Date Filed: November 02, 2026

Witness: Ann Bulkley
Request from: Public Utilities Regulatory Authority

Question:

(ROE-PROXY GROUP) Bulkley Pre-Filed Test., pp. 32–37. What are the economic conditions that would lead the Company to conclude more weight should be afforded to Capital Asset Pricing Model (CAPM)- based methods? Explain.

Response:

As discussed in the Company's response to RRU-130[i], given the inverse relationship between interest rates and utility share prices, the DCF model will likely understate the cost of equity during the forward-looking rate period when interest rates are expected to increase because the DCF model relies on historical share prices.

However, the CAPM can be estimated using projected interest rates as the estimate of the risk-free rate and therefore, will produce an estimate of the cost of equity that better reflects expected market conditions in an increasing interest rate environment.

Given the effect that market conditions can have on each model, certain jurisdictions have broadened dependence on multiple models including the Federal Energy Regulatory Commission, and the state utility regulatory commissions in Minnesota, Michigan, Iowa, Washington, New Jersey and Pennsylvania. Specifically, Ms. Bulkley is aware that the Pennsylvania Public Utility Commission has recently concluded that the capital market conditions of high inflation and increasing interest rates has resulted in the DCF model understating the utility cost of equity, and that weight should be placed on risk premium models, such as the CAPM, in the determination of the ROE (see, Penn. Pub. Util. Comm'n et.al. v, Aqua Penn. Wastewater Inc., Pennsylvania Public Utility Commission, Docket Nos. R-2021-3027385 and R-2021-3027386, Opinion and Order, May 12, 2022). See also Penn. Pub. Util. Comm'n et.al. v, Columbia Water., Pennsylvania Public Utility Commission, Docket Nos. R-2023-3040258, Opinion and Order, January 18, 2024).

Prior Referenced Response:

[i] RRU-130 Question:

(ROE-DCF) Bulkley Pre-Filed Test., pp. 24–32. Is there a time period during which the Company believes the constant growth discounted cash flow (DCF) model loses its reliability? Provide the time period and market circumstances.

RRU-130 Response:

Ms. Bulkley has not conducted a time series analysis of the DCF results. However, interest rates and utility share prices are inversely correlated, which means that increases in interest rates result in declines in the share prices of utilities and vice versa. For example, in an increasing interest rate environment, the utility sector would be expected to underperform the broader market with a likely decrease in the share prices of utilities occurring. Consequently, in an increasing interest rate environment, the DCF model, which relies on historical stock prices, will likely understate the cost of equity as utility stock prices decline and their dividend yields increase.