EXH. RAM-1Tr
DOCKETS UE-190529/UG-190530
2019 PSE GENERAL RATE CASE
WITNESS: DR. ROGER A. MORIN

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY,** **Respondent.**	**Docket UE-190529** **Docket UG-190530**

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF

DR. ROGER A. MORIN

ON BEHALF OF PUGET SOUND ENERGY

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PUGET SOUND ENERGY

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I. INTRODUCTION

Q. Please state your name, business address, and occupation.

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

Q. Please describe your educational background.

A. I hold a Bachelor of Engineering degree and an MBA in Finance from McGill University, Montreal, Canada. I received my Ph.D. in Finance and Econometrics at the Wharton School of Finance, University of Pennsylvania.

Q. Please summarize your academic and business career.

A. I have taught at the Wharton School of Finance, University of Pennsylvania, Amos Tuck School of Business at Dartmouth College, Drexel University,

University of Montreal, McGill University, and Georgia State University. I was a faculty member of Advanced Management Research International, and I am currently a faculty member of S&P Global Intelligence (formerly SNL Knowledge Center or SNL), where I continue to conduct frequent national executive-level education seminars throughout the United States. In the last 30 years, I have conducted numerous national seminars on "Utility Finance," "Utility Cost of Capital," "Alternative Regulatory Frameworks," and "Utility Capital Allocation," which I have developed on behalf of S&P Global Intelligence and its predecessors.

I have authored or co-authored several books, monographs, and articles in academic scientific journals on the subject of finance. They have appeared in a variety of journals, including The Journal of Finance, The Journal of Business Administration, International Management Review, and Public Utilities Fortnightly. I published a widely-used treatise on regulatory finance, *Utilities' Cost of Capital, Public Utilities Reports, Inc.*, Arlington, Va. 1984. In late 1994, the same publisher released my book, *Regulatory Finance*, a treatise on the application of finance to regulated utilities. A revised and expanded edition of this book, *The New Regulatory Finance*, was published in 2006. I have been engaged in extensive consulting activities on behalf of numerous corporations, law firms, and regulatory bodies in matters of financial management and corporate litigation. Please see the First Exhibit to the Prefiled Direct Testimony of Dr. Roger A. Morin, Exh. RAM-2, for an exhibit that details my professional qualifications.

Q. Have you previously testified on cost of capital before utility regulatory commissions?

A. Yes, I have been a cost of capital witness before nearly 50 regulatory bodies in North America, including the Washington Utilities and Transportation Commission (the "Commission"), Federal Energy Regulatory Commission, and the Federal Communications Commission. I have also testified before the following state, provincial, and other local regulatory commissions:

Alabama	Florida	Missouri	Oklahoma
Alaska	Georgia	Montana	Ontario
Alberta	Hawaii	Nebraska	Oregon
Arizona	Illinois	Nevada	Pennsylvania
Arkansas	Indiana	New Brunswick	Quebec
British Columbia	Iowa	New Hampshire	South Carolina
California	Kentucky	New Jersey	South Dakota
City of New Orleans	Louisiana	New Mexico	Tennessee
Colorado	Maine	New York	Texas
CRTC	Manitoba	Newfoundland	Utah
Delaware	Maryland	North Carolina	Vermont
District of Columbia	Michigan	North Dakota	Virginia
FCC	Minnesota	Nova Scotia	Washington
FERC	Mississippi	Ohio	West Virginia

Please see the First Exhibit to the Prefiled Direct Testimony of Dr. Roger A. Morin, Exh. RAM-2, for details of my participation in regulatory proceedings.

Q. What is the purpose of your testimony in this proceeding?

A. The purpose of my testimony in this proceeding is to present an independent appraisal of the fair and reasonable rate of return on common equity ("ROE") on the common equity capital invested in PSE's utility operations in the State of Washington. Based upon this appraisal, I have formed my professional judgment as to a return on such capital that would:

(1) be fair to ratepayers;

(2) allow PSE to attract the capital needed for infrastructure and reliability investments on reasonable terms;

(3) maintain PSE's financial integrity; and

(4) be comparable to returns offered on comparable risk investments.

I will testify in this proceeding as to that opinion.

Q. Please summarize your findings concerning PSE's cost of common equity.

A. Based on the results of various methodologies, current capital market conditions, and current economic industry conditions, I recommend the adoption of an ROE of 9.8 percent.

An ROE of 9.8 percent for PSE is required to: (i) attract capital on reasonable terms, (ii) maintain its financial integrity, and (iii) earn a return commensurate with returns on comparable risk investments.

My ROE range is derived from cost of capital studies that I performed using the financial models available to me and from the application of my professional

judgment to the results. I applied various cost of capital methodologies—including Discounted Cash Flow ("DCF"), Capital Asset Pricing Model ("CAPM"), and Risk Premium methodologies to a group of investment-grade dividend-paying combination gas and electric utilities which are covered in Value Line's Electric Utility Composite. The companies were also required to have the majority of their revenues from regulated utility operations, to be investment-grade, and pay dividends.

My recommended rate of return reflects the application of my professional judgment to the results in light of the indicated returns from my DCF, CAPM, and Risk Premium analyses.

Q. Would it be in the best interests of ratepayers for the commission to approve an ROE of 9.8 percent for PSE's utility operations?

A. Yes. My analysis shows that an ROE of 9.8 percent fairly compensates investors, maintains PSE's credit strength, and attracts the capital needed for utility infrastructure and reliability capital investments. Adopting a lower ROE would increase costs for ratepayers.

Q. Please explain how low allowed ROEs can increase both the future cost of equity and debt financing.

A. If a utility is authorized an ROE below the level required by equity investors, the utility or its parent will find it difficult to access equity capital. Investors will not provide equity capital at the current market price if the earnable return on equity

is below the level they require given the risks of an equity investment in the utility. The equity market corrects this by generating a stock price in equilibrium that reflects the valuation of the potential earnings stream from an equity investment at the risk-adjusted return equity investors require.

In the case of a utility that has been authorized a return below the level investors believe is appropriate for the risk they bear, the result is a decrease in the utility's market price per share of common stock. This reduces the financial viability of equity financing in two ways. First, because the utility's price per share of common stock decreases, the net proceeds from issuing common stock are reduced. Second, since the utility's market to book ratio decreases with the decrease in the share price of common stock, the potential risk from dilution of equity investments reduces investors' inclination to purchase new issues of common stock. The ultimate effect is the utility will have to rely more on debt financing to meet its capital needs.

As a company relies more on debt financing, its capital structure becomes more leveraged. Because debt payments are a fixed financial obligation to the utility, and income available to common equity is subordinate to fixed charges, this decreases the operating income available for dividend and earnings growth. Consequently, equity investors face greater uncertainty about future dividends and earnings from the firm. As a result, the firm's equity becomes a riskier investment.

The risk of default on a company's bonds also increases, making the utility's debt a riskier investment. This increases the cost to the utility from both debt and equity financing and increases the possibility a company will not have access to the capital markets for its outside financing needs. Ultimately, to ensure that PSE has access to capital markets for its capital needs, a fair and reasonable authorized ROE of 9.8 percent is required.

PSE must secure outside funds from capital markets to finance required utility plant and equipment investments irrespective of capital market conditions, interest rate conditions and the quality consciousness of market participants. Thus, rate relief requirements and supportive regulatory treatment, including approval of my recommended ROE, are essential requirements.

II. REGULATORY FRAMEWORK AND RATE OF RETURN

Q. Please explain how a regulated company's rates should be set under traditional cost of service regulation.

A. Under the traditional regulatory process, a regulated company's rates should be set so that the company recovers its costs, including taxes and depreciation, plus a fair and reasonable return on its invested capital. The allowed rate of return must necessarily reflect the cost of the funds obtained, that is, investors' return requirements. In determining a company's required rate of return, the starting point is investors' return requirements in financial markets. A rate of return can then be set at a level sufficient to enable a company to earn a return commensurate with the cost of those funds.

Funds can be obtained in two general forms, debt capital and equity capital. The cost of debt funds can be easily ascertained from an examination of the contractual interest payments. The cost of common equity funds (i.e., investors' required rate of return) is more difficult to estimate. It is the purpose of the next section of my testimony to estimate fair and reasonable ROE ranges for PSE's cost of common equity capital.

Q. What fundamental principles underlie the determination of a fair and reasonable ROE?

A. The heart of utility regulation is the setting of just and reasonable rates by way of a fair and reasonable return. There are two landmark United States Supreme Court cases that define the legal principles underlying the regulation of a public utility's rate of return and provide the foundations for the notion of a fair return:

1. *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923); and

2. *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

The *Bluefield* case set the standard against which just and reasonable rates of return are measured:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties ... *The return should be reasonable, sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to*

> *maintain and support its credit and enable it to raise money necessary for the proper discharge of its public duties*.

Bluefield Water Works & Improvement Co., 262 U.S. at 692 (emphasis added).

The *Hope* case expanded on the guidelines to be used to assess the reasonableness of the allowed return. The Court reemphasized its statements in the *Bluefield* case and recognized that revenues must cover "capital costs." The Court stated:

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock ... By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. *That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital*.

Hope Natural Gas Co., 320 U.S. at 603 (emphasis added).

The United States Supreme Court reiterated the criteria set forth in *Hope* in *Federal Power Commission v. Memphis Light, Gas & Water Division*, 411 U.S. 458 (1973); in *Permian Basin Rate Cases*, 390 U.S. 747 (1968); and, most recently, in *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989). In the *Permian Basin Rate Cases*, the Supreme Court stressed that a regulatory agency's rate of return order should

> reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed.

Permian Basin Rate Cases, 390 U.S. at 792.

Therefore, the "end result" of this Commission's decision should be to allow PSE the opportunity to earn a return on equity that is:

(i) commensurate with returns on investments in other firms having corresponding risks;

(ii) sufficient to assure confidence in PSE's financial integrity; and

(iii) sufficient to maintain PSE's creditworthiness and ability to attract capital on reasonable terms.

Q. How is the fair rate of return determined?

A. The aggregate return required by investors is called the "cost of capital." The cost of capital is the opportunity cost, expressed in percentage terms, of the total pool of capital employed by the utility. It is the composite weighted cost of the various classes of capital (e.g., bonds, preferred stock, common stock) used by the utility, with the weights reflecting the proportions of the total capital that each class of capital represents. The fair return in dollars is obtained by multiplying the rate of return set by the regulator by the utility's "rate base." The rate base is essentially the net book value of the utility's plant and other assets used to provide utility service in a particular jurisdiction.

Although utilities like PSE enjoy varying degrees of monopoly in the sale of public utility services, they (or their parent companies) must compete with everyone else in the free, open market for the input factors of production, whether labor, materials, machines, or capital, including the capital investments required to support the utility infrastructure. The prices of these inputs are set in the

competitive marketplace by supply and demand, and it is these input prices that are incorporated in the cost of service computation. This is just as true for capital as for any other factor of production. Since utilities and other investor-owned businesses must go to the open capital market and sell their securities in competition with every other issuer, there is obviously a market price to pay for the capital they require (e.g., the interest on debt capital or the expected return on equity). In order to attract the necessary capital, utilities must compete with alternative uses of capital and offer a return commensurate with the associated risks.

Q. How does the concept of a fair return relate to the concept of opportunity cost?

A. The concept of a fair return is intimately related to the economic concept of "opportunity cost." When investors supply funds to a utility by buying its stocks or bonds, they are not only postponing consumption, giving up the alternative of spending their dollars in some other way, they are also exposing their funds to risk and forgoing returns from investing their money in alternative comparable risk investments. The compensation they require is the price of capital. If there are differences in the risk of the investments, competition among firms for a limited supply of capital will bring different prices. The capital markets translate these differences in risk into differences in required return, in much the same way that differences in the characteristics of commodities are reflected in different prices.

The important point is that the required return on capital is set by supply and demand and is influenced by the relationship between the risk and return expected for those securities and the risks expected from the overall menu of available securities.

Q. What economic and financial concepts have guided your assessment of PSE's cost of common equity?

A. Two fundamental economic principles underlie the appraisal of PSE's cost of equity, one relating to the supply side of capital markets, the other to the demand side.

On the supply side, the first principle asserts that rational investors maximize the performance of their portfolios only if they expect the returns on investments of comparable risk to be the same. If not, rational investors will switch out of those investments yielding lower returns at a given risk level in favor of those investment activities offering higher returns for the same degree of risk. This principle implies that a company will be unable to attract capital funds unless it can offer returns to capital suppliers that are comparable to those achieved on competing investments of similar risk.

On the demand side, the second principle asserts that a company will continue to invest in real physical assets if the return on these investments equals, or exceeds, a company's cost of capital. This principle suggests that a regulatory board should

set rates at a level sufficient to create equality between the return on physical asset investments and a company's cost of capital.

Q. How does PSE obtain its capital and how is its overall cost of capital determined?

A. The funds employed by PSE are obtained in two general forms, debt capital and equity capital. The cost of debt funds can be ascertained easily from an examination of the contractual interest payments. The cost of common equity funds, that is, equity investors' required rate of return, is more difficult to estimate because the dividend payments received from common stock are not contractual or guaranteed in nature. They are uneven and risky, unlike interest payments. Once a cost of common equity estimate has been developed, it can then easily be combined with the embedded cost of debt based on the utility's capital structure, in order to arrive at the overall cost of capital (overall rate of return).

Q. What is the market required rate of return on equity capital?

A. The market required rate of return on common equity, or cost of equity, is the return demanded by the equity investor. Investors establish the price for equity capital through their buying and selling decisions in capital markets. Investors set return requirements according to their perception of the risks inherent in the investment, recognizing the opportunity cost of forgone investments in other companies, and the returns available from other investments of comparable risk.

Q. What must be considered in estimating a fair ROE?

A. The basic premise is that the allowable ROE should be commensurate with returns on investments in other firms having corresponding risks. The allowed return should be sufficient to assure confidence in the financial integrity of the firm, in order to maintain creditworthiness and ability to attract capital on reasonable terms. The "attraction of capital" standard focuses on investors' return requirements that are generally determined using market value methods, such as the DCF, CAPM, or risk premium methods. These market value tests define "fair return" because the return investors anticipate when they purchase equity shares of comparable risk in the financial marketplace. This is a market rate of return, defined in terms of anticipated dividends and capital gains as determined by expected changes in stock prices, and reflects the opportunity cost of capital. The economic basis for market value tests is that new capital will be attracted to a firm only if the return expected by the suppliers of funds is commensurate with that available from alternative investments of comparable risk.

III. COST OF EQUITY CAPITAL ESTIMATES

Q. How did you estimate a fair ROE for PSE?

A. To estimate a fair ROE for PSE, I employed three methodologies:

(i) DCF methodology;

(ii) CAPM methodology; and

(iii) Risk Premium methodology.

All three methodologies are market-based methodologies designed to estimate the return required by investors on the common equity capital committed to PSE.

Q. Why did you use more than one approach for estimating the cost of equity?

A. No one single method provides the necessary level of precision for determining a fair return, but each method provides useful evidence to facilitate the exercise of an informed judgment. Reliance on any single method or preset formula is inappropriate when dealing with investor expectations because of possible measurement difficulties and vagaries in individual companies' market data. Examples of such vagaries include dividend suspension, insufficient or unrepresentative historical data due to a recent merger, impending merger or acquisition, and a new corporate identity due to restructuring activities. The advantage of using several different approaches is that the results of each one can be used to check the others.

As a general proposition, it is extremely dangerous to rely on only one generic methodology to estimate equity costs. The difficulty is compounded when only one variant of that methodology is employed. It is compounded even further when that one methodology is applied to a single company. Hence, several methodologies applied to several comparable risk companies should be employed to estimate the cost of common equity.

As I have stated, there are three broad generic methods available to measure the cost of equity: DCF, CAPM, and risk premium. All three of these methods are

accepted and used by the financial community and firmly supported in the financial literature. The weight accorded to any one method may vary depending on unusual circumstances in capital market conditions.

Each methodology requires the exercise of considerable judgment on the reasonableness of the assumptions underlying the method and on the reasonableness of the proxies used to validate the theory and apply the method. Each method has its own way of examining investor behavior, its own premises, and its own set of simplifications of reality. Investors do not necessarily subscribe to any one method, nor does the stock price reflect the application of any one single method by the price-setting investor. There is no guarantee that a single DCF result is necessarily the ideal predictor of the stock price and of the cost of equity reflected in that price, just as there is no guarantee that a single CAPM or risk premium result constitutes the perfect explanation of a stock's price or the cost of equity.

A. DCF Estimates

Q. Please describe the DCF approach to estimating the cost of equity capital.

A. According to DCF theory, the value of any security to an investor is the expected discounted value of the future stream of dividends or other benefits. One widely used method to measure these anticipated benefits in the case of a non-static company is to examine the current dividend plus the increases in future dividend payments expected by investors. This valuation process can be represented by the following formula, which is the traditional DCF model:

$$K_e = D_1/P_0 + g$$

where: K_e = investors' expected return on equity
D_1 = expected dividend at the end of the coming year
P_0 = current stock price
g = expected growth rate of dividends, earnings, stock price, and book value

The traditional DCF formula states that under certain assumptions, which are described in the next paragraph, the equity investor's expected return (K_e) can be viewed as the sum of an expected dividend yield (D_1/P_0) plus the expected growth rate of future dividends and stock price (g). The returns anticipated at a given market price are not directly observable and must be estimated from statistical market information. The idea of the market value approach is to infer K_e from the observed share price, the observed dividend, and an estimate of investors' expected future growth.

The assumptions underlying this valuation formulation are well known, and are discussed in detail in Chapter 4 of my reference book, *Regulatory Finance*, and Chapter 8 of my more recent reference book, *The New Regulatory Finance*.

The standard DCF model requires the following main assumptions:

(i) a constant average growth trend for both dividends and earnings;

(ii) a stable dividend payout policy;

(iii) a discount rate in excess of the expected growth rate; and

(iv) a constant price-earnings multiple, which implies that growth in price is synonymous with growth in earnings and dividends.

The standard DCF model also assumes that dividends are paid at the end of each year when in fact dividend payments are normally made on a quarterly basis.

Q. How did you estimate PSE's cost of equity with the DCF model?

A. In estimating PSE's cost of equity, I applied the DCF model to a group of investment-grade, dividend-paying, combination gas and electric utilities with the majority of their revenues from regulated operations that are covered in the Value Line database.

In order to apply the DCF model, two components are required: the expected dividend yield (D_1/P_0), and the expected long-term growth (g). The expected dividend (D_1) in the annual DCF model can be obtained by multiplying the current indicated annual dividend rate by the growth factor (1 + g).

Q. How did you estimate the dividend yield component of the DCF model?

A. From a conceptual viewpoint, the stock price to employ in calculating the dividend yield is the then-current price of the security at the time of estimating the cost of equity. This is because the current stock prices provide a better indication of expected future prices than any other price in an efficient market. An efficient market implies that prices adjust rapidly to the arrival of new information. Therefore, current prices reflect the fundamental economic value of a security.

A considerable body of empirical evidence indicates that capital markets are efficient with respect to a broad set of information. This implies that observed

current prices represent the fundamental value of a security, and that a cost of capital estimate should be based on current prices.

In implementing the DCF model, I have used the current dividend yields reported in the Yahoo Finance Web site in April 2019. Basing dividend yields on average results from a large group of companies reduces the concern that the vagaries of individual company stock prices will result in an unrepresentative dividend yield.

Q. Why did you multiply the spot dividend yield by (1 + g) rather than by (1 + 0.5g)?

A. Some analysts multiply the spot dividend yield by one plus one half the expected growth rate (1 + 0.5g) rather than the conventional one plus the expected growth rate (1 + g). This procedure understates the return expected by the investor.

The fundamental assumption of the basic annual DCF model is that dividends are received annually at the end of each year and that the first dividend is to be received one year from now. Thus, the appropriate dividend to use in a DCF model is the full prospective dividend to be received at the end of the year. Since the appropriate dividend to use in a DCF model is the prospective dividend one year from now rather than the dividend one-half year from now, multiplying the spot dividend yield by (1 + 0.5g) understates the proper dividend yield.

Moreover, the basic annual DCF model ignores the time value of quarterly dividend payments and assumes dividends are paid once a year at the end of the year. Multiplying the spot dividend yield by (1 + g) is actually a conservative

attempt to capture the reality of quarterly dividend payments. Use of this method is conservative in the sense that the annual DCF model fully ignores the more frequent compounding of quarterly dividends.

Q. How did you estimate the growth component of the DCF model?

A. The principal difficulty in calculating the required return by the DCF approach is in ascertaining the growth rate that investors currently expect. Since no explicit estimate of expected growth is observable, proxies must be employed.

As proxies for expected growth, I examined the consensus growth estimate developed by professional analysts. Projected long-term growth rates actually used by institutional investors to determine the desirability of investing in different securities influence investors' growth anticipations. These forecasts are made by large reputable organizations, and the data are readily available and are representative of the consensus view of investors. Because of the dominance of institutional investors in investment management and security selection, and their influence on individual investment decisions, analysts' growth forecasts influence investor growth expectations and provide a sound basis for estimating the cost of equity with the DCF model.

Growth rate forecasts of several analysts are available from published investment newsletters and from systematic compilations of analysts' forecasts, such as those tabulated by Yahoo Finance. I used analysts' long-term growth forecasts reported

in Yahoo Finance as proxies for investors' growth expectations in applying the DCF model. I also used Value Line's growth forecasts as additional proxies.

Q. Why did you reject the use of historical growth rates in applying the DCF model to utilities?

A. I have rejected historical growth rates as proxies for expected growth in the DCF calculation for two reasons. First, historical growth patterns are already incorporated in analysts' growth forecasts that should be used in the DCF model, and are therefore redundant. Second, published studies in the academic literature demonstrate that growth forecasts made by security analysts are reasonable indicators of investor expectations, and that investors rely on analysts' forecasts. This considerable literature is summarized in Chapter 9 of my most recent textbook, *The New Regulatory Finance*.

Q. Did you consider any other method of estimating expected growth to apply the DCF model?

A. Yes, I did. I considered using the so-called "sustainable growth" method, also referred to as the "retention growth" method. According to this method, future growth is estimated by multiplying the fraction of earnings expected to be retained by the company, 'b', by the expected return on book equity, ROE, as follows:

$$g = b \times ROE$$

where: g = expected growth rate in earnings/dividends
b = expected retention ratio

ROE = expected return on book equity

Q. Do you have any reservations in regards to the sustainable growth method?

A. Yes, I do. First, the sustainable method of predicting growth contains a logic trap: the method requires an estimate of expected return on book equity to be implemented. But if the expected return on book equity input required by the model differs from the recommended return on equity, a fundamental contradiction in logic follows. Second, the empirical finance literature demonstrates that the sustainable growth method of determining growth is not as significantly correlated to measures of value, such as stock prices and price/earnings ratios, as analysts' growth forecasts. I therefore chose not to rely on this method.

Q. Did you consider dividend growth in applying the DCF model?

A. No, not at this time. The reason is that as a practical matter, while there is an abundance of earnings growth forecasts, there are very few forecasts of dividend growth. As a result, investors' attention has shifted from dividends to earnings. In addition, earnings growth provides a more meaningful guide to investors' long-term growth expectations. Indeed, it is growth in earnings that will support future dividends and share prices.

Q. Is there any empirical evidence documenting the importance of earnings in evaluating investors' expectations?

A. Yes, there is an abundance of evidence attesting to the importance of earnings in assessing investors' expectations.

First, the sheer volume of earnings forecasts available from the investment community relative to the scarcity of dividend forecasts attests to their importance. To illustrate, Value Line, Yahoo Finance, Zacks Investment, First Call Thompson, Reuters, and Multex provide comprehensive compilations of investors' earnings forecasts. The fact that these investment information providers focus on growth in earnings rather than growth in dividends indicates that the investment community regards earnings growth as a superior indicator of future long-term growth.

Second, Value Line's principal investment rating assigned to individual stocks, Timeliness Rank, is based primarily on earnings, which accounts for 65 percent of the ranking.

Q. How did you approach the composition of comparable groups in order to estimate PSE's cost of equity with the DCF method?

A. Because PSE is not publicly traded, the DCF model cannot be applied to PSE and proxies must be used. There are two possible approaches in forming proxy groups of companies.

The first approach is to apply cost of capital estimation techniques to a select group of companies directly comparable in risk to PSE. These companies are chosen by the application of stringent screening criteria to a universe of utility stocks in an attempt to identify companies with the same investment risk as PSE. Examples of screening criteria include bond rating, beta risk, size, percentage of revenues from utility operations, and common equity ratio. The end result is a small sample of companies with a risk profile similar to that of PSE, provided the screening criteria are defined and applied correctly.

The second approach is to apply cost of capital estimation techniques to a large group of utilities representative of the utility industry average and then perform adjustments to account for any difference in investment risk between the company and the industry average, if any. As explained below, in view of substantial changes in circumstances in the utility industry, I have chosen the latter approach.

In the unstable capital market environments, it is important to select relatively large sample sizes representative of the utility industry as a whole, as opposed to small sample sizes consisting of a handful of companies. This is because the equity market as a whole and utility industry capital market data are volatile. As a result of this volatility, the composition of small groups of companies is very fluid, with companies exiting the sample due to dividend suspensions or reductions, insufficient or unrepresentative historical data due to recent mergers, impending merger or acquisition, and changing corporate identities due to restructuring activities.

From a statistical standpoint, confidence in the reliability of the DCF model result is considerably enhanced when applying the DCF model to a large group of companies. Any distortions introduced by measurement errors in the two DCF components of equity return for individual companies, namely dividend yield and growth are mitigated. Utilizing a large portfolio of companies reduces the influence of either overestimating or underestimating the cost of equity for any one individual company. For example, in a large group of companies, positive and negative deviations from the expected growth will tend to cancel out owing to the law of large numbers, provided that the errors are independent. [1] The average growth rate of several companies is less likely to diverge from expected growth than is the estimate of growth for a single firm. More generally, the assumptions of the DCF model are more likely to be fulfilled for a large group of companies than for any single firm or for a small group of companies.

[1] If σ_i^2 represents the average variance of the errors in a group of N companies, and σ_{ij} the average covariance between the errors, then the variance of the error for the group of N companies, σ_N^2 is:

$$\sigma_N^2 = \frac{1}{N}\bar{\sigma}_i^2 + \frac{N-1}{N}\bar{\sigma}_{ij}$$

If the errors are independent, the covariance between them (σ_{ij}) is zero, and the variance of the error for the group is reduced to:

$$\sigma_N^2 = \frac{1}{N}\sigma_i^2$$

As N gets progressively larger, the variance gets smaller and smaller.

Moreover, small samples are subject to measurement error, and in violation of the Central Limit Theorem of statistics.[2] From a statistical standpoint, reliance on robust sample sizes mitigates the impact of possible measurement errors and vagaries in individual companies' market data. Examples of such vagaries include dividend suspension, insufficient or unrepresentative historical data due to a recent merger, impending merger or acquisition, and a new corporate identity due to restructuring.

The point of all this is that the use of a handful of companies in a highly fluid and unstable industry produces fragile and statistically unreliable results. A far safer procedure is to employ large sample sizes representative of the industry as a whole and apply subsequent risk adjustments to the extent that the company's risk profile differs from that of the industry average.

Q. Can you describe the proxy group for PSE's utility business?

A. As proxies for PSE's utility operations, I examined a group of investment-grade dividend-paying combination gas and electric utilities covered in Value Line's

[2] The Central Limit Theorem describes the characteristics of the distribution of values we would obtain if we were able to draw an infinite number of random samples of a given size from a given population and we calculated the mean of each sample. The Central Limit Theorem asserts:

(1) The mean of the sampling distribution of means is equal to the mean of the population from which the samples were drawn.

(2) The variance of the sampling distribution of means is equal to the variance of the population from which the samples were drawn divided by the size of the samples.

(3) If the original population is distributed normally, the sampling distribution of means will also be normal. If the original population is not normally distributed, the sampling distribution of means will increasingly approximate a normal distribution as sample size increases.

Electric Utility industry group, meaning that these companies all possess utility assets similar to PSE's. I began with all the companies designated as combination gas and electric utilities that are also covered in the Value Line Investment Survey. Please see the Second Exhibit to the Prefiled Direct Testimony of Dr. Roger A. Morin, Exh. RAM-3, for the companies designated as combination gas and electric utilities covered in the Value Line Investment Survey.

Fortis was added to the group since it owns several U.S. combination gas and electric companies. Private partnerships, private companies, non-dividend-paying companies, and companies below investment-grade (with a Moody's bond rating below Baa3) were eliminated. The final group of companies only include those companies with at least 50 percent of their revenues from regulated utility operations.

From the preliminary list of 29 companies shown on the Second Exhibit to the Prefiled Direct Testimony of Dr. Roger A. Morin, Exh. RAM-3, and as shown on the accompanying notes in the last column of that exhibit, I excluded nine companies marked with an X in column 3. Column 4 shows the rationale for exclusion.

The first company excluded company was Empire District Electric, which recently combined with a subsidiary of Liberty Utilities Co., the wholly owned regulated utility business subsidiary of Algonquin Power & Utilities Corp. The second excluded company was Entergy Corp., on account of its ongoing corporate restructuring and nuclear exposure. The third company was MDU Resources

because its revenues from regulated electric utility operations were less than 50 percent. The fourth excluded company was Pepco Holdings, which has been merged with Exelon. The fifth excluded company was PG&E since it has declared Chapter 11 bankruptcy and has suspended dividends.

The sixth company excluded was SCANA on account of its nuclear construction exposure. Unitil was the seventh company excluded because it is not covered in the Value Line database. Vectren was the eighth company excluded on account of its acquisition of by CenterPoint. The ninth excluded company was TECO Energy, which has been acquired by Emera.

The final group of 20 companies that comprise the proxy group is shown on the Third Exhibit to the Prefiled Direct Testimony of Dr. Roger A. Morin, Exh. RAM-4. I stress that this proxy group must be viewed as a portfolio of comparable risk. It would be inappropriate to select any particular company or subset of companies from this group and infer the cost of common equity from that company or subset alone.

Q. What DCF results did you obtain for PSE using Value Line growth projections?

A. The Fourth Exhibit to the Prefiled Direct Testimony of Dr. Roger A. Morin, Exh. RAM-5, displays the DCF analysis using Value Line growth projections for the twenty companies in PSE's proxy group. As shown on column 3 line 22, the average long-term earnings per share growth forecast obtained from Value Line is

6.43 percent for PSE's proxy group. Combining this growth rate with the average expected dividend yield of 3.30 percent shown on column 4, line 22 of the Fourth Exhibit to the Prefiled Direct Testimony of Dr. Roger A. Morin, Exh. RAM-5, produces an estimate of equity costs of 9.73 percent for PSE's proxy group, as shown on column 5, line 22.

Q. What DCF results did you obtain for PSE using analysts' consensus growth forecasts?

A. The Fifth Exhibit to the Prefiled Direct Testimony of Dr. Roger A. Morin, Exh. RAM-6, displays the DCF analysis using analysts' consensus growth forecasts for the twenty companies in PSE's proxy group. Please note that the growth forecast for MGE Energy was drawn from Value Line because the analyst forecast from Zacks Investment Research was not available for that company.

As shown on column 3, line 22 of the Fifth Exhibit to the Prefiled Direct Testimony of Dr. Roger A. Morin, Exh. RAM-6, the average long-term earnings per share growth forecast obtained from analysts is 5.~~05~~28 percent for PSE's proxy group. Combining this growth rate with the average expected dividend yield of 3.~~28~~26 percent shown on column 4, line 22, produces an estimate of equity costs of 8.~~33~~54 percent for PSE's proxy group.

Q. Please summarize the DCF estimates for PSE.

A. Table 1 below summarizes the DCF estimates for PSE:

Table 1. DCF Estimates for PSE

DCF Study	ROE
Value Line Growth Forecast	9.73%
Analysts Growth Forecast	8.~~33~~54%

Q. Dr. Morin, please provide an overview of your risk premium analyses.

A. In order to quantify the risk premium for PSE, I have performed four risk premium studies. The first two studies deal with aggregate stock market risk premium evidence using two versions of the CAPM methodology and the other two studies deal with the risk premiums that exist in the electric and gas utility industry.

B. CAPM Estimates

Q. Please describe your application of the CAPM risk premium approach.

A. My first two risk premium estimates are based on the CAPM and on an empirical approximation to the CAPM (ECAPM). The CAPM is a fundamental paradigm of finance. Simply put, the fundamental idea underlying the CAPM is that risk-averse investors demand higher returns for assuming additional risk, and higher-risk securities are priced to yield higher expected returns than lower-risk securities. The CAPM quantifies the additional return, or risk premium, required for bearing incremental risk. It provides a formal risk-return relationship anchored on the basic idea that only market risk matters, as measured by beta (β).

According to the CAPM, securities are priced such that:

EXPECTED RETURN = RISK-FREE RATE + RISK PREMIUM

Denoting the risk-free rate by R_F and the return on the market as a whole by R_M, the CAPM is stated as follows:

$$K = R_F + \beta \times (R_M - R_F)$$

where: K = investors' expected return on equity
R_F = risk-free rate
R_M = return on the market as a whole
β = systematic risk (i.e., change in a security's return relative to that of the market)

This is the seminal CAPM expression, which states that the return required by investors is made up of a risk-free component, R_F, plus a risk premium determined by $\beta \times (R_M - R_F)$. The bracketed expression $(R_M - R_F)$ expression is known as the market risk premium. To derive the CAPM risk premium estimate, three quantities are required: the risk-free rate (R_F), beta (β), and the market risk premium $(R_M - R_F)$.

For the risk-free rate (R_F), I used 4.2 percent, based on forecast interest rates on long-term U.S. Treasury bonds.

For beta (β), I used 0.60, based on Value Line estimates.

For the market risk premium $(R_M - R_F)$, I used 7.5 percent, based on both historical and forward-looking risk premium studies.

These inputs to the CAPM are explained below.

Q. How did you arrive at your risk-free rate estimate of 4.2 percent in your CAPM analyses?

A. To implement the CAPM and Risk Premium methods, an estimate of the risk-free return is required as a benchmark. I relied on noted economic forecasts, which call for a rising trend in interest rates in response to the recovering economy, renewed inflation, and record high federal deficits. Value Line, IHS (formerly Global Insight), the Congressional Budget Office, the Bureau of Labor Statistics, the Economic Report of the President, the 2019 White House budget, and the U.S. Energy Information Administration all project higher long-term Treasury bond rates in the future.

Q. Why did you rely on long-term bonds instead of short-term bonds?

A. The appropriate proxy for the risk-free rate in the CAPM is the return on the longest-term Treasury bond possible. This is because common stocks are very long-term instruments more akin to very long-term bonds, rather than to short-term Treasury bills or intermediate-term Treasury notes. In a risk premium model, the ideal estimate for the risk-free rate has a term to maturity equal to the security being analyzed. Since common stock is a very long-term investment because the cash flows to investors in the form of dividends last indefinitely, the yield on the longest-term possible government bonds, that is the yield on 30-year Treasury bonds, is the best measure of the risk-free rate for use in the CAPM. The expected common stock return is based on very long-term cash flows, regardless of an individual's holding time period. Moreover, utility asset investments generally

have very long-term useful lives and should correspondingly be matched with very long-term maturity financing instruments.

While long-term Treasury bonds are potentially subject to interest rate risk, this is only true if the bonds are sold prior to maturity. A substantial fraction of bond market participants, usually institutional investors with long-term liabilities (*e.g.*, pension funds and insurance companies), in fact hold bonds until they mature, and therefore are not subject to interest rate risk. Moreover, institutional bondholders neutralize the impact of interest rate changes by matching the maturity of a bond portfolio with the investment planning period. Or they engage in hedging transactions in the financial futures markets. Both academicians and practitioners have extensively documented the merits and mechanics of such immunization strategies.

Another reason for utilizing the longest maturity Treasury bond possible is that common equity has no finite maturity. The inflation expectations embodied in its market-required rate of return will therefore be equal to the inflation rate anticipated to prevail over the very long term. The same expectation should be embodied in the risk-free rate used in applying the CAPM model. It stands to reason that the yields on 30-year Treasury bonds will more closely incorporate within their yields the inflation expectations that influence the prices of common stocks than do short-term Treasury bills or intermediate-term U.S. Treasury notes.

Among U.S. Treasury securities, 30-year Treasury bonds have the longest term to maturity. The yields on such securities should be used as proxies for the risk-free

rate in applying the CAPM. Therefore, I have relied on the yield on 30-year Treasury bonds in implementing the CAPM and risk premium methods.

Q. Are there other reasons why you reject short-term interest rates as proxies for the risk-free rate in implementing the CAPM?

A. Yes. Short-term rates are volatile, fluctuate widely, and are subject to more random disturbances than are long-term rates. Short-term rates are largely administered rates. For example, Treasury bills are used by the Federal Reserve as a policy vehicle to stimulate the economy and to control the money supply. They are also used by foreign governments, companies, and individuals as a temporary safe-house for money.

As a practical matter, it makes no sense to match the return on common stock to the yield on 90-day Treasury bills. This is because short-term rates, such as the yield on 90-day Treasury bills, fluctuate widely, leading to volatile and unreliable equity return estimates. Moreover, yields on 90-day Treasury bills typically do not match the equity investor's planning horizon. Equity investors generally have an investment horizon far in excess of 90 days.

As a conceptual matter, short-term Treasury bill yields reflect the impact of factors different from those influencing the yields on long-term securities such as common stock. For example, the premium for expected inflation embedded into 90-day Treasury bills may be far different than the inflationary premium embedded into long-term securities yields. On grounds of stability and

consistency, the yields on long-term Treasury bonds match more closely with common stock returns.

Q. What is your estimate of the risk-free rate in applying the CAPM?

A. As discussed, all the noted interest rate forecasts that I am aware of point to significantly higher interest rates over the next several years. Table 2 below reports the forecast yields on 30-year U.S. Treasury bonds from several prominent sources, including the Congressional Budget Office, Bureau of Labor Statistics, U.S. Energy Information Administration, IHS (formerly Global Insight), Value Line, the 2019 White House budget, and the Economic Report of the President.

Table 2 Forecast Yields on 30-year U.S. Treasury Bonds

Source	Forecast
Value Line Economic Forecast	4.0%
U.S. Energy Information Administration	4.6%
Bureau of Labor Statistics	4.2%
Congressional Budget Office	4.2%
Economic Report of the President 2018	4.1%
White House Budget 2019	4.2%
IHS (Global Insight)	3.8%
AVERAGE	**4.2%**

The average 30-year long-term bond yield forecast from the seven sources is 4.2 percent, and the individual forecasts are quite consistent as they are closely clustered around the average. Based on this evidence, a long-term bond yield forecast of 4.2 percent is a reasonable estimate of the expected risk-free rate for purposes of forward-looking CAPM/ECAPM and Risk Premium analyses in the current economic environment.

Q. Why did you ignore the current level of interest rates in developing your proxy for the risk-free rate in a CAPM analysis?

A. I relied on projected long-term Treasury interest rates for three reasons. First, investors price securities on the basis of long-term expectations, including interest rates. Cost of capital models, including both the CAPM and DCF models, are prospective (*i.e.*, forward-looking) in nature and must take into account current market expectations for the future because investors price securities on the basis of long-term expectations, including interest rates. As a result, in order to produce a meaningful estimate of investors' required rate of return, the CAPM must be applied using data that reflects the expectations of actual investors in the market. While investors examine history as a guide to the future, it is the expectations of future events that influence security values and the cost of capital.

Second, investors' required returns can and do shift over time with changes in capital market conditions, hence the importance of considering interest rate forecasts. The fact that organizations such as Value Line, IHS (Global Insight), EIA, and CBO, among many others, devote considerable expertise and resources to developing an informed view of the future – and the fact that investors are willing to purchase such expensive services – confirm the importance of economic/financial forecasts in the minds of investors. Moreover, the empirical evidence demonstrates that stock prices do indeed reflect prospective financial input data.

Third, given that this proceeding is to provide ROE estimates for future proceedings, forecast interest rates are far more relevant. The use of interest rate forecasts is no different than the use of projections of other financial variables, such as growth rates, in DCF analyses.

Q. How did you select the beta for your CAPM analysis?

A. A major thrust of modern financial theory as embodied in the CAPM is that perfectly diversified investors can eliminate the company-specific component of risk, and that only market risk remains. The latter is technically known as "beta" (β), or "systematic risk." The beta coefficient measures change in a security's return relative to that of the market. The beta coefficient states the extent and direction of movement in the rate of return on a stock relative to the movement in the rate of return on the market as a whole. It indicates the change in the rate of return on a stock associated with a one percentage point change in the rate of return on the market. It measures the degree to which a particular stock shares the risk of the market as a whole. Modern financial theory has established that beta incorporates several economic characteristics of a corporation that are reflected in investors' return requirements.

PSE is not publicly traded. Therefore, proxies must be used. In the discussion of DCF estimates of the cost of common equity earlier, I examined a sample of investment-grade dividend-paying combined electric and gas utilities covered by Value Line. The average beta for PSE's proxy group is 0.62. Please see the Sixth Exhibit to the Prefiled Direct Testimony of Dr. Roger A. Morin, Exh. RAM-7, for

the beta estimates of the proxy group for PSE. Based on these results, I shall use 0.62 as an estimate for the beta applicable to the average company in the peer group.

Q. What market risk premium did you use in your CAPM analysis?

A. For the market risk premium, I used 7.5 percent. This estimate was based on the results of both historical and prospective studies of long-term risk premiums, and on one additional check.

Q. Can you describe the historical market risk premium study used in your CAPM analysis?

A. Yes. The historical market risk premium estimate is based on the results obtained in Duff & Phelps' 2019 Valuation Handbook (formerly published by Morningstar and earlier by Ibbotson Associates), which compiles historical returns from 1926 to 2018. This well-known study summarized on Exhibit 6.9 of the handbook shows that a very broad market sample of common stocks outperformed long-term U.S. Government bonds by 6.0 percent. The historical market risk premium over the income component of long-term U.S. Government bonds—rather than over the total return—is 6.9 percent.

The historical market risk premium should be computed using the income component of bond returns because the intent, even using historical data, is to identify an expected market risk premium. The income component of total bond return (*i.e.*, the coupon rate) is a far better estimate of expected return than the

total return (*i.e.*, the coupon rate + capital gain), because both realized capital gains and realized losses are largely unanticipated by bond investors. The long-horizon (1926-2018) market risk premium is 6.9 percent.

As a check on the historical market risk premium estimate, I examined the historical return on common stocks in real terms (inflation-adjusted) over the 1926-2018 period and added current inflation expectations to arrive at a current inflation-adjusted common stock return. According to the Duff & Phelps study, the average historical return on common stocks averaged 11.9 percent over the 1926-2018 period, while inflation averaged 3.0 percent over the same period. This implies a real return of 8.9 percent (11.9% - 3.0% = 8.9%). With current long-term inflation expectations of 2.1 percent,[3] the inflation-adjusted return on common stock becomes 11.0 percent (8.9% + 2.1% = 11.0%). Given the forecast yield of 4.2 percent, the implied market risk premium is 6.8 percent (11.0% - 4.2% = 6.8%). This is almost identical to the 6.9 percent estimate.

Q. On what maturity bond does the Duff & Phelps historical risk premium data rely?

A. Because 30-year bonds were not always traded or even available throughout the entire study period covered in the Duff & Phelps study of historical returns, the latter study relied on bond return data based on 20-year Treasury bonds. Given

[3] Thirty-year U.S. Treasury bonds are currently trading at a 3.0 percent yield, while 30-year inflation-adjusted bonds are trading at an approximate yield of 0.9 percent, implying a long-term inflation rate expectation of 2.1 percent.

that the normal yield curve is virtually flat above maturities of 20 years for most of the period covered in the Duff & Phelps study, the difference in yield is not material.

Q. Why did you use long time periods in arriving at your historical market risk premium estimate?

A. Because realized returns can be substantially different from prospective returns anticipated by investors when measured over short time periods, it is important to employ returns realized over long time periods rather than returns realized over more recent time periods when estimating the market risk premium with historical returns. Therefore, a risk premium study should consider the longest possible period for which data are available. Short-run periods during which investors earned a lower risk premium than expected are offset by short-run periods during which investors earned a higher risk premium than expected. Only over long-time periods will investor return expectations and realizations converge.

I have therefore ignored realized risk premiums measured over short time periods. Instead, I relied on results over periods of enough length to smooth out short-term aberrations, and to encompass several business and interest rate cycles. The use of the entire study period in estimating the appropriate market risk premium minimizes subjective judgment and encompasses many diverse regimes of inflation, interest rate cycles, and economic cycles.

To the extent that the estimated historical equity risk premium follows what is known in statistics as a random walk, one should expect the equity risk premium

to remain at its historical mean. Since I found no evidence that the market risk premium in common stocks has changed over time, that is, no significant serial correlation in the Duff & Phelps study prior to that time, it is reasonable to assume that these quantities will remain stable in the future.

Q. Should studies of historical risk premiums rely on arithmetic average returns or geometric average returns?

A. Whenever relying on historical risk premiums, only arithmetic average returns over long periods are appropriate for forecasting and estimating the cost of capital. Geometric average returns are not.[4]

Q. Please explain how the issue of what is the proper "mean" arises in the context of analyzing the cost of equity.

A. The issue arises in applying methods that derive estimates of a utility's cost of equity from historical relationships between bond yields and earned returns on equity for individual companies or portfolios of several companies. Those methods produce series of numbers representing the annual difference between bond yields and stock returns over long historical periods. The question is how to translate those series into a single number that can be added to a current bond yield to estimate the current cost of equity for a stock or a portfolio. Calculating

[4] *See* Roger A. Morin, Ph.D., *The New Regulatory Finance: Utilities' Cost of Capital*, Chapter 4 (2006); Richard A. Brealey, *et al*., *Principles of Corporate Finance* (8th ed. 2006); Roger A. Morin, Ph.D., *Regulatory Finance: Utilities' Cost of Capital*, Chapter 11 (1994).

geometric and arithmetic means are two ways of converting series of numbers to a single, representative figure.

Q. If both are "representative" of the series, what is the difference between the two means?

A. Each mean represents different information about the series. The geometric mean of a series of numbers is the value which, if compounded over the period examined, would have made the starting value grow to the ending value. The arithmetic mean is simply the average of the numbers in the series. Where there is any annual variation (volatility) in a series of numbers, the arithmetic mean of the series, which reflects volatility, will always exceed the geometric mean, which ignores volatility. Because investors require higher expected returns to invest in a company whose earnings are volatile than one whose earnings are stable, the geometric mean is not useful in estimating the expected rate of return which investors require to make an investment.

Q. Can you provide a numerical example to illustrate this difference between geometric and arithmetic means?

A. Yes. Table 3 below compares the geometric and arithmetic mean returns of a hypothetical Stock A, whose yearly returns over a ten-year period are very volatile, with those of a hypothetical Stock B, whose yearly returns are perfectly stable during that period. Consistent with the point that geometric mean returns ignore volatility, the geometric mean returns for the two series are identical (11.6 percent in both cases), whereas the arithmetic mean return of the volatile

stock (26.7 percent) is much higher than the arithmetic mean return of the stable stock (11.6 percent).

Table 3. Arithmetic vs Geometric Mean Returns

Year	Stock A	Stock B
2009	50.0%	11.6%
2010	-54.7%	11.6%
2011	98.5%	11.6%
2012	42.2%	11.6%
2013	-32.3%	11.6%
2014	-39.2%	11.6%
2015	153.2%	11.6%
2016	-10.0%	11.6%
2017	38.9%	11.6%
2018	20.0%	11.6%
Std. Deviation	**64.9%**	**0.0%**
Arith. Mean	**26.7%**	**11.6%**
Geom. Mean	**11.6%**	**11.6%**

If relying on geometric means, investors would require the same expected return to invest in both of these stocks, even though the volatility of returns in Stock A is very high while Stock B exhibits perfectly stable returns. That is clearly contrary to the most basic financial theory; that is, the higher the risk, the higher the expected return.

Chapter 4, Appendix A, of my book, *The New Regulatory Finance*, contains a detailed and rigorous discussion of the impropriety of using geometric averages in estimating the cost of capital. Briefly, the disparity between the arithmetic average return and the geometric average return raises the question as to what

purposes should these different return measures be used. The answer is that the geometric average return should be used for measuring historical returns that are compounded over multiple time periods. The arithmetic average return should be used for future-oriented analysis, where the use of expected values is appropriate. It is inappropriate to average the arithmetic and geometric average return; they measure different quantities in different ways.

Q. Can you describe the prospective market risk premium study used in your CAPM analysis?

A. The Seventh Exhibit to the Prefiled Direct Testimony of Dr. Roger A. Morin, Exh. RAM-8, provides a prospective DCF analysis to the dividend-paying stocks that make up the S&P 500 index using Value Line's screening software. The dividend yield on the dividend-paying stocks covered in Value Line's full database is currently 2.2 percent, and the average projected long-term growth rate is 10.0 percent. Adding the dividend yield to the growth component produces an expected market return on aggregate equities of 12.2 percent. Subtracting the risk-free rate of 4.2 percent from the latter, the implied risk premium is 8.0 percent over long-term U.S. Treasury bonds.

The average of the historical market risk premium of 6.9 percent and the prospective market risk premium of 8.0 percent is 7.5 percent, which is my final estimate of the market risk premium for purposes of implementing the CAPM.

Q. Is your market risk premium estimate of 7.5 percent consistent with the academic literature on the subject?

A. Yes, it is. In their authoritative corporate finance textbook, Professors Brealey, Myers, and Allen[5] conclude from their review of the fertile literature on the market risk premium that a range of five to eight percent is reasonable for the market risk premium in the United States. My own survey of the market risk premium literature, which appears in Chapter 5 of my latest textbook, *The New Regulatory Finance*, is also quite consistent with this range.

Q. What is your estimate of PSE's cost of equity using the CAPM approach?

A. Inserting those input values into the CAPM equation, namely a risk-free rate of 4.2 percent, a beta of 0.62, and a market risk premium of 7.5 percent, the CAPM estimate of the cost of common equity is: 4.2% + 0.62 × 7.5% = 8.9%.

Q. Can you describe your application of the empirical version of the CAPM?

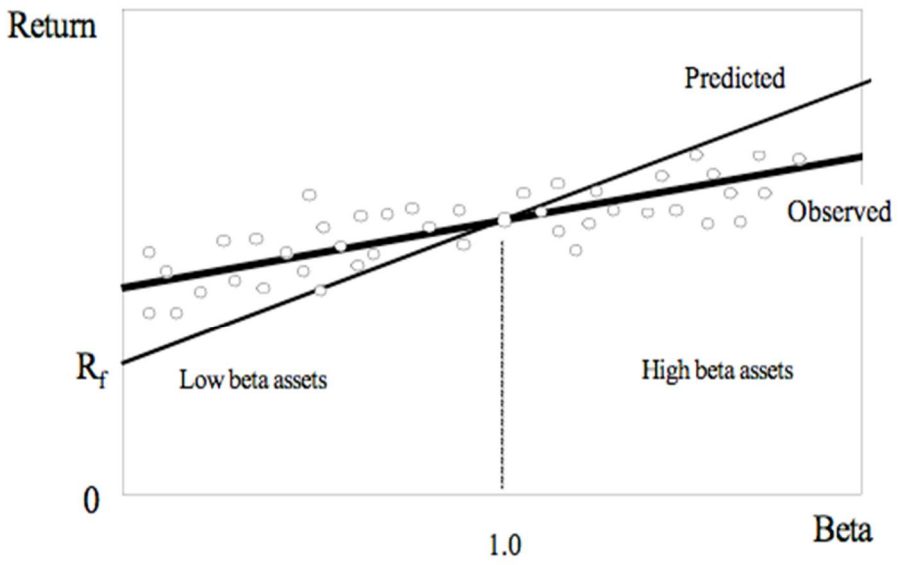
A. There have been countless empirical tests of the CAPM to determine to what extent security returns and betas are related in the manner predicted by the CAPM. This literature is summarized in Chapter 6 of my latest book, *The New Regulatory Finance*. The results of the tests support the idea that beta is related to security returns, that the risk-return tradeoff is positive, and that the relationship is linear. The contradictory finding is that the risk-return tradeoff is not as steeply

[5] Richard A. Brealey, *et al*., *Principles of Corporate Finance*, Irwin McGraw-Hill (8th ed. 2006).

sloped as the predicted CAPM. That is, empirical research has long shown that low-beta securities earn returns somewhat higher than the CAPM would predict, and high-beta securities earn less than predicted.

A CAPM-based estimate of cost of capital underestimates the return required from low-beta securities and overstates the return required from high-beta securities, based on the empirical evidence. This is one of the most well-known results in finance. It is displayed graphically below.

CAPM: Predicted vs Observed Returns



A number of variations on the original CAPM theory have been proposed to explain this finding. The ECAPM makes use of these empirical findings. The ECAPM estimates the cost of capital with the equation:

$$K = R_F + \alpha + (\beta \times ((R_M - R_F) - \alpha))$$

where:
- K = investors' expected return on equity
- R_F = risk-free rate
- R_M = return on the market as a whole
- α = the "constant" of the risk-return line
- β = systematic risk (i.e., change in a security's return relative to that of the market)

Inserting the long-term risk-free rate as a proxy for the risk-free rate, an alpha in the range of one to two percent, and reasonable values of beta and the market risk premium in the above equation produces results that are indistinguishable from the following more tractable ECAPM expression:

$$K = R_F + (0.25 \times (R_M - R_F)) + (0.75 \times \beta \times (R_M - R_F))$$

An alpha range of one to two percent is somewhat lower than that estimated empirically. The use of a lower value for alpha leads to a lower estimate of the cost of capital for low-beta stocks such as regulated utilities. This is because the use of a long-term risk-free rate rather than a short-term risk-free rate already incorporates some of the desired effects of using the ECAPM. In other words, the long-term risk-free rate version of the CAPM has a higher intercept and a flatter slope than the short-term risk-free version which has been tested. This is also because the use of adjusted betas rather than the use of raw betas incorporates

some of the desired effect of using the ECAPM.[6] Thus, it is reasonable to apply a conservative alpha adjustment. Please see the Eighth Exhibit to the Prefiled Direct Testimony of Dr. Roger A. Morin, Exh. RAM-9, for a discussion of the ECAPM, including its theoretical and empirical underpinnings.

In short, the following equation provides a viable approximation to the observed relationship between risk and return, and provides the following cost of equity capital estimate:

$$K = R_F + 0.25 \times (R_M - R_F) + 0.75 \times \beta \times (R_M - R_F)$$

Inserting the risk-free rate (R_F) of 4.2 percent, a market risk premium (R_M - R_F) of 7.5 percent and a beta of 0.62 in the above equation, the return on common equity is 9.6 percent.

Q. Is the use of the ECAPM consistent with the use of adjusted betas?

A. Yes, it is. Some have argued that the use of the ECAPM is inconsistent with the use of adjusted betas, such as those supplied by Value Line and Bloomberg. This is because the reason for using the ECAPM is to allow for the tendency of betas to regress toward the mean value of 1.00 over time, and, since Value Line betas are

[6] The regression tendency of betas to converge to 1.0 over time is very well known and widely discussed in the financial literature. As a result of this beta drift, several commercial beta producers adjust their forecasted betas toward 1.00 in an effort to improve their forecasts. Value Line, Bloomberg, and Merrill Lynch betas are adjusted for their long-term tendency to regress toward 1.0 by giving approximately weight of 66 percent to the measured raw beta and approximately weight of 33 percent to the prior value of 1.0 for each stock:

$$\beta_{adjusted} = 0.33 + 0.66\ \beta_{raw}$$

already adjusted for such trend, an ECAPM analysis results in double-counting. This argument is erroneous.

Fundamentally, the ECAPM is not an adjustment, increase, or decrease in beta. The observed return on high beta securities is actually lower than that produced by the CAPM estimate. The ECAPM is a formal recognition that the observed risk-return tradeoff is flatter than predicted by the CAPM based on myriad empirical evidence. The ECAPM and the use of adjusted betas comprise two separate features of asset pricing. Even if a company's beta is estimated accurately, the CAPM still understates the return for low-beta stocks. And even if the ECAPM is used, the return for low-beta securities is understated if the betas are understated. Referring back to the previous graph, the ECAPM is a return (vertical axis) adjustment and not a beta (horizontal axis) adjustment. Both adjustments are necessary. Moreover, the use of adjusted betas compensates for interest rate sensitivity of utility stocks not captured by unadjusted betas.

Q. Please summarize your CAPM estimates.

A. Table 4 below summarizes the common equity estimates obtained from the CAPM studies.

Table 4. CAPM Results

CAPM Method	ROE
Traditional CAPM	8.9%
Empirical CAPM	9.6%

C. Historical Risk Premium Estimates

Q. Please describe your historical risk premium analysis of the utility industry using Treasury bond yields.

A. A historical risk premium for the utility industry was estimated with an annual time series analysis applied to the utility industry as a whole over the 1930-2015 period, using Standard and Poor's Utility Index ("S&P Index") as an industry proxy. The risk premium was estimated by computing the actual realized return on equity capital for the S&P Utility Index for each year, using the actual stock prices and dividends of the index, and then subtracting the long-term Treasury bond return for that year. Please see the Ninth Exhibit to the Prefiled Direct Testimony of Dr. Roger A. Morin, Exh. RAM-10, for an analysis of the historical risk premium for the utility industry using an annual time series analysis applied to the utility industry as a whole over the 1930-2015 period, using the S&P Index as an industry proxy.

As shown on the Ninth Exhibit to the Prefiled Direct Testimony of Dr. Roger A. Morin, Exh. RAM-10, the average risk premium over the period was 5.6 percent over long-term Treasury bond yields and 6.1 percent over the income component of bond yields. As discussed previously, the latter is the appropriate risk premium to use. Given the risk-free rate of 4.2 percent and the historical estimate of 6.1 percent for bond returns, the implied cost of equity is 10.3 percent (4.2% + 6.1% = 10.3%).

Q. Are you concerned about the realism of the assumptions that underlie the historical risk premium method?

A. No, I am not, for they are no more restrictive than the assumptions that underlie the DCF model or the CAPM. While it is true that the method looks backward in time and assumes that the risk premium is constant over time, these assumptions are not necessarily restrictive. By employing returns realized over long time periods rather than returns realized over more recent time periods, investor return expectations and realizations converge. Realized returns can be substantially different from prospective returns anticipated by investors, especially when measured over short time periods. By ensuring that the risk premium study encompasses the longest possible period for which data are available, short-run periods during which investors earned a lower risk premium than they expected are offset by short-run periods during which investors earned a higher risk premium than they expected. Only over long time periods will investor return expectations and realizations converge, or else, investors would be reluctant to invest money.

D. Allowed Risk Premium Estimates

Q. Please describe your analysis of allowed risk premiums in the electric utility industry.

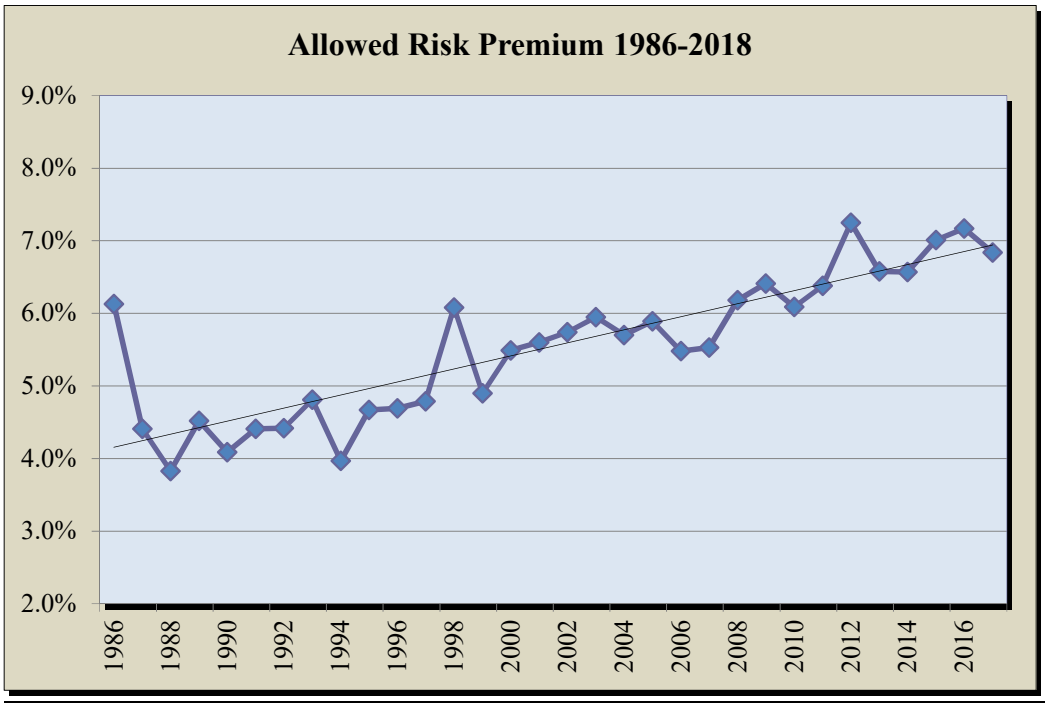
A. To estimate the electric and gas utility industry's cost of common equity, I also examined the historical risk premiums implied in the ROEs allowed by regulatory commissions utilities over the 1986-2018 period for which data were available,

relative to the contemporaneous level of the long-term Treasury bond yield. Please see the Tenth Exhibit to the Prefiled Direct Testimony of Dr. Roger A. Morin, Exh. RAM-11, for an analysis of historical risk premiums implied in the ROEs allowed by regulatory commissions utilities over the 1986-2018 period.

This variation of the risk premium approach is reasonable because allowed risk premiums are presumably based on the results of market-based methodologies (DCF, CAPM, Risk Premium, etc.) presented to regulators in rate hearings and on the actions of objective unbiased investors in a competitive marketplace. Historical allowed ROE data are readily available over long periods on a quarterly basis from Regulatory Research Associates (now S&P Global Intelligence) and easily verifiable from prior issues of that same publication and past commission decision archives.

The average ROE spread over long-term Treasury yields was 5.58 percent over the entire 1986-2018 period for which data were available from SNL. The graph below shows the year-by-year allowed risk premium. The escalating trend of the risk premium in response to lower interest rates and rising competition is noteworthy.

A careful review of these ROE decisions relative to interest rate trends reveals a narrowing of the risk premium in times of rising interest rates, and a widening of the premium as interest rates fall. The following statistical relationship between the risk premium ("RP") and interest rates ("YIELD") emerges over the 1986-2018 period:



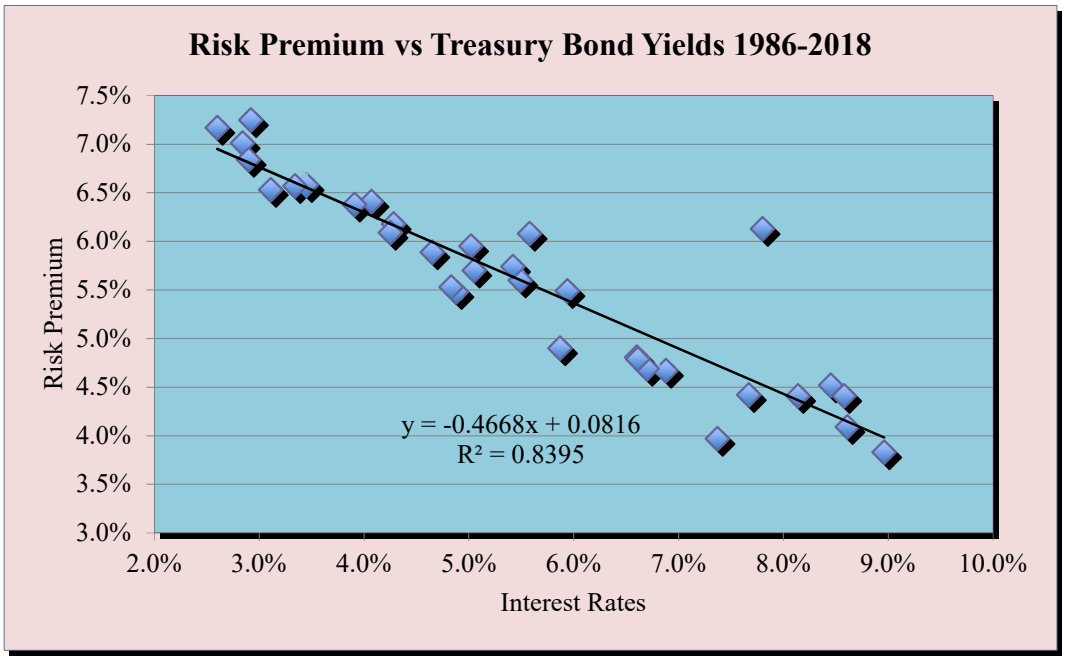
RP = 8.1600 - 0.4668 YIELD R^2 = 0.84

The relationship is highly statistically significant[7] as indicated by the very high R^2. The graph below shows a clear inverse relationship between the allowed risk premium and interest rates as revealed in past ROE decisions.

Inserting the long-term Treasury bond yield of 4.2 percent in the above equation suggests a risk premium estimate of 6.2 percent, implying a cost of equity of 10.4 percent. The latter result is very close to the 10.3 percent result of the historical risk premium study.[8]

[7] The coefficient of determination R^2, sometimes called the "goodness of fit measure," is a measure of the degree of explanatory power of a statistical relationship. It is simply the ratio of the explained portion to the total sum of squares. The higher R^2 the higher is the degree of the overall fit of the estimated regression equation to the sample data.

[8] There is no need to adjust this figure for flotation cost given that the ROE data are based on allowed returns.



Q. Do investors take into account allowed returns in formulating their return expectations?

A. Yes, they do. Investors do indeed take into account returns granted by various regulators in formulating their risk and return expectations, as evidenced by the availability of commercial publications disseminating such data, including Value Line and S&P Global Intelligence (formerly SNL and Regulatory Research Associates). Allowed returns, while certainly not a precise indication of a particular company's cost of equity capital, are nevertheless important determinants of investor growth perceptions and investor expected returns.

Q. Please summarize your risk premium estimates.

A. Table 5 below summarizes the ROE estimates obtained from the two risk premium studies.

Table 5. Risk Premium Estimates for PSE

Risk Premium Method	ROE
Historical Risk Premium	10.3%
Allowed Risk Premium	10.4%

IV. CONCLUSION

Q. Please summarize your results and recommendation.

A. To arrive at my final recommendation, I performed

(i) a DCF analysis on a group of investment-grade dividend-paying combination gas and electric utilities using Value Line's growth forecasts;

(ii) a DCF analysis on a group of investment-grade dividend-paying combination gas and electric utilities using analysts' growth forecasts;

(iii) a traditional CAPM using current market data;

(iv) an empirical approximation of the CAPM using current market data;

(v) historical risk premium data from electric utility industry aggregate data, using the current yield on long-term US Treasury bonds; and

(vi) allowed risk premium data from electric utility industry aggregate data, using the current yield on long-term US Treasury bonds.

Table 6 below summarizes the ROE estimates for PSE.

Table 6. Summary of ROE Estimates

Study	ROE
DCF - Combination Utilities Value Line Growth	9.7%
DCF - Combination Utilities Analysts Growth	8.~~3~~5%
Traditional CAPM	8.9%
Empirical CAPM	9.6%
Historical Risk Premium Electric	10.3%
Allowed Risk Premium	10.4%

If we remove the outlying result of 8.~~3~~5%, the average result of the various methodologies is 9.8%. Based on those central results, I use 9.8% as my recommended ROE for PSE.

I stress that no one individual method provides an exclusive foolproof formula for determining a fair return, but each method provides useful evidence so as to facilitate the exercise of an informed judgment. Reliance on any single method or preset formula is hazardous when dealing with investor expectations. Moreover, the advantage of using several different approaches is that the results of each one can be used to check the others. Thus, the results shown in Table 6 above must be viewed as a whole rather than each as a stand-alone. It would be inappropriate to select any particular number from Table 6 and infer the cost of common equity from that number alone.

Q. Do your various cost of equity estimates for PSE include an allowance for flotation costs?

A. No, they do not. Although flotation cost adjustments are necessary for privately held subsidiary utilities, I am not advocating a flotation cost adjustment for PSE in this proceeding because of the unique ownership structure of PSE. PSE's ultimate parent, Puget Holdings LLC, is owned by infrastructure investors that are predominantly pension funds. These pension funds do not issue equity to obtain funds and instead obtain funds from participants to a pension plan that must pay into such plan. In obtaining funds, these pension plans do not incur the types of costs that are normally associated with the flotation cost allowance. Additionally, it is my understanding that neither PSE nor any affiliate of PSE has any current plans to issue equity. In other words, it is unlikely that any equity injected into PSE for the foreseeable future will be funded by any equity issuance by PSE or any affiliate entity. For this reason, I do not advocate a flotation cost adjustment for PSE in this proceeding.

Q. Does this conclude your prefiled direct testimony?

A. Yes, it does.