PEPCO (3B)

POTOMAC ELECTRIC POWER COMPANY

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

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

2 A. My name is Dr. Roger A. Morin. My business
3 address is Georgia State University, Robinson College
4 of Business, University Plaza, Atlanta, Georgia,
5 30303. I am Professor of Finance at the College of
6 Business, Georgia State University and Professor of
7 Finance for Regulated Industry at the Center for the
8 Study of Regulated Industry at Georgia State
9 University. I am also a principal in Utility Research
10 International, an enterprise engaged in regulatory
11 finance and economics consulting to business and
12 government.

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

15 A. Yes, I did.

16 Q. WHAT IS THE PURPOSE OF THIS REBUTTAL TESTIMONY?

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

1 A. My specific conclusions on Mr. Rothschild's CAPM
2 analysis are that: 1) it is not a conventional
3 implementation of the classic CAPM, 2) it erroneously
4 relies on geometric mean returns rather than
5 arithmetic mean returns and as such understates the
6 cost of equity by 180 basis points, 3) it is stale and
7 as such understates the cost of equity by 35 basis
8 points, and 4) it is biased downward by the size
9 effect.
10 Allowance for these understatements of Pepco's
11 cost of equity would raise Mr. Rothschild's
12 recommended ROE from 9.25% to approximately 11.50%.
13 The evidence from both the DCF and CAPM frameworks, if
14 implemented properly, is that investors expect
15 substantially higher returns than what Mr. Rothschild
16 has found.
17 12. EFFECT OF BSA
18 Q. WHAT RETURN ADJUSTMENT DOES MR. ROTHSCHILD RECOMMEND
19 IF THE COMPANY'S PROPOSED BSA IS APPROVED?
20 A. If the Company's proposed BSA is approved, Mr.
21 Rothschild argues that Pepco will become one of the
22 least risky electric utilities in the country and that
23 its common stock will be akin to a high-grade AA-rated
24 corporate bond. No foundation, empirical support,

1 studies, or publications are offered for such a claim,
2 nor have I ever seen a utility company's bonds (which
3 of course carry less risk than stocks) upgraded to AA
4 as a result of the approval of risk-mitigating
5 mechanisms by regulatory bodies.

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

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

1 irrelevant to investors.

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

17 Second, the empirical evidence supports the
18 notion that company-specific risks matter. The
19 positive relationship between return and both standard
20 deviation and beta is well documented in both the
21 academic and trade financial literature. The
22 comprehensive study of historical returns on stocks
23 and bonds published annually by Ibbotson Associates

1 supports the conclusion that stocks are riskier than
2 bonds in terms of standard deviations.
3 There is also a rich empirical literature in
4 finance on the determinants of beta. Variability of
5 cash flows, the use of debt, and growth are perennial
6 members of the family of variables which exert an
7 upward influence on beta. Clearly, the variability of
8 cash flows, and thus beta, increases with competition.
9 Several authors in the finance literature have
10 shown that beta has three main components: demand
11 risk, operating leverage, and financial leverage.
12 Demand risk refers to the unanticipated variability in
13 demand and prices, caused by macroeconomic conditions,
14 regulation, competition, and supply imbalances and to
15 the unanticipated variability in operating and
16 financing costs caused by macroeconomic conditions,
17 regulation, competition, and technological change.
18 Leverage refers to the extent to which these demand
19 and cost uncertainties are magnified by the operating
20 cost and financial cost structures of the company.
21 In short, company-specific risks are highly
22 relevant in determining a company's fair and
23 reasonable return.
24 Q. ARE ELECTRIC UTILITIES' BUSINESS RISKS DIVERSIFIABLE?

1 A. The business risks of electric utilities are not
2 diversifiable risks to the extent that they affect all
3 the companies in the energy industry and to the extent
4 that they affect all industries by virtue of all
5 industries' common dependence on energy as an input to
6 the production process. Moreover, it is clear from
7 the myriad investment reports, company analyses, and
8 bond rating agency reports dealing with electric
9 utility stocks in the past several years that
10 investors are concerned with the growing competition
11 in the electric utility industry, with company-
12 specific risks, and especially with regulatory risks.
13 In short, both beta risk and company-specific risk
14 matter to investors, and certainly matter to bond
15 rating agencies.
16 Q. DO YOU AGREE WITH MR. ROTHSCHILD THAT PEPCO WOULD
17 BECOME ONE OF THE LEAST RISKY UTILITIES IN THE COUNTRY
18 AS A RESULT OF THE BSA MECHANISM?
19 A. No. The approval of adjustment clauses, riders,
20 and cost recovery mechanisms by regulatory commissions
21 is widespread in the utility business and is already
22 largely embedded in financial data, such as bond
23 rating and business risk scores. While adjustment
24 clauses, riders, and cost tracking mechanisms may

1 mitigate (on an absolute basis but not on a relative
2 basis) a portion of the risk and uncertainty related
3 to the day-to-day management of a regulated utility's
4 operations, there are other significant factors to
5 consider that work in the reverse direction for Pepco,
6 for example, regulatory risk and weak financial
7 metrics, that offset the presence of the
8 aforementioned mechanisms. I have never seen a
9 utility's bonds upgraded to AA in response to the
10 approval of a mechanism such as BSA.

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

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

24 13. CAPITAL STRUCTURE RECOMMENDATION