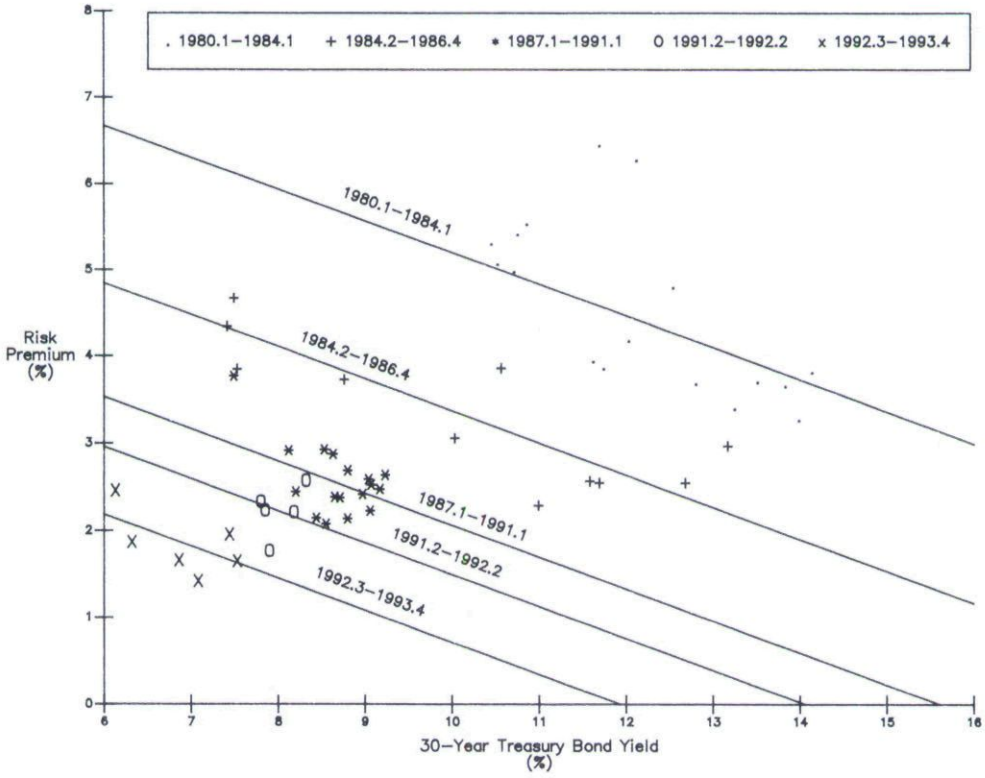
Figure 2. Observed Risk Premiums Plotted Against Treasury Bond Yields



of the binary variables. These tests indicated that significant shifts in the market's evaluation of the relative risk of debt and equity most likely occurred in 1984, 1987, 1991, and 1992.

Table 1 reports the results of fitting Equation (3). These results indicate an inverse relationship between ex ante risk premiums and interest rates over the sample period. A first-order autoregressive correction was made to adjust for the possibility of serial correlation during the sample period (see Johnston, 1984, pp. 321-324). The adjusted R^2 for Model 2 is 0.82. All variables are statistically significantly different from zero at the 0.01 level, except for D3 and D4, which are significant at the 0.05 level. As anticipated, the coefficient estimate of the Treasury bond variable is negative, which indicates the existence of a general inverse relationship between interest rates and risk premiums over the study period.

It is important to note that Model 2 identifies the basic relationship between risk premiums and interest rates, which is defined by the slope coefficient β, as statistically stable over the sample period. Stability of the Treasury bond slope coefficient over the study period was supported by statistical tests that permitted the slope coefficient to change.

C. Interpretation of Empirical Results

The inverse relationship indicated in Table 1 represents approximately 37 basis points for each 100 basis-point change in Treasury bond yields. This result is consistent with the Harris and Marston (1992) study, which found a 36 basis-point inverse relationship between long-term government bond rates and risk premiums for a broader sample of companies for the 1982-1991 period. However, our utility risk premium values are lower than those reported by Harris and Marston for the broader market. One might expect such a difference between the risk premium for utility stocks and the broader market, due to the relatively lower risk of utility stocks.

Harris and Marston found that changes in relative risk, as proxied by a yield spread variable, were important in explaining risk premium changes in subperiods between 1982 and 1991. They also noted, however, that the yield spread variable was more significant in the early 1980s and less significant in the latter 1980s. This phenomenon may be embedded within our intercept dummies, which also exhibited a declining level of magnitude and significance. Interestingly, the break-points for Harris and Marston's

Table 1. Model 2 Regression Results[a]

This table reports the results of fitting Equation (3). The risk premium is the dependent variable.

Variable	Coefficient	Standard Error	t-statistic
Intercept	8.880	0.776	11.444***
TB	-0.368	0.063	-5.878***
D1	-1.828	0.250	-7.318***
D2	-1.309	0.234	-5.598***
D3	-0.569	0.277	-2.051**
D4	-0.773	0.333	-2.320**
Adjusted R^2	0.815	Durbin Waston statistic	1.920

***Significant at the 0.01 level.
**Significant at the 0.05 level.

[a]Regressions were corrected for the possible existence of serial correlation using the Cochran-Orcutt method.

sub-periods closely approximate the break-points indicated by our tests.

Trends in the overall level of risk premiums provide one of the more intriguing comparisons between our results and those of Harris and Marston. Both studies support an inverse relationship throughout similar study periods. However, the late 1980s and early 1990s produced some of the highest risk premiums in Harris and Marston's study, while the same period produced some of the lowest risk premiums observed in our study. These results may be indicative of higher perceived risk for their broader sample relative to our utility stock sample during this period. Electric utility companies generally have significantly lower reported values for beta than would be reported for a broad market sample of companies. While beta is a somewhat controversial measure of risk, Harris and Marston report a significant positive relationship between beta and risk premiums.

Our results indicate that ex ante risk premiums for electric utility stocks remained inversely related to interest rates over the study period when changes regarding the market's evaluation of relative risk are taken into account. We acknowledge the limitation that our regression model is descriptive of the study period only; however, some measure of robustness would appear to be imparted by the fairly wide range of market climates in our study period.

During the study period, any number of events could have had an impact on the relative risks of debt and equity.[2] In all likelihood, this relationship will continue to be affected by innumerable future events. The projected growth rates for utility dividends and earnings during the early 1980s were viewed by some as too high to be sustainable and therefore not reasonable proxies for the long-run growth rate the DCF model requires. Interestingly, the projected dividend and earnings growth rates for the early 1990s have been viewed by some as too low. Therefore, results of a descriptive model developed from ex ante measures over a period of time can help to provide a reasonableness check concerning an estimate at one point in time.

IV. Usefulness of the Model

In developing cost of equity recommendations, the staff of the Virginia State Corporation Commission (VSCC) presently includes ex ante risk premium methods based on the information presented in this study as well as others. For example, the VSCC staff incorporated an earlier version of the model presented in this paper to formulate a cost of equity recommendation for The Potomac Edison Company in a 1993 rate case. At that time, the model included data from 1980 to 1991, which indicated two shifts in the level of risk premiums, one in the second quarter of 1994 and the other in the first quarter of 1987. The estimated slope coefficient at that time was -0.395, or roughly 40 basis points for each 100 basis-point change in interest rates.

Using the 6.3% average yield on 30-year Treasury bonds from July 1993 to September 1993, the model indicated a risk premium of 3.4%. Combined with the 6.3% interest

[2]Over the study period, the relative risks of debt and equity could have been affected by such factors as changing monetary policy, concern over the growing budget deficit, the savings and loan debacle, the Continental Illinois Bank crisis and other bank industry problems resulting from defaulted loans to developing countries, the leveraged buyout binge of the 1980s, and the 1987 stock market crash, to name a few.

rate, this risk premium produced a 9.7% cost of equity estimate. The VSCC staff also adjusted the average risk premium for the study period based on the model's slope coefficient to obtain a cost of equity estimate for the current level of interest rates. Using this approach, the 3.9% difference between the average interest rate over the study period (10.2%) and the recent 3-month average rate (6.3%) was multiplied by the approximate slope coefficient of 0.4%. The resulting 1.6% was then added to the 3.4% average risk premium for the study period to incorporate the inverse relationship between Treasury yields and utility equity risk premiums. This approach indicated a current risk premium of 5.0%, which indicated a current cost of equity of 11.3% when combined with the 6.3% interest rate. A 10 basis-point flotation cost adjustment was added to both estimates, thus providing cost of equity estimates of 9.8% and 11.4% from the risk premium study. The Potomac Edison Company's requested rate increase reflected a 12.50% return on equity (and increased rates had been in effect on an interim basis subject to refund since September 28, 1993). Ultimately, the VSCC authorized a cost of equity range of 10.4% to 11.4% in its Final Order issued on November 18, 1994.

In addition to providing the basis for a supplemental cost of equity estimate, our risk premium study may be applicable in a more relaxed regulatory framework. For example, in its investigation of alternative regulatory methods for local telephone companies, the VSCC established a number of regulatory options for local telephone companies in Case No. PUE930036. The Earnings Incentive Plan option in that case included the provision for an annually authorized return on equity range that would span 300 basis points and be based on a risk premium approach that recognizes an inverse relationship between risk premiums and interest rates. The risk premium for the bottom of the range in each year would be established as 2.0%, plus 0.5 times the difference between 10.0% and the three-month average yield on 30-year Treasury bonds from September through November of the preceding year. The risk premium for the top of the range would be determined in the same manner, except that the calculation would start with a base level of 5.0%. The resulting risk premiums (subject to the constraint that they cannot be less than zero) are added to the same three-month average yield on 30-year Treasury bonds in the risk premium formula to produce the cost of equity range. The average interest rate and risk premium from a study such as ours could easily be incorporated within a plan like the one developed by the VSCC. While the VSCC's plan did not incorporate a provision for the sharing of earnings, one could be included so that returns above the banded range could be shared.

V. Conclusions

This study furnishes evidence that equity risk premiums are not constant. Our results indicate a statistically significant inverse relationship between interest rates and utility equity risk premiums. Yet, considering that our study covers a recent 14-year period, the hypothesis of a constant ex ante risk premium should also be tested over a longer period. It would also be interesting to test whether the long-term average of ex ante risk premiums converges with the long-term average of ex post risk premiums. ■

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