UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Impacts of COVID-19 on the Energy Industry	Docket No. AD20-17-000

COMMENTS OF THE
TRANSMISSION ACCESS POLICY STUDY GROUP

The Transmission Access Policy Study Group ("TAPS") appreciates the opportunity to respond to the Commission's July 1, 2020 Supplemental Notice of Technical Conference. TAPS will focus its comments on Issue No. 1 of the third question set associated with Panel 4:

> How has the COVID-19 emergency affected financial market conditions and the returns needed by regulated entities? Should the Commission consider changes to its ROE policies in light of any such effects, and, if so, how?

TAPS submits that while the emergency has affected financial market conditions, the resulting effects on electric utilities' cost of equity are appropriately estimated by a well-specified application of the three market-based methods adopted in Opinion 569-A.[1] The pandemic's decimation of corporate earnings[2] undercuts a key premise of the Opinion 569-A version of the Capital Asset Pricing Model ("CAPM"): its belief that projecting perpetual earnings growth at sell-side analysts' five-year forecasts consensus rate, by companies already mature and large enough to pay dividends and be listed in the S&P 500, yields a credible estimate of investors' expected long-term equity market return. This new information thereby reinforces the need for the Commission to align its application of the CAPM method with the recommendations that

[1] *Ass'n of Bus. Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc.*, 169 FERC ¶ 61,129 (2020).

[2] *See* note 14 & accompanying text, *infra* .

TAPS made and supported in Docket No. PL19-4. But it does not call for the abandonment or upward revision of market-based methods.

I. INTEREST OF TAPS

TAPS is an association of transmission-dependent utilities ("TDUs") in more than 35 states promoting open and non-discriminatory transmission access.[3] Representing entities entirely or predominantly dependent on transmission facilities owned and controlled by others, TAPS has long recognized the need for reliable and secure transmission infrastructure that enables TAPS members to serve their load affordably. As TDUs, TAPS members pay transmission rates that are substantially increased when the Commission allows ROEs that exceed the cost of equity. TAPS has therefore participated actively in numerous Commission proceedings concerning transmission planning, pricing, and incentives policies.

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II. COMMENTS

A. Equity cost estimation methods grounded in financial market data reflect pandemic effects.

This Commission, like other regulators, has relied on financial-market-based equity cost estimation techniques over a very wide variety of financial market conditions—such as the much

[3] David Geschwind, Southern Minnesota Municipal Power Agency, chairs the TAPS Board. Jane Cirrincione, Northern California Power Agency, is TAPS Vice Chair. John Twitty is TAPS Executive Director.

higher interest rates of the early 1980s; the 1990 oil price shock and ensuing recession; the post-millennium recession associated with the dot-com bubble burst and 9/11; the global financial crisis and Great Recession circa 2008; and the intervening and subsequent booms. Those techniques have produced returns adequate to attract investors, while assuring ratepayers that allowed returns are tethered to market realities. And even as this Commission and state regulators have continued to rely on these techniques during the pandemic emergency, the consensus view of technical conference panelists was that the resulting allowed ROEs continue to afford utilities ample access to capital.[4]

All too predictably, however, the Edison Electric Institute ("EEI") is citing the pandemic's financial market effects as a reason to downplay market-based empirical models in favor of reliance on the (higher) ratio of earnings to accounting-based equity book values.[5] But neither EEI nor any other panelist has provided evidence that this ratio, which ignores the stock market price that investors must incur in order to buy into those earnings, measures the return that attracts investor capital.

[4] *See* Panel Testimony of Mauricio Gutierrez, President and Chief Executive Officer, NRG, Tr. 353:17-21 (on "access to capital," while "there was some uncertainty at the outset of the pandemic that [Fed] intervention was very, very effective and really stabilized the capital markets and I can tell you today that access to capital is pretty wide open."); *id.* at Tr. 353:21-354:2 (capital access has "more than recovered to pre-COVID-19 levels"); Panel Testimony of Kimberly Dang, President, Kinder Morgan, Tr. 363:15-18 ("debt access was limited prior to the fed coming in back in March, but I think since that time has been pretty readily available and readily available at reasonable rates"); Panel Testimony of Philip Moeller, Executive Vice President – Business Operations Group and Regulatory Affairs, Edison Electric Institute, Tr. 363:4-6, 363:22-23 (when asked "How has the COVID-19 emergency affected financial market conditions in the return needed by regulated entities?," answering "we have very little restraints right now").

[5] *See* Technical Conference Statement of Philip D. Moeller, Edison Electric Institute at 7 & n.7, Docket No. AD20-17 (June 30, 2020), eLibrary No. 20200630-5425 ("EEI Statement") (citing Motion for Leave to File Supplemental Comments and Supplemental Comments of the Edison Electric Institute, Docket No. PL19-4-000 (May 11, 2020), which in turn argues (at 13-17) that the Commission should apply the "Expected Earnings" method).

EEI states the right principle when it comments that base ROEs should be "commensurate with returns on investments in other enterprises having corresponding risks."[6] But the Commission must remember that over-estimating this risk-commensurate return can harm the public interest just as much as under-estimating it. First and foremost, an over-estimation error would be a direct hit to ratepayers, many of whom are unemployed and facing dire economic straits during the ongoing recession. And such over-estimation would also have long-term distortive effects on where investment is directed. For example, as NRG CEO Gutierrez testified, "investors in the power sector have a choice of where to invest their capital. If the Commission is too generous … it will diminish the willingness of the investors to invest in our business, which relies solely on the competitive market to set prices."[7] Accordingly, the Commission should apply sound empirical methods to financial market data so as to neutrally estimate utilities' cost of equity, rather than making yet more changes to its ROE methods to make them produce preconceived results.

It would be error to simply observe that stock market prices have varied widely over the course of 2020 and conclude that the risk of investing in electric utilities has increased and allowed ROEs should rise. To the contrary, the only Panel 4 witness representing an entity without a dog in the fight between low and high ROEs (namely, the Managing Director of Clearview Energy Partners), concluded that "A flight to quality as the market responds to economic stress is like[ly to] lower relative returns for the most stable businesses. Indeed, the applied ROE [a]s indicated by the models for electric utilities remained essentially stable over

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[6] EEI Statement at 6-7 (citing *FPC v. Hope*, 320 U.S. 591, 603 (1944); *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679, 693 (1923)).

[7] Tr. 328:16-21. *See also id.* at Tr. 368:1-8 (referencing "the spread between that return on equity and the treasury rates…" and testifying that "if that spread, if that premium is too large, then it would create a you know, a different incentive for investors that could potentially have an impact on competitive power companies").

the [p]ast six months of this year even though the equity market took quite a relative [dive]."[8] Drilling down into Clearview's model results, they show six-month rolling-average estimates that, for the Discounted Cash Flow ("DFC"), and Risk Premium ("RP") methods, stayed in narrow ranges,[9] and for the Capital Asset Pricing Model ("CAPM"), varied more widely but stayed below 9.0%.[10]

Since then, utility stocks' relative volatility—their "betas" as calculated by Value Line and by Bloomberg—appear to have increased substantially over the past few months, generally rising by about 0.3 to about 0.9.[11] The limited data currently available suggests that all stocks rose or fell together on pandemic-related information without regard to stock-specific risks, thus raising the betas of utility stocks that had been well below 1.0. If so, this observation illustrates the general point that financial-market-based empirical models register significant events that alter the cost of equity. While there is room to improve the models' parameters—particularly in the way we discuss in Part II below—any changes should be justified on their intrinsic merits, not contrived so as to dilute the significance of market-based models or otherwise force a preconceived result.

[8] Panel Testimony of Christine Tezak, Managing Director, Clearview Energy Partners, Tr. 342:3-8.

[9] *See* Opening Statement, Clearview Energy Partners, LLC, at 6, Docket No. AD20-17 (July 6, 2020), eLibrary No. 20200706-4003 (showing median DCF results that ranged from 7.51% to 8.34%, and RP point results that ranged from to 9.59% to 9.71%).

[10] *See id*. (showing median CAPM results that ranged from 7.23% to 8.60%).

[11] Solely by way of illustration and without advocating any particular result in that proceeding, we note that recent testimony in Docket No. EL20-57, eLibrary No. 20200701-5537, Testimony of Ann E. Bulkley, Exhibit No. WE-0001, at 46, Figure 10, reports that from May 1 to July 31, 2020, Value Line Betas rose for all ten members of the proxy group identified by the Complainant in that proceeding, typically by about 0.30.

B. The pandemic's effect on broad-portfolio earnings shows the fallacy of assuming perpetual earnings growth at near-term rates.

The composite price/earnings and price/forward earnings ratios of S&P 500 stocks are now above 25, rivaling or exceeding their highest levels ever.[12] These ratios mean that in valuing stocks, investors currently place less emphasis than ever on near-term expectations, and instead are betting on long-term results.[13] These ratios also reflect the fact that the pandemic-related recession has decimated recent and near-term forward earnings:

> Wall Street is predicting a deep drop in profits for virtually every sector of the economy … The consensus is that a second-half rebound will leave profits 19.7% lower at year-end than at the close of 2019 … A more realistic take comes from Savita Subramanian, managing director at Bank of America Merrill Lynch, who predicts a 29% drop in S&P earnings per share for 2020.[14]

Thus, the pandemic-related economic and financial market news has forcefully reminded investors that they cannot count on typically rosy projections of near-term earnings growth continuing forever.

In this context, TAPS reiterates its Docket No. PL19-4 recommendation[15] that the Commission's CAPM model use lower, more realistic forecasts of the long-term equity market return and equity market risk premium, by, *e.g.,* factoring long-term economy-wide (GDP) growth as a constraint on the earnings that flow into an economy-wide stock portfolio. Even

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[12] *See* Paul Vigna, *The Median S&P Stock Has Never Been More Expensive,* Wall St. J. (Aug. 23, 2020), https://www.wsj.com/articles/the-median-s-p-stock-has-never-been-more-expensive-11598202000.

[13] *See* Paul Krugman, *Stocks Are Soaring. So Is Misery.*, A27 N.Y. Times (Aug. 21, 2020) ("Apple has a price-earnings ratio — the ratio of its market valuation to its profits — of about 33. One way to look at that number is that only around 3 percent of the value investors place on the company reflects the money they expect it to make over the course of the next year.").

[14] Shawn Tully, *Here's how far corporate profits could plummet in 2020*, FORTUNE (May 17, 2020), https://fortune.com/longform/corporate-profits-earnings-2020-outlook-fortune-500-companies-guidance/.

[15] Comments of the Aluminum Assoc. *et al.*, at 99-109, Docket No. PL19-4-000 (Jun. 26, 2019), eLibrary No. 20190626-5146 ("TAPS Base ROE Comments"); Reply Comments of the Aluminum Assoc. *et al.*, at 24-27, Docket No. PL19-4-000 (Jul. 26, 2019), eLibrary No. 20190726-5132 ("TAPS Base ROE Reply Comments").

before the present recession, but following a comprehensive survey of both historical and forward-looking approaches to estimating the market-wide equity risk premium, the authors of a leading corporate finance textbook concluded that "we'd be suspicious of an estimated market premium that is … greater than 6.5 percent."[16] The Commission's peer and sister agencies, for purposes that include setting electricity transmission rates, modeling electric utility economics, and regulating coal rail shipment rates, apply CAPM models in which the equity market return is far below that utilized in Opinion No. 569-A.[17] If the Commission re-examines its ROE models in this proceeding, it should prioritize correcting that error.

[16] Michael C. Ehrhardt and Eugene F. Brigham, *Corporate Finance: A Focused Approach* at 351 (4th ed. 2011), https://epdf.pub/download/corporate-finance-a-focused-approach-4th-edition-2010.html ("*Ehrhardt and Brigham*").

[17] *See* TAPS Base ROE Comments at 107; *see also* FCC Wireline Competition Bureau Staff Report at 25-27, *Prescribing The Authorized Rate of Return: Analysis of Methods for Establishing Just and Reasonable Rates for Local Exchange Carriers*, WC Docket No. 10-90, DA 13-1111 (May 16, 2013) ("FCC Report") (estimating the equity market return as 2.83% + 5.88% = 8.71%); *In re. Connect Am. Fund*, 28 FCC Rcd. 7123, 7147 (2013); *later order, In re. Connect Am. Fund*, 81 Fed. Reg. 24282 at 24320, PP 251-52 (Apr. 25, 2016); *Railroad Cost of Capital—2018*, STB Ex Parte No. 558 (Sub-No. 22), (S.T.B. Aug. 5, 2019) (applying a 3.02% risk-free rate derived using 20-year U.S. Treasury bonds, and an equity market premium of 6.91%); *Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry's Cost of Capital*, STB Ex Parte No. 664 (Sub-No. 1), 2009 WL 197991 (S.T.B. Jan. 23, 2009); Board of Governors of the Federal Reserve System, Docket No. OP-1636, 84 Fed. Reg. 1126, n.21 (Feb. 1, 2019); David E. Pomper, *How FERC's Peers Estimate Equity Costs: A Deep Dive*, PUB. UTILS. FORTNIGHTLY (Dec. 2019), https://www.fortnightly.com/fortnightly/2019/12/how-fercs-peers-estimate-equity-costs.

CONCLUSION

TAPS urges the Commission to adhere to the principles discussed in these comments as it considers whether pandemic-related financial market events warrant changes to its equity cost estimation methods.

Respectfully submitted,

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