

Chapter 15 — Cost of Capital Applications and Comparable Groups

to dividend suspensions or reductions, insufficient or unrepresentative historical data due to recent mergers, divestitures, impending mergers or acquisitions, and changing corporate identities due to restructuring activities. Many electric utilities became part of larger corporate entities, or divested their generation assets. Several of the utility companies' bonds were downgraded or put on credit watch or negative outlook by the bond rating agencies. Under such circumstances of instability, a superior approach was, and continues to be, to apply cost of capital estimation techniques to a large group of electric utilities representative of the electric utility industry and then make adjustments to account for any difference in investment risk between the subject utility and the industry average.

Examples of Direct Approach

The following are illustrative examples of forming narrowly-focused comparable risk proxy groups. Many variations and refinements are possible, and these examples are suggestive and illustrative of the general procedure.

Example 1: The subject utility is a natural gas distribution company that is a wholly owned subsidiary of a parent company. As proxies for the subject utility's beta in a CAPM analysis, the betas of both the parent company and the betas of a sample of publicly traded natural gas distribution utilities can be examined, provided that the parent company is involved primarily in natural gas distribution activities. In order to minimize the well-known thin trading bias in measuring beta, it is reasonable to limit the sample to companies whose market capitalization exceeds a minimum capitalization threshold, say \$1,000 million.³ The average beta of investment-grade combination electric and gas utilities covered by Value Line provides a third proxy for the subject utility's beta.⁴ This procedure is reasonable given that the natural gas distribution business possesses an investment risk profile that is similar in risk to that of investment-grade combination electric and gas utilities. The latter possess economic characteristics similar to those of natural gas distribution utilities as they are both involved in the distribution of energy services products at regulated rates in a cyclical and weather-sensitive market. They both employ a capital-intensive network with similar physical characteristics. They are both subject to rate of return regulation. The CAPM, Risk Premium, and DCF methods are applied to the three proxies excluding inactively traded, non-dividend paying companies, and companies below investment-grade in the DCF analyses.

3. The thin trading bias occurs because observed returns contain stale information about past period returns rather than current period returns. Intuitively, suppose the stock market index surges forward but an individual company stock price remains unchanged due to lack of trading, the estimated beta is imparted a downward bias. The stock is unable to catch up to marketwide movements and appears to be a lower beta stock. Adjustment for the thin trading effect increases the beta estimate.

4. The group consists of utilities designated as "combination electric and gas" utilities by S&P in a comprehensive analysis of utility business risks. The original group includes gas, electricity, and natural gas distribution operating companies engaged in predominantly monopolistic distribution activities. Companies below investment-grade, that is, companies with a bond rating below Baa3, are eliminated as well as those companies without Value Line coverage. The final sample of companies is made up of the parent companies of these investment-grade electric and gas utility companies.