

Issues and Answers:

Should a Regulated Public Utility be an Investment Haven?

It has long been counted proven wisdom among financial advisors that “*In troubled times, invest in utilities.*” John Waggoner, personal financial columnist for USA Today, identified two reasons for this advice¹:

(1) Even in hard times, people trust in utilities because we all still need electricity, water, gas, phones, etc.; and

(2) Many utilities are regulated monopolies where allowed returns are set by a board or commission of the state. The permitted return on equity (or “*ROE*” - currently averaging around 10%) is not what investment advisors call “a wild growth opportunity.” But it is a return in line with other low-risk investments like tax-free bonds or large capital stocks.

Utility regulators have known at least since 1962² that there is a risk to maintaining this level of return on equity during times when interest rates, stock and bond returns are sluggish. Named for the researchers who first described this perverse incentive, it is called the Averch-Johnson Effect.

In a recent presentation before the National Association of Regulatory Utility Commissioners (NARUC), David M. Boonin,

“The **Averch–Johnson effect** is the tendency of companies to engage in excessive amounts of capital accumulation in order to expand the volume of their profits. If companies’ profits-to-capital ratio is regulated at a certain percentage then there is a strong incentive for companies to over-invest in order to increase profits overall. This goes against any optimal efficiency point for capital that the company may have calculated as higher profit is almost always desired over and above efficiency.”³

¹ John Waggoner, Personal Finance Columnist, “Utility Stocks a Good Bet in Troubled Times,” *USA Today*, 8/27/06

http://www.usatoday.com/money/perfi/columnist/waggon/2006-08-24-invest_x.htm

² Averch, Harvey; Johnson, Leland L. (1962). “Behavior of the Firm Under Regulatory Constraint”. *American Economic Review* 52 (5): 1052–1069.

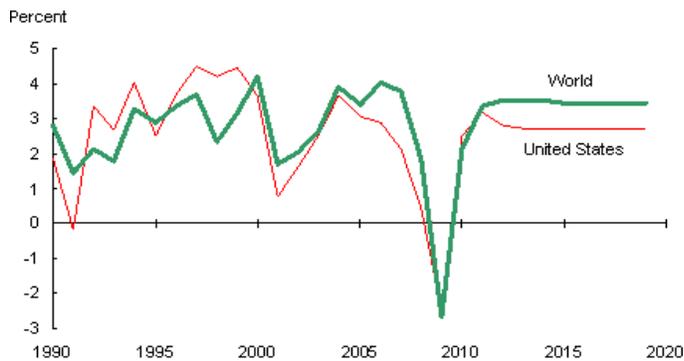
³ http://en.wikipedia.org/wiki/Averch%E2%80%93Johnson_effect

an economist with three decades experience in public utility regulation, testified that among the results of the Averch-Johnson effect is a **“tendency to over-invest in rate base.”** According to Boonin, this accompanies **“rates that are too high,”** sufficient to **hamper the economy.**⁴

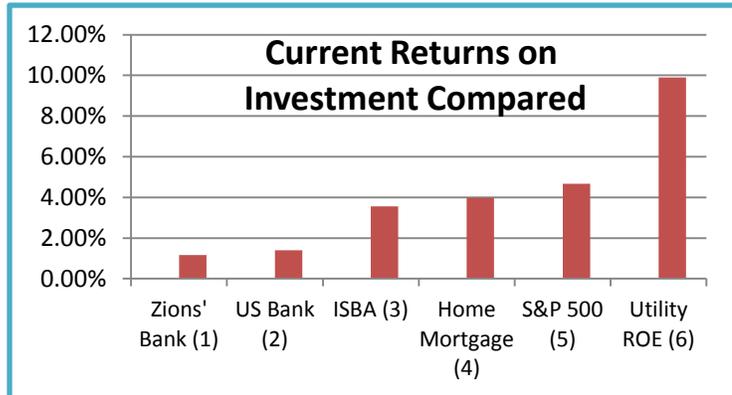
Today’s investment climate is exactly the one about which these experts warn. Utility returns on equity are well above most other returns available to medium-to-low risk money managers. (See chart ►)

Furthermore, sluggish economic growth is forecast to continue for several years into the future. These forecasts show U.S. gross domestic product growing at a modest 2.5% for the coming decade, a rate that will be below the world average.⁵

U.S. and world gross domestic product (GDP) growth



Source: *USDA Agricultural Projections to 2019*, February 2010. USDA, Economic Research Service.



- (1) APY on a 5-year “Internet IRA CD” as of 1/30/2012
- (2) APY on a 5-year CD with \$500 minimum as of 1/30/2012
- (3) CitiGroup est. yield on ISBA 20-year bond refinance 1/30/2012
- (4) National ave.30-yr fixed mortgage from Freddie Mac on 1/27/2012
- (5) YTD performance by price as of 1/27/2012
- (6) Recent IPUC allowed electric utility ROE

Integrated Resource Planning. It was, in part, to overcome the Averch-Johnson effect that Congress has increasingly encouraged utilities to create “integrated resource plans.”⁶ These plans outline anticipated investments, and, according to the law, “provide the opportunity for public participation and comment.” It was hoped that citizens could then, armed with advanced knowledge of planned investments, protect their rates from “investment haven driven” escalation.

The integrated resource planning process only works to the extent that the public is alerted to how planned investments will impact future rate increases.

⁴ David M. Boonin, NRRI, to NARUC Electricity Staff Subcommittee, NARUC Annual Convention, New Orleans, November 2008 <http://www.narucmeetings.org/Presentations/Return%20on%20Equity.pdf>

⁵ <http://www.ers.usda.gov/briefing/baseline/present2010.htm>

⁶ The Public Utility Regulatory Policies Act of 1978 (P.L. 95-617; 92 Stat. 3117; 16 U.S.C. 2601) as amended, section 111(d)(7).