PEPCO (3B)

POTOMAC ELECTRIC POWER COMPANY

BEFORE THE
PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA
REBUTTAL TESTIMONY OF DR. ROGER A. MORIN
FORMAL CASE NO. 1053

Q. PLEASE STATE YOUR NAME, ADDRESS, AND OCCUPATION.

A. My name is Dr. Roger A. Morin. My business address is Georgia State University, Robinson College of Business, University Plaza, Atlanta, Georgia, 30303. I am Professor of Finance at the College of Business, Georgia State University and Professor of Finance for Regulated Industry at the Center for the Study of Regulated Industry at Georgia State University. I am also a principal in Utility Research International, an enterprise engaged in regulatory finance and economics consulting to business and government.

Q. DID YOU FILE DIRECT TESTIMONY IN THIS PROCEEDING ON BEHALF OF POTOMAC ELECTRIC POWER COMPANY?

A. Yes, I did.

Q. WHAT IS THE PURPOSE OF THIS REBUTTAL TESTIMONY?

A. I have been asked to respond to the testimonies of Mr. Rothschild (Office of the People's Counsel or OPC), Mr. Oliver (AOBA), Dr. Foster (WMATA) and Mr. Gumer (OPC).

A. My specific conclusions on Mr. Rothschild's CAPM analysis are that: 1) it is not a conventional implementation of the classic CAPM, 2) it erroneously relies on geometric mean returns rather than arithmetic mean returns and as such understates the cost of equity by 180 basis points, 3) it is stale and as such understates the cost of equity by 35 basis points, and 4) it is biased downward by the size effect.

Allowance for these understatements of Pepco's cost of equity would raise Mr. Rothschild's recommended ROE from 9.25% to approximately 11.50%. The evidence from both the DCF and CAPM frameworks, if implemented properly, is that investors expect substantially higher returns than what Mr. Rothschild has found.

12. EFFECT OF BSA

Q. WHAT RETURN ADJUSTMENT DOES MR. ROTHSCHILD RECOMMEND IF THE COMPANY'S PROPOSED BSA IS APPROVED?

A. If the Company's proposed BSA is approved, Mr. Rothschild argues that Pepco will become one of the least risky electric utilities in the country and that its common stock will be akin to a high-grade AA-rated corporate bond. No foundation, empirical support, studies, or publications are offered for such a claim, nor have I ever seen a utility company's bonds (which of course carry less risk than stocks) upgraded to AA as a result of the approval of risk-mitigating mechanisms by regulatory bodies.

Q. DO YOU AGREE WITH MR. ROTHSCHILD THAT PEPCO-SPECIFIC RISKS ARE IRRELEVANT IN DETERMINING A COMPANY'S FAIR AND REASONABLE RETURN?

A. No, I do not. On pages 41-43 of his testimony, Mr. Rothschild argues that most of the specific risks faced by Pepco are diversifiable (unsystematic) and should not be compensated. In other words, company-specific business risks such as cost overruns, plant outages, forecasting error, credit risk and financial positions are all diversifiable risks which do not matter to investors, according to Mr. Rothschild. In his view, only systematic risks, as measured by beta, are associated with a risk premium. It is ironic that Mr. Rothschild has suddenly become enamored with the fundamental precepts of the CAPM to make his point after earlier refuting the model as a full-fledged method of estimating investor return. In any event, I strongly disagree with the highly counter-intuitive notion that company-specific business risks are irrelevant to investors.

First, the idea that only beta matters is inconsistent with the empirical evidence. Both market risk (beta) and company-specific risk (standard deviation of return) matter. While it is true that in a large diversified portfolio, the volatility of the portfolio's return is much more closely related to the beta coefficients of the constituent stocks than to their standard deviations, for undiversified portfolios, and even for reasonably diversified portfolios, there is strong empirical evidence suggesting that investors' risk assessments depend also on the standard deviation of return. The latter variability is strongly affected by financial position, credit risk, and demand variability, that is, competition.

Second, the empirical evidence supports the notion that company-specific risks matter. The positive relationship between return and both standard deviation and beta is well documented in both the academic and trade financial literature. The comprehensive study of historical returns on stocks and bonds published annually by Ibbotson Associates supports the conclusion that stocks are riskier than bonds in terms of standard deviations.

There is also a rich empirical literature in finance on the determinants of beta. Variability of cash flows, the use of debt, and growth are perennial members of the family of variables which exert an upward influence on beta. Clearly, the variability of cash flows, and thus beta, increases with competition.

Several authors in the finance literature have shown that beta has three main components: demand risk, operating leverage, and financial leverage. Demand risk refers to the unanticipated variability in demand and prices, caused by macroeconomic conditions, regulation, competition, and supply imbalances and to the unanticipated variability in operating and financing costs caused by macroeconomic conditions, regulation, competition, and technological change. Leverage refers to the extent to which these demand and cost uncertainties are magnified by the operating cost and financial cost structures of the company.

In short, company-specific risks are highly relevant in determining a company's fair and reasonable return.

Q. ARE ELECTRIC UTILITIES' BUSINESS RISKS DIVERSIFIABLE?

A. The business risks of electric utilities are not diversifiable risks to the extent that they affect all the companies in the energy industry and to the extent that they affect all industries by virtue of all industries' common dependence on energy as an input to the production process. Moreover, it is clear from the myriad investment reports, company analyses, and bond rating agency reports dealing with electric utility stocks in the past several years that investors are concerned with the growing competition in the electric utility industry, with company-specific risks, and especially with regulatory risks. In short, both beta risk and company-specific risk matter to investors, and certainly matter to bond rating agencies.

Q. DO YOU AGREE WITH MR. ROTHSCHILD THAT PEPCO WOULD BECOME ONE OF THE LEAST RISKY UTILITIES IN THE COUNTRY AS A RESULT OF THE BSA MECHANISM?

A. No. The approval of adjustment clauses, riders, and cost recovery mechanisms by regulatory commissions is widespread in the utility business and is already largely embedded in financial data, such as bond rating and business risk scores. While adjustment clauses, riders, and cost tracking mechanisms may mitigate (on an absolute basis but not on a relative basis) a portion of the risk and uncertainty related to the day-to-day management of a regulated utility's operations, there are other significant factors to consider that work in the reverse direction for Pepco, for example, regulatory risk and weak financial metrics, that offset the presence of the aforementioned mechanisms. I have never seen a utility's bonds upgraded to AA in response to the approval of a mechanism such as BSA.

Q. MR. ROTHSCHILD CLAIMS THAT YOUR RECOGNITION OF THE RISK-REDUCTION EFFECTS OF THE BSA IS A TOKEN ADJUSTMENT. IS HE RIGHT?

A. On page 8 of his testimony, Mr. Rothschild claims that there is no quantitative basis for my 25 basis points downward adjustment to account for the risk-reduction effects of the BSA, and that the 25 basis points reduction is a token adjustment. I disagree. On page 90 of my Direct Testimony I show that the 25 basis points adjustment is based on utility bond yield spreads between utility bonds rated average and bonds rated low Baa and on the effect of such mechanisms on the beta risk measure.

13. CAPITAL STRUCTURE RECOMMENDATION