THE ECONOMICS OF REGULATION

Theory and Practice in the Transportation and Public Utility Industries

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Revised Edition

1969
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for flotation and underpricing costs involved in the issuance of additional stock. An allowance of 10 percent is common and would result in an adjusted ratio of 8.3 percent—7.5 percent divided by 0.90.) This ratio implies that if the earnings-price ratio of a company has been running fairly consistently at 7.5 percent, then the stock will continue to sell at approximately its book value if future earnings per share amount to 8.3 percent of this book value.

Dividend-Price Ratio. If a stock has an average market value of $150 and the annual dividend is $9.00, the dividend-price ratio is 6 percent. This ratio thus represents the yield received by the investor at the average market price. Whereas the earnings-price ratio implies that investors are guided on the basis of earnings, the dividend-price ratio implies that investors are guided by dividend yields.[81]

For many years, it was thought that investors bought utility stocks largely on the basis of dividends.[82] More recently, however, studies indicate that the market is valuing utility stocks with reference to total per share earnings, so that the earnings-price ratio has assumed increased emphasis in rate cases.[83] Both ratios must be used with a great deal of caution because they may fail to indicate an adequate rate of return to attract capital. As stated by the California commission in a 1954 decision:

> Earnings-price ratios and dividend-price ratios merely reflect the prospective investors' appraisal of the market value of stock and as such are influenced by prevailing market and economic conditions and the individual requirements of the purchaser. While useful for comparative purposes and of value in presenting background information, they are not conclusive in themselves in the determination of the allowable fair return on investment in operative properties. It is one thing to say that these ratios indicate the terms under which a new investor might devote his money to the business; it is another thing to say that these terms represent or limit the return the applicant is entitled to receive on the capital committed to the service. It seems to us that reliance on ratios of this nature results in a restricted view of the subject of rate-of-return. Obviously, the price at which a security is bought on the market reflects anticipated earnings rather than past results of operations and it by no means follows that the rates at which present market sales prices are related to the past earnings represents the returns the purchasers at those prices are willing to accept in the future.

[81] Both earnings-price and dividend-price ratios "should cover representative periods of operation. Ratios used on a 'spot' basis, for a period of a month, or even a year, might produce very unsatisfactory results. Prices of utility stocks of the most stable type are influenced by short-run considerations—threats of war, tax legislation, changing governmental regulations, strikes, elections—all affect stock prices in one way or another. For dividend yields or earnings-price ratios to be really significant they must be considered over a sufficiently long period of time for the abnormal and unusual pressures to average out." Lionel W. Thatcher, "Cost-of-Capital Techniques Employed in Determining the Rate of Return for Public Utilities," 30 *Land Economics* 85, 92 (1954).

[82] See Eli W. Clemens, "Some Aspects of the Rate-of-Return Problem," 30 *Land Economics* 32, 34-35 (1954).

[83] See Fred P. Morrissey, "Current Aspects of the Cost of Capital to Utilities," 62 *Public Utilities Fortnightly* 217 (1958).