Staff's Revenue Requirement Cost of Service Report
filed on December 5, 2014 in
Case No. ER-2014-0258

At Page 33 after line 10 – preceding line 11

c. The Multi-stage DCF

i. Overview

The constant-growth DCF model may not yield reliable results if industry and/or economic circumstances cause expected near-term growth rates to be inconsistent with sustainable perpetual growth rates.[1] Consequently, as in the last rate case, Staff again performed a multi-stage DCF analysis in this case and is relying primarily on this analysis to draw conclusions on the change in the cost of common equity since the last rate case because the multi-stage DCF is dynamic enough to consider changes in near-term growth rates, but still maintain a consistent perpetual growth rate as this rate should not change much, if any, because there have been no structural changes in the economy or industry to support it.

A multi-stage DCF may use either two or more growth stages, depending on the situation being modeled. In any case, the last stage must use a sustainable rate as it is considered to last into perpetuity. In fact, in Staff's experience, most DCF analyses do not assume a growth rate much higher than the expected rate of inflation, currently 2.0% to 2.5%. The ability of a multi-stage DCF analysis to reliably estimate the cost of common equity is primarily driven by the analyst using a reasonable growth rate for the final stage because this rate is assumed to last into perpetuity. Where three stages are used, the second stage is generally a transitional phase between the high growth first stage and the constant growth final stage.[2]

In the present case, Staff used a three-stage DCF approach, the stages being years 1-5, years 6-10, and years 11 to infinity.[3] For stage one, Staff gave full weight to the analysts' five-year EPS growth estimates. Staff adopts these EPS estimates for the first stage of its model,

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[1] Dr. Aswath Damodaran, Professor of Finance of the New York University Stern School of Business, advocates using a multi-stage methodology if the constant-growth rate is expected to be 1-2% different than the earlier stage growth rates. Aswath Damodaran, *Investment Valuation: Tools and techniques for determining the value of any asset,* University Edition, John Wiley & Sons, Inc., 1996, p. 193.

[2] John D. Stowe, Thomas R. Robinson, Jerald E. Pinto and Dennis W. McLeavey, *Analysis of Equity Investments: Valuation*, Association for Investment Management and Research, 2002, p. 71-72.

[3] In practice, Staff extended the third stage only to year 200.

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File No. ER-2014-0258

because Staff understands that these projections are designed to represent expectations over this same 5-year period. For stage two, Staff linearly reduced the growth rate from the stage one level to the constant-growth third stage level, in which Staff assumed a perpetual growth rate range of 3.00% to 4.00%; mid-point 3.50% (*see* Schedules 14-1 through 14-3). Based on this set of assumptions, Staff's estimated cost of equity for both the broad and refined proxy group ranges from approximately 7.60% to 8.40%, mid-point of 8.00%.