



Christine O. Gregoire

# ATTORNEY GENERAL OF WASHINGTON

900 Fourth Avenue #2000 • Seattle WA 98164-1012

July 20, 2000

**VIA FEDERAL EXPRESS**

Carole Washburn  
WUTC  
1300 S. Evergreen Pk. Dr. S.W.  
PO Box 47250  
Olympia, WA 98504-7250

RE: *UE-991606/UG-991607 Avista Rate Case*

Dear Ms. Washburn:

Enclosed please find twenty-four copies of the response of Public Counsel to Bench Request No. 5.

Very truly yours,

Simon J. Fitch  
Assistant Attorney General  
Public Counsel  
(206) 389-2055

cc: All Parties



Response to Bench Request by Public Counsel

Request #: 5  
Date Received: 7/12/2000  
Date Due: 7/21/2000  
Answered by: Steve Hill – (304) 562-3645

- 5) Please provide a copy of “Public Utilities Reports” Advance Sheets dated March 4, 1994.

Response: See attached.

# Public Utilities Reports

## *Advance Sheets*

March 4, 1994

Index to Cases Reported appears on page ix.

---

## News and Commentary

Recent Filings page vii

---

### Cost of Equity Determinations — State Regulators Turn Back Challenges to the DCF Model

By

Philip S. Cross

---

Cost of capital determinations are generally among the more contentious aspects of utility rate proceedings — with the argument most often centering on the authorized rate of return on common equity (ROE).

The discounted cash flow (DCF) model, the methodology most frequently relied upon to establish authorized ROE, has often engendered spirited debate over the technical aspects of its application. Of late, however, some utilities have shifted the focus of the debate, arguing that the DCF model no longer produces reasonable results.

In a rate case decided last fall, an expert witness for Public Service Company of Colorado testified that under current economic conditions the DCF model is not providing acceptable cost of equity estimates. The witness, Dr. William Avera, argued that "current capital markets are distorted as a result of the Fed's attempts to ignite a recovery by lowering short-term interest rates", causing the DCF model to produce cost of equity estimates that are not substantially

---

higher than the yields on less risky capital investments such as utility bonds. Dr. Avera concluded that the commission should ignore the results of DCF analyses in setting authorized ROE. The commission disagreed, finding that the DCF results were consistent with the "remarkable declines in cost of capital in current markets." *Re Colorado Pub. Service Co.*, 148 PUR4th 1 (Colo.P.U.C.1993).

### ROE and Falling Interest Rates

The idea that the reasonable rate of return on equity for a utility might be holding steady, or even rising, despite declines in core interest rates has not been well received by state regulators.

Last October, the Florida Public Service Commission cut the ROE for Tampa Electric Company from 12 percent to 11.35 percent, even though the commission had found a 12 percent ROE to be reasonable in a rate case decided only nine months earlier.

The single piece of evidence cited by the commission in support of a ROE cut was that the average yield on 30-year bonds had declined from 7.43 percent at the time of the February 1993 rate order to 5.9 percent in October 1993. *Re Tampa Electric Co.*, Dkt. No. 930987-EI, Order No. PSC-93-1570-FOF-EI, Oct. 27, 1993 (Fla.P.S.C.).

More recently, the Florida commission turned down an offer by Florida Public Utilities Company to cut its ROE from 13 percent to 11.75 percent. Once again the commission cited the drop in interest rates. It said that "the bellwether 30 year treasury bond rate" had declined significantly and that its staff believed that the actual cost of equity for the utility was significantly lower than the company's offer. *Re Florida Pub. Utilities Co.*, 148 PUR4th 355 (Fla.P.S.C. 1993).

The notion that equity investors demand less compensation when interest rates fall was discussed by the California Public Utilities Commission in its latest annual generic cost of capital review for jurisdictional energy utilities. The low interest rates and low inflation seen over the past several years have worked together, the commission explained, to make utility equity attractive to investors — an attraction that is confirmed by the relatively high market price-to-book ratios currently observed in the utility industry.

Without focusing on the workings of the DCF or any other model for estimating the cost of equity capital, the commission noted that all of the analyses presented in the generic cost of capital review proceeding yielded "remarkably consistent results." Even with the many subjective elements involved in running the financial models, the results consistently pointed to a 100 basis point drop in

The Department also noted that the LDC had relied too heavily on non-market based methodologies — the payout ratio test and book value-based DCF — to arrive at its ROE recommendation. Such reliance, the commission said, failed to account for either significant declines in money costs or changes in the market for long-term securities. According to the commission, the July 2, 1993, issue of *Value Line* noted that CNC's original requested 12.8 percent ROE recommendation "may be somewhat optimistic in light of the current low interest rate environment." *Re Connecticut Nat. Gas Corp.*, 148 PUR4th 239 (Conn. D.P.U.C.1993).

### Beyond Methodologies and Theories

The ROE debate entails more than methods and theories. Utility regulators must fairly balance the interests of ratepayers and shareholders under current economic and social conditions.

In an electric rate order issued last summer, the Connecticut department wrapped up its ROE analysis with a discussion of the severity of the current economic downturn in the state. The department cited recent California decisions that reduced utility rates, noting that Connecticut and California had experienced similar economic woes attributable to defense spending cuts and the closing of military bases. The department concluded that in setting ROE, it must rely on "what is" in the state, as well as assessing national trends and averages. *Re Connecticut Light & Power Co.*, 144 PUR4th 161 (1993).

A recent Kentucky rate case provides a perhaps more telling example of what utilities are up against when regulators balance the interests of ratepayers and shareholders to arrive at an authorized ROE. A ratepayer intervenor had a simple way to counter the request by the utility for an ROE of 12.75 percent. In the words of the Kentucky Public Service Commission, the witness "expressed concern" about the reasonableness of the utility's request "as the best return he is able to obtain on a checking/savings account is in the range of 3 to 4 percent." *Re Equitable Gas Co., Inc.*, 144 PUR4th 376 (1993).

### Continued Reliance on the DCF Model — Recent State Rate Orders

ARIZONA

*Re Citizens Utilities Co.*, 144 PUR4th 495 (Ariz.C.C.1993).

News & Commentary

CALIFORNIA

*Re Sierra Pacific Power Co.*, D.93-12-022, Application Nos. 93-05-008 et al., Dec. 3, 1993 (Cal.P.U.C.).

COLORADO

*Re Public Service Co. of Colorado*, 148 PUR4th 1 (Colo.P.U.C.1993).

CONNECTICUT

*Re Connecticut Nat. Gas Corp.*, 148 PUR4th 239 (Conn.D.P.U.C.1993).  
*Re Connecticut Light & Power Co.*, 144 PUR4th 161 (Conn.D.P.U.C.1993).

DISTRICT OF COLUMBIA

*Re Washington Gas Light Co.*, 146 PUR4th 429 (D.C.P.S.C.1993).

FLORIDA

*Re Florida Pub. Utilities Co.*, 148 PUR4th 355 (Fla.P.S.C.1993).  
*Re Tampa Electric Co.*, Dkt. No. 930987-EI, Order No. PSC-93-1570-PDF-EI, Oct. 27, 1993 (Fla.P.S.C.).

ILLINOIS

*Re Illinois Gas & E. Co.*, 145 PUR4th 1 (Ill.C.C.1993).

MARYLAND

*Re Baltimore Gas & E. Co.*, 145 PUR4th 215 (Md.P.S.C.1993).

MASSACHUSETTS

*Re Bay State Gas Co.*, 139 PUR4th 3 (Mass.D.P.U.1992).

MINNESOTA

*Re Northern States Power Co.*, 148 PUR4th 1 (Minn.P.U.C.1993).

PENNSYLVANIA

*Pennsylvania PUC v. Metropolitan Edison Co.*, 141 PUR4th 321 (Pa.P.U.C.1993).

RHODE ISLAND

*Re Providence Gas Co.*, 146 PUR4th 570 (R.I.P.S.C.1993).

UTAH

*Re U S West Communications, Inc.*, 142 PUR4th 1 (Utah P.S.C.1993).