

Ameren Cr. Ex. 6

REGULATORY FINANCE: UTILITIES' COST OF CAPITAL

Roger A. Morin, PhD

in collaboration with
Lisa Todd Hillman

PROPERTY OF
COMMERCE CONSUMER

1994
PUBLIC UTILITIES REPORTS, INC.
Arlington, Virginia

OFFICIAL FILE

ILL. C. C. DOCKET NO. 12-0001

Ameren Cross Exhibit No. 6

Witness Phipps

Date 6-21-12 Reporter CB

EXAMPLE 5-1

Southeastern Electric's sustainable growth rate is required for an upcoming rate case testimony. As a gauge of the expected return on equity, authorized rates of return in recent decisions for Eastern U.S. electric utilities as reported by Value Line for 1993 and 1994 averaged 12%, with a standard deviation of 1%. In other words, the majority of these utilities were authorized to earn 12%, with the allowed return on equity ranging from 11% to 13%. As a gauge of the expected retention ratio, the average 1993 payout ratio of 34 eastern electric utilities as compiled by Value Line was 60%, which indicates an average retention ratio of 40%, with a standard deviation of some 5%. This was consistent with the long-run target retention ratio indicated by the management of The Southeastern Electric. It is therefore reasonable to postulate that investors expect a retention ratio ranging from 35% to 45% for the company with a likely value of 40%. In Table 5-4 below, expected retention ratios of 35% to 45% and assumed returns on equity from 11% to 13% are combined to produce growth rates ranging from 3.8% to 5.4% with a likely value of 4.8%.

TABLE 5-4
ILLUSTRATION OF THE SUSTAINABLE GROWTH METHOD
EXPECTED GROWTH RATE: $g = b \cdot r$

Expected Retention Ratio (<i>b</i>)	Expected Return on Book Equity (<i>r</i>)		
	11%	12%	13%
35%	3.85%	4.20%	4.55%
40%	4.40%	4.80%	5.20%
45%	4.95%	5.40%	5.85%

It should be pointed out that published forecasts of the expected return on equity by analysts such as Value Line are sometimes based on end-of-period book equity rather than on average book equity. The following formula¹² adjusts the reported end-of-year values so that they are based on average common equity, which is the common regulatory practice:

¹²The return on year-end common equity, r , is defined as $r = E/B_t$, where E is earnings per share, and B is the year-end book value per share. The return on average common equity, r_a , is defined as:

$$r_a = E/B_a$$

