Will FERC (Finally!) Resolve Electric Transmission ROEs?

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One way to examine whether the Commission's recent reformulations of its analysis of return on common equity[2] are likely to "resolve" current controversies on that subject is to evaluate those efforts through the prism of "reasoned decision-making." Reasoned decision-making requires the Commission "to offer 'a rational connection between the facts found and the choice made'"[3] in reaching a decision. "Reasoned decisionmaking, in which the rule announced is the rule applied, promotes sound results, and unreasoned decisionmaking the opposite. The evil of a decision that applies a standard other than the one it enunciates spreads in both directions, preventing both consistent application of the law by subordinate agency personnel (notably administrative law judges), and effective review of the law by the courts."[4] Other boundaries that reasoned decision-making places on the Commission's choices and uses of analytical tools include the requirements of: (1) a reasoned explanation

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1 Two things that ought to go without saying, but never do: (1) the views expressed in this paper are exclusively those of the author, and are not in any circumstances to be attributed to Duncan & Allen or any of the firm's clients; and (2) the author is solely responsible for any and all errors in this paper.

2 These efforts include: (1) Order Directing Briefs issued October 16, 2018 in *Coakley, et al. v. Bangor Hydro-Electric Co., et al.*, 165 FERC ¶ 61,030 (2018) in response to the remand in *Emera Maine v. FERC*, 854 F.3d 9 (D.C. Cir. 2017), (2) the companion Order Directing Briefs issued November 15, 2018 in the pending complaint proceedings against the transmission owners in the Midcontinent ISO in *Assn of Bus. Advocating Tariff Equity, et al. v. ALLETE, Inc., et al.*, 165 FERC ¶ 61, 118 (2018), (3) the Order Providing Guidance issued November 15, 2018 in *Ark. Pub. Svc. Comm'n v. System Energy Res., Inc.*, 165 FERC ¶ 61,119 (2018), (4) an Order on Complaint in *E. Tex. Elec. Coop. v. Pub. Svc. Co. of Okla.*, 166 FERC ¶ 61,020 (2019), and (5) the pending Notice of Inquiry (PL19-4-000) *Inquiry Regarding the Commission's Policy for Determining Return on Equity*, 166 FERC ¶ 61,207 (2019).

3 *Motor Vehicle Mfrs. Assn v. State Farm Mut. Ins. Co.*, 463 U.S. 29, 52 (1983), *quoting Burlington Truck Lines, Inc. v. United States,* 371 U.S. 156, 168 (1962).

4 *Allentown Mack Sales & Service v. NLRB*, 522 U.S. 359, 375 (1998) (Scalia, J.).

for a departure from settled policy and practice spanning nearly four decades,[5] and (2) a reasoned response to objections and evidence.[6]

Without giving away anyone's appellate playbook for *Coakley II: The Reprise*, this paper highlights ten respects in which the Commission's proposed framework for determining electric utility return on common equity seems short on foundation in reasoned decision-making. If implemented as currently proposed, that framework undoubtedly will please most investor-owned transmission owners and their advocates. On the same terms, that framework will frustrate and incite consumer interests, who will have ample reason to believe that the proposed new analytical framework lopsidedly benefits the transmission-owning utilities whom the rules have always favored and now promise to favor more. Of course, the Commission has made no decisions at this point, and handicapping the outcome of the ensuing regulatory and appellate proceedings is a notoriously chancy exercise fraught with opportunities for failure. So, in the words of E.B. White's immortal poem *I Paint What I See*, "'We'll see if it is,' said Rivera."

LOOKING BACK PART ONE: OPINION NOS. 531 AND 551

On June 19, 2014, the Commission issued a series of orders on the subject of return on equity for transmission owners. One of these orders was Opinion No. 531.[7] Others included a series of hearing orders on other pending Section 206 complaints challenging transmission owner ROEs. Finally, one was an order on remand from the United States Court of Appeals for the District of Columbia Circuit in *Southern California Edison Co. v. FERC*, 717 F.3d 177, 187-188 (D.C. Cir. 2013), in which the Commission abandoned its practice of "updating" DCF results based on changes in the average yields on ten-year Treasury bonds between the issuance of an initial decision and the issuance of a Commission decision.[8]

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5 *See, e.g.*, *West Deptford Energy, LLC v. FERC*, 766 F.3d 10, 20 (D.C. Cir. 2014) ("It is textbook administrative law that an agency must 'provide[] a reasoned explanation for departing from precedent . . ."); *Williams Gas Processing – Gulf Coast Co., LLC v. FERC*, 475 F.3d 319, 327 (D.C. Cir. 2006) (Commission action must be "justified either as consistent with precedent or as a considered departure therefrom").

6 *Petro Star v. FERC*, 835 F.3d 97, 102-103 (D.C. Cir. 2016); *Canadian Ass'n of Petroleum Producers v. FERC*, 254 F.3d 289, 299 (D.C. Cir. 2001); *Tesoro Alaska Petro. Co. v. FERC*, 234 F.3d 1286, 1294 (D.C. Cir. 2000) ("Unless an agency answers objections that on their face appear legitimate, its decision can hardly be said to be reasoned").

7 *Coakley, et al. v. Bangor Hydro-Elec. Co., et al.*, Opinion No. 531, 147 FERC ¶ 61,234 (2014), *order on paper hrg.*, Opinion No. 531-A, 149 FERC ¶ 61,032 (2014), *reh'g den.*, Opinion No. 531-B, 150 FERC ¶ 61,165 (2015), *vacated and remanded sub nom. Emera Maine v. FERC*, 854 F.3d 9 (D.C. Cir. 2017).

The public discussion at that Commission meeting[9] reflected the Commission's view that it had developed a new decisional paradigm that all Commissioners – except Commissioner Norris, dissenting in part – believed marked the way forward for the Commission's future ROE analysis for electric utilities. The pre-voting presentation highlighted the following:

- The Commission would henceforth incorporate into its Discounted Cash Flow analyses for public utility ROEs the same weighted average growth rate (two-third short-term growth rate, one-third forecasted Gross Domestic Product growth rate) used in pipeline cases.[10]

- The Commission concluded that "anomalous" capital market conditions (low Treasury bond yields being the one condition specifically identified) had somehow caused it to "have less confidence that the midpoint of the zone of reasonableness established [by its own DCF analysis] in this proceeding accurately reflects the equity returns necessary to meet the *Hope* and *Bluefield* capital attraction standards."[11]

- The Commission therefore found it necessary to consult "alternative benchmark methodologies" – all of which had been proffered by the transmission owners in that case – to ascertain the placement of the just and reasonable ROE within the "zone of reasonableness." The Commission found the Capital Asset Pricing Model ("CAPM"), Risk Premium and Expected Earnings analyses proffered by the transmission owners to be "informative," notwithstanding the fact that the

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8 *So. Cal. Edison Co.*, 147 FERC ¶ 61,240 at P 9 (2014) (". . . the capital market conditions since the 2008 market collapse and the record in this proceeding have shown that there is not a direct correlation between changes in U.S. Treasury bond yields and changes in ROE. Therefore, the premise underlying the Commission's use of U.S. Treasury bond yields for post-hearing ROE adjustments is not always accurate").

9 Transcript of the Commission's 1006th Public Meeting (June 19, 2014), at 29-52.

10 From its decision in *So. Cal. Edison Co.*, Opinion No. 445, 92 FERC ¶ 61,070 at 61,261-61,262 (2000) until Opinion No. 531, the Commission had used a constant (short-term) growth rate DCF analysis to set electric utility returns on equity.

11 Opinion No. 531, 147 FERC ¶ 61,234 at P 145 & n. 285. The Commission's own DCF analysis, presented as an Appendix to Opinion No. 531, adopted a range of implied costs of equity from 7.03 percent to 11.74 percent, with a midpoint of 9.39 percent. *Id.* at PP 142-143 and Appendix.

Commission had previously rejected their use in other cases, and to justify placing the just and reasonable ROE at the "midpoint of the upper half" of the range of implied costs of equity.[12] FERC also found that a review of state-authorized returns on equity for electric utilities supported "adjusting the ROE to a point halfway up the upper half of the zone of reasonableness in this case."[13] The resulting 10.57 percent ROE was higher than 35 of the 38 implied costs of equity in the Commission's DCF analysis.[14]

- The Commission would continue to cap "Total ROE" – the sum of "Base ROE" and all return-based incentives – at the high end of the range of implied costs of equity produced by its DCF analysis, as required by its Transmission Incentives rulemaking, Order No. 679.[15] In Opinion No. 531, the relevant value was 11.74 percent.[16]

On April 14, 2017, the United States Court of Appeals for the District of Columbia Circuit vacated and remanded Opinion No. 531 in *Emera Maine v. FERC*, 854 F.3d 9 (D.C. Cir. 2017). The Court explained two deficiencies in Opinion No. 531. First, the Court held that the Commission had failed to explain how the transmission owners existing "base" ROE (11.14 percent) was unjust and unreasonable – a finding required by Section 206(a) of the Federal Power Act. 854 F.3d at 19-30. Second, the

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12 Opinion No. 531, 147 FERC ¶ 61,234 at PP 146-147.

13 Opinion No. 531, 147 FERC ¶ 61,234 at P 148.

14 *Emera Maine v. FERC*, 854 F.3d 9, 32-33 (D.C. Cir. 2017).

15 *Promoting Transmission Investment through Pricing Reform*, Order No. 679, FERC Stats. & Regs. ¶ 31,222 at PP 2, 92-93 (2006), *order on reh'g*, Order No. 679-A, FERC Stats. & Regs. ¶ 31,236, *order on reh'g*, Order No. 679-B, 119 FERC ¶ 61,062 (2007).

16 Neither Opinion No. 531 nor the pre-voting presentation on it noted that the previously effective "cap" on "Total ROE" had been set in Opinion No. 489 in 2006 at 13.5 percent. *See Bangor Hydro-Elec. Co.*, Opinion No. 489, 117 FERC ¶61,129 at P 80 (2006), *modified*, 122 FERC ¶ 61,265 at P 25 (2008) (establishing a range of implied costs of equity from 7.3 percent to 13.5 percent, with a midpoint of 10.4 percent), *review den. sub nom. Conn. Dept. of Pub. Util. Control v. FERC*, 593 F.3d 30 (D.C. Cir. 2010). *And see Cent. Me. Pwr. Co.*, 125 FERC ¶ 61,079 at P 72 n. 62 (2008) (explaining effect of rehearing on calculation of Opinion No. 489 range). In New England, the cap on "Total ROE" sets the effective return on equity for approximately half of the transmission rate base that sets the Regional Network Service transmission revenue requirement.

Court held that the Commission "did not set forth a rational connection between the record evidence and its placement of the base ROE." 854 F.3d at 30-38.

In the meantime, on September 28, 2016, the Commission issued Opinion No. 551[17] in a broad-based Section 206 challenge to the 12.38 percent base ROE awarded to the transmission-owning participants in Midcontinent Independent System Operator ("MISO") Open Access Transmission Tariff ("OATT") in 2002.[18] As the Commission subsequently explained, the remand of Opinion No. 531 substantially put the brakes on its consideration of requests for rehearing of Opinion No. 551:

> In making its determinations in that proceeding, the Commission relied extensively on its conclusions in Opinion No. 531. Rehearing of Opinion No. 551 is now pending before the Commission. As a result of *Emera Maine*, the Commission will not be able to rely on Opinion No. 531 as precedent in addressing those rehearing requests, at least absent a further order on remand from *Emera Maine*.[19]

Opinion No. 551 contained some glosses on the Opinion No. 531 rationales, which indicated some fraying of the fabric of Opinion No. 531. These include the Commission's statements that:

- In concluding that the "anomalous" capital market conditions relied on in Opinion No. 531 had persisted into the Opinion No. 551 study period, the Commission stated that it "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."[20]

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[17] *Assn of Bus. Advoc. Tariff Equity v. Midcontinent Ind. Sys. Op.*, Opinion No. 551, 156 FERC ¶ 61,234 (2016).

[18] *See Pub. Svc. Comm'n of Ky. v. FERC*, 397 F.3d 1004, 1007-1008 (D.C. Cir. 2005) (describing proceedings establishing 12.38 percent ROE for MISO transmission owners).

[19] *ISO New England, Inc.*, 161 FERC ¶ 61,031 at P 28 (2017) (rejecting New England Transmission Owners' attempt to reimpose pre-Opinion No. 531 base and Total ROEs following Opinion No. 531 *vacatur*).

[20] Opinion No. 551, 156 FERC ¶ 61,234 at P 124. To borrow a line from the late Justice Potter Stewart, "I know it when I see it." *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964).

- The Commission's conclusion that its "finding that mechanical application of the DCF methodology 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"[21] does not explain how the CAPM and risk premium methodologies remain unaffected by whatever is supposed to be affecting the DCF analysis.[22]

- "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."[23]

- ". . . [W]e 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."[24]

- "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"[25]

For eighteen months – from the D.C. Circuit's April 14, 2017 remand of Opinion No. 531 to the October 16, 2018 of the Order Directing Briefs in *Coakley, et al. v. Bangor Hydro-Electric Co., et al.*, 165 FERC ¶ 61,030 – this was where matters stood on electric ROEs. And then . . .

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21 Opinion No. 551, 156 FERC ¶ 61,234 at P 131.

22 *Tennessee Gas Pipeline Co. v. FERC*, 926 F.2d 1206, 1210-1212 (D.C. Cir. 1991).

23 Opinion No. 551, 156 FERC ¶ 61,234 at P 168.

24 Opinion No. 551, 156 FERC ¶ 61,234 at P 194.

25 Opinion No. 551, 156 FERC ¶ 61,234 at P 232.

BACK TO THE FUTURE: THE *COAKLEY* BRIEFING PROPOSAL

On October 16, 2018, the Commission issued its Order Directing Briefs in *Coakley, et al. v. Bangor Hydro-Electric Co., et al.*, 165 FERC ¶ 61,030. Forsaking the cautious approach taken in Opinion No. 551 to the "alternative" methodologies, the *Coakley* Briefing Order proposes to incorporate them – along with the DCF – in creating a "composite zone of reasonableness." This composite zone would be a range bounded on the low end by the average of the low implied costs of equity developed for a given proxy group in a DCF analysis, a CAPM analysis and an Expected Earnings analysis, and on the high end by the average of the high implied costs of equity developed by those three methodologies.[26] The proxy group is to be developed using the Commission's established criteria, with the addition of a new specification for exclusion of high-end outlier implied costs of equity – those that exceed 150 percent of the unadjusted median of the composite range.[27]

In determining whether an existing ROE that is the subject of a challenge under FPA Section 206 has become unjust and unreasonable, the *Coakley* Briefing Order proposal would divide the range of implied costs of equity developed for the proxy group into quartiles based on midpoint implied cost of equity values for a group of utilities providing a shared service (such as RTO transmission), and median implied cost of equity values for individual electric utilities.[28] These quartiles center on the midpoint or median of the composite range, assigning the portion of the range below the midpoint (or median, as applicable) its own midpoint (or median). This is called the "lower midpoint" (or lower median). The portion of the range above the applicable measure of central tendency is then assigned its own center (midpoint or median) which is called the "upper midpoint" (or upper median). The *Coakley* Briefing Order offers no guidance on how analysts are expected to calculate median values in the context of a composite range driven entirely by its end points.

The *Coakley* Briefing Order then explains that:

> . . . a finding that the existing ROE of an average risk utility falls within the applicable range of presumptively just and reasonable ROEs (in the case of an average risk utility, the middle quartile of the newly-calculated zone of reasonableness) will support a holding that the existing ROE has not been shown to be unjust

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26 165 FERC ¶ 61,030 at PP 30-38.

27 165 FERC ¶ 61,030 at PP 49-54.

28 165 FERC ¶ 61,030 at PP 22-29. *See So. Cal. Edison Co. v. FERC*, 717 F.3d 177, 181-187 (D.C. Cir. 2013) for a summary of the history of the Commission's use of medians and midpoints of the range of implied costs of equity to establish the just-and-reasonable ROE.

> and unreasonable under the first prong of FPA section 206, at least absent additional evidence to the contrary. By the same token, a finding that the existing ROE of an average risk utility falls outside that range may support a holding that that the ROE has become unjust and unreasonable.[29]

Finally, in setting a new ROE in those instances in which an existing ROE is actually found to exceed just and reasonable levels, the *Coakley* Briefing Order proposes to average the central tendencies produced by the DCF, CAPM and Expected Earnings methodologies, and a single-value Risk Premium, to identify a new just and reasonable ROE.[30] The *Coakley* Briefing Order concludes with an illustrative application of its proposed new analytical paradigm.[31] For comparison, the following table sets out the results of the *Coakley* Brief Order illustration next to the corresponding results reached in Opinion No. 489 – the initial ROE determination for the New England Transmission Owners as RTO participants – in 2006,[32] prior to what the Commission has described elsewhere as "the 2008 market collapse."[33]

ICOE Range & Results	*Coakley* Brf. Order (2018)	Opinion No. 489 (2006)
High ICOE	13.08%	13.1% (orig.)/13.5% (reh'g)
Low ICOE	7.51% (composite)	7.3% (DCF only)
Midpoint (ROE)	10.41% (composite)	10.4% (DCF only)
Cap on "Total" ROE	13.08% (composite)	13.5% (DCF only)
50 bp adder for RTO	Yes.	Yes.

29 165 FERC ¶ 61,030 at P 28. The Commission may also consider "other indications of a change in capital market conditions since the existing ROE was established." *Id.* at P 29.

30 165 FERC ¶ 61,030 at PP 17, 32 and 59.

31 165 FERC ¶ 61,030 at PP 55-59.

32 *Bangor Hydro-Elec. Co.*, Opinion No. 489, 117 FERC ¶61,129 at P 80 (2006), *modified*, 122 FERC ¶ 61,265 at P 25 (2008) (establishing a range of implied costs of equity from 7.3 percent to 13.5 percent, with a midpoint of 10.4 percent), *review den. sub nom. Conn. Dept. of Pub. Util. Control v. FERC*, 593 F.3d 30 (D.C. Cir. 2010). *And see Cent. Me. Pwr. Co.*, 125 FERC ¶ 61,079 at P 72 n. 62 (2008) (explaining effect of rehearing on calculation of Opinion No. 489 range).

33 *So. Cal. Edison Co.*, 147 FERC ¶ 61,240 at P 9 (2014).

The convergence of values between the *Coakley* Briefing Order's illustrative application of the Commission's proposed new analysis and the results in Opinion No. 489 is uncanny.

TEN PROPOSITIONS: ANYONE FOR A USED DeLOREAN?

What follows is a non-exhaustive discussion of areas in which the paradigm proposed in the *Coakley* Briefing Order (and re-proposed, untethered from any evidentiary record, in the Commission's March 21, 2019 *Inquiry Regarding the Commission's Policy for Determining the Return on Equity for Public Utilities*, 166 FERC ¶ 61,207) thus far appears short of foundation in reasoned decision-making.

1. The risk-adjusted current market cost of equity capital is the just-and-reasonable return on common equity.

The *Coakley* Briefing Order exhibits an ambiguous view of the Commission's longstanding conclusion that there is "compelling economic justification for relying on the market cost of capital as the standard for rate of return decisions."[34] On the one hand, the *Coakley* Briefing Order at least pays lip service to the idea that the market cost of equity capital should control.[35] On the other hand, the primary driver of the upper end of the range of implied costs of equity used in the *Coakley* Briefing Order is the Expected Earnings analysis, which is based on "book" or accounting returns that bear an at best coincidental relationship to the market cost of equity capital, and are more often impervious to it. The Commission moved away from Expected Earnings in the early 1980s,[36] based in significant part on substantial

34 *Generic Determination of Rate of Return on Common Equity for Public Utilities*, Order No. 461, FERC Stats. & Regs. ¶ 30,722, at 30,499 & n. 189 (1987), *citing* Kolbe, Reed, Jr. and Hall, *The Cost of Capital: Estimating the Rate of Return for Public Utilities* (1984) at 21.

35 *See, e.g.*, 165 FERC ¶ 61,030 at P 30.

36 *Minn. Pwr. & Lt.*, Opinion No. 12, 3 FERC ¶ 61,045 at 61,132 (1978) ("We are interested in forward looking analyses of the market's required rates of return"); *Boston Edison Co.*, Opinion No. 53, 8 FERC ¶ 61,077 (1979) ("considering the vagaries of the stock market and the sensitivity of stock prices to such unpredictable factors as prevailing economic and market conditions, interest rates, investor confidence, international events, and inflation, it seems clearly beyond the capability of statistical analysis, however sophisticated, to calculate the precise return on common equity which will cause the price of a utility's stock to sell at or near its per share book value"); *Consumers Energy Co.*, 85 FERC ¶ 61,100 at 61,362 (1998) ("'no direct market-determined cost rate can be derived from this approach because the nature of the analysis is related to book values'"); Roger Morin, *New Regulatory Finance*, at 383 ("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

criticism of that methodology.[37] There is no reasoned explanation evident for the proposed shift in policy back to giving credence to accounting returns in determining ROE, and there are substantial and unanswered criticisms of the approach.

2. There is nothing "wrong" with the Discounted Cash Flow methodology.

The Commission's expressions of discomfort with the DCF analysis[38] are heavily influenced by gamed versions of the "alternative benchmark methodologies" presented by transmission owner witnesses.[39] "Anomalous" capital market conditions have not somehow caused the DCF methodology uniquely to systematically underestimate the market cost of equity capital. The proposition that one market-based methodology – the DCF – is somehow uniquely disabled, while other market-based methodologies – the Capital Asset Pricing Model ("CAPM") and the Risk Premium – are not, is dubious. DCF results are either input values for, or share inputs with, the CAPM and Risk Premium analyses. Thus, whatever impacts the DCF will impact those methodologies as well. The notion that the DCF somehow uniquely underestimates the market cost of equity capital[40] cannot be reconciled with the Efficient Market Hypothesis,[41] or with the fact that the DCF is either an input

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would be circular to set a fair return based on the past actions of other regulators, much like observing a series of duplicate images in multiple mirrors").

37 *See, e.g.*, Ezra Solomon, "Alternative Rate of Return Concepts and Their Implications for Utility Regulation," *Bell Journal of Economics and Mgmt. Science* 1 (1970), at 65-81; Stewart Myers, "The Application of Finance Theory to Public Utility Rate Cases," *Bell Journal of Economics and Mgmt. Science* 3 (Spring 1972); Basil Copeland, "Alternative Cost-of-Capital Concepts in Regulation," *Land Economics* 54 (August 1978), at 348-361; Alexander Robichek, "Regulation and Modern Finance Theory," Papers and Proceedings of the Thirty-Sixth Annual Meeting American Finance Association, New York City December 28-30, 1977, *Journal of Finance* 33 (June 1978), at 693-705; Franklin Fisher and John McGowan, "On the Misuse of Accounting Rates of Return to Infer Monopoly Profits," *American Economic Review* 73 (March 1983), at 82-97, 85.

38 165 FERC ¶ 61,030 at PP 40-48.

39 For example, the Commission's January 7, 2019 Order Granting Joint Motion for Disclosure in *Coakley, et al. v. Bangor Hydro-Elec. Co., et al.*, 166 FERC ¶ 61,013 (Appendix A) demonstrates that testimony on behalf of the New England Transmission Owners was the source of most of the data points used to develop the graph that appears as Figure 2 in the *Coakley* Briefing Order.

40 *Coakley* Paper Hearing Order at PP 40-48.

41 *Tennessee Gas Pipeline Co. v. FERC*, 926 F.2d 1206, 1210-1212 (D.C. Cir. 1991). *And see Ill. Bell Tel. Co. v. FCC*, 988 F.2d 1254, 1259 n. 6 (D.C. Cir. 1993) ("The DCF

into (CAPM), or share inputs with (Risk Premium), the market-based non-DCF models the October 16 Order proposes to incorporate into the Commission's ROE analysis. To the extent that the acuity of the DCF methodology has somehow become compromised, basic economic logic requires that the other market-based methodologies, if properly performed, would suffer from the same infirmity.[42] Asserting that "anomalous" capital markets introduced such a systematic bias, while simultaneously asserting that there is no need to understand either the underlying mechanism(s) of that claimed bias or the magnitude of the claimed underestimation, is not reasoned decisionmaking. The failure to relate the claimed shortcomings of the DCF with the extent of what was represented as an offsetting adjustment was a basic shortcoming of Opinion No. 531, according to *Emera Maine v. FERC*, 854 F.3d 9, 30-38 (D.C. Cir. 2017).

3. "Alternative benchmarks" that are admittedly flawed in their application, but "good enough" to "inform the placement" of the just and reasonable ROE, are not good enough to assume a role in actually determining ROE.

The Commission's acknowledgements, particularly in Opinion No. 551 (*see* discussion at pp. 5-6 above) of the analytical inaccuracies of the versions of the CAPM and Risk Premium (and Expected Earnings) analyses presented by the transmission owner witnesses in that case demonstrate that those analyses are insufficiently reliable to serve as the basis for actually determining a just and reasonable ROE. Neither the *Coakley* Briefing Order nor the ROE Notice of Inquiry offer any indication of what would be required to produce a reliable CAPM or Risk Premium analysis, but rely on the admitted flawed analyses already in the record as grounds for changing the Commission's mode of analysis in ROE cases.

4. Historical ROE values established in prior Commission proceedings over an arbitrary time frame (including settlements and other

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method 'has become the most popular technique of estimating the cost of equity, and it is generally accepted by most commissions. Virtually all cost of capital witnesses use this method, and most of them consider it their primary technique,'" *quoting* J.C. Bonbright, A.L. Danielsen and D.R. Kamerschen*, Principles of Public Utility Rates* (Public Utility Reports, Inc. 2d ed., 1988), at 317-18.

42 The Commission's conclusion (*ABATE v. MISO*, *supra*, Opinion No. 551, 156 FERC ¶ 61,234 at P 131) that "The finding that mechanical application of the DCF methodology 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" does not explain how the CAPM and risk premium methodologies remain unaffected by whatever is supposed to be affecting the DCF analysis.

references to pre-existing ROEs), provide no useful information concerning the current market cost of equity capital.

The variant of "Risk Premium" analysis on which the Commission has relied in past cases and in the *Coakley* Briefing Order is based on regression analyses of historical allowed returns on equity set by regulators versus utility bond yields. There are at least four fundamental problems with this approach. First, as the Commission itself has observed, capital market conditions since the market collapse of 2008 cast doubt on both the direction and the magnitude of any correlation between Treasury bond yields and return on equity – observation that applies with equal force to the direction and magnitude of any correlation between utility bond rates and return on equity. Second, the use of regressions between bond yields and historical allowed returns to set the equity risk premium ignores comparable risk, and thus fails to implement a fundamental requirement of *Hope* and *Bluefield*. Rather than reflecting current capital market conditions, and the business and financial risk of the proxy group of companies, this Risk Premium approach boils down to selecting a desired historical period to derive whatever Risk Premium result one wants. Third, there is no support whatsoever in the academic finance and economics literature for using such regressions to estimate an allowed ROE. Fourth, the number of actual observations establishing an ROE in the data set used in the regression analyses on which the Commission's version of a risk premium relies is far too limited to support a statistically valid study.

5. Book returns tell us nothing about the market cost of equity capital.

Asserted investor "reliance" on book returns does not establish relevance. Investor "reliance" on dartboards, Ouija boards or chicken entrails to estimate their required ROE would not mean the Commission should adopt its own dart-throwing approach, or add mediums or haruspices to its Technical Staff. As noted above, the Commission has a long history of walking away from Expected Earnings, and for good reasons. Nothing in the debate thus far provides a reasoned explanation for the proposal to change direction.

6. The process for constructing a "composite zone of reasonableness" laid out in the *Coakley* briefing order does not lend itself to establishing quartiles based on medians for determining ROE for single utilities.

The *Coakley* Briefing Order is explicit about its proposed methodology for developing the "composite zone of reasonableness" that is the centerpiece of the proposed new analysis:

> Specifically, we intend to use the composite zone of reasonableness produced by the DCF, CAPM, and Expected Earnings models. Each of these three methodologies relies on a proxy group to determine a zone of reasonableness, and thus the top and bottom of the zone of reasonableness produced by each methodology can be averaged to determine a single composite zone of reasonableness. After determining the composite zone of reasonableness, we will then calculate the lower midpoint/median, midpoint/median, and upper midpoint/median of that zone.[43]

The order never explains how the median of this "composite zone" – which is entirely derived by reference to its end points, and not to the dispersion of values within the proxy group sample under each of the three proxy group-based analyses (DCF, CAPM and Expected Earnings) – is supposed to be calculated. The methodology outlined in the *Coakley* Briefing Order does not appear to produce or preserve sufficient data on dispersion to permit the calculation of a median.

7. Eliminating high-end outliers is important, but the proposed 150-percent-of-unadjusted-median threshold is arbitrary and statistically unsound because it is blind to the dispersion of implied costs of equity within the proxy group sample. There are well-known and widely-used statistical tests for outliers; the Commission should use them.

"The Commission proposes to treat as high-end outliers any proxy company whose cost of equity estimated under the model in question is more than 150 percent of the median result of all of the potential proxy group members in that model before any high or low-end outlier test is applied, subject to a 'natural break' analysis similar to the approach the Commission uses for low-end DCF analysis results."[44] On the one hand, the implementation of an exclusion threshold for high-end outliers is a step forward. The Commission has referenced its observation in its 2004 RTO formation rehearing order in *ISO New England, Inc.*, 109 FERC ¶ 61,147 at P 205 (2004) as though the implied cost of equity and growth rate specifically referenced in that passage were somehow absolute and immutable values:

> . . . [W]e find PPL should be excluded from the Proxy Group because its 17.7 percent cost of equity is an extreme outlier and the inclusion of this number in the calculation in an unreliable ROE that will skew the results. . . . [I]t is often necessary to eliminate illogical results from cost of equity estimates that fail to meet threshold tests of economic logic. We believe a 13.3

43 165 FERC ¶ 61,030 at P 30.

44 165 FERC ¶ 61,030 at P 53.

> percent growth rate is not a sustainable growth rate over time and therefore does not meet threshold tests of economic logic.

Until the *Coakley* Briefing Order, the Commission had not provided any further content to the expression "threshold tests of economic logic" in the context of outliers. Its attempt at formulating a general test in the *Coakley* Briefing Order represents an incremental improvement over perpetual reference to values found too extreme in a fifteen-year old case. However, the 150-percent-of-unadjusted-median test is itself arbitrary. There is no evident basis for the choice of the 150 percent threshold. The Commission's suggestion that "[t]his test should identify those companies whose cost of equity under the model in question is so far above the cost of equity of a typical proxy company as to suggest that it is the result of atypical circumstances not representative of the risk profile of a more normal utility"[45] offers no explanation why a higher or lower threshold would not accomplish the same objective.

Dispersion matters in statistics. The Court's observation in *Emera Maine*, 854 F.3d at 32-33 that the midpoint-of-the-upper-half in Opinion No. 531 was higher than 35 of 38 implied cost of equity observations in the Commission's DCF analysis underscores one source of skepticism about the Commission's logic in that case. The fact that the 10.41 percent ROE value reached in the *Coakley* Briefing Order's illustrative application of its proposed analysis[46] is higher than 34 of 38 implied cost of equity observations in the Commission's Opinion No. 531 DCF analysis[47] suggests that the "end result" by which the new paradigm will be judged[48] differs little from the end result rejected in *Emera Maine*.

The discipline of statistics offers a number of well-known and readily applied screens for high-end outliers. The Grubbs Test[49] lends itself particularly well to ROE analysis precisely because it examines dispersion within a sample by comparing the

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45 165 FERC ¶ 61,030 at P 53.

46 165 FERC ¶ 61,030 at PP 54-59.

47 Opinion No. 531, 147 FERC ¶ 61,234 Appendix.

48 *Permian Basin Area Rate Cases*, 390 U.S. 747, 791-792 (1968) ("The Commission . . . is . . . obliged at each step of its regulatory process to assess the requirements of the broad public interests entrusted to its protection by Congress. Accordingly, the 'end result' of the Commission's orders must be measured as much by the success with which they protect those interests as by the effectiveness with which they 'maintain . . . credit and . . . attract capital'"); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

49 Frank Grubbs, "Sample criteria for testing outlying observations," *Annals of Mathematical Statistics* 21 (1950), at 27–58.

highest (or lowest) value in a sample to the sample average (mean) and measures the largest absolute deviation from the sample mean in units of the sample's standard deviation. The Commission should select a recognized, statistically valid screen for high-end outliers and require its consistent application.

8. The proposed "Step One" methodology impermissibly creates "zones of immunity" above the just-and-reasonable level of ROE, and the methodology set forth in the *Coakley* Briefing Order can result in allowed ROE values that fall outside of their corresponding zone of immunity. The "Step One" methodology proposed in the *Coakley* Briefing Order is unsound and unworkable.

The *Coakley* Briefing Order misreads and misapplies *Emera Maine's* criticism of Opinion No. 531 for failing to explain why it had found the existing ROE in that case to be unjust and unreasonable – the threshold inquiry under FPA Section 206(a).[50] In place of the required explanation, which could readily be supplied by reference to decreases in the market cost of equity capital between the July through December 2004 study period involved in Opinion No. 489 and the October 2012 to March 2013 study period at issue in Opinion No. 531, the *Coakley* Briefing Order proposes a "quartiles" approach.

The October 16 Order's proposal to use "zone of reasonableness quartiles" in assessing the justness and reasonableness of existing ROEs addresses neither financial impacts on consumers nor other, non-monetary factors that may impact the justness and reasonableness of an existing allowed ROE. In addition, just as the Commission strives to avoid "mechanical application" in determination of just and reasonable ROEs,[51] the mechanical application of these "zone of reasonableness quartiles" as proposed by the October 16 Order can create inherent contradictions, in which the averaging procedure by which the October 16 Order proposes to set an allowed ROE can result in an allowed ROE value that falls outside the zone of presumptive compliance with the just-and-reasonable standard. In such a circumstance, it is not clear how both the existing allowed ROE and the updated allowed ROE would be evaluated.

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50 *Emera Maine v. FERC*, *supra*, 854 F.3d at 28-29 ("FERC concluded that the existing 11.14 percent base ROE was unlawful solely because it had determined that 10.57 percent, which was "a numerical value below the existing numerical value," was a just and reasonable base ROE. . . . That conclusion, without any further explanation, is insufficient to prove that Transmission Owners' existing base ROE was unlawful") (internal citations omitted).

51 Opinion No. 531, 147 FERC ¶ 61,234 at PP 150-152 (2014), *rehearing denied*, Opinion No. 531-B, 150 FERC ¶ 61,165 at PP 36, 50 (2015), *remanded sub nom. Emera Maine v. FERC*, 854 F.3d 9 (D.C. Cir. 2017).

The October 16 Order's "quartile" proposal offers no explanation of the relationship of the proposal to the existence or absence of just and reasonable levels of ROE. The October 16 Order's "quartile" proposal appears to create a "zone of immunity" for levels of ROE that exceed the just-and-reasonable level. As in the Paragraph 57 example outlined above, the "quartile" proposal appears to immunize an ROE of up to 10.99 percent from challenge under FPA Section 206, even though the ultimate just-and-reasonable ROE is 10.41 percent – 58 basis points lower, which translates to a substantial amount of after-tax return in the context of RTO transmission arrangements. Such a result would be inconsistent with the Commission's previous explanation of its Section 206 scrutiny in *Bangor Hydro-Electric Co.*, 122 FERC ¶ 61,038 at PP 10-14 (2008), and the Court of Appeals' holding in *Emera Maine v. FERC*, 854 F.3d 9, 22 (D.C. Cir. 2017) that "[n]either the language of the FPA nor our precedents compel FERC to accept all rates within the . . . zone of reasonableness as just and reasonable in a section 206 proceeding." It would also be inconsistent with longstanding judicial precedent holding that the FPA does not tolerate "even a little" deviation from the just and reasonable standard.[52]

9. The one-and-done rhetoric on Section 206 complaints is foreclosed by the Regulatory Fairness Act, and inconsistent with settled Commission precedent.

There is a subtext in the discussion surrounding the analytical structure proposed in the *Coakley* Briefing Order that "successive or, as they're often referred to, pancaked complaints"[53] challenging return on equity somehow require suppression, and that the proposed "zone of reasonableness quartiles" approach may be a way to accomplish that suppression. Indeed, recent transmission owner briefing in the *Coakley* remand paper hearing referred to the "the scourge of pancaked ROE complaints that leave utilities . . . with an unknown ROE for more than seven years."[54] The antipathy toward successive Section 206 complaints challenging ROE is misplaced. It is also contrary to at least twenty-five years of Commission precedent under the Regulatory Fairness Act, which amended Section 206(b) of the FPA for the precise purpose of creating a measure of symmetry between customer rights under FPA Section 206 and public utility rights under FPA Section 205.[55]

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52 *Farmers Union Cent. Exch. v. FERC*, 734 F.2d 1486, 1508 (D.C. Cir. 1984), *quoting FPC v. Texaco Inc.*, 417 U.S. 380, 399 (1974).

53 Transcript of the Commission's 1048th Public Meeting (November 15, 2018), at 35:3-6.

54 Docket No. EL11-66-005, Initial Paper Hearing Brief of New England Transmission Owners (filed January 11, 2019).

55 *See, e.g., Belmont Mun. Lt. Dept. v. Cent. Me. Pwr. Co.*, 156 FERC ¶ 61,198 at PP 39-40 & n. 81 (2016) ("Notably, while EEI complains about the limitlessness of complaints

10. The limit on the sum of "Base ROE" and all return-based incentives cannot be modified in an adjudicatory proceeding.

Finally, the *Coakley* Briefing Order suggests, in its preliminary and illustrative application of its proposed methodology for reviewing ROE, that its new procedure would result in an increase in the "cap" on "Total ROE" (the sum of "base" ROE and all return-based incentives) from the 11.74 percent top end of the DCF range of implied costs of equity in that case to 13.08 percent. The 13.08 percent value is largely driven by the fact that "the Expected Earnings approach's zone of reasonableness is 8.10 percent to 14.20 percent."[56] This conclusion, which would increase the after-tax return on over $5.5 billion in transmission rate base by as much as 134 basis points, appears dubious.

The Commission's rulemaking resulting in Order No. 679 set the limit on total ROE as the upper bound of a DCF-determined zone of reasonableness.[57] The Administrative Procedure Act does not permit the Commission to modify a rule adopting by rulemaking other than by a further rulemaking.[58]

CONCLUSION

Will the *Coakley* Briefing Order or the Docket No. PL19-4-000 *Inquiry Regarding the Commission's Policy for Determining Return on Equity*[59] finally resolve electric transmission return on equity? Handicapping litigation outcomes is a notoriously frustrating exercise. Absent considerable adjustment, the road ahead looks long and rough.

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that can be filed with the Commission pursuant to section 206, it does not offer a similar remedy with regard to a utility's ability to file limitless section 205 filings with the Commission"); *ENE (Environment Northeast) v. Bangor Hydro-Electric Co.*, 151 FERC ¶ 61,125 at PP 25-35 (2015)

[56] 165 FERC ¶ 61,030 at P 56.

[57] *Promoting Transmission Investment through Pricing Reform*, Order No. 679, FERC Stats. & Regs. ¶ 31,222 at PP 92-93, 102.

[58] *Perez v. Mortgage Bankers Assn*, 575 U.S. ___, 135 S. Ct. 1199, 1206, 199 L.Ed.2d 186 (2015) ("[T]he D.C. Circuit correctly read § 1 of the APA to mandate that agencies use the same procedures when they amend or repeal a rule as they used to issue the rule in the first instance"); *Clean Air Council v. Pruitt*, 862 F.3d 1, 9 (D.C. Cir. 2017) ("As we have explained, 'an agency issuing a legislative rule is itself bound by the rule until that rule is amended or revoked' and 'may not alter [such a rule] without notice and comment'"), *quoting Nat'l Family Planning and Reproductive Health Assn, Inc. v. Sullivan*, 979 F.2d 227, 234 (D.C. Cir. 1992).

[59] 166 FERC ¶ 61,207 (2019).