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| PUC logo | COMMONWEALTH OF PENNSYLVANIAPENNSYLVANIA PUBLIC UTILITY COMMISSIONP.O. BOX 3265, HARRISBURG, PA 17105-3265 | **IN REPLY PLEASE REFER TO OUR FILE****M-2012-2317272****M-2012-2293611** |

**April 17, 2013**

**To: All EDCs, NGDCs, PGW, Water, and Waste Water Utilities**

 **Re: ROE Working Group, M-2012-2293611**

 **Act 11 Final Implementation Order, M-2012-2317272**

Act 11 of 2012[[1]](#footnote-1) (Act 11), *inter alia*, allows jurisdictional water and wastewater utilities, electric distribution companies (EDCs), natural gas distribution companies (NGDCs), and a city natural gas distribution operation (CNGDO) to petition for a distribution system improvement charge (DSIC). A DSIC will allow utilities to timely recover “the reasonable and prudent costs incurred to repair, improve or replace eligible property in order to ensure and maintain adequate, efficient, safe, reliable and reasonable service.” 66 Pa. C.S. § 1353(a).

A key component in the DSIC recovery calculation is the return on equity (ROE). The ROE should balance the interests of consumers and utilities, and be sufficient to attract, at reasonable rates, the capital needed to maintain and improve a utility’s infrastructure. Act 11 provides that the ROE shall be the equity return rate approved in the utility’s most recent fully litigated rate case. 66 Pa. C.S. § 1357(b)(2). However, for utilities that do not have an ROE from a recent rate case, Act 11 provides that the ROE shall be the equity return rate calculated by the Commission in the most recent Quarterly Earnings Report (QER). 66 Pa. C.S. § 1357(b)(3).

To prepare for implementation of Act 11, the Commission convened a working group of stakeholders[[2]](#footnote-2) to review the Commission’s QER process and, in particular, the parameters currently used to determine the market-based ROE for each of the major industry groups. The key issue areas were: Barometer Groups, ROE Models and Weighting, Range of Reasonableness, and Other Factors.

Various stakeholders submitted position papers on these issue areas,[[3]](#footnote-3) and staff provided its recommendations. This process has afforded the Commission with comprehensive analyses and recommendations for determining current market-based ROEs. The Commission appreciates the input and guidance provided and, upon consideration of that input, the Commission will make several changes to its current parameters for determining ROE to yield an improved market-based result.

Accordingly, based on our consideration of the input provided by the stakeholders and our staff, we shall adopt the following parameters for the QER process on a going-forward basis.

**Barometer Groups**

The criteria for determining industry barometer groups for ROE determinations will be formalized as follows:

* Industry-specific barometer group companies will be reviewed by staff on a quarterly basis;
* 50% or more of the company’s assets must be related to the jurisdictional utility industry;
* Company stock must be publically traded and must have at least three years of earnings history;
* Companies targeted by merger and acquisition (M&A) activity will be excluded; companies involved in M&A activity may be excluded;
* Investment information for company must be available to the Commission from more than one source, where more than one source exists, particularly earnings growth projections;
* Company must have an investment grade credit rating (S&P BBB- or better, Moody’s Baa3 or better; and
* Companies will be selected based on geographic regions:

EDCs: *Value Line* East Group Electric Utility companies;

NGDCs and CNGDO: *Value Line* Natural Gas Utility industry group companies; and

Water/Waste water: *Value Line* Water Utility industry group companies.

**ROE Models and Weighting**

The process to calculate ROE will:

* Use the Discounted Cash Flow (DCF) model the basis for calculating ROE;
* Use projected *earnings per share* growth without the projected dividend growth rate;
* Use *expected* dividend yield produced by the current stock price and the 52-week high/low stock price;
* Use 5-year projected annual dividend growth rate from *The Value Line Investment Survey* (*Value Line*) to determine the growth component of the expected dividend yield[[4]](#footnote-4);
* Use the Capital Asset Pricing Method (CAPM) only as a check on the DCF results;
* Use the 10-year U.S. Treasuries as the basis for the CAPM risk-free rate; and
* Make no leverage adjustment.

**Range of Reasonableness**

The process will use one standard deviation as a *range of reasonableness* for the calculated DCF results.

**Other Factors**

In addition, the process will give consideration to the ROEs recently adjudicated by the Commission in fully litigated rate cases in each industry, the need to attract, at reasonable rates, the capital needed to maintain and improve that industry’s infrastructure, and such other factors as the Commission deems appropriate and consistent with Act 11.

**Effective Date**

These updated ROE parameters will be used in, and effective with, the next QER. The QER will display barometer groups, dividend yields, growth rates, and calculations for DCF and CAPM. The updated parameters will improve the process used to determine an equity cost rate for purposes on the DSIC mechanism and will produce an ROE that will be reflective of current market conditions and provide the return rates necessary to attract the capital needed to maintain and improve utility infrastructure in accordance with the underlying purpose of Act11.

Questions may be directed to Andrew Herster, Bureau of Technical Utility Services, 717‑783-5392 or aherster@pa.gov.



 Sincerely,

 Rosemary Chiavetta

 Secretary

cc: Paul Diskin, Director, TUS

 Bohdan R. Pankiw, Chief Counsel
 Louise Fink Smith, Law Bureau

 Erin Laudenslager, TUS

 Andrew Herster, TUS

 David Huff, TUS

Electronic List

1. <http://www.legis.state.pa.us/WU01/LI/LI/US/HTM/2012/0/0011..HTM>. [↑](#footnote-ref-1)
2. The following entities participated in stakeholder discussions: Aqua Pennsylvania; Columbia Gas of PA; Duquesne Light; Energy Association of PA (EAP); Equitable Gas; FirstEnergy; various Industrial Customer Groups; National Fuel Gas; Pennsylvania Chapter of the National Association of Water Companies (PNAWC); PECO Energy Company; Peoples Natural Gas LLC; Pike County L&P; PPL Electric Utilities; Superior Water; UGI; United Water; York Water Company; the Office of Consumer Advocate (OCA); the Office of Small Business Advocate (OSBA); the Bureau of Investigation and Enforcement (BI&E); and other Commission staff. EAP member utilities include: Citizens’ Electric Company; Columbia Gas of PA; Duquesne Light Company; Equitable Gas Company; Metropolitan Edison Company; Pennsylvania Electric Company; Pennsylvania Power Company; Pike County Light & Power Company; National Fuel Gas Distribution Corp.; PECO Energy Company; Peoples Natural Gas Company; Peoples TWP LLC; Philadelphia Gas Works; PPL Electric Utilities; UGI Central Penn Gas; UGI Penn Natural Gas; UGI Utilities, Inc.; Valley Energy; Wellsboro Electric Company; and West Penn Power Company. PNAWC member utilities include: Pennsylvania American Water Company; York Water Company, United Water Pennsylvania, Superior Water, and “other smaller water utilities.” [↑](#footnote-ref-2)
3. Position papers were received from OCA, BI&E, and the “Sponsoring Utilities.” The entities that self-identified as Sponsoring Utilities are the EAP and its member utilities, Aqua PA, and the PNAWC. [↑](#footnote-ref-3)
4. Expected dividend yield is calculated as latest indicated dividend plus one-half *Value Line* 5-year projected annual dividend growth rate. [↑](#footnote-ref-4)