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# Comments on FERC ROE Methodology

Paul T. Hunt, Jr.
Director of Regulatory Finance and Economics
Southern California Edison Company*

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* All opinions expressed herein are those of the author and do not necessarily represent the views of the Southern California Edison Company or its affiliates.

# My Background

- Ph.D. in Economics from Stanford University
- Over 38 years at Southern California Edison Company
- Involved in 75+ cases as expert witness
- Cost of capital testimony and case management before California Public Utilities Commission
  - » Generic cases involving more than one utility; outside of General Rate Cases
- Cost of capital testimony before Federal Energy Regulatory Commission
  - » General Rate Cases
  - » Transmission construction work in progress cases
- Co-author, "Cost of Capital in Regulated Industries," in *Cost of Capital in Litigation: Applications and Examples* (John Wiley & Sons, Inc., 2010); revised version appears in *The Lawyer's Guide to Cost of Capital: Understanding Risk and Return for Valuing Businesses and Other Investments* (ABA (American Bar Association) Publishing, 2014)

# SCE's Interest in FERC ROE

- SCE's transmission system (generally 220kV voltage and above) is operated by the California Independent System Operator and SCE recovers its costs through a Transmission Owner tariff that since 2011 has been a formula rate with an adopted return on equity (ROE)
- About 20 percent of SCE's total system rate base is in the FERC's jurisdiction; the remainder is under the jurisdiction of the California Public Utilities Commission
- SCE has a replacement formula rate that is effective January 1, 2018, subject to refund; that rate is in settlement discussions at this time
- SCE announced at the end of February that it plans to file a new formula rate in March; that filing should occur in the near future

# NETO Briefing Order

- FERC issued the NETO Briefing Order on October 16, 2018 and followed by a related MISO Briefing Order on November 15, 2018

- On January 11, 2019, SCE filed a motion to intervene in the NETO docket for the purpose of briefing matters of general applicability raised in the NETO briefing order. SCE's objective is to ensure that when the Commission applies the briefing order ROE methodology to single-filing utilities, it has a complete record. The Commission has not ruled on SCE's motion.

- The briefing order contemplates many positive changes to the Commission's previous ROE methodology
  - Most important is using multiple models and methods to directly determine ROE, instead of merely providing confirmatory evidence

# Concerns Regarding the NETO Briefing Order

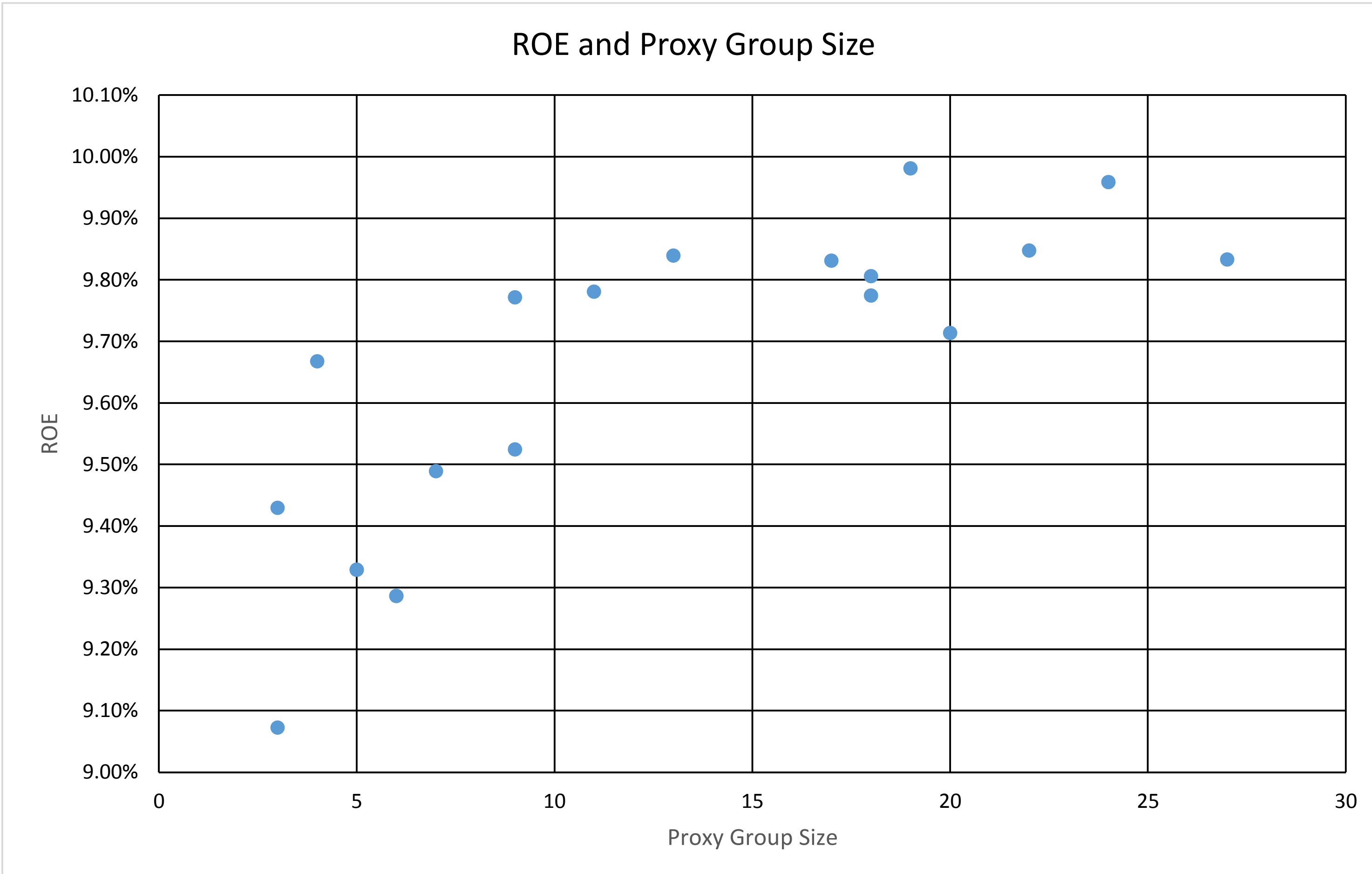
- Differential treatment of group-filing and single-filing utilities
  - The Commission proposes to use different methods to determine ROEs for below- or above-average risk utilities: for group-filers, the Commission proposes to use **midpoints** of the lower and upper halves of the zone of reasonableness, while for single-filers, the Commission proposes to use **medians**. This could result in significantly lower ROEs for single-filer utilities of above-average risk like SCE.
- ROE estimates from small proxy groups
  - The briefing order continues the Commission's existing process of basing proxy groups on the credit ratings of the filing utilities, plus or minus one notch. It is possible for a single-filing utility to have a very small proxy group, as small as three companies.
  - Smaller proxy groups tend to have lower ROEs, irrespective of risk
  - SCE's estimates find multiple instances where a less-risky proxy group has a higher ROE, which is not logical

# Upper Median/Upper Midpoint Differences by Proxy Group

| Upper Half Midpoint Estimate Minus Upper Half Median Estimate | | | | | | |
|---|---|---|---|---|---|---|
| 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% |

With some exceptions, above average group-filing utilities will receive a significantly higher ROE than above average single-filing utilities

# Proxy Group Size and Median ROE Estimates




In general, large proxy groups are associated with the highest ROEs

# Proxy Group Size by Credit Rating

| Average Proxy Group Size (Rounded) by Credit Rating Category | | | | | | |
|---|---|---|---|---|---|---|
| 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 |

In general, large proxy groups are associated with the highest ROEs; these tend to be "middle-rated" companies

# Average ROE Estimate by Proxy Group

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

The estimates in bold run contrary to expectations, in that while risks as measured by credit ratings increase, the allowed NETO ROEs decrease (each estimate in bold is less than another estimate above in the same column or left in the same row)

# SCE’s Concerns Regarding the NETO Briefing Order (Continued)

- Low-end outlier test
  - » NETO briefing order excludes “from the proxy group companies whose ROE fails to exceed the average 10-year bond yield by approximately 100 basis points …” citing Opinion 531.
  - » Opinion 531 relied on the Moody’s Public Utility Bond Yield Average for Baa utility bonds that “have maturities as close as possible to 30 years”; the NETO briefing order should be clarified.
  - » The NETO briefing order uses a spread of 100 basis points above the bond yield; SCE believes this spread should be modified to reflect changing financial market conditions. SCE proposes that the spread be 0.24 x the market risk premium, where 0.24 is the difference between the beta for corporate bonds estimated by Elton, Gruber, Agrawal and Mann (“Explaining the Rate Spread on Corporate Bonds,” *Journal of Finance*, February 2001) and the beta for a low-risk electric utility (0.50).
  - » SCE’s current calculation is 0.24 x 9.6% = 230 basis points,
    9.6% is SCE’s current estimate of the forward-looking market risk premium specified in the NETO briefing order

## SCE's Concerns Regarding the NETO Briefing Order (Continued)

- Use of only one DCF growth rate source
  - » NETO briefing order expresses concerns about the use of IBES three to five year earnings growth projections, including the comment that "they do not reflect as robust a consensus, or perhaps any consensus, now."
  - » SCE suggests that the Commission consider that in addition to a DCF model with IBES growth rates, the Commission expand its DCF method to include growth rates from Bloomberg, Morningstar, S&P Capital IQ, Value Line, and Zacks
  - » Of these six candidate growth rates, IBES may be the lowest and thus not representative of investors' expectations
  - » Using data as of the end of September 2018, SCE found the following rates for all of the Value Line utilities

| **Average and Median Growth Rates** | | |
|---|---|---|
| | | |
| 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% |

# Conclusion

- The NETO and MISO briefing orders contemplate many positive changes to the Commission's previous ROE methodology; however, additional changes may be in order
- The Commission's Notice of Inquiry issued on March 21, 2019 (PL19-4-000) may be the forum to address these issues