

which determined: (1) The average cost of common equity for the jurisdictional operations of public utilities for the year ending June 30, 1985 (hereafter the "base year"); (2) the average "ratemaking rate of return"² on common equity for the jurisdictional operations of public utilities for the base year; and (3) a quarterly indexing procedure to update the cost estimate and establish benchmark rates of return on common equity for use in individual rated cases.³ Order No. 442 was the second annual proceeding for evaluating the rate of return issue on a generic basis.⁴ The benchmark rates of return established are advisory only. As provided in § 37.7 of the Commission's regulations, the third proceeding will determine a rate of return on equity that will constitute a rebuttable presumption in rate cases.

In Order No. 442, the Commission decided to adopt a procedure for determining and updating the benchmark rate of return that was different in three respects from the procedure used in the first annual proceeding:

(1) It used a formulation of the Discounted Cash Flow (DCF) model that was somewhat different from the one that the Commission adopted in the last proceeding and proposed in the NOPR, in an effort to reflect more accurately the timing and growth of quarterly dividend payments and to recognize a relationship between nominal and effective required rates of return;

(2) It adjusted the average effective cost of common equity determined by the new DCF model to reflect certain ratemaking practices of this Commission and obtain what was referred to as the "ratemaking rate of return" to be used as the basis for the quarterly benchmark rates of return; and

(3) It used the most recent two calendar quarters of data on dividend yields as the basis for updating the benchmark rate of return; in contrast, the NOPR proposed to use only the most recent quarter's dividend yields.

Five of the commenters have requested rehearing of the order: (1) A group of utilities made up of Boston Edison Company, El Paso Electric Company, Florida Power Corporation, Montaup Electric Company, and Wisconsin Electric Power Company (hereinafter referred to as "BEC"); (2) Edison Electric Institute (EEI); (3) New England Power Company (NEP); (4) the Southern Company; and (5) the Wholesale Customer Group (WCC).

² As discussed in greater detail below, this term has been used to refer to the rate of return on common equity that, when applied to rate base, will give investors the opportunity to receive the required rate of return on common equity and give firms the opportunity to recover flotation costs.

³ Order No. 442, 51 FR 343 (1986).

⁴ Order No. 420, 50 FR 21,802 (1985).

BEC, EEI, NEP, and the Southern Company object to the "ratemaking rate of return" concept as implemented in the final rule. The Southern Company also reiterates positions previously expressed in its comments regarding growth rate, flotation cost, and the quarterly indexing procedure. In addition, the WCC objects to the equity accretion component of the growth rate.

III. Summary and Analysis of Issues Raised in Requests for Rehearing

A. Growth Rate and Indexing Procedure

As noted, the Southern Company has restated earlier arguments regarding the Commission's treatment of growth rate and has argued in favor of a "total recalculation of the generic [rate] using data as of the end of each quarter for the price and dividend figures." The rehearing request presents nothing new that would cause the Commission to reconsider the prior disposition of these issues. Because the Southern Company's position was considered and addressed in the original order, its request for rehearing on these issues will be denied.

B. Flotation Cost Adjustment

The Southern Company also repeats its recommendations that the flotation cost adjustment should include the effects of market pressure and be applied to total equity capital. However, the Southern Company makes one additional point in support of its recommendation that the adjustment be applied to all equity. It notes that the Commission requires that the expenses associated with issuance and sale of stock be included in Account No. 214 and that there is no provision for the separate recovery of expenses included in Account No. 214 as part of a utility's cost of service. Therefore, according to the Southern Company, this treatment of flotation costs results in a permanent reduction in common equity so that the flotation cost adjustment should be applied to all equity.

It is correct that flotation costs are not recovered as part of the company's cost of service; rather, they are considered part of the cost of common equity and recovered through the company's allowed rate of return. The issue here is not *whether* those costs should be recovered through the company's allowed rate of return; the issue is *how* an adjustment for such recovery should be made. The Southern Company does not explain why it believes the fact that such costs are not recovered as part of the company's cost of service supports its position regarding how those costs should be recovered through the company's allowed rate of return. The

method used to allow for the recovery of flotation costs through the allowed rate of return was explained in Order No. 442. No reason has been shown why the Commission's prior disposition of this issue should be changed. The Southern Company's request for rehearing regarding the flotation cost adjustment will therefore be denied.

C. Equity Accretion

WCC challenges the Commission's use of a 1.13 average market-to-book ratio to increase the growth rate used in the fundamental analysis from 4.5% to 4.7% to account for "equity accretion." Equity accretion (or conversely, dilution) occurs when a company issues new stock at a price above (or below) book value per share. Its contribution to the growth rate of book value is equal to the product of one factor which reflects the annual rate of new stock issuance ("s") and another factor which reflects whether and to what extent the company's stock is selling above or below book value ("v"). If the company's stock is selling above book value, "v" is positive; if it is selling below book value, "v" is negative. If the stock is issued at book value, "v" is zero and "sv" is zero. Thus, if the stock is selling above book value and "s" is assumed to be greater than zero, "sv" is positive and there is accretion; if it is selling below book value, "sv" is negative and there is dilution. WCC also contends that because accretion only occurs when net proceeds from a stock issuance exceed book value, the full flotation cost percentage should be deducted from the market-to-book ratio for purposes of computing "sv" in the external growth analysis.

WCC contends that the Commission erred in its earlier disposition of WCC's argument by citing to an argument not in fact made by any other commenter. The Commission, in responding to WCC, had cited BEC as rebutting WCC's suggestion that the "sv" component of the fundamental analysis should be negative.⁵ WCC claims that this was in error because BEC only suggested that the median rather than the mean average market-to-book ratios should be used. WCC argues that nothing in any of the comments or in Order No. 442 refutes its argument.

The Commission agrees that it misstated the contention of BEC in response to WCC on this point. Upon further consideration, however, the Commission finds that WCC's position does not warrant rehearing regarding

⁵ Order No. 442, 51 FR 343 at footnote 107.