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### **SESSION B: WILL FERC (FINALLY!) RESOLVE ELECTRIC TRANSMISSION ROES?**

**MAY 6, 2019, 11:00 AM – 12:15 PM**

In the fall of 2018, FERC addressed the D.C. Circuit remand in *Emera Maine v. FERC* in proceedings involving the New England Transmission Owners, MISO Transmission Owners, and several other transmission-owning companies. The resolution of these cases will significantly impact the way transmission ROEs are calculated. With the briefing in the New England and MISO proceedings set to end in April, the panelists will be poised to address:

- FERC's proposed ROE methodology
- Litigants' positions in the New England TOs and MISO TOs cases, including advocacy for additional changes
- How the financial industry views FERC's proposal

**Moderator:** David M. DeSalle, Partner, Potomac Law Group, PLLC

**Panelists:**

John P. Coyle, Partner, Duncan & Allen

Purvi Patel, Director Regulatory Strategy, ITC

Todd A. Shipman, Executive Advisor, Concentric Energy Advisors



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# Return on Equity

- PURVI PATEL
- DIRECTOR, REGULATORY STRATEGY
- ITC HOLDINGS CORP.



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# FERC ROE Policies Through The Years

- FORMER ROE POLICY – DEVELOPED IN THE 1950S
  - SINGLE-STEP DISCOUNTED CASH FLOW (DCF) METHODOLOGY
  
- *EMERA MAINE* ORDER (EL11-66) – ISSUED JUNE 2014
  - TWO-STEP DCF METHODOLOGY
  
- *EMERA MAINE* ON REMAND – ISSUED OCTOBER 2018
  - NEW METHODOLOGY UTILIZING CAPITAL ASSET PRICING, EXPECTED EARNINGS, AND RISK PREMIUM MODELS IN ADDITION TO DCF



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# Why The Need For Change

- MULTIPLE ROE COMPLAINTS FILED AT FERC AGAINST TRANSMISSION OWNERS IN:
  - ISO NEW ENGLAND (BETWEEN 2011 – 2016)
  - MISO (2013 AND 2015)
- FERC QUESTIONS WHETHER DCF MODEL CONTINUES TO PRODUCE ROES CONSISTENT WITH *HOPE AND BLUEFIELD*



# Two-Step DCF Methodology

- FERRE ISSUES OPINION NO. 531 TO SET BASE ROE IN NETO COMPLAINT I
  - ADOPTS TWO-STEP DCF METHODOLOGY
    - CONSIDERS LONG-TERM AND SHORT-TERM GROWTH RATES
- CONTINUED ANOMALOUS MARKET CONDITIONS LOWERS FERRE'S CONFIDENCE IN MIDPOINT VALUE OF TWO-STEP DCF MODEL
  - BASE ROE SET AT UPPER MID-POINT OF THE ZONE OF REASONABLENESS
  - ALTERNATIVE ROE MODELS SUPPORT PLACEMENT OF MIDPOINT



# Opinion No. 531 – D.C. Circuit Court Appeal

- NETOS AND CUSTOMERS APPEALED OPINION NO. 531
- NETOS ARGUED FERC HAD NOT PROPERLY FOUND PRIOR ROE UNJUST AND UNREASONABLE
- CUSTOMERS ARGUED THE BASE ROE SHOULD BE SET AT THE MID-POINT—NOT THE UPPER MID-POINT—OF THE ZONE OF REASONABLENESS
- D.C. CIRCUIT COURT REMANDED OPINION NO. 531, FINDING FERC FAILED TO:
  1. FIND THAT THE EXISTING ROE FOR THE NETOS WAS UNJUST AND UNREASONABLE BEFORE PROCEEDING TO SET A NEW JUST AND REASONABLE ROE
  2. DEMONSTRATE WHY IT IS JUST AND REASONABLE TO SET ROE AT THE UPPER MID-POINT TO ADDRESS ANOMALOUS MARKET CONDITIONS



# FERC Response to Remand

- ON OCTOBER 16, 2018, FERC ISSUED A LANDMARK ORDER SETTING FORTH A NEW METHODOLOGY FOR:
  - (i) DETERMINING WHETHER AN EXISTING ROE HAS BECOME UNJUST AND UNREASONABLE UNDER SECTION 206 OF THE FEDERAL POWER ACT; AND
  - (ii) ESTABLISHING A JUST AND REASONABLE ROE FOR A PUBLIC UTILITY.
- SIGNIFICANT CHANGES TO FERC'S APPROACH TO CALCULATING ROES
  - USE OF SEVERAL DIFFERENT METHODOLOGIES IN ADDITION TO THE DCF
  - TWO-PRONGED APPROACH FOR SECTION 206 CASES



# New Methodology (First Prong)

- USED TO DETERMINE IF EXISTING ROE REMAINS JUST AND REASONABLE
- USES THREE FINANCIAL MODELS – (1) TWO-STEP DCF, (2) CAPM AND (3) EXPECTED EARNINGS – TO ESTABLISH A COMPOSITE ZONE OF REASONABLENESS
  - THE COMPOSITE ZONE OF REASONABLENESS IS USED TO:
    - DETERMINE IF EXISTING ROE IS JUST AND REASONABLE; AND
    - (IF APPLICABLE) SET A NEW ZONE OF REASONABLENESS FOR DETERMINING A NEW BASE ROE AND CAP WITH ROE INCENTIVES
- AN ROE COMPLAINT WILL BE DISMISSED IF THE EXISTING ROE FALLS WITHIN THE QUARTILE OF THE COMPOSITE RANGE CENTERED ON POINT THAT CORRESPONDS WITH THE UTILITY'S/UTILITIES' RELATIVE RISK





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# New Methodology (Second Prong)

- USED TO ESTABLISH A NEW JUST AND REASONABLE ROE
  - USES FOUR FINANCIAL MODELS – MIDPOINTS/MEDIANS OF TWO-STEP DCF, CAPM, AND EXPECTED EARNINGS AVERAGED WITH RISK PREMIUM ESTIMATE – WITH EQUAL WEIGHTING TO PRODUCE A JUST AND REASONABLE ROE



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# Thoughts on New Methodology

- THE FOUR FINANCIAL MODEL METHODS WILL PROVIDE ESTIMATES MORE ALIGNED WITH INVESTOR EXPECTATIONS
- THE PROPOSED FIRST PRONG ANALYSIS REPRESENTS A FAIR AND OBJECTIVE MEANS TO AVOID PANCAKED ROE COMPLAINTS AND LITIGATION
- MINOR CHANGES
  - MODIFICATIONS TO LOW END SCREEN; NO HIGH END SCREEN
  - EVALUATE SHORT-TERM GROWTH RATES OTHER THAN IBES
  - RISK PREMIUM ANALYSIS SHOULD USE AVERAGE OF HISTORICAL AND PROJECTED BOND YIELD (MISO ORDER ONLY USES HISTORICAL)



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# Current State

- ON MARCH 21, 2019 FERC ISSUED A NOTICE OF INQUIRY TO EXAMINE POTENTIAL MODIFICATIONS TO FERC'S APPROACH TO DETERMINING A JUST AND REASONABLE ROES FOR PUBLIC UTILITIES, AS WELL AS INTERSTATE NATURAL GAS AND OIL PIPELINES.
  - INTENDED TO PROVIDE ALL STAKEHOLDERS AN OPPORTUNITY TO WEIGH IN ON FERC'S APPROACH OF DETERMINING THE ROE FOR REGULATED ENTITIES.
  - THE COMMISSION NOTED THAT THE NOI WON'T AFFECT THE DOCKET IT OPENED IN OCTOBER, NOR OTHER CURRENT ROE PROCEEDINGS



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# Final Thoughts

- ELECTRIC TRANSMISSION INFRASTRUCTURE IS THE BACKBONE OF THE ENERGY GRID AND IS A VERY CAPITAL-INTENSIVE ASSET.
- TRANSMISSION OWNERS REQUIRE SHAREHOLDER SUPPORT IN THE FORM OF CAPITAL INVESTMENT, AND REGULATORY SUPPORT IN THE FORM OF SOUND RATEMAKING POLICY IN ORDER TO BUILD, OWN, AND OPERATE THE TRANSMISSION INFRASTRUCTURE THAT ENSURES RELIABLE AND AFFORDABLE SERVICE TO CUSTOMERS
- REASONABLE AND STABLE ROES ENSURE CONTINUED EFFICIENT AND COST-EFFECTIVE ACCESS TO CAPITAL TO SUPPORT NEEDED INVESTMENTS



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# Will FERC (Finally!) Resolve Electric Transmission ROEs?

YES! DEFINITELY THEY ARE ON THE RIGHT TRACK



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# Will FERC (Finally!) Resolve Electric Transmission ROEs?

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## A Short History of New England TO ROE:

*Bangor Hydro-Elec. Co.*, Opinion No. 489, 117 FERC ¶61,129 at P 80 (2006), *modified*, 122 FERC ¶ 61,265 at P 25 (2008) (study period July-December 2004, established a DCF 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).





## A Short History of New England TO ROE (cont'd)

*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).



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## A Short History of New England TO ROE (cont'd)

*Coakley, et al. v. Bangor Hydro-Elec. Co., et al.*,  
165 FERC ¶ 61,030 (October 16, 2018).



## Opinion No. 489 vs. *Coakley* Briefing Order

Opinion No. 489 (2006)	
Study Period	July-Dec. 2004
High ICOE	13.1% (13.5% on rehearing)
Low ICOE	7.3%
Midpoint	10.4%
Cap on Total ROE	13.1%/13.5%
RTO Participation Adder	50 basis points

<i>Coakley</i> Briefing Order “Preliminary” (2018)	
Study Period	Oct. 2012-March 2013
Composite High ICOE	13.08%
Composite Low ICOE	7.51%
Composite Midpoint	10.41%
Cap on Total ROE	13.08%
RTO Participation Adder	50 basis points



## Coakley Briefing Order vs. Opinion No. 531

Coakley Briefing Order Preliminary (2018)	
Composite High ICOE	13.08%
Composite Low ICOE	7.51%
Composite Midpoint	10.41%
Cap on Total ROE	13.08%
Ordinal Rank in DCF Range (Higher than ___ of 39 ICOE Values)	4 <sup>th</sup> (higher than 34 of 38 ICOE Values in DCF Range)

Opinion No. 531	
High DCF ICOE	11.74%
Low DCF ICOE	7.03%
Midpoint DCF ICOE	9.39%
Midpoint of Upper Half	10.57%
Cap on Total ROE	11.74%
Ordinal Rank in DCF Range	3 <sup>rd</sup> (higher than 35 of 38 ICOE Values in DCF Range)



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## Anyone for a Used DeLorean?

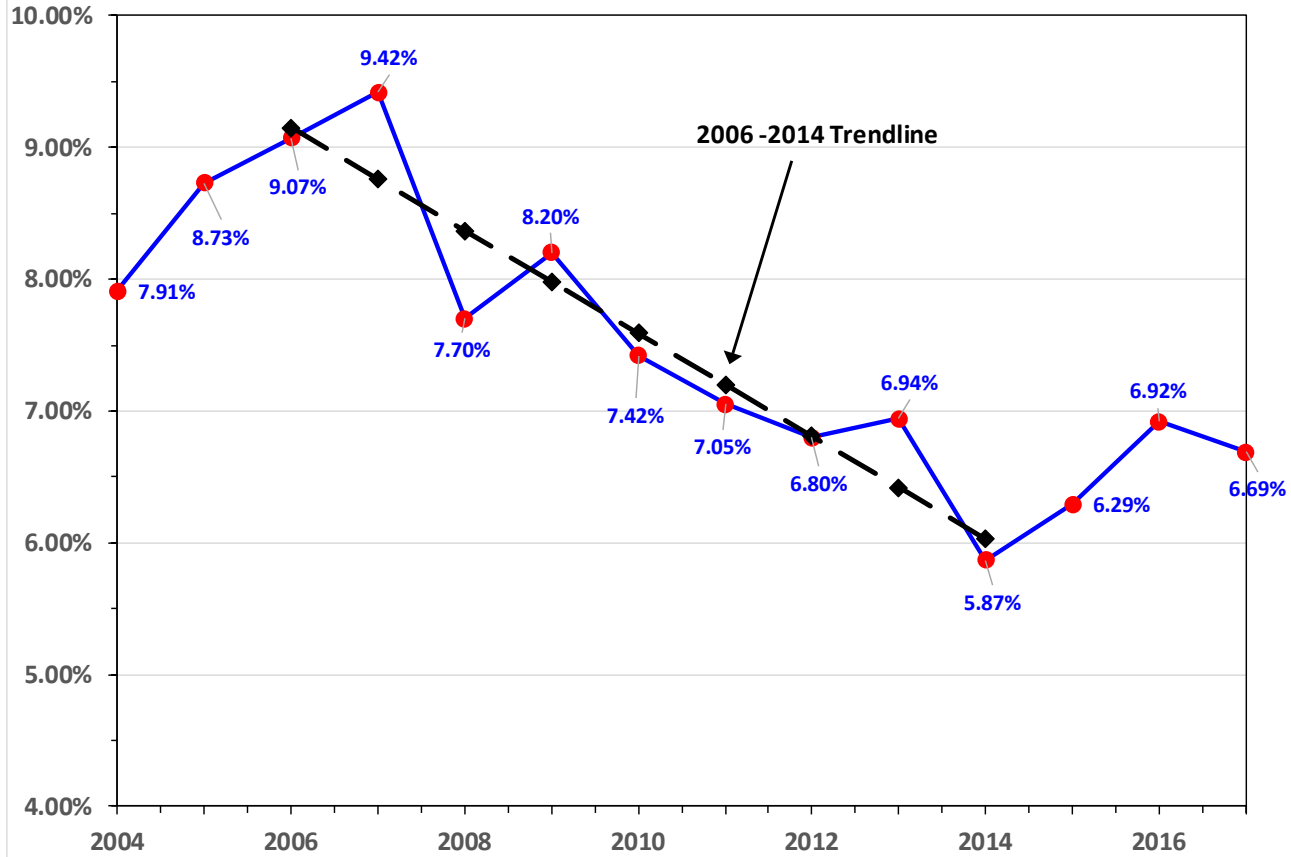




# Financial Context

Opinion No. 489 Study Period Data	
Study Period	July-Dec. 2004
Avg. Yield A-Rated Utility Bonds	5.8%
Avg. Yield Baa-Rated Utility Bonds	6.0%
Avg. Yield on 10-yr. Treasury Bonds	4.24%
Avg. US WACC (Damodaran)	7.91% (9.01% at 489 "update")
ROE (DCF midpoint)	10.4% (11.14% update)

Opinion No. 531 Study Period Data	
Study Period	Oct. 2012-Mar. 2013
Avg. Yield A-Rated Utility Bonds	4.05%
Avg. Yield Baa-Rated Utility Bonds	4.61%
Avg. Yield on 10-yr. Treasury Bonds	1.83%
Avg. US WACC (Damodaran)	6.72%
ROE (midpoint of upper half)	10.57%



Source: Damodaran on-line, <http://pages.stern.nyu.edu/~adamodar/>



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# Ten Propositions

- *COAKLEY* BRIEFING ORDER PRELIMINARY DETERMINATIONS AND REASONED DECISION-MAKING





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Proposition No. 1:

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



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Proposition No. 2:

There is nothing “wrong” with the Discounted Cash Flow methodology.



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Proposition No. 3:

“Alternative benchmarks” that are admittedly flawed in their application are not good enough to assume a role in actually determining ROE.



## Proposition No. 4:

Historical ROE values established in prior Commission proceedings over an arbitrary time frame (including settlements and other references to pre-existing ROEs) provide no useful information concerning the current market cost of equity capital.



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## Proposition No. 5:

Accounting or book returns tell us nothing about the market cost of equity capital.



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## Proposition No. 6:

The “composite zone of reasonableness” laid out in the *Coakley* briefing order does not work for establishing quartiles based on medians for determining ROE for single utilities.



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## Proposition No. 7:

There are well-known and widely-used statistical tests for high-end outliers; the Commission should use them.



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## Proposition No. 8:

The “Step One” methodology proposed in the *Coakley* Briefing Order is unsound and unworkable: (1) creates “zones of immunity” above just and reasonable ROE; and (2) can produce results in excess of zones of immunity.





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Proposition No. 9:

There is no “one-and-done” limit on Section 206 challenges to ROE. The market should control.



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## Proposition No. 10:

The DCF-based limit on the sum of “Base ROE” and all return-based incentives was established in a rulemaking and cannot be modified in an adjudicatory proceeding.



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Thanks for listening. Questions?



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# WILL FEREC (FINALLY!) RESOLVE ELECTRIC TRANSMISSION ROEs?

TODD A. SHIPMAN, CFA

EXECUTIVE ADVISOR

CONCENTRIC ENERGY ADVISORS



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- 30+ YEARS ON WALL STREET
- 20+ YEARS AT S&P GLOBAL RATINGS
- INDEPENDENT CONSULTANT AND ADVISOR AT CONCENTRIC ENERGY ADVISORS
- TESTIFY ON RATINGS AND CREDIT QUALITY, NOT ROE
- PERSPECTIVE IS MAINLY FROM FIXED INCOME SIDE



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- **AN ANALYST'S (PRAGMATIC) APPROACH TO ROE**
  - **ANALYSIS OF A RATE CASE**
    - **LOOK AT PARTS OF THE REVENUE REQ'T CALCULATION**
    - **DETERMINE THE CO'S ABILITY TO EARN THE AUTHORIZED RETURN**
    - **COMPARE RESULT TO PEERS**
    - **MAKE A CONCLUSION ON THE CASE OUTCOME AND ITS EFFECT ON YOUR OPINION ON THE REGULATORY ENVIRONMENT**
  - **FERC**
    - **FORMULAIC**
    - **SO IT'S REALLY JUST A MATTER OF MATH**





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## ▪ REALITIES OF SETTING ROE

- **Reminder: regulators are not setting the cost of equity, they're trying to discern what it is**
- **Easy to gauge how successful you are**
- **Signaling effect: authorized ROE (and equity component of capital structure) sends a message to investors and management**
- **Utilities have to compete for capital**







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## ▪ EFFECT OF FERC ROE DECISIONS

### Policy Impact

- Does the FERC want more or less investment in the grid?

### Company Management

- Allocation of Capital
- Effect on overall risk profile

### Investors

- Reward companies & managements that maximize returns/EPS growth while containing risk
- Regulatory risk: reward consistency and predictability (a virtuous circle)

