150 FERC ¶ 61,165
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Cheryl A. LaFleur, Chairman;
Philip D. Moeller, Tony Clark,
Norman C. Bay, and Colette D. Honorable.

Martha Coakley, Massachusetts Attorney General; Connecticut Public Utilities Regulatory Authority; Massachusetts Department of Public Utilities; New Hampshire Public Utilities Commission; Connecticut Office of Consumer Counsel; Maine Office of the Public Advocate; George Jepsen, Connecticut Attorney General; New Hampshire Office of Consumer Advocate; Rhode Island Division of Public Utilities and Carriers; Vermont Department of Public Service; Massachusetts Municipal Wholesale Electric Company; Associated Industries of Massachusetts; The Energy Consortium; Power Options, Inc.; and the Industrial Energy Consumer Group — Docket Nos. EL11-66-002

v.

Bangor Hydro-Electric Co.; Central Maine Power Co.; New England Power Co.; New Hampshire Transmission LLC; NSTAR Electric and Gas Corp.; Northeast Utilities Service Co.; The United Illuminating Co.; Unitil Energy Systems, Inc. and Fitchburg Gas and Electric Light Co.; Vermont Transco, LLC

Martha Coakley, Massachusetts Attorney General; Connecticut Public Utilities Regulatory Authority; Massachusetts Department of Public Utilities; New Hampshire Public Utilities Commission; Connecticut Office of Consumer Counsel; Maine Office of the Public Advocate; George Jepsen, Connecticut Attorney General; New Hampshire Office of Consumer Advocate; Rhode Island Division of Public Utilities and Carriers; Vermont Department of Public Service; Massachusetts Municipal Wholesale Electric Company; Associated Industries of Massachusetts; The Energy Consortium; — EL11-66-003

Power Options, Inc.; and the Industrial Energy
Consumer Group

v.

Bangor Hydro-Electric Co.; Central Maine Power Co.;
New England Power Co.; New Hampshire Transmission
LLC; NSTAR Electric and Gas Corp.; Northeast
Utilities Service Co.; The United Illuminating Co.;
Unitil Energy Systems, Inc. and Fitchburg Gas and
Electric Light Co.; Vermont Transco, LLC

OPINION NO. 531-B

ORDER ON REHEARING

(Issued March 3, 2015)

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1. On July 21, 2014, the New England Transmission Owners (NETOs),[1] a group of complainants (Complainants) and intervenors (collectively, Petitioners),[2] and the Eastern

[1] The NETOs include Bangor Hydro-Elec. Co.; Central Maine Power Co.; New England Power Co.; New Hampshire Transmission LLC; NSTAR Electric & Gas Corp.; Northeast Utilities Service Co.; United Illuminating Co.; Unitil Energy Systems, Inc. and Fitchburg Gas & Electric Light Co.; and Vermont Transco, LLC.

[2] Complainants include Martha Coakley, Massachusetts Attorney General; Connecticut Public Utilities Regulatory Authority; Massachusetts Department of Public Utilities; New Hampshire Public Utilities Commission; Connecticut Office of Consumer Counsel; Maine Office of the Public Advocate; George Jepsen, Connecticut Attorney General; New Hampshire Office of Consumer Advocate; Rhode Island Division of Public Utilities and Carriers; Vermont Department of Public Service; Massachusetts Municipal Wholesale Electric Co.; Associated Industries of Massachusetts; the Energy Consortium; Power Options, Inc.; and the Industrial Energy Consumer Group. Intervenors

(continued…)

Massachusetts Consumer-Owned Systems (EMCOS), filed requests for rehearing of the Commission's June 19, 2014 order on initial decision[3] concerning a complaint, filed pursuant to section 206 of the Federal Power Act (FPA),[4] challenging the NETOs' base return on equity (ROE) reflected in ISO New England Inc.'s (ISO-NE) open access transmission tariff (OATT).[5] In this order, we deny rehearing.

I. **Background**

2. The NETOs recover their transmission revenue requirements through formula rates included in ISO-NE's OATT. The revenue requirements for Regional Network Service[6] and Local Network Service[7] that the NETOs provide are calculated using the same single base ROE. On October 31, 2006, the Commission, in Opinion No. 489, established the base ROE at 11.14 percent, which consisted of an initial base ROE of 10.4 percent plus an upward adjustment of 74 basis points to account for changes in capital market conditions that took place between the issuance of the Administrative Law Judge's initial decision in that proceeding and the issuance of Opinion No. 489,[8] as reflected in changes in U.S. Treasury bond yields during that time period.

New Hampshire Electric Cooperative, Inc. and Maine Public Utilities Commission requested rehearing jointly with the Complainants.

[3] *Martha Coakley, Mass. Attorney Gen. v. Bangor Hydro-Elec. Co.*, Opinion No. 531, 147 FERC ¶ 61,234 (2014) (Opinion No. 531), *order on paper hearing*, Opinion No. 531-A, 149 FERC ¶ 61,032 (2014) (Opinion No. 531-A).

[4] 16 U.S.C. § 824e (2012).

[5] ISO-NE's OATT is section II of ISO-NE's Transmission, Markets, and Services Tariff (Tariff). *See* ISO-NE, Tariff, § II.

[6] Regional Network Service is the transmission service over the pool transmission facilities described in Part II.B of the OATT. ISO-NE, Tariff, § I.2 (50.0.0); *see also* ISO-NE, Tariff, § II.B Regional Network Service (0.0.0), *et seq.*

[7] Local Network Service is the network service provided under Schedule 21 and the Local Service Schedules of ISO-NE's OATT. ISO-NE, Tariff, § I.2 (50.0.0); *see also* ISO-NE, Tariff, Schedule 21 Local Service (1.0.0), *et seq.*

[8] *Bangor Hydro-Elec. Co.*, Opinion No. 489, 117 FERC ¶ 61,129 (2006) (Opinion No. 489), *order on reh'g*, 122 FERC ¶ 61,265 (2008), *order granting clarification*, 124 FERC ¶ 61,136 (2008), *aff'd sub nom. Conn. Dep't of Pub. Util. Control v. FERC*, 593 F.3d 30 (2010).

3. On September 30, 2011, the Complainants filed a complaint alleging that the NETOs' 11.14 percent base ROE was unjust and unreasonable because capital market conditions had significantly changed since that base ROE was established in 2006. The Complainants argued that the bubble in the U.S. housing market, the subsequent financial crisis and economic recession, and the fiscal and monetary policies of the U.S. government had caused a "flight to quality"[9] in the capital markets. The Complainants contended that these market conditions had lowered bond yields and, as a result, capital costs for utilities.[10] The Complainants argued that, as a result, the NETOs' 11.14 percent base ROE now exceeded the level necessary to satisfy the Supreme Court's standards in *Bluefield*[11] and *Hope*.[12] The Complainants asserted that, based on a discounted cash flow (DCF) analysis conducted by their expert witness, the just and reasonable base ROE for the NETOs should not exceed 9.2 percent.

4. On May 3, 2012, the Commission issued an order on the complaint, establishing hearing and settlement judge procedures.[13] The Hearing Order also set a refund effective date of October 1, 2011. The hearing commenced on May 6, 2012 and was completed on May 10, 2013.[14] In accordance with the hearing's procedural schedule, the participants each first submitted an ROE analysis,[15] based on data from a 6-month study period in

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[9] The "flight to quality" refers to investors seeking low-risk investment vehicles.

[10] Complaint, Ex. C-1 at 5-12.

[11] *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679 (1923) (*Bluefield*).

[12] *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) (*Hope*).

[13] *Martha Coakley, Mass. Attorney Gen.. v. Bangor Hydro-Elec. Co.*, 139 FERC ¶ 61,090 (2012) (Hearing Order).

[14] The parties conducted settlement negotiations but reached an impasse, leading to termination of the settlement procedures in August 2012. *Martha Coakley, Mass. Attorney Gen. v. Bangor Hydro-Elec. Co.*, 144 FERC ¶ 63,012, at P 28 (2013) (Initial Decision).

[15] The following expert witnesses submitted ROE analyses: Dr. William E. Avera, for the NETOs; Ms. Sabina U. Joe, for Trial Staff; Dr. John Wilson, for the EMCOS; and Dr. Randall Woolridge, for the Complainants.

2012,[16] and then filed an updated ROE analysis, using the same DCF methodology that each participant used in its initial analysis but with data based on the 6-month study period from October 2012 through March 2013.

5. On August 6, 2013, the Presiding Judge issued the initial decision, finding the NETOs' current 11.14 percent base ROE to be unjust and unreasonable.[17] The Presiding Judge adopted the DCF methodology used by the NETOs and found that it is appropriate to establish two different base ROEs in this proceeding—one for the 15-month refund period from October 1, 2011 (i.e., the refund effective date) to December 31, 2012, and one for the prospective period commencing when the Commission issues its order setting the going-forward base ROE. Thus, the Presiding Judge considered two separate DCF analyses relying on overlapping data from each period, the first using data from May 2012 through October 2012 and the second using data from October 2012 through March 2013. The Presiding Judge found the just and reasonable base ROE for the refund period to be 10.6 percent and the just and reasonable base ROE for the prospective period to be 9.7 percent.[18]

6. On June 19, 2014, the Commission issued Opinion No. 531, affirming in part and reversing in part the initial decision.[19] In Opinion No. 531, the Commission changed its approach on the DCF methodology to be applied in public utility rate cases, by adopting the two-step DCF methodology in place of the one-step DCF methodology the Commission had historically used. The Commission explained that the two-step DCF formula is k=D/P (1+.5g)+g, where "D/P," the dividend yield, is calculated using a single, average dividend yield based on the indicated dividend and the average monthly high and low stock prices over a six-month period; and "g," the constant dividend growth rate, is calculated by averaging short-term and long-term growth estimates, with the short-term estimate receiving two-thirds weight and the long-term estimate receiving one-third weight.[20]

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[16] Due to the different due dates for the parties' initial briefs, which ranged from October 2012 to January 2013, each party's initial ROE analysis was based on a different 6-month period in 2012.

[17] Initial Decision, 144 FERC ¶ 63,012 at P 544.

[18] *Id.*

[19] *See generally* Opinion No. 531, 147 FERC ¶ 61,234.

[20] *Id.* PP 15, 17, 39.

7. The Commission, after finding that there should be only one base ROE applicable to both the refund period and the prospective period in this proceeding, then applied the two-step DCF methodology to the facts of this proceeding, using a national proxy group of companies the Commission found were of comparable risk to the NETOs, to determine the NETOs' base ROE; however, because the parties had not litigated one input to the two-step DCF methodology—i.e., the appropriate long-term growth projection—the Commission instituted a paper hearing on that narrow issue. The Commission also found that, due to the anomalous capital market conditions reflected in the record, mechanically applying the DCF methodology and placing the NETOs' base ROE at the midpoint of the zone of reasonableness produced by that methodology would not satisfy the requirements of *Hope* and *Bluefield*.[21] Therefore, the Commission found it appropriate, based on the record evidence in the proceeding, to place the NETOs' base ROE halfway between the midpoint of the zone of reasonableness and the top of that zone.[22] However, the Commission explained that its finding on the specific numerical just and reasonable ROE for the NETOs was subject to the outcome of the paper hearing on the appropriate long-term growth projection to be used in the two-step DCF methodology.[23] The Commission also explained that, according to Commission precedent, "when a public utility's ROE is changed, either under section 205 or section 206 of the FPA, that utility's total ROE, inclusive of transmission incentive ROE adders, should not exceed the top of the zone of reasonableness produced by the two-step DCF methodology."[24]

8. On October 16, 2014, the Commission issued Opinion No. 531-A, the order on the paper hearing instituted by Opinion No. 531, finding that long-term projected growth in gross domestic product (GDP) is the appropriate long-term growth projection to use in the two-step DCF methodology.[25] Accordingly, the Commission found that a just and reasonable ROE for the NETOs is 10.57 percent, and that the NETOs' total or maximum ROE, including transmission incentive ROE adders, cannot exceed 11.74 percent, i.e., the top of the zone of reasonableness in this proceeding.[26] The Commission also ordered the

[21] *Id.* P 142.

[22] *Id.*

[23] *Id.*

[24] *Id.* P 165.

[25] Opinion No. 531-A, 149 FERC ¶ 61,032 at P 10.

[26] *Id.* PP 10-11.

NETOs to issue refunds for the 15-month refund period from October 1, 2011 through December 31, 2012.[27]

II. Discussion

A. Procedural Matters

9. On July 21, 2014, the NETOs, Petitioners, and EMCOS filed requests for rehearing of Opinion No. 531. On November 17, 2014, the NETOs requested rehearing of Opinion No. 531-A, in Docket No. EL11-66-003, by submitting the same pleading that they filed on July 21, 2014 as a request for rehearing of Opinion No. 531.[28] Because the NETOs submitted the same pleading as a request for rehearing of both Opinion Nos. 531 and 531-A and, therefore, presented identical arguments in those two proceedings, our merits determinations in the instant order apply to the NETOs' requests for rehearing in both Docket Nos. EL11-66-002 and EL11-66-003. Thus, we also deny the NETOs' request for rehearing of Opinion No. 531-A.

1. Answers to Rehearing Requests, and Related Answers to Answers

10. On August 5, 2014, the Petitioners filed an answer to the NETOs' request for rehearing (Petitioners' August 5 Answer), and the NETOs filed an answer to the Petitioners' request for rehearing (NETOs' August 5 Answer). On August 20, 2014, the NETOs filed an answer to the Petitioners' August 5 Answer (NETOs' August 20 Answer).[29] On August 22, 2014, the Petitioners filed an answer to the NETOs' answer to the Petitioners' request for rehearing (Petitioners' August 22 Answer). On September 4, 2014, the Petitioners filed an answer to the NETOs' August 20 Answer (Petitioners' September 4 Answer).

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[27] *Id.* PP 12, Ordering Paragraph (C).

[28] *See* NETOs, Request for Rehearing, Docket No. EL11-66-003, at 3 (filed Nov. 7, 2014) ("the NETOs seek rehearing of Opinion No. 531-A with respect to the same issues and on the same grounds upon which they sought rehearing of Opinion No. 531. These issues and grounds are set forth in the NETOs' 'Request for Rehearing and Motion for Clarification of the New England Transmission Owners,' which the NETOs filed with the Commission on July 21, 2014, and which is attached hereto and incorporated herein (*see* Attachment A)").

[29] While the NETOs' August 20 Answer was styled as a motion to clarify the record, the filing was, in substance, an answer to the Complainants' August 5 Answer.

11. Rule 713(d) of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.713(d) (2014), prohibits answers to a request for rehearing. Therefore, we reject the Petitioners' August 5 Answer and the NETOs' August 5 Answer. Accordingly, we also reject the answers to those answers—specifically, the NETOs' August 20 Answer, the Petitioners' August 22 Answer, and the Petitioners' September 4 Answer.

2. Motion to Strike

12. On August 5, 2014, the NETOs filed a motion to strike certain extra-record evidence from the Petitioners' request for rehearing. On August 20, 2014, the Petitioners filed an answer opposing the NETOs' motion to strike. We grant in part and deny in part the NETOs' motion to strike. The Commission has consistently held that the submission of additional factual information in a request for rehearing is inappropriate.[30] Therefore, we grant the NETOs' motion with respect to the extra-record evidence in Petitioners' request for rehearing. However, we deny the NETOs' motion with respect to the evidence that was already in the record and that Petitioners have merely reframed through graphical representation or basic arithmetic.[31]

3. Motions to Intervene Out-of-Time

13. On July 21, 2014, American Municipal Power, Inc. (AMP) filed a motion to intervene out-of-time and a request for rehearing,[32] and the American Public Power Association (APPA) and the National Rural Electric Cooperative Association (NRECA) jointly filed a motion to intervene out-of-time. APPA and NRECA also joined in the Petitioners' request for rehearing. On August 5, 2014, the NETOs filed an answer

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[30] *E.g.*, *Transcontinental Gas Pipe Line Corp.*, 94 FERC ¶ 61,066, at 61,278 (2001).

[31] Specifically, we deny the NETOs' motion with respect to (1) the altered version of the NETOs' risk premium analysis, at page 38 and Attachment A of Petitioners' request for rehearing; (2) the altered version of Opinion No. 531's Appendix showing an alternate source of growth rate projections, at pages 43 and 51, and at Attachment B, of Petitioners' request for rehearing; (3) the altered version of Opinion No. 531's Appendix reflecting an alternate low-end outlier adjustment, at pages 14, 62, and 63, and at Attachment C, of Petitioners' request for rehearing; (4) the altered version of Exhibit SC-524, at pages 26 and 27 of Petitioners' request for rehearing; (5) the histogram at pages 2-3 of Petitioners' request for rehearing; and (6) the histogram on pages 24-25 of Petitioners' request for rehearing.

[32] While AMP styled its filing as a motion for clarification, it is in substance a request for rehearing.

opposing AMP's, APPA's, and NRECA's motions to intervene out-of-time, and AMP's request for rehearing. On August 12, 2014, APPA and NRECA filed an answer to the NETOs' answer to the motions to intervene out of time and AMP's request for rehearing. On December 5, 2014, the Maine Public Advocate Office filed a motion to intervene out-of-time.

14. In ruling on a late-filed motion to intervene, the Commission applies the criteria set forth in Rule 214(d) of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.214(d) (2014), and considers, among other things, whether the movant had good cause for failing to file the motion within the time prescribed, whether any disruption to the proceeding might result from permitting the intervention, and whether any prejudice to or additional burdens upon the existing parties might result from permitting the intervention. A petitioner for late intervention bears a higher burden to show good cause for late intervention after the Commission has issued a final order in a proceeding, and it is the Commission's policy to deny late intervention at the rehearing stage, even when the movant claims that the decision establishes a broad policy of general application.[33]

15. We find that AMP, APPA, NRECA, and the Maine Public Advocate Office have not met their burden of justifying late intervention. The Complainants filed the complaint in this proceeding on September 30, 2011, alleging that the capital market conditions following the collapse of the housing bubble and the resulting economic recession were such that the NETOs' existing ROE was no longer just and reasonable; the Commission then set the complaint for hearing on May 30, 2012 and issued a dispositive order on June 19, 2014, nearly three years after the complaint was filed. Thus, AMP, APPA, NRECA, and the Maine Public Advocate Office had ample notice that this proceeding involved the Commission's approach to determining public utilities' ROE, that the effect of recent capital market conditions on that approach was an issue central to the complaint, and that a Commission order in this proceeding would have precedential effect on similar proceedings before the Commission. AMP, APPA, NRECA, and the Maine Public Advocate Office have not shown good cause for failing to file their motions to intervene during the statutory comment period, or subsequent to that period but prior to the Commission's issuance of Opinion No. 531. AMP's, APPA's, and NRECA's statements that they did not anticipate the specific outcome in this proceeding, without more, do not suffice to make that showing.[34] We therefore deny their late-filed motions to intervene.

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[33] *See, e.g.*, *Williston Basin Interstate Pipeline Co.*, 112 FERC ¶ 61,038, at P 12 (2005).

[34] APPA and NRECA cite *Duke Energy Carolinas, LLC, et al.*, 147 FERC ¶ 61,241 (2014) (*Duke*), as an example of an instance where the Commission has allowed a national organization's late intervention due to an order's far-reaching impacts. However, we find *Duke* to be distinguishable from the instant case. In *Duke*, the National

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Correspondingly, we also deny AMP's, APPA's, and NRECA's requests for rehearing, because under Rule 713(b) the Commission's Rules of Practice and Procedure only a party to a proceeding may seek rehearing. [35]

B. Substantive Matters

16. The arguments raised on rehearing involve issues concerning the burden of proof, placement of the NETOs' base ROE within the zone of reasonableness, the impact of the change in DCF methodology on the NETOs' existing transmission incentive ROE adders, and the timing of the Commission's establishment of the just and reasonable rate in this proceeding. As discussed below, we deny rehearing on these issues.

1. Burden of Proof

a. Opinion No. 531

17. The Commission in Opinion No. 531 affirmed the Presiding Judge's determination on the burden of proof,[36] explaining that under FPA section 206 the burden to show that a rate is unjust and unreasonable "shall be on the Commission or the complainant,"[37] and, in the context of an ROE proceeding, the burden entails finding that the existing ROE is not "commensurate with returns on investments in other enterprises having corresponding risks . . . [and] sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[38] The Commission explained that, to estimate the return necessary to attract equity investors, the Commission uses the DCF

Association of Regulatory Utility Commissioners (NARUC) failed to intervene in an Order No. 1000 proceeding. NARUC explained that it had intervened in multiple Order No. 1000 proceedings, but that its failure to intervene in *Duke* could only have been avoided if NARUC had intervened in every Order No. 1000 proceeding. Unlike *Duke*, the instant proceeding was the first case of its kind to challenge utilities' base ROEs during the economic recession of 2007-2009, and AMP, APPA, and NRECA should have known that the proceeding could have precedential effect on other proceedings.

[35] 16 U.S.C. § 825(l) (2012); 18 C.F.R. § 385.713(b) (2014); *see, e.g., Southern Company Servs., Inc.*, 92 FERC ¶ 61,167 (2000).

[36] Opinion No. 531, 147 FERC ¶ 61,234 at P 49.

[37] *Id.* P 50 (quoting 16 U.S.C. § 824e (2012)).

[38] *Id.* P 50 (quoting *Hope*, 320 U.S. at 603).

model, which identifies a zone of reasonable returns.[39] The Commission rejected the NETOs' argument that the Commission "does not have the authority under FPA section 206 to change the existing base ROE unless the evidence shows that it is entirely outside the zone of reasonableness."[40] The Commission explained that not every ROE within the zone of reasonableness is just and reasonable, and that the zone of reasonableness identified by the DCF model "is simply the first step in the determination of a just and reasonable ROE for a utility or group of utilities."[41]

b. **Request for Rehearing**

18. The NETOs argue that, because the NETOs' existing ROE of 11.14 percent falls within the zone of reasonableness, the Commission erred in finding that the Complainants and Trial Staff have carried their burden of establishing that the existing ROE is unjust and unreasonable.[42] According to the NETOs, court and Commission precedent support a finding that an ROE within the zone of reasonableness remains just and reasonable.[43] The NETOs state that the Commission misunderstood their contention with respect to FPA sections 205 and 206. They assert that FPA section 206 carries a two-prong burden, the first of which is to show that the existing rate is unjust and unreasonable. The NETOs assert that interpreting FPA section 206 otherwise would eliminate the difference between the burdens of proof under FPA sections 205 and 206 by requiring a complainant to show only that its proposed rate is more just and reasonable than the existing rate. The NETOs concede that not all rates within the zone of reasonableness are equally just and reasonable, but also argue that it is not enough to show that there is a more just and reasonable rate than the existing rate; rather the complainant must demonstrate through substantial evidence that the existing rate does not fall within the zone of just and reasonable rates.[44] The NETOs contend that no party satisfied the first prong of FPA section 206.

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[39] *Id.*

[40] *Id.* P 51.

[41] *Id.*

[42] NETOs Request for Rehearing at 26-27.

[43] *Id.* at 27-30 (citing *Me. Pub. Utils. Comm'n v. FERC*, 520 F.3d 464, 470-71 (D.C. Cir. 2008) (*Maine PUC*), *rev'd in part on other grounds sub nom. NRG Power Mktg., LLC v. Me. Pub. Utils. Comm'n*, 558 U.S. 165 (2010); *Calpine Corp. v. Cal. Indep. Sys. Operator Corp.*, 128 FERC ¶ 61,271, at P 41 (2009)).

[44] *Id.* at 36.

19. The NETOs assert that, in accordance with Commission and federal court precedent, any ROE within the zone of reasonableness cannot be found to be unjust and unreasonable. The NETOs further assert that the Commission erred in finding that the DCF zone of reasonableness is different from the zone of reasonableness under FPA section 206, and that the Commission has never before drawn a distinction between the DCF zone of reasonableness and the zone of reasonableness referred to when applying FPA section 206. The NETOs argue that determining the zone of reasonableness is not merely an intermediate step in a Commission-created DCF analysis whose final step is identification of a "pinpoint" just and reasonable ROE that the Commission believes is optimal in the context of that specific proceeding, but rather is identical to the zone of reasonableness used in FPA section 206 analyses. The NETOs state that in *Northeast Utilities Service Co.*, 124 FERC ¶ 61,044 (2008) (*Northeast Utilities*), *Central Maine Power Co.*, 125 FERC ¶ 61,079 (2008) (*Central Maine*), and *Desert Southwest Power, LLC*, 135 FERC ¶ 61,143 (2011) (*Desert Southwest*) the Commission explicitly identified the DCF zone of reasonableness with the more general zone of reasonableness used in the FPA section 206 context and treated the two as one and the same.[45]

20. The NETOs further argue that the Commission's reliance on *Bangor Hydro* to distinguish the DCF zone of reasonableness from the range of reasonableness under FPA section 206 is inappropriate because *Bangor Hydro* involved application of the last clean rate doctrine after the rate under consideration had been found to be unjust and unreasonable.[46] The NETOs argue that, if *Bangor Hydro* does mean that the DCF zone of reasonableness is not really a zone of reasonableness, then that case was wrongly decided because it would contradict Commission and court precedent, particularly the D.C. Circuit's decision in *City of Winnfield*.[47] The NETOs argue that, although Opinion No. 531 refers to the guidance on this issue in *City of Winnfield* as dicta, the Commission has relied on that guidance in previous decisions.[48] The NETOs argue that FPA section 206 carries a stricter burden of proof than FPA section 205, that the dual burden of proof

[45] *Id.* at 39.

[46] *Id.* at 41-42 (citing *Bangor Hydro-Electric Co.*, 122 FERC ¶ 61,038 (2008) (*Bangor Hydro*)).

[47] *Id.* at 42-43 (citing *City of Winnfield v. FERC*, 744 F.2d 871, 875-76 (D.C. Cir. 1984) (*City of Winnfield*)).

[48] *Id.* at 42 (citing *Texas Eastern Transmission Corp.*, 32 FERC ¶ 61,056, at 61,150 (1985); *Promoting Transmission Investment through Pricing Reform*, Order No. 679-A, FERC Stats. & Regs. ¶ 31,236, at P 98 (2006) (cross-referenced at 117 FERC ¶ 61,345, at P 98 (2006)) (Order No. 679-A); *New Dominion Energy Coop.*, 118 FERC ¶ 63,024, at n.154 (2007)).

under section 206 provides statutory protection to utility companies, and therefore that Congress intended to create asymmetry between FPA sections 205 and 206.[49] Lastly, the NETOs argue that Opinion No. 531 reduces the clarity and predictability of the zone of reasonableness determination by instituting a method that is no longer limited by an objective formula. The NETOs argue that the resultant lack of predictability increases the perceived risk which is counter to *Hope* and *Bluefield*.[50]

c. Commission Determination

21. We deny rehearing on the issue of the burden of proof. The NETOs once again assert that an existing base ROE cannot be found unjust and unreasonable as long as it is within the zone of reasonableness produced by a DCF analysis, and that the Commission's rejection of this argument in Opinion No. 531 is contrary to court and Commission precedent. We disagree.

22. The NETOs cite precedent setting forth a general ratemaking principle that "there is not a single 'just and reasonable rate' but rather a zone of rates that are just and reasonable; a just and reasonable rate is one that falls within that zone."[51] The NETOs equate references to a "zone of rates that are just and reasonable" or a "zone of reasonableness" in those cases to the "zone of reasonableness" produced by the DCF analysis we use to determine the ROE to include in a public utility's cost of service. On that basis, the NETOs contend that the Commission must show that the NETOs' existing ROE is outside the DCF zone of reasonableness in order to satisfy its FPA section 206 burden to show that their ROE is unjust and unreasonable.

23. In *City of Winnfield* and *Maine PUC*, which did not involve the determination of ROE, the term "zone of reasonableness" was used to express the general principle that under the FPA there can be more than one just and reasonable rate for a service. For example, in the portion of *City of Winnfield* cited by the NETOs, the court addressed the issue of whether the rate for a power sale should be based on an incremental fuel cost or a system average fuel cost, and the court explained that if either methodology was just and

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[49] *Id.* at 44 (citing *City of Winnfield*, 744 F.2d at 875).

[50] *Id.* at 45-46.

[51] *See, e.g.*, *Maine PUC*, 520 F.3d at 470-71 (upholding Commission determination that transition payments agreed to in a settlement redesigning New England's capacity market fell within a reasonable range of capacity prices); *City of Winnfield*, 744 F.2d at 875-76.

reasonable, the Commission could not force the utility to shift from one to the other in a section 206 proceeding.[52]

24. In determining the ROE component of a public utility's cost of service pursuant to a DCF analysis, however, the term "zone of reasonableness" has a particular, more technical meaning that differs from its meaning when used in general descriptions of what constitutes a just and reasonable rate charged by a public utility for jurisdictional service, such as in *City of Winnfield* and *Maine PUC*. The Commission uses a three-step process to determine the just and reasonable ROE component of the cost of service of a public utility or a group of public utilities. First, the Commission establishes a proxy group of companies of comparable risk. Second, the Commission performs a DCF analysis of each member of the proxy group in order to determine a "zone of reasonableness," within which to set a just and reasonable ROE. That DCF zone of reasonableness is the range from the lowest proxy member ROE to the highest proxy member ROE. Finally, the Commission establishes a just and reasonable ROE at a single point within the DCF zone of reasonableness.

25. Thus, in the context of determining an ROE, the establishment of the DCF zone of reasonableness is simply one step in the process of determining a just and reasonable ROE for inclusion in the cost of service of the subject public utility or utilities. Typically, the DCF zone of reasonableness is relatively broad. For example, in *Bangor Hydro*[53] setting the NETOs' existing ROE, the DCF zone of reasonableness was from 7.3 percent to 13.1 percent, or almost 600 basis points. In this case, the zone of reasonableness is from 7.03 percent to 11.74 percent, or nearly 500 basis points. Not every ROE within that relatively broad DCF "zone of reasonableness" is a just and reasonable ROE for the particular public utility or utilities at issue. As the Commission held in *Bangor Hydro*, "[c]ertain rates, though within the zone, may not be just and reasonable given the circumstances of the case."[54]

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[52] *See City of Winnfield*, 744 F.2d at 875 ("in that circumstance the agency is effectively using § 205, which is intended for the benefit of the utility—i.e., as a means of enabling it to increase its rates within what has been called the 'zone of reasonableness'—for the quite different purpose of *depriving the utility* of the statutory protection contained in § 206, that its existing rates be found to be entirely outside the zone of reasonableness before the agency can dictate their level or form.") (emphasis in original) (citation omitted).

[53] 122 FERC ¶ 61,038 at PP 10-15.

[54] *Id.* P 11 (quoting *Montana-Dakota Utils. Co. v. Nw. Pub. Serv. Co.*, 341 U.S. 246, 251 (1951) (*Montana-Dakota*)).

26. The decision of the United States Court of Appeals for the District of Columbia Circuit in *S. Cal. Edison Co*. *v. FERC*,[55] recognized that, in the context of determining ROE, not every ROE within the DCF zone of reasonableness is just and reasonable. In that case, the utility filed to modify its rates under FPA section 205. The court stated that section 205 required the Commission to approve the utility's rate proposal "as long as the new rates are just and reasonable."[56] Nevertheless, the court also held that the Commission had authority to require the utility's ROE to be set at the median of the zone of reasonableness, even though the midpoint of the zone, proposed by the utility, was also within the DCF zone of reasonableness. In short, the court recognized that the Commission need not treat every ROE within the zone of reasonableness as a just and reasonable ROE. If the Commission were required to find any and every ROE within the zone of reasonableness to be just and reasonable, the requirement that the Commission approve any section 205 rate proposal "as long as the new rates are just and reasonable"[57] would require the Commission to accept any ROE proposed by a utility in a section 205 rate case, as long as that ROE did not exceed the top of the range of reasonableness. However, the FPA has never been understood to require such a result, which would be contrary to the consumer protection purpose of the FPA.[58]

27. In Opinion No. 531, the Commission stated that the NETOs were erroneously seeking to apply a different just and reasonable standard in FPA section 206 cases than in section 205 cases. The Commission stated, "Despite the fact FPA section 205 does not require that every ROE within the zone of reasonableness be considered just and reasonable for purposes of a utility rate filing under FPA section 205, the NETOs would

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[55] *S. Cal. Edison Co. v. FERC*, 717 F.3d 177, 181-82 (D.C. Cir. 2013) (finding that the Commission had authority to set a utility's ROE at the median of the zone of reasonableness even though the utility proposed using the midpoint, which was also within the zone of reasonableness); *accord Montana-Dakota*, 341 U.S. at 251 (explaining that while statutory reasonableness is an abstract concept represented by an area rather than a pinpoint the Commission must translate that concept into a concrete rate, and it is the rate—not the abstract concept—that governs the rights of the buyer and seller).

[56] *S. Cal. Edison Co. v. FERC*, 717 F.3d at 181.

[57] *Wis. Pub. Power, Inc. v. FERC*, 493 F.3d 239, 254 (D.C. Cir. 2007).

[58] Given that the FPA was intended to be a consumer-protection statute, *see, e.g.*, *Pub. Sys. v. FERC*, 606 F.2d 973, 979 n.27 (D.C. Cir. 1979), it is hard to find persuasive an argument that would allow, under FPA section 205, a utility to propose an increase in its ROE to anywhere in the zone, but would effectively bar, under FPA section 206, a customer from seeking to decrease the ROE being challenged merely because the ROE falls somewhere within the zone.

require us to treat every existing ROE within the zone of reasonableness as just and reasonable in a section 206 case. Nothing in the FPA, however, supports such a different understanding of the phrase "just and reasonable" as between those two sections of the FPA when establishing a utility's ROE."

28. On rehearing, the NETOs do not challenge Opinion No. 531's interpretation of FPA section 205 as not requiring the Commission to treat any ROE proposed by the utility within the DCF zone of reasonableness as a just and reasonable ROE which the Commission must accept. However, the NETOs contend that Opinion No. 531 fails to recognize that the Commission's burden of proof under FPA section 206 contains two prongs: first, the burden to show that an existing rate is unjust and unreasonable; second, the burden to show that the replacement rate is just and reasonable. The NETOs agree that the showing the Commission must make under the second prong of section 206 in order to establish a replacement ROE "is identical to the required section 205 showing, as Opinion No. 531 states."[59] However, they assert that the showing of unjustness and unreasonableness which the Commission must make under the first prong of its section 206 burden "is very different from and more difficult to satisfy" than the showing of justness and reasonableness that must be made under either the second prong of section 206 or under section 205. As a result they assert that any ROE within the zone of reasonableness cannot be found unjust and unreasonable.

29. In making these arguments, the NETOs are confusing differences in who bears the burden of persuasion as between FPA sections 205 and 206 with the substantive "just and reasonable" standard contained in both those sections. The two sections of course differ as to who bears the burden of persuasion, because under FPA section 206 the Commission or complainant must show that the utility's existing rate is unjust and unreasonable and the Commission must show that its replacement rate is just and reasonable, whereas under FPA section 205 the utility need only show that its proposed rate is just and reasonable. However, as the Supreme Court has stated, sections 205 and 206 are "parts of a single statutory scheme under which . . . all rates are subject to being modified by the Commission upon a finding that they are unlawful."[60] While the party bearing the burden of persuasion is different under FPA section 205 and FPA

[59] NETOs Request for Rehearing at 35.

[60] *United Gas Pipe Line Co. v. Mobile Gas Serv. Co.*, 350 U.S. 332, 341 (1956). While this case involved the Natural Gas Act, the Supreme Court held in a companion case that the provisions of the FPA relevant to this question are substantially identical to the equivalent sections under the Natural Gas Act. *FPC v. Sierra Pacific Power Co.*, 350 U.S. 348, 353 (1956).

section 206, "the scope and purpose of the Commission's review remains the same – to determine whether the rate fixed by the [utility] is lawful."[61]

30. Because sections 205 and 206 are part of a single statutory scheme, it follows that a rate that is lawful under one section must also be lawful under the other and a rate that is unlawful under one section must also be unlawful under the other. For this to be true, the substantive standard to determine lawfulness under each section – the just and reasonable standard – must be applied in the same manner under each section. Therefore, if every ROE within the DCF zone of reasonableness must be treated as a lawful just and reasonable ROE which cannot be modified under the first prong of the Commission's FPA section 206 burden, as the NETOs contend, then every ROE within that zone must also be treated as a lawful just and reasonable ROE for all other purposes under the FPA, including a section 205 filing. This would require the Commission to find just and reasonable any ROE proposed by a utility in a section 205 proceeding that was within the DCF zone of reasonableness. However, as already discussed, the D.C. Circuit rejected that proposition in *SoCal Edison*.

31. The NETOs next contend that failing to treat all ROEs within the DCF zone of reasonableness as just and reasonable for purposes of the first prong of the Commission's 206 burden would erase the difference between the burden of proof under FPA sections 205 and 206, because the ROE determination in a section 206 proceeding would be the same as in a section 205 proceeding. We disagree. We recognize that in situations where the Commission has found that more than one methodology may be used to design a just and reasonable rate for a service, such as the incremental rate situation in *City of Winnfield* discussed above, the utility may choose one of the just and reasonable ratemaking methodologies in a section 205 proceeding, and the Commission then cannot require the utility to shift to a different just and reasonable methodology in a subsequent

[61] *United Gas Pipe Line Co. v. Mobile Gas Serv. Co.*, 350 U.S. at 341. The effect of the NETOs' argument, if that argument were to be accepted, would turn the statute on its head. Section 206 would no longer be a tool to challenge an ROE that was no longer reasonable, but rather would serve to insulate that ROE from challenge as long as it fell somewhere—anywhere—within the zone of reasonableness produced by a DCF analysis. A statute that was intended to protect ratepayers from exploitation, *see, e.g., Pub. Sys. v. FERC*, 606 F.2d at 979 n.27, would protect and preserve just such exploitation. But, as the Commission has recognized, as recently as last year the D.C. Circuit has already rejected just such an approach. *See* Opinion No. 531, 147 FERC ¶ 61,234 at P 52 (citing *S. Cal. Edison Co. v. FERC*, 717 F.3d 177).

section 206 proceeding.[62] However, the statute does not require that we approve multiple just and reasonable methodologies to resolve every ratemaking issue. In fact, the D.C. Circuit held in *S. Cal. Edison Co*. that the Commission may require the use of a particular methodology to determine the just and reasonable ROE to be included in a utility's cost of service, despite the existence of other possible methodologies for determining ROE.[63]

32. The Commission has long required the use of a DCF methodology (here the two-step DCF methodology adopted in Opinion No. 531) to determine a zone of reasonableness, with the lawful just and reasonable ROE set at a single numerical point within that range based on the circumstances and record of that case.[64] Therefore, when the Commission finds a utility's base ROE to be just and reasonable in a particular case, it finds *only* that single point to be just and reasonable given the facts and circumstances of that case.[65] It does *not* find any other base ROE within the DCF zone of reasonableness, either above or below the approved ROE, to be a just and reasonable base ROE for that utility or group of utilities. Thus, the DCF zone of reasonableness does not establish a continuum of just and reasonable base ROEs, any one of which the utility would equally be free to charge to ratepayers; rather, only the single point approved by the Commission within the DCF zone of reasonableness is the just and reasonable base

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[62] *See Consolidated Edison of New York, Inc. v. FERC*, 165 F.3d 992, 216-17 (D.C. Cir. 1999). ("While incremental treatment may be required at one end of the rate-setting continuum, and rolled-in pricing required at the other, in between the two extremes lie a series of intermediate points in which both cost-recovery methods would satisfy section 4's just and reasonable test. At each of these places along the continuum, the pricing mechanism will essentially lie in the hands of the initiating pipeline. It is only when the proposed rate crosses the boundary separating the just from the unjust that FERC can act under its section 5 authority to order a rate of its own formulation.")

[63] *S. Cal. Edison Co. v. FERC*, 717 F.3d at 182 ("In order to discharge its statutory duty of ensuring that '[a]ll rates . . . [are] just and reasonable' the Commission may require the use of a particular ratemaking methodology so long as its embrace of that methodology is not arbitrary and capricious.").

[64] *See, e.g., Williston Basin Interstate Pipeline Co. v. FERC*, 165 F.3d 54, 57 (D.C. Cir. 1999).

[65] *Cf. Montana-Dakota*, 341 U.S. at 251 (explaining that while statutory reasonableness is an abstract concept represented by an area rather than a pinpoint the Commission must translate that concept into a concrete rate, and it is the rate—not the abstract concept—that governs the rights of the buyer and seller).

ROE.[66] It follows that showing the existing base ROE established in the prior case is unjust and unreasonable merely requires showing that the Commission's ROE methodology now produces a numerical value below the existing numerical value. Contrary to the NETOs' assertion, the fact that both of the burdens of proof under FPA section 206 can be satisfied using a single ROE analysis—one that generates an ROE that both is below the existing ROE (thus demonstrating that the existing ROE is excessive) and that also is a just and reasonable ROE (thus demonstrating what the new ROE should be)—does not alter those two burdens.[67]

33. In short, the statute does not require that we treat all ROEs within the DCF zone of reasonableness as just and reasonable. Rather, the statute requires that, under section 206, before we may change an ROE we must find it unjust and unreasonable. And, in Opinion No. 531, that we did. Our ROE analysis showing that the NETOs' base ROE is 10.57 percent demonstrates both that their existing 11.14 percent ROE is unjust and unreasonable and that 10.57 percent is the NETOs' just and reasonable replacement base ROE.[68] Thus, we met both burdens under section 206.

34. The NETOs cite precedent that, while correctly stating the general principle of the FPA section 206 burden, is distinguishable from the facts of this case because that precedent did not discuss the FPA section 206 burden in the context of determining a utility's base ROE.[69] Whether a particular rate is just and reasonable, and what the range

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[66] As discussed below in P 35, the addition of an incentive adder for a project can justify a higher overall just and reasonable ROE (i.e., the base ROE plus the incentive adder) for that project.

[67] Further, we reject the NETOs' contention that the Commission's determination on the burden of proof in this proceeding broadens the Commission's discretion and will lead to increased uncertainty and litigation. *See* NETOs Request for Rehearing at 45-46. We are following our long-standing practice with regard to the zone of reasonableness identified by a DCF analysis.

[68] A utility's ROE is simply one component of the cost-of-service reflected in its overall rates for the services it provides. Typically, each component of the cost of service is a single number, based on the utility's actual costs during the relevant test period. For example, if a utility's existing cost of service includes a cost of labor of $10 million, a showing that its actual test period cost of labor is $9 million satisfies both the burden to show that the existing $10 million labor cost is unjustly and unreasonably high and the new just and reasonable labor cost is $9 million. Our treatment of ROE is no different.

[69] *See, e.g., Maine PUC*, 520 F.3d 464, *rev'd in part on other grounds sub nom. NRG Power Mktg., LLC v. Me. Pub. Utils. Comm'n*, 558 U.S. 165 (2010) (upholding Commission determination that transition payments agreed to in a settlement redesigning

(continued…)

of reasonableness is for that rate, largely depends on the nature of the rate at issue. While a utility's base ROE is a single, specific numerical value that is determined by using a well-known methodology, a tariff provision setting forth an energy market rule might produce a numerical result only in conjunction with many other associated market rules. A determination of what is an appropriate range of reasonableness, and what is just and reasonable, in these two disparate contexts requires different analyses and the balancing of different interests. As a result, the Commission uses different approaches to determining the just and reasonable resolution in different circumstances. In determining a utility's base ROE, the Commission has long used a methodology that produces a single, specific numerical value, not a range of reasonable values, and the Commission has therefore interpreted FPA section 206 to protect that specific numerical value, rather than a zone around that value.

35. The NETOs are correct that, in the context of incentive ROE adders authorized for projects, the Commission has capped the overall ROE for a particular project (i.e., the sum of the utility's base ROE and the incentive ROE adder for that project) at the top of the DCF zone of reasonableness.[70] However, it does not follow from this fact that all ROEs within the DCF zone of reasonableness must be treated as just and reasonable for purposes of the first prong of FPA section 206. The Commission awards an incentive adder based on a separate, independent showing that a particular project is of a type that qualifies for such an adder, and—as directed by Congress—the Commission allows the adder to be added to the base ROE and charged to ratepayers so long as the sum of the

New England's capacity market fell within a reasonable range of capacity prices); *Calpine Corp. v. Cal. Indep. Sys. Operator Corp.*, 128 FERC ¶ 61,271 (finding tariff provisions setting forth a method of socializing the costs of a market participant's financial default to be unjust and unreasonable); *Cal. Mun. Utils. Ass'n v. Cal. Indep. Sys. Operator Corp.*, 126 FERC ¶ 61,315 (2009) (finding that complainants failed to show tariff unjust and unreasonable due to a lack of sufficient safeguards to protect against the risk of anomalous settlements); *Cal. Indep. Sys. Operator Corp.*, 140 FERC ¶ 61,168 (2012) (finding tariff provisions concerning the repayment of an interconnection customers' network upgrade costs to be just and reasonable under FPA section 205).

[70] *See, e.g.*, *Northeast Utils. Serv. Co.*, 124 FERC ¶ 61,044, at P 71 (2008); *Central Maine Power Co.*, 125 FERC ¶ 61,079, at P 74 (2008); *Desert Southwest Power, LLC*, 135 FERC ¶ 61,143, at P 96 (2011). The Commission uses the DCF zone of reasonableness in the same manner to ensure that the sum of a utility's base ROE plus an incentive adder for joining an RTO is just and reasonable.

adder and base ROE for that project is just and reasonable under FPA section 205.[71] The Commission makes that determination by looking at whether the utility's base ROE plus the incentive ROE adder for that project remain within the zone of reasonableness. That is, the Commission looks to whether the sum of the base ROE and the adder for that project falls within the DCF-determined zone of reasonableness, or does that sum instead fall outside the zone of reasonableness, for that project. Absent both a showing that the particular project qualifies for such an adder, and a Commission finding that the resulting overall ROE satisfies the just and reasonable standard laid out in the FPA, the increased overall ROE for the project produced by summing the adder and the base ROE would not be just and reasonable.[72] This use of the DCF-determined zone of reasonableness to place an outer limit on the overall ROE that a utility may earn on a particular project does not in any way suggest that any base ROE up to the top of the DCF-determined zone of reasonableness must be treated as just and reasonable for purposes of FPA section 206. To the contrary, it is only the separate, independent finding that the project qualifies for an incentive adder that justifies increasing the overall ROE for that project to a point within the DCF-determined zone of reasonableness above the point at which the utility's base ROE is set.

2. <u>Placement of the Base ROE within the Zone of Reasonableness</u>

a. <u>Placement of the Base ROE above the Midpoint</u>

i. <u>Opinion No. 531</u>

36. The Commission in Opinion No. 531 found that, although it typically sets the base ROE for a group of utilities at the midpoint of the zone of reasonableness identified by the DCF methodology, "a mechanical application of the DCF methodology with the use of the midpoint here would result in an ROE that does not satisfy the requirements of *Hope* and *Bluefield*."[73] Therefore, the Commission explained that, "based on the record in this case, including the unusual capital market conditions present, . . . the just and reasonable base ROE for the NETOs should be set halfway between the midpoint of the zone of reasonableness and the top of the zone of reasonableness," i.e., 10.57 percent.[74]

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[71] *See* 16 U.S.C. § 824s(d) (2012) ("All rates approved under the rules adopted pursuant to [FPA section 219] . . . are subject to the requirements of sections [205 and 206] of this title that all rates . . . be just and reasonable.").

[72] *See generally, e.g., NSTAR Elec. Co.*, 125 FERC ¶ 61,313 (2008); *Northeast Utils. Serv. Co.*, 124 FERC ¶ 61,044 (2008).

[73] Opinion No. 531, 147 FERC ¶ 61,234 at P 142.

[74] *Id.*

The Commission explained that, as "[p]arties on both sides of the instant ROE issue argue that the unique capital market conditions have impacted the level of equity return the NETOs' require to meet the capital attraction standards of *Hope* and *Bluefield*," the Commission was "concerned that capital market conditions in the record are anomalous, thereby making it more difficult to determine the return necessary for public utilities to attract capital."[75] The Commission explained that "[i]n these circumstances, we have less confidence that the midpoint of the zone of reasonableness established in this proceeding accurately reflects the equity returns necessary to meet the *Hope* and *Bluefield* capital attraction standards."[76]

37. As a result of the anomalous capital market conditions reflected in the record, and their potential impact on the DCF model, the Commission found it "necessary and reasonable to consider additional record evidence, including evidence of alternative benchmark methodologies and state commission-approved ROEs, to gain insight into the potential impacts of these unusual capital market conditions on the appropriateness of using the [midpoint of the zone of reasonableness identified by the DCF methodology]."[77] The Commission found the additional record evidence—specifically the NETOs' risk premium analysis, Capital Asset Pricing Model (CAPM) analysis, expected earnings analysis, and evidence of state commission-authorized ROEs—supported a finding that an upward adjustment from the midpoint was warranted.[78]

38. After determining that the just and reasonable base ROE for the NETOs was above the midpoint, the Commission found that, because it "has traditionally looked to the central tendency to identify the appropriate return within the zone of reasonableness," it is appropriate to "look to the central tendency for the top half of the zone of reasonableness."[79] The Commission explained that "[w]hen placing a base ROE above the central tendency of the zone of reasonableness, the Commission has in the past placed the base ROE at the midpoint of the upper half of the zone."[80] The Commission therefore

[75] *Id.* P 145.

[76] *Id.*

[77] *Id.*

[78] *Id.* PP 146-150.

[79] *Id.* P 151.

[80] *Id.* P 152 (citing *S. Cal. Edison Co.*, Opinion No. 445, 92 FERC ¶ 61,070, at 61,266 (2000); *Consumers Energy Co.*, Opinion No. 429, 85 FERC ¶ 61,100, at 61,363-64 (1998)).

found that "a base ROE halfway between the midpoint of the zone of reasonableness and the top of that zone represents a just and reasonable ROE for the NETOs."[81]

ii. Requests for Rehearing

39. Petitioners and EMCOS argue that the Commission's placement of the NETOs' base ROE three-quarters of the way up the zone of reasonableness is contrary to record evidence and Commission precedent, and is therefore arbitrary and capricious. Petitioners assert that the only basis for establishing a base ROE above the central tendency of the zone of reasonableness is that the utility or utilities whose base ROE is at issue are riskier than the proxy group. Petitioners argue that the Commission's 38-member national proxy group is far more risky than the NETOs because the average corporate credit rating of the proxy group was between BBB and BBB+, whereas 80 percent of the NETOs are rated between BBB and A.[82] Petitioners further state that, using the appropriate weighting to reflect the relative size of each of the NETOs, the fair average of the NETOs' credit ratings is "A-/BBB+." Petitioners therefore argue that the Commission should place the NETOs' base ROE in the lower half of the zone of reasonableness.[83]

40. EMCOS assert that the Commission has previously and consistently concluded that the midpoint of the zone of reasonableness produces a just and reasonable ROE for a diverse group of utilities because it fairly and accurately evaluates risk. EMCOS further state that Opinion No. 531 acknowledges that the midpoint of the zone of reasonableness yields an appropriate ROE for a diverse group of utilities, but then rejects the use of the 9.39 percent midpoint in favor of the higher 10.57 percent figure.[84] EMCOS state that Opinion No. 531 cites only two cases in which the Commission adopted an ROE at the midpoint of the upper half of the zone of reasonableness, and in each of those cases the utility at issue had a higher risk profile than the proxy group.[85] Petitioners and EMCOS

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[81] *Id.*

[82] Petitioners Request for Rehearing 16-18.

[83] *Id.* at 19 (citing Ex. SC-207). Petitioners also cite several other sources claiming that the NETOs have a high level of rate certainty.

[84] EMCOS Request for Rehearing at 10 (citing Opinion No. 531, 147 FERC ¶ 61,234 at P 142).

[85] *Id.* at 13-14 (citing *Consumers Energy Co*., 85 FERC ¶ 61,100; *S. Cal. Edison Co*., 88 FERC ¶ 61,254 (1999)).

argue that those two cases resulted in upward adjustments of 18 and 58 basis points, compared to the 118 basis point increase in this proceeding.[86]

41. EMCOS state that Opinion No. 531 rejects the use of the midpoint of the zone of reasonableness asserting that capital market conditions here are "unique" and "anomalous." EMCOS state that the ROE awarded must reflect the capital market conditions under which the NETOs operate and that Commission precedent recognizes the importance of basing an ROE on current market data.[87] Petitioners and EMCOS state that Opinion No. 531 asserts it must adopt an ROE higher than the midpoint because *Hope* and *Bluefield* require the Commission to identify an ROE that will attract sufficient capital; however, this position fails to recognize that market conditions must be reflected in an ROE in order for it to be just and reasonable. EMCOS explain that they made this argument in their Initial Brief, and that Opinion No. 531 acknowledged it, but did not provide any explanation of why it does not apply here.[88] EMCOS argue that this case covers "the Great Recession" which had an effect on all companies and consumers, but Opinion No. 531's decision to upwardly adjust the base ROE in this proceeding uniquely shields the NETOs from the economic realities of that time period at the expense of New England consumers.[89]

42. Petitioners state that Opinion No. 531's reliance on a single issuance from UBS Financial Services (UBS) included in the testimony of the NETOs' witness, Ms. Lapson, is neither well-founded nor consistent with the record. Petitioners also state that the reports in Ms. Lapson's testimony were not selected by her, but were hand-picked by the NETOs' counsel and that the testimony includes almost nothing addressing the views of specific investment analysts as to the potential impact of an ROE reduction in this proceeding on future transmission investment. Petitioners further argue that, a few months after the UBS report, UBS changed its mind and stated that the outcome of this proceeding "impacts only the generic New England rates." Petitioners explain that there were many different views taken by other analysts which were unrebutted, which they state explains why there is no well-founded basis for a concern that a base ROE reduction

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[86] *Id.* at 14-15.

[87] *Id.* at 16-17 (citing *Portland Natural Gas Transmission Sys*., Opinion No. 510-A, 142 FERC ¶ 61,198, at P 233 (2013); *Consumer Advocate Div. of the Pub. Serv. Comm'n of West Virginia v. Allegheny Generating Co*., 68 FERC ¶ 61,207, at 61,998 (1994) (*West Virginia Consumer Advocate*)).

[88] *Id.* at 17-18 (citing *Bluefield*, 262 U.S. at 692; *Hope*, 320 U.S. at 614).

[89] *Id.* at 19.

to the central result of the national proxy group could undermine the NETOs' ability to attract capital.[90]

43. Petitioners and EMCOS also assert that the Commission erred in relying on certain record evidence—i.e., the evidence of state commission-authorized ROEs and the NETOs' alternative methodologies for estimating the cost of equity—to corroborate the placement of the base ROE within the zone of reasonableness. Petitioners and EMCOS argue that, in relying on these alternative methodologies, Opinion No. 531 departed from Commission precedent without providing an explanation for doing so. Petitioners contend that the Commission has repeatedly found that non-DCF approaches to determining transmission ROEs are "unlikely to produce a just and reasonable result."[91] For example, Petitioners contend that, in the case that recently concluded with the D.C. Circuit affirming the Commission's sole reliance on the electric utility DCF median, Southern California Edison Company had sought to bolster its case for a high ROE by relying on the CAPM analysis.[92] Petitioners note that the Commission refrained from according the non-DCF analyses even the little weight sought by Southern California Edison Company. Petitioners argue that the use of the NETOs' alternative methodologies should have been subject to the well-established test for an above-center ROE: no upward movement should be undertaken unless those methodologies make "a very persuasive case" that the central result of a conventional DCF study fails to identify the subject utility's true equity cost.[93] Petitioners contend that the Commission failed to state a reasoned basis for not applying the "very persuasive case" standard.

44. Petitioners and EMCOS further argue that the Commission's reliance on the NETOs' alternative benchmark methodologies without scrutinizing their flaws is inconsistent with reasoned decision-making and constitutes judicially-reversible error.[94] Petitioners and EMCOS also argue that the Commission's DCF analysis contains certain

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[90] Petitioners Request for Rehearing 53-57.

[91] *Id.* at 30 (citing *Xcel Energy Servs., Inc.*, 122 FERC ¶ 61,098 at P 73, *clarified*, 125 FERC ¶ 61,092 (2008) (*Xcel*)).

[92] *Id.* at 30-31 (citing *S. Cal. Edison Co.*, 131 FERC ¶ 61,020, at P 114 (2010) (*SoCal Edison*), *reh'g denied*, 137 FERC ¶ 61,016 (2011), *petition for review granted in part and denied in part*, *S. Cal. Edison Co. v. FERC*, 717 F.3d 177).

[93] *Id.* at 32.

[94] *Id.*; EMCOS Request for Rehearing at 20 (citing *Ill. Pub. Telecomm. Ass'n v. FCC*, 117 F.3d 555, 564 (D.C. Cir. 1997)).

flaws that undermine the Commission's decision to place the base ROE above the midpoint of the zone of reasonableness.

45. Petitioners' and EMCOS's arguments as to the specific, alleged flaws in both the Commission's DCF analysis and the record evidence on which the Commission relied to corroborate the placement of the base ROE above the midpoint are described below.

iii. Commission Determination

46. We deny rehearing on the issue of where to place the NETOs' base ROE within the zone of reasonableness produced by the Commission's DCF analysis.

47. As an initial matter, we disagree with Petitioners' and EMCOS's arguments concerning the circumstances under which the Commission may set a base ROE at a point other than the central tendency of the zone of reasonableness.[95] Petitioners assert that the Commission may only do so by comparing the NETOs' risks to the risks of the proxy group produced by the DCF methodology—i.e., by conducting a comparison that the Commission has historically referred to as the "relative risk analysis." We disagree. In this case, the Commission found the proxy group to be comparable in risk to the NETOs,[96] but determined that it was necessary to adjust the NETOs' base ROE above the midpoint based on considerations other than the relative risk analysis.[97] While the Commission has indeed adjusted a company's base ROE above or below the central

[95] We also disagree with Petitioners' argument that the two precedents the Commission cited in support of using the midpoint of the upper half of the DCF-produced zone of reasonableness are distinguishable from the instant case because the upward adjustments in those two cases—*S. Cal. Edison Co.*, Opinion No. 445, 92 FERC ¶ 61,070, and *Consumers Energy Co.*, Opinion No. 429, 85 FERC ¶ 61,100—were of 58 and 18 basis points, respectively, compared to the 118 basis adjustment in Opinion No. 531. Nothing in those cases indicates that the Commission made those adjustments because they were for 58 or 18 basis points. Instead, the Commission in Opinion Nos. 445 and 429 placed the ROE at the midpoint of the upper half of the zone after finding that an upward adjustment was warranted, which is what the Commission did in Opinion No. 531.

[96] *See* Opinion No. 531, 147 FERC ¶ 61,234 at P 96.

[97] *Id.* PP 144-145.

tendency of the zone or reasonableness based on the relative risk analysis,[98] the Commission is not limited to making adjustments based only on the relative risk analysis. Petitioners' argument to the contrary is inconsistent with both court and Commission precedent showing that the Commission has the discretion to make,[99] and has in fact made, adjustments to a rate based on the particular circumstances of a case, including whether unique circumstances render the results of the Commission's DCF analysis less reliable than usual.[100]

48. We disagree with Petitioners' argument that the NETOs' are less risky than the proxy group. While Petitioners assert that 80 percent of the NETOs' have credit ratings between BBB to A, whereas the average credit rating of the proxy group company is between BBB and BBB+, this alone does not show that the NETOs are less risky than the proxy group. As explained in Opinion No. 531, the Commission uses the credit rating band because it "include[s] in the proxy group only those companies whose credit ratings *approximate* those of the utilities whose rates are at issue."[101] We thus reiterate that Commission's finding that the credit rating band of the proxy group is comparable to the NETOs' credit ratings.[102] Further, Petitioners' argument is based on a flawed comparison of the two groups' credit ratings. Assuming *arguendo* that it is helpful to compare the distribution of the NETOs' credit ratings to the average credit rating of proxy group companies, that analysis should be accompanied by a comparison of how the distribution of the proxy group companies' credit ratings compare to the average credit rating of the proxy group. In other words, the distribution of the NETOs' credit ratings should be compared to the distribution of the proxy companies' credit ratings. Petitioners' comparison is misleading because it fails to do this. In this case 34 of the 38 companies

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[98] *See, e.g.*, *Williston Basin Interstate Pipeline Co. v. FERC*, 165 F.3d at 57 ("Once the Commission has defined a zone of reasonableness [using the DCF model], it then assigns the pipeline a rate within that range to reflect specific investment risks associated with that pipeline as compared to the proxy group companies.").

[99] *See, e.g.*, *Fed. Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942) ("The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances.")

[100] *See, e.g.*, *Town of Norwood, Mass. v. FERC*, 80 F.3d 526, 534-535 (D.C. Cir. 1996).

[101] Opinion No. 531, 147 FERC ¶ 61,234 at P 106 (emphasis added).

[102] *See id.* P 108.

in the proxy group—i.e., 89 percent of the proxy companies—have credit ratings between BBB and A, compared to the 80 percent of the NETOs within that band.[103] This indicates that the credit ratings of the proxy group companies and the NETOs are similarly distributed, and supports a finding that the two groups have comparable risk profiles.

49. Petitioners and EMCOS argue that the Commission erred in basing its decision to set the NETOs' base ROE above the central tendency of the zone of reasonableness produced by the DCF analysis on the presence of anomalous capital market conditions. Petitioners specifically argue that the slow economic growth reflected in the record is not anomalous, but is instead a "new normal" and should, therefore, not justify adjusting the base ROE above the midpoint. We are not persuaded by Petitioners' argument. In Opinion No. 531, the Commission acknowledged that parties on both sides of the issue had cited to unique capital market conditions.[104] The Commission also referenced U.S. Treasury bond yields, not economic growth, as an indicator of current capital market conditions. Given the undisputed presence of such anomalous capital market conditions, the Commission stated that it had "less confidence that the midpoint of the zone of reasonableness established in this proceeding accurately reflects the equity returns necessary to meet the *Hope* and *Bluefield* capital attraction standards."[105] However, we did not stop there in our analysis of whether it was appropriate to establish a base ROE above the midpoint. Rather, the record evidence of unusual capital market conditions served as an impetus for the Commission's consideration of additional record evidence. This consideration was necessary to evaluate, in this proceeding, whether setting the NETOs' ROE at the midpoint of the zone of reasonableness satisfied the requirements of *Hope* and *Bluefield*. Therefore, the Commission conducted a further analysis by analyzing the additional record evidence, including evidence of alternative benchmark methodologies and state commission-approved ROEs, to gain insight into the potential impacts of the unusual capital market conditions on the appropriateness of using the resulting midpoint. We then used this additional record evidence to corroborate our determination that placement at a point above the midpoint was warranted.[106]

50. We also reject EMCOS's argument that, even if the capital market conditions reflected in the record are anomalous, adjusting the NETOs' ROE based on an economic anomaly ignores the *Hope* and *Bluefield* requirement that a utility's ROE must reflect current market conditions. EMCOS specifically argue that whether capital market

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[103] *See* Ex. NET-701.

[104] Opinion No. 531, 147 FERC ¶ 61,234 at P 145.

[105] *Id.*

[106] *Id.* PP 146-149.

conditions in the record are anomalous from a historical perspective is irrelevant to the determination of a just and reasonable base ROE, because the base ROE must reflect the capital market conditions under which the NETOs operate, even if those conditions are historically anomalous. We disagree. The EMCOS's argument assumes that DCF analyses are immune to ever being skewed by economic anomalies. This assumption is unrealistic, as all methods of estimating the cost of equity are susceptible to error when the assumptions underlying them are anomalous.[107] The Commission, in fact, acknowledged this limitation in Opinion No. 531,[108] and was concerned that a mechanical application of the two-step DCF methodology with the use of the midpoint in such circumstances would produce a return that would not satisfy the requirements of *Hope* and *Bluefield*.[109] Therefore, based on the presence of anomalous capital market conditions, the Commission considered additional record evidence that supported an upward adjustment. Contrary to EMCOS's assertions, the Commission is not constrained to a mechanical application of the DCF methodology where the Commission determines that such an approach will not produce a just and reasonable result.[110] We further reject

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[107] Roger A. Morin, New Regulatory Finance 28 (Public Utilities Reports, Inc. 2006) ("For instance, by relying solely on the DCF model at a time when the fundamental assumptions underlying the DCF model are tenuous, a regulatory body greatly limits its flexibility and increases the risk of authorizing unreasonable rates of return. The same is true for any one specific model."). We note that participants on both sides of the instant ROE issue in this proceeding have relied upon Dr. Morin's New Regulatory Finance. *See*, *e.g.*, Ex. S-1 at 59-60 (Trial Staff exhibit quoting New Regulatory Finance); Ex. NET-300 at 67 (NETOs exhibit quoting New Regulatory Finance); Tr. 580-581 (Complainants' cross-examination relying on New Regulatory Finance).

[108] Opinion No. 531, 147 FERC ¶ 61,234 at PP 41, 145.

[109] *Id.* PP 150-152.

[110] *See Fed. Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. at 586 ("The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances.").

We note that neither of the Commission precedents to which Complainants cite in support of their argument—*Portland Nat. Gas Transmission Sys.*, Opinion No. 510-A, 142 FERC ¶ 61,198 (2013) (Opinion No. 510-A) and *West Virginia Consumer Advocate*, 68 FERC ¶ 61,207—constrain the Commission to mechanically apply a particular ratemaking approach without regard to economic anomalies. *West Virginia Consumer Advocate* did not involve any unusual capital market conditions. *See generally West*

(continued…)

EMCOS's argument that this analysis should be affected by the fact that the NETOs can subsequently request a rate increase under FPA section 205. The NETOs' ability to subsequently request a rate increase if economic conditions change does not excuse the Commission from establishing an ROE under FPA section 206 that meets the requirements of *Hope* and *Bluefield*.

51. Petitioners argue that the Commission erred in finding that a base ROE of 9.39 percent could undermine the NETOs' ability to attract capital for new investment, because the finding was based on only one analyst's report, from UBS, which is contradicted by record evidence of other analysts' reports. We disagree. Petitioners specifically cite analysts' reports from Credit Suisse; Goldman Sachs; Brean Murray, Carret & Co. (Brean Murray); Deutsche Bank; and a subsequent report from UBS. But none of the reports Petitioners cite contradicts the finding that a base ROE of 9.39 percent—i.e., a reduction of 175 basis points from the existing base ROE—could undermine the NETOs' ability to attract capital.[111]

52. The Deutsche Bank report and the subsequent report from UBS provide no analysis of how a reduced base ROE would impact the NETOs and, therefore, do not contradict the UBS report the Commission relied upon in Opinion No. 531. The Deutsche Bank report merely states the possibility that the Commission could reduce the NETOs' base ROE as a result of the low interest rate environment, while the later UBS

Virginia Consumer Advocate, 68 FERC ¶ 61,207. While Opinion No. 510-A did involve allegations of economic anomalies, the Commission in that case, in fact, weighed the evidence of anomalous conditions in determining whether to apply its policy of using the most recent record data or to use an alternative data set. *See* Opinion No. 510-A, 142 FERC ¶ 61,198 at P 233. Thus, Opinion No. 510-A demonstrates that the Commission may indeed consider, as it has here in Opinion No. 531, whether to apply or adjust an established policy based on anomalous economic conditions.

[111] We also reject Petitioners' argument that the NETOs' expert witness was not qualified to present testimony on this issue. The NETOs' expert witness has 43 years of experience as a financial professional, including 38 years focused on financial analysis and securities evaluation within the utilities sector, and was formerly the Managing Director of the utilities, power, and gas analytical team at Fitch Ratings, where she "supervised and wrote the credit rating criteria applied in the electric, gas, and water sector." Ex. NET-400 at 1-3.

The Presiding Judge, furthermore, admitted this witness's testimony into the record and found it "to have moderate probative value." *See* Initial Decision, 144 FERC ¶ 63,012 at P 576; *Entergy Servs., Inc.*, 109 FERC ¶ 61,108, at P 7 (2004) (citing 18 C.F.R. § 385.209 (2004)).

report describes the scope of the proceeding and predicts a general trend of lower ROEs for regulated utilities, without discussing the magnitude of the potential ROE reductions or their impact on utilities' ability to attract capital.

53. The reports from Credit Suisse, Goldman Sachs, and Brean Murray provide limited analysis of two holding companies that are parent companies to certain NETOs, and none of that analysis undermines the UBS report the Commission cited in Opinion No. 531. The Credit Suisse report states that a 50 to 100 basis point reduction in Northeast Utilities' ROE in this proceeding would be a "positive" for the company.[112] This statement, which we interpret to mean simply that a reduction of 50 to 100 basis points would be better for Northeast Utilities than would an even greater reduction, is silent on the impacts that a reduced ROE would have on Northeast Utilities' ability to attract capital. The Goldman Sachs report, which also only addresses Northeast Utilities, states that a 100 basis point reduction to Northeast Utilities' ROE would have a minimal impact on Northeast Utilities' earnings per share and that the impact could be overcome by adding $200-$300 million in transmission projects to Northeast Utilities' rate base. This evidence is solely focused on the impact that an ROE reduction would have on Northeast Utilities' earnings per share and, therefore, provides insufficient evidence to determine how such a reduction would impact Northeast Utilities' ability to attract capital.[113] Because the Credit Suisse and the Goldman Sachs reports only address the impact of ROE reductions of up to 100 basis points, neither is probative on the issue of how a significantly greater 175 basis point ROE reduction to 9.39 percent would affect the NETOs' ability to attract capital.

54. The Brean Murray report, which states that "[a] negative impact to [UIL Holdings] from an adverse decision would be minimal, in our view," is the least probative of these three reports. What would constitute an "adverse decision," for example, is unclear. Whether and to what magnitude an adverse ruling in this proceeding would impact the NETOs' ability to attract capital, moreover, cannot be determined with any certainty based on the magnitude of the impact the ruling might have on the much larger and more diversified parent company of one of the NETOs.

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[112] Petitioners Request for Rehearing at 57; Ex. SC-518 at 5. We further note that the 10.57 percent base ROE established in this proceeding reduced the NETOs' base ROE by 57 basis points, which is within the 50 to 100 basis point range that Credit Suisse reported would be a positive outcome for Northeast Utilities.

[113] While a company's earnings are undeniably relevant to its ability to attract capital, it is merely one of multiple factors investors rely on in determining whether to invest in the company. For example, looking at earnings in isolation provides no information about the company's dividend yield.

55. We are also unpersuaded by Petitioners' arguments that, if the Commission concludes that the NETOs' base ROE should be set above the midpoint of the zone of reasonableness, the base ROE should be placed at the true 75th percentile of the zone of reasonableness, i.e., 9.84 percent, rather than at the 10.57 percent midpoint of the upper half of the zone. As the Commission explained in Opinion No. 531, the Commission has traditionally used measures of central tendency to determine an appropriate return in ROE cases and, in cases involving the placement of the base ROE above the central tendency of the zone of reasonableness, the Commission has used the central tendency of the top half of the zone. Our decision to utilize the midpoint of the upper half of the zone is based on the record evidence in this proceeding and is consistent with the Commission's established policy of using the midpoint of the ROEs in a proxy group when establishing a central tendency for a region-wide group of utilities.[114] Further, we reject Petitioners' assertion that *Northwest Pipeline Corp.*, 99 FERC ¶ 61,305 (2002), requires the Commission to consider the distribution of results within the proxy group when determining where in the upper half of the zone to place the NETOs' base ROE. *Northwest Pipeline Corp.* does not bear on the Commission's decision in this proceeding to place the NETOs' base ROE above the midpoint of the zone of reasonableness, as that case involved the issue of which particular measure of central tendency should be used in setting a single pipeline's ROE *at the middle* of the zone of reasonableness.[115]

56. Lastly, we disagree with Petitioners that the Commission erred in relying on the NETOs' alternative methodologies to support its decision that an upward adjustment from the midpoint was warranted in this case. While Petitioners cite *Xcel*, 122 FERC ¶ 61,098, *Pacific Gas & Electric Company*, 141 FERC ¶ 61,168 (2012) (*PG&E*), *SoCal Edison*, 131 FERC ¶ 61,020, and *ITC Holdings Corp.*, 121 FERC ¶ 61,229 (2007)

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[114] *SoCal Edison*, 131 FERC ¶ 61,020 at P 92, *aff'd in relevant part, S. Cal. Edison Co. v. FERC*, 717 F.3d at 185-87.

[115] *Northwest Pipeline Corp.*, 99 FERC ¶ 61,305 at 62,276. The Commission typically looks to the central tendency as the "most just and reasonable" and "most appropriate" return that best considers that range, and typically uses the median as the measure of central tendency in cases involving a single utility's ROE and uses the midpoint as the measure of central tendency in cases involving the ROE for a group of utilities. *See Midwest Indep. Transmission Sys. Operator, Inc.*, 106 FERC ¶ 61,302, at PP 9-10 (2004), *aff'd in relevant part sub nom. Pub. Serv. Comm'n of Ky. v. FERC*, 397 F.3d 1004, 1010-11 (D.C. Cir. 2005) (*PSC of Kentucky*); *SoCal Edison*, 131 FERC ¶ 61,020 at P 92, *aff'd in relevant part*, *S. Cal. Edison Co. v. FERC*, 717 F.3d at 185-87. *Northwest Pipeline Corp.*, in contrast, merely explains the rationale for selecting the median as the appropriate measure of central tendency in a case involving a single utility's ROE.

(*ITC Holdings*), as precedent in which the Commission has declined to rely on alternative methodologies, we find the precedent to be distinguishable from the instant case because in none of those four cases did the record contain evidence of unique capital market conditions that called into question the rote application of the midpoint of the zone of reasonableness resulting from the Commission's DCF methodology. Additionally, in *PG&E*, the Commission set the ROE issue for hearing without any reference to the reliability of the alternative methodologies the utility submitted in support of its filing.[116] Further, Petitioners are mistaken that the Commission in *SoCal Edison* did not give weight to the alternative methodologies. As the Commission in that case explained, the three alternative methodologies submitted in that case "were not used by the Commission in setting a base ROE for SoCal Edison," but "were used to corroborate the results of its DCF analysis."[117] With regard to *ITC Holdings*, as discussed below, the CAPM analysis presented in that case contained methodological shortcomings that distinguish it from the NETOs' CAPM analysis in this case.[118]

57. Petitioners and EMCOS also allege that the Commission's DCF analysis and the evidence the Commission relied upon to corroborate it contain various flaws. Those arguments are addressed in turn below.

b. <u>Discounted Cash Flow Analysis</u>

i. <u>Opinion No. 531</u>

58. In Opinion No. 531, the Commission conducted a DCF analysis using a national proxy group of companies listed as Electric Utilities by *Value Line* and that had credit ratings within one notch above or below the NETOs' credit ratings (referred to as the "credit rating screen"), had paid 6-months of dividend yields without making or announcing a dividend cut, were not involved in merger and acquisition activity significant enough to distort the DCF results, and were not low-end or high-end outliers.

59. In using the national proxy group, rather than a regional proxy group, the Commission explained that "widening the geographic range of the proxy group allows for the application of more stringent screening criteria, to refine the proxy group to a level of risk more comparable, while maintaining a group of proxy companies that is sufficiently

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[116] *PG&E*, 141 FERC ¶ 61,168 at P 23.

[117] *SoCal Edison*, 131 FERC ¶ 61,020 at P 116. And here they were similarly used to "gain insight" and "inform" our thinking on whether an upward adjustment was reasonable. Opinion No. 531, 147 FERC ¶ 61,234 at PP 145-149.

[118] *See infra* P 115.

large and diverse to reliably capture the range of reasonable returns."[119] In applying the credit rating screen, the Commission explained that "the purpose of the credit rating band screen is to include in the proxy group only those companies whose credit ratings approximate those of the utilities whose rates are at issue."[120] The Commission found that, because investors rely on credit ratings from both Standard & Poor's (S&P) and Moody's, "basing the credit rating screen on data only from S&P does not necessarily provide an accurate estimate of the NETOs' risk."[121] Therefore, the Commission found that "in applying the credit rating proxy group screen to exclude companies more than one notch above or below the NETOs' credit ratings, it is appropriate to use both the S&P corporate credit ratings and the Moody's issuer ratings *when both are available*."[122] Because the NETOs' S&P credit ratings ranged from A- to BBB and Moody's credit ratings ranged from A2 to Baa2, the Commission excluded companies from the proxy group that were more than one notch above or below either of those credit rating bands.[123]

60. In screening the proxy groups for outliers, the Commission affirmed the Presiding Judge's application of the Commission's low-end outlier test in this proceeding, explaining that the "purpose of the low-end outlier test is to exclude from the proxy group those companies whose ROE estimates are below the average bond yield or are above the average bond yield but are sufficiently low that an investor would consider the stock to yield essentially the same return as debt."[124] The Commission explained that "[i]n public utility ROE cases, the Commission has used 100 basis points above the cost of debt as an approximation of this threshold, but has also considered the distribution of the proxy group companies to inform its decision on which companies are outliers."[125] The Commission explained that the cost of debt for the relevant study period was 4.61 percent and, therefore, the Commission eliminated three companies whose DCF results failed the low-end outlier test—Edison International (3.11 percent), Ameren Corp.

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[119] Opinion No. 531, 147 FERC ¶ 61,234 at P 96.

[120] *Id.* P 106.

[121] *Id.* P 107.

[122] *Id.*

[123] *Id.* P 108.

[124] *Id.* P 121.

[125] *Id.*

(5.26 percent), and Public Service Enterprise Group Inc. (PSEG) (5.62 percent).[126] The Commission explained that PSEG's DCF result was only one basis point above the 100 basis point threshold, and that the Commission's decision to eliminate PSEG was informed by the fact that there was a 141 basis point break between PSEG's DCF result and that of the next lowest proxy group company.[127]

61. With regard to the high-end outlier test, the Commission found that "the high-end outlier issue in this proceeding is moot,"[128] explaining that "[u]nder the two-step DCF methodology, it is unnecessary to screen the proxy group for unsustainable growth rates because the methodology assumes the long-term growth rate for each company is equal to GDP." The Commission explained that, as a result, "no company in the proxy group we are adopting here has a composite growth rate under the two-step DCF methodology in excess of the 7.66 percent growth rate of PNM Resources, Inc., or an ROE in excess of the 11.74 percent ROE of UIL Holdings," which are "well within any high-end outlier test we have previously applied in utility rate cases."[129]

ii. Requests for Rehearing

62. Petitioners assert that the Commission's DCF analysis in Opinion No. 531 contained flaws that undermine the Commission's decision to place the base ROE above the midpoint of the zone of reasonableness.

63. Petitioners argue that the Commission erred in relying on a short-term growth estimate for UIL Holdings, Inc. (UIL Holdings) of 8.07 percent, which Petitioners allege was based on only one analyst estimate.[130] According to Petitioners, Commission precedent indicates that, when calculating the dividend growth rate, the Commission's analysis should be based upon as much independently calculated data as possible, and that IBES growth estimates are reliable only insofar as they represent the consensus of

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[126] *Id.* P 123.

[127] *Id.*

[128] *Id.* P 118.

[129] *Id.*

[130] Petitioners Request for Rehearing at 48 (citing Exs. SC-313 and SC-314 (showing that 8.07 percent long-term growth projection for UIL Holdings represents the forecast of one analyst)).

multiple analysts.[131] In addition, Petitioners state that the Commission has made clear that its approval of the Yahoo! reported growth estimates that represent a consensus is not exclusive of other credible sources[132] and that comparable growth projections from other sources could be considered along with Value Line projections and what was then IBES.[133]

64. Petitioners state that it is critical in this case, and in future cases, that the Commission follow its precedent by requiring that the short-term growth rate for each proxy company be based on multiple projections. Petitioners argue that UIL Holdings's New England transmission business is smaller than its natural gas distribution business,[134] and it is therefore a less-than-ideal proxy for setting an electric transmission ROE.[135] Petitioners also assert that, during the relevant period, the Moody's credit rating for UIL Holdings was Baa3, lower than the Baa2 rating of its transmission subsidiary, United Illuminating Company, and the lowest rank among all retained proxy

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[131] *Id.* at 45 (citing *Yankee Atomic Elec. Co.*, Opinion No. 285, 40 FERC ¶ 61,372, at 62,210 (1987) (*Yankee Atomic*), *reh'g denied*, Opinion No. 285- A, 43 FERC ¶ 61,232 (1988) (rejecting sole reliance on Zacks' predictions of earnings growth in favor of multiple data sources for projecting earnings); *Northwest Pipeline Corp*., 87 FERC ¶ 61,266, at 62,059 (1999) (*Northwest Pipeline*) ("[t]he IBES data is a compilation of projected growth rates from various knowledgeable financial advisors with the industry.")).

[132] *Id.* at 46 (citing *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048, at PP 83-84 (2008), *reh'g dismissed*, 123 FERC ¶ 61,259 (2008) (conditionally allowing, but not requiring, reference to growth forecasts published by Yahoo!)).

[133] *Id.* (citing *ISO New England, Inc.*, 109 FERC ¶ 61,147, at P 205 (2004), *petition for review denied sub nom. Me. Pub. Utils. Comm'n v. FERC*, 454 F.3d 278 (D.C. Cir. 2006); *ISO New England, Inc.*, 110 FERC ¶ 61,111, at P 23, *reh'g denied*, 111 FERC ¶ 61,344 (2005)).

[134] *Id.* at 49.

[135] *Id.* (citing *Consumers Energy Co.*, Opinion No. 456, 98 FERC ¶ 61,333 (2002)).

companies.[136] Petitioners assert that these considerations provide reasons to avoid undue reliance on the forecasts of one analyst.[137]

65. Petitioners state that because the IBES projection for UIL Holdings was the opinion of a single analyst, Opinion No. 531 erred in failing to apply any of the other growth estimates available in the record to check whether the IBES projection for UIL Holdings produced reasonable results. Petitioners contend that neither Opinion No. 531 nor any participant identified a prior case in which the Commission placed the base ROE three-quarters of the way up the zone of reasonableness based on a high-end proxy result that was driven by the forecast of just one analyst. Petitioners state that using Value Line or Reuters data for UIL Holdings's short-term growth rate in the two-step DCF methodology provides a more appropriate benchmark than the NETOs' alternative cost of equity studies, and shows that a base ROE of 9.39 percent is sufficient for the NETOs.[138]

66. Petitioners also argue that UIL Holdings's DCF result reflects a "circularity problem" that counsels against placing the base ROE at the upper quarter of the zone of reasonableness, and instead supports placing the base ROE no higher than the true 75th percentile of the proxy group companies' DCF results. Petitioners state that the "circularity problem" is that much of UIL Holdings's dividends, earnings, and earnings growth are a result of ROE incentive adders, and UIL Holdings's DCF result reflects investors' expected revenues from those ROE incentive adders. Petitioners assert that the NETOs' base ROE should be determined exclusive of the transmission incentive revenues of the proxy group companies.

67. Petitioners also state that this circularity problem should have been mitigated by placing the base ROE closer to the true "75th percentile" of the proxy group DCF results, i.e., based on 75 percent of the 38 proxy company results (interpolated between the 28th-highest and 29th-highest results), rather than at the upper quarter of the zone of reasonableness. Petitioners state that the key difference between the actual 75th percentile and the top-quarter approach that Opinion No. 531 labels as the "75th percentile" is that the actual percentile reflects the distribution of proxy group results, whereas the Commission's top-quarter approach discards all of that information and relies on the 3:1 weighted average of the two most extreme results. Petitioners assert that discarding information on the distribution of proxy results and considering only their

[136] *Id.* (citing Ex. NET-600 at 9).

[137] *Id.*

[138] *Id.* at 45.

extremes is statistically indefensible and inconsistent with precedent applying Opinion No. 531's two-step DCF methodology.[139]

68. Lastly, Petitioners argue that the Commission erred in eliminating PSEG's DCF result of 5.61 percent as a low-end outlier, thereby raising the bottom of the zone of reasonableness produced by the Commission's DCF analysis. Petitioners state that this error reinforces the arguments against raising the base ROE within the zone of reasonableness. Petitioners state that Opinion No. 531 discarded PSEG's DCF result on the grounds that, although it was above the average bond yield by more than 100 basis points, it fell below a "natural break" in the proxy group's DCF results. Petitioners argue that, while Opinion No. 531 states that this rationale "buttressed" the decision to exclude PSEG, the natural break was actually the sole basis for the Commission's decision.[140]

69. Petitioners argue that the "natural break" standard must be applied evenhandedly to low-end and high-end outliers alike, but in Opinion No. 531 the Commission ignored the fact that there was a comparable "natural break" at the high end of the range of DCF results. Specifically, Petitioners assert that the 5.62 percent result for PSEG should not have been discarded unless the 11.74 percent result for UIL Holdings was also discarded.[141]

iii. <u>Commission Determination</u>

70. We deny rehearing on the various issues that Petitioners and EMCOS raise concerning the Commission's DCF analysis and their related objections to setting the base ROE above the midpoint of the zone of reasonableness.

71. Petitioners argue that the Commission erred in using UIL Holdings's DCF result to set the top of the zone of reasonableness in the Commission's DCF analysis, because UIL Holdings's DCF result was based on an IBES short-term growth projection that reflected only one analyst's growth rate projection. We reject this argument as it is contrary to years of established Commission precedent approving the use of IBES short-term growth projections in the two-step DCF methodology. For example, in *Transcontinental Gas Pipe Line Corp*.[142] the Commission rejected contentions that IBES

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[139] *Id.* at 58-59 (citing *Northwest Pipeline Corp*., 99 FERC ¶ 61,305).

[140] *Id.* at 60.

[141] *Id.* at 61.

[142] *Transcontinental Gas Pipe Line Corp*., Opinion No. 414-B, 85 FERC ¶ 61,323, at 62,268-9 (1998) (Opinion No. 414-B).

growth projections should not be used in the two-step DCF methodology, because the analysts making those projections allegedly are overly optimistic in their projections. The Commission pointed to substantial evidence in the record of that case that investors rely on IBES growth projections in making investment decisions. The Commission also noted that the appropriate dividend growth rate to include in a DCF analysis is the growth rate expected by the market. While the market may be wrong in its expectations as reflected in the IBES growth projections, the cost of common equity to a regulated enterprise depends upon what the market expects, not upon precisely what is actually going to happen.

72. We recognize that the Commission has supported its use of IBES growth projections based on the fact that the IBES data is a compilation of projected growth rates from various knowledgeable financial advisors.[143] However, the Commission has not required that the IBES growth projection for each member of the proxy group reflect a minimum number of analyst growth estimates.[144] IBES, which the Commission has long relied on as the source of the growth rate projections to be used in the Commission's DCF analyses, does not publish the number of analyst estimates on which a company's growth rate estimate is based.[145] As a result, there seems little reason to conclude that investors' reliance on IBES growth projections necessarily varies depending upon the exact number of analysts contributing to any particular IBES growth projection. On balance, we find it preferable to use a consistent source of dividend growth projections for all members of the proxy group as provided by IBES, rather than to use different sources of growth projections depending upon the number of analysts contributing to each IBES growth projection, which, as discussed below, could produce skewed results. Accordingly, if a proxy company has a growth rate estimate from IBES, as does UIL Holdings, that growth rate is acceptable for purposes of the Commission's DCF analysis, regardless of the number of analysts on which it was based.

73. Contrary to Petitioners' assertion, *Yankee Atomic* and *Northwest Pipeline* do not require a different result. *Yankee Atomic* involved a much different analysis than in the instant case, because the Commission found that the small proxy group in *Yankee Atomic* was "not a valid indicator of the Yankee companies' cost of capital because the five companies are different from the Yankees in too many significant respects."[146] Because

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[143] *Northwest Pipeline*, 87 FERC ¶ 61,266 at 62,059.

[144] *E.g.*, *SoCal Edison*, 131 FERC ¶ 61,020 at P 36.

[145] We also note that the Value Line data—which the Commission has similarly long relied upon as the source of earnings estimates in ROE proceedings—for any company consists of an earnings estimate from only one analyst.

[146] *Yankee Atomic*, 40 FERC ¶ 61,372 at 62,211.

the record did not contain a valid proxy group, the Commission had to project the Yankee Companies' dividend growth based solely on projections of those companies' own dividend growth. Therefore, the Commission determined that it should base the Yankee Companies' dividend growth projection on as many independent growth projections as possible. In contrast, this case involves a robust proxy group of companies that are comparable to the NETOs, for which dividend growth projections are available to enable the Commission to conduct a full DCF analysis. This provides the Commission a significant amount of information concerning the NETOs' cost of equity. As to *Northwest Pipeline*, in that case the Commission actually rejected the very argument on which Petitioners rely, as the Commission found that it would be inappropriate to use multiple sources of growth rate data, rather than IBES alone, in determining the short-term growth projection in the two-step DCF methodology.[147]

74. Petitioners argue that the Commission erred in placing the base ROE halfway between the midpoint of the zone of reasonableness and the top of the zone because UIL Holdings's high-end result is affected by a "circularity problem," i.e., that UIL Holdings's dividends, earnings, and earnings growth are impacted by its incentive ROE adders. The Commission has rejected this argument in the past, and we do so here for the same reasons. In Order No. 679-A, the Commission rejected the argument "that incentive ROEs will 'destabilize' the DCF methodology," explaining that

> First, . . . all ROEs approved pursuant to section 219 will be within the range of reasonableness, as determined consistent with our precedents. Second, any incentive ROEs granted under section 219 should have minimal effect, if any, on the overall range of reasonableness derived from the appropriate proxy group. The DCF methodology uses proxy groups of entire companies, not individual transmission projects. In other words, the "cash flows" being measured in the DCF method are the cash flows of entire companies. These cash flows should not be significantly affected by an incentive return for any particular transmission project for one company within the proxy group. Moreover, to the extent there is any small effect on the overall range of reasonableness, it will appropriately reflect the substantial risks associated with constructing new transmission[.][148]

75. Further, even assuming *arguendo* that this circularity problem exists, it exists for any proxy group company that receives incentive adders and Petitioners have presented no methodology for determining whether or how much a company's incentive adders

[147] *See Northwest Pipeline*, 87 FERC ¶ 61,266 at 62,058-59.

[148] Order No. 679-A, FERC Stats. & Regs. ¶ 31,236 at P 62 (cross-referenced at 117 FERC ¶ 61,345 at P 62).

might impact investors' expectations for a particular company, particularly where the proxy company at issue is involved in diverse business activities, as is UIL Holdings. Thus, absent more evidence, we are not persuaded that this potential "circularity problem" warrants an adjustment to the NETOs' base ROE. Further, even if Petitioners had shown this alleged circularity to be a legitimate problem warranting an adjustment to the base ROE, Petitioners have not shown that placing the base ROE at their proposed true 75th percentile of the proxy group results would be an appropriate solution.

76. We also reject Petitioners' argument that the Commission should have compared UIL Holdings's IBES growth rate against the Reuters data Trial Staff provided and the "br+sv"[149] data in the record. We relied only on IBES data for the DCF analysis in this proceeding, because that is the only short-term growth data available in the record for all the proxy companies. As the Commission explained in Opinion No. 531, "[u]sing different sources of growth rate data for different companies in a proxy group could produce skewed results, because those sources may take different approaches to calculating growth rates."[150] A comparison between UIL Holdings's IBES data and other non-IBES data in the record would be susceptible to this same skewing effect, and therefore would not provide a reliable comparison. Further, as the Commission explained in Opinion No. 531, while "the purpose of the 'br+sv' growth estimate is to act as a check on the reasonableness of the IBES forecasts," in practice the two sources often produce "widely divergent growth rates that do not engender much confidence in the reliability of the estimates."[151] We are, therefore, not persuaded that it is necessary to compare the IBES growth rate data to the "br+sv" data. In addition, we disagree with Petitioners that declining to mix growth rate sources is inconsistent with Opinion No. 531's allowance of credit ratings from both Moody's and S&P. The purpose of using data from both Moody's and S&P is to identify a group of comparable risk companies. In contrast, the purpose of not using multiple sources of growth rate data is to ensure that the cost of equity for each company in the proxy group is estimated using the same protocols.

77. We also reject Petitioners' argument that the Commission should have used the "br+sv" growth rate as the short-term growth rate in the two-step DCF methodology.

[149] The term "br+sv" represents the sustainable growth formula, in the one-step DCF methodology that the Commission used for public utilities prior to Opinion No. 531, where "b" is the percentage of earnings expected to be retained (after the payment of dividends), "r" is the expected rate of return on book equity, "s" is the percent of common equity expected to be issued annually as new common stock, and "v" is the equity accretion rate.

[150] Opinion No. 531, 147 FERC ¶ 61,234 at P 90.

[151] *Id.* P 37.

While the "br+sv" growth formula relies on short-term Value Line projections of five years or less for the various inputs to the formula, it seeks to estimate a company's "sustainable growth rate." For that reason, although the Commission has stated that the formula "only produces a projection of short-term growth, similar to the IBES projections,"[152] the Commission finds the formula unreasonable for use as the short-term growth projection in the two-step DCF methodology. By seeking to estimate a "sustainable growth rate," the "br+sv" growth formula also contains some elements of a long-term growth projection, in addition to a short-term growth projection, and thus is inappropriate for use as a purely short-term growth projection in a two-step DCF methodology. The Commission adopted the two-step DCF methodology because, among other reasons, its incorporation of a long-term growth projection in the cost of equity calculation would have the effect of ascribing sustainable long-term growth to all members of a proxy group.[153] Thus, the Commission's adoption of the two-step DCF methodology accomplishes what the use of the "br+sv" formula was intended to accomplish.[154]

78. We reject Petitioners' arguments that the Commission erred in its application of the low-end and high-end outlier tests. We reiterate that it is appropriate—and consistent with Commission precedent—to eliminate PSEG as a low-end outlier in this case because PSEG's DCF result is a mere 101 basis points above the applicable bond yield and there is a 141 basis point break between PSEG's DCF result and the next lowest result. Further, we reject as inconsistent with Commission precedent Petitioners' argument that the Commission should have adopted the NETOs' proposed adjustment to the low-end outlier test instead of placing the base ROE above the midpoint of zone of reasonableness. Petitioners have identified no precedent in which the Commission has adopted such an adjustment to the low-end outlier test, and we are not persuaded to do so in this case.

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[152] *Id.* P 34.

[153] *Id.* PP 38, 40.

[154] We also note that the Commission's rationale for adopting the two-step DCF methodology in Opinion No. 531 was, in part, to use a methodology that is more consistent with the methodology the Commission has applied in natural gas and oil pipeline cases. *See id.* P 36. However, using "br+sv" in place of IBES growth rates, as Complainants request, would produce a DCF methodology that is less closely aligned with the methodology the Commission uses in natural gas and oil pipeline cases, where the Commission has rejected the use of the "br+sv" formula. *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 100.

79. Petitioners next argue that, if the Commission eliminates PSEG as a low-end outlier, it must also eliminate UIL Holdings as a high-end outlier because UIL Holdings's DCF result is 112 basis points above the next highest DCF result, and the Commission must apply the same "natural break" analysis in both the low-end and high-end outlier tests. We disagree. The low-end outlier test and the high-end outlier test serve very different purposes: the low-end outlier test is intended to screen out companies whose ROE estimates are low enough that an investor would consider the stock to yield essentially the same return as debt,[155] whereas the high-end outlier test is intended to screen out companies whose growth rates are unsustainably high and therefore fail a threshold test of economic logic.[156] As the Commission explained in Opinion No. 531, the high-end outlier issue in this proceeding is moot because the two-step DCF methodology assumes that the long-term growth rate of all proxy companies is equal to GDP, and is therefore sustainable.

c. State Commission-Authorized ROEs

i. Opinion No. 531

80. The Commission in Opinion No. 531 found that the record evidence of state commission-approved ROEs supported the Commission's determination that a base ROE at the midpoint of the zone of reasonableness would not satisfy *Hope* and *Bluefield*. The Commission explained that, while it has "repeatedly held that it does not establish utilities' ROE based on state commission ROEs for state-regulated electric distribution assets,"[157] this proceeding presents "circumstances under which the midpoint of the zone of reasonableness established in this proceeding has fallen below state commission-approved ROEs, even though transmission entails unique risks that state-regulated electric distribution does not."[158] More specifically, the Commission explained that "while the midpoint in this case is 9.39 percent, the record indicates that, over the 24-month period from October 1, 2010 through September 30, 2012, approximately 85 percent to 91 percent of state commission authorized ROEs were between 9.8 percent and 10.74 percent."[159] Accordingly, the Commission found that "[a]lthough we are not using the state commission-approved ROEs to establish the NETOs' ROE in this

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[155] *See S. Cal. Edison Co.*, 92 FERC ¶ 61,070 at 61,266.

[156] *See, e.g.*, *ISO New England, Inc.*, 109 FERC ¶ 61,147 at P 205.

[157] Opinion No. 531, 147 FERC ¶ 61,234 at P 148.

[158] *Id.*

[159] *Id.*

proceeding, the discrepancy between state ROEs and the 9.39 percent midpoint serves as an indicator that an upward adjustment to the midpoint here is warranted to satisfy *Hope* and *Bluefield*."[160]

ii. Requests for Rehearing

81. Petitioners and EMCOS argue that the Commission erred in relying on state commission-authorized ROEs in Opinion No. 531, because comparisons to state-authorized ROEs are not relevant to this proceeding and do not support raising the NETOs' base ROE from the 9.39 percent midpoint to the 10.57 percent upper quartile figure.[161] Petitioners argue that Opinion No. 531 erroneously relies on the spin that the NETOs placed on Ex. NET-403's data, repeating their argument that "approximately 85 percent to 91 percent of state commission authorized ROEs were between 9.8 percent and 10.74 percent."[162] EMCOS argue that the fact that some state commission-approved ROEs are higher than the midpoint in this proceeding is insufficient evidence to support Opinion No. 531's decision to ignore the Commission's strong preference for the use of the midpoint.[163] Petitioners contend that reference points presented in the exhibit show that 89 percent of the past-period state commission ROE outcomes collected by the NETOs fall below 10.57 percent.[164] Petitioners further contend that the central tendency values of the state commission-authorized ROEs presented by the NETOs are a mode of 10 percent, median of 10.13 percent, a mean of 10.14 percent, and a midpoint of 10.25 percent. Petitioners argue that Opinion No. 531 does not explain how these data justify a 10.57 percent base ROE.[165]

82. Petitioners and EMCOS contend that the state commission-authorized ROEs upon which the Commission relied were tainted by substantial lag, and that relying on them is therefore inconsistent with Opinion No. 531's emphasis on using the most recent

[160] *Id.*

[161] Petitioners Request for Rehearing at 23; EMCOS Request for Rehearing at 25-26.

[162] Petitioners Request for Rehearing at 23.

[163] EMCOS Request for Rehearing at 11, 25-26 (citing *Fla. Gas Transmission Co. v. FERC*, 604 F.3d 636, 639 (D.C. Cir. 2010)).

[164] Petitioners Request for Rehearing at 23.

[165] *Id.* at 25.

information available in the record.[166] Petitioners argue that the record shows that more recent state-authorized base ROEs have averaged below 10 percent. For example, Petitioners state that the Regulatory Research Associates data for the first quarter of 2013 show that the average authorized state electric ROE "approximated 9.75 [percent], 25 [basis points] below the analogous adjusted average ROE for calendar-2012 (which approximated 10 percent)."[167] Petitioners state that Exhibit SC-423 shows that, on March 15, 2013, the New York State Public Service Commission approved an ROE of 9.3 percent for Niagara Mohawk Power Corporation, finding the rate to be "consistent with investor expectations while being slightly below other recently authorized rate plans."[168] In addition, Petitioners state that Exhibit SC-505 shows that, at around the same time, Northeast Utilities' retail ROE was set at 9.38 percent.[169]

83. Petitioners contend that the Commission should have made its own independent finding of the current cost of equity, based on financial market data, rather than being constrained by stale decisions reached elsewhere. Petitioners note that the Commission has previously rejected efforts to use state commission-authorized ROEs as a benchmark for setting regional transmission ROEs.[170] Petitioners argue that if state commission-authorized ROEs are irrelevant when they are lower than the result of the Commission's DCF analysis, then they are also irrelevant when they are higher than the result of the Commission's DCF study. Petitioners argue that the Commission's failure to recognize this symmetry in Opinion No. 531 or to offer any justification for ignoring it renders the decision arbitrary and capricious.[171] Similarly, EMCOS contend that Opinion No. 531 is inconsistent with *Missouri Public Service Commission v. FERC,* 337 F.3d 1066, 1077 (D.C. Cir. 2003) (*Missouri*), which explained that "[w]hen FERC relies upon a state agency's prior approval to support the conclusion that rates are in the public interest, the Commission must at least say something about the prior regulator's rationale for approving those rates."

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[166] *Id.* at 25-26 (citing Opinion No. 531, 147 FERC ¶ 61,234 at PP 55, 88); EMCOS Request for Rehearing at 11, 26 (citing *NorAm Gas Transmission Co. v. FERC*, 148 F.3d 1158, 1165 (1998)).

[167] Petitioners Request for Rehearing at 26.

[168] *Id.* at 28 (citing Ex. SC-423 at 18).

[169] *Id.*

[170] *Id.* at 29.

[171] *Id.* at 29-30.

iii. Commission Determination

84. We disagree with Petitioners' and EMCOS's arguments that the record evidence concerning state commission-authorized ROEs does not support placing the NETOs' base ROE above the midpoint of the zone of reasonableness. The Commission did not use the evidence of state commission-authorized ROEs to determine the level at which the NETOs' base ROE should be set. As explained below, the Commission merely relied on the state commission-authorized ROEs—in conjunction with evidence that interstate transmission is riskier than state-level distribution—as evidence that the 9.39 percent midpoint of the DCF-produced zone of reasonableness was insufficient to satisfy the requirements of *Hope* and *Bluefield* and, therefore, that an adjustment above 9.39 percent was warranted.[172]

85. Contrary to Petitioners' and EMCOS's arguments, applying other measures of central tendency to the NETOs' data on state commission-authorized ROEs does not undermine the Commission's conclusion that an upward adjustment was warranted. Petitioners point to various measures of central tendency for the state commission-authorized ROEs: mode of 10 percent, median of 10.13 percent, a mean of 10.14 percent, and a midpoint of 10.25 percent. But all of these figures are above the 9.39 percent midpoint of the zone of reasonableness; in light of the record evidence showing that interstate transmission is riskier than state-level distribution,[173] all of these figures support adjusting the NETOs' base ROE above that level. Further, while Petitioners focus on the fact that 89 percent of the state commission-authorized ROEs in the NETOs' study are below 10.57 percent, that fact is irrelevant to how the midpoint of the DCF-produced zone of reasonableness compares to the state commission-authorized ROEs. The more relevant fact is that almost 93 percent of the state commission-authorized ROEs are above the 9.39 percent midpoint produced by the Commission's two-step DCF methodology in this case.[174]

86. We reject Petitioners' and EMCOS's arguments that the Commission's reliance on the state ROE figures despite their time-lag is inconsistent with the Commission's preference for the most recent data in the record. The evidence of state commission-

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[172] *See* Opinion No. 531, 147 FERC ¶ 61,234 at PP 148-149.

[173] *See id.* P 149. We note that Petitioners have not refuted the record evidence that interstate transmission is riskier than state-level distribution. Petitioners' request for rehearing discusses the Commission's finding on the relative risks of transmission and distribution only in the context of whether the NETOs are more or less risky than the companies in the DCF proxy group. *See* Petitioners Request for Rehearing at 19-22.

[174] *See* Ex. NET-403.

authorized ROEs that the Commission relied upon is, in fact, the most recent complete study in the record. While the record does contain some more recent evidence of state commission-authorized ROEs, that evidence does not represent a data set comparable to the NETOs' 24-month study,[175] but is rather data for only one quarter in 2013 from Regulatory Research Associates concerning the recent trend in average authorized ROEs. According to Petitioners, the report from Regulatory Research Associates indicates that the average state commission-authorized ROE in the first quarter of 2013 "approximated 9.75 [percent], 25 [basis points] below the analogous adjusted average ROE for calendar-2012 (which approximated 10 percent)."[176] This evidence does not undermine, but supports, the Commission's conclusion that the 9.39 percent midpoint, determined by using the DCF methodology, is below most of the state ROEs.

87. We also reject Petitioners' argument that, in using state commission-authorized ROEs to corroborate the outcome of the DCF analysis, the Commission failed to make its own finding on the cost of equity. To the contrary, the Commission conducted its own DCF analysis and did make its own finding, based on the financial market data in the record. That the Commission looked to the state commission-authorized ROEs and alternative methodologies to corroborate the accuracy of its finding, does not undermine the Commission's finding on the cost of equity. Rather, the Commission's analysis of not only the DCF results but also additional record evidence demonstrates that the Commission fully reviewed the record to ensure a just and reasonable ROE sufficient to meet the capital attraction standards required by *Hope* and *Bluefield.*

88. We disagree that the Commission's use of state commission-authorized ROEs in Opinion No. 531 is inconsistent with Commission precedent. As the Commission explained in Opinion No. 531, while the Commission has rejected the use of state ROEs

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[175] The NETOs' study of state commission-allowed ROEs covered the time period from October 1, 2010 through September 30, 2012. *See* Ex. NET-400; Ex. NET-403.

[176] Petitioners Request for Rehearing at 26 (citing Ex. SC-524). We note that the Regulatory Research Associates' report states that the average state commission-allowed ROE for the first quarter of 2013 is 10.24 percent. The 9.75 percent figure to which Petitioners refer was calculated by excluding from the ROE decisions issued in that quarter those from one particular state commission and, as noted, would be 10.24 percent without that exclusion. Further, we note that the record evidence also shows that the average state commission-allowed ROE for the fourth quarter of 2012, i.e., the quarter immediately following the time period of the NETOs' state ROE study, was 10.10 percent. Thus, the data concerning state commission allowed-ROEs for the fourth quarter of 2012 (10.10 percent) and the first quarter of 2013 (10.24 percent) are consistent with the data in the NETOs' study of state commission-allowed ROEs, and do not indicate a downturn in state ROEs as Petitioners allege.

in the past, it has done so on the grounds that the state ROEs alone provide an insufficient basis for determining Commission-jurisdictional rates. Those cases are distinguishable from the instant proceeding, where the Commission instead compared the evidence provided by a significant number of state commission-authorized ROEs to the midpoint produced by the application of the Commission's traditional methodology and concluded that their levels, relative to each other, were illogical in light of the record evidence concerning the comparative risks of state-level electric distribution and interstate electric transmission. We also reject Petitioners' argument that, if state commission-approved ROEs are irrelevant when they are below Commission ROEs, then they are also irrelevant when they are above Commission ROEs. The Commission has not found state commission-approved ROEs to be irrelevant when they are lower than Commission-approved ROEs. As the Commission explained in Opinion No. 531, the relevance of the state commission-approved ROEs was determined in conjunction with the record evidence on the elevated risks of interstate transmission, compared to state-regulated distribution.

89. Lastly, we disagree with EMCOS's assertion that the Commission ignored *Missouri*, 337 F.3d 1066. *Missouri* is inapposite to the facts of this case as it involved the Commission's *adoption* of a specific rate, for a gas pipeline's sales under the Commission's jurisdiction, that had been "approved by [a state commission] under the regulatory regime that governed the pipeline prior to FERC's assertion of jurisdiction."[177] By comparison, in Opinion No. 531, the Commission did not adopt any rate approved by a state commission.

d. Risk Premium Analysis

i. Opinion No. 531

90. In Opinion No. 531, the Commission explained that the risk premium methodology is "based on the simple idea that since investors in stocks take greater risk than investors in bonds, the former expect to earn a return on a stock investment that reflects a 'premium' over and above the return they expect to earn on a bond investment."[178] The Commission further explained that "investors' required risk premiums expand with low interest rates and shrink at higher interest rates," and found that this link "provides a helpful indicator of how investors' required returns on equity

[177] *Missouri*, 337 F.3d at 1076.

[178] Opinion No. 531, 147 FERC ¶ 61,234 at P 147 (quoting Roger A. Morin, New Regulatory Finance 108 (Public Utilities Reports, Inc. 2006)) (internal quotations omitted).

have been impacted by the interest rate environment."[179] The Commission explained that it has in the past rejected the use of risk premium analyses to estimate investor-required returns on equity, but "those cases are distinguishable from the instant proceeding because they involved proposals to establish a constant risk premium based on the average difference between state commission ROEs and bond rates over multi-year periods."[180]

91. The Commission found the NETOs' risk premium analysis "informative,"[181] as it indicated that the NETOs' cost of equity "is between 10.7 percent and 10.8 percent, which is higher than the 9.39 percent midpoint produced by our DCF analysis."[182] The Commission explained that, in relying on the NETOs' risk premium analysis, "we do not depart from our use of the DCF methodology; rather, we use the record evidence to inform the just and reasonable placement of the ROE within the zone of reasonableness established in the record by the DCF methodology."[183]

ii. <u>Requests for Rehearing</u>

92. EMCOS argue that Opinion No. 531 erred by adopting the NETOs' risk premium analysis despite the fact that the Commission has repeatedly rejected the use of risk premium analysis for determining a just and reasonable ROE for a public utility.[184] EMCOS assert that the Commission in Opinion No. 531 attempted to distinguish those precedents from this proceeding on the basis that the risk premium analyses in those cases relied on "the average state commission ROEs and bond rates over multi-year periods."[185] However, EMCOS contend that the Commission's rationale is flawed because the Commission's rejection of risk premium analyses in the past was not due to the involvement of state commission ROEs, but rather was due to concerns regarding the

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[179] *Id.*

[180] *Id.* n.290.

[181] *Id.* P 146.

[182] *Id.* P 147.

[183] *Id.* P 146.

[184] EMCOS Request for Rehearing at 20-21 (citing *Consumers Energy Co.*, 64 FERC ¶ 63,029 (1993), *aff'd*, 85 FERC ¶ 61,100 at 61,361 (1998); *New England Power Co.*, 31 FERC ¶ 61,378, at 61,841 (1985)).

[185] *Id.* at 21 (citing Opinion No. 531, 147 FERC ¶ 61,234 at P 147 n.290).

reliability of the methodology to produce reliable results in fluctuating market conditions.[186] Additionally, EMCOS argue that Opinion No. 531 fails to respond to criticism that parties presented about the NETOs' risk premium analysis. EMCOS argue that Opinion No. 531's failure to respond to—or even acknowledge—the substantive arguments against the NETOs' specific risk premium analysis renders the decision arbitrary and capricious.[187]

93. Petitioners argue that the NETOs' version of a risk premium analysis contains multiple flaws. Petitioners argue that the NETOs' risk premium analysis detaches the ROEs from the regulatory contexts in which they were approved, and this disconnect should have rendered the NETOs' risk premium study irrelevant as a matter of law.[188] In addition, Petitioners assert that, even if it were acceptable to detach the allowed ROEs from their regulatory contexts, the NETOs' risk premium study's attempt to discern regulatory outcomes and assign dates to those outcomes contains numerous errors. Specifically, Petitioners contend that the risk premium study was performed by a person who did not appear at trial, lacked professional expertise in reading Commission decisions, and used examples supplied by the NETOs' counsel rather than a random or representative sample. Petitioners also argue that the NETOs' risk premium study is flawed because it assumes that the outcomes of Commission proceedings represent equity costs on the day the Commission issued its order approving the ROE, thereby ignoring both regulatory lag and the reality that many Commission decisions that identify an ROE do not involve finding a new, currently cost-based ROE.[189]

94. Additionally, Petitioners argue that the NETOs' risk premium study is flawed because the study makes no attempt to screen its inputs for comparable risk.[190] As an

[186] *Id.* (citing *Consumers Energy Co.*, 64 FERC ¶ 63,029, *aff'd*, 85 FERC ¶ 61,100 at 61,361; *New England Power Co.*, 31 FERC ¶ 61,378 at 61,841).

[187] *Id.* at 22 (citing *Ill. Pub. Telecomm. Ass'n v. FCC*, 117 F.3d at 564).

[188] *Id.* at 33-34 (citing *Pepco Holdings, Inc.*, 124 FERC ¶ 61,176, at P 127 (2008), *reh'g denied*, 139 FERC ¶ 61,144 (2012)).

[189] Similarly, EMCOS note that Trial Staff and the Complainants argued that the NETOs' risk premium analysis is based on Commission-allowed returns, which are not the same as the market indicated ROEs that this methodology claims to address. Moreover, EMCOS explain that the NETOs' analysis includes ROEs that are the result of settlements, which further skew the results. In addition, EMCOS explain that the NETOs' analysis is rife with errors regarding the applicable dates of the Commission approved ROEs upon which they rely.

[190] Petitioners Request for Rehearing at 35.

example illustrating this flaw, Petitioners state that the NETOs' risk premium study treated as representative of June 2012 risk premiums—without making any finding as to the current equity cost—a Commission order that merely extended to a new MISO participant the 12.38 percent ROE that was established for the MISO region more than a decade earlier.[191] Petitioners further state that the Commission, in Opinion No. 489, rejected the NETOs' reliance on MISO's 12.38 percent ROE as a benchmark for New England.[192] Petitioners also argue that the NETOs' risk premium study treats orders and data from 2008-2009 as comparable to the NETOs' ROE, which was established in 2006 based on data from 2004. The Petitioners further assert that the NETOs' study failed to include orders after June 2012, and that these omissions skewed the NETOs' results by missing the trend towards lower ROEs.

95. Petitioners argue that, although the NETOs' failed to present an informative risk premium study, they did provide a basis to construct a more useful one that accords with Opinion No. 531's discussion of the theory underlying the risk premium methodology. Specifically, Petitioners note Opinion No. 531's explanation that "investors' required risk premiums expand with low interest rates and shrink at high interest rates,"[193] and assert that the NETOs' risk premium study used an incorrect ratio in determining the rate at which risk premiums change in response to changes in interest rates. Petitioners argue that the NETOs' risk premium study relied on an inferred rate at which risk premiums expand when interest rates drop is about 93:100—i.e., a 100 basis points decline in interest rates is deemed to be offset by a risk premium increase of about 93 basis points—which leaves a net decline in the cost of equity of only 7 basis points for every 100 basis point change interest rates. However, Petitioners contend that the NETOs' witness disavowed that ratio at trial, by clarifying that "generally, one half of the move in equity returns [is] related to the move in bond returns," so "if bond returns go up 100 basis points, your best guess of equity costs is 50 or 60 basis points."[194] Therefore, Petitioners state that it is more appropriate to use 45:100[195] as the rate at which risk premiums expand when interest rates drop—i.e., a 100 basis points decline in interest rates is deemed to be offset by a risk premium increase of about 45 basis points—which leaves a net decline in the cost of equity of 55 basis points for every 100 basis point change in

[191] *Id.*

[192] *Id.* at 36.

[193] *Id.* at 37 (citing Opinion No. 531, 147 FERC ¶ 61,234 at P 147).

[194] *Id.* at 38.

[195] Petitioners calculate this ratio by taking the average of the 50-60 basis point range indicated by the NETOs' witness at trial.

interest rates. Petitioners argue that substituting that relationship in Ex. NET-704 for the implausible 93:100 ratio, indicates an ROE of 9.67 percent to 9.91 percent.[196]

96. Petitioners contend that Opinion No. 531's reliance on a stale and poorly designed study of past Commission orders was inconsistent with its finding that ROEs should reflect the most recent information available at the time of trial.

iii. Commission Determination

97. We deny rehearing on the issue of whether the NETOs' risk premium analysis is flawed. As the Commission explained in Opinion No. 531, the theory behind the risk premium methodology is that "since investors in stocks take greater risk than investors in bonds, the former expect to earn a return on a stock investment that reflects a 'premium' over and above the return they expect to earn on a bond investment."[197] There are multiple approaches that have been advanced to determine this equity risk premium for a utility.[198] For example, a risk premium can be developed directly, by conducting a risk premium analysis for the company at issue, or indirectly by conducting a risk premium analysis for the market as a whole and then adjusting that result to reflect the risk of the company at issue.[199] Another approach that investors might choose to look to in the utility context is to "examin[e] the risk premiums implied in the returns on equity allowed by regulatory commissions for utilities over some past period relative to the contemporaneous level of the long-term Treasury bond yield."[200] In the instant case, the NETOs followed the latter approach, developing their risk premium study by analyzing the ROEs allowed by this Commission since April 2006,[201] relative to the

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[196] Petitioners Request for Rehearing at 38.

[197] Roger A. Morin, New Regulatory Finance 108 (Public Utilities Reports, Inc. 2006).

[198] *See generally id.* at 107-130.

[199] *Id.* at 110.

[200] *Id.* at 123.

[201] *See* Ex. NET-704 at 3-4. We note that, although Petitioners assert that the NETOs failed to include any Commission orders issued after June 2012, Petitioners have not cited any final Commission orders establishing a utility's ROE between June 2012 and the date the Presiding Judge set as the deadline for the parties to update their exhibits prior to the hearing. While Petitioners correctly note that the Commission issued such an ROE order on May 6, 2013, that decision was issued after the final updating of exhibits.

contemporaneous level of the long-term Treasury bond yield,[202] to determine the risk premium implied by those regulatory decisions.[203]

98. Petitioners allege that the NETOs' risk premium analysis is flawed because it assigned arbitrary dates to the regulatory decisions on which it was based, ignored the fact that some of the decisions involved rates agreed to by settlement, ignored regulatory lag, and ignored the reality that some of the decisions did not involve the calculation of a current cost of equity. Given the varying duration of regulatory proceedings, it is difficult, if not impossible, to ensure precise contemporaneity between long-term Treasury bond yields and the cost of equity allowed by a regulator. Assigning approximate dates to the cost of equity determinations made in those regulatory proceedings, as the NETOs have done, is often unavoidable, and this fact alone does not undermine the relevance of risk premium analyses.[204] Similarly, whether the regulatory decision involved a settlement agreement or the application of a cost of equity that was calculated in the past, e.g., the 12.38 percent ROE established for the MISO region, does not affect the reliability of a risk premium analysis.[205] Risk premiums allowed by

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[202] NETOs also analyzed the ROEs allowed by regulatory decisions relative to long-term utility bond yields.

[203] *See* Ex. NET-704 at 1-2.

[204] We disagree with Petitioners that the Commission's reliance on the NETOs' risk premium analysis, despite the regulatory lag reflected therein, is inconsistent with Opinion No. 531's finding that "ROEs should reflect the most recent information available at the time of trial." Petitioners Request for Rehearing at 37. The NETOs' risk premium study upon which the Commission relied is indeed the most recent such study in the record.

[205] Further, contrary to Petitioners' assertion, the fact that the Commission, in Opinion No. 489, declined to use the 12.38 percent ROE from the MISO region as a benchmark in establishing the NETOs base ROE has no bearing on this proceeding. Using the ROE from the MISO region as a benchmark in establishing the just and reasonable ROE for the NETOs' is much different than using the ROE from the MISO region as one data point, among many, in a risk premium analysis that is then used to corroborate the results of the Commission's analysis. Additionally, assuming *arguendo* that (1) the 12.38 percent ROE for the MISO region was "stale" in June 2012, *see* Petitioners' Request for Rehearing at 35, (2) the 11.14 percent base ROE for the NETOs' was "stale" in August, November, and December of 2008, *see id.* at 36, and (3) it is therefore appropriate to exclude those data points from the NETOs' risk premium study, Petitioners have not shown that excluding those data points would materially affect the results of the NETOs' risk premium study or undermine its usefulness in

(continued…)

regulators "are presumably based on the results of market-based methodologies presented to regulators in rate hearings and on the actions of objective unbiased investors in a competitive marketplace."[206] This is no less true in the case of settlement agreements, as settling parties rely upon the same market-based methodologies in determining the rates they are willing to accept. In short, while the approach the NETOs used in their risk premium analysis, like any methodology for estimating the cost of equity, is not without inherent weaknesses, it is nonetheless an approach that investors routinely rely upon.[207] We similarly find the NETOs' risk premium analysis sufficiently reliable—not to set the ROE itself—but rather to corroborate our decision to place the NETOs' base ROE above the midpoint of the zone of reasonableness produced by the DCF analysis.

99. We also reject Petitioners' argument that the NETOs' risk premium study does not support placing the NETOs' base ROE above the midpoint of the zone of reasonableness because the NETOs' assumption regarding the inferred rate at which risk premiums expand when interest rates drop—i.e., the assumption that risk premiums expand by 93 basis points for every 100 basis point drop in interest rates—is unsupported. Petitioners assert that, if the NETOs' study is adjusted to reflect a more appropriate ratio than 93:100, the NETOs' risk premium study produces a result between 9.67 and 9.91 percent. While the rate at which risk premiums change as interest rates change is indeed important in a risk premium analysis, we find the alleged flaw to be immaterial in this context in

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corroborating the results of the Commission's DCF analysis. The NETOs' risk premium analysis compared the ROEs established in 66 cases from April 2006 through June 2012 to the contemporaneous 10-year U.S. Treasury bond yields to determine 66 risk premiums, which averaged 7.33 percent. Excluding the alleged stale ROEs would eliminate five of the 66 risk premiums from the NETO's analysis. The remaining 61 risk premiums average 7.28 percent, only marginally less than the average of the 66 risk premiums used in the NETOs' analysis. This indicates that exclusion of the allegedly stale ROEs would not materially reduce the 10.7 percent to 10.8 percent cost of equity produced by the NETOs' risk premium analysis.

[206] Roger A. Morin, New Regulatory Finance 125 (Public Utilities Reports, Inc. 2006).

[207] *Id.* at 123-125. We reject Petitioners' assertion that the NETOs' risk premium study was conducted by an unqualified analyst who did not appear at trial. The analyst to whom Petitioners refer did not conduct the NETOs' risk premium analysis, but rather assisted the NETOs' expert witness in conducting the analysis. *See* Tr. 647:9-648:10. Further, the analyst at issue is a chartered financial analyst, with a Masters Degree in Business Administration, who has assisted the NETOs' expert witness in preparing testimony in over 100 Commission proceedings. *See id.* at 648:14-22.

this case. As an initial matter, the alternative inferred rate—a ratio of 45:100—that Complainants put forth based on the NETOs' witness's testimony at hearing was based on state commission-allowed ROEs, not interstate transmission ROEs allowed by this Commission.[208] In light of the record evidence on the risk differential between state-regulated distribution and Commission-regulated interstate transmission, we are not persuaded that it is appropriate to apply to the NETOs, for the time period at issue in this proceeding, the inferred rate relationship between risk premiums and interest rates that was observed in state commission-allowed ROEs over a time period dating back a quarter century, to 1987. Further, the NETOs' determined the inferred rate relationship between risk premiums and interest rates in their risk premium study by conducting empirical observations and regression analysis of bond yields and Commission-allowed ROEs.[209] In sum, we are not persuaded that the NETOs' empirical results are invalid simply because they differ from the inferred rate relationship reflected in historical state commission-approved ROEs, particularly where anomalous capital market conditions exist that may impact the inferred relationship between risk premiums and interest rates.

100. EMCOS argue that the Commission erred in relying on the NETOs' risk premium analysis because doing so is inconsistent with precedent in which the Commission has rejected the use of risk premium analyses.[210] EMCOS assert that the Commission in Opinion No. 531 attempted to distinguish those precedents on the grounds that the risk premium analyses therein involved state commission-allowed ROEs. EMCOS contend that the Commission's interpretation of those precedents is incorrect, because the Commission in fact rejected the use of risk premium analyses in those past cases due to concerns that risk premium analyses are unreliable under fluctuating market conditions.

101. In Opinion No. 531, the Commission explained that the Commission's rejection of the risk premium analysis in a number of past cases, including *New England Power Co.*, is distinguishable from the instant case because those cases involved "*proposals to establish a constant risk premium* based on the average difference between state commission ROEs and bond rates *over multi-year periods*."[211] EMCOS mischaracterize the Commission's interpretation of *New England Power Co.* and other similar precedents

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[208] *See* Tr. 606:5-7 ("this is based on state returns, and state returns have marched to a slightly different drummer than FERC returns over the years.").

[209] *See generally* Ex. NET-704.

[210] EMCOS Request for Rehearing at 20-21 (citing *Consumers Energy Co.*, 64 FERC ¶ 63,029, *aff'd*, 85 FERC ¶ 61,100 at 61,361; *New England Power Co.*, 31 FERC ¶ 61,378 at 61,841).

[211] Opinion No. 531, 147 FERC ¶ 61,234 at n.290 (emphasis added).

by focusing on Opinion No. 531's reference to the fact that the risk premium analyses in the past cases relied upon state commission ROEs. As the italicized language in the above quote makes clear, however, the Commission's rationale for rejecting the proposal in *New England Power Co.* was not merely reliance on state commission-set ROEs, but was, as EMCOS correctly acknowledge, based on the Commission's finding that "[t]here is no direct relationship between historical risk premiums and a current cost of equity under constantly changing financial conditions."[212] In *New England Power Co.*, the utility proposed to calculate a risk premium based on the difference between the most recent 20-year average yield for certain money market indicators and the most recent 20-year average annual yield for Moody's Electric Utility common stocks plus the 10-year growth in dividends for those stocks. Thus, the utility assumed a constant risk premium for a 20-year period. In the instant case, the NETOs' risk premium analysis does not assume a constant risk premium over any length of time. Rather, the NETOs calculated a varying risk premium based on variations in the difference between allowed ROEs and bond yields during the time period from April 2006 through June 2012. Those cases in which the Commission rejected risk premium analyses in the past are thus distinguishable from the instant case, because unlike the proposals in those cases the NETOs have not proposed their risk premium analysis to establish a constant risk premium.[213]

e. CAPM Analysis

i. Opinion No. 531

102. In Opinion No. 531, the Commission explained that "[s]imilar to the risk premium analysis, the NETOs' CAPM uses interest rates as the input for the risk-free rate, which makes it useful in determining how the interest rate environment has impacted investors' required returns on equity."[214] The Commission also explained that "CAPM is utilized by investors as a measure of the cost of equity relative to its risk."[215] The Commission

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[212] *New England Power Co.*, 31 FERC at 61,841.

[213] Moreover, unlike other cases, the Commission here is *not* setting investor-required ROEs based on this risk premium, but is instead looking to it merely as "a helpful indicator" of the impact of the "interest rate environment" on "investors' required returns on equity." And from this analysis (and others discussed elsewhere in Opinion No. 531 and here) the Commission concludes only that the ROE should indeed be set above the midpoint. *See* Opinion No. 531, 147 FERC ¶ 61,234 at P 147 & n.290.

[214] Opinion No. 531, 147 FERC ¶ 61,234 at P 147.

[215] *Id.*

explained that it has in the past rejected the use of CAPM analyses, but "those cases are distinguishable from the instant proceeding because they involved CAPM analyses that were based on historic market risk premiums," whereas the NETOs' CAPM analysis "is based on forward-looking investor expectations for the market risk premium."[216]

103. The Commission found the NETOs' CAPM analysis "informative,"[217] as it produced a midpoint of 10.4 percent and a median of 10.9 percent, both of which are above the 9.39 percent midpoint produced by the Commission's DCF analysis.[218] The Commission explained that, in relying on the NETOs' CAPM analysis, "we do not depart from our use of the DCF methodology; rather, we use the record evidence to inform the just and reasonable placement of the ROE within the zone of reasonableness established in the record by the DCF methodology."[219]

ii. <u>Requests for Rehearing</u>

104. Petitioners assert that the NETOs' CAPM study is flawed because its assumption that the market as a whole (i.e., most of the S&P 500 companies) will grow at an annual rate of 10.3 percent is overly optimistic, unsustainable, double the historical norms and projections, and inconsistent with the GDP estimate the Commission relied upon in Opinion No. 531 for other purposes.[220] Petitioners argue that the NETOs calculated the unsustainable 10.3 percent growth rate by screening out almost a quarter of the market and placing excessive weight on the projections of non-utility companies' medium-term earnings per share growth while ignoring the fact that those estimates reflect unsustainable short-term stock repurchase programs and are not long-term projections.

105. Petitioners contend that the NETOs' CAPM study is also flawed because it relies on stock betas, which Petitioners assert are unreliable and do not meaningfully measure the risk differential between the proxy group and the dividend paying portion of the S&P 500 companies.[221] Petitioners state that the Commission in *ITC Holdings* found betas to

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[216] *Id.* n.292.

[217] *Id.* P 146.

[218] *Id.* P 147.

[219] *Id.* P 146.

[220] Petitioners Request for Rehearing at 39.

[221] *Id.* at 40 (citing *ITC Holdings Corp.*¸121 FERC ¶ 61,229, at P 43 (2007)); EMCOS Request for Rehearing at 23.

be an unreliable predictor of risk and, as a result, found the CAPM methodology to be inappropriate for determining a company's ROE.[222] Petitioners assert that, while the Commission in Opinion No. 531 attempted to distinguish *ITC Holdings* on the basis that it involved historical risk premiums, Opinion No. 531 did not attempt to address *ITC Holdings*'s finding that betas are unreliable. Similarly, EMCOS assert that, because the NETOs' CAPM analysis relied on betas, that analysis failed to incorporate forward-looking expectations, which undermines the Commission's claim that the NETOs' CAPM analysis is based on "forward-looking investor expectations" and is, therefore, distinguishable from CAPM analyses the Commission has rejected in the past.[223] Petitioners assert that their witness and Trial Staff's witness both presented more credible, forward-looking CAPM studies indicating a cost of equity of 7.5 percent and 8.2 percent, respectively, but that the Commission ignored both of these CAPM studies in Opinion No. 531.

106. In addition, Petitioners contend that the NETOs' CAPM study is flawed because it includes a "size adjustment" based on the theory that smaller companies are riskier and should, therefore, have higher growth and higher returns than the average company in the sample set. Petitioners argue that the NETOs' rationale is undermined by the Petitioners' calculation showing that the smaller firms in the NETOs' sample set have lower-than-average growth—an unweighted average of 9.8 percent, compared to the NETOs' weighted average of 10.3 percent.[224] Petitioners also argue that academic studies have shown that it is improper to apply this type of "size adjustment" to utilities.[225] Petitioners state that, without the size adjustment, the median and midpoint of the NETOs' CAPM analysis is 9.7 percent.[226]

107. EMCOS argue that the NETOs' CAPM analysis is flawed because it used a risky 30-year bond interest rate for the risk-free component of the calculation and inappropriately used a DCF result for the risk premium element of the analysis.

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[222] Petitioners Request for Rehearing at 31 (citing *ITC Holdings*¸121 FERC ¶ 61,229 at P 43; *Orange & Rockland Utils., Inc.,* Opinion No. 314, 44 FERC ¶ 61,253 (*Orange & Rockland*), *order on reh'g*, Opinion No. 314-A, 45 FERC ¶ 61,252 (1988), *reh'g denied,* 46 FERC ¶ 61,036 (1989)).

[223] EMCOS Request for Rehearing at 23 (citing Opinion No. 531, 147 FERC ¶ 61,234 at P 147 n.292).

[224] Petitioners Request for Rehearing at 41 (citing Ex. SC-514).

[225] *Id.* at 42 (citing SC-200 at 35-36).

[226] *Id.*

iii. Commission Determination

108. We deny rehearing on the issue of whether the NETOs' CAPM analysis is flawed. The CAPM methodology has three inputs: the risk-free rate, betas, and the market risk premium.[227] The risk-free rate and betas used in a CAPM study are generally not controversial. The risk-free rate is represented by a proxy, typically the yield on 30-year Treasury bonds.[228] Betas, which measure a stock's risk relative to the market, are published by several commercial sources. The market risk premium, which is where most CAPM studies diverge, can be estimated either using a backward-looking approach, a forward-looking approach, or a survey of academics and investment professionals.[229] A CAPM analysis is backward-looking if its market risk premium component is determined based on historical, realized returns.[230] A CAPM analysis is forward-looking if its market risk premium component is based on a DCF study of a large segment of the market.[231] In a forward-looking CAPM analysis, the market risk premium is calculated by subtracting the risk-free rate from the result produced by the DCF study.[232]

109. In this proceeding, the NETOs submitted a forward-looking CAPM study, using 30-year Treasury bonds for the risk-free rate, betas published by Value Line, and a market risk premium based on a DCF study of all S&P 500 companies that were paying dividends. The NETOs' CAPM approach is a generally accepted methodology routinely relied upon by investors and, therefore, one appropriately used to corroborate our own analysis. As discussed below, we reject the arguments that the NETOs' CAPM analysis contains flaws that undermine its usefulness as corroborative evidence, in determining whether the midpoint of the zone of reasonableness produced by the Commission's DCF analysis provides the NETOs a return that satisfies the requirements of *Hope* and *Bluefield*.

110. As an initial matter, we reject EMCOS's argument that the NETOs' CAPM analysis is flawed because it used a DCF study to determine the market risk premium. As

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[227] Roger A. Morin, New Regulatory Finance 150 (Public Utilities Reports, Inc. 2006).

[228] *Id.* at 151.

[229] *Id.* at 155-162.

[230] *Id.* at 155-156.

[231] *Id.* at 159-160.

[232] *See id.* at 150, 155.

explained above, using a DCF study is the standard method of calculating the market risk premium in a forward-looking CAPM analysis.[233] We are, therefore, unpersuaded that the use of a DCF study renders the NETOs' CAPM analysis deficient. We also disagree with Petitioners' argument that the NETOs' CAPM analysis relied on an overly optimistic growth rate input in determining the market risk premium. The growth rate in the NETOs' CAPM analysis is based on IBES data, which the Commission has long relied upon as a reliable source of growth rate data.[234]

111. While Petitioners' assert that the growth rate input is inflated because the NETOs calculated it based on only those S&P 500 companies that were paying dividends, we are not persuaded that the exclusion of those companies not paying dividends skewed the growth rate input. As the NETOs' witness correctly explained during the hearing, a DCF analysis can only be conducted for companies that pay dividends.[235] Accordingly, the proxy group in our DCF analysis consists of companies that pay dividends. Basing a CAPM study on only dividend-paying companies is therefore appropriate in this context, where the Commission is looking to the CAPM study to corroborate the results of a DCF analysis, because doing so produces a growth rate input that is more representative of the DCF proxy group than a CAPM study based on non-dividend-paying companies would be. Further, we are not persuaded by Petitioners' argument that non-dividend-paying companies have lower growth rate estimates than dividend-paying companies, because in many situations the opposite is true due to non-dividend-paying companies decision to retain and reinvest more of their earnings, rather than pay dividends.

112. We are also unpersuaded that the growth rate projection in the NETOs' CAPM study was skewed by the NETOs' reliance on analysts' projections of non-utility companies' medium-term earnings growth, or that the study failed to consider that those analysts' estimates reflect unsustainable short-term stock repurchase programs and are not long-term projections. As explained above, the NETOs based their growth rate input on data from IBES, which the Commission has found to be a reliable source of such data. Thus, the time periods used for the growth rate projections in the NETOs' CAPM study are the time periods over which IBES forecasts earnings growth. Petitioners' arguments against the time period on which the NETOs' CAPM analysis is based are, in effect, arguments that IBES data are insufficient in a CAPM study. We disagree. We acknowledge that CAPM analyses may be based on different time periods; however, without more evidence, i.e., a CAPM analysis based on a longer time period, we are not persuaded that the time period on which the NETOs' based their CAPM analysis

[233] *See supra* P 108.

[234] *See supra* PP 71-72.

[235] *See* Tr. 740: 3-4.

undermines the relevance of that analysis in corroborating the results of the Commission's DCF analysis.

113. Further, the fact that the Commission's two-step DCF methodology incorporates a long-term growth rate does not necessitate the incorporation of a long-term growth rate in the DCF study the NETOs used to develop the market risk premium for their CAPM analysis. The Commission's rationale for incorporating a long-term growth rate estimate in DCF analyses for public utilities was that it is often unrealistic and unsustainable for high short-term growth rates to continue in perpetuity.[236] Under the CAPM model, the market risk premium is based on the difference between the "required return on the overall market" and the risk-free rate.[237] The required return on the overall market is determined by conducting a DCF study of "a representative market index, such as the Standard & Poor's 500 Index."[238] As noted above, the NETOs developed the market risk premium in their CAPM analysis in exactly this way, by conducting a DCF analysis of the dividend-paying companies in the S&P 500 to determine the required return on the overall market. The rationale for incorporating a long-term growth rate estimate in conducting a two-step DCF analysis of a specific group of utilities does not necessarily apply when conducting a DCF study of the companies in the S&P 500. That is because the S&P 500 is regularly updated to include only companies with high market capitalization. While an individual company cannot be expected to sustain high short-term growth rates in perpetuity, the same cannot be said for a stock index like the S&P 500 that is regularly updated to contain only companies with high market capitalization, and the record in this proceeding does not indicate that the growth rate of the S&P 500 stock index is unsustainable.

114. We also reject EMCOS's argument that the NETOs' CAPM analysis was flawed because it relied on a "risky 30-year bond interest" to calculate the risk-free rate. As noted above, 30-year U.S. Treasury bond yields are a generally accepted proxy for the risk-free rate in a CAPM analysis, and are also considered superior to short- and intermediate-term bonds for this purpose.[239] Therefore, absent record evidence to the

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[236] Opinion No. 531, 147 FERC ¶ 61,234 at P 36 n.63 (citing Roger A. Morin, New Regulatory Finance 308 (Public Utilities Reports, Inc. 2006)).

[237] Roger A. Morin, New Regulatory Finance 146 (Public Utilities Reports, Inc. 2006).

[238] *Id.* at 159.

[239] *See* Roger A. Morin, New Regulatory Finance 151-152 (Public Utilities Reports, Inc. 2006) ("the yield on very long-term government bonds, namely, the yield on 30-year Treasury bonds, is the best measure of the risk-free rate for use in the CAPM and Risk Premium methods.").

contrary, we find 30-year Treasury bond yields to be an appropriate basis for the risk-free rate in the NETOs' CAPM analysis.

115. We also disagree with Petitioners' argument that the NETOs' CAPM study does not support placing the NETOs' base ROE above the midpoint because the study relies on betas. Petitioners' assertion is based on a misinterpretation of Commission precedent. While Petitioners correctly state that the Commission in *ITC Holdings* and *Consumers Energy Co.* found that "betas, *in isolation*, [are] unreliable predictors of risk,"[240] Petitioners ignore the qualifier "in isolation," which highlights an important distinction between the CAPM analyses at issue in those cases and the NETOs' CAPM analysis. In both *ITC Holdings* and *Consumers Energy Co.*, the parties submitted CAPM studies that analyzed only the utility whose rates were at issue. As the Commission explained in *Consumers Energy Co.*, "CAPM is more appropriately used for determining the composition of a portfolio of stocks."[241] In the instant proceeding, the NETOs' CAPM study analyzed, as a portfolio, a proxy group of electric utilities. Thus, the NETOs' CAPM study and associated use of betas do not raise the same concerns as did the studies in *ITC Holdings* and *Consumers Energy Co*.

116. We further disagree with EMCOS's argument that the NETOs' CAPM analysis is not forward-looking because it relies on betas. As explained above, whether a CAPM analysis is forward-looking or backward-looking depends on how the market risk premium—not the betas—are calculated.[242] Although it is true that betas are based on historical data, reliance on betas does not render a CAPM analysis backward-looking, as that term is commonly used in the CAPM context. As explained above, a CAPM study is backward-looking if its market risk premium component is determined based on historical, realized returns,[243] and a CAPM study is forward-looking if its market risk premium component is based on a DCF study of a large segment of the market.[244] Unlike the market risk premium component of the CAPM methodology, betas are necessarily

[240] *ITC Holdings Corp.*, 121 FERC ¶ 61,229 at P 43 (emphasis added); *Consumers Energy Co.*, 85 FERC ¶ 61,100 at 61,362 (emphasis added).

[241] *Consumers Energy Co.*, 85 FERC ¶ 61,100 at 61,362 n.26 (noting Trial Staff's testimony that, according to Value Line, beta should not be used to determine the ROE for a single company).

[242] *See supra* P 108.

[243] Roger A. Morin, New Regulatory Finance 155-156 (Public Utilities Reports, Inc. 2006).

[244] *Id.* at 159-160.

based on historical data, because "[t]he true beta of a security can never be observed."[245] Therefore, we disagree with EMCOS's assertion that the use of betas renders a CAPM analysis backward-looking. We reiterate that a CAPM study is forward-looking, notwithstanding its use of betas, if its market risk premium component is based on an appropriate DCF study.

117. We disagree with Petitioners' argument that the NETOs' CAPM analysis is flawed due to the fact that the NETOs applied a size adjustment to account for the difference in size between the NETOs and the dividend-paying companies in the S&P 500. This type of size adjustment is a generally accepted approach to CAPM analyses,[246] and we are not persuaded that it was inappropriate to use a size adjustment in this case. The purpose of the NETOs' size adjustment is to render the CAPM analysis useful in estimating the cost of equity for companies that are smaller than the companies that were used to determine the market risk premium in the CAPM analysis. While Petitioners assert that the record shows that smaller firms have lower growth,[247] Petitioners' assertion rests on a comparison of companies *within* the S&P 500—all of which have large market capitalization—rather than a comparison of the S&P 500 companies to companies smaller than the S&P 500 companies. While it may be true that larger dividend-paying members of the S&P 500 are growing faster than the smaller dividend-paying members of the S&P 500, this does not indicate how the growth rates of the dividend-paying members of the S&P 500 compare to the NETOs or to other groups of companies with smaller market capitalization (e.g., the companies in either the S&P 400, which consists of companies with mid-capitalization, or the S&P 600, which consists of companies with small capitalization). Further, Petitioners' assertion is contradicted by other record evidence indicating, and supporting the generally accepted principle,[248] that smaller firms are riskier than larger firms, and therefore experience faster growth.[249]

118. Petitioners also argue that the Commission erred in ignoring Complainants' CAPM study, which indicated a 7.5 percent cost of equity, and Trial Staff's CAPM study, which indicated an 8.2 percent cost of equity. However, we find both Complainants' and

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[245] *Id.* at 79.

[246] *Id.* at 187.

[247] Petitioners Request for Rehearing at 41 (citing Ex. SC-514).

[248] Roger A. Morin, New Regulatory Finance 187 (Public Utilities Reports, Inc. 2006).

[249] *See* Ex. NET-300 at 68 (citing *Morningstar*, "Ibbotson SBBI 2012 Valuation Yearbook," at 85).

Trial Staff's CAPM studies to be flawed. Complainants did not determine the market risk premium by using a DCF study to determine the required return on the overall market and then subtracting the risk-free rate from the DCF result, but instead estimated the market risk premium directly, using market risk premium studies. This approach is acceptable, in theory, as it is a valid method of determining market risk premium; however, it is not clear that Complainants executed the approach as a forward-looking analysis. While Complainants' approach is purportedly forward-looking, it is not clear from the record that their estimated market risk premium is, in fact, based on prospective data. Complainants used a market risk premium of 5.00 percent,[250] which appears to be determined using market risk premium data based on a mix of historical, prospective, and survey approaches.[251] While the record is not clear about how Complainants used these three categories of market risk premium studies to determine the market risk premium, if Complainants' market risk premium is based on a compilation of the three categories we do not consider the resulting market risk premium to be forward-looking. Further, even assuming *arguendo* that Complainants relied only on the prospective market risk premium studies, we are not persuaded that their CAPM study is sufficiently representative of the capital market conditions during this proceeding, as—importantly—all but one of the prospective studies listed in Complainants' exhibit pre-date the Great Recession.[252]

119. We find Trial Staff's CAPM analysis also to be flawed. Similar to Complainants' CAPM analysis, Trial Staff did not calculate the market risk premium by conducting a DCF analysis and subtracting the risk-free rate from the result, but by estimating the market risk premium directly. However, Trial Staff did not provide a study to support its estimated market risk premium,[253] and Trial Staff based its CAPM analysis on only 20 companies. Further, those 20 companies are members of the NETOs' proxy group. Because the purpose of the CAPM methodology is to calculate the cost of equity using a risk-return relationship based entirely on market risk,[254] the index of companies used in determining the market risk premium must be large enough to capture the market risk.[255]

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[250] Ex. SC-112 at 1.

[251] *Id.* at 4-6.

[252] *Id.* at 5-6.

[253] *See* Ex. S-1 at 98.

[254] Roger A. Morin, New Regulatory Finance 145-146 (Public Utilities Reports, Inc. 2006).

[255] *Id.* at 159-160.

We do not consider a group of 20 companies, all of comparable risk, sufficiently large or diverse to accurately reflect the risks of the market as a whole, and we are therefore not persuaded that such a group accurately reflects the market risk premium to be used in a CAPM study. In addition, we note that, unlike the NETOs, neither Complainants nor Trial Staff updated their CAPM studies during the hearing; as a result, the CAPM evidence provided by the NETOs represents the most recent CAPM evidence in the record. In sum, for the above reasons, we find Complainants' and Trial Staff's CAPM analyses to be unreliable as corroborative evidence in this proceeding.

f. Expected Earnings Analysis

i. Opinion No. 531

120. In Opinion No. 531, the Commission explained that the NETOs' expected earnings analysis "can be useful in validating" the ROE determination," given the expected earnings analysis's "close relationship to the comparable earnings standard that originated in *Hope*, and the fact that it is used by investors to estimate the ROE that a utility will earn in the future."[256] The Commission found the NETOs' expected earnings analysis "informative,"[257] as it produced a midpoint of 12.1 percent and a median of 10.2 percent, both of which are above the 9.39 percent midpoint produced by the Commission's DCF analysis.[258] The Commission explained that, in relying on the NETOs' expected earnings analysis, "we do not depart from our use of the DCF methodology; rather, we use the record evidence to inform the just and reasonable placement of the ROE within the zone of reasonableness established in the record by the DCF methodology."[259]

ii. Requests for Rehearing

121. Petitioners argue that the NETOs' version of an expected earnings analysis is flawed because it "attempts to forecast returns on *book* equity, rather than investor-required returns on equity purchased at above-book study-period stock prices."[260] Petitioners state that the NETOs' analysis forecasts returns on book equity because the

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[256] Opinion No. 531, 147 FERC ¶ 61,234 at P 147.

[257] *Id.* P 146.

[258] *Id.* P 147.

[259] *Id.* P 146.

[260] Petitioners Request for Rehearing at 43.

analysis turns on the "expected earnings/book equity ratio ("r") in Value Line's five-year forecast."[261] Petitioners contend that the Commission has long rejected setting ROEs "at the rate of return investors expect [the subject utility] to earn on [book] common equity (r), rather than the market cost of common equity (k)."[262] Petitioners assert that the Commission in Opinion No. 531 failed to address this inconsistency between the NETOs' expected earnings analysis and Commission precedent.

122. Petitioners further assert that the Commission's reliance on the NETOs' expected earnings analysis was especially unreasonable in this case because, in adopting the two-step DCF methodology, the Commission discarded the "br+sv" element of the one-step DCF methodology, which placed the "r" input in proper context by factoring it with other components of utility firm growth. Petitioners contend that, although the record contained the necessary data for the NETOs to place their "r" input in the appropriate context, the NETOs' expected earnings analysis ignored that data and instead emphasized "more speculative and optimistic" inputs.[263] Petitioners argue that the Commission in *Kern River Gas Transmission Co.*, Opinion No. 486, 117 FERC ¶ 61,077 (2006) (Opinion No. 486) held that dividends and payout ratios "should be considered in order to account for going-concern utilities' need to reinvest earnings instead of paying them all to shareholders;" however, Petitioners assert that the NETOs' have failed to do so.

123. Petitioners argue that, by relying on forecasted returns on book equity, rather than forecasted returns on the market cost of equity, the NETOs' expected earnings analysis ignores the market/book ratios of the proxy companies, which range from about 1.0 to 2.3.[264] Petitioners assert that, as a result, the NETOs' approach "simply reflects the perpetuation of a high market/book ratio, as was rejected in *Orange & Rockland*."[265] Petitioners also contend that the midpoint of the NETOs' expected earnings analysis is particularly unreliable because it was skewed upwards by Dominion's "unusually high earnings/book equity projection . . . which in turn reflected Dominion's exceptionally high market/book ratio."[266] Petitioners argue that the Commission's precedent on the use of midpoints in a cost of equity study is confined to DCF studies, and should not be used

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[261] *Id.* at 42-43.

[262] *Id.* at 43 (citing *Orange & Rockland*, 44 FERC ¶ 61,253 at 61,952).

[263] *Id.* at 44.

[264] *Id.*

[265] *Id.*

[266] *Id.* at 44-45.

in the context of the NETOs' expected earnings analysis because relying on a midpoint value that is distorted by a high market-to-book ratio would not help reveal the market cost of equity.[267] Petitioners contend that, if the Commission does give weight to the NETOs' expected earnings analysis, the NETOs' analysis "points no higher than its median result, which was 10.2 percent."[268]

124. EMCOS argue that the NETOs' expected earnings analysis fails to recognize the critical link that "when actual or forecasted earnings are considered as a guide to an appropriate ROE allowance, they must be evaluated in conjunction with actual or forecasted stock prices."[269] EMCOS further argue that Opinion No. 531 adopted and relied upon the NETOs' expected earnings analysis without addressing any of the concerns raised by Trial Staff or Complainants. For example, EMCOS note that Trial Staff argued that the NETOs' analysis "inappropriately relies on accounting return results, which are not reflective of the market's required return as indicated by actual equity stock investors."[270] In addition, EMCOS note that the Complainants raised concerns that the NETOs' analysis included several flaws that rendered it unreliable and "overly optimistic."[271] EMCOS argue that failure to address these arguments is the definition of arbitrary and capricious decision-making.[272]

iii. Commission Determination

125. A comparable earnings analysis is a method of calculating the earnings an investor expects to receive on the book value of a particular stock. A comparable earnings analysis can be based either on the stock's historical earnings on book value, as reflected on the company's accounting statements, or on forward-looking estimates of earnings on book value, as reflected in analysts' earnings forecasts for the company. The latter approach is often referred to as an "expected earnings analysis" and is the approach the NETOs used in conducting their comparable earnings analysis in this proceeding. Petitioners' and EMCOS's argue that the NETOs' expected earnings analysis is flawed and does not support the Commission's decision to place the NETOs' base ROE above

[267] *Id.* at 45.

[268] *Id.* at 42.

[269] EMCOS Request for Rehearing at 24 (citing Ex. No. EMC-3 at 8:15-18).

[270] *Id.* at 24-25 (citing Trial Staff Initial Brief at 60).

[271] *Id.* (citing Complainants Initial Brief at 62).

[272] *Id.* at 25 (citing *Ill. Pub. Telecomm. Ass'n v. FCC*, 117 F.3d at 564).

the midpoint of the zone of reasonableness produced by the Commission's DCF analysis. We disagree.

126. The NETOs conducted their expected earnings analysis by using the return on book equity that *Value Line* forecasted for the national group of companies that *Value Line* lists as Electric Utilities. The NETOs then multiplied each of those forecasted returns by an adjustment factor to determine each utility's average return, rather than its year-end return, explaining that using the year-end return would understate actual returns because of growth in common equity over the year.[273] We consider the NETOs' expected earnings analysis to be sound, as it is forward-looking, based on a reliable source of earnings data, and appropriately converts the proxy companies' earnings to reflect average returns.[274]

127. While Petitioners correctly state that the Commission in *Orange & Rockland* rejected a proposal that "would, in effect, set the allowed rate of return on common equity at the rate of return investors expect [the utility] to earn on common equity (r), rather than the market cost of common equity (k)," that precedent is inapposite to this case for two reasons. First, *Orange & Rockland* did not involve a comparable earnings analysis; it involved a proposal to alter the DCF model by adjusting the dividend yield to reflect the expected earnings of the company whose rates were at issue, i.e., Orange & Rockland. Specifically, Orange & Rockland proposed to calculate the dividend yield in its DCF study by dividing dividend payments by book value, instead of by a current stock price. By comparison, the NETOs have not proposed to alter the DCF model to reflect expected earnings, but rather submitted an expected earnings study based on a national proxy group of utilities whose risk profiles are comparable to the NETOs.

128. Second, *Orange & Rockland* is inapposite because the Commission in that case rejected a proposal that would have had the effect of *setting* Orange & Rockland's base ROE at Orange & Rockland's own expected return on book equity. In the instant case, the Commission did not *set* the NETOs' base ROE at their own expected return on book equity or endorse an ROE analysis that would have that effect. Rather, the Commission in Opinion No. 531 used the DCF methodology to determine the NETOs' market cost of equity, and found that the NETOs' expected earnings analysis of a national proxy group was used to determine—and only relevant to—whether the midpoint of the DCF-determined zone of reasonableness provided a market cost of equity sufficient to meet the

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[273] *See* Ex. NET-300 at 73, 32.

[274] *See, e.g.*, *S. Cal. Edison Co.*, 92 FERC ¶ 61,070 at 61,263 (finding it necessary to adjust Value Line's forecasted returns on book equity to reflect average returns rather than year-end returns); *see also* Roger A. Morin, New Regulatory Finance 305-306 (Public Utilities Reports, Inc. 2006).

requirements of *Hope* and *Bluefield*. The returns on book equity that investors expect to receive from a group of companies with risks comparable to those of a particular utility are relevant to determining that utility's market cost of equity, because those returns on book equity help investors determine the opportunity cost of investing in that particular utility instead of other companies of comparable risk. Such a calculation is consistent with the requirement in *Hope* that "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks."[275] As the NETOs' expert witness explained at trial, investors compare each investment alternative with the next best opportunity. If the utility is unable to offer a return similar to that available from other opportunities of comparable risk, investors will become unwilling to supply the capital on reasonable terms.[276]

129. Investors rely on both the market cost of equity and the book return on equity in determining whether to invest in a utility, because investors are concerned with both the return the regulator will allow the utility to earn *and* the company's ability to actually earn that return.[277] If, all else being equal, the regulator sets a utility's ROE so that the utility does not have the opportunity to earn a return on its book value comparable to the amount that investors expect that other utilities of comparable risk will earn on their book equity, the utility will not be able to provide investors the return they require to invest in that utility.[278] Thus, all else being equal, an investor is more likely to invest in a utility that it expects will have the opportunity to earn a comparable amount on its book equity as other enterprises of comparable risk are expected to earn. Because investors rely on expected earnings analyses to help estimate the opportunity cost of investing in a particular utility, we find this type of analysis useful in corroborating whether the results produced by the DCF model may have been skewed by the anomalous capital market conditions reflected in the record.

130. We also reject Petitioners' argument that it was unreasonable for the Commission to rely on the NETOs' expected earnings analysis without also considering the "br+sv" formula in the Commission's DCF analysis. Whether "r" is directly used in the Commission's calculation of the short-term growth rate in the DCF methodology does not bear on the validity of the NETOs' expected earnings analysis or on its relevance in

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[275] *Hope*, 320 U.S. at 603; *see also Petal Gas Storage, L.L.C.*, 496 F.3d 695 (D.C. Cir. 2007).

[276] Ex. No. NET-300 at 71.

[277] *See* Tr. 637:6-12.

[278] As the NETOs' witness testified, returns on book value are analogous to the allowed return on a utility's rate base. *Id.*

corroborating the results of the Commission's DCF analysis.[279] As explained below, the expected earnings analysis and DCF analysis are used to estimate two different types of returns, each valid in its own right, that investors rely upon in determining whether to invest in a particular company.[280]

131. As to the argument that the midpoint of the NETOs' expected earnings analysis is skewed upwards by the results of one company, i.e., Dominion, Petitioners conclusory statements that Dominion's expected earnings are "unusually high" and that Dominion's market-to-book ratio is "exceptionally high" are insufficient to show that Dominion's results skewed the NETOs' analysis. Petitioners state that Dominion has a market-to-book ratio of 2.255, that this value skewed the result of the NETOs' expected earnings analysis, and that there is no evidence that the NETOs have market-to-book ratios comparable to Dominion's.[281] However, Petitioners have provided no evidence demonstrating that Dominion's 2.255 market-to-book ratio is "exceptionally high," and there is no evidence that the NETOs' market-to-book ratios are not comparable to those of the proxy group companies. Lastly, even assuming *arguendo* that it would be more appropriate to eliminate Dominion or to use the median, rather than the midpoint, of the NETOs' expected earnings analysis, the result would be 11.2 percent or 10.2 percent, respectively. Both of these results are above the 9.39 percent midpoint of the DCF-produced zone of reasonableness and, therefore, corroborate the Commission's decision to place the NETOs' base ROE above the 9.39 percent midpoint.

132. While Petitioners and EMCOS[282] assert that the NETOs' expected earnings study ignores the proxy companies' market-to-book ratios, considering market-to-book ratios in an expected earnings study is inconsistent with the purpose of the comparable earnings model. The comparable earnings model is intended to estimate the return on book equity

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[279] We also reject Petitioners' assertion that Opinion No. 486 is relevant to the validity of the NETOs' expected earnings analysis. The language from Opinion No. 486 to which Complainants cite does not involve an expected earnings analysis; rather it concerns whether it is appropriate to base the dividend yield in a DCF analysis of a master limited partnership on its earnings, rather than on dividend payments in excess of earnings. *See* Opinion No. 486, 117 FERC ¶ 61,077 at P 153.

[280] *See infra* P 132.

[281] Petitioners Request for Rehearing at 44-45.

[282] EMCOS argue that the NETOs' expected earnings analysis is flawed because it does not evaluate forecasted earnings in conjunction with forecasted stock prices. This is merely another way of saying that the NETOs' expected earnings analysis failed to consider market-to-book ratios.

that investors expect the *utility* will earn; the market cost of equity, by comparison, is the estimated return to *investors* that an investor requires to invest in the utility. Petitioners and EMCOS seek to adjust the estimated return on book equity produced by the NETOs' expected earnings analysis into the market cost of equity, by applying a market-to-book adjustment. However, as noted above, the return on book equity is relied upon by investors to determine the opportunity cost of investing in a particular company, and investors rely upon expected earnings analysis for this purpose without attempting to convert that opportunity cost into the market cost of equity. We, therefore, find the NETOs' expected earnings analysis reliable as corroborative evidence in this proceeding, notwithstanding the lack of a market-to-book adjustment in that analysis. Further, even assuming *arguendo* that a market-to-book adjustment was appropriate, we are not persuaded that Petitioners' approach of simply dividing a utility's book return on equity by its market-to-book ratio would accurately estimate the utility's market cost of equity. We also disagree with EMCOS's argument that the NETOs' expected earnings analysis relies on accounting return results, and is therefore not corroborative of the market cost of equity. As noted above, the NETOs' expected earnings analysis is based on forecasted earnings, not historical returns reflected on accounting statements.

3. Impact of the DCF Methodology Change on Existing ROE Transmission Incentive Adders

a. Opinion No. 531

133. Opinion No. 531 explained that, "[b]ased on the Commission's policy that the total ROE including any incentive ROE is limited to the zone of reasonableness, the Commission has found in the past that an incentive ROE may not be implemented in full by the utility if the total ROE exceeds the zone of reasonableness."[283] The Commission found that "[n]othing in [Opinion No. 531] changes this Commission policy,"[284] and, therefore, "when a public utility's ROE is changed, either under section 205 or section 206 of the FPA, that utility's total ROE, inclusive of transmission incentive ROE adders, should not exceed the top of the zone of reasonableness produced by the two-step DCF methodology."[285]

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[283] Opinion No. 531, 147 FERC ¶ 61,234 at P 164.

[284] *Id.*

[285] *Id.* P 165.

b. Request for Rehearing

134. The NETOs request that the Commission clarify that adjustments to the NETOs' ROE incentive adders are outside the scope of this proceeding.[286] The NETOs state that the base ROE was the sole matter set for hearing, no party submitted evidence relating to incentive adders, and the issue was not discussed in the Initial Decision.[287] The NETOs assert that Opinion No. 531 does not state with specificity that the NETOs' total ROE must not exceed the top of the zone of reasonableness, and the NETOs interpret the Commission's language concerning capping the total ROE as a statement of a general ratemaking principle.[288]

135. If the Commission did intend to require the NETOs to reduce the total ROE to the top of the zone of reasonableness, the NETOs request rehearing of that decision. The NETOs state that the "ROE incentive adders were approved based upon a detailed record of the benefits and risks of the relevant projects and the nexus between the incentive adders and the projects, which included consideration of the ability of the incentive to facilitate construction of the project."[289] The NETOs state that, when the adders were approved, they were below the top end of the then-current zone of reasonableness. The NETOs argue that the Commission placed no conditions on the adders' continued effectiveness, and that the adders do not automatically change when the Commission determines a new zone of reasonableness.[290]

136. The NETOs state that the base ROE was the only matter at issue in this case, and that incentive adders were explicitly excluded by the complaint.[291] The NETOs argue that modifying the incentive adders in this proceeding would violate the Constitution's Due Process Clause and the Administrative Procedure Act.[292] The NETOs state that, in a similar case, the Commission granted an ROE adder without notice to the parties that the issue would be decided during the hearing and the D.C. Circuit found that the

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[286] NETOs Request for Rehearing at 6-7.

[287] *Id.* at 7-8.

[288] *Id.* at 8-9.

[289] *Id.* at 11-12.

[290] *Id.* at 13.

[291] *Id.* at 14-15.

[292] *Id.* at 15-16.

Commission had violated the parties' due process rights.[293] The NETOs state that, in each of the cases that the Commission cited in Opinion No. 531, the ROE incentive adders were implicated prior to the hearing, thus providing the parties with notice and the opportunity to submit evidence on the incentive adders. The NETOs assert that, assuming the Hearing Order had addressed incentive adders, the Commission erred in ruling that the adders must be reduced without accepting evidence on the issue.[294]

137. The NETOs request that the Commission clarify that the term "total ROE" refers to the total transmission assets of a utility rather than project-specific ROEs.[295] The NETOs argue that as long as the ultimate rate charged to consumers is just and reasonable, FPA section 219 is satisfied and the Commission has no basis to look at project-specific ROEs to determine whether they are below the top of the zone of reasonableness.[296]

138. The NETOs argue that, if the term "total ROE" includes incentive ROEs, Opinion No. 531 should be reversed as inconsistent with statutory requirements and Commission precedent. The NETOs state that in Order No. 679 the Commission stated that the test for reviewing a rate is whether the end result is reasonable.[297] The NETOs argue that such an evaluation necessarily involves review of the overall rate inclusive of all components, not merely a review of one component such as an individual project's incentive ROE.[298]

c. <u>Commission Determination</u>

139. We deny rehearing on this issue. As an initial matter, it is worth noting that Opinion No. 531 does not change the incentive ROE adders that the Commission previously granted to the NETOs. Rather, Opinion No. 531 follows Commission policy that a utility's ROE, even if it includes an incentive ROE adder, would be capped at the

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[293] *Id.* at 17-18 (citing *PSC of Kentucky*, 397 F.3d at 1011-12).

[294] *Id.* at 18-20.

[295] *Id.* at 20-22.

[296] *Id.* at 22-23.

[297] *Id.* at 23-24.

[298] *Id.* at 24-26 (citing *Northeast Utils. Serv. Co.*, 52 FERC ¶ 61,097 (1990), *reh'g denied*, 52 FERC ¶ 61,336; *Florida Power & Light Co.*, 24 FERC ¶ 61,171, at 61,408 (1983); *Florida Power & Light Co.*, 32 FERC ¶ 61,059 at 61,162 (1985)).

upper end of the transmission owner's DCF-determined zone of reasonableness. For example, in Order No. 679, the Commission made clear that the total ROE including any incentive ROE adder sought by an applicant must be within the utility's DCF-determined zone of reasonableness.[299] In the orders in which the Commission granted the NETOs' incentive ROE adders, the Commission also made clear that the total ROE including such adders would be capped at the high end of the NETOs' zone of reasonableness.[300] The fact that a transmission owner may not be able to implement in full its awarded incentive ROE adder because the resulting total ROE would exceed the high end of the transmission owner's zone of reasonableness is nothing new.[301] In addition, the

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[299] *Promoting Transmission Investment through Pricing Reform*, Order No. 679, FERC Stats. & Regs. ¶ 31,222, at PP 2, 93 (2006), *order on reh'g*, Order No. 679-A, FERC Stats. & Regs. ¶ 31,236, *order on reh'g*, 119 FERC ¶ 61,062 (2007); *Pac. Gas & Elec. Co*., 141 FERC ¶ 61,168, at P 26 (2012); *see also Town of Norwood, Mass. v. FERC*, 80 F.3d at 534-535 (supporting the principle that ROE should be cabined within the bounds of the zone of reasonableness, by reversing a Commission decision to set ROE at the bottom of the zone of reasonableness that was established in the utility's prior rate case and explaining that the Commission cannot rely on a zone of reasonableness established in a prior rate case if the utility's circumstances have since changed); 16 U.S.C. § 824s(d) (2012) ("All rates approved under the rules adopted pursuant to [FPA section 219] . . . are subject to the requirements of sections [205 and 206] of this title that all rates . . . be just and reasonable."); Order No. 679-A, FERC Stats. & Regs. ¶ 61,236 at P 15 (cross-referenced at 117 FERC ¶ 61,345 at P 15) (indicating that the Commission will keep any incentive ROE adder within the zone of reasonableness as a means to ensure the Commission comply with its regulatory responsibilities under the FPA). The courts have also recognized that utilities cannot charge rates that exceed the DCF-determined zone of reasonableness. *See, e.g.*, *Union Elec. Co. v. FERC*, 890 F.2d 1193, 1204 (D.C. Cir. 1989).

[300] *See, e.g.*, *Ne. Utils. Serv. Co.*, 124 FERC ¶ 61,044 at P 83.

[301] *See, e.g.*, *NSTAR Elec. Co.*, 125 FERC ¶ 61,313 at PP 81-87 (granting a New England transmission owner an incentive ROE adder, to be bound by the upper end of the zone of reasonableness previously established for the New England transmission owners; and determining, based on an updated DCF analysis, that the overall ROE including the incentive ROE adders remained within the zone of reasonableness); *accord Me. Pub. Utils. Comm'n v. FERC*, 454 F.3d at 288-89 (affirming the Commission's decision to grant transmission owners that join ISO New England a 50 basis point incentive ROE adder for RTO participation, and the Commission's decision to cap the overall ROE at the top of the zone of reasonableness); *Proposed Pricing Policy for Efficient Operation and Expansion of Transmission Grid*, 102 FERC ¶ 61,032, at P 37 (2003) (noting that, in implementing ROE-based incentives, including the RTO

(continued…)

Commission has summarily applied this policy in rate cases initiated after an ROE adder was approved. For example, in establishing a hearing on a section 205 rate filing by Pacific Gas and Electric Co. (PG&E), the Commission held that a 200 basis point adder originally granted to PG&E ten years earlier[302] and a 50 basis point ROE adder for RTO participation granted two years earlier[303] would be limited to within the new zone of reasonableness determined at the hearing.[304] Thus, whether the merits of a utility's incentive ROE adders are implicated by a proceeding is a much different issue than whether the utility can fully implement its incentive ROE adders due to changes in the zone of reasonableness for that utility. This proceeding involves only the latter of these two issues; it does not involve the merits of the NETOs' existing incentive ROE adders.

140. Contrary to the NETOs' assertion, the Commission's ruling in Opinion No. 531 on this issue was not merely a general statement of ratemaking principle, it was a continuation of a Commission policy that the NETOs' total ROE cannot exceed the zone of reasonableness calculated in this proceeding.[305]

141. The NETOs argue that the precedent cited by Opinion No. 531 concerning ROE incentive adders, such as *PG&E*, is distinguishable from the instant proceeding because in the incentives cases the incentives were implicated before the hearing, and the parties therefore had notice and opportunity to submit evidence on the issue. We disagree. In the cases cited by Opinion No. 531, the Commission did not set for hearing the issue of whether an existing incentive adder should be reduced to no higher than the top of the

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participation adder, those incentives would be subject to a cap on the overall ROE equal to the top of the range of reasonable ROEs for a proxy group).

[302] *See Western Area Power Admin.*, 100 FERC ¶ 61,331, at PP 12-13 (2002).

[303] *Pac. Gas & Elec. Co.*, 132 FERC ¶ 61,272, at P 23 (2010).

[304] *PG&E*, 141 FERC ¶ 61,168 at P 26 (continuing to grant a 200 basis point ROE adder for the PATH 15 upgrade project, granted prior to Order No. 679, and a 50 basis point adder for RTO participation, granted subsequent to Order No. 679, and in doing so "remind[ing] PG&E that any ROE adder is limited to within the range of reasonableness of the ROE.").

[305] This is reaffirmed by the Commission's determination in Opinion No. 531-A, the order on the paper hearing that the Commission established in Opinion No. 531, in which the Commission found that the zone of reasonableness produced by the DCF methodology in this proceeding is 7.03 percent to 11.74 percent and, therefore, that "the NETOs' total or maximum ROE, including transmission incentive ROE adders, cannot exceed 11.74 percent." Opinion No. 531-A, 149 FERC ¶ 61,032 at P 11.

new zone of reasonableness. Rather, the Commission summarily ruled on that issue before the hearing. Because the Commission has an established policy that incentive adders must be within the zone of reasonableness in order to comply with section 219(a) of the FPA, the issue of whether to reduce an incentive adder that would otherwise exceed the top of the zone of reasonableness does not present any issue of material fact that would be appropriate for consideration in a hearing.

142. In any event, the NETOs' did in fact have notice and opportunity to present argument on the issue of their total ROE. Because it is well established both that a proceeding to determine a utility's base ROE involves a determination of the utility's zone of reasonableness under the DCF methodology, and that a transmission owner's awarded incentive ROE adder could not exceed the high end of the zone of reasonableness, the NETOs had notice to present evidence regarding the zone and thus the ultimate just and reasonable total ROE.

143. We disagree with the NETOs' argument that *PSC of Kentucky*, 397 F.3d 1004, is relevant to this issue. That case involved the Commission's post-hearing decision to grant an incentive ROE that the Commission, in setting the case for hearing, explicitly declined to grant and stated would not be at issue in the proceeding. Those facts are distinguishable from the facts here.

144. In *PSC of Kentucky*, the court found that the Commission violated the parties' due process rights because the Commission, having initially determined that it would not grant an incentive ROE adder, at the end of the proceeding granted the incentive ROE adder, and thus failed to place the parties on notice at the outset that, post-hearing, its order might grant the incentive ROE adder.[306] The court explained that, while the Commission considered the petitioners' arguments regarding the incentive ROE adder on rehearing, the Commission did not allow them to present evidence at hearing on the relevant factual issue, i.e., the need for, or appropriate size of, the incentive ROE adder.[307] In contrast, here the parties had both opportunities to make their case. The NETOs had notice of the Commission's already-well-established policy that a utility's total ROE must remain within the zone of reasonableness identified by the DCF analysis, and the NETOs had the opportunity to submit—and did, in fact, submit—evidence at hearing on the relevant factual issue, i.e., the zone of reasonableness identified by the

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[306] *PSC of Kentucky*, 397 F.3d at 1012.

[307] *Id.*

DCF analysis. Further, they also have had the opportunity to raise their arguments concerning this issue on rehearing.[308]

145. The NETOs assert that the Commission's use of the term "total ROE" in Opinion No. 531 may be read to refer only to "the overall ROE of the utility (inclusive of all transmission assets), rather than project-specific ROEs," because the Commission did not "address the meaning of 'total ROE' in the context of a multiple-asset utility."[309] Contrary to the NETOs' assertion, Opinion No. 531 did address the meaning of the term "total ROE" both in the context of ROEs that apply to specific projects[310] and in the context of ROEs that apply to multiple utility assets.[311] To be clear, the term "total ROE" applies to, and has identical meaning in, both contexts. Requests for incentive ROE adders are typically presented to the Commission in one of three ways: (1) a request for incentive ROE adders that apply to all of a utility's transmission assets;[312] (2) a request for incentive ROE adders that apply only to specific transmission projects;[313] or (3) a request for a combination of incentive ROE adders, some of which apply to all of the utility's transmission assets and some of which apply only to specific transmission projects.[314] In each type of incentive ROE case, the Commission has explained that the total ROE, i.e., the base ROE plus any incentive adders, for the transmission assets to which the adder applies is capped at the top of the zone of reasonableness.[315] In other

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[308] *See, e.g.*, *State of Cal. ex rel. Lockyer v. FERC*, 329 F.3d 700, 711 (2003) ("the Commission provided all the procedural protections required by the Fifth Amendment and FPA when it carefully considered all the evidence and arguments that the petitioners offered in their petitions for rehearing and motions to intervene."); *see also ANR Pipeline Co. and TC Offshore LLC*, 143 FERC ¶ 61,225, at PP 57, 60 (2013).

[309] NETOs Request for Rehearing at 20-21.

[310] Opinion No. 531, 147 FERC ¶ 61,234 at P 164 (citing *Trans Bay Cable LLC*, 145 FERC ¶ 61,151 (2013), and *Atlantic Path 15, LLC*, 135 FERC ¶ 61,037 (2011)).

[311] *Id.* (citing *PG&E*, 141 FERC ¶ 61,168).

[312] *See, e.g.*, *Oklahoma Gas & Elec. Co.*, 122 FERC ¶ 61,071 (2008).

[313] *See, e.g.*, *NSTAR Elec. Co.*, 125 FERC ¶ 61,313; *see also RITELine Illinois, LLC & RITELine Indiana, LLC*, 137 FERC ¶ 61,039 (2011).

[314] *See, e.g.*, *PG&E*, 141 FERC ¶ 61,168.

[315] *See, e.g.*, *Oklahoma Gas & Elec. Co.*, 122 FERC ¶ 61,071 at P 36 n.26; *NSTAR Elec. Co.*, 125 FERC ¶ 61,313 at P 81; *PG&E*, 141 FERC ¶ 61,168 at P 26.

words, incentive ROE adders are capped by the top of the DCF-determined zone of reasonableness, regardless of the particular incentive ROE adder authorized or the transmission assets to which it applies. This is appropriate because all incentives ultimately must be evaluated according to the same methodology, i.e., they must be evaluated against a zone of reasonableness above which the record does not support the total ROE including any incentive ROE adders as just and reasonable.

146. We also reject the NETOs' argument that FPA section 219 is satisfied, and the Commission has no basis to change a project-specific ROE, as long as the utility's ultimate rate is just and reasonable. This argument is inconsistent with the Commission's precedent on project-specific ROE incentives, in which the Commission has held that the utility's total ROE for the project cannot exceed the zone of reasonableness.[316] In addition, the practical effect of the NETOs' argument—"even if an incentive ROE for a particular project exceeds a utility's zone of reasonableness, so long as the entire utility's ROE (inclusive of all transmission assets) falls within the utility's zone of reasonableness, no change would be needed to the project-specific incentive ROE"—appears to result in incentive ROE adders applying to facilities to which the Commission has not granted the adders. An incentive ROE adder may not serve to increase the ROE for a transmission asset that has not been granted an incentive. Lastly, we disagree with the NETOs that *Northeast Utilities Service Co.*, 52 FERC ¶ 61,097 (1990), *Florida Power & Light Co.*, 24 FERC ¶ 61,171 (1983), and *Florida Power & Light Co.*, 32 FERC ¶ 61,059 (1985), support allowing project-specific ROEs above the zone of reasonableness. Those cases did not involve an analysis of the utilities' ROE relative to the zone of reasonableness produced by a DCF methodology; rather, those cases involved analyses of the equity returns at issue relative to either the utilities' costs[317] or to other rate designs that the utility could have used.[318]

4. <u>Establishment of a Just and Reasonable Rate</u>

a. <u>Opinion No. 531</u>

147. The Commission in Opinion No. 531 did not establish the NETOs' just and reasonable ROE. As the Commission explained, the "finding concerning the specific numerical just and reasonable ROE for the NETOs is subject to the outcome of the paper

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[316] *See, e.g.*, *Pepco Holdings, Inc.*, 125 FERC ¶ 61,130, at PP 75-79, 91-94 (2008).

[317] *See Florida Power & Light*, 24 FERC ¶ 61,171 at 61,408; *Florida Power & Light Co.*, 32 FERC ¶ 61,059 at 61,162.

[318] *See Northeast Utils. Serv. Co.*, 52 FERC ¶ 61,097 at 61,485-486.

hearing on the appropriate long-term growth projection to be used in the two-step DCF methodology."[319]

b. Requests for Rehearing

148. EMCOS requests that the Commission clarify that it intended for Opinion No. 531 to establish 10.57 percent as the prospective base ROE in effect from the date of issuance of Opinion No. 531, pending the outcome of the paper hearing on the long-term growth rate for use in the two-step DCF methodology. Similarly, Petitioners argue that the Commission erred by not directing the NETOs to prospectively reduce their rates as of June 19, 2014, based on the tentative findings in Opinion No. 531.[320] Petitioners also argue that it was arbitrary and inconsistent with the section 206 "bond of protection" for the Commission to rely on the 4.39 percent long-term growth rate for purposes of excluding PSEG, while not relying on a 4.39 percent second-step growth rate for purposes of setting an interim or final ROE to be observed.[321]

149. Petitioners assert that the paper hearing is unlikely to materially alter the conclusions reached in Opinion No. 531 and that any refinement of the NETOs' ROE could be implemented as a refund or surcharge against the 10.57 percent base ROE. Petitioners argue that FPA section 206 requires the Commission to fix the rate to be observed as of the date of Opinion No. 531.[322] Petitioners further argue that courts have found that the Commission has "fixed" a rate when parties are in a position to supply their own inputs to a formula and thereby know the numerical rates. Petitioners contend that Opinion No. 531 provides such a formula by supplying a 10.57 percent base ROE and an 11.74 percent maximum ROE.[323]

150. Petitioners argue that implementing interim rates is required by the Commission's obligation to "act as speedily as possible" on FPA section 206 complaints.[324] Petitioners

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[319] Opinion No. 531, 147 FERC ¶ 61,234 at P 152.

[320] Petitioners Request for Rehearing at 66 (citing *New England Power Generators Association v. ISO New England Inc.*, 146 FERC ¶ 61,038, at P 26 (2014); *Georgia Power Co.*, 57 FERC ¶ 61,353 (1991)).

[321] *Id.* at 61-62.

[322] *Id.* at 69-70.

[323] *Id.* at 70-71.

[324] *Id.* at 71 (quoting 16 U.S.C. § 824e(b)).

state that, as an alternative to making the NETOs' new ROE prospectively effective as of June 19, 2014, the Commission could direct the NETOs to use the final ROE in its true-up calculation for the 2014 rate year.[325] Petitioners note that if the Commission uses this alternative method, the Commission must issue its order on the paper hearing before July 31, 2015 to ensure that the true-up filing is implemented with the correct ROE.[326]

c. Commission Determination

151. We deny Petitioners' and EMCOS's requests to prospectively establish the NETOs' replacement rate as of June 19, 2014.[327] FPA section 206 requires that "[w]henever the Commission, after a hearing held upon its own motion or upon complaint, shall find that any rate . . . is unjust, unreasonable, unduly discriminatory or preferential, the Commission shall determine the just and reasonable rate . . . to be thereafter observed and in force, and shall fix the same by order."[328] As the Commission explained in Opinion No. 531, however, its findings regarding the justness and reasonableness of the NETOs' rates were "tentative because [they were] subject to the submission of the record evidence at the paper hearing . . . as to the appropriate long-term growth rate."[329] While the appropriate long-term growth rate itself was a narrow issue, that input had the potential to materially affect the NETOs' ROE by altering the DCF results of the companies in the proxy group.[330] As a result, the Commission could not satisfy the requirement of FPA section 206 that it "fix" the just and reasonable rate to be in effect prospectively until after the paper hearing established by Opinion No. 531. Only

[325] *Id.* at 72 (citing *South Carolina Elec. & Gas Co.*, 132 FERC ¶ 61,043 (2010)).

[326] *Id.* at 74.

[327] The Commission established the just and reasonable ROE for the NETOs on October 16, 2014, in Opinion No. 531-A. *See* Opinion No. 531-A, 149 FERC ¶ 61,032 at PP 10-12.

[328] 16 U.S.C. § 824e (2012).

[329] Opinion No. 531, 147 FERC ¶ 61,234 at P 142.

[330] We reject Petitioners' assertion that it was inconsistent for the Commission to rely on the 4.39 percent GDP growth rate in eliminating PSEG from the proxy group as a low-end outlier and not rely on that GDP growth rate to establish a just and reasonable rate in Opinion No. 531. If the paper hearing had modified the 4.39 percent GDP growth rate, the Commission could have been required to reconsider its low-end outlier ruling based on the revised DCF results. However, the paper hearing did not change the 4.39 percent GDP growth rate and, therefore, no such reconsideration was required.

with the issuance of Opinion No. 531-A, on October 16, 2014, did the Commission establish the prospective just and reasonable rate.[331]

152. We similarly disagree with Petitioners that the Commission fixed the just and reasonable rate in Opinion No. 531 by providing a formula by which the parties could supply their own inputs and know the numerical rate. The Commission in Opinion No. 531 provided no such formula. Further, even assuming *arguendo* that the Commission's analysis could be characterized as a formula, a key input—the long-term growth rate—was unsettled pending the outcome of the paper hearing. Lastly, we reject Petitioners' request that we direct the NETOs to include the ROE established in this proceeding in their true-up calculation for the 2014 rate year. When the NETOs make the annual Regional Network Service true-up filing in 2015 to update the formula rates to reflect calendar year 2014 actual data, consistent with the requirements of the Regional Network Service formula, the filing should reflect the relevant ROEs in effect for any month within the 2014 time period. As mentioned above, the prospective effective date for the ROE determined in this proceeding is October 16, 2014, the issuance date of Opinion No. 531-A. Accordingly, Petitioners' alternative request to direct the NETOs to include the ROE determined in this proceeding for the entire 2014 calendar year is inconsistent with the effective date established in Opinion 531-A. We note that there are other complaints involving the NETOs' ROEs pending before the Commission in Docket Nos. EL13-33 and EL14-86 that may affect the ROE ultimately charged under the Regional Network Service formula for other months in 2014; however, any changes to the formula as a result of those complaints will not be effective until the Commission issues final orders in those proceedings.

<u>The Commission orders</u>:

(A) Petitioners', EMCOS's, and the NETOs' requests for rehearing of Opinion No. 531 are hereby denied, as discussed in the body of this order.

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[331] *See* Opinion No. 531-A, 149 FERC ¶ 61,032. The Commission in Opinion No. 531-A also directed the NETOs to issue refunds for the 15-month refund period in this proceeding, i.e., from October 1, 2011 through December 31, 2012.

(B) The NETOs' request for rehearing of Opinion No. 531-A is hereby denied, as discussed in the body of this order.

By the Commission. Commissioner Honorable is concurring with a separate statement attached.

(S E A L)

Kimberly D. Bose,
Secretary.

UNITED STATES OF AMERICA

FEDERAL ENERGY REGULATORY COMMISSION

Martha Coakley, Massachusetts Attorney General; Connecticut Public Utilities Regulatory Authority; Massachusetts Department of Public Utilities; New Hampshire Public Utilities Commission; Connecticut Office of Consumer Counsel; Maine Office of the Public Advocate; George Jepsen, Connecticut Attorney General; New Hampshire Office of Consumer Advocate; Rhode Island Division of Public Utilities and Carriers; Vermont Department of Public Service; Massachusetts Municipal Wholesale Electric Company; Associated Industries of Massachusetts; The Energy Consortium; Power Options, Inc.; and the Industrial Energy Consumer Group	Docket Nos. EL11-66-002 EL11-66-003

v.

Bangor Hydro-Electric Company; Central Maine Power Company; New England Power Company d/b/a National Grid; New Hampshire Transmission LLC d/b/a NextEra; NSTAR Electric and Gas Corporation; Northeast Utilities Service Company; The United Illuminating Company; Unitil Energy Systems, Inc. and Fitchburg Gas and Electric Light Company; Vermont Transco, LLC

(Issued March 3, 2015)

HONORABLE, Commissioner, *concurring*:

In denying the requests for rehearing, the Commission sets forth a cogent defense of Opinion No. 531 and duly considers and adequately addresses the arguments of the petitioners in the numerous requests for rehearing. Additionally, it is within the Commission's discretion to alter the DCF methodology for determining the just and reasonable rates of return for the NETOs.

I write separately to emphasize two important points to ensure that they are not lost in the shift in the DCF methodology and the placement of the base ROE above the central tendency of the zone of reasonableness. These points relate to: (1) the determination of the just and reasonable rate; and (2) the anomalous market conditions that prompted the consideration of alternative methodologies which ultimately led to the placement of the base ROE halfway between the midpoint and the top of the zone of reasonableness.

The just and reasonable rate of return for a public utility necessarily must consider *both* the protection of the consumer and the capital attraction standards set forth in *Hope* and *Bluefield*. The Commission appropriately relies upon the landmark *Hope* and *Bluefield* decisions to make the point that the allowed return should be adequate to enable it to secure the funding necessary for the proper discharge of its public duties. The duty to ensure the NETOs' ability to attract capital prompted consideration of additional record evidence and led to the use of alternative methodologies as benchmarks against which the DCF results were measured. However, while the Commission in Opinion No. 531 tacitly recognizes that a just and reasonable rate protects consumers, it does not emphasize consumer protection as forcefully as it could have. The primary purpose of the authority granted to the Commission to ensure a just and reasonable rate is to protect the consumer.[1] Indeed, the *Hope* decision, relied upon by this Commission to articulate the just and reasonable standard, explicitly provides that the Commission must balance both "investor and consumer interests."[2] In finding that balance, the Commission dedicates significant effort to ensuring that the NETOs are able to attract sufficient capital. While capital attraction is essential, Opinion No. 531 should not be interpreted as tipping the scale in favor of investor interests. As intended by Congress and confirmed by the Courts, consumer protection is in the DNA of FERC's ratemaking authority. Opinion No. 531 does not, and cannot, change that fact.

Keeping in mind the delicate balance that the Commission must strike when weighing investor and consumer interests, it is important to note that the finding of "anomalous market conditions" in Opinion No. 531 did not create a bright line test nor did it create a presumption that market conditions will be found to be anomalous going forward. The anomalous, or unusual, market conditions that were found in the original order to justify the placement of the base ROE above the central tendency of the zone of

[1] *See, e.g., Morgan Stanley Capital Grp. Inc. v. Pub. Util. Dist. No. 1 of Snohomish Cnty., Wash.*, 554 U.S. 527, 564 (2008) ("Congress enacted the FPA precisely because it concluded that regulation was necessary to protect consumers from deficient markets.").

[2] *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

reasonableness were, by definition, atypical. Any public utility that seeks to rely upon anomalous market conditions to justify placement of its base ROE in the upper end of the zone of reasonableness will be tasked with demonstrating, in each case, that market conditions are indeed anomalous and that the adequacy of a base ROE set at the midpoint of the zone of reasonableness should be scrutinized. The utility should expect a rigorous analysis of the record when it attempts to make such a demonstration.

The decision in Opinion No. 531 is within the Commission's broad discretion to determine the just and reasonable rate. I concur with this denial of the requests for rehearing to emphasize the points discussed above.

Colette D. Honorable
Commissioner

Document Content(s)