

Chapter 10

Flotation Cost Adjustment

This chapter demonstrates that an adjustment to the market-based cost of capital is necessary for flotation costs associated with the procurement of equity capital, and discusses the mechanics and controversies involved in applying this adjustment.

A typical utility is continuously issuing stock through its dividend reinvestment plan and employee stock option plan, and/or is selling new shares to the public on a regular basis in order to maintain its construction program and meet its mandated service requirements. The costs of issuing these securities are just as real as operating and maintenance expenses or costs incurred to build utility plants, and fair regulatory treatment must permit the recovery of these costs.

10.1 Flotation Cost Allowance

The simple fact of the matter is that common equity capital is not free. Flotation costs associated with common stock issues are very similar to the flotation costs associated with bonds and preferred stocks. Flotation costs are incurred, and if they are not expensed at the time of issue, they must be recovered through a rate of return adjustment. This is routinely done for bond and preferred stock issues by most regulatory commissions. To illustrate the conventional regulatory practice, consider this example. A utility company issues \$100 million of 10-year bonds at an interest rate of 5%. Flotation costs are 2% of the amount of the proceeds, \$2 million. The interest paid each year is \$100 million \times 5% = \$5 million. The flotation cost of \$2 million is amortized over the 10-year life of the bond, so that the amortization each year equals $\$2M/10 = \0.2 million. The cost of debt K_d is then:

$$K_d = \frac{\text{Interest} + \text{Amortization of flotation costs}}{\text{Principal} - \text{Unamortized flotation costs}}$$
$$= \frac{\$5,000,000 + \$200,000}{\$100,000,000 - \$2,000,000} = 5.31\%$$

The cost of debt needs to be increased by 31 basis points in order to allow for the recovery of flotation costs. The recovery process is very similar for common stock issues.

In the case of issues of new common equity, flotation costs represent the discounts that must be provided to place the new securities. Flotation costs have three major components:

(1) the direct component, which is the compensation to the security underwriter for his marketing/consulting services, for the risks involved in distributing the issue, and for any operating-administrative expenses associated with the issue (printing, legal, prospectus, registration, etc.). The direct component includes the "spread" and "other direct expenses." The "spread" consists of a direct fee paid by the issuer to the underwriter (a.k.a. investment banker). The fee is simply the difference between the price the issuer receives and the offer price, and is directly related to the number of shares issued since it is a per-share cost item. "Other direct expenses" include additional direct costs incurred by the issuer that are not part of the compensation to underwriters such as filing fees, legal fees, and taxes, and are reported on the issuing prospectus. These are largely fixed costs, independent of the issuing price.

(2) the indirect component, or market pressure, which represents the downward pressure on the stock price as a result of the increased supply of stock from the new issue, reflecting the basic economic fact that when the supply of securities is increased following a stock or bond issue, the price falls.¹ Indirect expenses also include the costs of management time spent working on the new issue. They are independent of the issuing price and are not reported on the prospectus.

(3) the potential market price decline related to external market variables; this is often referred to as the allowance for "market break."

To prevent the dilution of existing shareholders' investment resulting from these three factors, an amount must be added to the rate of return on common equity to obtain the final cost of equity financing. This incremental return is referred to as the "flotation cost allowance," and is the sum total of direct flotation expenses, market pressure, and market break.

To demonstrate the need for adjusting the market-determined return on equity for flotation costs, consider the following simple example. Shareholders invest \$100 of capital on which they expect to earn a return of 10%, or \$10, but the company nets \$95 because of issuance costs. It is obvious that the company will have to earn more than 10% (namely, 10.5%) on its net book investment

¹ Another plausible reason for the downward market pressure effect is the information asymmetry between managers and investors. If a stock is undervalued, management will be reluctant to sell new stock, and the reverse is true if the stock is overvalued. Investors are aware of this and therefore mark down the price when companies issue stock, for it must be overvalued.