156 FERC ¶ 61,234
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Norman C. Bay, Chairman;
Cheryl A. LaFleur, and Tony Clark.

Association of Businesses Advocating Tariff Equity Docket No. EL14-12-002
Coalition of MISO Transmission Customers
Illinois Industrial Energy Consumers
Indiana Industrial Energy Consumers, Inc.
Minnesota Large Industrial Group
Wisconsin Industrial Energy Group

v.

Midcontinent Independent System Operator, Inc.
ALLETE, Inc.
Ameren Illinois Company
Ameren Missouri
Ameren Transmission Company of Illinois
American Transmission Company LLC
Cleco Power LLC
Duke Energy Business Services, LLC
Entergy Arkansas, Inc.
Entergy Gulf States Louisiana, LLC
Entergy Louisiana, LLC
Entergy Mississippi, Inc.
Entergy New Orleans, Inc.
Entergy Texas, Inc.
Indianapolis Power & Light Company
International Transmission Company
ITC Midwest LLC
Michigan Electric Transmission Company, LLC
MidAmerican Energy Company
Montana-Dakota Utilities Co.
Northern Indiana Public Service Company
Northern States Power Company-Minnesota
Northern States Power Company-Wisconsin
Otter Tail Power Company
Southern Indiana Gas & Electric Company

OPINION NO. 551

ORDER ON INITIAL DECISION

(Issued September 28, 2016)

Paragraph Numbers

1. This order addresses briefs on and opposing exceptions to an Initial Decision issued on December 22, 2015 by the presiding Administrative Law Judge (Presiding Judge) in the captioned proceedings.[1] The Initial Decision set forth the Presiding Judge's findings concerning a complaint filed pursuant to section 206 of the Federal Power Act (FPA)[2] challenging the Midcontinent Independent System Operator, Inc. (MISO) Transmission Owners' (TOs) base return on equity (ROE) reflected in MISO's Open Access Transmission, Energy and Operating Reserve Markets Tariff (Tariff). In this order, we affirm the Initial Decision.

I. Background

2. On September 23, 2002, the Commission affirmed an initial decision that approved a base ROE of 12.38 percent for MISO TOs, but the Commission modified the initial decision to include an upward adjustment of 50 basis points for turning over operational control of transmission facilities.[3] On remand from the U.S. Court of Appeals for the District of Columbia Circuit, among other things, the Commission vacated its prior order concerning the 50 basis point adder and stated that MISO TOs may make filings under section 205 of the FPA to include an incentive adder.[4] The 12.38 percent base ROE continues to be the applicable ROE under Attachment O of the MISO Tariff used by all MISO TOs except for American Transmission Company, LLC (ATC).[5]

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[1] *Ass'n of Bus. Advocating Tariff Equity v. Midcontinent Indep. System Operator, Inc.*, 153 FERC ¶ 63,027 (2015) (Initial Decision).

[2] 16 U.S.C. § 824e (2012).

[3] *Midwest Indep. Transmission Sys. Operator, Inc.*, 100 FERC ¶ 61,292 (2002), *order denying reh'g*, 102 FERC ¶ 61,143 (2003).

[4] *Midwest Indep. Transmission Sys. Operator, Inc.*, 111 FERC ¶ 61,355 (2005).

[5] ATC's base ROE of 12.2 percent was established as part of a settlement agreement that was filed with the Commission on March 26, 2004. In Docket No. ER04-108-000, the Commission approved the uncontested settlement. *Am. Transmission Co. LLC*, 107 FERC ¶ 61,117 (2004).

3. On November 12, 2013, Complainants[6] filed a complaint (Complaint) alleging that the current base ROE is unjust and unreasonable. Additionally, Complainants argued that the capital structures of certain MISO TOs feature unreasonably high amounts of common equity and that MISO TOs' capital structures should be capped at 50 percent common equity. Finally, Complainants contended that the ROE incentive adders received by ITC Transmission for being a member of a regional transmission organization (RTO) and by both ITC Transmission and Michigan Electric Transmission Company, LLC (METC) for being independent transmission owners were unjust and unreasonable and should be eliminated.

4. On October 16, 2014, the Commission set for hearing the issue of whether MISO TOs' base ROE is unjust and unreasonable and established the refund effective date at November 12, 2013.[7] The Commission denied the Complaint with respect to the capital structure issue, finding that Complainants had neither demonstrated that such existing capital structures are not just and reasonable nor cited any precedent for capping, for ratemaking purposes, the level of common equity in such capital structures for individual utilities, much less groups of utilities.[8] The Commission also denied the Complaint with respect to ROE incentive adders.

5. On July 21, 2016, the Commission generally denied requests for rehearing and clarification of the Hearing Order.[9] However, the Commission clarified that non-public utility transmission owners are subject to the outcome of this proceeding. Therefore, the Commission stated that, if the Commission find that MISO TOs' existing base ROE is unjust and unreasonable and requires them to amend their Attachment Os. Accordingly, the Commission will also require those non-public utility transmission owners that incorporate the existing base ROE in their rates to amend their Attachment Os to incorporate the just and reasonable base ROE on a prospective basis. However, the

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[6] Complainants, a group of large industrial customers, are: Association of Businesses Advocating Tariff Equity; Coalition of MISO Transmission Customers; Illinois Industrial Energy Consumers; Indiana Industrial Energy Consumers, Inc.; Minnesota Large Industrial Group; and Wisconsin Industrial Energy Group.

[7] *Ass'n of Bus. Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc.* 149 FERC ¶ 61,049, at P 188 (2014) (Hearing Order).

[8] *Id.* P 190.

[9] *Ass'n of Bus. Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc.*, 156 FERC ¶ 61,060 (2016) (Rehearing Order).

Commission stated that the MISO non-public utility transmission owners would only be subject to any refund obligations imposed in this proceeding to the extent they have voluntarily committed to make such refunds in prior FPA section 205 proceedings relating to the inclusion of the transmission revenue requirement in MISO's jurisdictional rates.[10]

6. On February 12, 2015, in Docket No. EL15-45-000, a different set of complainants filed a second complaint challenging the public utility MISO TOs' base ROE. By order dated June 18, 2015, the Commission set this matter for hearing and established a refund effective date of February 12, 2015, the day after the expiration of the refund period established by the Hearing Order. That refund period expired May 11, 2016.[11]

7. On December 22, 2015, in this proceeding, the Presiding Judge issued the Initial Decision finding, *inter alia*, that MISO TOs' existing 12.38 percent base ROE is unjust and unreasonable and should be reduced to 10.32 percent. The Presiding Judge also prescribed refunds, with interest, for the period from November 12, 2013 through February 11, 2015.[12] In the Initial Decision, the Presiding Judge explained that the 10.32 percent base ROE represents the midpoint of the upper half of the zone of reasonableness (upper midpoint) of 7.23 percent to 11.35 percent.[13]

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[10] *Id.* PP 47-48.

[11] *Arkansas Elec. Coop. Corp. v. ALLETE, Inc.*, 151 FERC ¶ 61,219, at P 1 (2015) (Second Complaint Hearing Order).

[12] Initial Decision, 153 FERC ¶ 63,027 at P 491.

[13] *Id.* P 110.

8. Joint Customer Intervenors,[14] Complainants, MISO TOs,[15] Resale Power Group of Iowa (Iowa Group), and Trial Staff each filed briefs on exception and opposing exceptions to the Initial Decision. Organization of MISO States (OMS) filed a brief on exceptions and jointly filed, with Joint Consumer Advocates, a brief opposing exceptions.[16]

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[14] Joint Customer Intervenors consist of Arkansas Electric Cooperative Corporation, Mississippi Delta Energy Agency and its members, Clarksdale Public Utilities Commission of the City of Clarksdale, Mississippi and Public Service Commission of Yazoo City, Mississippi, Hoosier Energy Rural Electric Cooperative, Inc., South Mississippi Electric Power Association, and Southwestern Electric Cooperative.

[15] MISO TOs for the purpose of this order refers to: ALLETE, Inc. for its operating division Minnesota Power (and its subsidiary Superior Water, L&P); Ameren Services Company, as agent for Union Electric Company d/b/a Ameren Missouri, Ameren Illinois Company d/b/a Ameren Illinois, and Ameren Transmission Company of Illinois; American Transmission Company LLC; Cleco Power LLC; Duke Energy Corporation for Duke Energy Indiana, Inc.; Entergy Arkansas, Inc.; Entergy Louisiana, LLC; Entergy Gulf States Louisiana, L.L.C.; Entergy Mississippi, Inc.; Entergy New Orleans, Inc.; Entergy Texas, Inc.; Indianapolis Power & Light Company; International Transmission Company d/b/a ITC Transmission; ITC Midwest LLC; METC; MidAmerican Energy Company; Montana-Dakota Utilities Co.; Northern Indiana Public Service Company; Northern States Power Company, a Minnesota corporation, and Northern States Power Company, a Wisconsin corporation, subsidiaries of Xcel Energy Inc.; Northwestern Wisconsin Electric Company; Otter Tail Power Company; Southern Indiana Gas & Electric Company (d/b/a Vectren Energy Delivery of Indiana); and Wolverine Power Supply Cooperative, Inc. Intervenor Xcel Energy Services Inc. did not join certain of the MISO Transmission Owners' pleadings in this proceeding, but generally supports this brief on behalf of respondents Northern States Power Company, a Minnesota corporation, and Northern States Power Company, a Wisconsin corporation. *See* MISO TOs Brief on Exceptions at n.1.

[16] On February 10, 2016, Joint Consumer Advocates also filed a brief on exceptions, which were due on January 21, 2016. Because of its lateness, we do not consider this brief part of the record in this proceeding. *See* 18 C.F.R. § 385.711(a)(1)(i) (2016).

II. Overview of the Commission's Determinations in this Order

9. In this order, we affirm the conclusions of Initial Decision. We find the Presiding Judge correctly determined that there were anomalous capital market conditions, such that we have less confidence that the midpoint of the zone of reasonableness produced by a mechanical application of the Discounted Cash Flow (DCF) methodology satisfies the capital attraction standards of *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia*[17] and *Federal Power Commission v. Hope Natural Gas Co.*[18] We affirm that, in these circumstances, the Presiding Judge reasonably considered evidence of alternative methodologies for determining ROE and the ROEs approved by state regulatory commissions, for purposes of deciding whether the MISO TOs' ROE should be set at a point above the midpoint of the DCF zone of reasonableness. That evidence corroborates our determination that an ROE above the midpoint is necessary to satisfy *Hope* and *Bluefield*. Accordingly, we find that the just and reasonable ROE for the MISO TOs should be set at the central tendency of the upper half of the zone of reasonableness. We agree with the Presiding Judge that, as a result of this analysis, the appropriate base ROE for MISO TOs is 10.32 percent. We find that the Presiding Judge correctly applied the DCF methodology, including its inclusion of TECO Energy, Inc. (TECO) in the DCF proxy group. As discussed below, we also find that MISO TOs correctly employed the expected earnings alternative, though this finding does not affect the Initial Decision's conclusion.

10. We agree with the Presiding Judge that the base ROE should not be reduced for certain MISO TOs based on their capital structure or the use of transmission formula rates. We also reject Complainants' proposed "quartile approach," as discussed below. Except where specifically mentioned herein, we affirm the determinations in the Initial Decision.

III. Discussion

A. Burden of Proof

1. Initial Decision

11. The Presiding Judge explained that, to modify a rate under FPA section 206, the Commission or complainant has the burden of showing that the existing rate is unjust and

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[17] 262 U.S. 679, 692-93 (1923) (*Bluefield*).

[18] 320 U.S. 591, 603 (1944) (*Hope*).

unreasonable. He also explained that a "complainant shows that a Base ROE is unjust and unreasonable by establishing that it is higher than is necessary to meet the requirements set forth in [*Hope* and *Bluefield*]."[19] The Presiding Judge further explained that *Bluefield* dictates that the return should be "equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties."[20] Additionally, the Presiding Judge noted that the return should be "commensurate with returns on investments in other enterprises having corresponding risks."[21]

12. The Presiding Judge continued, stating that the return "should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties."[22] That is, the return should be "sufficient to assure confidence in the financial integrity of the enterprise so as to maintain its credit and to attract capital."[23]

13. Finally, the Presiding Judge stated that a base ROE that "authorized a utility to collect more than is necessary to satisfy the requirements of *Hope* and *Bluefield* would exploit consumers and, therefore, would be unjust and unreasonable," so "Complainants and other participants seeking reduction of MISO TOs' Base ROE . . . have the burden of proving that MISO TOs' Base ROE exceed that level."[24] The Presiding Judge further stated that "[i]f the evidence establishes that MISO TOs exceed [the zone of reasonableness], [Complainants] will have met their burden."[25]

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[19] Initial Decision, 153 FERC ¶ 63,027 at P 19.

[20] *Bluefield*, 262 U.S. at 693.

[21] *Hope*, 320 U.S. at 603.

[22] *Bluefield*, 262 U.S. at 693.

[23] *Hope*, 320 U.S. at 603.

[24] Initial Decision, 153 FERC ¶ 63,027 at P 24.

[25] *Id.* P 26.

2. **Briefs on Exceptions**

14. Joint Customer Intervenors argue that the Initial Decision is ambiguous and could be interpreted to mean that, in order to meet their burden, Complainants and aligned parties must establish that the ROE exceeds the zone of reasonableness.[26] Joint Customer Intervenors assert that, while such a showing would suffice to meet their burden, the ROE may also be unjust and unreasonable even if it is not outside the zone of reasonableness. Joint Customer Intervenors argues that, to find otherwise would be incorrect and inconsistent with *Martha Coakley, Mass. Attorney Gen. v. Bangor Hydro-Electric Company*,[27] and Joint Customer Intervenors take exception to the extent that the Initial Decision held an ROE must be outside the zone of reasonableness to be unjust and unreasonable.[28]

3. **Briefs Opposing Exceptions**

15. MISO TOs challenge Joint Customer Intervenors' claim. MISO TOs argue that the Presiding Judge did not need to "delve into the nuances of the burden of proof . . . and neither should the Commission."[29]

4. **Commission Determination**

16. We affirm that FPA section 206 does not require complainants or the Commission to demonstrate that an existing ROE falls outside the zone of reasonableness in order for that ROE to be considered unjust and unreasonable. The Commission disagreed with MISO TOs' identical argument in the Rehearing Order in this proceeding.[30] Moreover,

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[26] Joint Customer Intervenors Brief on Exceptions at 9 (citing Initial Decision, 153 FERC ¶ 63,027 at P 26).

[27] Opinion No. 531, 147 FERC ¶ 61,234, at P 12, Opinion No. 531, Opinion No. 531-A, *order on paper hearing*, 149 FERC ¶ 61,032 (2014), Opinion No. 531-B, *order on reh'g*, 150 FERC ¶ 61,165 (2015) (citing *RITELine Ill., LLC*, 137 FERC ¶ 61,039, at P 68 (2011); *N. Pass Transmission LLC*, 134 FERC ¶ 61,095, at P 46 (2011); *S. Cal. Edison Co.*, 131 FERC ¶ 61,020, at P 51 (2010)).

[28] Joint Customer Intervenors Brief on Exceptions at 9-10.

[29] MISO TOs Brief Opposing Exceptions at 49.

[30] *See* Rehearing Order, 156 FERC ¶ 61,060 at P 17.

as the Commission has previously concluded, not all points within the zone of reasonableness necessarily satisfy the just and reasonable standard.[31]

B. Proxy Group and DCF Analysis

17. In order to determine the just and reasonable ROE for public utilities, the Commission applies the DCF model to a proxy group of comparable companies. The Commission uses the following standards to select the proxy group: (1) a national group of companies considered electric utilities by Value Line Investment Survey (Value Line); (2) the inclusion of companies with credit ratings no more than one notch above or below the utility or utilities whose rate is at issue; (3) the inclusion of companies that pay dividends and have neither made nor announced a dividend cut during the six-month study period; (4) the inclusion of companies with no major merger activity during the six-month study period; and (5) companies whose DCF results pass threshold tests of economic logic.[32]

18. With simplifying assumptions, the formula for the DCF model reduces to: P = D/k-g, where "P" is the price of the common stock, "D" is the current dividend, "k" is the discount rate (or investors' required rate of return), and "g" is the expected growth rate in dividends. For ratemaking purposes, the Commission rearranges the DCF formula to solve for "k", the discount rate, which represents the rate of return that investors require to invest in a company's common stock, and then multiplies the dividend yield by the expression (1+.5g) to account for the fact that dividends are paid on a quarterly basis. Multiplying the dividend yield by (1+.5g) increases the dividend yield by one half of the growth rate and produces what the Commission refers to as the "adjusted dividend yield." The resulting formula is known as the constant growth DCF model and can be expressed as follows: k=D/P (1+.5g) + g. Under the Commission's two-step DCF methodology, the input for the expected dividend growth rate, "g," is calculated using both short-term and long-term growth projections.[33] Those two growth rate estimates are averaged, with the short-term growth rate estimate receiving two-thirds

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[31] *Id*.

[32] Opinion No. 531, 147 FERC ¶ 61,234 at P 92.

[33] *Id.* PP 15-17, 36-40, *order on paper hearing*, Opinion No. 531-A, 149 FERC ¶ 61,032 at P 10.

weighting and the long-term growth rate estimate receiving one-third weighting.[34] The Commission generally conducts the DCF analysis based on the most recent six months of financial data in the record.[35]

19. In this case, the Presiding Judge determined that the DCF Study Period for calculating the zone of reasonableness should be the most recent six-month period for which there is financial data in the record, January to June 2015.[36] He rejected MISO TOs' argument that the Commission should not include data subsequent to the November 12, 2013 to February 10, 2015 refund period unless the data are "reasonably representative of the refund period."[37] While the study period utilized in Opinion No. 531 roughly coincided with the refund period, the Presiding Judge noted that that similarity is not an "essential element" of the Commission's decision to consider data outside of the refund period.[38] In any case, the Presiding Judge observed, the overlap between the study period and the refund period in Opinion No. 531 was not much greater than it is here. Lastly, the Presiding Judge noted that any ROE established as part of this proceeding is likely to apply for "an appreciable period of time outside of the Refund Period."[39] Accordingly, the best course of action is to fashion a base ROE based on the most recent data in record.

20. In order to establish a proxy group, the Presiding Judge reviewed the DCF-determined cost of equity for 42 companies. The Presiding Judge determined that 37 of those companies should be included in the proxy group. Of those companies, the lowest cost of equity was Public Service Enterprise Group's 7.23 percent and the highest cost was TECO's 11.35 percent.[40] As described in more detail below, the Presiding Judge rejected contentions that TECO should be excluded from the proxy group because of certain Merger and Acquisition (M&A) Activity. However, following Opinion No. 531,

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[34] Opinion No. 531, 147 FERC ¶ 61,234 at PP 17, 39.

[35] *Id.* P 160.

[36] Initial Decision, 153 FERC ¶ 63,027 at PP 56, 61.

[37] *See* Opinion No. 531, 147 FERC ¶ 61,234 at P 64.

[38] Initial Decision, 153 FERC ¶ 63,027 at P 58.

[39] *Id.* P 61.

[40] *Id.* P 63.

the Presiding Judge excluded three companies — Edison International, FirstEnergy Corporation (FirstEnergy), and Entergy Corporation (Entergy) — because their ROEs were less than 5.65 percent, which is 100 basis points above the average yield for public utility bonds rated Baa by Moody's.[41] The Presiding Judge also excluded Madison Gas and Electric Energy, Inc. because it did not have a credit rating from either Moody's Investors Service or S&P and, therefore, could not be shown to have a credit rating of not more than one notch above or below MISO TOs, as required by Opinion No 531.[42] In addition, the Presiding Judge also excluded Unitil Corporation (Unitil) from the proxy group because it is not one of the companies covered by Value Line and because, unlike the companies in Value Line, Unitil has a capitalization of less than $1 billion.[43]

21. For short-term growth rates, the Presiding Judge adopted the five-year growth rates proposed by Complainants' witness, Mr. Gorman, and, for companies not included in Mr. Gorman's sample, five-year growth rates proposed by Joint Consumer Advocates' witness, Mr. Hill. Both provided projected Institutional Brokers' Estimate System (IBES) growth estimates published by *Yahoo! Finance* obtained on July 13, 2015.[44] For the long-term growth rate, the Presiding Judge adopted the 4.39 percent Gross Domestic Product (GDP) growth rate proposed by Trial Staff witness, Mr. Keyton, reasoning that his method of calculating the growth rate most closely paralleled the method that the Commission used in Opinion No. 531.[45]

22. The parties' briefs on exceptions raise two issues with respect to the Presiding Judge's rulings with respect to the proxy group and the DCF analysis of each member of the proxy group. These are: (1) whether TECO should have been excluded from the proxy group and (2) whether in future cases short-term growth projections could be based on Value Line data. We address these issues below.

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[41] *Id.* PP 66-67.

[42] *Id.* PP 70, 72 (citing Opinion No. 531, 147 FERC ¶ 61,234 at P 106).

[43] *Id.* PP 74-75, 77.

[44] *Id.* P 49.

[45] *Id.* P 44.

1. Inclusion of TECO in the Proxy Group

23. As explained in Opinion No. 531, the Commission's practice is "to eliminate from the proxy group any company engaged in M&A activity significant enough to distort the [company's] DCF inputs" — i.e., the company's "stock prices, dividends, or growth rates."[46] TECO is the only company whose M&A activity is at issue here. We first summarize TECO's M&A activity before turning to the Initial Decision, the briefs on and opposing exceptions, and our decision whether to include TECO in the proxy group.

24. TECO engaged in two M&A activities that could potentially require its exclusion from the proxy group. First, on September 2, 2014, nearly four months before the beginning of the updated the study period, TECO completed its acquisition of New Mexico Gas Company (New Mexico Gas).[47] The record reveals that, several months later, during the January 2015 to June 2015 study period, analysts were still assessing the impact of the New Mexico Gas acquisition on TECO earnings. For example, the May 22, 2015 issue of Value Line noted that the acquisition should increase TECO's earnings, although the acquisition was just one of several factors, including strong customer growth and impending rate increases, that Value Line identified to support the projected increase in TECO's earnings for 2015 and 2016.[48]

25. Second, on October 20, 2014, roughly a month after closing the New Mexico Gas acquisition, TECO announced an agreement to sell its coal mining subsidiary, TECO Coal Corporation (TECO Coal) to Cambrian Coal Corp. (Cambrian) for $120 million and a contingent payment of up to $50 million, depending on coal prices.[49] TECO's stock price rose approximately 8 percent in the month following news of the sale. A few months later, in February 2015, TECO announced an amendment to the terms of the agreement that lowered the purchase price to $80 million, but increased the maximum contingent payment to $60 million.[50] Later in February, a securities analyst at UBS upgraded TECO from "neutral" to "buy," noting the potential sale of TECO Coal as one of the reasons for the upgrade. Throughout this period in early 2015, IBES's growth

[46] Opinion No. 531, 147 FERC ¶ 61,234 at P 114.

[47] Exh. S-4 at 12.

[48] Initial Decision, 153 FERC ¶ 63,027 at P 91; Exh. S-6 at 161.

[49] *Id.* P 98; Exh. S-3.

[50] *Id.* P 98. The terms of the sale were amended again in mid-April 2015.

projections for TECO increased from 6.43 percent in January to 7.08 percent in February and all the way up to 9.20 percent by March 2015, even as at least one analyst expressed skepticism that TECO would complete the sale of TECO Coal.[51]

26. In April 2015, TECO announced that it was considering selling TECO Coal to other potential buyers in the event that the deal with Cambrian fell through.[52] As it happened, TECO announced in June 2015, the last month of the study period, that the deal with Cambrian had not closed as scheduled, but that it had received a non-binding offer for TECO Coal from an undisclosed buyer. The IBES growth projections remained steady at 9.20 percent throughout April, May, and June, notwithstanding the multiple reports casting doubt on TECO's ability to complete the sale of TECO Coal.[53] In early July 2015, TECO announced that it had failed to reach an agreement with the undisclosed buyer, but that a sale of TECO Coal to Cambrian remained a possibility. A week later, on July 13, 2015, IBES's growth projection for TECO declined to 7.68 percent.[54] The Presiding Judge used the 7.68 percent IBES growth projection in his DCF analysis of TECO.

a. <u>Initial Decision</u>

27. The Presiding Judge rejected the contentions of Complainants, Joint Customer Intervenors, Iowa Group, and Trial Staff that TECO should be excluded from the proxy group.[55] The Presiding Judge concluded that neither the acquisition of New Mexico Gas nor the attempted sale of TECO Coal was sufficient to "distort" the DCF inputs.[56] Beginning with the New Mexico Gas acquisition, the Presiding Judge concluded that any earnings distortion caused by the acquisition was insufficient to exclude TECO. As an

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[51] *Id.* P 101; Exh. S-4 at 15; S-6 at 147, 171.

[52] Initial Decision, 153 FERC ¶ 63,027 at P 99.

[53] *Id.* P 101; Exh.S-6 at 149, 151.

[54] Initial Decision, 153 FERC ¶ 63,027 at P 101. The Presiding Judge's Order Establishing Procedural Schedule provided that the cut-off date for data to be used by any party in updates of ROE studies would be July 13, 2015. Exh. JCA-22. *See also infra* note 88.

[55] Initial Decision, 153 FERC ¶ 63,027 at PP 79, 81.

[56] *Id.* PP 81, 96, 106.

initial matter, the Presiding Judge noted that Mr. Gorman, the "principal advocate" of excluding TECO on the basis of its acquisition of New Mexico Gas, did not advocate that position in his original testimony in February 2015, but altered his position to advocate exclusion of TECO in his updated testimony in July 2015.[57] The Presiding Judge, however, concluded that the updated information on which Mr. Gorman relied did not suggest that TECO should be excluded from the proxy group. In particular, the Presiding Judge determined that Mr. Gorman was "incorrect" to suggest that TECO's IBES growth rate had increased 280 basis points between his original and updated testimony. The Presiding Judge observed that, although it was true that the IBES growth rate estimate increased from 6.43 percent in January 2015 to 9.20 percent in June 2015, that number had declined to 7.68 percent by the time of Mr. Gorman's updated testimony, meaning that the actual increase in the growth rate was just 125 basis points, less than half of the 280-basis-point increase to which Mr. Gorman testified.[58]

28. In addition, the Presiding Judge determined that Mr. Gorman's characterization of the May 2015 Value Line report was also "inaccurate."[59] The Presiding Judge noted that TECO's acquisition of New Mexico Gas was just one of many factors that led Value Line to increase its projection for TECO's 2015 earnings. As the Presiding Judge explained, Value Line also emphasized the strong growth prospects for TECO's Florida utilities and an anticipated reduction in TECO's cost of debt. The Presiding Judge also noted that Value Line's increased earnings projections for 2016 were not based on the acquisition of New Mexico Gas. Instead, the Presiding Judge concluded that that increase was based on a pending rate increase for one of TECO's Florida utilities and on New Mexico Gas's own growth projections, whose sustainability was not called into question by the evidence in the record.[60] The Presiding Judge also concluded that, because the acquisition's effect on earnings was limited to 2015, there was no reason to conclude that the acquisition would have an effect on the IBES "Next 5 Years" of growth projections, which is the basis for the DCF analysis.[61] The Presiding Judge rejected arguments that the purchase of New Mexico Gas had decreased short-term earnings expectations relative

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[57] *Id.* P 82.

[58] *Id.* P 90.

[59] *Id.* P 91.

[60] *Id.* PP 94-96.

[61] *Id.* PP 95-96.

to the long-term expectations to the point of "distort[ing]" the DCF input, as the Commission to exclude a proxy company on the basis of merger activity.[62]

29. The Presiding Judge also declined to exclude TECO on the basis of its attempted sale of TECO Coal. Although concluding that the "efforts to sell TECO Coal affected investors' perceptions of TECO," the Presiding Judge nevertheless concluded that this effect did not rise to the level of a distortion.[63] The Presiding Judge noted that, throughout the study period, TECO's projected growth rate increased even as the prospects of completing the sale of TECO Coal diminished. The Presiding Judge thus concluded that the growth projections for TECO "do not appear to have been related in any way to" the efforts to sell TECO Coal.[64] In addition, the Presiding Judge recognized that, in the months after the agreement to sell TECO Coal to Cambrian, TECO's stock price increased 20 percent while the industry average decreased 2 percent.[65] Based on that divergence, the Presiding Judge concluded that the potential sale of TECO Coal "may have distorted [TECO's] dividend yield downward during the study period."[66] However, the Presiding Judge declined to exclude TECO, reasoning that, because TECO was at the upper end of the zone of reasonableness and because the divestiture efforts appeared to have lowered TECO's cost of equity, to exclude TECO would have the effect of correcting a distortion that lowered the upper bound of the zone of reasonableness by *further lowering* the upper bound of the zone.[67] That result, the Presiding Judge concluded, would make the DCF analysis a "less reliable" guide to determining TECO's cost of equity.[68] Finally, the Presiding Judge also asserted that the sale of a business unit — or, in this case, an attempted sale — is neither a merger nor an acquisition and, therefore, should not be a reason to exclude a company based on M&A activity.

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[62] *Id.* PP 90-95.

[63] *Id.* PP 100, 106.

[64] *Id.* P 103.

[65] *Id.* P 104.

[66] *Id.* P 106.

[67] *Id.* P 107.

[68] *Id.* P 108.

b. Briefs on Exception

30. Complainants, Joint Customer Intervenors, and Trial Staff contend that the Presiding Judge should have excluded TECO. Joint Customer Intervenors contend that the Presiding Judge erred when he decided not to exclude TECO on the basis that it was at the top of the zone of reasonableness and that the M&A activity appeared to depress TECO's dividend yield. Joint Customer Intervenors also argue that Commission precedent requires the exclusion of any company that engages in significant M&A activity, regardless of its position in the zone of reasonableness or what effect that activity appeared to have on the DCF inputs, including the dividend yield.[69] Joint Customer Intervenors also contend that the Presiding Judge erred to the extent that he declined to exclude TECO on the basis that "[a] sale of a unit (much less an attempted sale) is neither a merger nor an acquisition."[70] Joint Customer Intervenors aver that a sale is a form of M&A activity—since some company is acquiring the asset being sold—and that it "defies logic" to exclude a company that purchases an asset from the proxy group, but not exclude the company that sells it.[71] Similarly, Joint Customer Intervenors argue that the fact that the sale was not completed is irrelevant as the Commission has "routinely" excluded companies from the proxy group based on contemplated or attempted merger or acquisition activity.

31. Complainants contend that the Presiding Judge erred to the extent that he declined to exclude TECO in part because TECO's acquisition of New Mexico Gas occurred several months before the beginning of the January-June 2015 updated study period on which the Initial Decision relied.[72] Complainants defend Mr. Gorman's decision to include TECO based on the original study period, but exclude TECO based on the updated study period. They argue that, although TECO both acquired New Mexico Gas and announced the agreement to sell TECO Coal during the initial study period, which covered July-December, 2014, those activities "were perceived by investors as having only a modest impact on TECO's earnings" during that period and, therefore,

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[69] Joint Customer Intervenors Brief on Exceptions at 12; Trial Staff Brief on Exceptions at 13-14.

[70] Joint Customer Intervenors Brief on Exceptions at 12; Trial Staff Brief on Exceptions at 14-15 (observing that a sale was sufficient to trigger a company's exclusion in Opinion No. 531).

[71] Complainants Brief on Exceptions at 14.

[72] *Id.* at 13.

Mr. Gorman reasonably decided to include TECO in the proxy group.[73] Complainants contend that during the updated study period, by contrast, there was evidence that the acquisition would have a more significant impact on TECO's earnings. In particular, Complainants point to the fact that Value Line stated that TECO's earnings were likely to increase "considerably" and listed the New Mexico Gas acquisition as one of the reasons for that prediction.[74] Complainants contend that this change in earnings expectations justified Mr. Gorman's decision to change course and exclude TECO from the proxy group. In addition, Complainants take exception to how the Presiding Judge interpreted Value Line's discussion of the factors affecting TECO's earnings. Although Complainants acknowledge that there were multiple factors contributing to TECO's growth estimates, they assert that these additional factors affecting the growth do not nullify the effect of the acquisition, which they argue is sufficient to exclude TECO.[75]

32. In addition, Complainants argue that the Presiding Judge erred by concluding that Value Line's earnings forecast limited the impact of the New Mexico Gas acquisition to 2015.[76] They contend that, although Value Line discussed the acquisition's impact on 2015 earnings, it never stated that that the effects of the acquisition were limited to 2015. Complainants further contend that Value Line's discussion of the factors contributing to earnings growth in 2016 were "additional factors"—i.e., over and above those affecting the 2015 earnings—that is, they were not the only factors affecting the 2016 earnings projections. In any case, Complainants argue, the Presiding Judge wrongly concluded that the 2015 earnings projections were not included in the IBES five-year growth projections. Consequently, they contend, the Presiding Judge erred in concluding that the New Mexico Gas acquisition did not affect the IBES five-year growth projections used in the DCF analysis.[77]

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[73] *Id.* at 13-14.

[74] *Id.* at 15-17. Complainants also briefly suggest that TECO should have been excluded on the basis of its attempts to sell TECO Coal. They note that TECO's stock price increased 8 percent when it announced the sale of TECO Coal. Trial Staff makes a similar point. Trial Staff Brief on Exceptions at 13.

[75] Complainants Brief on Exceptions at 20-21.

[76] *Id.* at 18.

[77] *Id.* at 19-20.

33. Finally, Complainants assert that the Presiding Judge erroneously discounted Mr. Gorman's testimony on the basis that the IBES growth rate projection for TECO had increased only 125 basis points, rather than the 277 basis points that Mr. Gorman testified to. Complainants contend that Mr. Gorman's calculation was correct as of July 13, 2015, when he downloaded the information from *Yahoo! Finance* and, therefore, and that the Initial Decision was wrong to conclude that the projected growth rate had increased only 125 basis points. In any case, they argue, a 125-basis-point increase still represents a meaningful change in TECO's estimated growth rate.

34. Trial Staff echoes many of these arguments regarding TECO Coal. In particular, Trial Staff contends that the Presiding Judge failed to adequately justify the conclusion that changes in TECO's stock price, estimated growth rate, and other investment measures were not related to the sale of TECO Coal.[78]

c. <u>Briefs Opposing Exception</u>

35. MISO TOs contend that the Presiding Judge properly included TECO in the proxy group. They argue that the Commission's screening criteria require a company's exclusion on the basis of M&A activity only when (1) that activity takes place during the study period and (2) that activity is sufficient enough to distort the inputs for the DCF analysis.[79] Because the acquisition of New Mexico Gas took place outside the updated study period, MISO TOs assert that it does not meet the first criterion for being excluded on the basis of M&A activity. In addition, MISO TOs contend that there were several factors affecting TECO's estimated growth rate and, therefore, it is not clear whether the effects of the New Mexico Gas acquisition had a significant effect on the estimated growth rates. MISO TOs also contend that the Presiding Judge correctly concluded that the change in TECO's estimated growth rate was 125 basis points, not the 280 basis points that Mr. Gorman testified to.[80] In any case, they argue, investors did not react significantly to this information and the stock price remained within "a narrow band" during the study period.[81]

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[78] Trial Staff Brief on Exceptions at 13.

[79] MISO TOs Brief Opposing Exceptions at 38.

[80] *Id.* at 41.

[81] *Id.* at 42.

36. Turning to the sale of TECO Coal, MISO TOs contend that any distortion associated with the attempted sale would have occurred when the sale was first announced, which was before the updated study period.[82] In addition, they state that there was little variation between TECO's stock prices and those of the Dow Jones Utility Average, suggesting that whatever effect the attempted sale had on TECO's stock price was minimal.[83] MISO TOs also assert that the Presiding Judge correctly determined that the attempted sale did not significantly affect TECO's IBES growth rates or Value Line's earnings per share (EPS) estimates—a result that MISO TOs contend is not surprising given that TECO Coal accounts for less than 1.5 percent of TECO's market capitalization.[84]

d. <u>Commission Determination</u>

37. We affirm the Presiding Judge's decision to include TECO in the proxy group. As explained in Opinion No. 531, it is the Commission's "practice . . . to eliminate from the proxy group any company engaged in M&A activity significant enough to *distort* the DCF inputs."[85] We do not exclude a company simply because it has engaged in any M&A activity or that activity may cause changes in the DCF inputs.[86] Rather, we exclude a company if the M&A activity may cause temporary changes in DCF inputs that are not sustainable or representative of longer-term investor expectations for the company. For the reasons that follow, we conclude that neither TECO's acquisition of New Mexico Gas nor TECO's attempted sale of TECO Coal constitutes M&A activity sufficient to distort the DCF inputs.

38. We begin with New Mexico Gas. As noted, TECO's acquisition of New Mexico Gas was completed on September 2, 2014, nearly four months before the beginning of the

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[82] *Id.* at 43.

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

[84] *Id.* at 47.

[85] Opinion No. 531, 147 FERC ¶ 61,234 at P 114 (emphasis added).

[86] *Bangor Hydro-Elec. Co.*, Opinion No. 489, 117 FERC ¶ 61,129, at PP 67-68 (2006) ("We also reject [the] . . . argument that Commission precedent supports, in every instance, the exclusion from a proxy group of any utility engaged in merger activity."), *order on reh'g*, 122 FERC ¶ 61,265, *order on clarification*, 124 FERC ¶ 61,136 (2008).

updated study period, which covered January-June, 2015.[87] As such, speculation about whether the acquisition would be completed could not have affected, much less distorted, the stock price or the other DCF inputs during the updated study period. Nevertheless, Complainants contend that TECO should be excluded on the grounds that the acquisition of New Mexico Gas created a temporary and unsustainable increase in TECO's expected earnings. We disagree. As an initial matter, we find that, over the course of the updated study period, the IBES growth estimates increased 125 basis points, not 280 basis points that Mr. Gorman testified to.[88] However, as illustrated by the July 13, 2015 *Yahoo! Finance* data included along with the testimony of Mr. Hill, the actual growth projected earnings growth for TECO at the end of the updated study period used in the parties' DCF analysis was 7.68 percent, 125 basis points above the 6.43 percent at the beginning of the study period.

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[87] Initial Decision, 153 FERC ¶ 63,027 at PP 80, 84.

[88] Exh. JC-22 at 7. Complainants contend that there is a disputed issue of fact regarding the appropriate growth rate for TECO at the end of the updated study period. Complainants Brief on Exceptions at 21-22. They assert that Mr. Gorman's testimony, in which he states that TECO's growth rate increased by 280 basis points from its 6.43 percent level in January 2015, implies a growth rate of 9.20 percent as of the end of the study period, while Join Consumer Advocates' witness, Mr. Hill, stated that he used a growth rate of 7.68 percent. *Id.* We affirm the Presiding Judge's decision to rely on Mr. Hill's 7.68 percent growth rate. Mr. Hill's testimony states clearly that he relied upon the numbers from *Yahoo! Finance* on July 13, 2015, the cut-off date for ROE data used in the updated study period, to evaluate TECO's merger activity. *See* Exh. JCA-22; Order Establishing Procedural Schedule, Docket No. EL14-12, at 3 (Jan. 23, 2015). Mr. Gorman, by contrast, does not state when he compiled the growth rate data on which he relied in deciding to exclude TECO. Exh. JC-22 at 7. Although, later in his testimony, Mr. Gorman stated that he used data taken from *Yahoo! Finance* on July 13, 2015 to perform the DCF analysis, *id.* at 8, that analysis did not include TECO, as Mr. Gorman had already determined to exclude TECO from the proxy group. *See* Exh. JC-25; Exh. JC-22 at 7. As a result, there is nothing in Mr. Gorman's testimony that suggests that he used July 13, 2015 IBES data – and not data from earlier in the study period, when the IBES growth rate was 9.20 percent, Exh. S-4 at 15 – when deciding whether to exclude TECO from the proxy group. Accordingly, we agree with the Presiding Judge that the 7.68 percent growth rate used by Mr. Hill represents the more reliable figure and more clearly represents "the most recent record evidence of the growth rates actually expected by the investment community." Opinion No. 531, 147 FERC ¶ 61,234 at P 89.

39. We conclude that there is no evidence in the record suggesting that the New Mexico Gas acquisition caused a significant and unsustainable increase in TECO's earnings expectations during the updated study period. The May 22, 2015 Value Line report suggests that the acquisition will increase earnings "over and above" the savings TECO will realize from no longer paying transaction costs associated with the acquisition. There is nothing suggesting that the additional increase is unsustainable. After all, all other things being equal, an earnings increase is what we would expect when a company increases its regulated gas and electric customers by 50 percent, as TECO did in acquiring New Mexico Gas.[89] In any case, the acquisition was just one of many factors, along with rate increases for TECO's Florida utilities and an anticipated reduction in TECO's cost of debt, that supported Value Line's increased earnings projections.[90] The Value Line report thus is not evidence suggesting that the acquisition distorted TECO's expected growth rate based on temporary, short-term developments that are unlikely to continue.

40. Turning to TECO's attempts to sell TECO Coal, we similarly conclude that there is no evidence suggesting that those efforts "distorted" the DCF inputs. Unlike the acquisition of New Mexico Gas, the efforts to sell TECO extended into the updated study period and, therefore, it is possible that speculation related to the potential merger could have affected TECO's DCF inputs. Nevertheless, we conclude that any effect was either too small or too attenuated to rise to the level of a distortion requiring TECO's exclusion from the proxy group.

41. We find that the record does not show that the attempted sale of TECO Coal distorted TECO's expected earnings. We first note that TECO Coal represents less than 1.5 percent of TECO's total market capitalization.[91] The sale of such a relatively small

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[89] *See* Joint Customer Intervenors Brief on Exceptions at 12. To the extent that the parties suggest that TECO should be excluded because its earnings outlook improved because it is no longer incurring the transaction cost associated with the acquisition, we reject their argument. Adopting that position would require that the Commission exclude companies for a year after almost any major merger or acquisition as the savings from no longer incurring the transaction costs materialize in annual earnings. That result is not the purpose of the M&A screen.

[90] Initial Decision, 153 FERC ¶ 63,027 at P 91.

[91] Exh. MTO-23 at 99 (valuing TECO Coal using the most recent non-contingent purchase price for the attempted sale to Cambrian). Although it is of course possible that the expected earnings growth rate would have further increased during this period were it not for the eroding chances of a successful sale of TECO Coal, we conclude that there is

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asset is, as a general matter, not the type of input-distorting transaction that the M&A screen is intended to address. Additionally, many of the public utilities, especially relatively large companies that make a good comparison for TECO, are regularly engaged in potential mergers or acquisitions of small business units or subsidiaries. Excluding such companies from the proxy group on the basis of any small purchase or sale would unnecessarily shrink the group of representative companies, thereby making the proxy group, and the resulting DCF analysis, a less reliable tool for ensuring that the allowed ROE satisfies the requirements of *Hope* and *Bluefield*.

42. In this case, the evidence confirms that TECO's potential sale of its underperforming asset, TECO Coal, had little impact on its projected growth rates or stock prices. As the Presiding Judge observed, IBES's projected growth rates for TECO steadily increased throughout the first five months of the six-month study period, even as the prospects for selling TECO Coal steadily deteriorated.[92] If the potential sale of TECO Coal was a significant factor affecting TECO's DCF inputs, we would anticipate at least some decline in the expected growth rate as the prospects for a sale deteriorated between February and June, 2015. Instead, as noted, TECO's expected growth rate first increased between February and March and then held steady through June.[93] In short, the record simply does not suggest that the potential sale had much, if any, effect on the growth rate used in the DCF analysis.

43. Similarly, we conclude that there is no evidence in the record that the attempted sale of TECO Coal caused a distortion in TECO's stock price. The comparison of TECO's stock price versus the Dow Jones Utility Average submitted by Dr. Avera[94] shows that the two moved in near lockstep from November 2014 through April 2015, which significantly overlaps with the study period. In any case, Dr. Avera's graph shows that TECO outperformed the industry average by an even greater amount for much of March and April, 2015, when the chances of a successful sale appeared to be diminishing.[95] Once again, if the potential sale of TECO Coal was affecting TECO's

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no evidence in the record suggesting that the decreasing likelihood of a sale provided any such drag on TECO's earnings expectations.

[92] Initial Decision, 153 FERC ¶ 63,027 at P 103.

[93] *Id.* P 101.

[94] Exh. MTO-23 at 99.

[95] The Presiding Judge did not rely on Dr. Avera's chart because the y-axis for TECO's stock price was smaller relative to the y-axis for the industry average, which,

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DCF inputs in any significant way, we would not expect to see TECO's stock price performing well relative to the industry average even as the prospects for the sale declined. Although it might be argued that looking at relative performance is somewhat misleading, and that TECO's stock would have performed consistently worse relative to the industry average were it not for the potential sale, there is no evidence in the record suggesting that that is the case here and our M&A screen does not require a company's exclusion from the proxy group on so speculative a basis.[96]

2. Short-term Growth Projection

a. Initial Decision

44. The Presiding Judge adopted IBES short-term growth rates published by *Yahoo! Finance* obtained on July 13, 2015 for each proxy company that was included in the proxy group of at least one participant.[97] The Presiding Judge further stated that the Commission has "long relied on IBES growth projections as evidence of the growth rates expected by the investment community" and that since the discontinuation of the IBES Monthly Data Book in 2008, it has consistently used the IBES growth rate estimates published by *Yahoo! Finance* as the source of analysts' consensus growth rates.[98]

45. Additionally, the Presiding Judge stated that he did not need to address the arguments MISO TOs made in support of use of Value Line growth rates because "one can only use one set of growth rates" and the "decision . . . based on the most recent data

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according to the Presiding Judge, caused Dr. Avera's chart to underrepresent the variation in TECO's stock price. That observation does not require us to change our conclusion, which rests in part on the fact that TECO's performed better relative to the industry average when the prospects for the sale dimmed, than when the sale appeared most likely to occur.

[96] Although there is evidence in the record that some analysts viewed TECO Coal as "a drag on shares" of TECO, Initial Decision, 153 FERC ¶ 63,027 at P 100, that evidence does not suggest that the increasingly dim prospect of eliminating that "drag" was sufficient to "distort" the DCF inputs, especially given the absence of any apparent correlation between the DCF inputs and the prospects for a successful sale of TECO Coal.

[97] Initial Decision, 153 FERC ¶ 63,027 at P 44.

[98] *Id.* P 46.

available actually dictates the use of IBES growth rates" because they were the only data presented for the DCF study period.[99]

b. Briefs on Exceptions

46. MISO TOs do not except to the Presiding Judge's use of IBES short-term growth projections in his DCF analysis of the companies included in the proxy group in this proceeding. However, they argue that the Commission should confirm that, in future proceedings as warranted by the surrounding facts and circumstances, the growth projections published by Value Line constitute an acceptable and comparable source of short-term earnings growth estimates that may be considered for use in the two-step DCF analysis.

47. MISO TOs state that MISO TOs' witness, Dr. Avera offered alternative two-step DCF studies using the IBES short-term growth estimates, as published by *Yahoo! Finance* and Value Line short-term estimates.[100] MISO TOs state that Dr. Avera's studies relied exclusively on data from the six-month period ending on January 31, 2015 (the Refund Period). All other DCF studies entered into evidence by opposing parties, whether developed for the Refund Period or the updated six-month period ending in June 2015, used IBES growth forecasts. Hence, the record contains no Value Line short-term growth estimates for the updated six-month period ending in June 2015, which the Presiding Judge used for his DCF analysis.[101] For this reason, MISO TOs state that the Presiding Judge found that his decision to evaluate the base ROE using the updated DCF study period "actually dictates use of IBES growth rates," given the record's absence of Value Line growth rates for the Update Period.[102]

48. MISO TOs request that the Commission unequivocally announce that the Initial Decision includes no merits determination regarding the appropriateness of using Value Line growth estimates in the two-step DCF methodology in public utility cases.[103] In the alternative, MISO TOs conditionally except to this aspect of the Initial Decision to ensure

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[99] *Id.* PP 48-49.

[100] MISO TOs Brief on Exceptions at 13.

[101] *Id.* at 13.

[102] *Id.* at 14 (citing Initial Decision, 153 FERC ¶ 63,027 at P 49).

[103] *Id.* at 14.

that this case is not interpreted as disqualifying comparable sources of short-term growth rates, including Value Line, in future proceedings.[104]

49. In support, MISO TOs argue that, as recently as Opinion No. 531, the Commission has stated that "there may be more than one valid source of growth rate estimates" and stated that, in applying the two-step DCF methodology, the "short-term growth estimate will be based on the five-year projections reported by IBES (or a comparable source)."[105] MISO TOs argue that a number of witnesses challenged the comparability of Value Line but that the Initial Decision did not address these arguments given that no party introduced Value Line data into the proceeding to determine the short-term growth rate for the Update Period.[106]

50. MISO TOs also argue that record evidence demonstrates the comparability of Value Line growth data as both IBES and Value Line projections are expressed on an EPS basis and neither "can be endorsed as systematically more reliable than the other."[107] Additionally, MISO TOs argue that no party disputes that Value Line's growth rate estimates: (1) have a wide financial community circulation; (2) reflect projections from reputable financial analysts that develop short-term growth rate estimates; (3) are reported to investors on a timely basis; and (4) are used by institutions and other investors. For these reasons, MISO TOs argue that Value Line's forecasts satisfy the comparability requirement articulated in Opinion No. 531.[108]

51. Furthermore, MISO TOs argue that previous applications of the DCF Formula using IBES growth estimates do not preclude the future use of Value Line growth estimates or undercut their reliability. In support of this position, MISO TOs point out that Value Line is a "trusted and reputable source for investment data" because it is a "widely-followed, independent investor service."[109] Additionally, MISO TOs argue that the record discredits any attempt to disqualify Value Line growth estimates as "not

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[104] *Id.* at 14.

[105] *Id.* at 15.

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

[107] *Id.* at 16.

[108] *Id.* at 18 (citing Opinion No. 531 at P 102).

[109] *Id.* at 18-19.

strictly forward looking."[110] They further argue that the Value Line user guide explains that Value Line's projections are "of growth for each item for the coming 3 to 5 years" and that it is not a detriment to inform investors of Value Line's starting point for measuring the rate of change.[111]

52. MISO TOs state that opposing parties' suggest that the Commission disqualified Value Line growth data for use in the two-step DCF methodology when, in prior proceedings, the Commission rejected proposals to use estimates from different sources for different proxy companies and/or to average IBES data with Value Line growth estimates.[112] MISO TOs argue that these cases do not involve the explicit issue that MISO TOs hope to clarify here. MISO TOs also dispute the claim that the Value Line's EPS estimates are attributable to a single analyst. They point out that, in Opinion No. 531-B, the Commission stated that it would not rely on "an analyst head-count" to evaluate the relative reliability of data sources.[113]

53. MISO TOs also dispute opposing parties' attempts to show that Value Line's estimates are less current than IBES's, arguing instead that Value Line reports its estimates on a timely basis and updates them regularly.[114] MISO TOs also ask the Commission to make explicit that the EPS growth forecasts published by Value Line and IBES are presumed to be comparable, and that the source of short-term growth data to be used in any future application of the two-step DCF model will be determined on a case-by-case basis.[115]

c. <u>Briefs Opposing Exceptions</u>

54. Complainants, OMS/Joint Consumer Advocates, Joint Customer Intervenors, Iowa Group, and Trial Staff agree with the Presiding Judge's adopting IBES as the source of short-term growth rate data for this case. Complainants argue that the Presiding Judge's

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[110] *Id.* at 19.

[111] *Id.* at 19-20.

[112] *Id.* at 21.

[113] *Id.* at 22.

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

[115] *Id.* at 23.

adoption of the five-year IBES growth rate presented by Mr. Gorman's analysis, as supplemented by the IBES data from Mr. Hill's DCF analysis, relies on the Commission's rationale for adopting IBES growth rate projections, as outlined in Opinion No. 531. Complainants state that the Commission has "long relied on IBES growth rate projections as evidence of the growth rates expected by the investment community."[116]

55. Complainants also disagree with MISO TOs' argument that neither IBES nor *Value Line* should be presumed more reliable than the other.[117] Complainants ask the Commission to dismiss this argument as moot because Value Line growth data was absent for the time period adopted by the Initial Decision. Similarly, Joint Customer Intervenors argue that addressing MISO TOs' exception here would have no impact on this proceeding, and would only influence what may or may not be appropriate in future scenarios with different facts and circumstances.[118]

56. In a similar vein, OMS/Joint Consumer Advocates state that what MISO TOs really seek is in the nature of a declaratory order, i.e., a Commission pronouncement applicable to unspecified future cases.[119] OMS/Joint Consumer Advocates state that the Commission's rules provide other more suitable vehicles for parties to request such broad statements of generic policy, including Rule 207(a)(2), which authorizes the filing of petitions for "[a] declaratory order . . . to . . . remove uncertainty."[120] Iowa Group also characterizes the MISO TOs' request for clarification as a collateral attack on Opinion Nos. 531 and 531-B.[121]

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[116] Complainants Brief Opposing Exceptions at 5 (citing Initial Decision, 153 FERC ¶ 63,027 at P 46).

[117] *Id*. (citing MISO TOs Brief on Exceptions at 16-18).

[118] Joint Customer Intervenors Brief Opposing Exceptions at 17-18.

[119] OMS/Joint Consumer Advocates Brief Opposing Exceptions at 14 (citing MISO TOs Brief on Exceptions at 23).

[120] *Id.* at 14 (citing 18 C.F.R. § 385.207(a)(2) (2016)).

[121] Iowa Group Brief Opposing Exceptions at 8 (citing MISO TOs Brief on Exception at 14).

57. OMS/Joint Consumer Advocates further state that MISO TOs are disingenuous in suggesting that the Presiding Judge rejected reliance on Value Line's short-term earnings growth rates only out of necessity, rather than based on a finding that the IBES growth rates were shown to be preferable on the merits. OMS/Joint Consumer Advocates contend that the latest Value Line reports for the adopted study period were in fact in the record for all relevant companies,[122] and, if it had been appropriate, the Presiding Judge would have used those reports' short term EPS growth rates as DCF inputs.[123] OMS/Joint Consumer Advocates state that the Commission should reject MISO TOs' request that the Commission declare that "the EPS growth forecasts published by Value Line and IBES, if available for all proxy companies, are presumed to be comparable."[124] OMS/Joint Consumer Advocates and Joint Customer Intervenors assert that Value Line's short-term earnings growth rates are patently not comparable to IBES growth rates, in multiple respects.[125] For example, OMS/Joint Consumer Advocates and Joint Customer Intervenors state that, unlike the IBES forecasts, the Value Line EPS forecasts "consist[] of an earnings estimate of only one analyst."[126] OMS/Joint Consumer Advocates also state that IBES short-term growth projections are based on analysts' independent evaluation of prospective growth and not inherently tied to past performance. By contrast, OMS/Joint Consumer Advocates state that Value Line forecasts start from an earnings baseline that starts more than three years in the past.[127] Trial Staff also state that the "ANNUAL RATES" section Value Line data used by MISO TOs' witness, Dr. Avera, are plainly from a past three-year period to a future three-year period.[128]

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[122] OMS/Joint Consumer Advocates Brief Opposing Exceptions at 11 (citing Exh. S-6 at 9-55).

[123] *Id.*

[124] *Id.* at 15 (citing MISO TOs Brief on Exceptions at 23).

[125] Joint Customer Intervenors Brief Opposing Exceptions at 5.

[126] OMS/Joint Consumer Advocates Brief Opposing Exceptions at 15 (citing Opinion No. 531-B, 150 FERC ¶ 61,165 at P 72 n.145; Joint Customer Intervenors Brief Opposing Exceptions at 5 (citing Exh. JCI-4 at 21:10-14).

[127] OMS/Joint Consumer Advocates Brief Opposing Exceptions at 16 (citing Exh. JCA-11 at 10-12; Exh. JCI-4 at 19-20; Exh. S-1 at 79-82).

[128] Trial Staff Brief Opposing Exceptions at 8 (citing Tr. 622:10; Exh. S-1 at 80-81).

OMS/Joint Consumer Advocates state that, because Value Line's EPS forecasts are derived from an historical three-year baseline, those estimates will be an especially poor predictor of future EPS growth.[129] In addition, OMS/Joint Consumer Advocates state that IBES updates its consensus forecast whenever there is a change in the forecast of one of its polled analysts, whereas Value Line publishes its estimates on a fixed schedule (once every three months).[130] OMS/Joint Consumer Advocates argue that at any given point in time, the IBES consensus forecast is more likely to reflect the most up to date information.[131]

58. Additionally, OMS/Joint Consumer Advocates state that Value Line's forecasts are not consistent with the Commission's decision in Opinion No. 531 to "change the way DCF analyses are conducted in public utility cases to use *the same methodology* as the Commission uses in natural gas and oil pipeline cases."[132] OMS/Joint Consumer Advocates state that Value Line's partially retrospective growth rate is not used in pipeline cases, where the precedents specifically reject using Value Line reports to test the reasonableness of projected growth rates.[133]

59. OMS/Joint Consumer Advocates and Trial Staff oppose MISO TOs' request for a case-by-case determination of the short-term growth rate forecast data source.[134] According to OMS/Joint Consumer Advocates and Iowa Group, MISO TOs' proposal would enable litigants to select whichever source of short-term growth rate data is most advantageous for a given study period.[135] Joint Customer Intervenors go further,

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[129] OMS/Joint Consumer Advocates Brief Opposing Exceptions at 16.

[130] *Id.* (citing Exh. JCI-4 at 21:17 – 22:3).

[131] *See also* Joint Customer Intervenors Brief Opposing Exceptions at 5-6 (citing Exh. JCI-4 at 21:10-14; Opinion No. 531, 147 FERC ¶ 61,234 at P 88).

[132] OMS/Joint Consumer Advocates Brief Opposing Exceptions at 17 (citing Opinion No. 531, 147 FERC ¶ 61,234 at P 32 (emphasis supplied)).

[133] *Id.*

[134] *Id.* at 18 (citing Initial Decision, 153 FERC ¶ 63,027 at P 48); Trial Staff Brief Opposing Exceptions at 43-44.

[135] OMS/Joint Consumer Advocates Brief Opposing Exceptions at 19 (citation

(continued...)

arguing that MISO TOs chose the Value Line growth rates because they were the most advantageous source of short-term growth rates.[136]

60. In addition, OMS/Joint Consumer Advocates state that, if the Commission grants the relief that MISO TOs request, the Commission should put some boundaries around the data source debate in the future.[137] Specifically, OMS/Joint Consumer Advocates state that the Commission should provide guidance as to how it will apply the new rules in future cases.[138] Joint Customer Intervenors also argue that, while MISO TOs portray IBES as just one among many potential sources of growth rate estimates, it is only appropriate to use a comparable source of short-term growth estimates where IBES growth rate estimates are not available.[139] Iowa Group offers that in Opinion No. 531 the Commission applied exactly the same two-step DCF model that it has used for twenty years to set returns on equity for gas and oil pipelines to electric transmission utilities. Iowa Group explains that in doing so, the Commission relied on oil and gas pipeline precedent that established its preference for IBES short-term growth rates.[140]

61. Trial Staff states that it is not the Initial Decision that states IBES estimates are "preferable" – it is the Commission's statements and actions over many years that indicate that preference.[141] Trial State further contends that the Commission has never for any purpose used the particular data from the "ANNUAL RATES" section of the Value Line company reports, which are the basis of Dr. Avera's earnings growth input.[142]

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omitted); Iowa Group Brief Opposing Exceptions at 11; *see also* Joint Customer Intervenors Brief Opposing Exceptions at 7.

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

[137] Joint Customer Intervenors also express concern about the lack of boundaries here by pointing out that MISO TOs propose no criteria for judging whether a particular source is comparable. *Id.* at 7.

[138] OMS/Joint Consumer Advocates Brief Opposing Exceptions at 20.

[139] Joint Customer Intervenors Brief Opposing Exceptions at 7.

[140] Iowa Group Brief Opposing Exceptions at 8-9.

[141] Trial Staff Brief Opposing Exceptions at 6.

[142] *Id.* at 8 citing Tr. 621:20-622:2.

d. Commission Determination

62. We reject MISO TOs' request for clarification that the growth projections published by Value Line constitute an acceptable and comparable source of short-term earnings growth estimates that may be considered for use in the two-step DCF analysis. In Opinion No. 531, the Commission held that "in future public utility cases, the Commission will adopt the same two-step DCF methodology it uses in natural gas and oil pipeline cases."[143] While the Commission has refrained from mandating the exclusive use of IBES data in its natural gas and oil pipeline rate of return cases, the Commission has stated that "IBES data is the preferred data source for computing the short-term growth rate."[144] The Commission has explained that the "IBES data is a compilation of projected growth rates from various knowledgeable financial advisors within the investment community."[145] As such, the IBES short-term growth estimates generally represent consensus growth rate estimates by a number of analysts. By contrast, the Commission has rejected the use of Value Line growth estimates in gas pipeline ROE cases, because they are the estimates of a single analyst and thus do not constitute such consensus estimates.[146]

63. MISO TOs suggest that, despite the Commission's refusal to use Value Line short-term growth estimates in natural gas and oil pipeline ROE cases, the Commission intended in Opinion No. 531 to permit the use of Value Line estimates in public utility ROE cases. They rely heavily on the Commission's statement in Opinion No. 531 that

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[143] Opinion No. 531, 147 FERC ¶ 61,234 at P 39.

[144] *Nw. Pipeline Corp.*, 92 FERC ¶ 61,287, at 62,002 (2000). *See also Nw. Pipeline, Corp.*, 79 FERC ¶ 61,309, at 62,385 (1997) (finding that "[t]he IBES figures should be used for the short-run growth rate of reach of the proxy companies.").

[145] *See, e.g.*, *Northwest Pipeline Corp.*, 87 FERC ¶ 61,266, at 62,058-62,059 (1999); *Enbridge Pipelines (KPC)*, 100 FERC ¶ 61,260, at P 234 (2002).

[146] *Northwest Pipeline Corp.*, 87 FERC at 62,058-62,059; and *Enbridge Pipelines (KPC)*, 100 FERC ¶ 61,260 at P 234. *See* Opinion No. 531-B, 150 FERC ¶ 61,165 at n.145, stating that the Value Line data "for any company consists of an earnings estimate from only one analyst, rather than consensus estimates."

the "short-term growth estimate will be based on the projections reported by IBES (or comparable source)."[147] Opinion No. 531 provided a more extensive discussion of short-term growth rates after the general statement relied on by the MISO TOs. There, the Commission stated that the "growth rates used in the DCF model should be the growth rates expected by the market" and that the Commission "has long relied on IBES growth projections as evidence of the growth rates expected by the investment community."[148] The Commission also addressed a proposal by Trial Staff to use Reuters Estimates Database (RED) growth projections published by *reuters.com* for those companies in the proxy group for which the IBES growth projection only reflected the view of one analyst.[149] Trial Staff argued the RED growth projections should be used because they were consensus estimates reflecting the views of more than one analyst. The Commission, however, rejected this proposal because Trial Staff had not provided RED growth projections for all the companies in the proxy group, while IBES data for all the proxy companies was available in the record.[150] While the Commission stated that it is willing to allow the substitution of "comparable data," the Commission explained that "an alternative source of growth rate data should only be used when that source can be used for the growth projections of all of the proxy group companies" because using different sources could "produce skewed results, because those sources may take different approaches to calculating growth rates."[151] For this reason, the Commission emphasized that it has "consistently used a single investor service such as IBES for the investment analysts' growth rate estimates."[152]

64. Thus, consistent with the discussion in Opinion No. 531, the Commission is willing to use short-term growth data published by a source comparable to IBES. However, because the Commission requires the use of analysts' consensus growth rates

[147] Opinion No. 531, 147 FERC ¶ 61,234 at P 39.

[148] *Id.* PP 89-90.

[149] *Id.* P 90.

[150] *Id.*

[151] *Id.* (citing to *ISO New England, Inc.*, 109 FERC ¶ 61,147, at P 205 (2004) (finding that a presiding judge is not precluded from finding candidates for inclusion in the proxy group for which comparable data can reasonably be substituted for the growth rate data reported by IBES or Value Line)).

[152] *Id.*

as the short-term growth rate input in the DCF methodology, only data sources that publish analysts' consensus growth rate estimates, such as the RED growth forecasts at issue in Opinion No. 531, can be considered comparable to IBES.[153] Value Line does not publish such consensus growth rate estimates. We believe that investors, particularly larger institutional investors such as mutual funds and pension funds, are far more likely to rely upon published consensus estimates than they are to rely on Value Line. In addition, published consensus estimates sourced from investment analysts, e.g., IBES's growth rate estimates, are updated on a rolling basis, sometimes as frequently as daily, and are therefore superior to Value Line's growth rate estimates, which are updated only on a lagging, quarterly basis.[154] We therefore decline to grant MISO TOs' request that we presume that the short-term growth forecasts published by Value Line and IBES to be comparable.

65. Accordingly, we affirm the Presiding Judge's holdings concerning the proxy group and the DCF analysis of each proxy company. We therefore affirm the Presiding Judge's finding that the zone of reasonableness for establishing MISO TOs' ROE is from 7.23 percent to 11.35 percent. We now turn to the issue of where within that range to set the MISO TOs' ROE.

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

66. The Commission has typically set the base ROE in RTO/ISO cases at the midpoint of the zone of reasonableness.[155] However, in Opinion No. 531, the Commission found that, because of the presence of anomalous capital market conditions in that case, the central tendency of the zone of reasonableness produced by a mechanical application of the DCF methodology would not satisfy the requirements of *Hope*[156] and *Bluefield*.[157]

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[153] *See, e.g., id.* P 89.

[154] While we find that Value Line's *growth rate estimates* are not acceptable as the short-term consensus growth rate input for the two-step DCF model, we reiterate that Value Line is a valid source of general financial data and affirm that Value Line estimates and financial data (e.g., betas) are acceptable as inputs for alternative cost of equity methodologies.

[155] *See S. Cal. Edison Co.*, 131 FERC ¶ 61,020 at P 91, remanded on other grounds sub nom. *S. Cal. Edison Co. v. FERC*, 717 F.3d 177 (2013).

[156] *Hope*, 320 U.S. 591.

[157] *Bluefield*, 262 U.S. at 693.

Opinion No. 531 corroborated that finding by reference to several alternative methodologies for determining the cost of equity. The Commission accordingly concluded that the just and reasonable ROE in that case should be set at the midpoint of the upper half of the zone of reasonableness.

67. Below, we first consider whether the Presiding Judge correctly held that there are anomalous capital market conditions in this case that would justify setting MISO TOs' ROE above the midpoint produced by a mechanical application of the DCF analysis. Because we affirm the Presiding Judge's conclusion that there were anomalous market conditions, we proceed to consider whether the relevant alternative methodologies corroborate that the mechanical application of the DCF analysis does not result in an ROE consistent with *Hope* and *Bluefield*. Based on the record in this case, including the presence of unusual capital market conditions, we conclude that the just and reasonable base ROE for MISO TOs should be set at the midpoint of the upper half of the zone of reasonableness.[158] Based on the DCF study adopted by the Presiding Judge, we affirm the Presiding Judge's finding that the just and reasonable base ROE for MISO TOs is 10.32 percent.

1. Anomalous Market Conditions

a. Initial Decision

68. The Presiding Judge determined that it is MISO TOs' burden to show that anomalous capital market conditions justify selecting an ROE above the midpoint of the zone of reasonableness.[159] The Presiding Judge explained that this showing required evidence that (1) anomalous conditions make it difficult to determine whether an ROE set at the midpoint of the zone of reasonableness reflects the risks facing MISO TOs and (2) other points of comparison, including credible alternative valuation models and the ROEs allowed by state public utility commissions support an ROE above the midpoint of the zone.

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[158] We calculate the midpoint of the upper half of the zone as follows: (1) calculate the midpoint of the full zone of reasonableness; (2) define the upper half of the zone of reasonableness as the range of cost of equity estimates that are bounded, on the low end, by the midpoint of the full zone of reasonableness and, on the high end, by the highest cost of equity result among the proxy group companies; and (3) calculate the midpoint of the cost of equity results in that upper range, inclusive of the endpoints.

[159] Initial Decision, 153 FERC ¶ 63,027 at P 120.

69. The Presiding Judge determined that anomalous market conditions existed during the study period and that these conditions complicated the task of assessing whether an ROE at the midpoint of the zone of reasonableness accurately reflected the risks facing MISO TOs.[160] The Presiding Judge determined that the Federal Reserve's "unprecedented" purchases of debt securities were the primary factor driving the reduction in short-term interest rates and, as a result, causing a reduction in the dividend yields of public utility stocks. The Presiding Judge concluded that these circumstances are unique and, in all likelihood, unsustainable and temporary because they depend on the Federal Reserve's actions to depress interest rates. The Presiding Judge also found that investors expected the Federal Reserve to allow interest rates to "normalize."[161]

70. The Presiding Judge concluded that these conditions—and the depressed interest rates in particular—had rendered the DCF model less reliable. The Presiding Judge explained that the DCF model assumes that, under normal conditions, an investor will evaluate a stock by considering the anticipated flow of future dividends, discounted for risk, that would accrue to owners of that stock.[162] However, the Presiding Judge concluded that, during the study period, investors were not abiding by the DCF model's assumptions. Instead, the Presiding Judge determined that the Federal Reserve's actions had reduced the returns on debt securities to a level that investors "find unacceptable," causing them to move their money into other classes of assets, including electric-utility stocks.[163]

71. The Presiding Judge concluded that these investors were basing their purchasing decisions "solely [on] the current yields of those stocks" and not on the present value of future dividends, as the DCF model assumes. The Presiding Judge further concluded that investors were making these decisions notwithstanding their belief that the expected rise in interest rates would inevitably cause these stocks to decline in value. The Presiding Judge further concluded that these "hot money," short-term investors would, therefore, liquidate their positions in these stocks once they "sense" that the Federal Reserve has begun to allow conditions to normalize, causing a significant decline in their price.[164] As

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[160] *Id.* P 219.

[161] *Id.* P 224.

[162] *Id.* P 226.

[163] *Id.* P 227.

[164] *Id.* PP 192, 228.

a result, the Presiding Judge concluded that, during the study period, the interest of hot money investors had caused electric-utility stock prices to become inflated to a level that did "not reflect the risks that investment in these securities entails."

72. As a result of these findings, the Presiding Judge determined that the MISO TOs met their burden to show that "the evidence calls into question the reliability of the DCF analysis in this proceeding" and, by extension, whether the midpoint of the zone of reasonableness is the just and reasonable ROE for MISO TOs. Accordingly, the Presiding Judge determined that Opinion No. 531 required the consideration of alternative valuation methods and the ROEs recently authorized by state public utility commissions.[165]

b. Briefs on Exceptions

73. Complainants argue that the Presiding Judge erred in finding that anomalous market conditions existed during the relevant study period. Complainants state that Opinion No. 531 does not articulate a standard for identifying "anomalous market conditions" and that the record in this proceeding also lacks such a standard. Complainants note that the Presiding Judge, even absent evidence, extrapolates this to mean "unprecedented" and "unsustainable." Complainants contend that the Presiding Judge is unable to meet his own "unprecedented" standard because the actions of the Federal Reserve were known to investors prior to the study period.[166]

74. Complainants contend that the record does not demonstrate that current market conditions impacted DCF inputs, focusing on the impact of Federal Reserve actions on investor behavior. Complainants state that the Presiding Judge implies that the Federal Reserve's actions are not reflected in financial market data, a theory which conflicts with the DCF analysis' assumption of efficient market theory.[167] Complainants argue that there is no basis to dispute that the Federal Reserve's policies are relevant information that is known to investors. Rather, current market conditions are already reflected in the DCF and have no impact on MISO TOs' capital attraction capabilities.[168]

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[165] *Id.* PP 229-230.

[166] Complainants Brief on Exceptions at 28-29.

[167] *Id.* at 30 (citing Initial Decision, 153 FERC ¶ 63,027 at P 225).

[168] *Id.* at 31; *see also* Trial Staff Brief on Exceptions at 33 (citing Initial Decision, 153 FERC ¶ 63,027 at PP 201-205).

75. Complainants contend that the Presiding Judge interprets *Hope* and *Bluefield's* capital attraction standard as applying only to long-term investors, an interpretation that is both unsubstantiated and without legal precedent.[169] Complainants also argue that the evidence in this proceeding demonstrates that such a distinction is unnecessary because the DCF model accounts for both long- and short-term investors.[170] According to Complainants, even if short-term investors do not purchase and hold, the sale price of the shares they sell remains based on the long-term cash flow expectations of that security.

76. Complainants argue that the record does not demonstrate that current market conditions negatively impacted MISO TOs' ability to attract capital. The Federal Reserve's policies, Complainants contend, have not resulted in increases to the current low capital cost environment.[171] Complainants assert that, given the indications by the Federal Reserve of gradual systematic change, no significant impact on capital markets is expected, as shown in an August 2015 *Bloomberg Businessweek* article.[172] Complainants argue that there is no immediate impetus for the Federal Reserve to modify or terminate its monetary policy such that the impact of Quantitative Easing will remain in effect for the foreseeable future.[173] Consequently, MISO TOs will continue to have access to low-cost capital for the foreseeable future. Complainants also contend that the record, including statements by the Federal Reserve, undermines the Presiding Judge's finding that investors expect significant interest rate increases in the future.[174] Complainants also cite financial publications showing that investors expect interest rates to rise only gradually.[175]

77. Complainants contend that rather than relying on assertions about the actions of "hot money," the ROE should be based on the two-stage DCF analysis, without

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[169] Complainants Brief on Exceptions at 31-32 (citing Initial Decision, 153 FERC ¶ 63,027 at P 207).

[170] *Id.* at 32-33 (citing Exh. JCA-11 at 25).

[171] *Id.* at 33 (citing Exh. JC-9 at 7).

[172] *Id.* at 33-34 (citing Exh. OMS-23 at 1).

[173] *Id.* at 34 (citing Exh. JC-9 at 34).

[174] *Id.* at 35 (citing Exh. S-15 at 10).

[175] *Id.* at 36 (citing Exh. OMS-22 at 2).

adjustments for anomalous market conditions. Complainants state that if capital market costs increase in the future such that MISO TOs' base ROE is insufficient, they may propose adjustments under section 205 of the FPA.

78. Trial Staff asserts that, while long-term interest rates are indeed low when compared to those prevailing in the recent past, they are not anomalously low when properly viewed in a longer historical context.[176] According to Trial Staff, Mr. Keyton noted that interest rates are subject to long-term cycles that can last for decades.[177] Trial Staff asserts that interest rates on 10-year U.S. Treasury bonds were under three percent during 1953, 1954 and 1955 and generally increased for almost 30 years, reaching a peak of 13.92 percent in 1981 and then receded to a level below three percent again in 2011, where they remain today.[178] Trial Staff further states that interest rates on *Moody's* Baa bonds reached a peak of 9.38 percent during the Great Depression in 1933 and generally fell for a period of 13 years, reaching a low of 3.03 percent in 1946.[179] Then, according to Trial Staff, similar to the pattern found with Treasury debt, interest rates on *Moody's* Baa bonds increased in a secular manner until reaching a peak of 16.60 percent in 1981, and subsequently began a long and steady decline, falling below five percent in 2012, where they have remained ever since.[180] Trial Staff argues that, when viewed in the context of a historical period that is long enough to capture the entirety of an interest rate cycle, a view not available to the Commission in the Opinion No. 531 proceeding, the interest rates on long-term bonds during the DCF study periods in this proceeding are neither unusual nor demonstrably anomalous.

79. Trial Staff asserts that the Presiding Judge erred in relying on Paragraph 50 of Opinion No. 531-B[181] to reject Trial Staff's argument that, if MISO TOs' cost of equity increases in the future and long-term investors in utility stocks begin to perceive more favorable risk-adjusted investment alternatives, MISO TOs are free to file for a return that will allow them to retain the confidence of investors willing to commit funds to

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[176] Trial Staff Brief on Exceptions at 20.

[177] *Id.* at 20 (citing Initial Decision, 153 FERC ¶ 63,027 at PP 123-141; 222).

[178] *Id.* at 20-21 (citing Exh. S-2, Schedule No. 1).

[179] *Id*. (citing Exh. S-2, Schedule No. 2).

[180] *Id.* at 21.

[181] *Id.* at 40 (citing Initial Decision, 153 FERC ¶ 63,027 at PP 204-205).

ensure their creditworthiness and long-term financial integrity. Although Paragraph 50 assumes that the DCF inputs have been distorted by economic abnormalities, Trial Staff states that, in this instance, the only DCF input at issue, current dividend yield, has fallen in line with declining interest rates as a result of market forces, consistent with an economic relationship that has been long accepted by the Commission. Trial Staff explains that the decline in interest rates, to a greater or lesser extent driven by policies of the Federal Reserve, as well as other market forces, has resulted in a decline in dividend yield and in the cost of equity capital. Trial Staff further explains that the current level of dividend yield on utility stocks simply reflects the decline in the cost of equity, rather than some amorphous and unexplained distortion in measuring it. Trial Staff concludes that, given the absence of credible evidence that either of the DCF inputs, current dividend yield or earnings growth has been distorted by purportedly anomalous capital market conditions, placement of MISO TOs' base ROE at the midpoint of the DCF zone of reasonableness automatically ensures that the capital attraction standards of *Hope* and *Bluefield* will be met.[182]

80. Trial Staff avers that while the Federal Reserve's Quantitative Easing programs undoubtedly helped the Treasury Department finance the large federal deficits following the 2008 financial crisis and necessarily had some impact on lowering yields on Treasury debt,[183] other actors in the financial community besides the Federal Reserve, both public and private, were acquiring Treasury debt at historically low yields. Trial Staff asserts that after the Federal Reserve's third round of Quantitative Easing program ended in October 2014, the market interest rate on long-term Treasury debt continued to decline.[184] Trial Staff asserts that this fact implies that the participation of private investors contributed meaningfully to interest rates on Treasury debt, and that resulting rates were less the result of Federal Reserve intervention than the product of private capital market activity responding to prevailing market conditions.[185]

81. Trial Staff notes that, on several occasions in his Initial Decision, the Presiding Judge dismissed assertions concerning other structural reasons for the low interest rates during the DCF study period and appeared to adopt the MISO TOs' position that

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[182] *Id.* at 41.

[183] *Id.* at 25 (citing Exh. S-1 at 107:20-108:10).

[184] *Id.* (citing Exh. S-7).

[185] *Id.* at 25-26.

intervention by the Federal Reserve was the sole or central cause.[186] For example, Trial Staff states that the Presiding Judge rejected arguments by Trial Staff and other participants that the current level of long-term interest rates and their potential future trajectory is due in part to investors' expectations concerning future inflation.[187] Furthermore, Trial Staff contends that the Initial Decision presents a distorted analysis of the array of relevant economic forces impacting the capital markets during the DCF study period.

82. Trial Staff states that, while the Presiding Judge acknowledges present circumstances, he does not concede that low interest rates, low dividend yields, and high equity prices reflect low equity costs.[188] Trial Staff asserts that this is conceptually incorrect and contrary to the Commission's accepted position and may have led the Presiding Judge to make subsequent findings that are also inconsistent with the factual record and accepted economic logic.

83. Trial Staff asserts that the record lacks evidence that long-term investors in utility stocks, with at least a partial focus on the anticipated return offered by a potentially increasing stream of future dividend payouts, are deserting utility stocks. Trial Staff states that the Presiding Judge's speculation that the "Total Returns"[189] provided by an investment in utility stocks may currently be unsatisfactory to long-term investors whose participation is necessary to maintain their financial integrity and creditworthiness[190] is contradicted by long-term investors' continued investment in those stocks. Trial Staff states that, while investment by "hot money" investors in utility stocks may have contributed to an increase in utility stock prices and reduced total returns provided by them by reducing current dividend yield, this merely reflects a decline in the overall market cost of debt and equity capital in an efficient market.

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[186] *Id.* at 27 (citing, *e.g.*, Initial Decision, 153 FERC ¶ 63,027 at PP 170-180, 221-223).

[187] *Id.* at 27 (citing, *e.g.*, Initial Decision, 153 FERC ¶ 63,027 at PP 169, 189 n.249).

[188] *Id.* at 34 (citing Initial Decision, 153 FERC ¶ 63,027 at PP 137, 215, 216).

[189] *Id.* at 37.

[190] *Id.* at 37-38 (citing Initial Decision, 153 FERC ¶ 63,027 at P 218).

84. Trial Staff further argues that the Presiding Judge accepted MISO TOs' position that interest rates are likely to rise significantly in the future while virtually ignoring other evidence that this is unlikely to happen. Trial Staff points to the fact that Dr. Avera proffers a claim almost identical to that which he has been making since his testimony in the Opinion No. 531 proceeding,[191] that the existence of "widespread expectations in the investment community are for interest rates to rise significantly as the Federal Reserve moves to normalize its monetary policies and the economy moves toward a more normal pattern of growth."[192] Trial Staff counters that interest rates have gone down rather than up since that time, as shown in Exhibit No. S-7.[193] Finally, Trial Staff offers the example that, while the Presiding Judge gave decisional weight to predictions of increases in interest rates by sources cited by Dr. Avera, he dismissed the views of other observers on this same issue.[194] According to Trial Staff, under these circumstances, there is no basis to refer to alternative methodologies to inform placement of MISO TOs' cost of equity within the DCF zone.

85. Iowa Group states that MISO TOs failed to sustain their burden of proving that alleged anomalous market conditions had skewed the DCF inputs.[195] Iowa Group argues that the Presiding Judge erred by reinterpreting *Hope* and *Bluefield* to classify investors on the basis of their investment intent or motivation. Iowa Group asserts that Ms. Lapson did not quantify any impact that "hot money" investors might have on the price or prices of any particular proxy group, observing that the retreat of "hot money" would drive proxy group prices down and dividend yields up.[196]

86. Iowa Group also asserts that the evidentiary record does not establish that a utility's financial stability and growth is irrelevant (or of far less interest) to short-term investors. It further states that *Hope* and *Bluefield* require that a utility's ROE be: (1) fair to *all* shareholders, regardless of the weight a shareholder places on the growth or yield of a particular stock; and (2) fair to consumers as well, meaning protecting them

[191] *Id.* at 30 (citing Exh. NET-300 at 12-14; Tr. 616:17-618:11).

[192] *Id.* at 30 (citing Exh. MTO-23 at 103:15-17).

[193] *Id.* at 30.

[194] *Id.* at 30-31 (citing Initial Decision, 153 FERC ¶ 63,027 at PP 189, 223).

[195] Iowa Group Brief on Exceptions at 11.

[196] *Id.* at 13 (citing Initial Decision, 153 FERC ¶ 63,027 at P 210).

from exorbitant rates[197] or as Congress opined when it enacted the FPA, from deficient markets.[198] Iowa Group states that if the Presiding Judge's classification of shareholders is correct, the possibility of overcompensating investors rises significantly.

87. Iowa Group argues that the Presiding Judge also erred in finding that (1) short-term investors are supporting the proxy group utilities' stock prices, inflating share values and depressing dividend yields, and that this "fact" provides "no assurances that these utilities' Total Returns are sufficient to satisfy the requirements of the long-term investor,"[199] as well as (2) low interest rates set by the Federal Reserve Bank had distorted DCF calculations by driving down the yields of Baa Bonds and thereby skewing the 100-basis point screen.[200]

88. Additionally, Iowa Group states that the Presiding Judge excluded Edison International, FirstEnergy, and Entergy from the proxy group because their estimated ROEs (4.38 percent, 5.01 percent, and 5.36 percent, respectfully) either fell below the average Baa Bond yield (4.65 percent) or exceeded it by less than 100 basis-points. Iowa Group asserts that if, as the Presiding Judge found, short-term investors purchase utility shares only to obtain their dividend yield, it follows that such investors would purchase FirstEnergy shares because the higher adjusted dividend yield they would receive from such purchases (3.99 percent) would equal, or exceed, the yield they would receive from two of the 39 proxy group companies. Iowa Group further asserts that the same would be true for Entergy, which, according to Appendix A, has an adjusted dividend yield of 4.23 percent. Iowa Group offers that if the Presiding Judge is correct, then short-term investors would be purchasing Entergy shares since that yield exceeds the yields they would earn on the shares of 29 out of the 37 final proxy group companies.[201]

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[197] *Id.* at 15 (citing *American Pub. Power Assoc. v FPC*, 522 F. 2d 142, 147 (D.C. Cir. 1975) (Bazelon, J. concurring) and *Washington Gas Light Co. v. Baker*, 188 F. 2d 11, 15 (D.C. Cir. 1950) (referencing U. S. Supreme Court cases dating back to 1890)).

[198] *Id.* at 15 (citing *Morgan Stanley Capital Group, Inc. v. Pub. Util. District No. 1*, 554 U.S. 527, 564 (2008) (Ginsburg, J. concurring)).

[199] *Id.* at 15-16 (citing Initial Decision, 153 FERC ¶ 63,027 at P 210).

[200] *Id.* at 18-19 (citing Initial Decision, 153 FERC ¶ 63,027 at PP 155-157).

[201] *Id.* at 17.

89. Iowa Group argues that this evidence indicates that either the Presiding Judge is correct in finding all estimated ROEs below 5.65 percent (to use Dr. Avera's word) illogical and FirstEnergy and Entergy must be excluded from the final proxy group *or* it is correct in finding that short-term investors are purchasing equity only for dividend yield and FirstEnergy and Entergy should be included in the final proxy group. Iowa Group states that these findings are mutually exclusive.

90. Iowa Group states that the Presiding Judge erred when it found that low interest rates set by the Federal Reserve distorted DCF calculations by driving down the yields of Baa Bonds and thereby skewing the 100-basis point screen.[202] Iowa Group argues that the 257 basis point fluctuation in average Baa bond yields over the six and a half years after 2008 that the Presiding Judge highlighted in the Initial Decision does not prove that the DCF's low-end outlier screen was distorted.[203] In fact, Iowa Group points out that the magnitude of this fluctuation pales in comparison to other six-year periods shown on the same exhibit.[204] Iowa Group avers that the fact that a small variance in Baa bond yields coincided with Federal Reserve Bank's implementation of an economic stabilization and stimulus policy is hardly the foundation for finding a distortion in DCF calculations. Moreover, Iowa Group states that even if the "low-end outlier" screen were increased to its 2008 level of 8.22 percent and applied to the DCF results shown in the Initial Decision's Appendix B, the resulting Base ROE would be lower than that set by the Initial Decision. Iowa Group also states that this screen produces a zone of reasonableness that extends from an estimated return of 8.32 percent for SCANA Corporation to the 11.35 percent estimated return for TECO. Iowa Group asserts that, having corrected the effect of the alleged anomalous market conditions on the DCF inputs by raising the bottom of the zone, MISO TOs' new base ROE would not exceed the midpoint, which is 9.835 percent.[205]

91. Iowa Group asserts that the Commission has adjusted a base ROE up or down from the midpoint when there is substantial evidence to do so.[206] Iowa Group states

[202] *Id.* at 18-19 (citing Initial Decision, 153 FERC ¶ 63,027 at PP 155-157).

[203] *Id.* at 19 (citing Initial Decision, 153 FERC ¶ 63,027 at PP 157).

[204] *Id.* (citing Exh. S-5 at 2).

[205] *Id.* at 19-20.

[206] *Id.* at 20-21 (citing *S. Cal. Edison Co.*, 92 FERC ¶ 61,070, at 61,266 (2000); *Consumers Energy Co.*, 85 FERC ¶ 61,100, at 61,363-61,364 (1998). Iowa Group explains that both of these cases involved adjusting the utility's ROE above the DCF

(continued...)

that, given the lack of evidence to adjust a base ROE here, three options are available: (1) acknowledge the absence of evidence and set the base ROE at the midpoint; (2) re-open the record to allow the parties to submit proof as the extent of the effect; or, (3) consider Opinion No. 531's placement of the base ROE to be a default placement unless the record supports another quantification method. Iowa Group states that the Presiding Judge chose the last option, which constitutes clear error.[207] Iowa Group asserts that under the Administrative Procedure Act, the Presiding Judge was required to "articulate a rational connection between the facts found and the choices made."[208] Iowa Group further asserts that the Presiding Judge's punting of the quantification issue by defaulting to Opinion No. 531's Base ROE placement does not establish such a connection.

92. Iowa Group asserts that the Presiding Judge's utilization of a default quantification is particularly inappropriate in this case because it assumes, without proof, that the alleged anomalous market conditions affected the DCF inputs for each of the proxy companies to exactly the same extent. Iowa states that the Commission's practice of setting RTO-wide Base ROEs at the DCF midpoint rests on the assumption (upheld by the courts) that when setting the Base ROE for a diverse set of transmission companies, the midpoint of the proxy group's DCF zone of reasonableness is reasonably representative of the range of risks experienced by the RTO members. Iowa further explains that in other words, the midpoint, by taking into account the highest and lowest results, assures that the Base ROE accurately reflects the risk experienced by companies analogous to the RTO members.[209] Iowa Group states that there is no such assurance in this case. In fact, Iowa Group avers that there is no evidence in this case as to whether the Presiding Judge's 103 basis point upward adjustment is reasonably representative of the effect of the economic anomalies on MISO TOs' Base ROE. Iowa Group concludes

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midpoint because, based upon the record evidence, the Commission found that the utility's risk profile differed from that of the proxy group. In the case at hand, MISO TOs did not present any evidence to support a finding that they were riskier than the ID's proxy group. Iowa Group Brief on Exceptions at n.60.

[207] *Id.* at 21.

[208] *Id.* at 22 (citing *Pub. Serv. Comm'n v. Fed. Energy Reg. Comm'n*, 397 F.3d 1004, 1008 (D.C. Cir. 2005)).

[209] *Id.* (citing *S. Cal. Edison v. Fed. Energy Reg. Comm'n*, 717 F.3d 177, 183 (D.C. Cir. 2013); *City of Charlottesville v. Fed. Energy Reg. Comm'n*, 661 F.2d 945, 950-51 (D.C. Cir. 1981)).

that without such evidence, the Presiding Judge's placement of the Base ROE at the midpoint of the zone of reasonableness's upper quartile does not constitute reasoned decision-making.[210]

93. Iowa Group asserts that the Presiding Judge's upward adjustment of the DCF zone of reasonableness's midpoint constitutes nothing more than an adjustment to normalize the DCF results so that they reflect the results that would be produced under "normal" financial market conditions. However, according to Iowa Group, the Commission has held that it does not make such adjustments as evidenced by its findings in *Portland Natural Gas Transmission System*.[211] Iowa Group states that the Commission instead explicitly rejected the argument that DCF data from the immediately preceding time period would be more appropriate and found that the cost of capital for the pipeline was representative of the time period in issue, measured by the DCF methodology without special consideration to the underlying turmoil in the financial markets. Iowa Group further states that when the same pipeline underwent another rate review in an immediately subsequent time period, the DCF results reflected those changes.[212] Iowa Group asserts that it is therefore not impermissible or problematic for the Commission to measure the cost of capital on the basis of prevailing capital markets, whether they be favorable or unfavorable to equity investors on the one hand, or consumers on the other. Iowa Group avers that the Commission should not make a practice of "normalizing" Base ROE allowances to take account of unusual or idiosyncratic conditions in the financial markets, especially here, where, as Ms. Lapson testified, the process of normalizing markets could last up to 30 years and the exact extent of alleged anomalies on the DCF model's inputs for the proxy companies is completely unknown.[213]

94. Iowa Group asserts that the expansive character of the generalizations relied upon in the Initial Decision to justify its upward adjustment of the DCF zone of reasonableness's midpoint, combined with their amorphous evidentiary connections to

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[210] *Id.* at 22.

[211] *Id.* at 23-24 (citing *Portland Nat. Gas Transmission System,* Opinion No. 510-A, 142 FERC ¶ 61,198, at PP 219-220 (2013), *aff'g in relevant part,* Opinion No. 510, 134 FERC ¶ 61,129 (2011)).

[212] *Id.* at 24 (citing *see* Opinion No. 510, 134 FERC ¶ 61,129 at P 225; *Portland Nat. Gas Transmission System,* Opinion No. 524, 142 FERC ¶ 61,197, at PP 6, 290, and 323 (2013)).

[213] *Id.* at 24.

the DCF inputs and the lack of data quantifying the extent of the alleged economic anomalies impacts on those inputs, provide fertile ground for future claims for similar adjustments. Iowa Group argues that avoiding this result requires the Commission to reject the Presiding Judge's upward adjustment of the Base ROE on the ground that it does not withstand the rigorous scrutiny emphasized by Commissioner Honorable in Opinion No. 531-B.[214]

95. Joint Customer Intervenors assert that the current capital market conditions are neither "unprecedented" nor "unsustainable," and do not deviate from what is normal, but are instead evidence of a new and consistent normal.[215] Joint Customer Intervenors state that the capital market conditions cited in Opinion No. 531 have lasted at minimum four years and therefore have been shown to be sustainable. Joint Customer Intervenors refer to Mr. Solomon's analysis, which demonstrates that "[t]he consistency and persistence of the levels of capital costs over that . . . period demonstrate that current bond yields cannot be considered aberrational, but rather reflect a new and consistent normal."[216] Joint Customer Intervenors state that the current bond yields appear to be "part of a long-term decline in yields that began in the early 1980s."[217] Joint Customer Intervenors assert that former Federal Reserve Board Chairman, Dr. Benjamin Bernanke, has stated that "[l]ow interest rates are not a short-term aberration, but part of a long-term trend" and that "ten-year government bond yields in the United States were relatively low in the 1960s, rose to a peak above 15 percent in 1981, and have been declining ever since."[218]

96. Joint Customer Intervenors contend that the Presiding Judge's focus on the actions of the Federal Reserve, rather than on the actual market conditions such as the relatively low level of interest rates and inflation, appears to have contributed to the determination that anomalous market conditions existed.[219] Joint Customer Intervenors state that

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[214] *Id.* at 24-25.

[215] Joint Customer Intervenors Brief on Exceptions at 17-18 (citing Exh. JCI-1 at 27:16-19).

[216] *Id.* at 18 (citing Exh. JCI-1 at 27:16-19).

[217] *Id.* at 19 (citing Exh. JCI-4 at 27:5-7).

[218] *Id.* at 20-21 (citing Exh. JCI-6 at 1).

[219] *Id.* at 23.

the Federal Reserve acted to stimulate the economy after the Great Recession, which Joint Customer Intervenors argue would tend to increase economic activity, inflation, and the opportunity cost of capital.[220] Joint Customer Intervenors assert that the Presiding Judge's reliance on the actions of the Federal Reserve as the cause of the alleged anomalous market conditions is unfounded because, without the actions of the Federal Reserve, inflation and the cost of capital could have been lower.[221]

97. According to Joint Customer Intervenors, Mr. Solomon demonstrated that, despite MISO TOs' claim that Federal Reserve bond purchases had made bond investments unavailable to investors interested primarily in yield, federal debt as a percentage of annual GDP has doubled since 2008.[222] Joint Customer Intervenors state that the Presiding Judge dismissed Mr. Solomon's exhibit because the questions raised therein were highly technical and there was a lack of expert testimony.

98. Joint Customer Intervenors also state that the Presiding Judge erred by holding that *Hope* and *Bluefield* require the Commission to distinguish between short- or long-term investors, and by finding that the evidence demonstrates that MISO TOs are only attracting short-term investors.[223] According to Joint Customer Intervenors, the Presiding Judge determined that an ROE can be considered too low if the capital made available to the company comes from the wrong type of investors. Joint Customer Intervenors assert, however, that a short-term investor selling its stock has to accept a price based on the expected long-term cash flow to be derived from the stock.[224]

99. Joint Customer Intervenors also point out that "[r]ates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid."[225] Joint Customer Intervenors state that the Initial Decision appeared to take a

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[220] *Id.* at 24 (citing Exh. JCA-1 at 6:9-15, 7:10-12; Exh. JCA-11 at 24:10-12.).

[221] *Id.* at 24.

[222] *Id.* at 25 (citing Exh. JCI-7).

[223] *Id.* at 26.

[224] *Id.* at 27 (citing *Williston Basin Interstate Pipeline Co.*, 81 FERC ¶ 61,033, at P 61,175 (1997) (*Williston Basin*) ("even a short-term investor would be concerned about long-term growth . . . .")).

[225] *Id.* at 27 (citing *Hope*, 320 U.S. 605).

different view by acknowledging that "the cost to electric utilities of raising capital by issuing stock is also low" but nevertheless holding that "this does not mean that the [cost of equity] is low."[226] According to Joint Customer Intervenors, the Presiding Judge thereby found that an ROE set at the DCF midpoint would enable MISO TOs to raise capital, yet would be insufficient to attract long-term investors and thus would fail to comply with the Initial Decision's interpretation of *Hope* and *Bluefield*. Joint Customer Intervenors contend that the Presiding Judge failed to support the theory that the cost of equity is higher than the cost of raising capital, and assert that this theory is contrary to existing precedent.[227]

100. Joint Customer Intervenors also argue that the Presiding Judge erred by concluding that MISO TOs would not attract a sufficient number of long-term investors if the ROE were set at the midpoint of the DCF range of reasonableness. According to Joint Customer Intervenors, the Initial Decision suggested that a period of six years and eight months may qualify as short-term.[228] Joint Customer Intervenors argue that, if six years and eight months qualifies as short-term, the Presiding Judge effectively held that the midpoint of the DCF can only be relied upon when evidence demonstrates that most investors plan to hold their securities for at least seven years. Joint Customer Intervenors assert, however, that no court or regulatory agency has ever required such a showing.[229]

101. According to Joint Customer Intervenors, the Presiding Judge assumed that the supposed prevalence of short-term investors among utility stockholders is significant because short-term investors are likely to sell their stock as soon as the allegedly anomalous conditions change. Joint Customer Intervenors state that this assumption relied on Ms. Lapson's belief that it is anomalous for investors to buy and hold yield-producing securities when they expect interest rates to rise.[230] Joint Customer Intervenors argue, however, that the forecasts cited in the Presiding Judge predict interest rates to rise

[226] *Id.* at 27-28 (citing Initial Decision, 153 FERC ¶ 63,027 at PP 215-216).

[227] *Id.* at 28 (citing *Boston Edison Co. v. FERC*, 885 F.2d 962, 965 (1st Cir. 1989) (holding that the DCF asks "what is the minimum amount that one must pay new investors . . . to offer the utility the money that it needs for investment")).

[228] *Id.* (citing Initial Decision, 153 FERC ¶ 63,027 at P 177).

[229] *Id.* at 29.

[230] *Id.* at 35 (citing Initial Decision, 153 FERC ¶ 63,027 at P 146).

by 2019 and that it is hardly anomalous for investors to expect interest rates and other capital market parameters to change over the ensuing several years. Furthermore, Joint Customer Intervenors note that the Presiding Judge stated that "the Federal Reserve's calibration of its increase in the federal-funds target rate . . . may delay the rate impact of normalization, but will not prevent the suddenness of that impact once short-term rates start to provide acceptable yield."[231] Joint Customer Intervenors argue that, even if the Presiding Judge is correct and a sudden selloff of utility stocks by short-term investors leaves MISO TOs with difficulty raising capital, MISO TOs have the right under FPA section 205 to file for increased rates and to put those increased rates into effect after 60 days. Joint Customer Intervenors contend that the Presiding Judge would effectively require customers to pay excessive rates for years to avoid the possibility that MISO TOs might collect insufficient rates for 60 days. Joint Customer Intervenors, therefore, assert that the Initial Decision thus failed to engage in "a balancing of the investor and the consumer interests."[232]

102. Joint Customer Intervenors also argue that the Presiding Judge erred in finding that the reliability of the DCF analysis in this proceeding should be called into question.[233] Joint Customer Intervenors assert that the Commission's two-step DCF methodology, when properly implemented, correctly measures the market cost of capital. Joint Customer Intervenors explain that the Commission's DCF methodology is based on three major components: the dividend, the price of common stock, and the expected dividend growth rate.[234] Joint Customer Intervenors state that the dividend is published by the company and the price of common stock is determined in the competitive marketplace, while growth rate forecasts are developed and published by independent entities that generally are relied on by investors in forming their future outlook. Joint Customer Intervenors assert that, as the DCF methodology is forward-looking and based on the expectations of investors, the DCF results reflect the reality of the capital markets and the actual market cost of equity capital.[235]

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[231] *Id.* at 35-37 (citing Initial Decision, 153 FERC ¶ 63,027 at P 199).

[232] *Id.* at 29-30 (citing *Hope*, 320 U.S. 345).

[233] *Id.* at 21 (citing Initial Decision, 153 FERC ¶ 63,027 at P 228).

[234] *Id.* at 21-22 (citing Opinion No. 531, 147 FERC ¶ 61,234 at P 15).

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

103. According to Joint Customer Intervenors, the Presiding Judge relied heavily on the finding of anomalous capital market conditions in Opinion No. 531, yet failed to recognize that the record established in the instant proceeding differs from that before the Commission in Opinion No. 531 and compels the conclusion that capital market conditions cannot be considered anomalous in the relevant period.[236] Joint Customer Intervenors assert that the Presiding Judge considered arguments that were not found in Opinion No. 531 in support of MISO TOs' contention that conditions were anomalous, but dismissed arguments that conditions were not anomalous because the Commission had not accepted such arguments in Opinion No. 531.[237]

104. Joint Customer Intervenors contend that the record in the instant proceeding includes the following factors that, in contrast to the finding of anomalous market conditions in Opinion No. 531, indicate that economic conditions have not been aberrational: (1) the six-month average ten-year U.S. Treasury bond yield was above two percent by 28 basis points; (2) the unemployment rate dropped substantially to below six percent; (3) the economy expanded and the stock market was strong; (4) the Federal Reserve had substantially wound down its Quantitative Easing initiative; and (5) inflation remained below the Federal Reserve's Open Market Committee's two percent target level.[238] Joint Customer Intervenors argue that the Presiding Judge did not closely examine these conditions or explicitly reject the evidence that the market conditions do not warrant an upper-midpoint ROE for MISO TOs and thus erred in finding that market conditions were anomalous.[239]

105. Joint Customer Intervenors argue that the evidence presented in the hearing failed to demonstrate a correlation between the ROE and the level of transmission investment. They state that MISO TOs' witness, Mr. Kramer, was not able to say whether a base ROE greater than 12.38 percent would have resulted in the construction of more new projects.[240] Joint Customer Intervenors also claim that Mr. Kramer was unable to provide evidence of whether a lower base ROE would have resulted in the same level of

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[236] *Id.* at 15-16 (citing Opinion No. 531, 147 FERC ¶ 61,234 at PP 115, 116, 119).

[237] *Id.* at 16 (citing Opinion No. 531, 147 FERC ¶ 61,234 at P 205).

[238] *Id.* at 17 (citing Exh. JCI-1 at 26:12-23).

[239] *Id.*

[240] *Id.* at 52-53 (citing Exh. JCI-14 at 1).

benefits.[241] Joint Customer Intervenors also argue that the Presiding Judge relies upon the statements of MISO TOs' witness, Ms. Lapson, asserting that an ROE reduction would result in a reduction in earnings and cash flow, and that credit ratings might be affected.[242] Joint Customer Intervenors claim, however, that no party provided evidence to suggest that the base ROE that Joint Customer Intervenors argue for would impair transmission investment in MISO.[243]

106. Joint Customer Intervenors also argue that the capital market conditions during the study period in the instant proceeding were similar to those addressed in the May 12, 2015 Entergy Initial Decision,[244] in which the Presiding Judge found that capital market conditions were not anomalous. Therefore, Joint Customer Intervenors argue that the Presiding Judge erred in finding such conditions were anomalous here.[245]

107. OMS states that evidence submitted by Trial Staff showing historical bond yields going back to the year 1919 leads to the conclusion that the low bond yields seen during the study period in this docket are not unprecedented.[246] OMS also states that the Presiding Judge essentially found that capital market conditions are "anomalous" because they are unsustainable, and they are unsustainable because either interest rates will go up or investors will stop expecting them to go up. OMS states that the simple fact is that market conditions change over time because the market forces that shape those conditions change over time. Furthermore, OMS contends that whether or not investors perceive the Federal Reserve's accommodative monetary policy as temporary is beside the point because, it can credibly be argued, *all* market forces are temporary.[247] OMS argues that

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[241] *Id.* at 53 (citing Exh. JCI-13 at 1).

[242] *Id.* at 54 (citing Initial Decision, 153 FERC ¶ 63,027 at PP 463-470).

[243] *Id.*

[244] *Entergy Ark., Inc.*, 151 FERC ¶ 63,008, at P 89 (2015) (Entergy Initial Decision).

[245] Joint Customer Intervenors Brief on Exceptions at 24-25.

[246] OMS Brief on Exceptions at 13-14 (citing Exh. S-1 at 12).

[247] *Id.* at 16 (emphasis supplied).

what actually matters is whether investors expect that the eventual ending of the Federal Reserve's current program of accommodative actions will significantly impact their investments, such as by causing interest rates and bond yields to spike. OMS contends that the answer is far less certain than the Initial Decision suggests.

108. OMS also states that the record evidence casts considerable doubt on the extent to which Federal Reserve policies actually affect the inputs to a DCF study. For example, OMS contends that the record includes an article written by Dr. Bernanke questioning the Federal Reserve's ability to affect interest rates over the long-term, and stated that real interest rates are determined by a broad array of economic factors (including prospects of economic growth), not solely by Federal Reserve actions.[248] In addition, OMS states that the Presiding Judge agrees with MISO TOs' contention that Federal Reserve policy decreased yields on long-term U.S. Treasury bonds by increasing the demand for (and prices of) those securities, but it ignores the *supply* side of that equation.[249] OMS states that overlapping in time with Quantitative Easing, but swamping it in magnitude, large Federal deficits were being financed by the issuance of new federal debt securities, to the extent that Federal debt as a share of Gross Domestic Product more than doubled after 2008.[250] OMS argues therefore that even if Quantitative Easing bond purchases exerted a downward pressure on bond yields (by pulling down the supply of U.S. Treasury bonds, driving up their price and pushing down yields), new Federal bond issuances to finance the growing deficit had the opposite effect; by adding to the supply of Federal debt securities, prices were pushed down and yields were driven up.

109. OMS states that the Presiding Judge found that, as a result of falling interest rates and dividend yields, the cost to electric utilities of raising capital by issuing stock is low.[251] OMS states, however, that the Presiding Judge erred by rejecting the conclusion that logically follows from the finding – namely, that the costs of common equity for utilities is also low. OMS argues that the Presiding Judge's findings in this regard rely on the premise that the cost of equity must satisfy the total return requirements of a long-term investor to satisfy *Hope* and *Bluefield*.[252] OMS states that none of the testimonies

[248] *Id.* at 23 (citing Exh. JCI-6 at 2).

[249] *Id.* at 24 (citing Initial Decision, 153 FERC ¶ 63,027 at P 123 (emphasis supplied)).

[250] *Id.* (citing Exh. JCI-7 at 84, figure 1).

[251] *Id.* at 25 (citing Initial Decision at P 215).

[252] *Id.* at 25-26 (citing Initial Decision, 153 FERC ¶ 63,027 at P 210).

prepared by MISO TOs' expert witnesses' distinguish between the required returns of long-term versus short-term investors to satisfy the standards in *Hope* and *Bluefield*. Rather, OMS states that the distinction was first included in the record during the hearing as part of the Presiding Judge's clarification question to Ms. Lapson. OMS contends that Complainants and supporting intervenors had no opportunity to include expert testimony in the record to address this new distinction and whether it is at all relevant to determining the cost of equity of MISO TOs. OMS states that Complainants and supporting intervenors could not have anticipated such issues being raised during the hearing because: (1) the DCF does not distinguish between "short-term" and "long-term" investors; and (2) there is no Commission precedent discussing the proposition that there is a difference between the results of the DCF study and the true cost of equity.

110. OMS states that the finding that the DCF analysis does not reflect the true cost of equity because it does not satisfy the requirements of the long-term investors was developed by the Presiding Judge who, according to OMS, appears to be uncertain himself about the validity of this theory.[253] OMS states that the Commission should not affirm rulings that rely on such equivocal findings. OMS states that there is no credible evidence in the record showing that investors no longer care about dividend growth and continue to invest in the utility stock just for the yield. Moreover, OMS contends that if the Presiding Judge's theory is credited, then the Presiding Judge contradicted himself in discarding as illogical two low-end results that exceeded the study-period Baa utility bond yield of 4.65 percent, but did so by less than 100 basis points.[254] OMS states that the basis of the standard 100 basis point screen is a finding that investors in utility stocks require appreciably more yield than utility bonds provide.[255]

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[253] *Id.* at 27 (citing Initial Decision, 153 FERC ¶ 63,027 at PP 216 (the total returns of proxy companies "are not necessarily" equivalent to their cost of equity), 218 (expectations of dividend growth "may" not be guiding investment decisions; investors "may" be purchasing stock only for the current yield; the proxy group stock prices "may" not reflect long-term investors satisfaction)).

[254] *Id.* at 27-28 (citing Initial Decision, 153 FERC ¶ 63,027 at PP 65, 158).

[255] *Id.* at 28 (citing Opinion No. 531, 147 FERC ¶ 61,234 at P 122 ("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.")).

111. OMS states that investor behavior belies any expectation of sharply increased interest rates. OMS states that MISO TOs' case is grounded on the proposition that investors are (and, during the study period, were) expecting an impending end to the capital market conditions that have prevailed for the past several years, once the Federal Reserve begins to normalize its post-recession monetary policies.[256] OMS states that MISO TOs also contend that investors expect a sharp rise in interest rates and bond yields – an expectation that renders the current conditions "anomalous." OMS argues that, while the Initial Decision accepts both premises of MISO TOs' case, there is a significant flaw in MISO TOs' theory. OMS contends that a fundamental assumption of the DCF method is that investors are rational actors who manifest their knowledge and expectation about the market through the prices they are willing to pay for stock. OMS states that if investors in utility stocks are expecting an imminent jump in interest rates due to Federal Reserve policy normalization, their rational response would be for them to sell those stocks before the increases in interest rates begin. If the expectation were sufficiently widespread and enough investors pursue the path of rational self-interest, OMS contends that utility stock prices would fall as shares are sold into the market, which would cause the dividend yields on those stocks to increase. But, OMS argues that the record evidence shows that simply has not happened. According to OMS, that yields on utility stocks have not increased implies that investors have elected not to sell their shares, a decision that can only mean that investors expect that the normalization of Federal Reserve monetary policy will be gradual and have little to no adverse impacts on the value of their holdings.[257]

112. OMS states that the Presiding Judge's finding that, during the study period, "many investors have expected that the Federal Reserve will normalize current market-capital conditions, and that interest rates will rise significantly over the next few years," is contradicted by evidence in the record.[258] OMS contends that the record demonstrates that, since the Federal Reserve ended its Quantitative Easing Program in October 2014, bond yields and interest rates changed very little.[259] OMS states that, contrary to the Presiding Judge's findings, the record shows that during the study period there was no clear consensus within the investment community as to what specific actions the normalization of Federal Reserve policy would entail, or what impact those actions might

[256] *Id.* at 20 (citing Initial Decision, 153 FERC ¶ 63,027 at P 222).

[257] *Id.* at 19-20.

[258] *Id.* at 16-17 (citing Initial Decision, 153 FERC ¶ 63,027 at P 222).

[259] *Id.* at 17 (citing Exh. S-1 at 63:21-22; Exh. JCI-1 at 27:9-14).

have on interest rates and bond yields. OMS states that, prior to or within the study period, the Federal Reserve reassured the investment community that any change in its accommodative monetary policy would not be drastic. OMS states the January 2015 minutes to the Federal Open Market Committee, cited by Ms. Lapson and included in the record, include a resolution to maintain the Federal Reserve policy of reinvesting principal payments from its holdings of agency debt and agency mortgage backed securities because maintaining a sizable level of long-term securities "should help maintain accommodative financial conditions."[260] OMS contends that, although the Presiding Judge interpreted the Federal Open Market Committee minutes to support a finding that investors expect interest rates to rise because the minutes indicate that "normalization" could start at any time, the minutes can just as easily be understood to say that, even if investors believed that a change in the Federal Reserve's accommodative monetary policies was a certainty and that it would lead to higher interest rates, investors also knew that any such policy changes (1) could take some time to implement, and (2) would likely be carefully measured (not dramatic or sudden) because the Federal Reserve also was charged with pursuing a set of important economic objectives that were tied to promoting recovery from the recent recession.

c. **Brief Opposing Exceptions**

113. MISO TOs argue that the record demonstrates the existence of anomalous capital market conditions affecting DCF inputs and results and ask the Commission to affirm the Initial Decision's finding of anomalous market conditions.[261] MISO TOs point to the fact that the Federal Reserve holds "massive amounts" of U.S. Treasury bonds and mortgage-backed securities. They argue that these holdings cause bond prices to spike and yields to decline and suppress the short-term federal funds target rate, which leads fixed-income investors to seek yield in higher risk assets, such as electric utility stocks. MISO TOs state that these circumstances result in utility equity price increases and yield decreases.[262] In response to arguments that investors were aware of the Federal Reserve's policies during the relevant period and that the capital market has effectively settled into a "new normal" and cannot be considered anomalous, MISO TOs argue that these arguments conflate the duration of anomalies with the existence of anomalies.[263]

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[260] *Id.* at 19-20 (citing Exh. S-10 at 20).

[261] MISO TOs Brief Opposing Exceptions at 7-8.

[262] *Id.* at 8.

[263] *Id.* at 9-10.

Further, MISO TOs assert that the fact that these conditions have persisted longer than anticipated does not undercut the Presiding Judge's conclusion that investors expect the Federal Reserve to normalize and for interest rates to eventually rise.[264]

114. MISO TOs further argue that the DCF model is not infallible and dispute arguments that the DCF model accurately estimates the cost of equity capital irrespective of prevailing capital market conditions. MISO TOs argue that, in Opinion No. 531-B, the Commission stated that "all methods of estimating the cost of equity are susceptible to error when the assumptions underlying them are anomalous."[265] MISO TOs argue that accepting the opposing parties' contrary arguments here would disregard the Commission's explicit instruction in the Hearing Order that the participants' evidence and DCF analyses conform to Opinion No. 531.[266]

115. Moreover, MISO TOs argue that the Presiding Judge demonstrated how anomalies can undermine a model's ability to accurately estimate a utility's cost of equity and raised sufficient doubt about the DCF results' reliability to compel examination of alternative benchmarks.[267] In response to arguments that the Presiding Judge's analysis "failed to prove distortion of DCF inputs or quantify their impact," MISO TOs argue that Opinion Nos. 531 and 531-B require no such standard of proof, only sufficient evidence to question the reliability of the DCF midpoint.[268] MISO TOs further state that the Presiding Judge noted that the DCF midpoint will not be just and reasonable if it does not appropriately represent utilities' risks.[269]

116. MISO TOs further note that the Presiding Judge's analysis clearly links capital market conditions and the DCF model and explains that *Hope* and *Bluefield*'s dual standards can only "be rationally applied" in the context of long-term investment decisions, since short-term investors have less interest in a utility's financial integrity and

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[264] *Id.* at 10.

[265] *Id.* at 11 (citing Opinion No. 531-B, 150 FERC ¶ 61,165 at P 50).

[266] *Id.* at 12 (citing Hearing Order, 149 FERC ¶ 61,049 at P 186).

[267] *Id.* at 12.

[268] *Id.* at 12.

[269] *Id.* at 13.

creditworthiness.[270] MISO TOs contend that the Presiding Judge found credible testimony that capital market anomalies have caused investors to deploy capital in ways inconsistent with the objectives and assumptions underlying *Hope* and *Bluefield* and the DCF model. This evidence attested that historically low interest rates available from conventional long-term investments are driving investors to better yielding, riskier alternatives, such as utility equities.[271] MISO TOs assert that, consequently, utilities' stock prices have risen and associated yields have declined.[272]

117. MISO TOs also respond to arguments that the Presiding Judge's analysis reflects an interpretation of *Hope* and *Bluefield* that is improperly applied to the DCF and arguments that the Presiding judge's findings cannot "be squared" with the correlation between the cost of debt and equity and the direction relationship between low interest rates, low dividend yields, high equity prices, and a low cost of equity.[273] MISO TOs argue that, in the context of establishing returns for regulated transmission owners, the concepts of capital attraction and financial integrity only have meaning in the long-term horizon as transmission assets take years to plan and construct and are often in service for decades.[274]

118. MISO TOs also take issue with attempts to marginalize the testimony of Ms. Lapson, arguing against the use of the midpoint DCF value by citing to opposing parties' own witnesses who acknowledge the effect of current capital market conditions on DCF inputs. MISO TOs argue, in short, that there is clear evidence that the Federal Reserve's historically unprecedented monetary policies have altered normal investment behavior.[275]

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[270] *Id.* at 14.

[271] *Id.* at 14.

[272] *Id.* at 14.

[273] *Id.* at 15 (citing Trial Staff Brief on Exceptions at 33-35).

[274] *Id.* at 16.

[275] *Id.* at 17.

d. Commission Determination

119. We affirm the Presiding Judge's conclusions, though we do not adopt the totality of his reasoning, concerning anomalous capital market conditions. For the reasons discussed below, we conclude that the record in this proceeding demonstrates the presence of unusual capital market conditions, such that we have less confidence that the central tendency of the DCF zone of reasonableness (the midpoint in this case) accurately reflects the equity returns necessary to meet *Hope* and *Bluefield*.

120. As the Commission found in Opinion No. 531, the DCF methodology, like all cost of equity estimation methodologies, "may be affected by potentially unrepresentative financial inputs" as a result of unusual economic conditions.[276] As Roger A. Morin states in his treatise, *New Regulatory Finance*,[277] "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." Therefore, it is reasonable, under those conditions, to consider the results of alternative methods for estimating the cost of equity when determining whether a mechanical reliance on the central tendency of the DCF-produced zone of reasonableness produces a just and reasonable ROE.[278] Our finding of anomalous market conditions does not, by itself, justify awarding an ROE above the central tendency of the DCF-produced zone of reasonableness. Rather, that finding supports a consideration of other cost of equity estimation methodologies in determining whether mechanically setting the ROE at the central tendency satisfies the capital attraction standards of *Hope* and *Bluefield*.

121. The record in this proceeding raises the same concerns regarding capital market conditions that the Commission identified in Opinion No. 531. Bond yields remained at historically low levels during the study period. For example, the yield on 10-year U.S. Treasury bonds, which the Commission noted in Opinion No. 531[279] was below

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[276] Opinion No. 531, 147 FERC ¶ 61,234 at P 41. *See also* Opinion No. 531-B, 150 FERC ¶ 61,165 at P 50 ("all methods of estimating the cost of equity are susceptible to error when the assumptions underlying them are anomalous").

[277] *New Regulatory Finance* 28 (Public Utilities Reports, Inc. 2006).

[278] *See, e.g.*, Opinion No. 531, 147 FERC ¶ 61,234 at P 145, *order on reh'g*, Opinion No. 531-B, 150 FERC ¶ 61,165 at P 50.

[279] Opinion No. 531, 147 FERC ¶ 61,234 at n.285.

two percent in that case and had not been below three percent since the 1950s, was at 2.07 percent[280] during the study period. Also, the yield on short-term U.S. Treasury bonds was historically low, ranging from zero to 0.25 percent.[281] Additionally, we note that, while the Federal Reserve has ended the Quantitative Easing program under which it was purchasing unprecedented levels of U.S. Treasury bonds and mortgage-backed securities,[282] the Federal Reserve continues to hold approximately $4.25 trillion[283] of those bonds, a level only slightly below recent record highs, and is reinvesting the principal payments from those holdings to purchase approximately $16 billion of mortgage-backed securities per month and rolling over the U.S. Treasury bonds at auction.[284] This record evidence is indicative of the same type of unusual capital market conditions that the Commission found concerning in Opinion No. 531. Parties point out that certain capital market conditions have changed since Opinion No. 531, including the winding down of Quantitative Easing, the slight increase in U.S. Treasury bond yields, the lower unemployment rate, and strong stock market performance. Though the Commission noted certain economic conditions in Opinion No. 531, the principal argument was based on low interest rates and bond yields, conditions that persisted throughout the study period. Consequently, we find that capital market conditions are still anomalous as described above, and, therefore, we disagree with Iowa Group's assertion that there is not substantial evidence to justify a potential adjustment.

122. Because the evidence in this proceeding indicates that capital markets continue to reflect the type of unusual conditions that the Commission identified in Opinion No. 531, we remain concerned that a mechanical application of the DCF methodology would result in a return inconsistent with *Hope* and *Bluefield*.[285] We conclude that the fact that these

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[280] *See* Exh. S-5 at 8.

[281] *See* Exh. MTO-16 at 22-23.

[282] *See id.* at 17-20.

[283] *See id*. at 18, 23.

[284] *See* Exh. MTO-1 at 22.

[285] Opinion No. 531 states:

> There is 'model risk' associated with the excessive reliance or mechanical application of a model when the surrounding conditions are outside of the normal range. 'Model risk' is the risk that a theoretical model that is used to value real-world transactions fails to

(continued...)

conditions have persisted over the approximately two years since the end of the study period adopted in Opinion No. 531 does not, in and of itself, mean that these conditions are not anomalous. Ms. Lapson describes the model risk associated with the reliance on mechanical application of a model and discusses how it is necessary to test model outcomes against other investment benchmarks as a check.[286] As the Commission found in Opinion No. 531, under these circumstances, we have less confidence that the midpoint of the zone of reasonableness in this proceeding accurately reflects the equity returns necessary to meet the *Hope* and *Bluefield* capital attraction standards.[287] We therefore find it necessary and reasonable to consider additional record evidence, including evidence of alternative 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 resulting midpoint.

123. Complainants and intervenors make a number of arguments against the Presiding Judge's determination that anomalous market conditions justify examining alternative methodologies and state-commission approved ROEs to assess whether the ROE should be placed in the upper half of the zone of reasonableness. Such arguments, discussed in more detail below, largely pertain to the Presiding Judge's reasoning, such as the distinction between short-term and long-term investors, reasoning that we do not adopt even though we reach the same conclusions. Additionally, because we base our conclusion on a different rationale than the Presiding Judge, we need not consider arguments regarding the Presiding Judge's consideration of evidence on which we do not rely.

124. Parties argue that the record does not support the Presiding Judge's finding that capital market conditions during the study period are anomalous, either generally or based on the Presiding Judge's definition of anomalous as "unprecedented and unsustainable." We do not adopt that definition so we do not need to consider those arguments here. As described above, evidence in the record regarding historically low interest rates and Treasury bond yields as well as the Federal Reserve's large and persistent intervention in markets for debt securities are sufficient to find that current capital market conditions are anomalous. Although the record indicates that there was a

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predict or represent the real phenomenon that is being modeled.

147 FERC ¶ 61,234 at n.6.

[286] *See* Exh. MTO-16 at 30-31.

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

past period of similarly low interest rates, it occurred more than sixty years ago. Similarly, while Complainants provide evidence that interest rates have been trending downwards, the current levels may be so low as to cause irregularities in the outputs of the DCF. Despite such yields remaining low for several years, we find that they are anomalous and could distort the results of the DCF model.

125. Parties also argue that MISO TOs have not presented evidence that the actions of the Federal Reserve directly affected DCF methodology results. Specifically, Trial Staff argues that there is no credible evidence that any of the DCF inputs have been distorted by purportedly anomalous capital market conditions. As described above, we find that the relevant anomalous capital market conditions cited in Opinion No. 531 are still present in this proceeding. Moreover, because the analytical approach we use here, and which we used in Opinion No. 531, gives us confidence that the resulting ROE satisfies the requirements of *Hope* and *Bluefield*, a direct causal analysis linking specific capital market conditions to particular inputs or assumptions in the DCF model is not necessary. Consistent with Opinion No. 531, we find that the DCF methodology is subject to model risk of providing unreliable outputs in the presence of unusual capital market conditions.[288] The Commission has not required a mathematical demonstration of how each anomalous capital market condition specifically distorts the DCF analysis and it is uncertain whether such an analysis is even possible given the complexities of capital markets and how various phenomena could affect the DCF methodology results.[289] For that reason, in the presence of anomalous capital market conditions, the Commission examines other evidence, namely the results of alternative methodologies and state-commission approved ROEs to assess the reasonableness of the results of the DCF methodology. We find that the record contains sufficient evidence of anomalous capital market conditions.

126. We also disagree with arguments regarding the lack of effect of Federal Reserve's actions, including OMS' assertion that the effect on capital market conditions of

[288] Opinion No. 531, 147 FERC ¶ 61,234 at n.286.

[289] While we do not adopt the Presiding Judge's rationale concerning the specific causal link between the anomalous capital market conditions and the results of the DCF model, we acknowledge that the Presiding Judge's rationale might have merit and our determination here is without prejudice to that rationale. However, given the difficulty of establishing a causal relationship between complex capital market conditions and the results of any particular financial model, we are not persuaded that the record evidence in this proceeding is adequate to definitively conclude that the Presiding Judge's rationale explains how the current capital market conditions are impacting the DCF model.

increases in the Federal Reserve's holdings of U.S. Treasury bonds has been more than counteracted by large increases in federal debt outstanding during the same period. OMS has provided no evidence showing that increases in the amount of U.S. Treasury bonds directly counteract and nullify the effect of direct capital market interventions by the Federal Reserve.[290] Similarly, no party has shown that other global events or investor behavior caused the anomalous capital market conditions. Again, the fact remains that capital market conditions are anomalous, such that mechanical application of the DCF methodology could produce unreasonable results.

127. Parties raise numerous objections to the Presiding Judge's distinction between short-term and long-term investors in finding that the midpoint ROE produced by the application of the DCF methodology is insufficient. Because we do not adopt this element of the Presiding Judge's reasoning, we need not respond to these objections. Instead, we find that where anomalous market conditions give us reason to have less confidence in DCF methodology outputs, it is reasonable to consider alternative methodologies and state-commission approved ROEs in determining a just and reasonable ROE. Our not adopting this reasoning also renders moot assertions regarding a contradiction between finding that short-term investors require lower returns and maintaining the 100-basis point low end screen in the DCF methodology.

128. Complainants are correct that the record does not contain evidence that economic conditions have "negatively impacted" the ability of MISO TOs to raise capital.[291] MISO TOs have been raising capital successfully with a 12.38 percent ROE, which we determine here is excessively high. However, MISO TOs bear no obligation to demonstrate difficulty raising capital in excess of the ROE adopted by the Initial Decision. Furthermore, there is record evidence that a decrease in ROE of that magnitude – a 309 basis point reduction from 12.38 percent to 9.29 percent –could undermine the ability of MISO TOs to attract capital for new investment in electric transmission.[292]

[290] Further, we note that, even if more U.S. Treasury bonds are available, the low interest rates in the record are equally applicable to those bonds.

[291] Complainants Brief on Exceptions at 33.

[292] Exh. MTO-1 at 7. For example, Ms. Lapson pointed out a June 11, 2013 Wolf Research paper that stated "Material reductions in the base ROE could lower the quality of and divert capital away from the transmission business, given its generally riskier profile than that for state-regulated utility businesses, such as distribution and generation. Moreover, investors could deploy capital to infrastructure projects with higher allowed

(continued...)

129. Parties also argue that, because the impending rise of interest rates will not happen suddenly or soon, the returns provided by the midpoint of the DCF analysis are sufficient. They also argue that rational investors would not invest in assets that are assumed to be likely to lose value soon. Such arguments are inapplicable to the rationale adopted in this order. Our reasoning, unlike the Presiding Judge's, does not rely on assessing investor expectations of the specific timing of potential interest rate increases that could affect utilities' future ability to raise capital. We do not find that the ROE needs to be sufficient for when interest rates increase. Similarly, we are not finding that investors are necessarily making investments without considering the potential effects on stock valuation of likely future interest rate increases. Rather, we find that current capital market conditions may cause the mechanical application of the DCF methodology to produce an ROE that does not meet the requirements of *Hope* and *Bluefield*.

130. Similarly, we disagree with Iowa Group's argument that any upward adjustment represents an improper attempt to "normalize" the DCF results to reflect normal capital market conditions. Any finding of anomalous capital market conditions and subsequent adjustments represents an attempt to counteract imprecision in the DCF model caused by capital market conditions and not a results-oriented attempt to raise the ROE to what it more typically is.

131. Trial Staff and others also argue that, if and when capital market conditions change, MISO TOs can request an increase in their effective ROE. As described above, anomalous market conditions may skew the current outputs of the DCF methodology, such that the mechanical application of the DCF methodology could provide an unjust and unreasonable ROE. Subsequent requests for rate increases would not address this shortcoming. The Commission also addressed this argument in Opinion 531-B where it found that transmission owners' "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*."[293]

132. We also disagree with arguments that the DCF methodology fully incorporates available information and investor expectations such that capital can be raised as inexpensively as the DCF results suggest. We find that such an outcome may not be the case due to model risk inherent in the DCF methodology in the presence of unusual market conditions. The finding that mechanical application of the DCF methodology

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returns, such as Commission-regulated natural gas pipelines, or to other industries generally."

[293] Opinion No. 531-B, 150 FERC ¶ 61,165 at P 50.

may produce results inconsistent with *Hope* and *Bluefield* in certain circumstances is not inconsistent with the efficient market theory underlying the typical application of the DCF methodology in normal circumstances. Thus, consistent with the rationale explicated in Opinion No. 531, we disagree with Joint Customer Intervenors' assertion that the Presiding Judge erred in questioning the reliability of the DCF methodology in this proceeding based on the sources of information employed by this methodology.

133. We disagree with Joint Customer Intervenors' contention that the findings of the Presiding Judge in the Entergy Initial Decision are relevant to the ROE determination in this proceeding. Regardless of the timing of the study period in that proceeding, the findings in an initial decision, unless affirmed by the Commission, are not precedential.

134. We also disagree with Iowa Group's contention that any finding of anomalous capital market conditions and potential subsequent upward adjustment of the ROE is a "default" policy. In each proceeding, the Commission will evaluate the facts during the relevant period to determine whether capital market conditions are unusual and, if so, the Commission will consider alternative benchmark methodologies and state commission-approved ROEs as additional evidence that might suggest that a mechanical application of the DCF results in an ROE insufficient to satisfy the requirements of *Hope* and *Bluefield*.[294] We also disagree with Iowa Group's assertion that there is no evidence that anomalous market conditions apply equally to DCF inputs from each member of the proxy group. This argument implies that MISO TOs would need to provide detailed studies of the effects of capital market conditions for each member of the proxy group, which would be unduly burdensome, if not impossible. Moreover, such a showing is unnecessary since capital market conditions apply across the entire economy and are not specific to individual utilities.

135. MISO TOs presented three alternative methodologies for estimating the cost of equity in this proceeding: a risk premium analysis, a capital asset pricing model (CAPM) analysis, and an expected earnings analysis. These alternative methodologies are the same ones that the Commission relied upon in Opinion No. 531 to corroborate the Commission's determination that a mechanical application of the DCF methodology results in an ROE that does not satisfy *Hope* and *Bluefield*. MISO TOs' risk premium analysis based upon Commission-authorized ROEs indicates that the Operating Companies' cost of equity is 10.36 percent.[295] MISO TOs' CAPM analysis produces a midpoint cost of equity estimate of 10.06 percent once an adjustment for the effect of

[294] *See* Opinion No. 531, 147 FERC ¶ 61,234 at P 145.

[295] Exh. MTO-29 at 1.

firm size is made.[296] MISO TOs' expected earnings analysis produces a midpoint ROE range of 11.99 percent. Thus, all three alternative methodologies produce cost of equity estimates substantially in excess of the 9.29 percent midpoint of the zone of reasonableness produced by the DCF analysis in this case. As the Commission did in Opinion No. 531, we find that these analyses are informative and corroborate our decision to place MISO TOs' ROE at the central tendency of the upper half of the zone of reasonableness produced by our DCF analysis of the proxy group companies, rather than the midpoint.

136. In addition, the record indicates that all of the current state ROEs exceeded the 9.29 percent midpoint of the DCF zone of reasonableness in this case. The midpoint of the current state ROEs is 9.95 percent.[297] As the Commission explained in Opinion No. 531, in situations where our DCF methodology produces ROEs below those approved at the state level, for functions that are riskier than the state-regulated functions, such a relationship might indicate that a mechanical application of the DCF methodology with the use of the central tendency of the resulting zone of reasonableness will not satisfy the requirements of *Hope* and *Bluefield*.

137. As the Commission found in Opinion No. 531, in considering these other methodologies and the ROEs allowed by state commissions, we do not depart from our use of the DCF methodology; rather, due to the presence of unusual capital market conditions, we find it appropriate to look to other record evidence to inform the just and reasonable placement of the ROE within the zone of reasonableness produced by the DCF methodology.[298] Below, we address the participants' arguments against each of MISO TOs' alternative ROE methodologies.

2. <u>CAPM</u>

138. Investors use CAPM analysis as a measure of the cost of equity relative to risk.[299] The CAPM methodology is based on the theory that the market-required rate of return for a security is equal to the risk-free rate, plus a risk premium associated with the specific

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[296] *See* Exh. MTO-1 at 95:9-18.

[297] Exh. MTO-42 at 1-2. *See* Exh. MTO-16 at 52-56. Ms. Lapson eliminated a Base ROE of 10.95 percent as an outlier.

[298] Opinion No. 531, 147 FERC ¶ 61,234 at P 146.

[299] *Id.* P 147.

security. Specifically, the CAPM methodology determines the cost of equity by taking the "risk-free rate" and adding to it the "market-risk premium" multiplied by "beta."[300] The risk-free rate is represented by a proxy, typically the yield on 30-year U.S. Treasury bonds.[301] Betas, which are published by several commercial sources, measure a specific stock's risk relative to the market. The market risk premium is calculated by subtracting the risk-free rate from the expected return. The expected return can be estimated either using a backward-looking approach, a forward-looking approach, or a survey of academics and investment professionals.[302] A CAPM analysis is backward-looking if the expected return is determined based on historical, realized returns.[303] A CAPM analysis is forward-looking if the expected return is based on a DCF study of a large segment of the market.[304] Thus, 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.[305]

139. In this proceeding, MISO TOs submitted a forward-looking CAPM analysis of each company in the proxy group using the 2.7 percent 30-year U.S. Treasury bond yield for the risk-free rate, beta values for each proxy company reported by Value Line, and a market risk premium based on a DCF study of all dividend-paying companies in the S&P 500.[306] In that DCF study, MISO TOs added the weighted average dividend of those companies (2.4 percent) to the average of the weighted average growth rates projected for the companies by IBES and Value Line (8.9 percent). This resulted in a uniform cost of equity for the dividend-paying companies in the S&P 500 of 11.3 percent. The MISO TOs then subtracted from that figure the 2.7 percent risk-free rate to obtain a risk premium of 8.6 percent. The MISO TOs multiplied this risk premium by the beta listed for each proxy company by Value Line and added the risk-free rate to that

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

[301] *Id.* at 151.

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

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

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

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

[306] Exh. MTO-1 at 97-98.

product. This CAPM analysis produces an unadjusted ROE range of 7.86 percent to 10.87 percent for the proxy group, with a midpoint value of 9.37 percent.

140. However, after adjusting for the effect of each proxy company's size, MISO TOs' CAPM analysis produced an ROE range of 7.50 percent to 12.61 percent, with a midpoint value of 10.06 percent.[307] MISO TOs' witness, Dr. Avera, explained that the "size adjustment reflects the fact that differences in investors' required rate of return that are related to firm size are not fully captured by beta."[308] Dr. Avera based his size adjustments on data contained in a table published in Morningstar Inc.'s (Morningstar) "2015 Ibbotson SBBI Market Report." The table adjusts each proxy company's cost of equity based on its size, reducing the unadjusted cost of equity of larger companies, while increasing those of smaller companies.[309]

a. Initial Decision

141. The Presiding Judge determined that the CAPM model offered by Dr. Avera was credible and supported allowing MISO TOs to earn a base ROE above the 9.29 percent midpoint of the zone of reasonableness.[310] The Presiding Judge explained that Dr. Avera's model was "substantially similar" to the CAPM that the Commission found useful in determining the placement of the base ROE in Opinion No. 531. The Presiding Judge rejected Mr. Gorman's contention that the growth rate used for the DCF analysis in Dr. Avera's CAPM was unsustainable and should be based, at least in part, on long-term growth rates, noting that the Commission had rejected this argument in Opinion No. 531-B on the grounds that the long-term growth rate does not necessarily apply to a curated set of large companies, like those included in the S&P 500. The Presiding Judge also rejected Mr. Gorman's arguments that Morningstar does not make size adjustments for companies with betas of less than 1.0, including public utilities, concluding that these arguments were not born out by the Morningstar data.[311]

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[307] Initial Decision, 153 FERC ¶ 63,027 at P 264 (citing Exh. MTO-30 at 1).

[308] Exh. MTO-1 at 98.

[309] Exh. MTO-30 at 1.

[310] Initial Decision, 153 FERC ¶ 63,027 at P 313.

[311] *Id.* PP 268-269.

142. The Presiding Judge also rejected Mr. Gorman's contention that, based on the utility industry's low beta, Morningstar also makes a downward "industry premium" adjustment that offsets any upward adjustment for size.[312] Mr. Gorman contended that Morningstar's SBBI 2013 Valuation Yearbook recommends an industry premium, as well as a size adjustment. Mr. Gorman stated that Morningstar recommends a negative industry premium adjustment for the electric-utility industry of between 3.4 percent and 4.09 percent. However, the Presiding Judge found that, on cross-examination, Mr. Gorman admitted that the Morningstar industry premium to which he referred was used for its "buildup method" of estimating cost of equity, and is not used to develop a CAPM.

143. The Presiding Judge also rejected the CAPM analysis advanced by Mr. Gorman and Mr. Hill, noting that it differed in several material respects from the CAPM that Commission relied upon in Opinion No. 531. The Presiding Judge noted, for instance, that this analysis did not use forward-looking data for its risk premium, nor did it use the 30-year U.S. Treasury bonds as its proxy for the risk-free rate of return, and that this analysis made no effort to adjust for the capitalization of the companies considered.[313]

144. The Presiding Judge also rejected, as inconsistent with Opinion Nos. 531 and 531-B, arguments by Mr. Hill that Dr. Avera's model was invalid because it considered historical data and because it did not consider long-term growth rates.[314] The Presiding Judge also rejected Mr. Hill's criticism of Dr. Avera's size-based adjustments to the risk premium, concluding that they "fail[ed] to grasp, much less address, the rationale underlying the size adjustment."[315] The Presiding Judge also elected not to rely on Mr. Hill's CAPM on the grounds that it was partly backward looking, in contrast to the CAPM relied upon by the Commission in Opinion No. 531, and also because it addressed stock price appreciation rather than earnings growth and failed to adjust for the companies' market capitalization, which, as noted, is required by the CAPM model.[316]

145. The Presiding Judge also rejected the Joint Consumer Advocates' critiques of Dr. Avera's methodology, which were based largely on the testimony of Mr. Solomon,

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[312] *Id.* PP 270-271.

[313] *Id.* PP 280-283.

[314] *Id.* PP 284-286.

[315] *Id.* P 290.

[316] *Id.* PP 294-297.

concluding that they were inconsistent with the Commission's reliance on a CAPM model in Opinion Nos. 531 and 531-B. In particular, the Presiding Judge noted that Mr. Solomon's critiques would have excluded companies that the Commission in Opinion No. 531-B found appropriate to include in the CAPM model.[317]

146. Finally, the Presiding Judge rejected Mr. Keyton's critiques of Dr. Avera's CAPM. The Presiding Judge concluded that Mr. Keyton's arguments regarding the sustainability of the growth the rates and the measure of a risk-free return used by Dr. Avera were effectively rejected by the Commission in Opinion No. 531-B, substantially for the reasons stated above.

b. <u>Briefs on Exceptions</u>

147. Complainants and other parties contend that the Presiding Judge erred by accepting Dr. Avera's CAPM analysis despite evidence demonstrating that flaws in the analysis render the results unreliable.[318] Complainants explain that Mr. Gorman proposed certain adjustments to correct Dr. Avera's CAPM analysis, such as replacing the size premium adjustment with an industry premium adjustment.[319] Complainants explain that the Presiding Judge stated that "Mr. Gorman failed to demonstrate that [the Morningstar] analysis is inappropriate for utilities."[320] Complainants state that the Presiding Judge appears to have misunderstood Mr. Gorman's proposal, which argues that Morningstar recognized that there are differences in risk that are not captured by the beta attributable to the industry in which a company operates.[321]

148. Complainants state that the Presiding Judge misunderstands Opinion No. 531 and Morningstar's methodology. Complainants aver that the Opinion No. 531 proceeding did not include evidence involving the industry risk premium and Morningstar's broad

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[317] *Id.* PP 298-303.

[318] Complainants Brief on Exceptions at 48-51; Joint Customer Intervenors Brief on Exceptions at 43-47; OMS Brief on Exceptions at 33-37; Trial Staff Brief on Exceptions at 42-44.

[319] Complainants Brief on Exceptions at 48 (citing Exh. JC-9 at 20-22 (stating that an industry premium adjustment for the electric utility industry would be negative)).

[320] *Id.* at 49 (citing Initial Decision, 153 FERC ¶ 63,027 at P 281).

[321] *Id.* (citing Exh. JC-9 at 20-21).

variation of the CAPM model to reflect firm size and industry risk. Complainants argue that Morningstar does not limit its risk return criteria to only a size adjustment, and instead uses all available and applicable information to accurately adjust the CAPM to reflect investment risk.[322] Complainants state that the Presiding Judge erred by concluding that the buildup method is not a variation of CAPM, and assert that Morningstar undertakes multiple adjustments from the base CAPM to account for both a size adjustment and an industry risk premium.[323]

149. Trial Staff states that Dr. Avera's CAPM calculation arrives at the weighted average growth rates projected for all dividend-paying companies on the S&P 500 through the use of both IBES and Value Line. Trial Staff further states that the Presiding Judge found that in Opinion No. 531, "the Commission found a CAPM using a format substantially similar to that used by Dr. Avera in this case to be a useful guide in determining the placement of the Base ROE," and that "Dr. Avera's CAPM is credible and supports allowing the MISO TOs' to collect a Base ROE above the Midpoint."[324] Trial Staff asserts, however, that this finding is in error because Dr. Avera's CAPM calculation in the Opinion No. 531 proceeding used only IBES growth rate projections.[325] Trial Staff states that Dr. Avera's CAPM calculation in the instant proceeding is contrary to the Commission's stated preference, which the Presiding Judge acknowledges in his Initial Decision, to use IBES as the source for growth rates and to use only one source for growth rates in a given calculation.[326] Trial Staff asserts that Opinion No. 531 leaves no doubt that it is "inappropriate to use estimates from different sources for different proxy group companies."[327] Trial Staff asserts that Dr. Avera's use of both IBES and Value Line data contradicts the Presiding Judge's finding in the Initial Decision that use of

[322] *Id.* at 49-50 (citing Exh. JC-9 at 21-22).

[323] *Id.* at 49-50.

[324] Trial Staff Brief on Exceptions at 42 (citing Initial Decision, 153 FERC ¶ 63,027 at PP 310-311).

[325] *Id.* (citing Opinion No. 531-B, 150 FERC ¶ 61,165 at P 110 ("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")).

[326] *Id.* at 43 (citing Initial Decision, 153 FERC ¶ 63,027 at P 43).

[327] *Id.* at 44 (citing Opinion No. 531, 147 FERC ¶ 61,234 at P 90).

IBES alone is appropriate for growth rate projections used in the Commission's DCF analysis in this proceeding.[328]

150. Trial Staff argues that the Presiding Judge incorrectly concluded that (1) the beta component of the CAPM risk-premium calculation "serves to mitigate any differences" between the divergent growth rates used in Dr. Avera's CAPM and DCF analyses, and (2) the beta component of the CAPM "serves the same purpose as the long-term growth rate component" of the DCF.[329] Trial Staff argues that beta measures risk (i.e., the variability of expected returns) and is a different concept than a sustainable growth rate, which measures a firm's long-term expansion. Trial Staff, therefore, asserts that it is not possible for beta to mitigate an unsustainable growth rate or serve the same purpose as the long-term growth rate.[330]

151. Joint Customer Intervenors state that Dr. Avera used a 9 percent market risk premium instead of the independently-published Morningstar market risk premium of 6.2 percent.[331] Joint Customer Intervenors assert that had Dr. Avera used Morningstar's 6.2 percent market risk premium, his midpoint unadjusted ROE would have been just 7.5 percent.[332]

152. Joint Customer Intervenors assert that Dr. Avera inappropriately adjusted the theoretical construct based on his contentions that "financial research indicates that the CAPM does not fully account for observed differences in rates of return attributable to firm size" and that "empirical tests of the CAPM have shown that low-beta securities earn returns somewhat higher than the CAPM would predict, and high-beta securities earn somewhat less than predicted."[333] According to Joint Customer Intervenors,

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[328] *Id.* at 43-44.

[329] *Id.* at 44 n.84 (citing Initial Decision, 153 FERC ¶ 63,027 at P 305).

[330] *Id.* n.84.

[331] Joint Customer Intervenors Brief on Exceptions at 44 (citing Exh. MTO-1 at 97).

[332] *Id.* (citing Exh. JCI-4 at 45:11-13).

[333] *Id.* at 44-45 (citing Exh. MTO-1 at 113).

Dr. Avera's adjustments increased the CAPM-derived midpoint ROE from 9.53 percent to 10.24 percent.[334]

153. Joint Customer Intervenors state that Mr. Solomon noted that the Commission has previously rejected the use of the CAPM methodology because its beta does not fully capture and differentiate risks of common stocks, and argued that CAPM results are thus unreliable and should not be used. Joint Customer Intervenors assert that the Presiding Judge did not address the merit of this argument.[335]

154. Joint Customer Intervenors note that the Presiding Judge found that Dr. Avera's "decision to include only . . . short-term growth components inevitably skews his zone of reasonableness upward."[336] Joint Customer Intervenors contend that this finding indicates that for a DCF study of non-utility companies to produce a reasonable result, a second-stage growth rate must also be included. Joint Customer Intervenors argue, however, that Dr. Avera failed to apply a second-stage growth rate, which the Commission found necessary in Opinion No. 531. Joint Customer Intervenors state that the Presiding Judge recognized that the Commission reasoned in Opinion No. 531-B that "[w]hile 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."[337] Joint Customer Intervenors argue, however, that Dr. Avera's CAPM analysis did not use a stock index; rather it used a fixed portfolio of approximately 400 stocks picked *ex ante*. Moreover, Joint Customer Intervenors assert that the Presiding Judge effectively conceded that each company in that portfolio will see its growth trend towards the long-term GDP growth rate and, therefore, the portfolio as a whole must likewise trend towards the long-term GDP growth rate. Joint Customer Intervenors explain that the beta component of CAPM is a measure of stock volatility, and disagree with the Presiding Judge's finding that the "beta component serves the same purpose of the long-term growth-rate . . . ."[338]

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[334] *Id.* at 45 (citing Exh. JCI-4 at 45:17-19; Exh. MTO-7 at 1).

[335] *Id.* at 44 (citing Exh. JCI-4 at 45:22-46:11).

[336] *Id.* at 45-46 (citing Initial Decision, 153 FERC ¶ 63,027 at P 328).

[337] *Id.* at 46 (citing Initial Decision, 153 FERC ¶ 63,027 at PP 267 & 304; Opinion No. 531-B, 150 FERC ¶ 61,165 at P 113).

[338] Joint Customer Intervenors Brief on Exceptions at 46-47 (citing Initial

(continued...)

155. Joint Customer Intervenors state that Dr. Avera's approach relies on a DCF analysis of approximately 400 dividend-paying companies culled from the S&P 500. Joint Customer Intervenors contend that, if the Commission has concerns about the accuracy of the DCF methodology employing a proxy group of electric utilities, it makes even less sense to depend on an aggregation of dividend-paying companies in the S&P 500. According to Joint Customer Intervenors, dividends are less important and less reliable for S&P 500 companies when compared to electric utilities, which have been known as relatively low risk, income-producing investments.[339]

156. OMS states that Dr. Avera's CAPM study for the instant proceeding, which incorporates Value Line growth estimates, differs materially from his CAPM study cited in Opinion No. 531, which relied on growth rates taken from Yahoo! Finance's reporting of IBES estimates.[340] OMS asserts that Value Line growth estimates are substantially backward-looking, and notes that the Initial Decision found Value Line to be inferior in a separate passage.[341]

157. OMS argues that the Presiding Judge erred by treating beta as a substitute for second-stage growth. OMS states that beta is a measure of volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole.[342] OMS states that, while the beta for utility stock consistently averages well below 1.0, exceptions in which a utility stock's beta exceeds 1.0 and thus increases that proxy's CAPM result, are Common.[343] OMS states that the second-stage growth rate, on the other hand, is

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Decision, 153 FERC ¶ 63,027 at P 305).

[339] *Id.* at 45.

[340] OMS Brief on Exceptions at 37 (citing Opinion No. 531-B, 150 FERC ¶ 61,165 at P 110; Exh. MTO-30 at 1, note (b)).

[341] *Id.* (citing Initial Decision, 153 FERC ¶ 63,027 at PP 48-49).

[342] OMS Brief on Exceptions at 36 (citing Andrew J. Cueter, *Using Beta* (Oct. 2012), http://www.valueline.com/Tools/Educational_Articles/Stocks/Using_Beta.aspx#.Vp5VhZorJaQ).

[343] *Id.* at 36 (citing Richard A. Michelfelder and Panayiotis Theodossiou, *Public Utility Beta Adjustment and Biased Costs of Capital in Public Utility Rate Proceedings* (Nov. 2013), at 60, 66 (showing in Figure 1 that the top decile of utility betas exceeded 1.0 for some years and the highest utility beta exceeded 1.0 in most years)).

necessary to incorporate the effect of changes in the general economy (as represented by GDP growth) in forecasting the long-term growth of an individual company or group of companies. According to OMS, the second-stage growth rate is part of getting to a reliable number for the expected long-term return on a fully diversified equity portfolio – an essential ingredient for a CAPM study to produce any sort of useful result. OMS argues that to equate beta and the second-stage growth rate because in this particular instance "[e]ach serves to lower the top of the zone of reasonableness" is not well-reasoned.[344]

158. OMS states that the growth component of the portfolio return calculation used by Dr. Avera weighted short-term growth rates forecasted by IBES and Value Line at 100 percent, thereby assuming that the growth rates over the next five years will continue forever. OMS asserts that this premise is implausible and flies in the face of the Commission's determination in Opinion No. 531 to use a weighted average of short and long-term growth rates in its two-step DCF analysis. OMS states that the failure to incorporate a blended growth rate is the precise reason the Presiding Judge rejected Dr. Avera's DCF study of non-utility companies, wherein the Presiding Judge observed that "[Dr. Avera's] decision to include only dividend yields and short-term growth components inevitably skews his zone of reasonableness upward."[345] OMS argues that it is arbitrary and capricious for the Initial Decision to reject one of Dr. Avera's studies for its failure to incorporate long-term growth rates, while adopting another that suffers from precisely the same flaw.[346]

159. OMS acknowledges that Opinion No. 531-B rejected arguments that the Commission erred by adopting a CAPM formulation that failed to include a second-stage growth rate. OMS states that, consistent with Opinion No. 531-B, the Presiding Judge held that "[w]hile an individual company cannot be expected to sustain high short-term growth rates into 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."[347]

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[344] *Id.* at 36-37 (citing Initial Decision, 153 FERC ¶ 63,027 at P 305).

[345] OMS Brief on Exceptions at 34 (citing Initial Decision, 153 FERC ¶ 63,027 at P 328).

[346] *Id.*

[347] *Id.* at 35 (citing Initial Decision, 153 FERC ¶ 63,027 at P 304 (quoting Opinion No. 531-B, 150 FERC ¶ 61,165 at P 113)).

OMS contends, however, that such reasoning makes no more sense in the Initial Decision than it did before.[348]

160. OMS states that, in rejecting Dr. Avera's non-utility DCF analysis for its failure to incorporate a second-stage growth factor, the Presiding Judge implicitly recognized that, over time, each individual company in Dr. Avera's portfolio will see its growth rate trend downward toward the long-term GDP growth rate. OMS asserts that, if each company in the portfolio will see its growth rate trend toward the GDP growth rate, so also will the portfolio as a whole. OMS, therefore, contends that the CAPM calculation is illogical and indefensible.[349]

161. OMS asserts that the rationale, as stated in Opinion No. 531 and adopted by the Initial Decision, simply does not apply. OMS explains that the portfolio Dr. Avera used in his CAPM study was not the S&P 500 itself, with a constantly updated cast of high-capitalization companies; rather, it was a fixed portfolio of 400 stocks. OMS stresses that the 400 stock portfolio will not be "regularly updated" to include only companies with high market capitalizations.[350]

c. <u>Briefs Opposing Exceptions</u>

162. MISO TOs contend that the Presiding Judge correctly accepted Dr. Avera's CAPM analysis and correctly found that this analysis supports establishing a base ROE above the midpoint. MISO TOs argue that the arguments raised by Complainants, Joint Customer Intervenors, and OMS were all considered and rejected in Opinion No. 531-B and thus were appropriately rejected, implicitly or explicitly, in the Initial Decision.[351] MISO TOs state that Opinion No. 531-B analyzed and found meritless arguments critical of Dr. Avera's CAPM analysis because Dr. Avera (1) performed a DCF study on the S&P 500, (2) employed a size adjustment, (3) did not employ a long-term growth component, and (4) relied on betas based on historical data as a risk measure.[352]

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[348] *Id.*

[349] *Id.* at 35-36.

[350] *Id.* at 35.

[351] MISO TOs Brief Opposing Exceptions at 28.

[352] *Id.* at 28-29.

163. MISO TOs argue that Complainants' advocacy for Mr. Gorman's CAPM analysis does not withstand scrutiny because Mr. Gorman's CAPM market premium is not based on a DCF analysis or any other forward-looking approach. MISO TOs assert that Mr. Gorman's use of Morningstar's buildup method is distinct from, and not used in, the CAPM methodology.[353] Furthermore, MISO TOs state that the publication on which Mr. Gorman relied only applies an industry-based adjustment factor to the buildup method of estimating risk premiums and not to the well-established CAPM that Dr. Avera employed and that the Commission accepted in Opinion No. 531.[354]

164. With regard to Trial Staff's objections to Dr. Avera's use of both IBES and Value Line growth rate estimates in his CAPM analysis, MISO TOs assert that the Presiding Judge cited Dr. Avera's CAPM analysis for the limited purpose of informing placement of the base ROE within the zone of reasonableness. MISO TOs argue that the Presiding Judge did not explicitly find that only IBES growth rate data are acceptable for purposes of applying the DCF model.[355]

d. <u>Commission Determination</u>

165. We affirm the Presiding Judge's findings that the MISO TOs' witness, Dr. Avera, properly performed his CAPM analysis and that the CAPM methodology supports the Commission's determination that the mechanical application of the DCF methodology results in an ROE that is inconsistent with *Hope* and *Bluefield*.

166. With regard to MISO TOs' size premium adjustment, the Commission stated in Opinion No. 531-B that the use of such an adjustment was "a generally accepted approach to CAPM analyses."[356] The Commission explained that "[t]he purpose of the . . . 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."[357] Moreover, Mr. Gorman acknowledged that Morningstar proposes to add a size premium adjustment to the CAPM return because

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[353] *Id.* at 29 (citing Complainants Brief on Exceptions at 48-51).

[354] *Id.* at 29-30 (citing Initial Decision, 153 FERC ¶ 63,027 at P 271).

[355] *Id.* at 31.

[356] Opinion No. 531-B, 150 FERC ¶ 61,165 at P 117.

[357] *Id.* P 117.

research suggests that systematic risk for small companies may not be completely reflected in the company's beta.[358] While Mr. Gorman asserted that Morningstar uses portfolios with a beta greater than one and the national proxy group has a beta less than one,[359] he does not explain how or why that fact would produce overstated results that would bar MISO TOs from making a size premium adjustment. Indeed, nothing in the record supports the notion that there is a correlation between beta and the size premium adjustment used by MISO TOs. As such, we are not persuaded by Complainants' and Joint Customer Intervenors' assertions that the size premium adjustment that is used by Morningstar cannot be used by MISO TOs.[360] For these reasons, we reject Complainants' argument that the size premium adjustment is flawed.

167. With regard to Complainants' proposed industry premium adjustment, the primary issue is whether it should be included in CAPM analyses or it should be limited to Morningstar's buildup method of determining the cost of equity. Complainants assert that the buildup method is a variation of CAPM. However, a thorough examination of Morningstar's buildup method reveals that the underlying formula differs from the generally accepted CAPM formula.[361] Indeed, the buildup method formula used by Morningstar does not consider beta, a fundamental input used in CAPM analyses. Therefore, as an initial matter, we affirm the Presiding Judge's conclusion that Mr. Gorman has failed to demonstrate that Morningstar's use of an industry premium adjustment in its buildup method has any relevance to CAPM analyses.[362]

168. Nevertheless, Complainants assert that an industry premium adjustment to the CAPM analysis is necessary. Therefore, they bear the burden of demonstrating that the inclusion of this adjustment is appropriate. Morningstar explains that the industry premium "measures how risky the industry is in relation to the market as a whole,

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[358] Exh. JC-9 (corrected) at 20-21.

[359] *Id.* at 20.

[360] *See* Initial Decision, 153 FERC ¶ 63,027 at P 281.

[361] Exh. MTO-59 at 6 (the buildup method formula used by Morningstar is as follows: Cost of Equity Estimate = Riskless Rate + Equity Risk Premium + Industry Risk Premium + Size Premium). For comparison, the CAPM formula is as follows: Required return = Risk-free Rate + Beta x (Expected Return – Risk-free Rate). *See* Initial Decision, 153 FERC ¶ 63,027 at P 259 (citing Exh. JC-9 at 41:2-10).

[362] *See* Initial Decision, 153 FERC ¶ 63,027 at P 271.

regardless of size."[363] As discussed above, beta, like the industry risk premium, is a measure of risk relative to the market. We note that every company in the national proxy group has a beta of less than one.[364] From that, we conclude that the betas already reflect the fact that the proxy group companies are low risk relative to the market generally. Accordingly, because the betas already reflect the relative risk of the industry, we conclude that it would be inappropriate to add an industry risk premium to the CAPM analyses.

169. Trial Staff argues against the use of Value Line growth rates in MISO TOs' CAPM analysis. While the Commission has found that Value Line's growth rate estimates are not acceptable as the short-term consensus growth rate input for the two-step DCF model, the Commission has nevertheless found that Value Line is a valid source of general financial data. In the instant CAPM analysis, the Value Line data is used in conjunction with IBES data and both are averaged over a 400-company data set. This use of growth rate data is fundamentally different from how growth rate data is used in our DCF model, because it is intended to provide a less precise cost of equity estimate than the DCF model. Although we require more precision from our DCF model—as the primary financial model that we use, and have used for decades, to determine public utility ROEs—that same degree of precision is less essential in the CAPM analysis because that analysis is but one of multiple pieces of evidence corroborating the results of our DCF analysis. Furthermore, no party demonstrated that the Value Line growth rate estimates for dividend-paying S&P 500 companies are unreasonably high or low, or that reliance on IBES growth rate estimates alone would produce a materially different CAPM result using data from the study period. For these reasons, we conclude that MISO TOs' use of both IBES and Value Line growth rate estimates in their CAPM analysis is reasonable for purposes of corroborating the results of the DCF analysis.

170. While we agree with Trial Staff, Joint Customer Intervenors, and OMS that beta does not serve the same function as the long-term growth rate component of the DCF,[365] we note that a long-term growth rate component is not required in the DCF study used to develop the market risk premium for MISO TOs' CAPM analysis. As the Commission explained in Opinion No. 531-B, the rationale for requiring a two-step DCF methodology that incorporates a long-term growth rate input when conducting a DCF study on a specific group of public utilities does not necessarily apply when conducting a DCF study

[363] Exh. MTO-59 at 4.

[364] *See* Exh. MTO-30 at 1-2.

[365] Trial Staff Brief on Exceptions at 44 n.84.

of the companies in the S&P 500. While it is often unrealistic and unsustainable for high short-term growth rates for an individual company to continue in perpetuity, the S&P 500 is regularly updated to only include companies with high market capitalization.[366] Joint Customer Intervenors and OMS argue that this rationale does not apply because MISO TOs did not rely on the S&P 500 index, but instead studied approximately 400 dividend-paying companies culled from the S&P 500. We disagree. MISO TOs did not arbitrarily select companies; they selected every dividend-paying stock included in the S&P 500, a group that is regularly updated.[367] As such, it is indisputable that each company selected by MISO TOs had a high market capitalization at that time. Therefore, consistent with Opinion No. 531-B, we find that the DCF study of the approximately 400 dividend-paying stocks selected by MISO TOs need not include a two-step DCF methodology that incorporates a long-term growth rate input.

171. Joint Customer Intervenors assert that MISO TOs' CAPM analysis should have used the Morningstar market risk premium of 6.2 percent, which was based on the arithmetic average difference between stocks and Treasury bills from 1926 to 2013.[368] However, the Morningstar market risk premium relies on historical data and, therefore, any CAPM analyses using the Morningstar market risk premium would be backward-looking.[369] Joint Customer Intervenors, therefore, request that the Commission accept a backward-looking CAPM analysis despite the fact that the Commission has historically accepted forward-looking CAPM analyses and rejected backward-looking CAPM analyses.[370] Accordingly, we reject Joint Customer Intervenors' requested use of the Morningstar market risk premium because doing so would result in a CAPM analysis that is not representative of the capital market conditions present during this proceeding.[371]

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[366] Opinion No. 531-B, 150 FERC ¶ 61,165 at P 113.

[367] *See* Initial Decision, 153 FERC ¶ 63,027 at P 260. Non-dividend paying S&P companies must be excluded from the DCF analysis, because a DCF analysis cannot be performed for a non-dividend paying company.

[368] Exh. JCA-1 at 21:21-27.

[369] *See* Opinion No. 531-B, 150 FERC ¶ 61,165 at P 108 (citing Roger A. Morin, *New Regulatory Finance* 155-156 (Public Utilities Reports, Inc. 2006)).

[370] Initial Decision, 153 FERC ¶ 63,027 at PP 279-280 (citing Opinion No. 531, 147 FERC ¶ 61,234 at P 147 n.292).

[371] Opinion No. 531-B, 150 FERC ¶ 61,165 at P 118 (finding that a CAPM study

(continued...)

172. For the reasons stated above, we affirm the Presiding Judge's acceptance of the CAPM analysis to be used as corroborative evidence, in determining whether the midpoint of the zone of reasonableness produced by the Commission's DCF analysis provides a return that satisfies the requirements of *Hope* and *Bluefield*.[372]

3. Risk Premium

173. The risk premium methodology, in which interest rates are a direct input, 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."[373] As the Commission found in Opinion No. 531, investors' required risk premiums expand with low interest rates and shrink at higher interest rates. The link between interest rates and risk premiums provides a helpful indicator of how investors' required returns on equity have been impacted by the interest rate environment.

174. Multiple approaches have been advanced to determine the equity risk premium for a utility.[374] 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.[375] Another approach for 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 U.S. Treasury bond yield."[376]

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is reliable and sufficiently representative of capital market conditions if it is prospective and does not pre-date the Great Recession).

[372] *See* Initial Decision, 153 FERC ¶ 63,027 at P 311.

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

[374] *See generally* Roger A. Morin, *New Regulatory Finance* 107-130 (Public Utilities Reports, Inc. 2006).

[375] *Id.* at 110.

[376] *Id.* at 123.

175. MISO TOs' witness, Dr. Avera, followed a variation of the latter approach, developing a risk premium study by analyzing the ROEs allowed by this Commission for the period from 2006 through 2014, relative to the contemporaneous level of the yield of BBB-rated bonds, to calculate equity risk premiums for each year during that period.[377] Dr. Avera then averaged these annual risk premiums to determine an average risk premium for the entire 2006-2014 period of 4.77 percent.[378]

176. Dr. Avera next adjusted this risk premium to reflect the tendency of risk premiums to rise as interest rates fall. Dr. Avera stated that the average yield of bonds rated BBB by S&P during the period 2006 to 2014 was 5.90 percent. However, the average yield of bonds rated Baa by Moody's during the January-June 2015 period used for the DCF analysis in this case was 4.55 percent, a difference of 1.35 percent.[379] This difference reflects the extent to which current bond yields have fallen below the 2006-2014 average. Based on MISO TOs' regression analysis of the annual equity risk premiums he calculated for each of the nine years from 2006 to 2014, the risk premium during that period increased by approximately 77.07 basis points for each percentage drop of the BBB-rated bond yields.[380] By applying the 77.07 basis point coefficient to the 1.35 percent reduction in bond yields, Dr. Avera calculated a risk premium adjustment of 1.04 percent, which Dr. Avera added to the 4.77 percent average risk premium for the 2006-2014 period to calculate an adjusted risk premium for the six-month DCF study period of 5.81 percent. Finally, Dr. Avera added the 5.81 percent adjusted risk premium to the 4.55 percent Baa-rated bond yield during the six-month DCF study period to calculate a risk premium-based cost of equity of 10.36 percent.[381]

a. <u>Initial Decision</u>

177. The Presiding Judge determined that the risk premium model offered by Dr. Avera was valid and supports awarding MISO TOs a base ROE above the midpoint of the zone

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[377] Exh. MTO-29 at 3; *see also* Exh. MTO-29 at 3.

[378] Exh. MTO-1 at 101:18-19.

[379] Exh. MTO-29 at 1. MISO TOs treated BBB and Baa rate bonds as having equivalent yields.

[380] *See* Exh. MTO-29 at 6.

[381] Exh. MTO-29 at 1; *see also* Initial Decision, 153 FERC ¶ 63,027 at PP 233-235.

of reasonableness. The Presiding Judge noted that the Commission in Opinion No. 531 accepted Dr. Avera's risk-premium analysis and that he had supported his contention that the risk premium rises as the interest rates fall with numerous authorities.[382] The Presiding Judge rejected Mr. Gorman's risk premium model, observing that it was "appreciably different" from the analysis used by the Commission in Opinion No. 531 and that Mr. Gorman did not justify these differences. The Presiding Judge also noted that Mr. Gorman did not address the inverse relationship between bond yields and the risk premium that the Commission "endorsed" in Opinion No. 531.

178. The Presiding Judge also rejected the criticisms of the risk premium model advanced by various witnesses, noting that, although they might be a reason not to rely on the risk premium model in lieu of a DCF analysis, they did not demonstrate that it shouldn't be used as a check on the DCF model.[383] Relying on the Commission's determinations in Opinion No. 531-B, the Presiding Judge also rejected arguments that risk premium model suffered from regulatory lag—the idea that bond yields were not contemporaneous with the various study periods—and that the risk premium analysis was flawed because many of the included ROEs were set by settlement. Finally, the Presiding Judge rejected critiques of Dr. Avera's sample size and statistical methodology, noting that they were equivalent or superior to those that the Commission accepted and relied upon in Opinion No. 531.

b. Briefs on Exceptions

179. Complainants argue that Dr. Avera's risk premium analysis, which the Initial Decision adopted, is inconsistent with the finding of anomalous market conditions. Complainants contend that, because the Initial Decision found that current market conditions are unsustainable, it is inappropriate to accept Dr. Avera's risk premium model, which Complainants assert is based on an unsustainable relationship between equity returns and bond yields during a period of unsustainable capital market conditions.[384]

180. Complainants assert that Dr. Avera's risk premium analysis is flawed because the regression study is based on only nine observations (the annual equity risk premiums for each year from 2006 to 2014). Complainants note that, rather than looking at the

[382] Initial Decision, 153 FERC ¶ 63,027 at P 260.

[383] *Id.* P 241.

[384] Complainants Brief on Exceptions at 37-39.

individual company-authorized ROEs, Dr. Avera made simplifying assumptions that likely increased the results.[385] Complainants also allege that, rather than relying on independent market participants' projected Baa-rated bond yield, Dr. Avera developed his own projected utility bond yield.[386] Complainants further assert that Dr. Avera's adjustments to the data produce excessive ROEs based on today's current capital market environment.[387] Complainants also cite to arguments from Mr. Solomon and Mr. Hill regarding flaws in the risk premium analysis.[388]

181. Complainants state that Dr. Avera's risk premium analysis should be disregarded and that Mr. Gorman's risk premium analysis should be considered.[389] According to Complainants, unlike Dr. Avera's risk premium analysis, Mr. Gorman's risk premium analysis is based on two estimates of equity return over the period of 1986 to 2015 to account for variations of the risk premium based on market conditions and investor risk perceptions.[390] Complainants explain that Mr. Gorman's risk premium analysis using U.S. Treasury bonds resulted in a range of 8.25 percent to 10.57 percent, his risk premium analysis using Baa-rated bonds resulted in a range of 7.53 percent to 10.13 percent, and the two analyses together resulted in a range of 7.53 percent to 10.57 percent with a midpoint of 9.05 percent.[391]

182. Complainants state that the current A-rated utility-bond yield to U.S. Treasury bond yield spread is approximately 116 basis points, while the 36-year average A-rated utility-bond yield spread is 152 basis points. Complainants further state that the current Baa-rated utility-bond yield to U.S. Treasury bond yield spread is approximately equal to

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[385] *Id.* at 45-46 (citing Exh. JC-9 at 27). Mr. Gorman seems to have argued that Dr. Avera erred by relying on the average authorized returns for each year, thereby weighing each of the eight authorized returns from 2013 less than each of the five authorized returns from 2014.

[386] *Id.* at 46 (citing Exh. JC-9 at 28).

[387] *Id.* at 46 (citing Exh. JC-9 at 28-29).

[388] *Id.* at 46-47 (citing Exh. JCI-4 at 41, Exh. JCA-11 at 36-42).

[389] *Id.* at 47.

[390] *Id.* at 39-40 (citing Exh. JC-9 at 47).

[391] *Id.* at 42-43 (citing Exh. JC-22 at 17).

the 36-year average utility-bond yield spread. According to Complainants, the utility-bond yield spreads are evidence that the market considers electric utilities to be relatively low-risk investments and that utilities continue to have strong access to capital markets.[392]

183. Joint Customer Intervenors contend that several witnesses demonstrated flaws in Dr. Avera's risk premium analysis. Joint Customer Intervenors assert that the Initial Decision improperly rejected the identification of flaws in Dr. Avera's regression analysis on the basis that the Commission accepted the methodology in Opinion No. 531. Joint Customer Intervenors argue, however, that MISO TOs broadened the limited purpose for which the alternative analyses were used in Opinion No. 531 and that the flaws identified in the instant proceeding were not considered in Opinion No. 531.[393]

184. Joint Customer Intervenors argue that Dr. Avera's risk premium analysis was flawed because it relied completely on historical data, inconsistent with the Commission's long-established policy that the ROE methodology must be forward-looking.[394] Joint Customer Intervenors contend that the use of a historical risk premium analysis in conjunction with a forward-looking DCF analysis amounts to an unreliable mismatch.[395]

185. Joint Customer Intervenors contend that the Initial Decision dismissed their witness Mr. Solomon's arguments without addressing them.[396] First, Joint Customer Intervenors assert that Dr. Avera's risk premium analysis lacked a direct equity market input, thereby producing an unreliable and inflated estimate of the current cost of common equity capital. Second, Joint Customer Intervenors also assert that Dr. Avera's risk premium analysis' use of interest rates and risk premiums as the only inputs in its

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[392] *Id.* at 42.

[393] Joint Customer Intervenors Brief on Exceptions at 39-43.

[394] *Id.* at 40 (citing Exh. JCI-4 at 41:15-16; *S. Cal. Edison Co.*, Opinion No. 445, 92 FERC ¶ 61,070 (2000)).

[395] *Id.*

[396] *Id.* at 40-42 (citing Initial Decision, 153 FERC ¶ 63,027 at P 255; *NorAm Gas Transmission Co. v. FERC*, 148 F.3d 1158, 1165 (D.C. Cir. 1998)).

regression analysis failed to consider other factors that influence risk premiums and thus cannot account for historical volatility in risk premiums.[397]

186. According to Joint Customer Intervenors, Mr. Solomon demonstrated that more recent data indicates that Dr. Avera's analysis was upwardly and improperly biased. Joint Customer Intervenors state that Dr. Avera's risk premium analysis calculated a 5.62 percent risk premium for the DCF study period during the first half of 2015, which Joint Customer Intervenors point out is 27 basis points above the 5.35 percent risk premium Dr. Avera observed for 2014.[398]

187. Joint Customer Intervenors also state that Dr. Avera's risk premium analysis calculated that, for every 1 percent drop in utility bond yields, the cost of equity capital goes down by just under 23 basis points. Joint Customer Intervenors note, however, that Dr. Avera concluded in a separate state commission-based risk premium analysis that ROEs declined over 57 basis points for every 1 percent reduction in the average utility bond yield. Joint Customer Intervenors argue that the disparity between the two analyses further supports placing no reliance on the results of such historical analyses.[399]

188. OMS asserts that Dr. Avera's risk premium study is fatally flawed by the inclusion of at least one data point that is demonstrably invalid and results in a grossly excessive risk premium. OMS states that one of the Base ROE decisions that Dr. Avera included in his data set can in no way be considered a cost of equity determination and, therefore, had no place in the data set of historic risk premiums.[400] OMS states that *ITC Holdings* was merely a docketing order insofar as ROE is concerned; it established that litigation of a just and reasonable ROE for the Entergy Operating Companies' transmission assets would be determined prospectively in the instant proceeding, rather than in the Entergy transmission rate docket. OMS argues that, by treating *ITC Holdings* the same as other orders where the Commission actually calculated a just and reasonable return for a company, Dr. Avera grossly inflated the historical risk premium.[401]

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[397] *Id.* at 41 (citing Exh. JCI-4 at 51:17-20, 42:1-15).

[398] *Id.* at 41-42 (citing Exh. MTO-6 at 3).

[399] *Id.* at 43 (citing Exh. MTO-10).

[400] OMS Brief on Exceptions at 31 (citing *ITC Holdings Corp*., 143 FERC ¶ 61,257 (2013), *order on reh'g*, 146 FERC ¶ 61,111, at P 25 (2014) (*ITC Holdings*)).

[401] *Id.*

189. OMS states that it is a straightforward matter to correct the errors committed by Dr. Avera. OMS states that the Commission may take administrative notice of its past decisions and those decisions' underlying bases to the extent necessary to consider OMS' corrected version of Exhibit No. MTO-29.[402] OMS states that, by limiting the data points to actual base ROE determinations, its corrected version of Exhibit No. MTO-29 produces a value significantly lower than 10.32 percent.[403]

c. <u>Briefs Opposing Exceptions</u>

190. MISO TOs argue that the Presiding Judge correctly accepted Dr. Avera's risk premium analysis, and that his analysis simply serves as a check on the midpoint of the DCF range, and not the cost of capital model used to set the authorized ROE. MISO TOs assert that the Commission has previously accepted Dr. Avera's approach for its limited purpose.[404] MISO TOs state that the Presiding Judge properly concluded that Mr. Gorman's alternate risk premium analysis was "unreliable and produced cost of equity estimates that were unrepresentatively low."[405] MISO TOs disagree with OMS' characterization of the Commission's decision in *ITC Holdings* as "merely a docketing order insofar as ROE is concerned."[406] MISO TOs assert that the Commission found the current 12.38 percent ROE to be just and reasonable for Entergy as a MISO transmission owner, and rejected arguments for a different ROE.[407]

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[402] *Id.* at Attachment 1 (removing or revising various data points from the list compiled by MISO TOs).

[403] OMS Brief on Exceptions at 32-33. OMS proposes a risk premium cost of equity of 9.94 percent. *Id.*, Attachment 1.

[404] MISO TOs Brief Opposing Exceptions at 24 (citing Opinion No. 531-B, 150 FERC ¶ 61,165 at PP 97-101).

[405] *Id.* at 26.

[406] *Id.* (citing OMS Brief on Exceptions at 31); *see ITC Holdings*, 146 FERC ¶ 61,111.

[407] MISO TOs Brief Opposing Exceptions at 27 (citing *ITC Holdings*, 146 FERC ¶ 61,111 at P 60).

d. <u>Commission Determination</u>

191. We affirm the Presiding Judge's findings that the MISO TOs' risk premium study is valid and supports awarding the MISO TOs a base ROE above the midpoint. We disagree with Complainants' assertion that risk premium analyses cannot be relied upon during a period of anomalous capital market conditions. The Commission has already considered this question. In Opinion No. 531, the Commission stated that alternative methodologies serve as additional evidence to gain insight into the potential impacts of unusual capital market conditions on the appropriateness of using the resulting midpoint. The Commission found the risk premium analysis to be informative, and used it and other alternative methodologies to inform the placement of the just and reasonable ROE within the zone of reasonableness established by the DCF methodology.[408] Consistent with this precedent, we find that, as a general matter, it is appropriate to rely on risk premium analyses as corroborative evidence during periods of anomalous capital market conditions.

192. With regard to assertions regarding the number of observations in MISO TOs' regression analysis, we find that the nine-year period is sufficiently large to inform a risk premium study. Since the issuance of Order No. 679, when the Commission commenced setting "up-front ROEs," a substantial amount of ROE data points became available. Moreover, MISO TOs' regression analysis covers a period both before and after the financial crisis, and considers approximately 80 Commission-accepted ROE data points over the nine-year period.[409] Neither Complainants nor Complainant-aligned parties provided additional Commission-accepted ROE data points for the years preceding 2006, so we have no evidence that doing so would substantially impact MISO TOs' regression analysis.[410]

193. While Complainants suggest that each ROE data point should be its own observation in the regression analysis, we are not persuaded that doing so would be

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[408] Opinion No. 531, 147 FERC ¶ 61,234 at PP 145-146.

[409] Exh. MTO-29 at 4-5.

[410] Complainants' risk premium analysis considers state commission-accepted ROEs for the period from 1986 through March 2015. *See* Exh. JC-19. The Commission rejected the results of a similar risk premium study due to the risk differential between state-regulated distribution and Commission-regulated interstate transmission. Opinion No. 531-B, 150 FERC ¶ 61,165 at P 99. Accordingly, we reject Complainants' risk premium analysis.

superior to MISO TOs' regression analysis, based on the nine annual equity premiums during the years 2006-2014. Complainants' proposal would require each ROE data point to be matched with the bond yield that existed on the date of the Commission's acceptance of that data point.[411] However, Complainants have not demonstrated why the bond yield on that specific date is more representative of the interest rate environment than the average annual bond yields used by MISO TOs. Indeed, there is no fixed relationship – and there is a lag – between dates of the relevant study period and the date on which the Commission adopts an ROE, with the variation depending on the facts of the case. Therefore, it seems that assigning the bond yield on one specific date to each data point would add an unnecessary amount of volatility to the regression analysis. Furthermore, the Commission already held in Opinion No. 531-B that assigning approximate dates to the cost of equity determinations is often unavoidable and does not undermine the relevance of risk premium analyses. For these reasons, we find that the methodology used by MISO TOs in their regression analysis is appropriate.

194. We also reject Complainants' argument that MISO TOs should have relied on independent market participants' projected Baa-rated bond yield. The Presiding Judge held that projected yields used in risk premium analyses are speculative and less reliable than historical yields, and rejected Dr. Avera's use of projected Baa-rated bond yields. As an initial matter, we agree with the Presiding Judge and, for that reason, reject Complainants' argument.

195. With regard to Joint Customer Intervenors' argument that MISO TOs' risk premium analysis was flawed because it relied completely on historical data, we note that the risk premium analysis accepted in Opinion No. 531-B was based on "empirical observations and regression analysis of bond yields and Commission-allowed ROEs"—i.e., forms of historical data.[412] In any event, because the risk premium analysis uses regulated ROEs, it would be inappropriate to attempt to project what such ROEs would be. Moreover, despite Joint Customer Intervenors' assertion that MISO TOs' risk premium analysis is inconsistent with the Commission's policy that the ROE methodology must be forward-looking, we are not relying on the risk premium analysis to set the ROE itself. Instead, we find that MISO TOs' risk premium analysis is sufficiently reliable to corroborate our decision to place MISO TOs' base ROE above the midpoint of the zone of reasonableness produced by the DCF analysis.[413]

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[411] Exh. JC-9 (corrected) at 27.

[412] Opinion No. 531-B, 150 FERC ¶ 61,165 at PP 97-101.

[413] *Id.* P 98.

196. We disagree with Joint Customer Intervenors' assertion that MISO TOs' risk premium analysis is flawed because it lacks a direct market input and fails to consider other factors that influence risk premiums. MISO TOs' risk premium analysis is similar to the risk premium analysis accepted in Opinion No. 531-B. Therefore, in order to demonstrate that MISO TOs' risk premium analysis is flawed, Joint Customer Intervenors must either raise and reasonably support new arguments that were not considered in the Opinion No. 531 proceeding, or differentiate between the two risk premium analyses. Joint Customer Intervenors fail to do either. For example, Joint Customer Intervenors generically claim that MISO TOs' risk premium analysis is lacking, but do not propose specific factors that should be considered. As a result, we have no basis to conclude that any further considerations are necessary. Moreover, while Joint Customer Intervenors claim that MISO TOs' risk premium analysis cannot account for historical volatility, they fail to demonstrate that this purported historical volatility would result in materially different risk premium results.[414]

197. Joint Customer Intervenors disagree with MISO TOs' regression analysis and its result: for every percentage drop of the BBB-rated bond yields, the risk premium increased approximately 77.07 basis points and, therefore, the cost of equity capital would decrease by approximately 22.93 basis points. We note, however, that the 77.07 basis point coefficient proposed by MISO TOs is substantially less than the 93 basis point coefficient in the analysis that the Commission relied upon in Opinion No. 531-B.[415] Furthermore, despite Joint Customer Intervenors' arguments to the contrary, the Commission held in Opinion No. 531-B that it was not persuaded by arguments that the results of a Commission-based risk premium analysis "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."[416]

198. As for OMS' argument that MISO TOs included data points in their risk premium analysis that should not have been considered, the Commission dismissed similar arguments in Opinion No. 531-B by concluding that "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

[414] *See* Opinion No. 531-B, 150 FERC ¶ 61,165 at P 98.

[415] *Id.* P 99.

[416] *Id.* P 99.

the reliability of a risk premium analysis."[417] Accordingly, we reject OMS' arguments that *ITC Holdings* and other data points should be removed from MISO TOs' risk premium analysis.

199. OMS also proposes revisions to the dates of several data points included in MISO TOs' risk premium analysis. Although we agree with OMS that any necessary corrections should be made, OMS has not demonstrated that its proposed date corrections would materially affect the results of MISO TOs' risk premium analysis.[418] Therefore, we find that these discrepancies do not undermine the usefulness of MISO TOs' risk premium analysis as corroborative evidence.

200. For the reasons stated above, we find that MISO TOs' risk premium analysis is sufficiently reliable to corroborate the results of the DCF analysis in this proceeding. We, therefore, affirm the Presiding Judge's acceptance of the risk premium analysis to be used as corroborative evidence, in determining whether the midpoint of the zone of reasonableness produced by the Commission's DCF analysis provides a return that satisfies the requirements of *Hope* and *Bluefield*.[419]

4. Expected Earnings

201. A comparable earnings analysis is a method of calculating the earnings an investor expects to receive on the book value of a particular stock. The analysis can be either backward looking using the company's historical earnings on book value, as reflected on the company's accounting statements, or forward-looking using estimates of earnings on book value, as reflected in analysts' earnings forecasts for the company.[420] The latter approach is often referred to as an "expected earnings analysis" and is the approach that MISO TOs used in this proceeding. As the Commission explained in Opinion No. 531-B, "returns on book equity help investors determine the opportunity cost of

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[417] *Id.* P 98. In *ITC Holdings*, the Commission approved the Entergy Operating Companies' use of the 12.38 percent ROE established for the MISO region. *ITC Holdings*, 146 FERC ¶ 61,111 at P 25.

[418] While OMS calculated a risk premium cost of equity of 9.94 percent, OMS' analysis revised dates for several data points *and* removed approximately 15 data points from MISO TOs' risk premium analysis. OMS Brief on Exceptions, Attachment 1.

[419] *See* Initial Decision, 153 FERC ¶ 63,027 at P 258.

[420] *See* Opinion No. 531-B, 150 FERC ¶ 61,165 at P 125.

investing in that particular utility instead of other companies of comparable risk" and, as a result, an expected earnings analysis can be useful for corroborating whether the results produced by the DCF model may have been skewed by the anomalous capital market conditions reflected in the record.[421]

202. MISO TOs' forward-looking expected earnings analysis uses the same proxy group used in their two-step DCF analysis. MISO TOs' witness, Dr. Avera, started with the return on book equity that Value Line forecasts for each proxy company for the period 2017 to 2019.[422] He then multiplied each of those returns by an adjustment factor to determine each utility's average return, rather than its year-end return. After the elimination of one outlier result,[423] Dr. Avera's analysis produced an adjusted ROE range of 7.61 percent to 16.37 percent, with a midpoint value of 11.99 percent. As with the other alternative methodologies accepted herein, this midpoint value exceeds the 9.29 percent midpoint value of the Commission's two-step DCF analysis.[424]

a. <u>Initial Decision</u>

203. The Presiding Judge declined to rely on Dr. Avera's forward-looking expected earnings analysis. While acknowledging that the Commission in Opinion No. 531 relied upon an expected earnings analysis "identical in all material respects" to Dr. Avera's, the Presiding Judge observed that the Commission was not aware of a critique by Dr. Morin—on whose authority the Commission relied in accepting the expected earnings analysis in Opinion No. 531—that such analysis should be based on a sample of unregulated, rather than regulated, companies. Because Dr. Avera's analysis relied on the regulated companies in the proxy group, and because of "Dr. Avera's inability to address [Dr. Morin's] rejection" of the use of regulated companies in an expected earnings analysis, the Presiding Judge elected not to rely on Dr. Avera's analysis.[425]

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[421] *Id.* PP 128-129.

[422] Ex. MTO-31.

[423] Dr. Avera eliminated Dominion Resources' adjusted return on common equity of 18.38 percent.

[424] *See* Initial Decision, 153 FERC ¶ 63,027 at P 118.

[425] *Id.* P 325.

b. **Briefs on Exceptions**

204. MISO TOs ask the Commission to reverse the Initial Decision and instead find that the expected earnings analysis provides a useful and probative benchmark for purposes of evaluating DCF results when anomalous capital market conditions justify consideration of alternative estimates of the cost of equity.[426] MISO TOs refer to the Presiding Judge's conclusion that Dr. Avera failed to follow the approach in Dr. Morin's *New Regulatory Finance*.[427]

205. MISO TOs assert that Dr. Avera's study was the same analysis submitted and accepted in Opinion No. 531 and, although the Presiding Judge argues that the Commission was not aware of Dr. Morin's statement that proxy groups should be made up of unregulated companies, the record in neither proceeding supports this inference.[428] MISO TOs assert that *New Regulatory Finance* does not mandate exclusive reliance on unregulated companies.[429] MISO TOs argue that Dr. Morin's critique of using regulated companies relates entirely to the application of the comparable earnings approach using historical data, which reflects in part past actions of other regulators and historical conditions. MISO TOs argue that this is distinct from the forward-looking expected earnings approach relied upon by the Commission in Opinion No. 531, which MISO TOs contend is no more susceptible to concerns over regulatory influence than the analysts' EPS growth rates that are used to apply the DCF model.[430]

206. MISO TOs argue that the critical inquiry for assessing the merits of an expected earnings analysis is whether the studied companies are of comparable risk to the utilities whose rates are at issue, not whether they are regulated.[431] MISO TOs further state that, although Dr. Avera conceded that expected earnings of non-regulated companies may

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[426] MISO TOs Brief on Exceptions at 2.

[427] *Id.* at 24 (citing Initial Decision, 153 FERC ¶ 63,027 at P 323).

[428] *Id.* at 25 (citing Initial Decision, 153 FERC ¶ 63,027 at P 323).

[429] *Id.* (citing Roger A. Morin, *New Regulatory Finance* 381 (Public Utilities Reports, Inc. 2006) (stating that "[t]he reference group is usually made up of unregulated industrial companies.")).

[430] *Id.* at 25-26.

[431] *Id.* at 26.

also provide a logical benchmark for evaluating a just and reasonable ROE, this does not preclude consideration of other electric utilities' expected earnings. MISO TOs argue that *Principles of Public Utilities Rates* supports Dr. Avera's assertion that an analysis of comparable earnings may be conducted for "utilities or nonregulated firms."[432]

207. Finally, MISO TOs argue that the Presiding Judge failed to credit Dr. Avera's testimony regarding the use of the expected earnings model by the Virginia State Corporation Commission (Virginia Commission), which is required by statute to consider the earned returns on book value of electric utilities in its region and has established allowed ROEs based on earned returns on book value for peer groups of other electric utilities.[433] MISO TOs argue that Dr. Avera's point was to show that regulators do not consider the expected earning analysis to be useful only when applied to unregulated enterprises and that there is no reason to assume that the Virginia Commission's rationale for its practice is different than the rationale offered by Dr. Avera and Mr. Bonbright – that an expected earnings study of comparable enterprises can provide useful estimates of investor expectations.[434]

c. <u>Briefs Opposing Exceptions</u>

208. Complainants and other parties contend that the Commission should affirm the Presiding Judge's rejection of Dr. Avera's expected earnings analysis.[435] Complainants point out that Dr. Avera's methodology departs from Dr. Morin's prescribed method of composing a proxy group by using a group of electric utilities, rather than a group of unregulated companies.[436] Complainants argue that Dr. Avera was unable to justify this

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[432] *Id.* (citing James C. Bonbright *et al.*, Principles of Public Utility Rates 329 (2d ed. 2006)).

[433] MISO TOs Brief on Exceptions at 27.

[434] *Id.*

[435] Complainants Brief Opposing Exceptions at 7-11; Trial Staff Brief Opposing Exceptions at 9-16; Iowa Group Brief Opposing Exceptions at 11-16; Joint Customer Intervenors Brief Opposing Exceptions at 8-17; OMS/Joint Consumer Advocates Brief Opposing Exceptions at 21-24.

[436] Complainants Brief Opposing Exceptions at 7 (citing Initial Decision, 153 FERC ¶ 63,027 at PP 315-316, 323).

departure from Dr. Morin's expected earnings methodology such that their arguments should be rejected.[437]

209. Complainants assert that MISO TOs' arguments that the Commission was aware of Dr. Morin's statement that proxy group should be made up of unregulated companies are unpersuasive and made up of circumstantial evidence.[438] Complainants also disagree with MISO TOs' argument that this departure from Dr. Morin's expected earnings approach is permissible given the Commission's recognition of Dr. Morin as an authority on the expected earnings analysis.[439] According to Complainants, the record in this proceeding is lacking evidence that justifies such a departure. Complainants state that a plain reading of Opinion No. 531 demonstrates that the Commission was unaware of the proxy group flaw in the expected earnings analysis. Complainants assert that Dr. Avera's expected earnings results in circular ratemaking,[440] problems of which the Commission has recognized.[441]

210. Complainants contend that the Presiding Judge's rejection of Dr. Avera's expected earnings analysis was based on the record in this proceeding and represents reasoned decision making. According to Complainants, the Presiding Judge's rejection of Dr. Avera's expected earnings analysis does not affect the Presiding Judge's ultimate ROE recommendation and, by taking exception, MISO TOs are seeking what is effectively an inappropriate advisory opinion from the Commission.[442]

211. Complainants disagree with MISO TOs' argument regarding the Virginia Commission's use of a similar expected earnings methodology.[443]

[437] *Id.* at 8.

[438] *Id.* (citing MISO TOs Brief on Exceptions at 25-26).

[439] *Id.* at 8-9 (citing Initial Decision, 153 FERC ¶ 63,027 at P 315).

[440] *Id.* at 9 (citing Exh. S-1 at 97-98).

[441] *Id.* (citing *Minnesota Power and Light Co.*, Opinion No. 12, 3 FERC ¶ 61,045, at 61,132 (1978)).

[442] *Id.* at 9-10.

[443] *Id.* at 10 (citing MISO TOs Brief on Exceptions at 27).

Complainants assert that a mere description of a state Commission's purported use of this method is not sufficient to justify Dr. Avera's departure from Dr. Morin's guidance.[444]

212. Complainants also argue that the record demonstrates other flaws in Dr. Avera's expected earnings analysis. Complainants state that the non-regulated assets of MISO TOs can affect the expected return on their consolidated operations. Complainants also state that the earned return on book equity does not describe the return investors currently require to make an investment in the National Proxy Group of companies and, therefore, it does not establish what the current market cost of equity is for these companies.[445] Complainants note that, in addition to Mr. Gorman, the following witnesses testified that Dr. Avera's expected earnings study is fundamentally flawed and consequently produces unreliable results: Mr. Hill, Iowa Group's witness Mr. Parcel, Mr. Solomon, and Mr. Keyton.[446]

213. Trial Staff notes that the Presiding Judge relied on Mr. Keyton's observations that both the Commission, in Opinion Nos. 531 and 531-B, and Dr. Avera, in his testimony, referred extensively to Roger Morin's *New Regulatory Finance*.[447] Trial Staff argues, however, that Dr. Avera failed to follow the specific three step methodology outlined by Dr. Morin, and instead repeated the type of expected earnings analysis that he used in the Opinion No. 531 proceeding.[448]

214. Trial Staff objects to the use of utility book rates of return as data inputs for an expected earnings study, and asserts that doing so introduces an element of circularity into the analytical process. Trial Staff states that limiting the data field to regulated utilities perpetuates established allowed ROEs rather than estimating the current market costs of equity.[449] Despite MISO TOs' argument that circularity concerns have been

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[444] *Id.* at 10 (citing Initial Decision, 153 FERC ¶ 63,027 at P 321).

[445] *Id.* at 10-11 (citing Exh. JC-9 at P 17).

[446] *Id.* at 11.

[447] Trial Staff Brief Opposing Exceptions at 10 (citing Initial Decision, 153 FERC ¶ 63,027 at PP 315-323).

[448] *Id.* (citing Roger A. Morin, *New Regulatory Finance* 383 (Public Utilities Reports, Inc. 2006)).

[449] *Id.* at 11 (citing Exh. S-1 at 98).

obviated by Dr. Avera's use of projected Value Line rates of return on book equity,[450] Trial Staff contends that Dr. Avera's use of projected book rates of return intensifies rather than ameliorates the noted defect. Trial Staff states that if utilities are awarded an ROE on the basis of what Value Line expects them to earn, there is a clear likelihood that they will converge in the future.[451]

215. According to Trial Staff, Dr. Avera used the Value Line data for the period from 2017 to 2019 when shorter-term projections were also available.[452] Trial Staff argues that, given that the expected accuracy of predictive estimates decline as their temporal horizon increases, it would have been preferable for Dr. Avera to average the three available Value Line earned rate of return projections instead of relying solely on the most distant one.[453]

216. Trial Staff disagrees with MISO TOs' contention that the methodology used by Dr. Avera is analytically identical to the one the Commission accepted in Opinion No. 531. Trial Staff acknowledges that, in Opinion No. 531, the Commission cited Dr. Morin's treatise in support of use of this methodology as a check on DCF results.[454] However, according to Trial Staff, the general discussion of this issue in Opinion No. 531 can hardly be read as an endorsement of the particular calculations performed by Dr. Avera on the data he selected for his study. Trial Staff argues that, as with the case of the Commission's inadvertent use of Dr. Avera's dividend yield calculation in Opinion No. 531, the Commission cannot be held to have approved an expected earnings methodology that it had not substantively examined.[455]

217. Regarding MISO TOs' contention that other authorities, such as the Virginia Commission, find comparable earnings studies relying on regulated utility data to be

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[450] *Id.* at 14 (citing MISO TOs Brief on Exceptions at 25-26 (noting that Dr. Morin generally discusses the use of historical data in his discussion of the comparable earnings methodology)).

[451] *Id.* at 14.

[452] *Id.* at 11-12 (citing Exh. S-1 at 100-101).

[453] *Id.* at 12 (citing Exh. S-1 at 100-101).

[454] *Id.* at 13 (citing Opinion No. 531, 147 FERC ¶ 61,234 at P 147).

[455] *Id.* at 13-14.

acceptable, Trial Staff states that MISO TOs do not attempt to defend or even explain the rationale underlying that choice.[456] Furthermore, Trial Staff states that the Commission has expressly ruled on this issue, indicating its preference for the use of nonregulated firms in conducting a comparative earnings analysis.[457] Trial Staff asserts that neither Dr. Avera nor MISO TOs' brief on exception explain the rationale for the Virginia Commission's ROE determinations.[458]

218. Iowa Group asserts that an expected earnings analysis on regulated utilities produces a rate-making circularity that perpetuates allowed returns on equity rather than measuring the actual cost of capital. Iowa Group asserts that the authorities cited by MISO TOs each recognize and discuss this limitation.[459]

219. According to Iowa Group, the purpose of regulation is to produce the same result that would occur in an unregulated market and, therefore, focusing on regulated returns does not produce a reliable measure of the cost of equity for an unregulated firm.[460] Iowa Group states that conducting an expected earnings analysis based on a proxy group consisting solely of regulated utilities involves allowed returns on equity and requires setting a utility's return based on other utilities' returns. Iowa Group, therefore, states that a utility-based expected earnings study will reflect a regulated marketplace over time and that such a result is contrary to one of the fundamental economic principles of utility regulation. Iowa Group asserts that a historical versus forward-looking distinction is meaningless in this context, since both rely on regulated returns. [461]

220. Joint Customer Intervenors assert that Dr. Avera's expected earnings analysis was invalid because it was applied to regulated utilities, while his primary authority,

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[456] *Id.* at 15.

[457] *Id.* at 15 (citing Opinion No. 12, 3 FERC at 61,132).

[458] *Id.* at 15 (citing Initial Decision, 153 FERC ¶ 63,027 at P 321.

[459] Iowa Group Brief Opposing Exceptions at 14-15 (citing James C. Bonbright, Principles of Public Utility Rates 329-330 (Public Utilities Reports, Inc. 2006); Roger A. Morin, *New Regulatory Finance* 383 (Public Utilities Reports, Inc. 2006); David C. Parcell, The Cost of Capital: A Practitioner's Guide 118-119 (2010)).

[460] *Id.* at 14.

[461] *Id.* at 16.

New Regulatory Finance, states that the comparable earnings approach should only be applied to a comparable risk group of unregulated companies.[462] Joint Customer Intervenors contend that MISO TOs cannot be permitted to rely on a source as a standard for analysis and then disregard that source at will.[463]

221. Joint Customer Intervenors object to MISO TOs' citation to *Principles of Public Utility Rates*, arguing that MISO TOs cite to this source for the first time in their brief on exceptions. Joint Customer Intervenors also note that MISO TOs omitted statements in *Principles of Public Utility Rates* that suggest that the issue of circularity is raised if the comparable earnings approach is applied to regulated utilities.[464]

222. Joint Customer Intervenors contend that MISO TOs' argument is anecdotal and without explanation for why or how the Virginia Commission applied its approach. Joint Customer Intervenors assert that MISO TOs failed to justify departure from the methodology that both Dr. Avera and the Commission have cited as the principal authority on the expected earnings model.[465]

223. In response to MISO TOs' argument that Opinion No. 531's cite to *New Regulatory Finance* demonstrates that the Commission was aware of Dr. Morin's prohibition on the use of regulated utilities in the expected earnings analysis, Joint Customer Intervenors assert that the prohibition was not discovered or brought to the Commission's attention in that proceeding.[466]

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[462] Joint Customer Intervenors Brief Opposing Exceptions at 9-10 (citing Dr. Roger A. Morin, *New Regulatory Finance* 381-382 (Public Utilities Reports, Inc. 2006); Initial Decision, 153 FERC ¶ 63,027 at P 316).

[463] *Id.* at 13.

[464] *Id.* at 11 (citing MISO TOs Brief on Exceptions at 26; James C. Bonbright, Principles of Public Utility Rates 239-330 (Public Utilities Reports, Inc. 2006)).

[465] *Id.* at 12.

[466] *Id.* at 13-14 (citing MISO TOs Brief on Exceptions at 25).

224. Joint Customer Intervenors assert that MISO TOs' reference to Dr. Morin's statement that "[t]he reference group is *usually* made up of unregulated industrial companies" is without context, does nothing to refute Dr. Morin's conclusion and rationale for excluding regulated utilities, and fails to recognize the multiple additional instances where Dr. Morin cautions against the use of regulated utilities.[467]

225. Joint Customer Intervenors assert that MISO TOs' claim that Dr. Morin's prohibition on the use of regulated utilities does not apply to forward-looking analyses amounts to a conclusory statement. Joint Customer Intervenors argue that this claim is refuted by Dr. Morin's recognition of the use of the projected comparable earnings approach, and by the absence of any statement by Dr. Morin that the projected comparable earnings approach ameliorates the issue of circularity.[468]

226. Joint Customer Intervenors note that Mr. Solomon explained that Dr. Avera's expected earnings analysis was not based on market data, but on projected returns on book equity, and that the Commission has historically rejected the comparable earnings method.[469] According to Joint Customer Intervenors, the Commission has recognized that the allowed rate of return shall be set "at the rate of return investors require on their investment" and that "when the price-to-book ratio is greater than one, the rate of return investors expect to earn on common equity is greater than the rate of return investors require from their investment in common stock."[470] Joint Customer Intervenors note that Dr. Avera's expected earnings analysis shows a midpoint of 11.44 percent and that the average price-to-book ratio for the proxy group is 1.79.[471]

227. Joint Customer Intervenors assert that an investor willing to pay more than the book value for a utility's expected earnings expects to earn something less than the expected earned rate of return on book value on that investment. Joint Customer

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[467] *Id.* at 14 (citing MISO TOs Brief on Exceptions at 25 & n.67; Dr. Roger A. Morin, *New Regulatory Finance* 381-382 (Public Utilities Reports, Inc. 2006)).

[468] *Id.* at 14-15 (citing MISO TOs Brief on Exceptions at 26; Dr. Roger A. Morin, *New Regulatory Finance* 385 (Public Utilities Reports, Inc. 2006)).

[469] *Id.* at 15 (citing Exh. JCI-4 at 49:14-20).

[470] *Id.* at 15 (citing *Orange and Rockland Utilities, Inc.*, 44 FERC ¶ 61,253, at 61,952 (1988) (*Orange and Rockland*)).

[471] *Id.* at 16 (citing Exh. JCI-4 at 50:14-17).

Intervenors contend that the range for investors' required ROE should be bracketed by the-earnings-to-price ratio and the expected earned rate on return on book value. Joint Customer Intervenors assert that the midpoint of that range is below the 9.29 percent midpoint of the Presiding Judge's DCF range.[472]

228. OMS/Joint Consumer Advocates state that Dr. Avera's inclusion of regulated utilities in his expected earnings sample group creates an inescapable circularity. According to OMS/Joint Consumer Advocates, a regulatory commission's actions necessarily will affect a utility's future earnings, a forecast of which, in turn, then becomes a factor in establishing the ROE in the next regulatory decision, which itself will then affect future earnings and forecasts thereof. OMS/Joint Consumer Advocates state that excluding regulated utilities from the sample group, as indicated to be necessary by the very source on which Dr. Avera relied,[473] is essential if such circularity is to be avoided.[474]

229. OMS/Joint Consumer Advocates state that MISO TOs give no indication in their brief on exceptions that the base ROE adopted in the Initial Decision would be any different had Dr. Avera's expected earnings study been accepted, nor would any such claim be plausible. OMS/Joint Consumer Advocates state that MISO TOs, therefore, seek nothing more than a request for Commission guidance about how the expected earnings method should be applied in other proceedings in the future. OMS/Joint Consumer Advocates contend that there are other avenues, more appropriate for the task, for obtaining generic guidance of that sort from the Commission.[475]

d. Commission Determination

230. We reverse the Presiding Judge's rejection of MISO TOs' expected earnings analysis. Complainants and Complainant-aligned parties assert that MISO TOs' expected

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[472] *Id.* at 16-17.

[473] OMS/Joint Consumer Advocates Brief Opposing Exceptions at 22 (citing Initial Decision, 153 FERC ¶ 63,027 at PP 315, 320, and 323).

[474] *Id.* (citing Opinion No. 12, 3 FERC at 61,132 (stating that "while the comparative earnings technique can be helpful in determining whether an allowed rate of return is commensurate with the return on investments in other enterprises, if the comparison is only with regulated companies, there is a certain circularity.")).

[475] *Id.* at 23.

earnings analysis is flawed for a variety of reasons. As discussed in more detail below, we disagree with these assertions and find that the results of MISO TOs' expected earnings analysis corroborates our determination that MISO TOs should be awarded an ROE above the midpoint of the zone of reasonableness produced by the DCF analysis.[476]

231. The Presiding Judge's rejection of MISO TOs' expected earnings analysis relies on the premise that Dr. Morin's guidance in *New Regulatory Finance* precludes the inclusion of regulated companies in expected earnings proxy groups.[477] MISO TOs argue that *New Regulatory Finance* does not mandate exclusive reliance on unregulated companies in forward-looking expected earnings analyses. We agree. In particular, we note that that conclusion is consistent with Dr. Morin's analysis in *New Regulatory Finance*:

> In defining a population of comparable-risk companies, care must be taken not to include other utilities in the sample, since the rate of return on other utilities depends on the allowed rate of return. The *historical* book return on equity for regulated firms is not determined by competitive forces but instead reflects the *past* actions of regulatory commissions. It would be circular to set a fair return based on the *past* actions of other regulators, much like observing a series of duplicative images in multiple mirrors. The rates of return earned by other regulated utilities may well have been reasonable under historical conditions, but they are still subject to tests of reasonableness under current and prospective conditions.[478]

Dr. Morin's recommendation to avoid other utilities in the sample is based on his concern that the use of historical book ROE would be based on past actions of regulatory commissions and, therefore, reliance on those past actions to set an ROE would raise issues of circularity. However, MISO TOs' expected earnings analysis is forward-looking and based on Value Line forecasts, adjusted to reflect each utility's average return.[479] As the Commission explained in Opinion

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[476] Our analysis below does not rely on the arguments regarding the Virginia Commission's use of expected earnings analyses; therefore, we dismiss such arguments as moot.

[477] *See* Initial Decision, 153 FERC ¶ 63,027 at P 323.

[478] Dr. Roger A. Morin, *New Regulatory Finance* 383 (Public Utilities Reports, Inc. 2006) (Emphasis supplied).

[479] *See* Initial Decision, 153 FERC ¶ 63,027 at P 314.

No. 531-B, an expected earnings analysis, in contrast to a comparable earnings analysis, is sound when it is forward-looking and based on a reliable source of earnings data.[480]

232. Moreover, while Complainants and Complainant-aligned parties refer to various other excerpts from Dr. Morin's *New Regulatory Finance*, each appears to refer to comparable earnings analyses that are based on historical earnings on book value.[481] Thus, even if the Commission did not consider Dr. Morin's statement that proxy groups for comparable earnings analyses should be made up of unregulated companies, that statement alone does not invalidate MISO TOs' expected earnings analysis.

233. We disagree with Complainant-aligned parties' assertions that MISO TOs' expected earnings analysis will nevertheless raise issues of circularity or lead to the convergence of Commission-approved ROEs and the Value Line projections. MISO TOs' zone of reasonableness, in which Commission-approved ROEs are placed, is established by the results of the DCF study. The expected earnings analysis, like the other alternative methodologies accepted herein, is merely used as corroborative evidence. Therefore, we are not persuaded that our acceptance of the expected earnings analysis, which at most can corroborate the Commission's decision to place an ROE above the midpoint of the zone of reasonableness, will raise issues of circularity or lead to a convergence of Commission-approved ROEs to the Value Line projections.

234. We also disagree with Complainants' contention that MISO TOs' expected earnings analysis is flawed because the return on book value does not establish the current market cost of equity for proxy group companies.[482] As the Commission explained in Opinion No. 531-B, investors rely upon the return on book equity to determine the opportunity cost of investing in a particular company, and investors rely

[480] Opinion No. 531-B, 150 FERC ¶ 61,165 at PP 125-126. *See, e.g.*, *Southern California Edison Co.*, Opinion No. 445, 92 FERC ¶ 61,070, at 61,263 (2000) (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).

[481] *See, e.g.*, Dr. Roger A. Morin, *New Regulatory Finance* 382 (Public Utilities Reports, Inc. 2006) (providing the three steps required to implement a comparable earnings analysis).

[482] This appears to be another way of saying that MISO TOs' expected earnings analysis did not consider market-to-book ratios.

upon expected earnings analysis for this purpose without attempting to convert that opportunity cost into the current market cost of equity.[483] Therefore, consistent with Opinion No. 531-B, we find MISO TOs' expected earnings analysis reliable as corroborative evidence in this proceeding, notwithstanding the lack of a market-to-book adjustment in their analysis. Furthermore, even assuming *arguendo* that a market-to-book adjustment was appropriate, we are not persuaded that Joint Customer Intervenors' approach would accurately estimate the utility's market cost of equity.[484]

235. We also disagree with Joint Customer Intervenors' reliance on *Orange & Rockland* in crafting their argument that the expected earnings analysis cannot be relied upon because the market-to-book ratio of the proxy group exceeds one.[485] As the Commission explained in Opinion No. 531-B, *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 in that proceeding.[486] MISO TOs do not make such a proposal. Instead, MISO TOs have submitted an expected earnings analysis based on their national proxy group of utilities with comparable risk profiles to MISO TOs. Therefore, unlike *Orange & Rockland*, where the Commission rejected a proposal that would have had the effect of setting the base ROE at the company's own expected ROE, MISO TOs' expected earnings analysis is only relevant to the determination of whether the midpoint of the DCF-produced zone of reasonableness provides a market cost of equity sufficient to meet the requirements of *Hope* and *Bluefield*.[487] 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

[483] Opinion No. 531-B, 150 FERC ¶ 61,165 at P 132.

[484] *See* Joint Customer Intervenors Brief Opposing Exceptions at 16.

[485] *Id.* at 15 (citing *Orange and Rockland,* 44 FERC ¶ 61,253 at 61,952 (*Orange and Rockland*)).

[486] Opinion No. 531-B, 150 FERC ¶ 61,165 at P 127.

[487] *Id.* P 128.

commensurate with returns on investments in other enterprises having corresponding risks."[488]

236. As the Commission explained in Opinion No. 531-B,[489] 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. 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. 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.

237. We are also not persuaded by Trial Staff's assertion that MISO TOs should have also considered shorter term Value Line projections than the 2017-2019 projects they used. While Trial Staff asserts that shorter term projections were available to MISO TOs, it is unclear if those shorter term projections would have resulted in materially different results. Therefore, we are not persuaded that MISO TOs' reliance on Value Line projections for 2017-2019 undermined the usefulness of MISO TOs' expected earnings analysis as corroborative evidence.

238. We also reject the arguments that MISO TOs' exception to the Presiding Judge's rejection of their expected earnings analysis has no relevance on this proceeding and is effectively an attempt to receive general guidance from the Commission. While it is true that, despite his rejection of MISO TOs' expected earnings analysis, the Presiding Judge elected to set the ROE at the upper midpoint of the DCF-produced zone of reasonableness, the placement of the ROE was disputed by Complainants and Complainant-aligned parties in their briefs on exceptions. Given that the expected earnings analysis can further corroborate our finding that a mechanical application of the

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

[489] Opinion No. 531-B, 150 FERC ¶ 61,165 at P 129.

DCF methodology does not satisfy *Hope* and *Bluefield*, MISO TOs' exception to the Presiding Judge's rejection of their expected earnings analysis is appropriate.

239. For the reasons stated above, we reverse the Presiding Judge's rejection of MISO TOs' expected earnings analysis.[490] We find that MISO TOs' expected earnings analysis is sufficiently reliable to be used as corroborative evidence that the midpoint of the zone of reasonableness produced by the mechanical application of the DCF methodology does not result in a return that satisfies the requirements of *Hope* and *Bluefield*.

5. State ROEs

240. MISO TOs' witness, Ms. Lapson, presented evidence that all state-authorized ROEs during the period April 1, 2013 through March 31, 2015 for integrated electric utilities providing generation, transmission, and distribution services ranged from 9.5 percent to 10.4 percent.[491] In addition, 87.34 percent of state-authorized ROEs for both integrated electric utilities and distribution-only electric utilities during that period were within this range. Ms. Lapson also testified that investing in Commission-regulated electric transmission involves significant risks that investment in other utilities does not and that setting MISO TOs' ROE at a level generally below state-authorized ROEs will make investment in interstate electric transmission less attractive than investment in conventional electric utility activities.

a. Initial Decision

241. The Presiding Judge determined that the state-authorized ROEs in the record support setting MISO TOs' base ROE above the midpoint of the DCF zone of reasonableness. The Presiding Judge observed that the midpoint of the DCF zone of reasonableness is lower than all of the state-authorized ROEs for integrated electric utilities and two-thirds of the state-authorized ROEs for distribution-only utilities. The Presiding Judge noted that MISO TOs face risks that are at least as great as the risks facing both categories of companies.[492] The Presiding Judge rejected arguments regarding the data used to identify the state-authorized ROEs, noting that, consistent with Opinion Nos. 531 and 531-B, this data reflected the most recent data in the record.[493]

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[490] *See* Initial Decision, 153 FERC ¶ 63,027 at P 323.

[491] Exh. MTO-42 at 1-2.

[492] Initial Decision, 153 FERC ¶ 63,027 at PP 454-456.

[493] *Id.* PP 366-367.

The Presiding Judge also rejected the argument that the 50 basis point incentive ROE adder should be considered in setting the base ROE, noting that the Commission flatly rejected this argument in Opinion No. 531.[494] Finally, the Presiding Judge rejected a host of arguments contending that differences in the risk profile of the state-regulated utilities rendered base ROE comparisons inapt.

b. Briefs on Exceptions

242. OMS states that the Presiding Judge interpreted Opinion No. 531-B as requiring that he give more weight to the fact that the average state-authorized ROE exceeded the DCF midpoint than to the demonstrated downward trajectory in state-authorized ROEs.[495] OMS argues that, in this regard, the Presiding Judge misconstrues Opinion No. 531-B. According to OMS, the Commission did not, in that instance, consider and dismiss a proven downward movement in state ROEs; rather, it simply found that the record lacked proof of such a downward trend.[496] OMS states that the record evidence clearly shows a downturn in state-authorized ROEs over the past decade continuing through the DCF study period. It further contends that the failure of Ms. Lapson's study to account for this trend is a "fatal flaw" that disqualifies the study for use as support for setting the base ROE above the midpoint.[497] Furthermore, OMS contends that the downward trend in state-authorized ROEs should alleviate concerns about capital being shifted away from transmission investments into distribution investments.

243. OMS further argues that, in Opinion No. 531, the Commission compared the investment risks of electric infrastructure with those of electric distribution infrastructure and concluded that the Commission-approved ROE for transmission assets should be higher than the state-authorized ROEs for distribution assets.[498] OMS avers that the basis for this finding was the Commission's determination that investing in transmission carries greater risk than investing in distribution. However, OMS states that Ms.

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[494] *Id.* P 380.

[495] OMS Brief on Exceptions at 38-39 (citing Initial Decision, 153 FERC ¶ 63,027 at P 363).

[496] *Id.* at 39 (citing Opinion No. 531-B, 150 FERC ¶ 61,165 at n.176).

[497] *Id.*

[498] *Id.* at 40 (citing Opinion No. 531, 147 FERC ¶ 61,234 at P 149).

Lapson's analysis is based solely on state-authorized ROEs for integrated utilities, and that Ms. Lapson consciously avoided using data from distribution-only companies.[499]

244. OMS states that the Presiding Judge found that the mean, median, and midpoint of the state-authorized ROEs for distribution-only utilities (9.45 percent, 9.55 percent, and 9.41 percent, respectively) are above the midpoint of the DCF analysis adopted in the Initial Decision (i.e., 9.29 percent).[500] OMS contends, however, that the mean and the midpoint of the state-authorized ROE numbers for distribution-only utilities are below the base ROE of 9.54 percent recommended by Mr. Gorman and that the median is only 0.01 percent above Mr. Gorman's proposed ROE for MISO TOs.[501] OMS states that, to the extent that state-authorized ROEs for distribution-only utilities are a meaningful consideration in setting transmission ROEs, the base ROE proposed by the Complainants in this proceeding is reasonable and sufficient.

245. OMS also asserts that the Commission should reject the Presiding Judge's finding that investing in MISO TOs' Commission-regulated electric transmission entails risks that are at least as great as the risks of investing in the integrated electric utilities analyzed by Ms. Lapson, and therefore it would be illogical to award a base ROE for MISO TOs that is below the state-authorized ROEs of these integrated electric utilities.[502] OMS states that there is no evidence in the record that supports the proposition that the risks assumed by MISO TOs, or by transmission companies in general, are at least as great as those of the integrated utilities studied by Ms. Lapson. On the contrary, OMS states that evidence presented by Mr. Hill indicates that the risks of transmission service are less than the risks of integrated utility operations, which include the risks of competitive operations.[503] Joint Customer Intervenors similarly argue assert that the Presiding Judge failed to consider evidence demonstrating that the formula rate-based transmission service at issue here is less risky than the integrated generation and distribution service regulated by the state commissions.[504]

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[499] *Id.* (citing Exh. MTO-16 at 54:5-14 and OMS Reply Brief at 31).

[500] *Id.* at 41 (citing Initial Decision, 153 FERC ¶ 63,027 at P 400).

[501] *Id.* (citing Exh JC-1 at 2:13; Exh. JC-9 at 32:7-8).

[502] *Id.* (citing Initial Decision, 153 FERC ¶ 63,027 at P 453).

[503] *Id.* at 41-42 (citing Exh. JCA-1 at 35:17-22).

[504] Joint Customer Intervenors Brief on Exceptions at 47-48 (citing Exh. JCI-4 at

(continued...)

246. OMS also states that, should the Commission find that MISO TOs are largely or predominantly integrated or that MISO TOs have risks "at least as great" as those of integrated utilities, an upward adjustment from the DCF midpoint based on comparing utilities having similar risk profiles would not be supportable here. OMS reiterates its Reply Brief argument that an upward adjustment of the base ROE in reliance on Ms. Lapson's state ROE benchmark would not compensate investors by an amount that is in any way linked to the risks that purportedly exceed those associated with distribution companies. Rather, according to OMS, it would simply confer on investors in transmission infrastructure a premium, but one that has no nexus to the risks it is meant to address.[505] OMS states that over-compensating investors for transmission risks is not without its own adverse impacts, including potentially reducing the amount of capital available for other necessary electric infrastructure investments.

247. Joint Customer Intervenors state that the Commission, prior to Opinion No. 531, had long held that wholesale ROE determinations should not be influenced by state-authorized ROEs.[506] Joint Customer Intervenors also argue that incentives should be taken into consideration when comparing the base ROEs awarded to MISO TOs in this proceeding to the state-awarded ROEs. Joint Customer Intervenors assert that it is inappropriate to compare state-awarded ROEs that do not include incentives to Commission-awarded ROEs that do not include incentives.[507]

248. Joint Customer Intervenors explain that Mr. Solomon presented an analysis by SNL Financial that demonstrated that the overwhelming majority of electric utilities are not able to earn their state-awarded ROEs, while MISO TOs' transmission formula rates provide assurance that MISO TOs are able to earn their Commission-awarded ROE. Joint Customer Intervenors state that the utilities in the SNL Financial study earned ROEs that were, on average, 120 basis points below their state-awarded ROEs. Joint Customer Intervenors therefore argue that MISO TOs' ROE should not be compared to

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32:21-36:2).

[505] OMS Brief on Exceptions at 42 (citing OMS Reply Brief at 32).

[506] Joint Customer Intervenors Brief on Exceptions at 47 (citing *Middle S. Services, Inc.*, Opinion No. 124, 16 FERC ¶ 61,101, at 61,221 (1981); *Boston Edison Co.*, Opinion No. 411, 77 FERC ¶ 61,272, at 62,172 (1996); *Jersey Cent. Power & Light Co.*, Opinion No. 408, 77 FERC ¶ 61,001, at 61,009 (1996)).

[507] *Id.* at 48-49.

state-awarded ROEs but should instead be compared to the ROEs that utilities can reasonably be expected to earn under those state-awarded ROEs.[508]

c. Briefs Opposing Exceptions

249. MISO TOs argue that the Presiding Judge properly credited Ms. Lapson's state ROE evidence and correctly found that wholesale transmission is at least as risky as an integrated electric utility and more risky than a distribution-only electric utility.[509] MISO TOs agree that Ms. Lapson's study supports allowing MISO TOs to collect a base ROE above the midpoint, as the DCF midpoint is lower than all the state-authorized ROEs for integrated utilities and lower than two-thirds of the distribution-only electric utilities' state-authorized ROEs.[510] MISO TOs argue that, given "the clear Commission precedent support consideration of state-authorized" ROEs, the Presiding Judge correctly discredited the arguments made in Joint Customers' and OMS's exceptions, which MISO TOs assert, were previously rejected in Opinion Nos. 531 and 531-B.[511] In particular, MISO TOs contend that the Presiding Judge correctly disregarded arguments that the downward trend in state ROEs undermined the usefulness of Ms. Lapson's evidence. Additionally, MISO TOs argue that it is equally unpersuasive for Joint Customers to argue that the Presiding Judge erred by excluding from consideration any ROE incentives awarded under FPA section 219.[512]

d. Commission Determination

250. We agree with the Presiding Judge that the state-authorized ROE study by Ms. Lapson corroborates the finding that a mechanical application of the DCF methodology does not satisfy *Hope* and *Bluefield*. We do so because the 9.29 percent midpoint calculated by the Presiding Judge's DCF study is lower than all of the state-authorized ROEs of integrated electric utilities and most of the distribution-only utilities in that study and because investing in MISO TOs' Commission-regulated electric transmission entails risks that are "at least as great" as those faced by investors in

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[508] *Id.* at 49-50 (citing Exh. JCI-7 at 110-113).

[509] MISO TOs Brief Opposing Exceptions at 31.

[510] *Id.* at 32.

[511] *Id.* at 32-33 (citing Initial Decision, 153 FERC ¶ 63,027 at PP 353-81).

[512] *Id.* at 33.

integrated electric utilities.[513] In Opinion No. 531, the Commission found that record evidence of state commission-approved ROEs supported adjusting the New England transmission owners' base ROE above the midpoint of the zone of reasonableness. In that decision, the Commission stated that it was not "using state commission-approved ROEs to establish the . . . ROE" but that the Commission found that "the discrepancy between state ROEs and the . . . midpoint serve[d] as an indicator that an adjustment to the midpoint . . . is necessary to satisfy *Hope* and *Bluefield*."[514] In Opinion No. 531-B, the Commission further explained that "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 . . . midpoint of the . . . zone of reasonableness was insufficient to satisfy . . . *Hope* and *Bluefield*."[515] We find that the rationale employed there justifies our adoption of the Presiding Judge's finding with regard to Ms. Lapson's study.

251. We also find that OMS's and Joint Customer Intervenors' claims about a downward trend in overall state-authorized ROEs from 10.54 percent in 2005 to 9.58 percent during the first six months of 2015, are not enough, in and of themselves, to overcome the fact that the midpoint is below the vast majority of state-authorized ROEs that became effective during the April 1, 2013 through March 31, 2015 period of Ms. Lapson's study.[516] As noted above, the relevance of the study is to examine whether a survey of state-authorized ROEs might support making an upward adjustment to the Commission-allowed ROE. A study demonstrating that the vast majority of state-authorized ROEs studied exceed the midpoint of the zone of reasonableness suggests that the midpoint of that zone may be too low, and the asserted downward trend in state-authorized ROEs does not, in and of itself, counter this suggestion. First, irrespective of any downward trend in overall state commission-approved ROEs, the fact remains that every single state commission-approved ROE for a vertically integrated utility in the April 1, 2013 through March 31, 2015 study period exceeded the midpoint of the Presiding Judge's DCF study, including those in the first three months of 2015. Mr. Gorman's study, which asserted that the average of state-authorized ROEs declined to 9.58 percent during the first six months of 2015, included distribution-only electric

[513] Initial Decision, 153 FERC ¶ 63,027 at P 455.

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

[515] Opinion No. 531-B, 150 FERC ¶ 61,165 at P 84.

[516] Initial Decision, 153 FERC ¶ 63,027 at P 353.

utilities, as well as integrated electric utilities.[517] In addition, Mr. Gorman's 9.58 percent figure is still above the 9.29 percent midpoint of the DCF zone of reasonableness. Moreover, Mr. Gorman excluded base ROEs authorized by the Virginia Commission. As the Presiding Judge pointed out, inclusion of the Virginia Commission-authorized ROEs would have raised the average of the state-authorized ROEs approved in the first half of 2015 to 10.09 percent,[518] 80 basis points above the 9.29 percent midpoint of the DCF zone of reasonableness.

252. We further disagree with OMS that Ms. Lapson's analysis is "based solely on state-authorized ROEs for *integrated* utilities" and that "she consciously avoided using data from distribution-only companies."[519] As the Presiding Judge noted, Ms. Lapson's study includes data from distribution-only utilities.[520] Additionally, OMS makes arguments comparing the mean and midpoint of the state-authorized ROE numbers for distribution-only utilities to the 9.54 percent base ROE recommended by Mr. Gorman. Again, we note that the Ms. Lapson's study's only relevance is to determine whether state-authorized ROEs are higher than the midpoint of the DCF zone of reasonableness. The study does not prescribe where in the zone of reasonableness the base ROE should be established. Ms. Lapson's study clearly indicates that the 9.29 percent midpoint is lower than all of the state-authorized ROEs of integrated electric utilities in the study and lower than two-thirds of all of the state-authorized ROEs of distribution-only electric utilities in the study.[521]

253. We also disagree with arguments that the record does not contain evidence that MISO TOs and other transmission companies face risks that are at least as great as the risks of investing in integrated electric utilities. Ms. Lapson's study contains an extended discussion of the risks faced by MISO TOs and transmission owners in general.[522] For instance, Ms. Lapson explains that developing interstate electric transmission is subject to "controversy and public opposition" and "subject to the requirements of multiple

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[517] Exh. JC-26 at 1.

[518] Initial Decision, 153 FERC ¶ 63,027 at P 370.

[519] OMS Brief on Exceptions at 40.

[520] *See*, *e.g.*, Initial Decision, 153 FERC ¶ 63,027 at PP 338, 401, 402.

[521] Initial Decision, 153 FERC ¶ 63,027 at PP 455-56.

[522] *See id.* PP 340-48.

jurisdictions," which can increase project complexity and force transmission developers to "make economic concessions to . . . gain approvals."[523] Furthermore, Ms. Lapson states that transmission-owning utilities face "execution risks in completing the project and the risk that parties may seek to disallow rate recovery of any cost overruns."[524] Lapson also notes that medium or small utilities, such as "quite a few of the MISO [TOs]" require external funding, a consideration which creates uncertainty associated with capital market conditions and access to the debt and equity markets.[525]

254. Ms. Lapson also asserts that MISO TOs have capital expenditure (capex) commitments higher than most electric utilities and observes that utilities with high capex are exposed to execution or implementation risks associated with large capital investment, risks associated with the fact that "nearly all of the MISO TOs are invested in capex in excess of their internal cash from operations," and risks associated with the need for external financing.[526] Additionally, we note, and agree with, the Presiding Judge's conclusion that "investment in electric transmission poses a number of unique risks that investment in integrated electric utilities does not" and that investment in "MISO TOs' transmission entails additional risks due to the owners' high capex requirements."[527]

255. We also disagree with Joint Customer Intervenors' argument that "failing to consider the incentives included in state-awarded ROEs and then comparing them to FERC-awarded ROEs that do not include incentive adders is inappropriate on its face."[528] Ms. Lapson stated that she removed all incentive adders from the state-authorized ROEs included in her study, and the Presiding Judge found that the other parties had not provided evidence to show that any of the state-authorized ROEs included in her study

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[523] Exh. MTO-39 at 40:14, 18-22.

[524] *Id.* at 40: 22-24.

[525] *Id.* at 41:1-6.

[526] Initial Decision, 153 FERC ¶ 63,027 at PP 342-347 (citing Exh. MTO-16 at 40:4-5, 13-15.

[527] Initial Decision, 153 FERC ¶ 63,027 at P 397 (citing Exh. MTO-16 at 35, Table 3, 40:4-19, 41:10-42:12; Moody's Rating Methodology, Regulated Electric and Gas Utilities, December 23, 2013 at 24).

[528] JCI Brief on Exceptions at 49.

did include such incentives.[529] It is appropriate to compare state-authorized ROEs that do not include incentive adders with FERC-approved ROEs that also do not include incentive adders, as Ms. Lapson did. As the Commission explained in Opinion No. 531, "[a]lthough section 219 of the FPA gives [the Commission] authority to provide incentives above the base ROE, nothing in section 219 relieves [the Commission] from first setting the base ROE at a place that meets *Hope* and *Bluefield*."[530] Since the base ROE must therefore not include incentives, it would be equally inappropriate to compare state-authorized ROE data that includes state-awarded ROE incentives.

256. Joint Customer Intervenors also argue that the Commission should not compare MISO TOs' ROE to state-awarded ROEs, but should instead compare MISO TOs' ROE to the state-awarded ROEs that utilities can expect to actually earn. Again, Ms. Lapson's conclusions serve as one indicator among several suggesting that the 9.29 percent midpoint of the DCF-produced zone of reasonableness is insufficient to satisfy *Hope* and *Bluefield*. That is, these conclusions, along with the other alternative methodologies described above have convinced us to set the base ROE above the midpoint in this proceeding. The survey does not, and should not, serve to prescribe the Commission's placement of the base ROE at any particular point within the zone of reasonableness. Additionally, we find that evidence that Joint Customer Intervenors provide to argue that not all utilities can expect to actually earn the state-authorized ROE they are permitted earn is both incomplete and not wholly supportive of their argument here.[531]

6. Impact of Base ROE on Planned Investment

a. Initial Decision

257. The Presiding Judge concluded that setting MISO TOs' base ROE at the midpoint of the zone of reasonableness "could undermine their ability to attract capital for new investment in electric transmission."[532] The Presiding Judge reviewed the evidence provided by Mr. Kramer, observing, in particular, that the 2014 MISO Transmission Expansion Plan (MTEP) contemplated roughly $20 billion of investment in transmission facilities. The Presiding Judge recounted how Ms. Lapson explained that MISO TOs'

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[529] Exh. MTO-16 at 52. Initial Decision, 153 FERC ¶ 63,027 at P 374.

[530] Opinion No. 531, 147 FERC ¶ 61,234 at P 153.

[531] Exh. JCI-4 at 34:1-12.

[532] Initial Decision, 153 FERC ¶ 63,027 at P 480.

ROE was one of their primary sources of cash flow, which they used to fund investment in new transmission facilities.[533] In addition, she noted that this cash flow also helped to demonstrate MISO TOs' financial health to investors. Too large a reduction in base ROE would thus both cut off their cash flow as a significant source of investment capital and make it more difficult for MISO TOs to attract reasonably priced capital. Limited access to capital could, in turn, force MISO TOs to divert investment from projects contemplated in the MTEP and instead toward transmission projects for local reliability, which they are obligated to build.[534] In addition, the Presiding Judge also noted Ms. Lapson's observation that a large ROE reduction could create continued uncertainty, reducing investor interest in transmission-owning entities more generally.[535]

258. In reaching those conclusions, the Presiding Judge rejected the argument that the fact that the MISO TOs had not yet cancelled or deferred any transmission projects, even though they expected some reduction in base ROE, demonstrated that an ROE reduction was unlikely to reduce their investment in transmission infrastructure. The Presiding Judge explained that Ms. Lapson's testimony indicated that too large an ROE reduction would impair new investment, not that any reduction whatsoever would have that effect.[536] The Presiding Judge explained that, in Opinion No. 531, the Commission relied on evidence showing that a 175 basis-point reduction in ROE "*could*" reduce transmission investment. The Presiding Judge therefore concluded that Opinion No. 531 was consistent with the conclusion that reducing MISO TOs' base ROE from its current level to the midpoint of the zone of reasonableness, a 310-basis-point reduction, could undermine their ability to attract new capital to invest in transmission infrastructure.[537]

b. <u>Briefs on Exception</u>

259. Joint Customer Intervenors argue that the evidence did not demonstrate a correlation between the ROE and the level of transmission investment. According to Joint Customer Intervenors, Mr. Kramer stated that "he does not know what would have happened" when asked whether the amount of new projects would have exceeded

[533] *Id.* PP 465-466.

[534] *Id.* PP 468-469.

[535] *Id.* P 471.

[536] *Id.* PP 473-475.

[537] Initial Decision, 153 FERC ¶ 63,027 at PP 476-477.

the levels he cited if the Commission had allowed a return higher than the current 12.38 percent ROE.[538] Joint Customer Intervenors also claim that Mr. Kramer was unable to provide "evidence that indicates whether or not the same benefits would or would not have been achieved . . . under the suggested hypothetical of a lower base ROE."[539] Joint Customer Intervenors further argue that Ms. Lapson's statements, while relied upon by the Initial Decision, merely assert that a reduction in ROE would result in a reduction in earnings and cash flow, and that credit ratings might be affected.[540] Joint Customer Intervenors assert that there is no evidence in the record suggesting that their proposed base ROE would do any harm to transmission investment in the MISO region.[541]

c. <u>Briefs Opposing Exception</u>

260. MISO TOs argues that Joint Customers wrongly suggest that the Presiding Judge was required to quantify the precise ROE necessary to sustain transmission investment, as such precision is not required by the FPA.[542] Additionally, MISO TOs argue that the Presiding Judge "cited ample record support" to support his conclusion that setting the DCF at the midpoint of zone of reasonableness would have placed MISO TOs' base ROE below the ROE available for comparable or less risky investments, thereby impairing MISO TOs ability to compete for capital.[543] In particular, they note that the Presiding Judge adequately responded to the contention that federally regulated transmission mission facilities are less risky than those subject to state regulation and, therefore, that the federally regulated entities could still adequately attract capital, even if they are receiving a lower ROE.

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[538] Joint Customer Intervenors Brief on Exceptions at 52-53 (citing Ex. JCI-14 at 1).

[539] *Id.* at 53 (citing Ex. JCI-13 at 1).

[540] *Id.* at 54 (citing Initial Decision, 153 FERC ¶ 63,027 at PP 463-470).

[541] *Id.*

[542] MISO TOs Brief Opposing Exceptions at 37.

[543] *Id.*

d. Commission Determination

261. We affirm the Presiding Judge's conclusion that setting MISO TOs' base ROE at the midpoint of the zone of reasonableness could impair investment in transmission facilities. As the Commission explained in Opinion No. 531, adequate transmission investment supports the Commission's responsibility to ensure that rates are just and reasonable because new transmission facilities help to "promote efficient and competitive electricity markets, reduce costly congestion, enhance reliability, and allow access to new energy resources, including renewables."[544] We continue to find that this is the case, including for the $20 billion of transmission investment contemplated by the 2014 MTEP.[545]

262. We find that reducing MISO TOs ROE to the midpoint of the zone of reasonableness could, as Ms. Lapson and Mr. Kramer explained, put at risk the MTEP investments as well as those in other beneficial transmission facilities. By reducing MISO TOs' cash flow, an overly large ROE reduction will reduce MISO TOs' ability to fund new transmission investment with the profits from their existing operations. In addition, an overly large ROE reduction could cause MISO TOs' credit ratings and/or other measures of financial health to deteriorate, impairing their ability to raise external capital to fund new transmission facilities. In particular, as Ms. Lapson explained, a "radical reduction" in MISO TOs ROE could cause investors to shift their capital to state-regulated utilities, which may have a similar risk to MISO TOs and, as discussed above, may earn an ROE greater than the midpoint of the zone of reasonableness, making them significantly more attractive investments. As she explained, a recent UBS report identified a "perception" that "investors were already beginning to react to the potential for lower [b]ase ROEs by shifting their investment capital to [state-regulated] electric and gas retail distribution investments and away from wholesale electric transmission."[546]

263. We conclude that reducing MISO TOs' ROE to the midpoint of the zone of reasonableness could be sufficient to bring about those results. As the Presiding Judge explained, in Opinion No. 531, the Commission concluded that a 175-basis-point ROE reduction—from an ROE of 11.14 to an ROE of 9.39—could put transmission investment at risk.[547] The same is true here. Based on the evidence in this proceeding, we conclude

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

[545] Initial Decision, 153 FERC ¶ 63,027 at PP 459, 461.

[546] *Id.* P 350 (citing Exh. MTO-44).

[547] *Id.* P 479 (citing Opinion No. 531, 147 FERC ¶ 61,234 at P 150).

that a base ROE reduction nearly twice as large as the Commission considered in Opinion No. 531 — that is, a reduction from an ROE of 12.38 to an ROE of 9.29 — is at least as likely to put transmission investment at risk as was the reduction contemplated in Opinion No. 531. Thus, as in Opinion No. 531, we find that the potential for reduced transmission investment counsels against a mechanical application of the DCF.[548]

264. Joint Customer Intervenors' arguments do not require a contrary conclusion. In particular, we note that the Commission has never required a demonstrated correlation between a particular ROE level and a particular level of transmission investment or that a reduction in ROE will cause particular harms to customers within MISO. Further, the Commission, in Opinion No. 531, concluded that evidence that a certain ROE reduction "could" imperil transmission investment militated against imposing such a reduction.[549] For the reasons discussed, we conclude that the evidence in the record suggests that setting MISO TOs' base ROE at the midpoint of the zone of reasonableness could impair their ability to invest in new transmission infrastructure.

265. Based on the presence of anomalous capital market conditions and informed by the returns indicated by the CAPM, expected earnings, and risk premium analyses discussed above, we find that the ROE for MISO TOs should be above the midpoint of the zone of reasonableness established by the DCF analysis. We now turn to the issue of precisely where in the upper half of the zone of reasonableness to set MISO TOs' ROE.

7. **Placement of the Base ROE above the Midpoint**

a. **Initial Decision**

266. The Presiding Judge concluded that the presence of anomalous market conditions justified an ROE above the midpoint of the zone of reasonableness. The Presiding Judge concluded that, consistent with Opinion No. 531, it was appropriate to set the base ROE at the midpoint of the upper half of the zone of reasonableness.[550]

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[548] *See* Opinion No. 531, 147 FERC ¶ 61,234 at P 150.

[549] *Id.*

[550] Initial Decision, 153 FERC ¶ 63,027 at PP 118-119, 491.

b. <u>Briefs on Exceptions</u>

267. Joint Customer Intervenors contend that, to the extent that capital market conditions were anomalous and such conditions justified a return higher than the midpoint of the zone of reasonableness, the appropriate point would be the 75th percentile of the zone of reasonableness. They state that their witness, Mr. Mr. Solomon testified that the 75th percentile is the point in the zone of reasonableness at which 25 percent of the proxy companies have higher ROEs and 75 percent of the proxy companies have lower ROEs. Joint Customer Intervenors argue that, while the Initial Decision stated that the Commission has thus far selected either the midpoint or the upper midpoint to be the base ROE applicable to multiple transmission owners, there is no Commission policy mandating the choice of the upper midpoint following a decision to choose a point above the midpoint or median.[551] Joint Customer Intervenors note that the Commission has chosen a point other than the midpoint or upper midpoint.[552] Joint Customer Intervenors argue that, even if the Commission had never chosen a point other than the midpoint or upper midpoint, the Commission has never declared that only those two points may be considered and, therefore, other points could be considered.[553]

268. OMS states that, should the Commission find that anomalous market conditions existed during the study period, the Commission need not (and should not) default to placing the Base ROE at the upper midpoint. OMS states that the Commission's charge in cases such as this is to set the new Base ROE at a level sufficient for MISO TOs to attract capital on reasonable terms, but no higher, and that to comply with that mandate, the Commission must have the flexibility to set the Base ROE anywhere between the DCF midpoint and the upper midpoint. OMS notes that, in Opinion No. 531-B, the Commission rejected a proposal to allow a Base ROE at the 75th percentile of the zone of reasonableness on the grounds that Commission precedent supported use of the "central tendency" to determine an appropriate return in cases involving the placement of the Base ROE for a region-wide group of utilities.[554] OMS states that Opinion No. 531-B

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[551] Joint Customer Intervenors Brief on Exceptions at 50-51 (citing Initial Decision, 153 FERC ¶ 63,027 at P 118).

[552] *Id.* at 51 (citing *Sw. Pub. Serv. Co.*, Opinion No. 421, 83 FERC ¶ 61,138, at 61,637-38 (1998)).

[553] *Id.*

[554] OMS Brief on Exceptions at 28 (citing Opinion No. 531-B, 150 FERC ¶ 61,165 at P 55).

also rejected arguments that Commission precedent requires the Commission to consider distribution of results within the proxy group when determining where in the upper half of the zone the Base ROE should be placed.[555]

269. OMS contends that the Presiding Judge only evaluated the alternative benchmarks to determine if a higher ROE should be used than the midpoint. OMS argues that the Presiding Judge erred by finding irrelevant the relationship between the ROE values from the alternative benchmarks and the upper midpoint, which would support a value lower than the upper midpoint.[556]

270. OMS argues that the Commission should not bind itself to an "either-or" choice between the DCF midpoint and the Upper Midpoint; rather, it must be able to set the Base ROE at other points of central tendency within the upper-half of the zone of reasonableness, such as the mean or the median of the upper-half of the zone. OMS states that the Commission could also set the Base ROE at any point of central tendency within a range between the midpoint of the DCF zone of reasonableness and the Upper Midpoint (i.e. between 9.29 percent and 10.32 percent). OMS argues that the Commission should take care to preserve maximum flexibility in establishing the new base ROE for MISO TOs, and reject the notion that it is limited to a binary choice between the DCF midpoint and the upper midpoint, where capital market conditions have been proven "anomalous."[557]

271. Complainants contend that the Initial Decision erred in failing to consider their proposed four quartile approach for placement of the ROE.[558] Complainants state that, even though the Commission typically considers the midpoint to be the best embodiment of the central tendency within the zone of reasonableness for the base ROE for multiple utilities, the Commission has expressed concern that this approach gives undue weight to the two extreme values in that range.[559] Complainants state that, to mitigate this

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[555] *Id.* (citing Opinion No. 531-B, 150 FERC ¶ 61,165 at P 55).

[556] *Id.* at 9.

[557] *Id.* at 29.

[558] Complainants Brief on Exceptions at 23 (citing Complainants Initial Brief at 40-43; *see also* Complainants Reply Brief at 28-29).

[559] *Id*. (citing Opinion No. 531, 147 FERC ¶ 61,234 at P 144 (citing *S. Cal. Edison Co*., 131 FERC ¶ 61,020, at P 91 (2010), *remanded on other grounds sub. nom. S. Cal. Edison Co. v. FERC*, 717 F.3d. 177 (D.C. Cir. Ct. 2013) and *S. Cal. Edison Co*.,

(continued...)

shortcoming, Mr. Gorman separated the DCF estimates within his original zone of reasonableness (i.e., 6.75 to 11.01 percent) into four quartiles and redefined the upper and lower bounds of the zone by using the medians of the upper and lower quartiles, resulting in a zone of reasonableness from 8.60 to 9.56 percent. Mr. Gorman then recommended a base ROE situated at the 9.08 percent midpoint between these outer bounds, which he recommended for MISO TOs that have common equity ratios of 55 percent or less.[560] Complainants contend that this approach is appropriate because of the distortive effect of the extreme values, as demonstrated by the effect of their removal.[561]

c. **Briefs Opposing Exceptions**

272. MISO TOs argue that the placement of the new base ROE at the upper half midpoint is consistent with Opinion No. 531 and produces reasonable results supported by alternative benchmarks and state ROEs.[562] In support of this argument, MISO TOs argue that nothing in Opinion Nos. 531 or 531-B requires the Presiding Judge to calibrate the precise increment by which the DCF midpoint is affected by anomalous capital market conditions and such "exactitude is neither practical nor necessary to satisfy" the FPA.[563] MISO TOs note that the Presiding Judge relied on Opinion No. 531 to inform his zonal placement because this precedent represents the Commission's "most current explication of its approach to zonal placement," and the issues decided in Opinion No. 531 "were substantively identical" to the questions at issue here.[564]

273. MISO TOs argue that, while in deviating from midpoint values in the past, the Commission has typically relied upon comparative risk assessment, this fact does not preclude consideration of ROE adjustments based on other factors, including demonstrated infirmities in DCF inputs and results.[565] MISO TOs also argue that there is

131 FERC ¶ 61,020 at P 86 (citing *Northwest Pipeline Corp.*, 99 FERC ¶ 61,305 at 62,276 (2002)).

[560] *Id*. at 24 (citing Ex. JC-1, pp. 33-37; *see also* Ex. JC-22, pp. 18-19).

[561] *Id*. at 24-25.

[562] MISO TOs Brief Opposing Exceptions at 19.

[563] *Id.* at 20.

[564] *Id.* at 21.

[565] *Id.* at 21.

no requirement that the Presiding Judge examine every conceivable zonal point within the DCF range or quantify the exact basis-point impact of the documented capital market anomalies. They further argue that the upper-half midpoint is "consistent with the Commission's preference for the central tendency."[566]

274. MISO TOs also state that the Presiding Judge did not need to explicate his reasons for not adopting Complainants' quartile approach, because such approach is "arbitrary and contrived merely to constrict the zone of reasonableness."[567] Additionally, they state that Mr. Gorman articulated the rationale for his proposal and the Presiding Judge rightly rejected this approach.[568]

d. <u>Commission Determination</u>

275. In the Initial Decision, the Presiding Judge determined that, consistent with Commission precedent, in the presence of anomalous capital market conditions, the base ROE should be established at the upper midpoint of the zone of reasonableness. The Presiding Judge stated that, when determining the base ROE applicable to multiple transmission owners, "the only two places within the zone of reasonableness that have thus far proved consistent with the Commission's preference of the central tendency" are the midpoint and upper midpoint, which the Presiding Judge determined to be 9.29 percent and 10.32 percent, respectively.[569] In this proceeding, we adopt the Presiding Judge's finding that the upper midpoint of the zone of reasonableness represents the just and reasonable base ROE for the MISO transmission owners.

276. We are unpersuaded by contentions that, if the Commission concludes that MISO TOs' 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, rather than at the 10.32 percent midpoint of the upper half of the zone. As the Commission explained in Opinion No. 531-B,[570] the Commission has traditionally used measures of central tendency to determine an appropriate return in ROE cases and, in cases involving

[566] *Id.* at 22 (citing Initial Decision at P 118).

[567] *Id.* n.50.

[568] MISO TOs Brief Opposing Exceptions at n.50.

[569] Initial Decision, 153 FERC ¶ 63,027 at P 118.

[570] Opinion No 531-B, 150 FERC ¶ 61,165 at P 55.

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.[571]

277. We also disagree with the assertion that there is no evidence to support the specific upward adjustment. Such exactitude has never been required in determining the appropriate placement of ROEs within the zone of reasonableness or for determining the appropriate size of incentives. The Commission maintains discretion to use its judgment in weighing factors specific to a given proceeding to determine where within the zone of reasonableness the final base ROE should be placed.

278. The Commission has held that the midpoint is the appropriate measure of the central tendency for groups of utilities.[572] That determination is not altered by the use of the midpoint of the upper half of the zone of reasonableness.

279. In response to Joint Customer Intervenors, while anomalous market conditions reduce the Commission's confidence in the establishment of the ROE at the midpoint of the zone of reasonableness, the Commission has not required a precise correlative relationship between a particular ROE and a desired level of transmission investment. Additionally, while we disagree with Complainants' proposed quartile approach, we also find that Joint Customer Intervenors failed to convince us that the 75th percentile of the zone of reasonableness reflects the appropriate base ROE here.

280. We disagree with OMS' argument that the Presiding Judge erred in not considering that the alternative benchmarks indicate that the ROE should be lower than the upper midpoint. MISO TOs' risk premium and expected earnings analyses, which the Commission accepts as discussed above, featured respective midpoint ROEs of 10.36 and 11.99 percent, both of which *exceed* the upper midpoint, indicating that the upper midpoint is not generally higher than the ROEs produced by the alternative benchmarks.

281. Finally, we reject the Complainants' proposal to set MISO TOs' ROE at 9.08 percent based on their four quartile approach. A base ROE of 9.08 percent would be

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[571] *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.

[572] *See, e.g.*, S. *Cal. Edison Co.*, 131 FERC ¶ 61,020 at P 91.

below the 9.29 percent midpoint of the DCF zone of reasonableness in this case. The Complaints' proposal is thus contrary to our holding above that MISO TOs' ROE should be set at a point above the midpoint of the zone of reasonableness.

D. Other Issues

1. Capital Structure

a. Initial Decision

282. At hearing, Complainants and JCA both propose that whatever base ROEs are approved in this proceeding be reduced for all MISO TOs with equity ratios of 55 percent or higher. Mr. Gorman contends that the base ROEs of these utilities should be lowered by 20 basis points.[573] Mr. Hill recommends that the allowed base ROEs of MISO TOs that have common equity ratios of 55 percent or above should be adjusted downward five basis points for every one percent difference between the ratemaking common equity ratio and 49 percent (the average common equity ratio of what he refers to as "the electric utility sample group"). Conversely, he recommends that the base ROEs of firms with equity ratios at or below 45 percent should be adjusted upward five basis points for every one percent difference between the ratemaking common equity ratio and 49 percent.[574] Both Complainants/Joint Consumer Advocates contended that a utility with a higher equity ratio is less risky than comparable utilities with lower equity ratios, and that its base ROE should be lowered to reflect that rate differential.[575]

283. The Presiding Judge rejected proposals to adjust MISO TOs' base ROE based on their equity ratios. The Presiding Judge determined that these arguments amounted to a collateral attack on the Commission's rejection in the Hearing Order of an argument that it should cap MISO TOs' actual or hypothetical capital structure at 50 percent equity. The Presiding Judge concluded that lowering the base ROE for utilities with an equity ratio greater than 50 percent would "do indirectly what the Commission said it would not do directly."[576] The Presiding Judge further noted that the Commission's approach to

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[573] Exh. JC-1 at 36:13-17.

[574] Exh. JCA-1 at 43:27–44:9; Exh. JCA-11 at 63-64.

[575] Exh. JC-1 at 20-21; Exh. JCA-11 at 45.

[576] Initial Decision, 153 FERC ¶ 63,027 at P 483.

setting the base ROE already incorporates measures of the utilities' risk, obviating the need to account for the effect of capital structure on risk.

b. Briefs on Exceptions

284. Complainants argue that the Presiding Judge erred in rejecting Complainants' recommended capital structure-based ROE adjustments as a collateral attack on the Hearing Order. Complainants argue that the Hearing Order did not foreclose consideration of all issues related to MISO TOs' capital structure for evaluating the base ROE such that their argument warrants consideration.[577] Specifically, the Commission found that issues regarding capital structures "are best addressed with respect to that ROE, which the Commission is setting for hearing."[578] Complainants state that an equity-heavy capital structure increases costs to ratepayers and recommends a 20 basis point reduction to the base ROE of MISO TOs whose common equity structure exceeds 55 percent to account for their lower risk.[579]

c. Briefs Opposing Exceptions

285. MISO TOs also argue that the Presiding Judge correctly rejected Complainants' collateral attack on the Hearing Order's rejection of a cap on common equity ratios.[580]

d. Commission Determination

286. We disagree with Complainants' argument that the Commission should reduce the base ROEs of utilities with capital structures featuring at least 55 percent equity by 20 basis points. Although this proposal is not beyond the scope of this proceeding, as it is distinct from Complainants' request to prohibit equity-rich capital structures, it is insufficiently supported and inconsistent with the Commission's methodology for determining where in the DCF zone of reasonableness to place a specific public utility. While the Commission has indeed adjusted a company's base ROE above or below the

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[577] Complainants Brief on Exceptions at 51.

[578] *Id.* at 51-52 (citing Hearing Order, 149 FERC ¶ 61,049 at P 199).

[579] Complainants Brief on Exceptions at 52 (citing Complainants Initial Brief at 90; *see also* Complainants Reply Brief at 39-41).

[580] MISO TOs Brief Opposing Exceptions at 49-51.

central tendency of the zone of reasonableness based on the relative risk analysis,[581] it does so only after a full evaluation of all relevant factors including both business and financial risk.[582] This is because lower financial risk may be offset by higher business risk or vice versa. Complainants have provided no such complete evaluation of any of the MISO TOs' relative risk versus the proxy group. Rather, they seek a risk adjustment based upon a single factor, an alleged equity-rich capital structure, without consideration of any other risk factor. This is contrary to Commission policy.

287. Moreover, although equity-rich capital structures may reduce utility risk Complainants have not attempted to justify or provide quantitative support for presumably arbitrary 55 percent threshold for this penalty. Additionally, Complainants' observation that their proposed 20 basis-point reduction is approximately one third of the difference between the spread between A and Baa utility bond yields for the six months ending December 2014,[583] lacks quantitative support such that it does not make the choice of this threshold any less arbitrary. Complainants provide no evidence of how much a higher return correlates with a higher credit rating. Complainants also do not justify why their proposed ROE reduction should apply to all utilities with equity percentages above 55 percent, regardless of what the equity percentage is.

288. In any event, Complainants' position fails to take into account the fact that our criteria for selecting members of the proxy group are intended to produce a proxy group made up of companies of similar risk. Those criteria include screens to ensure that the proxy group contains only utilities with similar credit ratings to the utility at issue. To the extent that a higher percentage equity in the capital structure reduces a utility's risk, as Complainants and Joint Consumer Advocates assert, then the utility's credit rating would be correspondingly higher than that of a utility with a typical capital structure. The resulting higher credit ratings of members of the proxy group would reduce the calculated ROE, because higher-rated companies generally have lower ROEs. Consequently, additional reductions to the ROEs that are proposed by Complainants essentially reduce the ROE twice for featuring equity-rich capital structures.

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[581] *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").

[582] *See, e.g.*, *El Paso Natural Gas Co.*, Opinion No. 528-A, 154 FERC ¶ 61,120 at PP 302-340 (2016) (Opinion No. 528-A).

[583] *See* Exh. MTO-1 at 36.

289. Furthermore, as a policy matter, the Commission does not directly incentivize utilities' to adjust their preferred capital structures. The Commission has not previously directly encouraged utilities to feature more debt in their capital structure. We find that it would be inappropriate to encourage additional debt leveraging of utilities, many of which are undertaking large investments or do not have high credit ratings.

2. Formula Rate ROE Adjustments

a. Initial Decision

290. The Presiding Judge rejected the arguments of Joint Consumer Advocates and Joint Customer Intervenors that MISO TOs' formula rates reduce their business risks, at least relative to state-regulated utilities. The Presiding Judge observed that, although the parties appeared to "agree that formula rates reduce the risk of under-recovery, but deny the utility the benefits of over-recover[y]," the record did not indicate which effect was likely to predominate, making it impossible to determine the net effect of formula rates on a company's risk profile.[584] The Presiding Judge also concluded that the record did not contain evidence that the formula rates gave MISO TOs a significant advantage in more rapidly recovering their costs relative to state-regulated electric utilities.[585] In addition, the Presiding Judge distinguished a series of earlier Commission cases, in which the Commission appeared to adopt the proposition that formula rates reduced a utility's business risk. The Presiding Judge explained that those cases involved generators that had contracted to sell electricity to corporate affiliates that agreed to purchase all of the generators' output and the generator had a formula rate that provided for the recovery of all its expenses — circumstances that the Presiding Judge determined were not present for MISO TOs.[586] Finally, the Presiding Judge also noted that "a formula rate . . . appears to best serve the public interest" and, therefore, that lowering a public utility's ROE on the basis that it receives a formula rate could run counter to Commission objectives.[587]

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[584] Initial Decision, 153 FERC ¶ 63,027 at P 419.

[585] *Id.* PP 429-430, 432.

[586] *Id.* PP 435-443.

[587] *Id.* PP 449-450.

b. Briefs on Exceptions

291. Joint Customer Intervenors assert that the Presiding Judge failed to consider evidence demonstrating that the formula rate-based transmission service at issue here is less risky than the integrated generation and distribution service regulated by the state commissions.[588] OMS states that the Commission has explained that, in determining the ROE for public utilities, its evaluation of investment focuses on the two major sources of uncertainty to a company: the business risk and financial risk. OMS reiterates the arguments that Attachment O to the MISO Tariff – a comprehensive formula rate transmission rate – substantially mitigates the business risk faced by MISO TOs, and that this reduction in risk must be considered and given effect in determining a just and reasonable ROE for MISO TOs.[589] OMS states that the Presiding Judge rejected those arguments, citing three reasons why the availability of formula rates should not be a factor in the ROE determination. OMS contends that each of the three reasons relied upon by the Presiding Judge is erroneous.

292. First, OMS states that the Presiding Judge appears to have adopted MISO TOs' contention that formula rates are a double-edge sword; they eliminate the need for utilities to file rate cases when costs are increasing, but do not eliminate the risk of retroactive downward adjustments to rates when the formula has operated to over-recover costs.[590] OMS states that the inability to enjoy a windfall when costs are declining is not a factor that should be thought to balance out the mitigation of business risk formula rates provide in an increasing-cost environment.

293. Second, OMS states that the Presiding Judge found that formula rates serve the "public interest" because they ensure that a utility earns no more or less than its authorized Base ROE.[591] OMS states that this interest would be adversely affected, according to the Presiding Judge, if base ROEs were reduced to reflect the lower business risk faced by a company with a formula rate.[592] OMS argues that the Initial Decision's

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[588] Joint Customer Intervenors Brief on Exceptions at 47-48 (citing Exh. JCI-4 at 32:21-36:2).

[589] OMS Brief on Exceptions at 44 citing OMS Initial Brief at 34-35.

[590] *Id.* (citing Initial Decision, 153 FERC ¶ 63,027 at P 446).

[591] *Id.* at 45 (citing Initial Decision, 153 FERC ¶ 63,027 at P 447).

[592] *Id.* (citing Initial Decision, 153 FERC ¶ 63,027 at P 448).

finding in this regard misses the point that was argued by OMS and others because it focuses on the pros and cons of formula rates from the point of view of utilities, not from the perspective of investors. OMS states that investors care more about the certainty of cost recovery over time than they do about the opportunity for short-term windfalls, and therefore investors require less of a return from companies that offer a certainty of cost recovery than they do from companies offering instead the remote chance for an occasional windfall.[593] OMS contends that, by failing to give effect to this fact, the Presiding Judge confers a Base ROE that is higher than the actual risk-adjusted cost of equity for companies with full-cost recovery formula rates.

294. Finally, OMS states that the Presiding Judge relies on the fact that "the Commission has recently ignored without comment contentions that it should reduce a utility's Base ROE based on its utilization of allegedly less risky formula rates."[594] OMS argues that the Commission's silence in *PATH* cannot be construed as a determination on the merits of the question, and the Commission made clear in a more recent incarnation of the *PATH* proceedings that "silence is not evidence of Commission policy."[595] Furthermore, OMS contends that in *PATH* and the other orders to which the Initial Decision alludes[596] (save one), the Commission declined to expressly recognize the risk-mitigating effects of formula rates in the context of considering ROE *incentives*, not in the context of determining a just and reasonable, properly risk-adjusted *base* ROE. That the Commission did not expressly give effect to the risk-mitigating impact of formula rates in ROE adder cases, according to OMS, says nothing about the ability of formula rates to mitigate the risks that are relevant in Base ROE cases. OMS states that the only case cited by the Presiding Judge that specifically addressed a utility's base ROE is *Virginia Electric & Power Company*, where the Commission reduced the requested base ROE without expressly addressing, one way or the other, the argument that formula rates

[593] *Id.* n.155 ("It is well-established in the financial literature that investors are generally 'risk-averse.' This means that the required return for an investment that has symmetric expectations of gains and losses is greater than the required return for an investment with certainty of no gains or losses.").

[594] *Id.* at 46 (citing Initial Decision, 153 FERC ¶ 63,027 at P 445 (citing *Potomac-Appalachian Transmission Highline, L.L.C.*, 122 FERC ¶ 61,188 (2008) (*PATH*))).

[595] *Id.* (citing *Potomac-Appalachian Transmission Highline, L.L.C.*, 153 FERC ¶ 61,308, at P 13 (2015)).

[596] *Id.* at 46 (citing Initial Decision, 153 FERC ¶ 63,027 at n.570).

mitigate risks.[597] OMS asserts that since silence is not evidence of Commission policy, the Initial Decision's reliance on these orders is not well-founded.

c. Briefs Opposing Exceptions

295. MISO TOs state that the Commission has previously found that formula rate tariffs do not fully mitigate the cost recovery risk of federally-regulated transmission or render public utilities less risky than state-regulated enterprises.[598]

296. In support of this argument, they state that the Commission has previously found that formula rate tariffs do not fully mitigate the cost recovery risk of federally-regulated transmission or render public utilities less risky than state-regulated enterprises.[599] Additionally, in response to OMS's argument that the Presiding Judge wrongly discounted Mr. Hill's comparable risk evidence, MISO TOs claim that OMS documented no errors in the Presiding Judge's finding that such evidence was outdated, inapplicable, incomplete, or inconsistent with testimony offered by other witnesses.[600] MISO TOs also argue that the Presiding Judge rightly determined that Mr. Solomon's testimony was incomplete, tangentially relevant, or not supportive of Mr. Solomon's position.[601]

d. Commission Determination

297. We affirm the Presiding Judge's determination that the use of formula rates does not warrant a lower base ROE. To the extent that formula rates reduce risk, they would, similar to the use of more equity in the capital structure, improve utility credit ratings. This would in turn affect the DCF proxy group based on screens requiring a group of similarly-rated utilities, diminishing the ROE produced by the DCF analysis. Additionally, nearly all electric utilities feature transmission formula rates. Consequently, the use of such formula rates is reflected in the proxy group within the DCF analysis.

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[597] *Id.* at 46-47 citing *Virginia Elec. & Power Co.*, 123 FERC ¶ 61,098, at P 58 (2008).

[598] MISO TOs Brief Opposing Exceptions at 35.

[599] *Id.*

[600] *Id.* at 35-36.

[601] *Id.* at 36.

298. Finally, as the Commission previously explained in Opinion No. 531, "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," which in this case, would be 11.35 percent.[602] We therefore find that MISO TOs' total or maximum ROE, including transmission incentive ROE adders, cannot exceed 11.35 percent.[603]

The Commission orders:

(A) MISO TOs' base ROE is hereby set at 10.32 percent with a total or maximum ROE including incentives not to exceed 11.35 percent, effective on the date of this order, as discussed in the body of this order.

(B) MISO and MISO TOs are hereby directed to submit compliance filings with revised rates to be effective the date of this order reflecting a 10.32 percent base ROE and a total or maximum ROE not exceeding 11.35 percent (inclusive of transmission incentive ROE adders), within thirty (30) days of the date of this order, as discussed in the body of this order.

(C) MISO and MISO TOs are hereby directed to provide refunds, with interest calculated pursuant to 18 C.F.R. § 35.19a (2016), within thirty (30) days of the date of this order, for the 15-month refund period from November 13, 2013 through February 11, 2015, as discussed in the body of this order.

(D) MISO and MISO TOs are hereby directed to file a refund report detailing the principal amounts plus interest paid to each of their customers within forty-five (45) days of the date of this order.

By the Commission. Commissioner Honorable is not participating.

(S E A L)

Nathaniel J. Davis, Sr.,
Deputy Secretary.

[602] Opinion No. 531, 147 FERC ¶ 61,234 at P 165.

[603] *See* Opinion No. 531-A, 149 FERC ¶ 61,032 at P 11.

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