REPORT OF THE FINANCE AND TRANSACTIONS COMMITTEE

This report summarizes developments concerning finance and transactions in 2018.*

I. FERC PROPOSES NEW METHODOLOGY TO DETERMINE UTILITY RETURN ON EQUITY

In October, the Federal Energy Regulatory Commission (FERC or the Commission) proposed a new methodology for determining return on equity (ROE) for electric utilities.[1] In *Emera Maine v. FERC*,[2] the U.S. Court of Appeals for the D.C. Circuit had vacated and remanded back to the FERC Opinion No. 531, "which addressed the New England Transmission Owners (NETO) ROE."[3] The Finance and Transactions Committee previously discussed the D.C. Circuit's findings in its last Committee Report.[4]

In the instant order, the Commission describes its approach to addressing the issues that were remanded in *Maine*.[5] Rather than relying solely on the discounted cash flow method (DCF) traditionally used to determine an electric utility's ROE, FERC intends "to give equal weight to the results of the four financial models"[6] in the *Maine* record in an effort to ensure that the "chosen ROE is based on substantial evidence" and closer aligns their methodology with "how investors inform their investment decisions."[7]

The Commission begins with a proposed framework to be used to determine "whether an existing ROE remains just and reasonable," meeting the "first prong

* The Finance and Transactions Committee thanks Frederic Brassard, Glenn Camus, Max Leo Fin, Matthew Jones, Miles Kiger, and Mark Williams for their contributions to this report.

1. Order Directing Briefs, 165 F.E.R.C. ¶ 61,030 at P 1 (2018) [hereinafter ROE Order].
2. Emera Maine v. FERC, 854 F.3d 9 (D.C. Cir. 2017).
3. ROE Order, *supra* note 1, at P 1 (citing Opinion No. 531, *Coakley Mass. Attorney Gen. v. Bang or Hydro-Elec. Co.*, 147 F.E.R.C. ¶ 61,234 (2014), *order on paper hearing*, Opinion No. 531-A, 149 F.E.R.C. 61,032 (2014), *order on reh'g*, Opinion No. 531-B, 150 F.E.R.C. ¶ 61,165 (2015)).
4. *Report of the Finance and Transactions Committee*, 39 ENERGY L.J. 1 (2018).
5. ROE Order, *supra* note 1, at P 4.
6. *Id.* at P 15. The four financial models referenced are the discounted cash flow (DCF), capital-asset pricing model analysis (CAPM), expected earnings analysis (Expected Earnings) and risk premium analysis (Risk Premium). The ROE Order Appendix provides a detailed description of each model. *Id.* at P 40.
7. *Id.*

of the [Federal Power Act] (FPA) section 206 analysis."[8] FERC proposes "relying on the three financial models . . . to establish a composite zone of reasonableness," and then utilizing "that composite zone of reasonableness . . . to identify a range of presumptively just and reasonable ROEs for utilities with a similar risk profile."[9] By utilizing this approach, the Commission intends "to dismiss an ROE complaint if the targeted utility's existing ROE falls within the range of presumptively just and reasonable ROEs for a utility of its risk profile—unless that presumption is sufficiently rebutted."[10]

"Where [an] existing ROE has been shown to be unjust and unreasonable" under the second prong of the FPA section 206 test,[11] the Commission proposes "to rely on all four financial models" (discounted cash flow (DCF), capital-asset pricing model analysis (CAPM), expected earnings analysis (Expected Earnings), and risk premium analysis (Risk Premium)) "to produce four cost of equity estimates."[12] The Commission states that a just and reasonable ROE will result from giving the four models equal weight and averaging the four estimates.[13] For each of the DCF, CAPM, and Expected Earnings models, the Commission proposes "to use the central tendency of the respective zones of reasonableness as the cost of equity estimate for average risk utilities," and "then average those three midpoint/median figures with the sole numerical figure produced by the Risk Premium model to determine the ROE of average risk utilities."[14] FERC would use the medians "of the resulting lower and upper halves of the zone of reasonableness to determine ROEs for below or above average risk utilities, respectively,"[15] and, rather than capping a utility's total ROE at the top of the zone of reasonableness as is currently done, the Commission proposes to use the "composite zone of reasonableness produced by the DCF, CAPM, and Expected Earnings to establish the cap on a utility's total ROE."[16]

FERC concluded the order by establishing a paper hearing on how the proposed framework should apply to the four proceedings involving the NETO ROE.[17]

II. NEW LAW AMENDS FPA SECTION 203 TO ADD MONETARY THRESHOLD TO PUBLIC UTILITY M&AS

An amendment to the FPA's merger, acquisition and divestiture statute, section 203 of the FPA,[18] was signed into law on September 28, 2018.[19] Public Law

8. *Id.* at P 16.
9. *Id.*
10. ROE Order, *supra* note 1, at P 16.
11. *Id.* at P 17.
12. *Id.*
13. *Id.*
14. *Id.*
15. ROE Order, *supra* note 1, at P 17.
16. *Id.*
17. *Id.* at P 38.
18. *See generally* 16 U.S.C. §824b (2018).
20. Federal Power Act, Pub. L. No. 115-247, § 203, 132 Stat. 3152 (2018).

115-247 (PL 115-347 or the Amendment) makes a potentially simplifying change to one provision of section 203 by exempting one class of transaction from pre-consummation FERC M&A approval requirements.[20] PL 115-247 takes effect on March 27, 2019.[21]

"Section 203's sweep is broad; essentially, any direct or indirect "disposition" of voting control over any" FPA "jurisdictional facilities" (including the physical facilities and FERC tariffs of "almost every U.S. generating company, wholesale power marketer, transmission provider, and traditional franchised utility) requires pre-consummation section 203 authorization."[22] Only selected types of transactions have received advance FERC "blanket authorizations"[23] or are exempt, "usually those involving [certain] qualifying facility generators[24] and purely retail businesses and facilities." "Some classes of "holding companies" of electric power businesses and assets are also subject to section 203's requirements."[25]

"PL 115-247 provides a limited exemption from section 203 for physical facility consolidation transactions valued at no greater than $10 million."[26] "The amendment is narrow; in practical terms, it addresses one situation that has been commonly encountered in the transmission sector. When a FERC-regulated transmitting utility has a new generation or transmission customer that is physically interconnected to the utility, the ownership and control of the interconnection facilities must often be turned over to the public utility. In most cases, the customer facilities being turned over to the transmitting public utility are not yet FERC-jurisdictional, but in a number of cases, turnover took place only after the facilities became subject to section 203, and in several of these cases, FERC has deemed some facility turnover transactions, conducted without section 203 approvals, to be FPA violations, and has publicly imposed penalties."[27]

"Transactions involving asset values over $1 million that are subject to the amendment must be reported to FERC, and FERC must report to Congress, by September 28, 2020, on the efficacy and impact of the amendment."[28] "The amendment will likely save FERC-regulated parties from the need to file the one to three dozen interconnection turnover applications that are typically filed each

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21. *Id.*

22. *Id.*

22. Mark C. Williams, *FERC Reduces Interconnection-Asset Transfer Paperwork*, MORGAN, LEWIS & BOCKIUS LLP: POWER & PIPES BLOG (Oct. 3, 2018), https://www.morganlewis.com/blogs/ powerandpipes/ 2018/10/ferc-reduces-interconnection-asset-transfer-paperwork.

23. *Id.*; *see also* 18 C.F.R. §33.1(c)(2009).

24. Williams, *supra* note 22; *see also* 18 C.F.R. §292.601(c) (2010).

25. Williams, *supra* note 22.

26. *Id.*

27. *Id.*; *See, e.g.*, *International Transmission Company, Michigan Electric Transmission Company, LLC, ITC Midwest LLC, ITC Great Plains, LLC*, 146 F.E.R.C. ¶ 61,172 (2014).

28. Williams, *supra* note 22.

year."[29] "FERC has had few substantive legal issues to review in these applications, and the amendment largely may be viewed as a paperwork-reduction measure."[30]

In November, FERC issued the implementing rulemaking directed by the amendment's text.[31] Comments were due by December 31, 2018.

III. PJM Increases Generator M&A and Asset-Sale Requirements

"PJM Interconnection, L.L.C. (PJM), the regional transmission organization (RTO) that manages and controls transmission and interconnection facilities and electric markets in the Mid-Atlantic and Great Lakes region," recently changed its operating manual to require "that generating entities that are subject to certain direct or indirect changes in ownership or control deliver nearly immediate notice of those changes to PJM."[32] "This change to PJM Manual 14D (the PJM Manual)[33] became effective on June 1, 2018." Generation in "PJM's RTO service territory includes almost 179,000 megawatts (MW) of installed generating capacity,[34] not including other generating capacity that can be imported into PJM from adjacent U.S. utility service territories and other RTOs. PJM has more than 1,000 members, and more than 65 million people live within its RTO service territory.[35] Notably, within PJM's service territory, there are almost 1,400 generating assets."[36]

"Numerous direct and indirect ownership transactions take place every year. In the FERC's 2016–17 docketing year, more than 180 merger, acquisition, and control-disposition applications filed with the FERC under section 203 of the FPA concerned PJM generating assets or entities affiliated with PJM" electric generation, transmission, or distribution assets or power marketing activities.[37] "As many generator merger, acquisition, and control transactions take place every year

29. *Id.* Based on filings carrying the FERC "EC" docket prefix submitted during FERC's 2017-18 filing year.

30. Williams, *supra* note 22.

31. *Implementation of Amended Section 203(a)(1)(B) of the Federal Power Act*, 83 Fed. Reg. 61,338 (2018) (codified at 18 C.F.R. pt. 33).

32. Mark C. Williams, et al., *PJM Interconnection Implements New Requirements for Generator Interest and Asset Sales*, MORGAN, LEWIS & BOCKIUS LLP: LAWFLASH (July 11, 2018), https://www.morganlewis.com/pubs/pjm-interconnection-implements-new-requirements-for-generator-interest-and-asset-sales; *see also* PJM OPERATIONS PLANNING DIVISION, MANUAL 14D: GENERATOR OPERATIONAL REQUIREMENTS REVISION: 45 at § 2.2.1 (Sept. 27, 2018) [hereinafter PJM MANUAL 14D).

33. Williams, et al., *supra* note 32; *see also* PJM MANUAL 14D, *supra* note 32.

34. Williams, et al., *supra* note 32; *see also* PJM, PJM 2017 ANNUAL REPORT 22 (April 2018), https://www.pjm.com/-/media/about-pjm/newsroom/annual-reports/2017-annual-report.ashx?la=en [hereinafter PJM ANNUAL REPORT].

35. Williams, et al., *supra* note 32; *see also* PJM ANNUAL REPORT, *supra* note 35, at 24.

36. Williams, et al., *supra* note 32; *see also* PJM, *PJM At A Glance* https://www.pjm.com/~/media/about-pjm/newsroom/fact-sheets/pjm-at-a-glance.ashx (last visited Mar. 5, 2019). This figure includes only those generating assets that PJM "monitors and coordinates," and therefore excludes numerous small, direct-retail generators that are customer controlled or are otherwise located behind the meter.

37. Williams, et al., *supra* note 32. Based on a November 17, 2018 search of publicly available documents on the FERC Online eLibrary.

involving facilities and entities that are exempt from FERC section 203 review,[38] it is likely that many transactions in addition to those [] applications involving PJM generators or their upstream owners took place."

"PJM's new requirements apply to any PJM-participant generator that is subject to a direct or indirect 10% or greater voting ownership interest change, or that is subject to a sale of physical generation assets; all such transactions are termed 'change-in-ownership transactions'" in the PJM Manual.[39] "A generating entity that is (a) a customer under a PJM generator interconnection agreement, or (b) a PJM member generation owner must report a change-in-ownership transaction to PJM both (1) promptly, when an FPA section 203 application is filed with FERC, by serving the application on PJM's general counsel and the general counsel to PJM's external independent market monitor, and (2) whether or not a section 203 application is filed, within ten days following the execution of binding transaction documents, by notice to PJM's client management department."[40] "Notwithstanding any notice or consent provisions of a generator's agreements with PJM (such as interconnection or membership documents), PJM's new requirements provide that any "updates" to those documents must be provided to PJM within ten days after the closing of the change-in-ownership transaction.[41] The generator's notice to PJM (and its independent market monitor) must include an enumeration of all of the generator's agreements with PJM; the generation facility's identifying information and maximum electrical size (in MW), and a listing of all of the generating facility's owners and PJM-identifying numbers; a description of the change-in-ownership transaction, including the identification of the parties; the identification of the entity that markets the generator's electrical output within PJM; a listing of any generators that are affiliated with the new ownership, together with a simplified organization chart; and in the case of asset-level transactions, certain additional corporate information in the form of a letter to PJM's president."[42]

IV. FERC MAKES CHANGES TO MLP COST-BASED RATES

In 2018, the Commission undertook several actions regarding the elimination of the income tax allowance for cost-of-service-based rates by master limited partnership (MLP) pipelines. These changes are quite significant for FERC-regulated entities using the MLP structure and relevant for other pass-through entity structures.

These FERC actions have been anticipated since the D.C. Circuit issued its July 1, 2016, decision in a case challenging several orders from FERC related to

38. *Id.*; *see generally*, 18 C.F.R. § 33.1(c) (providing certain blanket authorizations for certain transactions subject to section 203), 18 C.F.R. § 292.601(c) (providing certain exemptions from section 203 to qualifying cogeneration facilities and to certain qualifying small power production facilities).

39. Williams, et al., *supra* note 32; *see also* PJM MANUAL 4D, *supra* note 32, at 19-20.

40. Williams, et al., *supra* note 32; *see also* PJM MANUAL 4D, *supra* note 32, at 20-21.

41. Williams, et al., *supra* note 32; *see also* PJM MANUAL 4D, *supra* note 32, at 20-21.

42. Williams, et al., *supra* note 32; *see also* PJM MANUAL 4D, *supra* note 32, at 20-21.

filings by SFPP, L.P., an MLP with oil pipeline operations, for cost-of-service tariffs on its pipeline services.[43]

In *United Airlines*, the court held that FERC failed to demonstrate sufficient justification in concluding that no double recovery of taxes for partnership pipelines resulted from such pipelines receiving both a tax allowance and use of the discounted cash flow (DCF) model for determining return on equity in setting their rates.[44] The court noted that although investors in a partnership pipeline incur taxes, the partnership pipeline itself does not and the DCF model for assessing return on equity already "determines the pre-tax investor return required to attract investment, irrespective of whether the regulated entity is a partnership or a corporate pipeline."[45] Thus, under FERC's ratemaking policy then in effect, an equity investor would receive a higher after-tax return on investments in a partnership pipeline than a corporate pipeline, resulting in rates FERC had not shown to be just and reasonable as required under the relevant statutes and case law.[46] The court vacated FERC's orders granting the pipeline an income tax allowance in setting its rates and remanded the case to the Commission to consider any mechanisms by which FERC could, on a reasoned basis, demonstrate there would be no impermissible double recovery.[47]

In March, approaching two years after the D.C. Circuit's decision in *United Airlines*, the Commission (i) issued its own holding in the remanded case,[48] (ii) issued a revised policy statement on the tax allowance issue (Revised Policy Statement),[49] and (iii) issued a Notice of Proposed Rulemaking (NOPR) proposing natural gas pipelines make one-time filings to, in part, address whether their rates should be reduced to reflect the revised tax allowance policy and the reduction of the corporate income tax effected by the Tax Cuts and Jobs Act.[50]

In its order on the remanded case, the Commission denied SFPP, L.P. an income tax allowance in setting its rates.[51] The Commission explained that, in order to attract capital, a partnership pipeline must provide a market return that allows investors to earn their required rate of return after covering any associated income

43. United Airlines, Inc. v. FERC, 827 F.3d 122 (D.C. Cir. 2016).

44. *Id*. at 136.

45. *Id*.

46. *Id*. at 128, 136; *see also* Federal Power Comm'n v. Hope Nat. Gas Co., 320 U.S. 591, 603 (1944); *see also* 49 U.S.C. § 10701 (1996); *see also* 15 U.S.C. § 717c (2018) (requiring just and reasonable rates in the context of natural gas pipelines).

47. *United* Airlines, 827 F.3d at 137.

48. Opinion No. 511-C, *SFPP, L.P.*, 162 F.E.R.C. ¶ 61,228 at P 2 (2018) [hereinafter *SFPP*].

49. Revised Policy Statement on Treatment of Income Taxes, 162 F.E.R.C. ¶ 61,227 (2018) [hereinafter Revised Policy Statement].

50. *SFPP*, 162 F.E.R.C. ¶ 61,228; *see also Revised Policy Statement*, 162 F.E.R.C. ¶ 61,227; *see also* Notice of Proposed Rulemaking, *Interstate and Intrastate Natural Gas Pipelines; Rate Changes Relating to Federal Income Tax Rate*, 162 F.E.R.C. ¶ 61,226 (2018); *see also* An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018 (Tax Cuts and Jobs Act), Pub. L. No. 115-97, 131 Stat. 2054 (2017).

51. *SFPP*, 162 F.E.R.C. ¶ 61,228, at P 2.

tax liability.[52] Therefore, in respect of partnership pipelines, the DCF model calculates a market rate already reflective of investors' tax liabilities, with a tax allowance resulting in a double recovery.[53] On the other hand, the DCF model does not reflect the corporate income tax "[b]ecause the corporate income tax is not an investor-level tax," so no double recovery occurs by providing corporation pipelines with a tax allowance.[54]

The Commission's Revised Policy Statement superseded its 2005 Income Tax Policy Statement, which had provided that investor-level income tax costs could be attributed to pipelines organized as partnerships and therefore included in the cost-of-service for such entities when setting rates.[55] Under the new guidance, pipelines organized as MLPs (as distinct from other forms of partnerships) will no longer be permitted to recover an income tax allowance in their cost of service.[56] Additionally, although not outright prohibited from using the income tax allowance in tandem with the DCF model, non-MLP partnership pipelines will need to address the same double-recovery concern as the issue arises in subsequent FERC proceedings.[57]

Although FERC proposed to take industry-wide action regarding natural gas pipeline rates in its NOPR, similar action was not proposed with respect to oil pipeline rates.[58] Instead, the Commission instructed MLP oil pipelines to reflect the new tax allowance policy in their normal course reporting used in the index-based ratemaking process applicable to oil pipelines (but not natural gas pipelines).[59]

In July, after the notice-and-comment period following the NOPR expired and the Commission had time to make resulting revisions, FERC issued its final rule implementing rate changes with respect to natural gas pipelines in light of the double recovery issue pertaining to partnership pipelines identified in *United Airlines* and the income tax reductions provided by the Tax Cuts and Jobs Act to corporation pipelines, with such rule effective September 13, 2018.[60]

Notably, following comments and criticisms from partnership pipelines during the notice and comment period, FERC expressly did not address the merits of the double-recovery holding in Opinion No. 511-C or the policy announced in the Revised Policy Statement.[61] However, it noted that the binding precedent of *United Airlines* and Opinion No. 511-C could be considered in subsequent actions

52. *Id*. at P 22.

53. *Id*.

54. *Id*. at P 25.

55. *Revised Policy Statement*, 162 F.E.R.C. ¶ 61,227, at P 15; *see also Policy Statement on Income Tax Allowances*, 111 F.E.R.C. ¶ 61,139 (2005) [hereinafter 2005 Income Tax Policy Statement].

56. *Revised Policy Statement*, 162 F.E.R.C. ¶ 61,227, at PP 2, 45, 46.

57. *Id*. at PP 3, 8, 45.

58. *Id*. at P 46.

59. *Id*.

60. Final Rulemaking, *Interstate and Intrastate Natural Gas Pipelines; Rate Changes Relating to the Federal Income Tax Rate; American Forest & Paper Association*, 83 Fed. Reg. 36,672 (2018) (to be codified at 18 C.F.R. pts. 154, 260, and 284).

61. *Id*. at 36,678-79.

and "encourage[d] pipelines to consider the guidance provided by the Revised Policy Statement."[62] Regardless, these issues were left to be addressed as appropriate in future investigations and hearings.[63]

Among other things, the final rule called for a one-time report on the effect of the Tax Cuts and Jobs Act on a pipeline's rates and for natural gas pipelines to either voluntarily file a rate reduction, commit to a general rate case in the near future, explain why no rate changes are needed, or to take no action at this time.[64] It also amended Title 18, part 154 of the Code of Federal Regulations to require each natural gas pipeline organized as a pass-through entity (including both MLP and non-MLP partnership pipelines) to either "eliminate any income tax allowance and accumulated deferred income taxes reflected in its current rates" or "reduce its maximum rates to reflect the decrease in the Federal income tax rates applicable to partners pursuant to the Tax Cuts and Jobs Act" when filing a limited rate filing.[65]

In allowing MLPs and other pass-through entities to assert eligibility for a tax allowance and yet still voluntarily reduce rates, the Commission stated that it hopes to incentivize all pipelines to "quickly reduce rates and to pass on the benefits of reduced tax costs [pursuant to the Tax Cuts and Jobs Act] to customers without the need for a full examination of costs and revenues."[66]

62. *Id*. at 36,679.
63. *Id*. at 36,680.
64. *Id*. at 36,677.
65. 83 Fed. Reg. 36,672, at 36,679-80, 36,715; *see also* 18 C.F.R. § 154.404 (2018).
66. 83 Fed. Reg. 36,672, at 36,680.

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