the CAPM because it (i) focuses on utility-specific market conditions and observable data (e.g., utility stock prices and utility dividend forecasts), and (ii) does not rely on investor estimates of the overall market return or the determination of utility betas relative to that market return over time.

If the Commission considers an alternative to the two-step DCF model, the selection should not be made or changed on the basis of perceived "market conditions" that will last for an indeterminant amount of time. Instead, a blended approach that weights a combination of the DCF and CAPM models would promote investor confidence that the ROE estimate is determined in a reasonable and reliable manner. This was proved during and after the financial crisis of 2008-2009, when the blended methodology used by New York State yielded ROE estimates that correlated more closely with the increasing cost of utility equity (as manifested in falling stock prices and rising utility debt yields) than did average nationally authorized ROEs.

The Commission should consider adopting a weighted ROE model that is comprised of results from the two-step DCF model (2/3) and the CAPM model (1/3). This methodology has produced reasonable results in New York State for nearly two decades. Both financial models use a common proxy group with companies screened for having 70% of revenue derived from regulated businesses, rated at least investment grade by Moody's and S&P, currently paying a dividend and not being involved in any significant merger activity that potentially may distort the equity price. For the DCF model, short-term growth is based on forecasted dividend payments from Value Line, Inc. ("Value Line") while long-term growth is a function of the portion of earnings that are retained within the business. CAPM inputs consist of the Value Line Beta, the rate of return of a risk-free investment, and an expected market risk premium. The risk-free rate uses a three-month average of the most recent yields on the 10-year and 30-year U.S. Treasuries. The expected market risk premium is derived from the most recent three-month average of the implied and required market returns for investors contained in Merrill Lynch's Quantitative Profiles and subtracting the risk-free rate.

The recommended weighting of DCF (2/3) and CAPM (1/3) as an alternative to sole reliance on the two-step DCF model is justified because the DCF model inputs – other than dividend growth rates – are readily observable and less subjective as compared to the CAPM inputs. The CAPM is blended with the DCF model because when it is applied utilizing reasonable assumptions for its key inputs, it also provides a reasonable cost of equity estimate. It is accorded less weight because the CAPM provides a less stable foundation and less transparent inputs to support ROE calculations. Model transparency is critical to supporting investor confidence in the result, and investors value such transparency.

The Commission should not consider ROEs approved by state commissions when determining a cost of equity. In most cases there is no indication of how the authorized ROE was derived. This makes it impossible to evaluate whether the award is reasonable and can reduce investor confidence that the authorized return approximates the utility's actual cost of equity. Additionally, state commission ROEs vary due to the diversity of modeling methods, weightings, proxy group screening criteria, and other factors. A few state commissions use formulaic rate plans, but the vast majority do not explain their methodologies clearly. If, however, the Commission decides to consider state ROE results for comparison purposes, it should refer only to states that rely on transparent methodologies to establish utility ROEs.

Topic F: ***Mismatch between Market-based ROE determinations and Book-Value Rate Base***

The mismatch between market-based ROE determinations and a book value rate base, which has existed for many years does not necessarily merit a "correction." Rational investors know that regulators apply market-based methodologies to utility book values and they factor that practice into their market price valuations of the utilities.

There are a number of plausible reasons why utility market-to-book ratios currently exceed 1.0x by a wide margin. First, it is possible that utility stock investors now value the consistency and predictability of utility regulatory environments more than in previous economic cycles. Less utility revenue is at risk than in prior years due to the widespread implementation of true-up mechanisms, deferrals, and multi-years rate plans. Additionally, many utility holding companies are expanding their involvement in riskier unregulated or more lightly-regulated businesses, which potentially can achieve higher growth rates than their regulated holdings with lower capital intensity. Further, with increased costs associated with land and equipment, it is possible that the cost for utilities to reproduce their plant, distribution,

and other assets significantly exceeds the value of these assets on their books. Finally, higher market-to-book valuations reflect a clear recognition by utility investors that approved ROEs are well above their return requirements. Simply stated, the high market-to-book ratios for utilities that derive a vast majority of their revenues from regulated investments indicate that investor return requirements are well below what state regulators are authorizing.

The Commission should not modify its use of ROE models, which focus on a proxy group with predominantly regulated revenues, to account for the mismatch between market value-based ROE determinations and book value rate base. Most regulated utilities operate within a holding company structure and the market-to-book values internalize the knowledge that investors are buying equity of the holding company, which may have a significant amount of non-regulated revenue. Adjusting the DCF model to address this mismatch may result in compensating utilities for non-utility operations. Similarly, adjusting ROEs to capture current market book values above or below 1.0x could introduce many subjective factors into the process that would be very difficult, if not impossible, to quantify in a consistent and transparent manner. This would undermine the reliability of ROE estimates provided by the financial models.

Topic H: ***Model Mechanics and Implementation***

The following discussion explains various parameters that should be included in the order addressing the ROE NOI and responsive pleadings. In particular, the Commission should continue to use the DCF model, with inputs and methods as described below, to determine ROEs. The Commission also should reject the Risk Premium model, especially if it adopts the CAPM in a blended methodology with the DCF, because those two models share a number of the same attributes.

In addition, Value Line should be deemed the preferred source for financial forecasts used in the DCF model. Value Line services have been available since 1931. Value Line provides independent, unbiased investment research which allows investors to make informed decisions. Value Line forecasts estimate earnings as well as dividends and, unlike other investor services, it provides forecasted dividend growth rates in addition to forecasted earnings growth rates. Value Line thus provides investors with the impact on payout ratios when the two growth rates are materially different, and insight to the sustainability of forecasted dividend growth rates. These data are more reliable than alternative inputs such as analyst forecasts of earnings growth rates, or a data source that forecasts only earnings growth. Value Line data is, in general, well understood by the investment community and lends a degree of predictability to the rate setting process. Whether or not the Commission decides to use Value Line data in its financial models, the sources used for proxy company growth rates should be widely available to typical investors and the process used to develop the forecast should be transparent.

Because it is widely accepted that forecast accuracy declines as the period covered by the financial estimates increases, the Commission should continue to utilize analysts' growth estimated only for the first stage of a two-stage DCF model.

Estimated gross domestic product (GDP) forecasts are a good proxy for long-term growth. They can be used as a reference check for the long-term growth rate that the DCF model forecasts for the proxy group companies, based upon forecasted dividend growth and earnings retention. The sustainable growth rate used should be the product of retention growth plus the additional growth from raising new shares at prices well above book value. Short-term growth rates can be higher, but long-term growth rates for a company cannot exceed GDP for an

indefinite period, particularly in a seemingly mature industry like utilities that are facing very low to negative sales growth due to energy efficiency, which enables the GDP forecast to serve as a proxy for the long-term growth rate.

Most regulated utilities are part of a holding company structure where the holding company, not the regulated utility, is publicly traded. The holding company also may include non-regulated operations. This creates a disparity because holding company financial data is used as an input to the DCF model for estimating the utility's ROE. This disparity can be mitigated by using a robust proxy group with carefully selected screening criteria. In New York State, for instance, this approach in recent years effectively has (i) excluded from the proxy group utilities with a substantial portion of revenues from non-regulated operations, and (ii) resulted in proxy group holding companies with an aggregate average of regulated revenue over 90%.

CONCLUSION

Consistent with the foregoing discussion, the Commission should adopt policies and methodologies that establish ROEs using transparent, reliable, and consistent protocols that reflect actual market conditions.

Respectfully submitted,

/s/ John Sipos
John Sipos
Acting General Counsel
Public Service Commission
of the State of New York
3 Empire State Plaza

By: S. Jay Goodman
Assistant Counsel
3 Empire State Plaza
Albany, New York 12223-1350
Tel: (518) 402-1537
jay.goodman@dps.ny.gov

Dated: June 26, 2019
Albany, New York

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in this proceeding.

Dated: Albany, New York
June 26, 2019

/s/ S. Jay Goodman

S. Jay Goodman
Assistant Counsel
3 Empire State Plaza
Albany, NY 12223-1305
(518) 402-1537

Document Content(s)