Principles of Public Utility Rates

Second Edition

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the literature with some commissions totally disregarding the new issue to those that apply an adjustment to the entire equity balance.

The Market to Book Ratio Issue

Introduction. One ongoing critical issue is whether the allowed rate of return should be designed to prevent the market prices of public utility stocks from rising to substantially above book value or falling to substantially below book value? A rigorous and literal application of a cost-of-capital-measure of a fair rate of return as outlined above would indicate that a commission should attempt to regulate rates so as to maintain the market value of a utility's stock on a par with its book value (or rate-base value) plus some allowance for underpricing. Yet such an attempt may be impractical or even impossible.

In the first place, commissions cannot forecast, except within wide limits, the effect their rate orders will have on the market prices of the stocks of the companies they regulate. In the second place, whatever the initial market prices may be, they are sure to change not only with the changing prospects for earnings, but with the changing outlook of an inherently volatile stock market. In short, market prices are beyond the control, though not beyond the influence, of rate regulation. Moreover, even if a commission did possess the power of control, any attempt to exercise it in the manner just suggested would result in harmful, uneconomic shifts in public utility rate levels. In addition, many utilities are regulated by more than one jurisdiction. Even if one commission were to attempt to regulate on the basis of market to book ratios, the commissions in the other jurisdictions would not be bound by its actions. Finally, even if regulators could put them in parity it may be undesirable following the theory of the second best if the comparable earnings exceed the cost of capital (see Kahn, 1970, pp. 52-53).

Two Facts. This situation is recognized even by supporters of a cost-of-capital standard of a fair rate of return, who undertake to meet the difficulty in two ways. First, the current cost of equity capital is rarely identified as a spot cost. Instead, it is taken to mean a normal or average capital-attracting rate of return characteristic of the recent market and typical of the market anticipated in the not distant future. Secondly, the estimated weighted average cost of capital resulting from the application of this normalized estimate of the current cost of equity may be characterized as a minimum allowance, subject to a