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## PUBLIC SERVICE COMMISSION

Chair Marc Korman  
Environment and Transportation Committee  
250 Taylor House Office Building  
Annapolis, MD 21401

### **RE: HB 981 - Information - Investor-Owned Public Service Companies - Base Rate Proceeding - Equity Market Return**

Dear Chair Korman and Committee Members:

The Public Service Commission (the “Commission”) appreciates the opportunity to provide this informational testimony for HB 981. The bill requires the Commission to calculate a 10-year United States equity market return using multiple objective sources, and allows the Commission to adjust utility rates based on the utility’s risk compared to the calculated market return. The purpose of this testimony is to describe the Commission’s current process for evaluating appropriate rates of return for utilities and outline possible impacts this legislation may have on the ratemaking process.

In a rate case, the Commission must establish rates that allow a utility the opportunity to achieve a fair rate of return (ROR), which is a weighted average of the utility’s cost of debt and equity. A utility’s cost of equity, or its return on equity (ROE), is based on investor expectation of potential earnings for their investment. The Commission must determine a fair ROE based on established legal standards, and ROE must be re-examined in each rate case based on current market expectations. The legal standards for a fair ROE dictate that it must be: a) comparable to returns investors expect to earn on investments of similar risk; b) sufficient to assure confidence in the company’s financial integrity; and c) adequate to maintain and support the company’s credit and to attract capital.<sup>1</sup>

In its determination, during the rate case the Commission considers various financial models that incorporate multiple inputs to estimate the value of an investment. One of the more commonly-used models is called the Capital Asset Pricing Model (CAPM), which calculates expected return by comparing an asset’s risk to market risk. CAPM includes an equity market return as one of several inputs.<sup>2</sup>

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<sup>1</sup> *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm’n of W. Va.*, 262 U.S. 679,692-693 (1923); *Fed. Power Comm’n v. Hope Nat. Gas Co.*, 320 U.S. 591, 603 (1944). See also Commission Order No. 88432, Case No. 9443 (2017) at 97.

<sup>2</sup> There are other models used that do not include the US equity market return as an input. The discounted cash flow model, for example, estimates the value of an investment using its expected future performance, accounting for the time value of money.

When equity market return is used as an input for a financial model in a rate case, expert witnesses for most parties—including the utility, Commission Technical Staff, and Office of People's Counsel—can calculate it using several data sources. These include market returns over time, surveys of investors, paid or free sources from financial firms, and the witness's own calculations based on financial information available about companies in the equity markets. Accordingly, expert testimony related to ROE in a rate case allows the Commission to consider multiple objective sources for equity market return as well as each expert's professional opinion as to the most appropriate formulation.

Parties to a rate case do not often file legal challenges to the Commission's rate of return determination. When they do, courts give the Commission's findings considerable deference because of the legal standard of review and the breadth of the evidentiary record contemplated by the Commission.<sup>3</sup> The equity market return is currently just one of many factors in that evidentiary record. Operationally, this proposed legislation could be seen as restricting the Commission's consideration of financial models that are not predicated upon the 10-year US market equity return, which may deprive the Commission of the use of other appropriate and important tools it currently uses to evaluate ROE.

Should the Committee be inclined to give this bill a favorable report, the Commission would respectfully recommend the following amendments to ensure it does not limit the Commission's ability to establish a fair ROE: (a) remove descriptors of the equity market return including "United States" and "10-year"; (b) remove the "objective" qualification, as it is unclear what this accomplishes and the multiple approaches for arriving at an equity market return are generally known; (c) remove provision 4-206.2(c), as it could limit the Commission from considering other models that do not rely upon an equity market return when developing ROE; and (d) in the interest of equitable application, specify that these requirements apply to all base rate proceedings for investor owned utilities before the Commission and not just those for investor owned electric and gas companies.

Please contact Niki Wiggins, Director of Legislative Affairs, at [irene.wiggins3@maryland.gov](mailto:irene.wiggins3@maryland.gov) if you have any questions related to this informational testimony.

(signature to follow)  
Sincerely,

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<sup>3</sup> See e.g. *Md. Off. of People's Counsel v. Md. Pub. Serv. Comm'n*, 226 Md. App. 176, 180 (2015), which is the most recent instance of a party filing an appeal of the Commission's determination of ROE. The Maryland Court of Appeals ultimately rejected a challenge by Pepco that the Commission's decision to approve an ROE of 9.36%--when Pepco requested 10.25%--was erroneous. The court found substantial evidence in the record to support the Commission's decision.

A handwritten signature in blue ink, appearing to read 'Kumar', with a stylized flourish extending to the right.

Kumar P. Barve  
Chair, Maryland Public Service Commission