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Chapter 13
Comparable Earnings

The Comparable Earnings standard has a long and rich history in regulatory proceedings, and finds its origins in the fair return doctrine enunciated by the U.S. Supreme Court in the landmark *Hope* case. The governing principle for setting a fair return decreed in *Hope* is that the allowable return on equity should be commensurate with returns on investments in other firms having comparable risks, and that 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. Two distinct standards emerge from this basic premise: a standard of Capital Attraction and a standard of Comparable Earnings. The Capital Attraction standard focuses on investors' return requirements, and is applied through market value methods described in prior chapters, such as DCF, CAPM, or Risk Premium. The Comparable Earnings standard uses the return earned on book equity investment by enterprises of comparable risks as the measure of fair return.

13.1 Rationale

The Comparable Earnings approach stems from a particular interpretation of the *Hope* language that states that returns are to be defined as book rates of return on equity (ROE) of other comparable firms. Book return on common equity is computed by dividing the earnings available to common shareholders by the average book common equity. ROE should be measured using "normalized" earnings, that is, earnings before extraordinary items and unusual charges. To implement the approach, a group of companies comparable in risk to a specified utility is defined, the book return on equity is computed for each company, and the allowed return is set equal to the average return on book value for the sample. The reference group of companies is usually made up of unregulated industrial companies of similar risk.

The rationale of the method is that regulation is a duplicate for competition. The profitability of unregulated firms is set by the free forces of competition. In the long run, the free entry of competitors would limit the profits earned by these unregulated companies, and, conversely, unprofitable ventures and product lines would be abandoned by the unregulated companies. In other words, the free entry and exit of competitors should ensure that the profits earned by non-regulated firms are normal in the economic sense of the term. Aggregating book rates of return over a large number of comparable risk unregulated companies would even out any abnormal short-run profit aberrations, while averaging over time would dampen any cyclical aberrations. Thus, by averaging the book profitability of a large number of unregulated companies