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Testimony of MPSC Commissioner Rachael Eubanks

Before the

House Energy Policy Committee

Representative Gary Glenn, Chairman

Presented

March 20, 2018

Good morning Chairman Glenn, Vice Chair Hauck, Vice Chair Lasinski, and members of the Committee. My name is Rachael Eubanks, and I am a Public Service Commissioner. Thank you for the opportunity to speak with you today regarding return on equity. As you consider this important issue and the impacts it has on Michigan's ratepayers, I wanted to take a moment to share with you a "commissioner's perspective" and some of the considerations that my fellow commissioners and I – along with commissioners through the decades and across the country – study as we look to set return on equity in each rate case that comes before us.

I'd also like to serve as a resource for you as you study this issue. I've been on the Commission since 2016, and in my previous career I served as financial advisor to four State Treasurers over the course of 10 years. In my past role I participated in over $20 billion of financing for public projects in Michigan on behalf of the State during a particularly turbulent period. This gives me a unique background and perspective that I hope can be used to assist you as you evaluate financial issues.

As I begin, please know that I'm happy to answer any questions you may have regarding financial fundamentals, return on equity, or the commission process to help you gain a better understanding of this very complex issue. However, because there are several rate cases pending before the Commission, and because authorized return on equity is one of the most contested issues of any rate case, it is not appropriate for me to answer questions on the specifics of Commission decisions relating to determining return on equity.

Ok, disclaimer delivered.

It is fitting that I am speaking to you as you are in the process of hearing testimony on this issue from various parties, each with unique perspectives and positions. You (have seen/will see) firsthand how different their perspectives are and how contentious the discussion can be. This puts us in a very similar position – you get to hear all the arguments from both sides, usually quite some distance apart in tremendously technical language, and through all of that you have to weed out what approach sounds the most fair and reasonable and in the public interest.

I'm going to talk today about three main issues: First, what is authorized return on equity? Second, how is authorized return on equity determined? Third, how does return on equity impact ratepayers?

What is "authorized return on equity?" First, let's define "return on equity" or ROE. ROE is a measure of how much profit a company generates with the money shareholders have invested. It is calculated as the amount of net income returned as a percentage of shareholders equity, or stock.

In utility finance, we deal with two ROEs. The first is "authorized ROE" which is used in the ratemaking process and the second is "earned ROE" which is a measure of actual performance. Authorized ROE is a determination of what a prudently managed, similarly situated utility could expect to earn and is determined looking into the future. Earned ROE is a measure of how the utility actually performs. Authorized ROE and earned ROE are rarely the same.

Our staff has tracked historic authorized and earned ROE for Consumers Energy, Consumers Gas, DTE Electric, and DTE Gas going back to 2006.[1] Many years, there is a significant variation between the two. There are years where the utility companies earn more than their authorized ROE, but there are also years where they have earned less than their authorized ROE. Just because a projected ROE is built into rates does not mean the company and their shareholders will automatically see this return – they still have to do the work.

Of course, other factors outside the utility's control can also move the earned ROE in either direction. For instance, unforeseen expenses, such as storms that cause severe damage, can negatively impact these earnings. Additionally, under Michigan's statutorily established energy efficiency, now energy waste reduction, programs, the utilities receive Energy Waste Reduction incentive payments which has impacted earned ROE. Our most recent analysis of the impact of these incentive payments on earned ROE ranges from 0% to .3% or 30 basis points. I've included this analysis for you with the copy of my written testimony.[2]

You'll notice on this chart that Indiana Michigan Power and SEMCo are listed. That brings up another important point: Issues of authorized ROE don't impact only Consumers and DTE, they impact <u>all</u> of Michigan's rate regulated utilities: Indiana Michigan Power, UPPCo, UMERC, Alpena Power, Xcel, and the others, which makes determination of authorized ROE a very case specific determination as the authorized ROE that is fair and reasonable for Consumers may not necessarily be fair and reasonable for UMERC.

Which leads to my next point, how is authorized ROE determined?

Let's look first at the legal standards governing authorized ROE. These standards have been in place for decades and have been litigated through the court system on several occasions. Fundamentally,

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[1] Table of Authorized v. Earned Return on Equity and Corresponding Bond Ratings for Consumers Electric, DTE Electric, Consumers Gas, and DTE Gas

[2] Impact of Energy Waste Reduction Incentive Payments on Earned ROE

the question boils down to whether an authorized ROE is fair and reasonable. In determining this standard, the United States Supreme Court in the landmark Hope and Bluefield cases[3] has ruled that consideration should be given to both investors and ratepayers. A utility is entitled to earn a return similar to those enterprises having corresponding risk, but that return should not be so high as to place an unnecessary burden on ratepayers. Additionally, the earnings of a utility should be sufficient to ensure investor confidence in the financial soundness of the enterprise, as well as to support its credit and raise capital. The Return on Equity should also reflect economic and financial market conditions.

Authorized Return on Equity is a piece of the ratemaking formula, but it is a significant and contentious issue in any rate case encompassing many expert witnesses, numerous financial analyses, and hours of cross-examination.

The various parties to the case begin by selecting a group of utility companies from across the country to use as comparisons to the utility company in the rate case. This group is known as the "proxy group." Each party selects their own proxy group based on its view on similarities to the utility. They look at attributes such as generation capacity, property plans and equipment values, common stock dividends, and credit ratings in an attempt to achieve a proxy group that closely resembles the Michigan utility. Developing the proxy groups is a critical part of the analysis because if a peer utility is too big or small, or more or less financially healthy, that means they have a different set of realities that change how willing investors are to extend capital to that utility. However, the end result is typically a subset of utilities from across the country that are similarly situated as a starting point for comparison.

Once a party has established their proxy group, a variety of financial analyses are performed. The most common types of analysis look at Discounted Cash Flow, Capital Asset Pricing, Risk Premium, or Risk Factors. Once completed, these analyses provide a range of potential Returns on Equity from which each party picks their recommendation. Issues relating to the appropriate analysis and inclusion or exclusion of specific companies from the proxy groups are all issues of significant focus during the cross exam and rebuttal portions of the rate case.

Factors outside of modeling results are also included as part of the comparison. This goes back to the landmark Supreme Court cases: what is fair or reasonable "is not subject to mathematical computation with scientific exactitude but depends upon a comprehensive examination of all factors involved, having in mind the objective sought to be attained in its use."[4] This concept of "all factors" is very open ended, and can include things like the national economy, Michigan's economy and its relation to the national economy, the economy of the service territory of the utility, geo-political factors, whether the utility is in an expansionary capital cycle, etcetera. Something to highlight here is that the Michigan economy and the economy of the utility's service territory do not necessarily move in the same direction, or in similar magnitude as the national economy.

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[3] See Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia, 262 US 679; 43 S Ct 675; 67 L Ed 1176 (1923); Federal Power Commission v. Hope Natural Gas Co., 320 US 591; 64 S Ct 281; 88 L Ed 333 (1944).

[4] *Township of Meridian v. City of East Lansing*, 342 Mich 734, 749; 71 NW2d 234 (1955).

The entirety of this record and evidence is considered by the commissioners as we look to set an authorized ROE that is fair and reasonable for both Michigan ratepayers and the utility shareholders.

Authorized Return on Equity is not just an issue given serious consideration in the regulatory process, but it is an issue of tremendous impact in the day-to-day operations of the utilities – and these impacts directly impact Michigan ratepayers. Which leads to my final point: the impact of Return on Equity on Michigan ratepayers.

Authorized Return on Equity impacts the overall financial health of the utilities and this directly impacts ratepayers.

The Commission has stated in its orders that in setting the Authorized ROE it strives to achieve an optimized result in order to best benefit ratepayers. This does not necessarily mean a lower ROE. This may seem counterintuitive at first glance. But a financially unhealthy utility is not in the best interest of ratepayers. The utility industry is one of the most capital intensive industries, and each utility's access to capital, its ability to invest and reinvest in its business, and the services it provides, are critically important to serving its customers.

A utility's financial health should be viewed holistically as both equity and debt are impacted by one another and are interrelated. Generally, a rule of thumb is about half of a utility's capital structure is debt, and the other half equity; together this encompasses the overall cost of capital. The credit rating agencies, who do not invest in the utility, but assign credit scores for investors to use, consider ROE as part of their analysis. They are the Experian or Equifax for corporate and public issuers who inform the credit card company what interest rate to charge you, not the credit card itself. The scores the rating agencies assign factor heavily into the cost of debt. The rating agencies are fairly transparent in how they rate all debt issuers and publish the analysis that explains what goes into the ratings. IN the case of ratings determined by Moody's Investor Service, 25% of a regulated utility's ratings are determined by its ability to recover costs and earn returns. In Moody's Investor Service's 2017 Rating Methodology for Regulated Electric and Gas Utilities, Moody's details "Why it Matters" in its introductory sentence explaining that, "This rating factor examines the ability of a utility to recover its costs and earn a return over a period of time, including during differing market and economic conditions."[5] This is a debt rating agency discussing the importance of returns. If you were to review a Moody's report for utilities with ratings in Michigan, you will find that the ROE is explicitly mentioned repeatedly in how the rating was determined. This is because it impacts the overall financial health of the utility, which in turn, impacts how likely it will be to repay its debt. In other words, ROE does have a direct impact on debt costs.

One last point on credit ratings. The utilities have what looks like a potpourri of ratings, for the Holding Company, for the Operating Company, and even within that, ratings for secured, unsecured, senior and junior lien debt. The rating agencies also provide information on how each rating relates to one another. The regulated utilities' ratings in Michigan, which are supported directly by ratepayer dollars,

[5] Regulated Electric and Gas Utilities Rating Methodology, Moody's Investor Service, Revised June 23, 2017, Pg. 12.

are higher because of the fair and reasonable regulatory environment in which they operate. This directly translates to ratepayer benefit.

We've talked a lot of theory here and I'm sure what's on your minds is, "what does this all mean in the real world?"

I mentioned at the beginning of my testimony that I worked on $20+ billion of financings on behalf of the State. You may be wondering what some of those are. Well, we are sitting in one here today as we speak. This building, the Anderson House Office Building, has been refinanced twice since it was built, the first time in early 2008. When the decision was made to move forward with the refinancing we had no idea we were already headed down the road toward an unprecedented national financial crisis, capital was going to become hard, if not impossible, to come by, and Michigan was going to be hit particularly hard. But in the winter of 2008, we were blissfully unaware of this impending tidal wave as we readied this bond issue for market.

Now, when you access the market, there is weeks or months of preparing documents, procuring credit ratings, and consulting table after table of economic indicators, sales calendars and your crystal ball to try to guess the exact day that capital is least expensive – and this is all done before anything actually happens. However, no matter how much you prepare and try to guess the future, the success of an offering is ultimately determined over the course of a couple of hours when you go out into the market to take orders. Some days, those couple of hours go well and investors are clamoring. Other days, it goes less well, and you're doing whatever you can to get the proceeds you need. The day we were selling the bonds for this building, no investor was interested. Capital had disappeared from the market essentially overnight, yet walking away from the sale altogether was not an option. It had to get done. So how did we do it? We added return for investors and an insurance policy, which also came at an additional cost. Then we went out to the market again a few weeks later and scraped together enough investor interest to get all the proceeds we needed. None of the increases in costs were part of the original plan, but in a difficult market, it was still very much a success. And you got some new elevators out of it too.

I am grateful that those days are behind us and as stressful as the economic downturn was for us in the financial world, I learned a lot, albeit the hard way. It's easier to know what you'll need to access capital during the good times, when markets move predictably and investor dollars are plentiful. As we learned in 2008 though, this isn't always the case and adjusting to market fluctuations is absolutely vital in the finance world. This is what the commission attempts to do in each rate case and with every authorized ROE. We look at the evidence, review the testimony and analyses, we run the numbers, we peer into our crystal balls and we try to divine what is going to be needed to respond to the market. It's not an easy task, one that considers both quantitative and qualitative factors, but the task is worth doing because it is of absolute necessity and tremendous impact.

Again, thank you Mr. Chairman for the opportunity to testify on this important issue. I'm happy to address any questions.

Financial Incentive Awards

Program Year	Consumers Energy Electric	Consumers Energy Gas	DTE Energy - Electric	DTE Energy - Gas	Indiana Michigan Power Co.	Semco Energy Inc.	Annual Total
2009	$3,323,612	$2,361,693	$3,008,829	$913,374	n/a	n/a	$9,607,508
2010	$5,076,731	$3,407,064	$6,200,000	$2,400,000	n/a	n/a	$17,083,795
2011	$7,281,670	$7,312,307	$8,400,000	$3,400,000	n/a	n/a	$26,393,977
2012	$10,027,210	$7,282,721	$10,400,000	$4,300,000	n/a	n/a	$32,009,931
2013	$10,364,556	$7,166,544	$10,562,411	$3,848,020	n/a	n/a	$31,941,531
2014	$11,231,840	$6,090,390	$12,716,895	$3,617,094	$618,074	$780,795	$35,055,088
2015	$11,426,037	$6,277,944	$13,100,000	$3,600,000	$759,727	$933,725	$36,097,433
2016	$11,582,390	$6,640,135	$13,300,000	$3,700,000	$579,101	$1,197,815	$36,999,441
Total	$70,314,046	$46,538,798	$77,688,135	$25,778,488	$1,956,902	$2,912,335	$225,188,704

Line	Description*	Consumers Electric	Consumers Gas	Consumers Total	DTE Electric	DTE Gas	DTE Combined	I&M	SEMCO
1	Net Income	458,000,000	155,000,000	613,000,000	622,000,000	138,000,000	760,000,000	239,900,000	24,259,000
2	Proprietary Capital			5,940,345,542	5,996,581,141	1,212,789,896	5,996,581,141	2,151,747,058	267,454,885
3	ROE			10.3%	10.4%	11.4%	12.7%	11.1%	9.1%
4	Net Income			613,000,000	622,000,000	138,000,000	760,000,000	239,900,000	24,259,000
5	Financial Incentive Awarded	11,582,390	6,640,135	18,222,525	13,300,000	3,700,000	17,000,000	579,101	1,197,815
	FIT Rate			35%	35%	35%	35%	35%	35%
	Financial Incentive after tax			11,844,641	8,645,000	2,405,000	11,050,000	376,416	778,580
6	Net Income w/ incentive removed			601,155,359	613,355,000	135,595,000	748,950,000	239,523,584	23,480,420
7	ROE w/o incentives			10.1%	10.2%	11.2%	12.5%	11.1%	8.8%
8	ROE			10.3%	10.4%	11.4%	12.7%	11.1%	9.1%
9	ROE without incentives			10.1%	10.2%	11.2%	12.5%	11.1%	8.8%
10	ROE increase due to financial incentives			0.2%	0.1%	0.2%	0.2%	0.0%	0.3%

*Source is P-521 2016

*Financial Incentive Dollar Awards Chart from Poli/Gould