

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

**Docket Nos. UE-121697 and UG-121705
Puget Sound Energy, Inc. and NW Energy Coalition
Joint Petition for Approval of a Decoupling Mechanism**

PUBLIC COUNSEL DATA REQUEST NO. 057

PUBLIC COUNSEL DATA REQUEST NO. 057:

Re: Testimony of Dr. Michael J. Vilbert, Exhibit No. MJV-1T, p. 16, II. 9-10.

- a) When Dr. Vilbert refers to “Brattle’s” empirical analysis, is he referring to the analysis presented in his testimony in this proceeding or some other separate publication by the Brattle Group?
- b) Brattle has published analyses of decoupling in the gas utility industry other than that included in Dr. Vilbert’s testimony in this proceeding, correct?
- c) Please describe in detail how the Brattle empirical analysis included in Dr. Vilbert’s testimony in this proceeding is different from the gas utility decoupling studies published by the Brattle Group (e.g., “The Impact of Decoupling on the Cost of Capital, An Empirical Investigation.” March 2011, “Revised” 2012)
- d) Please provide complete copies of 1) “The Impact of Decoupling on the Cost of Capital, An Empirical Investigation.” March 2011 and 2) the same report, revised and re-published in 2012.
- e) When was the Brattle empirical analysis of gas utility decoupling undertaken? Was it done for Dr. Vilbert’s testimony in this case or is it a separate study for publication?

Response:

- a) Page 16, lines 9-10, of the Prefiled Direct Testimony of Dr. Michael J. Vilbert, Exhibit No. ____ (MJV-1T), refers to Brattle’s study of decoupling in the natural gas local distribution company (“gas LDC”) industry provided in this testimony and workpapers. It is updated from earlier work in the gas LDC industry that was most recently published in July 2012, and is included in the workpapers provided.
- b) Yes. Brattle has updated the gas decoupling study in this proceeding since the original study was published in March 2011, Joseph B. Wharton, Michael J.

Vilbert, Richard E. Goldberg, and Toby Brown, *The Impact of Decoupling on the Cost of Capital: An Empirical Investigation*, Original Version March 2011, and Revised July 2012). Brattle has not done any separate studies of the effect of decoupling on the cost of capital for the natural gas LDC industry.

- C) The methodology for the Brattle study of decoupling in the natural gas LDC industry was not changed for the update in the Prefiled Direct Testimony of Dr. Michael J. Vilbert, Exhibit No. ____ (MJV-1T), with one exception. The LRAM was excluded as a form of decoupling in this updated gas study, which affected one gas subsidiary of Atmos and one of Columbia Gas, compared to the Brattle 2012 gas study. The inclusion of exactly decoupling with revenue true-up and fixed-variable rates made the current gas and electric studies consistent for the definition of decoupling, as discussed in Puget Sound Energy, Inc.'s ("PSE") Response to Public Counsel Data Request No. 052. The ROE estimates are taken from cost of capital testimony filed by Brattle witnesses. The update made the following improvements to the data that Dr. Vilbert believes increase the accuracy of the results:
- The study period was extended two years from June 2010 to May 2012;
 - The number of independent cost of capital estimates increases from 18 to 26;
 - The number of delivery subsidiaries with decoupling increased from 19 to 22. The number 24 on page 18, line 19 of the Prefiled Direct Testimony of Dr. Michael J. Vilbert, Exhibit No. ____ (MJV-1T), is incorrect. It should be 22.
 - The dates of the decoupling Orders were refined based on a more detailed source: Pamela Morgan, *A Decade of Decoupling for U.S. Energy Industries: Rate Impacts, Designs, and Observations*, December 2012;
 - The LRAM was excluded as a form of decoupling in the study, which affected one gas subsidiary of Atmos and one of Columbia Gas, and
 - Finally, the EIA publicly available natural gas delivery data was updated to 2013 to include the most recent values, as mentioned in the Prefiled Direct Testimony of Dr. Michael J. Vilbert, Exhibit No. ____ (MJV-1T), at page 19, lines 19-20, and page 20, lines 1-2.
- d) Attached as Attachment A to PSE's Response to Public Counsel Data Request No. 057 is a copy of "The Impact of Decoupling on the Cost of Capital, An Empirical Investigation" published in March 2011.

Attached as Attachment B to PSE's Response to Public Counsel Data Request No. 057 is a copy of "The Impact of Decoupling on the Cost of Capital, An Empirical Investigation" published in June 2012.

- e) The original study of decoupling in the gas LDC industry was completed in early 2011 and was not done for any proceeding. That original study was updated in 2012, when it was discovered that there was a mistake in two of the public sources used to determine which gas LDCs had straight fixed variable rates. Both of the sources had missed the fact that NICOR's subsidiary, Northern Illinois Gas Company, had received an order from the Illinois Commerce Commission instituting a straight fixed variable rate design in March 2009. Correcting this characterization resulted in slight changes to regression coefficients but did not change the conclusion that there was no statistically significant evidence that decoupling lowered the cost of capital.

- f) The corrected gas LDC study was partially updated in the spring of 2013 and presented in two conferences, Eastern Conference for the Center for Research in Regulated Industries, Shawnee on Delaware, PA, May 17, 2013 and the Western Conference of the Center for Research in Regulated Industries, Monterey, CA, June 21, 2013. The update was not published in report form. The gas update was finalized in October 2014 for reference in the Prefiled Direct Testimony of Dr. Michael J. Vilbert, Exhibit No. ____ (MJV-1T).

**ATTACHMENT A to PSE's Response to
PUBLIC COUNSEL Data Request No. 057**

The Impact of Decoupling on the Cost of Capital

An Empirical Investigation

By Joseph B. Wharton, Michael J. Vilbert, Richard E. Goldberg, and Toby Brown¹

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The Brattle Group provides consulting and expert testimony in economics, finance, and regulation to corporations, law firms, and governments around the world.

We have offices in Cambridge, Massachusetts; San Francisco, California; and Washington, DC. We also have offices in Brussels, London, and Madrid.

For more information, please visit www.brattle.com.

Introduction

Revenue decoupling (or simply “decoupling”) is a form of regulated ratemaking that separates cost recovery from changes in the volume of sales for a regulated utility. It originated as a policy response in the 1980s when utilities were first encouraged to develop energy efficiency (EE) programs, which can significantly reduce the consumption of regulated commodities such as electricity, gas, or water.

Research into the costs and benefits of EE technologies has shown that the long-run savings significantly exceed the costs, and EE programs have the additional benefit of producing no harmful emissions. Recently, more states have begun to adopt long-term goals for EE and designated the utilities as the program administrators. Despite the programs being beneficial and cost effective to society, there is a significant disincentive for the utilities to actively pursue the EE programs unless they are accompanied by some type of revenue decoupling and incentives.

This disincentive begins with the fact that a large share of an electric, gas, or water utility’s costs are fixed in the short run and do not vary with the amount of the commodity produced and delivered. Traditional cost-of-service ratemaking collects these “base” revenues largely through volumetric rates (i.e., per therm, kilowatt hour, or 100 cubic feet). A successful EE program will reduce the volume of sales and simultaneously reduce recovery of the fixed costs, which include the equity returns, so regulated utilities have what is called a “throughput disincentive” to carry out EE programs.

¹ The authors wish to thank those members of *The Brattle Group* who provided comments including Larry Kolbe, Hannes Pfeifenberger, Bente Villadsen, Dan Kiernan, and Jenny Palmer.

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There are various forms of decoupling, but the basic idea is that if sales exceed forecast, the utility will refund to customers the over-recovery of fixed costs. If sales are less than forecast, the utility will be able to add a charge to future rates to fully recover its fixed costs. This removes the throughput disincentive and therefore the conflict of interest for utility management. With decoupling in place, managers of regulated investor-owned utilities avoid one major hurdle to pursuing EE programs that are in the public interest and maintain their fiduciary duty to protect the interests of their shareholders.² However, a new hurdle has appeared in the form of a tangible regulatory risk of a lowered allowed return on equity (ROE) for utilities that implement decoupling.

In addition to management's conflict of interest in reducing sales volume, EE programs are likely to increase the variability of the utility's revenues because the effectiveness of the program adds another element of forecasting error into setting the revenue requirement. As decoupling policies become increasingly prevalent and important, some intervenors and commission staffs have argued that decoupling, by design, reduces the variability of revenues by decoupling cost recovery from sales volume, which, they argue, translates directly into reduced risk. Intervenor, therefore, have also argued that the regulated company's cost of capital be reduced because cost of capital is the payment to investors bearing business and financial risks.³

In the majority of decisions approving decoupling in the past, regulators did not explicitly conclude that decoupling reduces a utility's cost of capital. However, in a very visible minority, regulators did decrease the allowed ROE, with the reductions generally ranging from 10 to 50 basis points (bps) (100 bps = one percent). More ominously, intervenors in some gas, electric, and water utility rate cases have suggested that the decoupling impact on ROE should be as large as 250 to 300 bps.⁴

After reviewing a number of decisions where reductions were imposed by the regulators, we find that the reductions, whether moderate or substantial, appear to be based on theoretical arguments without the support of empirical evidence to demonstrate an actual relationship between decoupling and the cost of capital. To test this theory, we have completed the first empirical investigation, of which we are aware, on the hypothesis that decoupling lowers the cost of capital.

The findings of our analysis do not support the belief that utilities with decoupling have a lower cost of capital than utilities without decoupling. Contrary to what some might expect to find, at least on the basis of the opinions of certain intervenors and the (minority set of) judgments where commissions reduced allowed rates of return because of decoupling, we found that the estimated cost of capital for decoupled utilities was higher by a small but statistically significant amount.

2 There are three conditions that are likely to be necessary to ensure that a utility's management is enthusiastic about the effect of large-scale EE programs on their financial performance. The first is decoupling, as discussed in this paper, and the second is the timely and concurrent recovery of the direct EE costs. Although together these two conditions make the utility financially indifferent, they do not provide the utility with a strong reason to pursue energy efficiency. The third condition is a performance incentive, which gives the management a financial incentive and, when successful, positive news for shareholders. Although utilities operate under a regulatory bargain, investors value growth in earnings and wish to see some other real value when growth is being reduced by public policy directives.

3 See Chapter 20 of Brealey, Myers, and Allen, *Principles of Corporate Finance*, 9th edition, McGraw Hill Irwin, 2008.

4 For example, see pages 19-20 of "Phase 1B Testimony of Terry L. Murray on behalf of the Division of Ratepayer Advocates on Return on Equity Adjustments" before the California Public Utilities Commission, filed October 19, 2007, Docket No. I. 07-01-022.

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Section 1 **VOLUMETRIC RATES, DECOUPLING,⁵ AND THE THROUGHPUT DISINCENTIVE**

Under traditional ratemaking, regulated utilities collect their base revenues, including the return on capital they hope to earn, using a combination of fixed charges and volumetric rates. (Volumetric rates are in dollars per kilowatt-hour for electric utilities or dollars per therm for gas utilities. Revenues collected through volumetric rates vary with overall usage.⁶) Volumetric-based cost recovery does not follow the principle of basing rates on marginal cost because a large part of a utility's costs is fixed and does not vary with the level of output and sales. Traditionally, the fixed charges generate only a small proportion of total revenues and do not fully recover the fixed element of total costs. If actual sales are less than forecast sales used to set rates, the utility will not earn its allowed ROE.

Successful EE programs will reduce sales volume relative to what sales would have been without the EE program and perhaps relative to sales volumes in previous years. The effect of declining sales on the revenue requirement (as well as the effect of increases in prudent costs) will be addressed in the next general rate case; when base rates are reset based on actual sales, but the lost fixed cost recovery for the effect of past EE programs will remain. Even with revised volumetric rates in place as a result of a rate case (and taking into account the effect of EE programs), the throughput disincentive immediately comes back into effect, so that between general rate cases, any reduction in sales from EE programs results in a reduction in earned ROE. To counteract the effect of declining sales on earned ROE, the utility may be forced to file more frequent general rate cases, which are time consuming, expensive, and risky, and therefore not a desirable solution. Thus utilities with volumetric rates have a throughput disincentive to carry out more aggressive programs for their customers to reduce energy usage, lower their utility bills, and help meet climate change policy goals.

This tension is in contrast with the overall cost effectiveness of the EE programs from several other perspectives. It is regularly shown in regulatory filings that a wide variety of utility-administered EE programs are cost effective from society's point of view. Because of their cost effectiveness and emissions-reducing effects, a number of states have adopted formal EE resource standards or similar EE goals. A recent survey of electric utilities showed that ratepayer-funded EE expenditures increased by over 57 percent between 2007 and 2009.⁷ It is evident that the issue of addressing the throughput disincentive is becoming increasingly important. Decoupling of one form or another has been approved for natural gas local distribution companies (LDCs) in about 28 states and is pending in 4 more.⁸ Decoupling has also been approved for electric utilities in about 13 states and is pending in 7 more.⁹

5 This study assesses two different ratemaking approaches and uses the term "decoupling" to include both: 1) decoupling with general revenue true-up mechanisms and 2) straight fixed-variable rates. A related form of decoupled ratemaking is a lost revenue adjustment mechanism that focuses specifically on the impacts of EE programs on base revenues. Some discussions of decoupling limit the term to just the first approach and some include all three. There is no agreement about which of the three is best. This paper is only interested in the cost of capital impacts, not the comparative merits of the three types of decoupling. We include the first two decoupling approaches because they have similar impacts in insulating revenues collected from changes in the commodity throughput, other than those driven by increased numbers of customers. As is generally true, the companies in our gas sample use only these two forms of decoupled ratemaking.

6 A small percentage of fixed costs are recovered through customer charges and are not part of the decoupling issue. Some fixed costs for large customers are recovered in demand charges and are much less affected by EE programs. Finally, fuel and purchased power are large, variable costs for electric and gas consumers, and are both independent of the throughput disincentive, because revenues and costs go up or down together and changes generally cancel each other out.

7 "Summary of Ratepayer Funded Electric Efficiency Impacts, Expenditures and Budgets," Based on CEE/IEE Industry Database, Updated IEE Brief, May 2010.

8 American Gas Association, *Innovative Rates, Non-Volumetric Rates and Tracking Mechanisms: Current List*, as of June 2010.

9 Institute for Energy Efficiency, *State Energy Efficiency Frameworks*, July 2010, pages 2-3; updated for adoption in Arizona and moving Nevada to a different policy.

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If energy efficiency is the goal, decoupling is a useful form of regulated ratemaking that separates, or decouples, the collection of base revenues from sales of the product, so that utility profits are not hurt from the reductions in sales (for example, caused by EE programs). Decoupling removes the throughput disincentive, aligns the interests of utility management with the public policy goal of EE, and reduces sales with the management goal of earning the allowed rate of return for investors.

Section 2 DECOUPLING AND THE COST OF CAPITAL

Decoupling was adopted for three electric utilities in California in the 1980s as an adjunct to EE policies and has continued ever since, except for a brief hiatus during restructuring after 1998. California utilities have never had their cost of capital explicitly reduced because of decoupling. However, as decoupling has grown in importance in recent years within other states, a substantial regulatory risk has also emerged in the form of the potential reduction in the allowed ROE.

To date, about one-fifth of regulatory decisions that we have reviewed related to decoupling for gas and electric utilities have concluded that decoupling does reduce a utility's cost of capital, and accordingly these decisions have reduced the allowed ROE. The reductions in allowed ROEs have ranged from 10 to 50 bps. However, in our review of these cases, we could not find any empirical evidence that supported a reduction of any particular magnitude. The other four-fifths of the decisions adopted decoupling without explicitly reducing the cost of capital. Since the subject has gained greater notoriety, regulatory risk may still resurface as an issue when those utilities litigate their cost of capital in future general rate cases. We have developed an approach to investigate whether any reduction in the allowed ROE is warranted, and if so, how small or how large the reduction should be.

A utility's operating earnings (i.e., earnings before income taxes) are the difference between base revenues (non fuel) and the sum of all prudent costs, which include operations and maintenance (O&M), administrative and general (A&G), depreciation, and interest. There are several sources of variability in the base revenue stream that can also be eliminated by the decoupling mechanisms analyzed here. EE programs decrease revenues because they decrease sales. Other increases and/or decreases in base revenue are driven by changes in weather, business activity over the business cycle, the net number of new customers, and the number of delinquent bills. By design, decoupling eliminates or significantly weakens the linkage between revenues and the volume sold, independent of the source of variability.

Decoupling stabilizes revenues, but net income still varies. Although depreciation and interest expense are relatively stable, other costs can change quickly between rate cases. At times of rapid capital investment, such as the present for utilities that are facing significant environmental retrofits, depreciation and interest may also increase rapidly so that general rate cases are frequently required. O&M and A&G costs can rise more than revenue, but are reasonably predictable and do not vary as directly with sales as do revenues. Therefore, if decoupling stabilizes the revenue side of the earnings equation, does it stabilize operating earnings as well? This leads directly to the question: if decoupling reduces revenue variability largely independent of the cost situation, does risk go down at the same time? A more targeted question is whether decoupling reduces the non-diversifiable risk that determines the cost of capital in financial markets? The answer is not a simple "yes."

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Not all risks or sources of variance in earnings affect the cost of capital equally, because investors can simply avoid certain risks. For example, extremes of weather, including extreme mildness, will cause variance in a single utility's revenues and is a risk factor for that utility's earnings. However, investors can assemble a portfolio of utility stocks from across the U.S. climate zones and mitigate the weather effects of individual stocks in the portfolio. For the portfolio of utility stocks, the effect of weather variations should largely cancel out, removing weather as a source of investment risk, and negating its effect on the cost of capital. Portfolio formation removes other such risks that can be minimized by diversification.

Non-diversifiable risks, also known as "business risks," are the risks that remain after diversification. They are the risks that drive a company's cost of capital because investors must bear them. The distinction between diversifiable risk and non-diversifiable business risk is important to recognize when evaluating the effect of decoupling, or other regulatory policy, on a company's cost of capital. Simply reducing total risk does not imply that the cost of capital has been reduced. The risk reduced must be part of a company's business risk to affect its cost of capital, so only reductions in business risk justify a reduction in a regulated company's allowed ROE. Thus, we believe that there is strong need to address the empirical question of whether the presumed decrease in risk from adoption of decoupling policy results in a measurable decrease in the cost of capital for regulated utilities.

Section 3 AN EMPIRICAL TEST OF THE EFFECT OF DECOUPLING ON THE COST OF CAPITAL

For the nearly five year study period from October 2005 to June 2010, we examined a sample of exchange-traded companies in the natural gas distribution sector for which estimates of the cost of capital were available. For these holding companies, we examined each of their regulated gas LDC subsidiaries and identified whether and when each LDC had decoupled versus traditional volumetric rates. We then compared the estimated cost of capital across two mutually exclusive groups: regulated utilities with all or a large share of revenues collected under decoupled ratemaking versus regulated utilities with all or a large share of traditional volumetric rates.

During the study period, co-author Dr. Michael Vilbert and others at *The Brattle Group* participated in a number of rate proceedings where the cost of capital was estimated for a sample of regulated gas LDCs. Some of the LDCs examined in these proceedings had decoupled rates at the beginning, some did not, and some became decoupled during the period. Hence, the cost of capital estimates from these proceedings provide a natural experiment on the impact of decoupling on the cost of capital. The specifics of our study are described below.

Developing a Sample of Traded Natural Gas Holding Companies

Our analysis is based on a carefully selected sample of holding companies that were exclusively or primarily involved in the regulated natural gas distribution industry. Over the study period, *Brattle* expert witnesses submitted cost of capital testimony 18 separate times based on an evolving sample of 6 to 12 gas LDC holding companies. Across the 18 dates, over 170 estimates of the cost of capital were made and submitted into evidence, subject to scrutiny.

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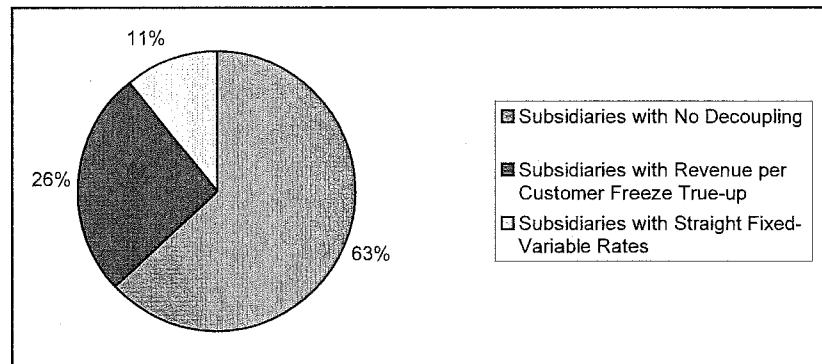
In each proceeding, *Brattle* selected a sample from the universe of all traded natural gas LDC holding companies followed by the investment advisory service, the *Value Line Investment Survey*, using six sample selection criteria that are designed to remove companies with characteristics that could bias the cost of capital estimates.¹⁰ Over the study period, the selection criteria remained the same, but the composition of the sample changed slightly (i.e., due to mergers). Thus, we have assembled a record of statistically valid estimates of the change in the cost of capital for every holding company in the sample for the study period.

Determining the Degree of Decoupling for Companies in the Sample

Holding companies, not their subsidiaries, have the market information necessary to estimate the cost of capital, because they have publicly traded stock. However, it is the individual state-regulated subsidiaries, not the holding companies themselves, that can be granted decoupled rates by state regulators. Hence, to characterize the degree of decoupling of each holding company, it is necessary to examine the decoupling policies of its subsidiaries in each state in which the subsidiary operates.¹¹

To begin, we identified all regulated gas LDCs belonging to each holding company in the sample and then used a combination of primary and secondary sources to identify the subset of those gas LDCs that had decoupled rates during the study period. The 12 holding companies collectively held 46 regulated natural gas LDC subsidiaries as of June 2010. We used a broad definition of decoupling and included true-up decoupling schemes and straight fixed-variable (SFV) rates.¹² Figure 1 shows the distribution in June 2010 of true-up and SFV decoupling schemes among the 46 subsidiaries in our sample.

Figure 1 Shares of Decoupling Mechanisms in Natural Gas Sample (June 2010)



10 The sample selection criteria are:
 a. An investment grade credit rating, i.e., BBB- or better from S&P;
 b. No dividend cuts during the last five years;
 c. Revenues or assets > \$300 million;
 d. Greater than half of the assets in the regulated line of business, either natural gas distribution or regulated electric operations;
 e. Data available from Value Line, Bloomberg, and Moody's; and
 f. No major mergers or acquisitions during the last three years.

11 In this report, we use the term "subsidiary" to refer to the part of a utility that is regulated at the state level. A particular holding company might own two utilities that are separate corporations. Assume the first is located in a single state, while the second has a service territory extending over three states. In our analysis, this holding company would have four "subsidiaries."

12 See footnote 6. We did not find any gas LDC companies with decoupling in the form of a lost fixed revenue adjustment mechanism, which is found frequently in electric utilities.

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In our sample of 46 subsidiaries of 12 gas LDC holding companies, 37 percent had decoupling policies in place. We believe this is higher than the overall proportion of all LDCs in the population having decoupled rates. In total, we estimate there are approximately 49 LDCs across the U.S. with decoupling,¹³ out of an estimated population of over 300 LDCs,¹⁴ implying that the proportion with decoupling is less than one-sixth, as shown below in Table 1.

Table 1 Natural Gas Decoupling Penetration

Natural Gas Delivery Utilities			
Population and <i>Brattle</i> Sample of Regulated Subsidiaries: Total and Decoupled			
	Gas LDC Subsidiaries	Number Decoupled	Share Decoupled
In Total Population	341	49	14%
In <i>Brattle</i> Sample	46	17	37%

Notes
 The total row refers to all gas LDCs, counting them per state separately in which it delivered volumes of at least five bcf in 2008.
 The sample row refers to 12 publicly-traded companies that meet *Brattle* criteria.

Not only does decoupling vary by subsidiary, but for some subsidiaries in our sample the status of decoupling has changed over time because state regulators have approved new mechanisms and, in some cases, changed or eliminated decoupling. To reflect this variation, we developed a robust decoupling index for each holding company over time. First, for each subsidiary, we made a specific designation of whether or not it was decoupled for each year in the sample period. Second, we aggregated the decoupling scores of the regulated subsidiaries to produce an overall decoupling score for the holding company. In this aggregation, we weighted all of the individual subsidiary scores (i.e., one or zero) based on their volume of gas distributed in 2008.

¹³ This is based on our examination of published reviews, for example, *Review of Distribution Revenue Decoupling Mechanisms*, Pacific Economics Group, March 2010, and *State Energy Efficiency Regulatory Frameworks*, Institute for Electric Efficiency, January 2010.

¹⁴ Based on EIA Form 176 data. In counting LDCs, such as in Figure 1, we exclude LDCs transporting less than five bcf per year. In estimating the index of decoupling for a holding company at points in time, we do not exclude any subsidiaries.

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Table 2 below shows the decoupling index for each natural gas holding company in the sample at the end of the study period (June 2010).

Table 2 Decoupling Index for the Natural Gas Sample (June 2010)

Company	Number of Gas LDC Subsidiaries	Decoupling Index
AGL	6	0.82
Atmos	12	0.01
Laclede	1	1.00
New Jersey Resources	1	1.00
Nicor	1	0.00
NiSource	9	0.40
Northwest Natural	3	0.93
Piedmont	3	0.75
South Jersey Industries	1	1.00
Southwest Gas	3	0.68
WGL	3	0.00
Vectren	3	1.00
Total	46	

Notes
 Each subsidiary is counted once per state in which it operates.
 The aggregate decoupling score for each group is the number of its gas LDC subsidiaries with decoupling, multiplied by the 2008 gas volumes for those subsidiaries, then divided by the total 2008 group gas volumes.

Estimating the Cost of Capital for Companies in the Sample

The cost of capital is defined as the return investors require in order to invest in an asset, or the expected return available on investments of comparable risk. There are a number of good and frequently used approaches for estimating the cost of capital for a company. One approach, though not used here, is to create estimates using historical data to estimate the parameters of a cost of capital model (e.g., estimate the Capital Asset Pricing Model (CAPM) beta using historical stock price returns). Another approach, which we do use here, is to compare current stock prices with forward-looking forecasts of cash flows from the business (e.g., one can use discounted cash flow (DCF) methods to compare the value of expected future dividends from the stock with current stock prices to estimate the expected returns). For this study, we used the DCF approach to estimate the cost of capital to analyze the effect of decoupling, because the DCF approach has the advantage of reflecting changes in the cost of capital more quickly than do other approaches that rely on the analysis of historical data.¹⁵ In the DCF model, the discount rate that makes the present value of expected future dividends equal to the current stock price is the estimate of the cost of equity (COE) for the company.

¹⁵ For example, estimates of beta, the systematic risk parameter in the CAPM, are normally based upon three to five years of historical data. A policy that changed a company's cost of capital would lead to a change in the company's beta, but that change would not be fully reflected in the beta estimate for three to five years.

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We chose to use a multi-stage version of the DCF model. In this version, security analysts' forecasts of company-specific future earnings were used for a five-year, first stage of the multi-stage analysis to estimate expected dividends.¹⁶ Later stages were added to ensure that the growth rate for each company eventually settled down to a single long-term growth rate based on the forecast of the long-term U.S. GDP growth rate. In particular, forecast growth rates for years 6 through 10 were linearly trended between company-specific earnings growth rates for the first 5 years and the long-term GDP growth rate in effect starting in year 11. Earnings growth was translated into corresponding expected dividend payments over time.

The COE is information of interest to regulators when they set the allowed ROE for a utility, so our focus is ultimately on whether there is a measurable reduction in the COE from the policy of decoupling. In general, the COE increases not only with increased business risk but also with increased financial risk.¹⁷ Therefore, in testing for an impact on the cost of capital from decoupling, we systematically account for differences in the COE in different holding companies in the sample that arise from different levels of financial risk, which has nothing to do with decoupling.

To control for the effect of differences in capital structure (i.e., differences in financial risk) among the sample companies, we converted estimates of the COE into corresponding estimates of the overall after-tax weighted-average cost of capital (ATWACC).¹⁸ The ATWACC measures the cost of capital for the business itself, while the COE estimate represents the cost of equity capital taking into account the equity-holders' additional financial risk from the company's level of debt financing. In other words, the ATWACC captures only the effect of business risk, while the COE is also affected by financial risk. For that reason, we use the ATWACC in our statistical analysis.

Statistical Analysis of Decoupling on the Cost of Capital

To determine the impact of decoupling on the cost of capital, we carried out the five statistical tests described below. The results of these tests were all in general agreement and collectively demonstrate that the overall impact in our data sample of the holding companies from decoupling of their rates was most likely a small increase, rather than a decrease, in their cost of capital. The estimated increases from the tests ranged from 6 to 42 bps. In some of the tests, the conclusion of an increase in cost of capital was statistically significant. In other tests, a small decrease cannot be ruled out, but even in those cases, it is far more likely that the rate increased rather than decreased. The estimated impacts and associated 95 percent confidence intervals for all five statistical tests can be seen in Figure 4. Our conclusion that decoupling most likely caused a small positive impact on cost of capital is shown in Figure 4 by noting that the bulk of the confidence interval in every case is above the zero "no effect" horizontal line.

¹⁶ We also implemented the test using the simple or constant growth DCF method. The results (not reported here) were not substantially different than those based upon the multi-stage DCF method.

¹⁷ Financial risk is related to the degree to which the company's assets are debt financed. The greater the share of debt in the capital structure, the greater the interest that must be paid out of operating revenues before any shareholder earnings are available.

¹⁸ To be specific, the after-tax weighted-average cost of capital (ATWACC) is the measure we use. ATWACC is a weighted average of both the equity and debt returns after taking into account the tax deductibility of interest payments. The weights used in the calculation are the market values of debt and equity in the capital structure. See Chapter 20 of Brealey, Myers, and Allen, *op cit*.

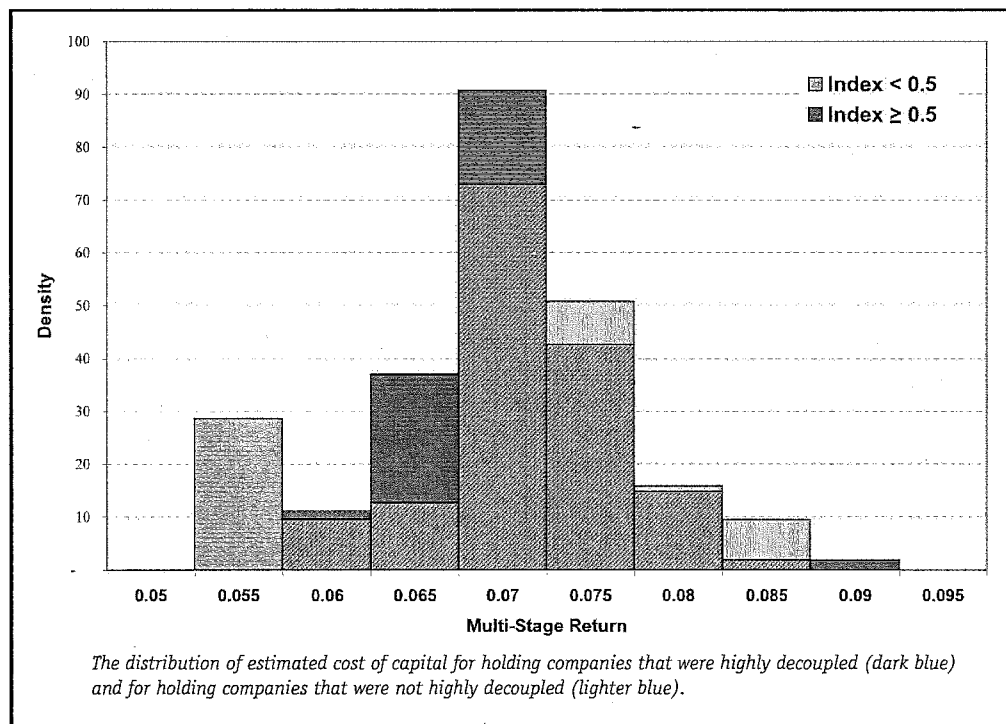
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In the first test of the impact of decoupling on the cost of capital, we split the sample at each observation date into one of two groups: the group where the decoupling index (which can vary between zero and one) is below 0.5, and the remaining utilities in the group where the decoupling index is greater than or equal to 0.5. We then compare the frequency distribution of the cost of capital estimates (specifically, the ATWACC calculated using a multistage DCF) for each group.

If the impact of decoupling on the cost of capital is large, we would expect the cost of capital estimates for the group with a high decoupling index to be noticeably lower than those with low decoupling index. Figure 2 displays the distribution of returns with a decoupling index of greater than 0.5 (dark blue) on top of the distribution of returns with a decoupling index of less than 0.5 (light blue). The cross hatch represents areas of overlap. We see that any impact of the differences in cost of capital from decoupling between the groups is smaller than the diversity in cost of capital within each group from other differences.

Figure 2 Distribution of Returns



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The first result is that the average cost of capital for the highly decoupled group was 7.313 percent, and the average cost of capital for the other group was 7.257 percent. Hence, we find that the more highly decoupled group of holding companies had a cost of capital that was slightly higher on average (5.6 bps) than the group with less decoupling. To examine the statistical significance of this first conclusion, we carried out a two-sample t-test and found that the test gave a 95 percent confidence interval of the difference in average cost of capital between the groups that ranged from 17 bps lower up to 28 bps higher for the highly decoupled group. Therefore the observed difference in means is not statistically different from zero at this confidence level.¹⁹ In other words, a t-test on the two groups leads to an expectation that the drop in cost of capital from decoupling is highly likely to be less than 17 bps and is actually somewhat more likely to be positive than negative. The results of this first test raise the question of whether it is possible that companies with decoupling in place may actually have a higher cost of capital than companies without decoupling. The answer is that it is indeed possible; if investors view decoupled rates as a signal that the company faces some additional source of risk, then the cost of capital could actually increase if rates were decoupled.

As a hypothetical example, consider a utility whose sales volume was primarily driven by a highly diversifiable risk such as weather, and the other factors including EE impacts are assumed to be absent. In this example, there would be no material reduction in the cost of capital from the risk reduction due to decoupling. However, suppose that investors view the implementation of decoupled rates as an implication that the utility would be under increased regulatory scrutiny which could increase the possibility of disallowances, or that the decoupled rate program would limit the utility's ability to recover unanticipated costs outside of the decoupling program. In such a case, investors may see the decoupled rates as a sign that other risks could increase, and therefore the cost of capital could increase because of those risks. In other words, *a priori* we do not know whether decoupled rates will increase or decrease a utility's cost of capital — it is an empirical question that can be answered only through the kind of statistical analysis that we have done here.

Our first statistical test put a 95 percent confidence interval range on the estimated impact from decoupling on the cost of capital that is almost 50 bps wide. A natural next step is to see if there are patterns to the cost of capital data that can account for enough of the variability in returns in the subgroups to more tightly constrain the assessed limits on the decoupling impact.

Figure 3 displays the cost of capital estimates by time period for each of the 12 holding companies in the sample and shows that the cost of capital estimates vary by time period and company. (In Figure 3, for each time series of cost of capital estimates for one holding company, the bold lines represent the exact periods in which the company's decoupling index was high, i.e., greater than or equal to 0.5.) It is evident that there is a great deal of shared time variation²⁰ in the estimates, in addition to a great deal of company-specific variation. This observation serves to suggest additional statistical tests that should separate out the effects of shared time variation and company-specific variation in the statistical analysis.²¹

19 This confidence interval was from a t-test based on the assumption that the sample variances of the two groups were equal. The assumption of equal variance makes the 95 percent confidence interval range slightly smaller but does not change the conclusion that the difference in means is not statistically significant.

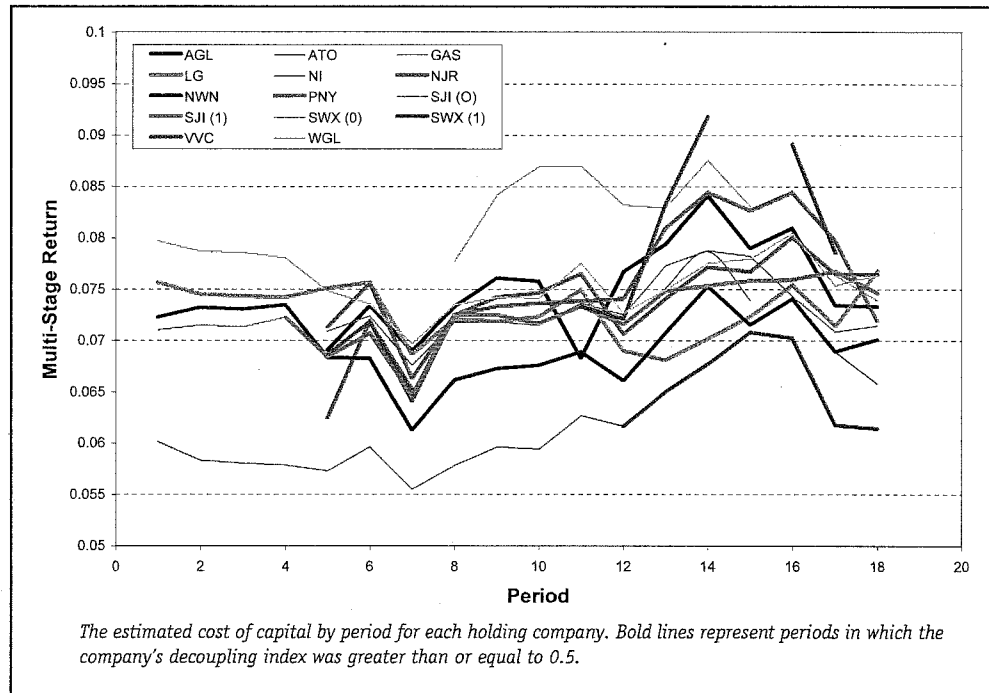
20 Shared time variation is the variation in the ROE estimates that occur as a result of being done at different points in time.

21 The broken lines in Figure 3 are due to missing data for some estimation periods.

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Figure 3 Cost of Capital Over Time



The four additional statistical tests were done using linear regression analyses. In all four additional tests, we accounted for shared time and company-specific variation through the use of time period- and company-specific indicator variables, which are common ways to isolate the impact of such factors from the impact of the quantity you are testing (here the level of decoupling). The use of these indicator variables accounted for over 80 percent of the variation in the estimated costs of capital in the data.²² The four tests differ in how the decoupling index was treated and whether the prior value of the cost of capital was included in the regression. In two of the tests, the decoupling is represented as an indicator variable with a value of one if decoupling is greater than or equal to 0.5 (highly decoupled) and zero if it is less than 0.5. In the other two tests, decoupling is represented using the actual numerical value of the decoupling index. The use of the actual value of the decoupling index is to determine whether the cost of capital estimates vary even if decoupling affects a relatively small or large portion of the assets of the holding companies.

To summarize, the four additional tests consist of two regressions with decoupling, represented with an indicator variable, carried out both with and without the inclusion of the prior cost of capital. The other two regressions, with decoupling represented by the decoupling index, were carried out both with and without the inclusion of the prior cost of capital in the regression.

²² Examination of the regression residuals with a normal quantile-quantile plot and carrying out a Jarque-Bera test did not indicate problems with either non-normality or heteroscedasticity. However, the regression residuals do show some degree of serial correlation so we used Newey-West adjusted standard errors when making inference regarding the statistical significance of the impact of decoupling on the cost of capital.

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In the first regression analysis, adding an indicator for the decoupling index being at least 0.5 into the regression leads to an estimated increase of 36 bps in the cost of capital from being highly decoupled (with a Newey-West 95 percent confidence interval ranging from +16 to +55 bps). This result is consistent with the results of the initial t-test, because both include the region from +16 to +28 bps in their 95 percent confidence interval range. The impact of being highly decoupled is greater than zero (with statistical significance at the 95 percent confidence level). In other words, we have been able to show that the cost of capital in our sample was higher for decoupled companies than for companies with volumetric rates by taking into account company-specific differences and the variation in the cost of capital over time.

In the second regression analysis, we estimated the impact of decoupling by using the decoupling index itself as an explanatory variable in the regression and by taking into account company-specific differences and the variation in the cost of capital over time. This test shows that the increase in the cost of capital is 40 bps for a fully decoupled company compared to one with no decoupling (zero decoupling index).²³

For the third and fourth regression analyses, we re-ran the prior two regressions with the additional inclusion of the prior period's cost of capital. The prior period's cost of capital was included to directly address some serial correlation, which we had seen in regression residuals from the base regression of cost of capital on period and company. The two regressions differ by the representation of decoupling as either an index or as an indicator variable. We note that the time intervals between the data points were not of uniform length because the underlying cost of capital studies are done when they are needed for regulatory proceedings, not on any fixed schedule. We believe the results of these third and fourth regressions still provide reliable evidence.²⁴ Both when we included the indicator of the decoupling index being at least 0.5 into the regression and when we included the decoupling index itself into the regressions, we found that the 95 percent confidence interval²⁵ on the impact of decoupling contained the common region from +22 to +28 bps found in the prior three tests.

The results of the five tests provide what we consider to be strong evidence that the overall impact on companies' cost of capital following decoupling of their rates was more likely an increase than a decrease. The estimated impact and associated 95 percent confidence intervals for all five statistical tests can be seen in Figure 4.

23 The Newey-West 95 percent confidence interval ranges from +22 bps up to +59 bps. In this case, the positive result is statistically significant at the 95 percent confidence interval. This result remains consistent with the prior two tests, because they all contain the interval from +22 to +28 bps in their 95 percent confidence intervals.

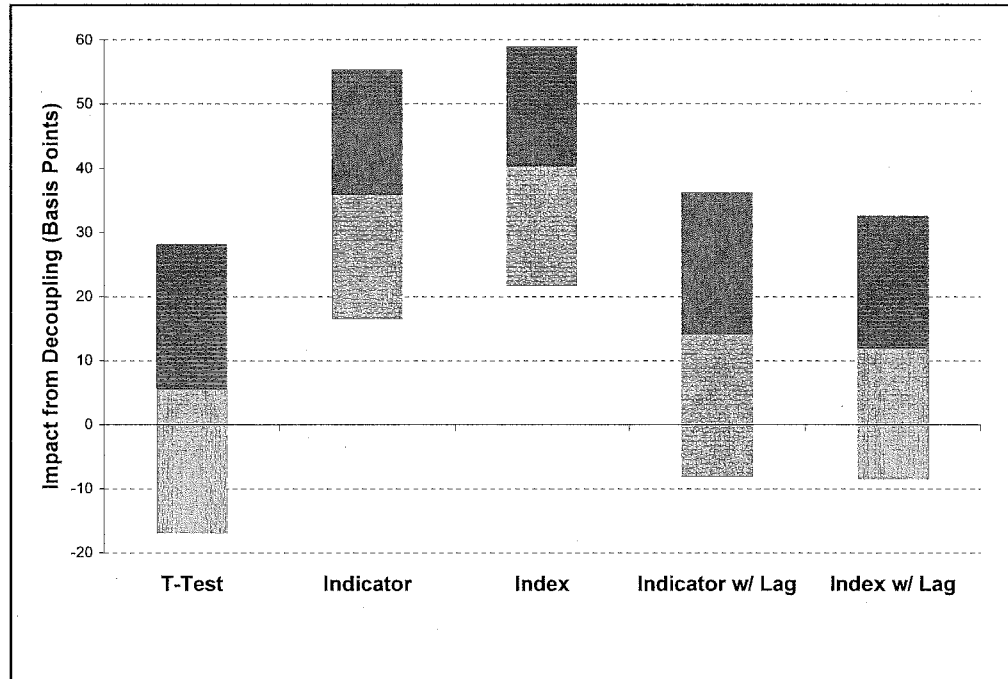
24 We believe that the non-uniform periods of time are not an important issue in this analysis. Capital markets adjust to new information on a daily or even more frequent basis. The real issue is whether there were important changes between the observations to give them a degree of independence. Even to the casual observer, it is clear that the period from 2005 to 2010 was a period of change in U.S. financial markets, so the observations appear sufficiently independent to us.

25 For the regressions with the prior cost of capital included, "HC3" standard errors were used as described by Long and Ervin, "Using Heteroscedasticity Consistent Standard Errors in the Linear Regression Model," *The American Statistician*, 2000.

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Figure 4 Summary of Estimated Impact of Decoupling on Cost of Capital



Conclusion

Our statistical tests do not support the position that the cost of capital is reduced by the adoption of decoupling. If decoupling decreases the cost of capital, these tests strongly suggest that the effect must be minimal because it is not detectable statistically.

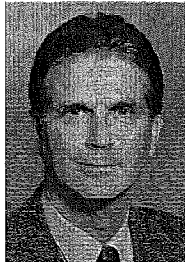
As decoupling continues to grow in importance, cases will arise where intervenors and commission staff may explore the extent to which decoupling reduces business risk and the utility's cost of capital. To date, in a minority of cases in which decoupling was approved, the utility explicitly had their allowed ROE reduced. Our research leads us to conclude that these reductions have been implemented with no empirical analysis to support the ROE reduction. The results of our analysis show that if such empirical analysis had been done, it is unlikely that it would have supported even the moderate reductions in allowed ROE that were imposed on the utilities.

Where decoupling is associated with implementing enhanced EE programs (as is almost always the case), adopting a reduction in allowed ROE in essence punishes a utility for pursuing EE programs. If a utility's management fears an unjustified reduction in the allowed ROE as a result of decoupling, the original disincentive to pursue EE programs is recreated in a new form, and the purpose of decoupling to align the interests of ratepayers, shareholders, and society as a whole may be frustrated.

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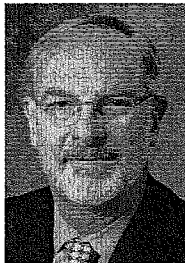


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THE IMPACT OF DECOUPLING ON THE COST OF CAPITAL: AN EMPIRICAL INVESTIGATION

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¹ The authors are Principals or Senior Associates of *The Brattle Group*, a firm which provides consulting and expert testimony in economics, finance, and regulation to corporations, law firms, and governments around the world. See www.Brattle.com. The authors also want to thank members of *The Brattle Group* who provided comments including Larry Kolbe, Hannes Pfeifenberger, Bente Villadsen, Dan Kiernan, Jenny Palmer and Stephanie Schwartz.

INTRODUCTION

Decoupling is a form of regulated ratemaking that separates cost recovery from changes in the volume of sales for a regulated utility. It originated as a policy response in the 1980s when utilities were first encouraged to develop energy efficiency (EE) programs, which can significantly reduce the consumption of regulated commodities, such as electricity, gas, or water.

Research into the costs and benefits of EE technologies has shown that the long-run savings frequently exceed the costs, and EE programs have the additional benefit of producing no harmful emissions. Recently, more states have begun to adopt long-term goals for EE and designated the utilities as the program administrators. Despite the programs being beneficial and cost-effective to society, there is a substantial disincentive for the utilities to pursue the EE programs actively unless they are accompanied by some type of “revenue decoupling” and incentives.

This disincentive begins with the fact that a large share of an electric, gas, or water utility’s costs are fixed in the short run and do not vary with the amount of the commodity produced and delivered. Traditional cost-of-service ratemaking collects these “base” revenues largely through volumetric rates (i.e., per therm, kilowatt hour, or 100 cubic feet). A successful EE program will reduce the volume of sales and simultaneously reduce recovery of the fixed costs, which include the equity returns, so regulated utilities have what is called a “throughput disincentive” to carry out EE programs.

“Revenue decoupling” (or simply “decoupling”) is a ratemaking methodology that severs the link between sales and cost recovery. There are various forms of decoupling, but the basic idea is that if sales exceed forecast, the utility will refund to customers the over recovery of fixed costs. If sales are less than forecast, the utility will be able add a charge to future rates to recover fully its fixed costs. This removes the throughput disincentive and therefore the conflict of interest for utility management. With decoupling in place, managers of regulated investor-owned utilities eliminate one major hurdle to pursuing EE programs that regulators determine are in the public interest and maintain their fiduciary duty to protect the interests of their

shareholders.² However, a new hurdle has recently appeared in the form of a tangible regulatory risk of a lowered allowed return on equity (ROE) for utilities that implement decoupling.

In addition to management's conflict of interest in reducing sales volume, EE programs are likely to increase the variability of the utility's revenues because the effectiveness of the EE program adds another element of forecasting error into setting the revenue requirement. As decoupling policies become increasingly prevalent and important, some intervenors and some commission staffs have argued that decoupling, by design, reduces the variability of revenues by decoupling cost recovery from sales volume, which, they argue, translates directly into reduced business risk. Intervenor therefore have also argued that the regulated company's cost of capital be reduced because cost of capital is the payment to investors bearing business and financial risks.³

In the majority of decisions approving decoupling in the past, regulators did not explicitly conclude that decoupling reduces a utility's cost of capital. However, in a very visible minority, regulators did decrease the allowed ROE, with the reductions generally ranging from 10 to 50 basis points (bps) (100 bps = 1 percentage point). Of more concern is that intervenors in some gas, electric, and water utility rate cases have suggested the decoupling impact on ROE should be as large as 250 to 300 bps.⁴ After reviewing a number of decisions where reductions were imposed by the regulators, we find that the reductions, whether moderate or substantial, appear to be based on theoretical arguments without the support of empirical evidence demonstrating an actual relationship between decoupling and the cost of capital. To test this theory, we have completed the first empirical investigation, of which we are aware, on the hypothesis that

² There are three conditions that are likely to be needed to ensure that a utility's management is enthusiastic about the effect of large scale EE programs on their financial performance. The first is decoupling, as discussed in this paper, and the second is the timely and concurrent recovery of the direct EE costs. Although together these two conditions make the utility financially indifferent, they do not provide the utility with a strong reason to pursue energy efficiency. The third condition is a performance incentive, which gives the management a financial incentive and, when successful, positive news for shareholders. Although utilities operate under a regulatory bargain, investors value growth in earnings and wish to see some other real value when growth is being reduced by public policy directives.

³ See Chapter 20, Brealey, Myers and Allen, *Principles of Corporate Finance*, 9th edition, McGraw Hill Irwin, 2008.

⁴ For example, see pp. 19-20 of "Phase 1B Testimony of Terry L. Murray on behalf of the Division of Ratepayer Advocates on Return on Equity Adjustments" before the California Public Utilities Commission filed October 19, 2007 in Docket No. I. 07-01-022.

decoupling lowers the cost of capital. This was done on natural gas distribution utilities between 2005 and 2010.

The findings of our analysis do not support the belief that utilities with decoupling have a lower cost of capital compared to utilities without decoupling. Contrary to what some might expect to find, at least on the basis of the opinions of certain intervenors and the minority set of judgments where Commissions reduced allowed rates of return because of decoupling, our results show that the estimated difference in the cost of capital for decoupled *versus* non-decoupled (or traditional) natural gas distribution utilities was not statistically different from zero.

SECTION 1: VOLUMETRIC RATE, DECOUPLING,⁵ AND THE THROUGHPUT DISINCENTIVE

Under traditional ratemaking, regulated utilities collect their base revenues, including the return on capital they hope to earn, using a combination of fixed charges and volumetric rates. (Volumetric rates are in dollars per kilowatt-hour for electric utilities or dollars per therm for gas utilities. Revenues collected through volumetric rates vary with overall usage.⁶) Volumetric-based cost recovery does not follow the principle of basing rates on marginal cost because a large part of a utility's costs is fixed and does not vary with the level of output and sales. Traditionally, the fixed charges generate only a small proportion of total revenues and do not fully recover the fixed element of total costs. If actual sales are less than forecast sales used to set rates, the utility will not earn its allowed ROE.

⁵ This study assesses two different ratemaking approaches and uses the term "decoupling" to include both: 1) decoupling with general revenue true-up mechanisms and 2) straight fixed-variable rates. A related, third form of decoupled ratemaking is a lost revenue adjustment mechanism (LRAM) that focuses specifically on the impacts of EE programs on base revenues. Some discussions of decoupling limit the term to just the first approach and some include all three. There is no agreement about which of the three is best. This paper is only interested in the cost of capital impacts, not the comparative merits of the three types of decoupling. We include the first two decoupling approaches because they have similar impacts in insulating revenues collected from changes in the commodity throughput, other than those driven by increased numbers of customers. The companies in our gas distribution utility sample use only these two forms of decoupled ratemaking.

⁶ A small percentage of fixed costs are recovered through customer charges and are not part of the decoupling issue. Some fixed costs for large customers are recovered in demand charges and are much less affected by EE programs. Finally, fuel and purchased power are large, variable costs for electric and gas consumers, and are both independent of the throughput disincentive, because revenues and costs go up or down together and changes generally cancel each other out.

Successful EE programs will reduce sales volume relative to what sales would have been without the EE program and perhaps relative to sales volumes in previous years. The effect of declining sales on the revenue requirement (as well as the effect of increases in prudent costs) will be addressed in the next general rate case when base rates are reset based on actual sales, but the lost fixed cost recovery for the effect of past EE programs will remain. Even with revised volumetric rates in place as a result of a rate case (and taking into account the effect of EE programs), the throughput disincentive immediately comes back into effect, so that between general rate cases, any reduction in sales from EE programs results in a reduction in earned ROE. To counteract the effect of declining sales on earned ROE, the utility may be forced to file more frequent general rate cases, which are time consuming, expensive, and risky, and therefore not a desirable solution. Thus utilities with volumetric rates have a throughput disincentive to carry out more aggressive programs for their customers to reduce energy usage, lower their utility bills, and help meet climate change policy goals.

This tension is in contrast with the overall cost effectiveness of the EE programs from several other perspectives. It is regularly shown in filings that a wide variety of utility-administered EE programs are cost effective from society's point of view. Because of their cost effectiveness and emissions-reducing effects, a number of states have adopted formal EE resource standards or similar EE goals. A 2010 survey of electric utilities showed that ratepayer-funded EE expenditures increased by over 57 percent between 2007 and 2009.⁷ It is evident that the issue of addressing the throughput disincentive is becoming increasingly important. As of 2010, decoupling of one form or another had been approved for natural gas LDCs in about 28 states and is pending in four more.⁸ As of 2010, decoupling had been approved for electric utilities in about 13 states and is pending in seven more.⁹

If energy efficiency is the goal, decoupling is a useful form of regulated ratemaking that separates, or decouples, the collection of base revenues from sales of the product, so utility

⁷ Summary of Ratepayer Funded Electric Efficiency Impacts, Expenditures and Budgets, Based on CEE/IEE Industry Database, *Updated IEE Brief*, May 2010.

⁸ American Gas Association, *Innovative Rates, Non-Volumetric Rates and Tracking Mechanisms: Current List*, as of June 2010.

⁹ Institute for Energy Efficiency, *State Energy Efficiency Frameworks*, July 2010, pp. 2-3; updated for adoption in AZ and moving NV to a different policy.

profits are not hurt from the reductions in sales (for example, caused by EE programs). Decoupling removes the throughput disincentive and aligns the interests of utility management with the public policy goal of EE, and reduced sales with the management goal of earning the allowed rate of return for investors.

SECTION 2: DECOUPLING AND THE COST OF CAPITAL

Decoupling was adopted for three electric utilities in California in the 1980s as an adjunct to EE policies and has continued ever since (except for a brief hiatus during restructuring after 1998). California utilities have not had their cost of capital explicitly reduced because of decoupling. However, as decoupling has grown in importance in recent years in other states, a substantial regulatory risk has also emerged in the form of the potential reduction in the allowed ROE.

As of 2010, about one-fifth of regulatory decisions that we have reviewed related to decoupling for gas and electric utilities have concluded that decoupling does reduce a utility's cost of capital, and accordingly these decisions have reduced the allowed ROE. The reductions in allowed ROEs have ranged from 10 to 50 bps. However, in our review of these cases, we could find no empirical evidence that supported a reduction of any particular magnitude. The other four-fifths of the decisions adopted decoupling without explicitly reducing the cost of capital. Since the subject has gained greater notoriety, regulatory risk may still resurface as an issue when those utilities litigate their cost of capital in future general rate cases. We have developed an approach to investigate whether any reduction in the allowed ROE is warranted, and if so how small or how large should the reduction be.

A utility's operating earnings (i.e., earnings before income taxes) are the difference between base revenues (non-fuel) and the sum of all prudent costs (operations and maintenance (O&M), administrative and general (A&G), depreciation, interest). There are several sources of variability in the base revenue stream that can also be eliminated by the decoupling mechanisms analyzed here. EE programs decrease revenues because they decrease sales. Other increases and/or decreases in base revenue are driven by changes in weather, business activity over the business cycle, the net number of new customers, and the number of delinquent bills. By design, decoupling eliminates or significantly weakens the linkage between revenues and the volume sold, independent of the source of variability.

Decoupling stabilizes revenues, but net income can still vary. Although depreciation and interest expense are relatively stable, other costs can change quickly between rate cases. At times of rapid capital investment, like the present for utilities that are facing significant environmental retrofits, depreciation and interest may also increase rapidly so that general rate cases are frequently required. O&M and A&G costs can rise more than revenue but are reasonably predictable and do not vary as directly with sales as do revenues. Therefore, if decoupling stabilizes the revenue side of the earnings equation, does it stabilize operating earnings as well? This leads directly to the question: if decoupling reduces revenue variability largely independent of the cost situation, does risk go down at the same time? A more targeted question is whether decoupling reduces the non-diversifiable risk that determines the cost of capital in financial markets? The answer is not a simple “yes.”

Because investors can simply avoid certain risks, not all risks or sources of variance in earning affect the cost of capital equally. For example, extremes of weather, including extreme mildness, will cause variance in a single utility’s revenues and are a risk factor for that utility’s earnings. However, investors can assemble a portfolio of utility stocks from across the U.S. climate zones and mitigate the weather effects of individual stocks in the portfolio. For the portfolio of utility stocks, the effect of weather variations should largely cancel out, removing weather as a source of investment risk, and negating its effect on the cost of capital. Portfolio formation removes other such risks that can be minimized by diversification.

Non-diversifiable risks (also known as “business risks”) are the risks that remain after diversification, and they are the risks that drive a company’s cost of capital because investors must bear them. The distinction between diversifiable risk and non-diversifiable business risk is important to recognize when evaluating the effect of decoupling, or other regulatory policy, on a company’s cost of capital. Simply reducing total risk does not imply that the cost of capital has been reduced. The risk reduced must be part of a company’s business risk to affect its cost of capital, so only reductions in business risk justify a reduction in a regulated company’s allowed ROE. Thus, we believe that there is strong need to address the empirical question of whether the presumed decrease in risk from adoption of decoupling policy results in a measurable decrease in the cost of capital for regulated utilities.

SECTION 3: AN EMPIRICAL TEST OF THE EFFECT OF DECOUPLING ON THE COST OF CAPITAL

For the nearly five year period from October 2005 to June 2010 (the study period), we examined a sample of exchange-traded companies in the natural gas distribution sector for which estimates of the cost of capital were available. For these holding companies, we examined each of their regulated gas local distribution company (LDC) subsidiaries and based on published sources we identified whether and when each LDC operated under decoupled *versus* traditional volumetric rates. We then compared the estimated cost of capital across two mutually exclusive groups that we could observe: regulated utilities with more than 50% share of revenues collected under decoupled ratemaking *versus* regulated utilities with less than 50% share of traditional volumetric rates. During the study period, co-author Dr. Michael Vilbert and others at *The Brattle Group* participated in a number of rate proceedings where the cost of capital was estimated for a sample of regulated gas LDCs. Some of the LDCs examined in these proceedings had decoupled rates at the beginning, some did not, and some became decoupled during the period. Hence, the cost-of-capital estimates from these proceedings provide a natural experiment on the impact of decoupling on the cost of capital. The specifics of our study using the estimates from the proceedings are described below.

DEVELOPING A SAMPLE OF TRADED NATURAL GAS HOLDING COMPANIES

Our analysis is based on a systematically selected sample of holding companies (HCs) that were exclusively or primarily involved in the regulated natural gas distribution industry. Over the study period, *Brattle* expert witnesses submitted cost of capital testimony 18 separate times based on an evolving sample of six to 12 gas LDC holding companies. Across the 18 dates, over 170 HC-specific estimates of the cost of capital were made and submitted into evidence and subject to scrutiny.

In each proceeding, *Brattle* selected a sample from the universe of all traded natural gas LDC holding companies followed by the investment advisory service, the *Value Line Investment Survey*, using six sample selection criteria that are designed to remove companies with

characteristics that could bias the cost of capital estimates.¹⁰ Over the study period, the selection criteria remained the same, but the composition of the sample changed slightly due to changing circumstances of the companies, for example, due to a merger (selection criteria No. 6). Thus, we have assembled a record of statistically valid estimates of the changes in the cost of capital for the study period for every holding company in the sample.

DETERMINING THE DEGREE OF DECOUPLING FOR COMPANIES IN THE SAMPLE

The study has an important dichotomy. Holding companies, not their subsidiaries, have the market information necessary to estimate the cost of capital, because they have publicly traded stock. However, individual, state-regulated subsidiaries, not the holding companies themselves, can be granted decoupled rates by state regulators. Hence, we characterized the degree of decoupling of each holding company by examining the decoupling policies of its subsidiaries after differentiating each state in which the subsidiary operates.¹¹

To begin, we identified all regulated gas LDCs belonging to each holding company in the sample and then used a combination of primary and secondary sources to identify the subset of those gas LDCs that had decoupled rates during the study period. The 12 holding companies collectively held 46 regulated natural gas LDC subsidiaries as of June 2010. We used a broad definition of decoupling and included true-up decoupling schemes and straight fixed-variable (SFV) rates.¹²

¹⁰ The sample selection criteria are:

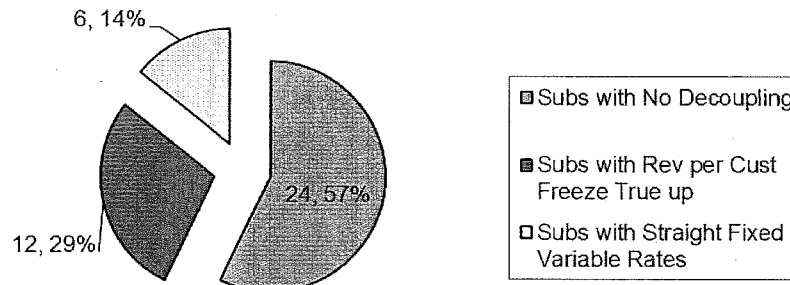
1. An investment grade credit rating, i.e., BBB- or better from S&P;
2. No dividend cuts during the last 5 years;
3. Revenues or assets > \$300 million;
4. Greater than half of the assets in the regulated line of business, either natural gas distribution or regulated electric operations;
5. Data available from Value Line, Bloomberg and Moody's; and
6. No major mergers or acquisitions during the last 3 years.

¹¹ In this report, we use the term "subsidiary" to refer to the part of a utility that is regulated at the state level. A particular holding company might own two utilities that are separate corporations. Assume the first is located in a single state, while the second has a service territory extending over three states. In our analysis, this holding company would have four "subsidiaries".

¹² See footnote 6 above. We did not find any gas LDC companies with decoupling in the form of a lost fixed revenue adjustment mechanism (LRAM), which is found frequently in electric utilities.

Figure 1 shows the distribution in June 2010 of true-up and SFV decoupling schemes among the 46 subsidiaries (subs) in our sample.¹³

Figure 1 Natural Gas Sample LDC Penetration of Decoupling Mechanisms in June 2010



Our evidence is that the decoupling share in our sample is relatively high. In the total population of gas LDCs across the U.S., we estimate there are approximately 49 LDCs with decoupling,¹⁴ out of an estimated population of about 340 LDCs,¹⁵ or a penetration of gas LDCs of about one-seventh. In our sample of 46 subsidiaries of 12 gas LDC holding companies, 43 percent had decoupling policies in place, as shown below in Table 1.

¹³ Four of the subsidiaries are quite small, so they are not included where a count of companies with a specific policy is made, such as in this discussion. They are included in the quantification of the Decoupling Index discussed below.

¹⁴ This is based on our examination of published reviews, for example, *Review of Distribution Revenue Decoupling Mechanisms*, Pacific Economics Group (March 2010), *State Energy Efficiency Regulatory Frameworks*, Institute for Electric Efficiency (January 2010).

¹⁵ Based on EIA Form 176 data. In counting LDCs, such as in Figure 1, we exclude LDCs transporting less than 5 bcf per year. In estimating the Index of decoupling for a holding company at points in time, we do not exclude any subsidiaries.

Table 1 Natural Gas LDC Decoupling Penetration in June 2010

	Gas LDC subsidiaries (>5 bcf)	Decoupled	Share Decoupled
Total	341	49	14%
In Sample	42	18	43%

Notes:

- The Total row refers to all gas LDCs, counting each one once per state in which it delivered volumes of at least 5 bcf in 2008.
- The In Sample row refers to gas LDCs of 12 publicly-traded companies with a large proportion of operationis in gas distribution, using same criteria as above. For the In Sample row, the volumn delivery condition removes 4 LDCs from this table. See footnote 15.

Not only does decoupling vary by subsidiary, but for some subsidiaries in our sample the status of decoupling has changed over time because state regulators have approved new mechanisms and, in some cases, changed or eliminated decoupling. To reflect this variation, we developed a robust Decoupling Index for each holding company over time. First, for each subsidiary, we made a specific designation of whether or not it was decoupled for each year in the sample period. Second, we aggregated the decoupling scores of the regulated subsidiaries to produce an overall decoupling score for the holding company. In this aggregation, we weighted all of the individual subsidiary scores (i.e., 1 or 0) based on their volume of gas distributed in 2008.

Table 2 below shows the Decoupling Index or “score” for each natural gas holding company in the sample in June 2010, the end of the study period.

Table 2 Decoupling Index for the Natural Gas Sample in June 2010

Company	Number of gas LDC subsidiaries	Decoupling Scores
AGL	6	0.82
Atmos	12	0.01
Laclede	1	1.00
New Jersey Resources	1	1.00
Nicor	1	0.00
NiSource	9	0.40
Northwest Natural	3	0.93
Piedmont	3	0.75
South Jersey Industries	1	1.00
Southwest Gas	3	0.68
WGL	3	0.00
Vectren	3	1.00
	46	

ESTIMATING THE COST OF CAPITAL FOR COMPANIES IN THE SAMPLE

The cost of capital is defined as the return investors require before investing in an asset, or comparably, as the expected return available on investments of comparable risk. There are a number of good and frequently used approaches for estimating the cost of capital for a company. One approach, not used here, is to create estimates using historical data to estimate the parameters of a cost of capital model (e.g., estimate the Capital Asset Pricing Model (CAPM) beta using historical stock price returns). Another approach is to compare current stock prices with forward-looking forecasts of cash flows from the business (e.g., the discounted cash flow (DCF) method compares the value of expected future dividends from the stock with current stock prices to estimate the level of expected returns). For this study, we used the DCF approach to estimate the cost of capital to analyze the effect of decoupling. Our reason was that the DCF approach has the advantage of reflecting changes in the cost of capital more quickly than do other approaches that rely on the analysis of historical data.¹⁶ In the DCF model, the discount

¹⁶ For example, estimates of beta, the systematic risk parameter in the CAPM, are normally based upon 3 to 5 years of historical data. A policy that changed a company's cost of capital would lead to a change in the company's beta, but that change would not be fully reflected in the beta estimate for 3 to 5 years.

rate that makes the present value of expected future dividends equal to the current stock price is the estimate of the cost of equity (COE) for the company.

We chose to use a multi-stage version of the DCF model. In this version, security analysts' forecasts of company-specific future earnings were used for a five-year first stage of the multi-stage analysis to estimate expected dividends.¹⁷ Later stages were added to insure that the growth rate for each company eventually settled down to a single long-term growth rate based on the forecast of the long-term U.S. GDP growth rate. In particular, forecast growth rates for years 6 through 10 were linearly trended between company-specific earnings growth rates for the first 5 years and the long-term growth GDP growth rate in effect starting in year 11. Earnings growth was translated into corresponding expected dividend payments over time.

The COE is the information of interest to regulators when they set the allowed ROE for a utility, so our focus is ultimately on whether there is a measurable reduction in the COE from the policy of decoupling. In general, the COE increases not only with increased business risk but also with increased financial risk.¹⁸ Therefore, in testing for an impact on the cost of capital from decoupling, we systematically account for differences in the COE in different holding companies in the sample that arise from different levels of financial risk, which has nothing to do with decoupling.

To control for the effect of differences in capital structure (i.e., differences in financial risk) among the sample companies, we converted estimates of the COE into corresponding estimates of the overall after-tax weighted-average cost of capital (ATWACC).¹⁹ The ATWACC measures the cost of capital for the business itself, while the COE estimate represents the cost of equity capital taking into account the equity-holders' additional financial risk from the company's level of debt financing. In other words, the ATWACC captures only the effect of business risk, while

¹⁷ We also implemented the test using the simple or constant growth DCF method. The results (not reported here) were not substantially different than those based upon the multi-stage DCF method.

¹⁸ Financial risk is related to the degree to which the company's assets are debt financed. The greater the share of debt in the capital structure, the greater the interest that must be paid out of operating revenues before any shareholder earnings are available.

¹⁹ To be specific, the after-tax weighted-average cost of capital (ATWACC) is the measure we use. ATWACC is a weighted average of both the equity and debt returns after taking into account the tax deductibility of interest payments. The weights used in the calculation are the market values of debt and equity in the capital structure. See Chapter 20 of Brealey, Myers and Allen, *op cit*.

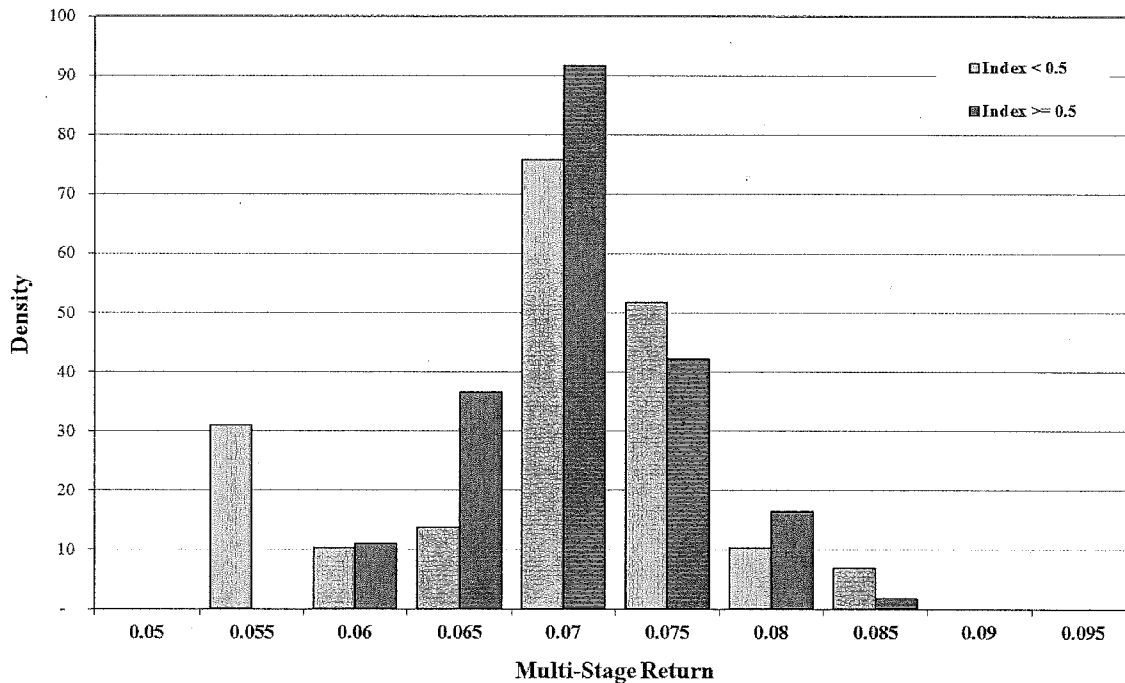
the COE is also affected by financial risk. For that reason, we use the ATWACC in our statistical analysis below.

STATISTICAL ANALYSIS OF DECOUPLING ON THE COST OF CAPITAL

To determine the impact of decoupling on the cost of capital, we carried out the five statistical tests described below. The results of these tests were all in general agreement and collectively demonstrate that the overall impact of decoupling the rates of the subsidiaries on the cost of capital of the holding companies was not statistically different from zero. There was no evidence of a decrease in the cost of capital. The estimates of changes from the five tests ranged from -9 bps to +16 bps. In none of the tests could we conclude that there was a statistically significant decrease (or counterintuitive increase) in cost of capital. The estimated impacts and associated 95 percent confidence intervals for all five statistical tests are summarized in Figure 4. Our conclusion that decoupling does not cause a measureable decrease in the cost of capital is shown in Figure 4 by noting that all five of the confidence intervals contain the zero “no effect” horizontal line.

We now proceed to describe the five statistical tests. In the first T-test of the impact of decoupling on the cost of capital, we split the sample at each observation date into one of two groups: the group where the Decoupling Index (which can vary between 0 and 1) is below 0.5 and the remaining utilities in the group where the Decoupling Index is greater or equal to 0.5. We then compare the frequency distribution of the cost of capital estimates (specifically, the ATWACC calculated using a multistage DCF) for each group. If the impact of decoupling on the cost of capital is large, we would expect the costs of capital estimates for the group with a high Decoupling Index to be noticeably lower than those with low Decoupling Index. Figure 2 displays the distribution of returns with a Decoupling Index of greater than 0.5 (dark blue) on top of the distribution of returns with a Decoupling Index of less than 0.5 (light blue). For the remainder of the paper, we refer to the group of companies with a Decoupling Index of greater than or equal to 0.5 as more decoupled and those with a Decoupling Index of less than 0.5 as less decoupled. We see that any impact of the differences in cost of capital from decoupling between the groups is smaller than the diversity in cost of capital within each group from other differences.

Figure 2 Cost of Capital Distribution for More Decoupled Holding Companies (dark blue) and Less Decoupled Holding Companies (light blue)



The first result is that the average cost of capital for the more decoupled group was 7.347 percent, and the average cost of capital for the less decoupled group was 7.186 percent. Hence, we find that the more decoupled group of holding companies had a cost of capital that was slightly higher on average, +16 bps, than the less decoupled group. To examine the statistical significance of this first conclusion, we carried out a two-sample T-test and found that the test gave a 95 percent confidence interval of the difference in average cost of capital between the defined groups that ranged from 7 bps lower (-7 bps) to 39 bps higher for the more decoupled group. The observed difference in means is not statistically different from zero at this confidence level.²⁰ In other words, a T-test on the two groups leads to an expectation that any reduction in cost of capital from decoupling is highly likely to be less than 7 bps.

²⁰ This confidence interval was from a T-test based on the assumption that the sample variances of the two groups were equal. The assumption of equal variance makes the 95 percent confidence interval range slightly smaller but does not change the conclusion that the difference in means is not statistically significant.

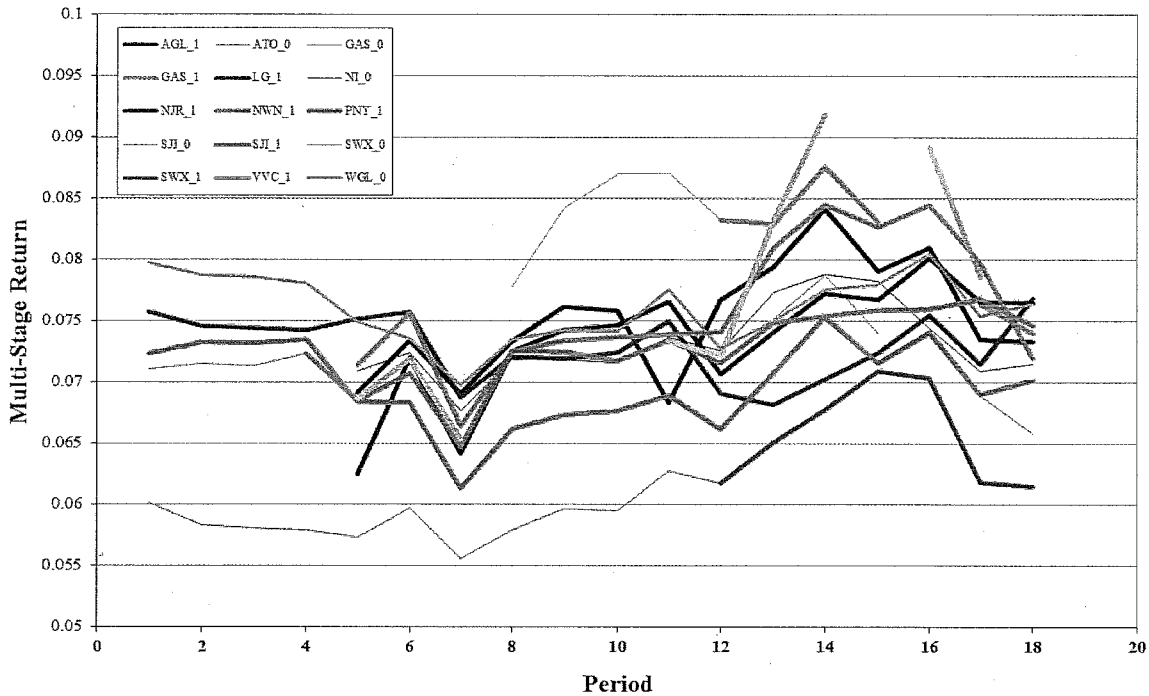
Our first statistical test put a 95 percent confidence interval range on the estimated impact from decoupling on the cost of capital that is 46 bps wide. A natural next step is to see if there are patterns to the cost of capital data that can account for enough of the variability in returns in the subgroups to more tightly constrain the assessed limits on the decoupling impact.

Figure 3 displays the cost of capital estimates by time period for each of the 12 holding companies in the sample and shows that the cost of capital estimates vary by time period and company. (In Figure 3, for each time series of cost of capital estimates for one holding company, the bold lines represent the exact periods in which the company's Decoupling Index was high, i.e., ≥ 0.5 .) It is evident that there is a great deal of shared time variation²¹ in the estimates, in addition to a great deal of company-specific variation. This observation serves to suggest additional statistical tests that should separate out the effects of shared time variation and company-specific variation in the statistical analysis.²²

²¹ Shared time variation is the variation in the ROE estimates that occur as a result of being done at different points in time.

²² The broken lines in Figure 3 are due to removing some holding companies using the objective criteria and for missing data for some estimation dates.

Figure 3 Estimated Cost of Capital for each Holding Company over Time in Bold Lines when the Decoupling Index was ≥ 0.500



Four additional statistical tests are done using linear regression analyses. In all four additional tests, we accounted for shared time and company-specific variation through the use of time period-specific and company-specific indicator variables (which are common ways to isolate the impact of such factors from the impact of the quantity you are testing, here the level of decoupling). The use of these Indicator variables accounted for over 80 percent of the variation in the estimated costs of capital in the data.²³ The four tests differ in how the Decoupling Index was treated and whether the prior value of the cost of capital was included in the regression. In two of the tests, the decoupling is represented as an Indicator variable with a value of 1 if decoupling is ≥ 0.5 (“more decoupled”) and 0 if it is < 0.5 . In the other two tests, decoupling is represented using the actual numerical value of the Decoupling Index. The use of the actual

²³ Examination of the regression residuals with a normal quantile-quantile plot and carrying out a Jarque-Bera test did not indicate problems with either non-normality or heteroskedasticity. However, the regression residuals do show some degree of serial correlation so we used Newey-West adjusted standard errors when making inference regarding the statistical significance of the impact of decoupling on the cost of capital.

value of the Decoupling Index is to determine whether the cost of capital estimates vary even if decoupling affects a relatively small or large portion of the assets of the holding companies.

To summarize, the four additional tests consist of two regressions with decoupling represented with a Decoupling Index variable carried out both with and without the inclusion of the prior cost of capital, and two regressions with decoupling represented by the Decoupling Index variable carried out both with and without the inclusion of the prior cost of capital in the regression.

In the first regression analysis, adding an Indicator for the Decoupling Index being at least 0.5 into the regression leads to an estimated slight increase of +6 bps in the cost of capital from being more decoupled (with a Newey-West 95 percent confidence interval ranging from -28 to +39 bps). This result is consistent with the results of the initial T-test, because both include the common region from -7 to +39 bps in their 95 percent confidence interval range. The impact of being more decoupled is not significantly different from zero.

In the second regression analysis, we estimated the impact of decoupling by using the Decoupling Index itself as an explanatory variable in the regression and by taking into account company-specific differences and the variation in the cost of capital over time. This test shows that the slight increase in the cost of capital is +5 bps for a fully decoupled holding company compared to one with no decoupling (0 Decoupling Index).²⁴

For the third and fourth regression analyses, we reran the prior two regressions with the additional inclusion of the prior period's cost of capital in the regressions. The prior period's cost of capital was included to address directly some serial correlation which we had seen in regression residuals from the base regression of cost of capital on period and company. The two regressions differ by the representation of decoupling as either an Index or as an Indicator variable. Both results are estimates of slight reductions in the cost of capital of -5 bps and -9 bps, for the Indicator with lag and the Index with lag, respectively. We note that the time intervals between the data points were not of uniform length because the underlying cost of capital studies are done when they are needed for regulatory proceedings, not on any fixed

²⁴ For the second regression, the Newey-West 95 percent confidence interval ranges from -30 bps up to +40 bps. This result of no impact remains consistent with the prior two tests, because they all contain the interval from -7 to +17 bps in their 95 percent confidence intervals.

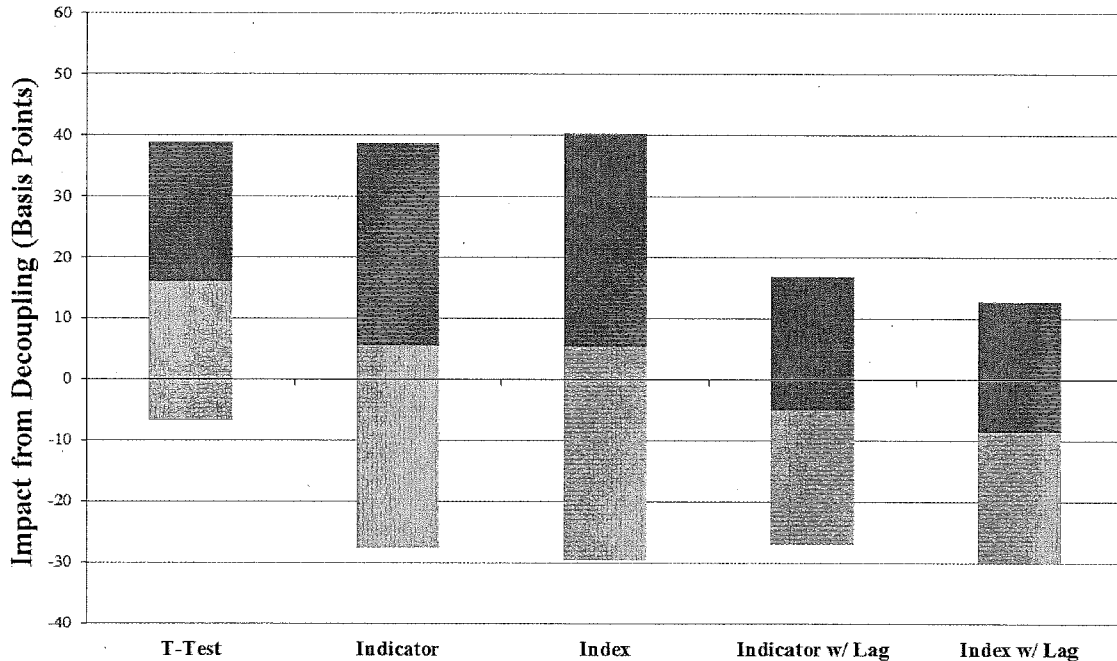
schedule. We believe the results of these third and fourth regressions still provide important evidence.²⁵ Both when we included the Decoupling Index being at least 0.5 into the regression and when we included the Decoupling Index itself into the regressions, we found that the 95 percent confidence interval²⁶ on the impact of decoupling contained the common region from -7 to +13 bps found in the prior three tests. This is the common region for all five statistical tests and includes the zero (0 bps) impact of decoupling.

In conclusion, these results provide what we consider strong evidence that the overall impact in our data sample on companies' cost of capital following decoupling of their rates was not statistically different from zero. The estimated impact and associated 95 percent confidence intervals for all five statistical tests can be seen in Figure 4.

²⁵ We believe that the non-uniform periods of time between the dates of the cost of capital estimates are not an important issue in this analysis. Capital markets adjust to new information on a daily or even more frequent basis. The real issue is whether there were important changes between the observations to give them a degree of independence. Even to the casual observer, it is clear that the period from 2005 to 2010 was a period of change in U.S. financial markets, so the observations appear sufficiently independent to us.

²⁶ For the regressions with the prior cost of capital included, "HC3" standard errors were used as described by Long J. S., Ervin L. H., *Using Heteroscedasticity Consistent Standard Errors in the Linear Regression Model*. The American Statistician, 54, 217-224, 2000.

Figure 4 Confidence Intervals for Five Statistical Tests for an Impact of Decoupling on the Cost of Capital



CONCLUSION

Our statistical tests do not support the position that the cost of capital is reduced by adoption of decoupling. If decoupling decreases the cost of capital, these tests strongly suggest that the effect must be minimal because it is not detectable statistically.

As decoupling continues to grow in importance, cases will frequently come up where intervenors and commission staff may explore the extent to which decoupling reduces business risk and the utility’s cost of capital. To date, in a minority of cases in which decoupling was approved, the utility explicitly had their allowed ROE reduced. Our research leads us to conclude that these reductions are likely to have been implemented without empirical analysis to support the ROE reduction. The results of our analysis show that if such empirical analysis had been done, it is unlikely that it would have supported even the moderate reductions in allowed ROE than were imposed on the utilities.

Where decoupling is associated with implementing enhanced EE programs (as is almost always the case), adopting a reduction in allowed ROE in essence punishes a utility for pursuing EE programs. If a utility's management fears an unjustified reduction in the allowed ROE as a result of decoupling, the original disincentive to pursue EE programs is recreated in a new form, and the purpose of decoupling to align the interests of ratepayers, shareholders, and society as a whole may be frustrated.