



Double Jeopardy: FERC-Regulated Transcos and Retail Consumers

NARUC Annual Meeting 2014

SPIEGEL &
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LLP

“Why do some transcos double leverage?”

- One (causal) reason: ITC subsidiaries in MISO receive ROEs of up to 13.88%, motivating equity-heavy subsidiary capital structures
- MISO’s high ROE and high cap on incentives exploits a flaw in FERC’s method for setting region-wide ROEs

Thomson Reuters' Bangalore office



DCF Proxy Result (Simplified):

Proxy's Cost of Equity =
(Dividend/Price) +
Earnings Growth Rate

E.g.: Yahoo Earnings/Share Forecast for Portland Gen'l (POR)

Growth Est	POR
Current Qtr.	20.00%
Next Qtr.	-18.60%
This Year	16.30%
Next Year	5.60%
Past 5 Years (per annum)	10.33%
Next 5 Years (per annum)	10.96%



10.96%

<http://finance.yahoo.com/q/ae?s=POR+Analyst+Estimate>, 9/22/2014

Reuters Growth Estimate for POR

- Reuters reported the same mean growth rate of 10.96%, and provided further details for how that number was calculated.
- Reuters believed that one analyst had a whopping 20.43% growth rate, which drove the mean value.

	# of Estimates	Mean	High	Low	1 Year Ago
LT Growth Rate (%)	4	10.96	20.43	5.00	6.30

But Reuters was wrong!

- The 20.43% estimate was not based on an analyst estimate, but a calculation based on a misunderstanding of a data file provided by Deutsche Bank.
- Reuters incorrectly used an unadjusted 2013 EPS values as base to calculate a three-year (rather than five-year) EPS growth rate.
- Reuters stated its IBES database “should have excluded [the 20.43%] but it was missed to exclude.”

POR Drove DCF Results

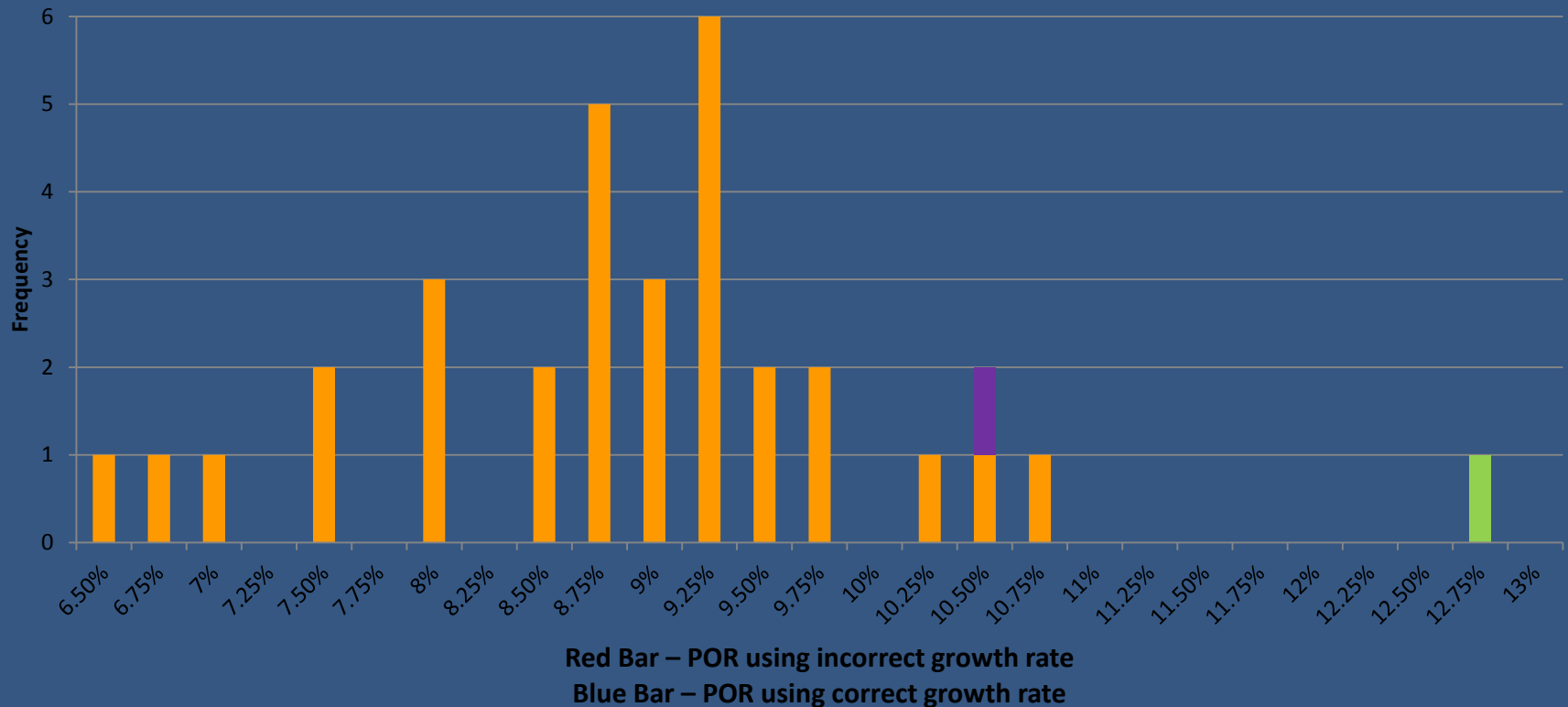
Company	(a) (b)		(a) (a) (a)			Cost of Equity	
	Dividend Yield		Growth Rate				
	6-Mo. Average	Adjusted	IBES	GDP	Weighted		
ALLETE	3.90%	1.0300	4.02%	6.00%	4.39%	5.46%	9.48%
Alliant Energy	3.69%	1.0245	3.78%	4.90%	4.39%	4.73%	8.51%
Ameren Corp.	4.07%	1.0100	4.11%	2.00%	4.39%	2.80%	6.91%
American Elec Pwr	3.94%	1.0240	4.03%	4.79%	4.39%	4.66%	8.69%
Avista Corp.	4.18%	1.0250	4.28%	5.00%	4.39%	4.80%	9.08%
Black Hills Corp.	2.76%	1.0350	2.86%	7.00%	4.39%	6.13%	8.99%
Cleco Corp.	3.07%	1.0350	3.18%	7.00%	4.39%	6.13%	9.31%
CMS Energy Corp.	3.76%	1.0329	3.88%	6.58%	4.39%	5.85%	9.73%
Consolidated Edison	4.58%	1.0126	4.64%	2.52%	4.39%	3.14%	7.78%
Dominion Resources	3.47%	1.0301	3.57%	6.02%	4.39%	5.48%	9.05%
DTE Energy Co.	3.60%	1.0293	3.71%	5.85%	4.39%	5.36%	9.07%
Duke Energy Corp.	4.39%	1.0210	4.48%	4.19%	4.39%	4.26%	8.74%
Edison International	2.69%	1.0188	2.74%	3.75%	4.39%	3.96%	6.70%
El Paso Electric	2.94%	1.0350	3.04%	7.00%	4.39%	6.13%	9.17%
Empire District Elec	4.30%	1.0150	4.36%	3.00%	4.39%	3.46%	7.83%
Great Plains Energy	3.57%	1.0263	3.66%	5.25%	4.39%	4.96%	8.63%
Hawaiian Elec.	4.97%	1.0200	5.07%	4.00%	4.39%	4.13%	9.20%
IDACORP, Inc.	3.16%	1.0200	3.22%	4.00%	4.39%	4.13%	7.35%
ITC Holdings Corp.	1.61%	1.0562	1.70%	11.23%	4.39%	8.95%	10.65%
NextEra Energy, Inc.	3.08%	1.0312	3.18%	6.23%	4.39%	5.62%	8.79%
Northeast Utilities	3.50%	1.0311	3.61%	6.21%	4.39%	5.60%	9.21%
NorthWestern Corp.	3.44%	1.0400	3.58%	8.00%	4.39%	6.80%	10.37%
Otter Tail Corp.	4.13%	1.0300	4.25%	6.00%	4.39%	5.46%	9.72%
PG&E Corp.	4.17%	1.0322	4.30%	6.44%	4.39%	5.76%	10.06%
Pinnacle West Capital	4.17%	1.0218	4.26%	4.35%	4.39%	4.36%	8.62%
Portland General Elec.	3.45%	1.0561	3.64%	11.21%	4.39%	8.94%	12.58%
Pub Sv Enterprise Grp	4.03%	1.0060	4.05%	1.20%	4.39%	2.26%	6.32%
Sempra Energy	2.71%	1.0348	2.80%	6.95%	4.39%	6.10%	8.90%
Southern Company	4.79%	1.0168	4.87%	3.35%	4.39%	3.70%	8.57%
Vectren Corp.	3.74%	1.0200	3.81%	4.00%	4.39%	4.13%	7.94%
Westar Energy	4.00%	1.0145	4.06%	2.90%	4.39%	3.40%	7.45%
Xcel Energy, Inc.	3.89%	1.0225	3.98%	4.49%	4.39%	4.46%	8.43%
Range of Reasonableness				6.32%	--	12.58%	

- Yahoo's growth rate drove POR's implied cost of equity way up, so it set the top of the range.

12.58%

POR was a clear outlier

Histogram of DCF Results



Errors in Reuters Data Abound

	# of Estimates	Mean	High	Low	1 Year Ago
SALES (In millions)					
Quarter Ending Mar-14	4	3,850.97	4,117.05	3,138.57	3,923.11
Quarter Ending Jun-14	4	4,406.98	4,595.38	4,278.45	4,681.76
Year Ending Dec-14	13	17,797.80	18,833.80	17,425.00	18,757.80
Year Ending Dec-15	10	18,511.50	19,774.90	17,835.50	19,531.20
Earnings (per share)					
Quarter Ending Mar-14	11	0.53	0.60	0.42	0.51
Quarter Ending Jun-14	10	0.69	0.73	0.65	0.76
Year Ending Dec-14	24	2.76	2.86	2.70	2.93
Year Ending Dec-15	18	2.86	3.02	2.75	
LT Growth Rate (%)	8	9.00	45.00	2.30	5.11

45%
!?!?

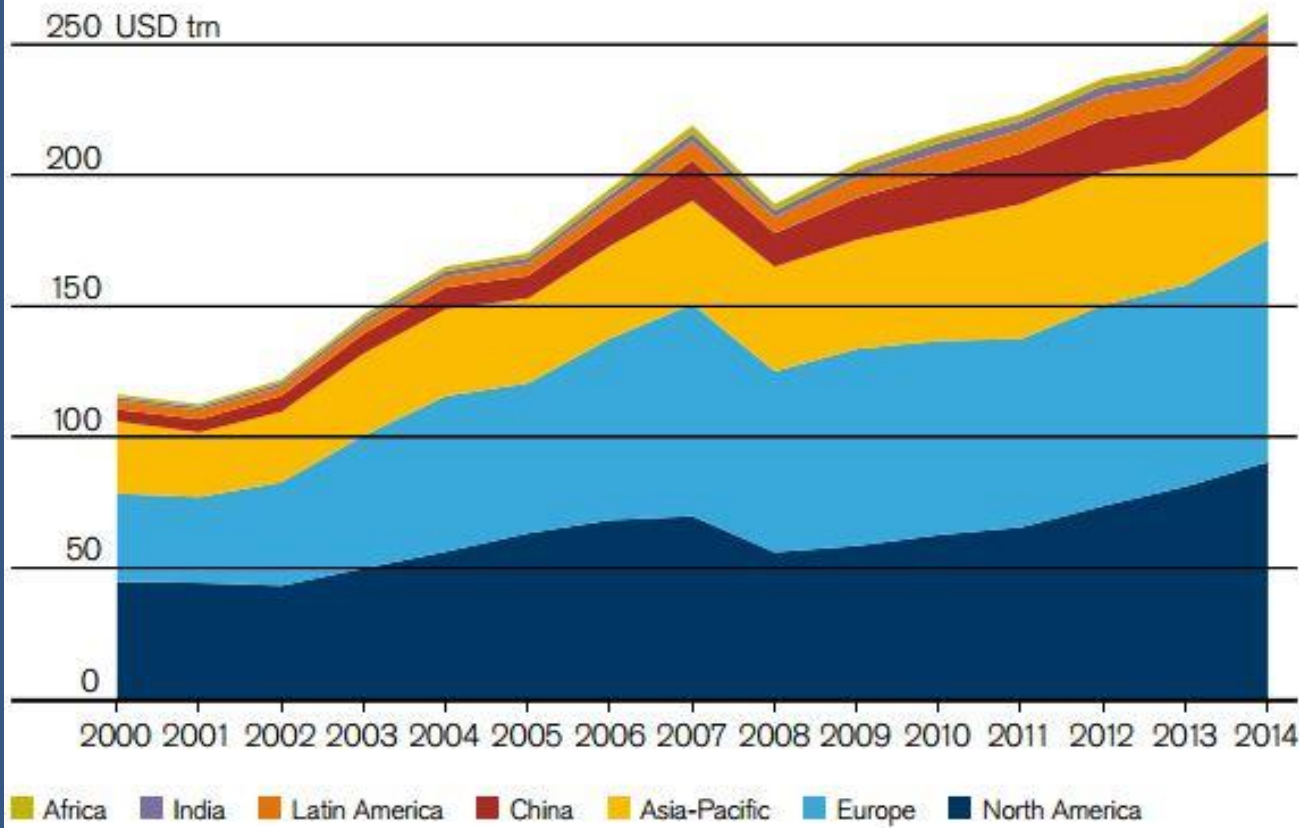
Reuters Report for Southern Company, 1/31/2014

What should drive ROE: Equity's cost given glutted capital supply

Figure 1

Total global wealth 2000–2014, by region

Source: James Davies, Rodrigo Lluberas and Anthony Shorrocks, Credit Suisse Global Wealth Databook 2014.



Parent Control Over Sub's Debt Issuance

- “[I]ssue of paramount importance”: Whether “PEC [parent] has controlled or still controls the issuance of debt by Panhandle.”

Panhandle Initial Decision, 68 FERC
¶ 63,008 (1994).

FERC's Theory: Regulated Single Leveraging

- “While the Commission prefers to use the actual capital structure of the entity that does the financing to raise funds for the pipeline, it may use a different capital structure *where the actual capital structure is not representative of the pipeline's risk profile.*”

Panhandle E. Pipe Line Co., Opinion No. 395, 71 FERC ¶ 61,228 (1995) (“*Panhandle*”).

Capital Structure Representative of Risk Profile

DECEMBER 23, 2013

INFRASTRUCTURE

MOODY'S
INVESTORS SERVICE

RATING METHODOLOGY Regulated Electric and Gas Utilities

Factor 4: Financial Strength

Weighting 40%	Sub-Factor Weighting		Aaa	Aa	A	Baa	Ba	B	Caa
Debt / Capitalization	Standard Grid		< 25%	25% - 35%	35% - 45%	45% - 55%	55% - 65%	65% - 75%	≥ 75%
	Low Business Risk Grid	7.5%	< 29%	29% - 40%	40% - 50%	50% - 59%	59% - 67%	67% - 75%	≥ 75%

Capital Structure Representative of Risk Profile

Rating Companies in the Regulated Electric, Natural Gas and Water Utilities Industry
January 2014



Regulated Electric, Natural Gas and Water Utilities Financial Risk Rating

PRIMARY FRR METRICS

Regulated Electric, Natural Gas and Water Utilities – Primary FRR Metrics

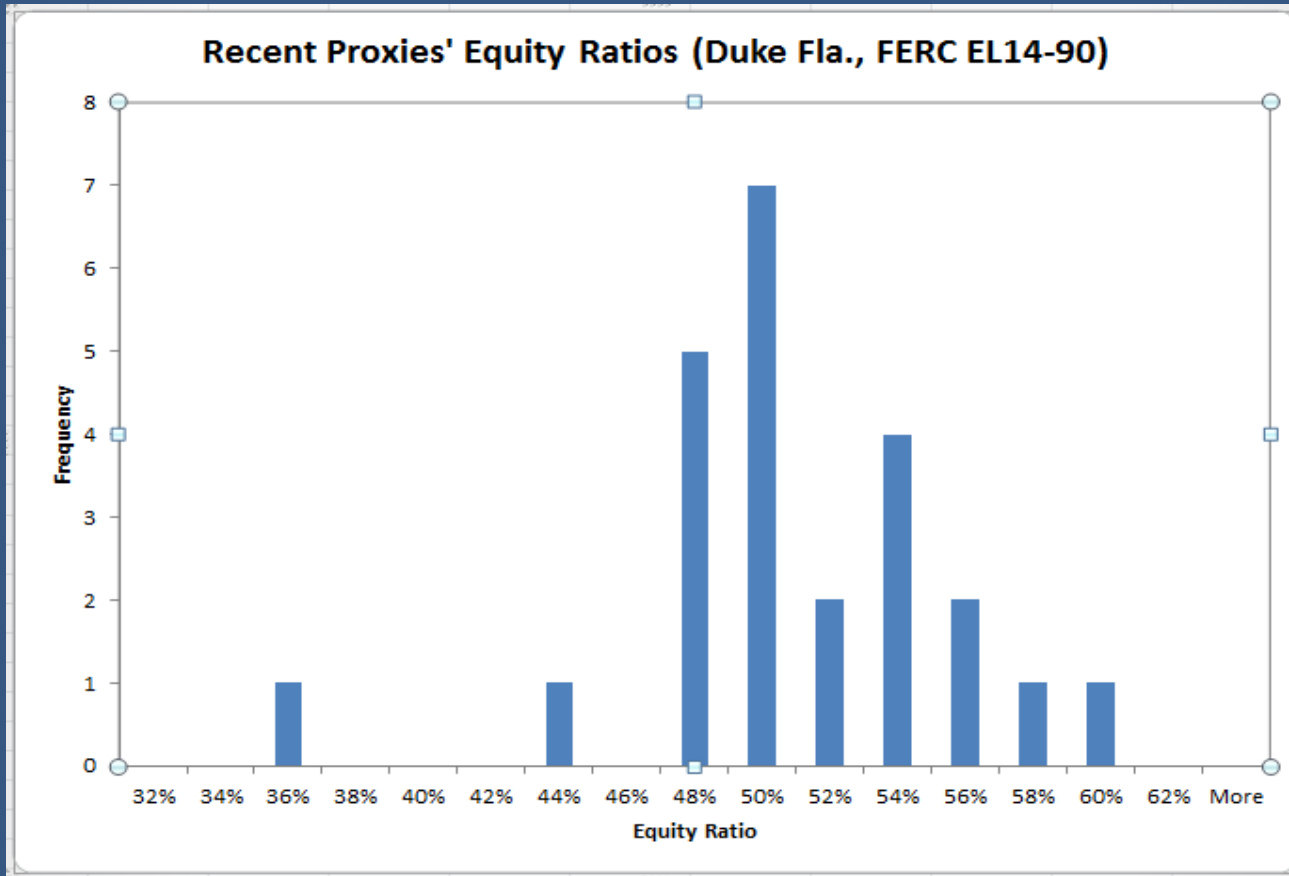
Primary Metric	AA	A	BBB	BB/B
Cash flow-to-debt	> 17.5%	12.5% to 17.5%	10% to 12.5%	< 10%
Debt-to-capital	< 55%	55% to 65%	65% to 75%	> 75%
EBIT-to-interest	> 2.8x	1.8x to 2.8x	1.5x to 1.8x	< 1.5x

“Most Leveraged Proxy” Standard

- “The publicly traded proxy companies are chosen because they are comparable to the applicant pipeline. ... [B]ecause their capital structures are market driven, they are presumed to be reasonable.”

Transcontinental Gas Pipe Line Corp., 80 FERC ¶61,157 (1995).

Proxy Ratios Range Widely





If the subsidiary has far more equity than rating agencies find adequate for its bond rating and business risk, and debt costs $<$ cost of equity, isn't it obvious that the parent is limiting subsidiary debt issuance?



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