DEVELOPMENTS IN FERC POLICY FOR DETERMINING RETURN ON EQUITY

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Synopsis: Recent agency orders and court decisions are reshaping the Federal Energy Regulatory Commission's (FERC or the Commission) policy for determining the just and reasonable return on equity (ROE) for electric utilities, natural gas pipelines, and petroleum pipelines based on the *Hope* and *Bluefield* capital attraction standards.[1] This article examines the Commission's policy on ROE determinations and how this policy may be shaped by recent court decisions. Opinion No. 531 *et al*., established a new methodology for determining the base ROE of electric public utilities, yet it was vacated and remanded by the U.S. Court of Appeals for the D.C. Circuit in *Emera,* leaving many open questions as to what the Commission's policy for determining the base ROE of public utilities currently is.[2] The Midcontinent Independent System Operator (MISO) ROE proceeding leading to Opinion No. 551 followed the guidance provided in vacated Opinion No. 531.[3] At this point, it's uncertain how the decision in *Emera* will impact the ruling in Opinion No. 551, and how the Commission will address issues that were core to subsequent ROE litigation in MISO and New England, such as defining anomalous capital market conditions.[4] The D.C. Circuit's opinion in *United Airlines* and the Commission's notice of inquiry regarding income tax cost recovery also leave open questions as to the appropriate consideration of certain FERC tax policies in ROE determinations.[5] In exploring this recent precedent, this article addresses questions such as: What must FERC do to carry its burden of demonstrating that an existing ROE is unjust and unreasonable? What is the significance of the zone of reasonableness under sections 206 and 219 of the Federal Power Act (FPA)? What is the role of the discounted cash flow (DCF) methodology in ROE determinations? Can FERC justify placement of a base ROE above the midpoint of the zone of reasonableness for a group of utilities without a risk analysis? What risk factors could be taken into account when determining placement of the base ROE within the zone of reasonableness? And, does the Commission's tax

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1. FPC v. Hope Nat. Gas Co., 320 U.S. 591 (1944); Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n, 262 U.S. 679 (1923).

2. Opinion No. 531, *Coakley v. Bangor Hydro-Elec. Co.*, 147 F.E.R.C. ¶ 61,234 (2014) [hereinafter Opinion No. 531], *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), *vacated* [hereinafter Opinion 531-B]; Maine v. FERC, 854 F.3d 9 (D.C. Cir. 2017) [hereinafter Emera].

3. Opinion No. 551, *Ass'n of Businesses Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc*., 156 F.E.R.C. ¶ 61,234 (2016) *reh'g pending* [hereinafter Opinion No. 551].

4. *Id*. at 137.

5. United Airlines, Inc. v. FERC, 827 F.3d 122 (D.C. Cir. 2016); *Inquiry Regarding the Commission's Policy for Recovery of Income Tax Costs*, 157 F.E.R.C. ¶ 61,210 (2016) [hereinafter Tax NOI].

allowance policy combine with its ROE policy to produce double recovery of income taxes in the case of partnerships?

Glossary of Acronyms

ALJ	Administrative Law Judge
APA	Administrative Procedure Act
CAPEX	Capital Expenditure
CAPM	Capital Asset Pricing Model
COE	Cost of Equity
DCF	Discounted Cash Flow analysis
FERC	Federal Energy Regulatory Commission
FPA	Federal Power Act
GDP	Gross Domestic Product
IBES	Thomson Reuters' Institutional Brokers Estimate System
MISO	The Midcontinent Independent System Operator
MISO TOs	MISO transmission owners
New England TOs	New England transmission owners
NGA	Natural Gas Act
RTO	Regional Transmission Organization
ROE	Return on Equity
TOs	Transmission owners
Upper mid-point	The midpoint of the upper half of the zone of reasonableness
Value Line	Value Line Investment Survey

I. INTRODUCTION

The Commission's jurisdiction extends to establishing "just and reasonable" rates for certain sales and transmission of electricity in interstate commerce, sales and transportation of natural gas in interstate commerce, and transportation of crude oil and refined petroleum products in interstate commerce.[6] Historically, all of these services were provided at cost-based rates.[7] While the commodity sales subject to the Commission's jurisdiction are increasingly made at market-based rates, some of these sales and most jurisdictional transmission and transportation service rates are cost-based rates.[8]

The Commission's cost-based rate analysis is bounded by fundamental rate-making standards established by the Supreme Court in *Hope* and *Bluefield*.[9] These standards require the Commission to balance the interests of consumers with those

6. 16 U.S.C. § 824d (2016); 16 U.S.C. § 824e (2016); 15 U.S.C. § 717d (1938); 15 U.S.C. § 717e (1938).
7. *Id.*
8. *Id.*
9. *Hope*, 320 U.S. at 615.

of the industry.[10] The Commission is charged with preventing exploitation of consumers, while ensuring that utilities can earn a return that is: (1) "commensurate with returns on investments in other enterprises having corresponding risks;" and (2) "sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[11]

A foundational part of the analysis the Commission undertakes in making its just and reasonable determination with respect to cost-based rates involves examining the public utility's costs.[12] These costs include the cost of capital, which is the cost of debt and the cost of attracting equity investment.[13] The return on equity (ROE) is the implied cost of equity. It is established by the Commission in response to either a rate filing or a complaint.

The Commission uses its DCF methodology as its primary tool for evaluating whether a proposed ROE is within a "zone of reasonableness" and just and reasonable.[14] As discussed in more detail below, the DCF methodology presumes that an investment in common stock is worth the present value of the infinite stream of dividends discounted at a market rate commensurate with the investment's risk.[15] The methodology looks at the level of future dividends expected from a group of proxy companies in relation to stock price to determine a zone of reasonableness comprised of a range of potentially just and reasonable ROEs for the subject company.[16] Traditionally, the Commission has placed the base ROE of a group of utilities at the midpoint of the DCF zone of reasonableness.[17]

However, in Opinion No. 531 *et al*., the Commission was not satisfied that the midpoint of the DCF zone would produce an ROE in compliance with the *Hope* and *Bluefield* standards for the New England transmission owners (New England TOs).[18] The Commission expressed a concern that "anomalous" capital market conditions during the study period in that case – such as low bond yields and interest rates – may have rendered the results of the DCF methodology unreliable.[19] To address this concern, Opinion No. 531 looked at the cost of equity resulting from alternative benchmarks such as the Capital Asset Pricing Model (CAPM), risk premium, and expected earnings analyses presented by the New England TOs.[20] It further looked at the ROEs approved by state commissions and concluded that the New England TOs' ROE needed to be above state-approved

10. *Id*. at 610.

11. *Id*. at 603.

12. *Bluefield*, 262 U.S. at 694.

13. Opinion No. 531, *supra* note 2, at P 17.

14. *Id*. at P 6. The zone of reasonableness is a range of possible reasonable rates established using the DCF methodology.

15. *Id*. at P 76.

16. *Id*. at P 77.

17. *Id*. at PP 26, 144; *Ass'n of Businesses Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator*, Inc., 153 F.E.R.C. ¶ 63,027 at P 25 (2015) [hereinafter First MISO Initial Decision].

18. Opinion No. 531, *supra* note 2, at P 142.

19. *Id*. at PP 129, 145.

20. *Id*. at PP 146-47.

ROEs in order to satisfy the requirements in *Hope* and *Bluefield* because investing in transmission is riskier than investing in distribution.[21]

The Commission did not define market "anomaly" and did not require parties claiming its existence to prove a connection between such an anomaly and the inputs to the DCF model.[22] Instead, in the authors' view, the Commission has created an undefined exception to the presumptive validity of the DCF methodology for "anomalous" market conditions.[23] This exception will allow parties in future ROE proceedings to use alternative benchmark methodologies – previously considered inferior to the DCF – along with state-authorized ROEs, to challenge DCF results.[24] While FERC stressed in Opinion No. 531 that it was not departing from its use of the DCF methodology, the purported existence of anomalous capital market conditions made the Commission question the integrity of the DCF outcomes in some (but not all) recent ROE proceedings.[25]

The uncertainty created by Opinion No. 531 does not end here. The Commission placed the base ROE at the midpoint of the upper half of the zone of reasonableness (upper midpoint) without finding the risks faced by the New England TOs to be higher than those of the proxy group and without using the alternative benchmarks to inform the placement of the base ROE.[26] The D.C. Circuit's decision in *Emera* rejected this approach as arbitrary and capricious because the Commission failed to provide adequate justification for using the upper midpoint.[27]

In essence, the Commission seems to have departed from its prior policy of relying almost exclusively on the DCF results without clearly explaining circumstances that would restore confidence in the DCF outcomes, as well as the appropriate role for use of alternative benchmarks in establishing the ROE of public utilities.[28] As a result, the parameters that will be used in future proceedings to determine placement of the base ROE within the zone of reasonableness are unclear.[29] The FERC should define what constitutes a market anomaly, explain how such anomalies affect use of the DCF methodology, and provide a clear statement and a reasoned explanation as to the role and value of each alternative benchmark when anomalous capital market conditions exist.

Opinion No. 531, *et al.* issued a number of important policy decisions that include unifying the DCF methodologies employed in both public utility and pipeline rate adjustments and eliminating updates using treasury bond data.[30] Most of these new policies were not challenged in *Emera* and so it seems likely they will remain unchanged when the Commission addresses the D.C. Circuit's vacatur and remand. The Court's nonspecific vacatur instruction left unclear whether the

21. *Id*. at PP 148-49.
22. Opinion No. 531, *supra* note 2; *Emera*, 854 F.3d at 27-28.
23. Opinion No. 531, *supra* note 2, at PP 37, 41.
24. *Id*. at P 145.
25. *Id*. at PP 41, 145.
26. *Emera*, 854 F.3d at 28-30.
27. *Id*. at 30.
28. *See generally* Opinion No. 531, *supra* note 2.
29. *Id*.
30. *Id*. at PP 11, 41, 147, 160.

Commission would rely on the portions of Opinion No. 531 that were not addressed by the Court.[31] In a recent order the Commission stated that it will not rely on Opinion No. 531 as precedent in ongoing ROE proceedings, such as the MISO ROE complaints, until it issues its order on remand.[32]

This article examines evolving issues related to the Commission's DCF methodology and its implementation in recent cases to better understand the challenges ahead for FERC practitioners. These issues include: the burden of proof to establish the existence of a market anomaly and the presumptions the Commission created around this undefined concept; the comparability of short-term growth data sources; the appropriateness of using alternative benchmarks and state-approved ROEs; and consideration of other risk factors – such as capital structures, level of capital expenditures (CAPEX), and formula rates – in determining the appropriate placement of the base ROE within the DCF zone of reasonableness.[33] Other developments addressed include recent Court of Appeals decisions that may significantly influence the Commission's ROE policies.[34] For example, the Commission: (1) may no longer use a single analysis for approving ROEs when addressing a section 206 complaint; and (2) may not place the base ROE at the upper midpoint as it would likely have under earlier precedent.[35]

While Opinion Nos. 531 and 551 are electric utility ROE cases, the Commission's new unified DCF approach to jurisdictional ROE determinations makes the principles established in these opinions relevant to gas and petroleum pipelines.[36] And vice versa, evolving principles in oil and gas pipeline ROE cases are now more transferable to electric ROE determinations.[37] On the pipeline side, this article looks at whether the relationship between FERC's DCF ROE methodology and income tax allowances results in double recovery in the case of partnership pipelines and how these issues could be relevant to electric ROE determinations. The FERC's unified ROE approach means that the resolution of this issue could also apply in the case of future matters involving electric utilities.[38] In *United Airlines*, the D.C. Circuit questioned FERC's tax allowance policy, as applied to partnership pipelines, in light of the potential for double recovery inherent in the combination of the DCF ROE and the tax allowance.[39] Remand on this point prompted the Commission to issue a notice of inquiry seeking comments on methods to allow regulated entities to earn an adequate return without double recovery of investor-level taxes for partnerships or similar pass-through entities.[40] The

31. *Emera*, 854 F.3d at 30 ("We therefore vacate FERC's orders and remand the case for proceedings consistent with this opinion.").

32. *See ISO New England Inc.*, 161 FERC ¶ 61,031, at P 28 (2017) ("we recognize that, as a result of the Court's vacatur, those opinions cannot serve as precedent in other proceedings.") (citing Burlington Northern, Inc. v. United States, 459 U.S. 131, 140 (1982)).

33. Opinion No. 531, *supra* note 2, at PP 15, 21-22, 25, 131, 146.

34. *See generally Emera.*

35. Opinion No. 531, *supra* note 2, at PP 26, 151-52; *Emera*, 854 F.3d at 27-29.

36. Opinion No. 531, *supra* note 2, at PP 8, 13.

37. *Id*. at PP 8, 13.

38. *See generally* Tax NOI, *supra* note 5; *see also United Airlines*.

39. *United Airlines*, 827 F.3d at 127.

40. *See generally* Tax NOI, *supra* note 5.

Commission has received comments on the two possible outcomes identified by the Court in *United Airlines*: (1) "eliminating all income tax allowances and setting rates based on pre-tax returns," and (2) "remov[ing] any duplicative tax recovery for partnership pipelines directly from the discounted cash flow return on equity."[41] Thus, partnership pipelines are facing the possibility of a reduction in their effective overall allowed rate of return.

II. BURDEN OF PROOF UNDER FPA SECTION 206 – *EMERA*

The FPA allows public utilities to collect "just and reasonable" rates for the transmission or sale of electric energy and gives the FERC the authority to ensure that rates charged by utilities are just and reasonable.[42] Under FPA section 206, a party challenging the filed rate has the burden of establishing that such rate is unjust and unreasonable.[43] The New England TOs argued that in Opinion No. 531 *et al.,* the complainants and FERC had failed to meet their respective burdens under section 206 of the FPA, and that therefore the Commission's decision was deficient for two reasons: (1) a rate that falls within the zone of reasonableness cannot be unjust and unreasonable (zone of immunity theory); and (2) the Commission failed to specifically find the filed rate to be unjust and unreasonable, instead presuming that by establishing a new just and reasonable rate, the filed rate automatically became unjust and unreasonable (single analysis theory).[44] The D.C. Circuit in *Emera* rejected the New England TOs' zone of immunity theory, but agreed that the Commission's use of a single analysis was improper.[45]

A. New England Transmission Owners' Zone of Immunity Theory Rejected

In *Emera*, the New England TOs argued that FERC must show that an existing rate is "entirely outside the zone of reasonableness" before it can exercise its section 206 authority to change that rate.[46] The New England TOs then argued that because the 11.14% base ROE they were allowed was within FERC's newly determined zone of reasonableness, FERC could not find it to be unjust and unreasonable and still meet its burden under section 206 of the FPA.[47] The premise of this argument was that all rates within the zone of reasonableness are just and reasonable rates, such that any existing rate within this zone is "immune" from a complaint under FPA section 206.[48]

The D.C. Circuit rejected this argument, ruling that whether a particular rate within the zone is the just and reasonable rate for the utility at issue "depends on

41. *United Airlines*, 827 F.3d at 137.
42. 16 U.S.C. § 824d.
43. 16 U.S.C. § 824e.
44. *Emera*, 854 F.3d at 16.
45. *Id*. at 23.
46. *Id*. at 20 (quoting City of Winnfield v. FERC, 744 F.2d 871, 875 (D.C. Cir. 1984)).
47. *Id*. at 10.
48. *Id*.

a number of factors," and that the fact that a rate falls within the zone of reasonableness does not establish that the rate is the just and reasonable rate.[49] The Court further found that the precedent cited by the New England TOs did not support their position because these cases addressed the boundaries for courts reviewing FERC's ratemaking decisions under FPA section 205, not the showing necessary under FPA section 206 to find that an existing rate is unjust and unreasonable.[50] The Court concluded that "while showing that the existing rate is entirely outside the zone of reasonableness may illustrate that the existing rate is unlawful, . . . that is not the only way in which FERC can satisfy its burden under section 206."[51]

B. The Commission's Single ROE Analysis Approach Rejected

In Opinion No. 531-B, the Commission held that it could satisfy its dual burden under section 206 through a single ROE analysis that generates an ROE that is both: (i) below the existing ROE (thus demonstrating that the existing ROE is excessive); and (ii) a just and reasonable ROE (thus demonstrating what the new ROE should be).[52] The New England TOs challenged this approach, arguing that the FERC failed to follow the two-step procedure mandated by section 206 (*i.e.*, first finding that their existing base ROE was unjust and unreasonable, and then establishing the just and reasonable rate).[53] The Commission first determined that 10.57% would be a just and reasonable base ROE, and only afterward found the existing 11.14% ROE to be unlawful because it was not equivalent to 10.57%.[54]

The D.C. Circuit agreed with the New England TOs.[55] While a utility filing a rate adjustment under FPA section 205 must show only that the proposed adjustment is lawful (not that the existing rate is unlawful), under section 206, the challenger of the existing rate bears the burden of proving that the existing rate is unlawful before a new just and reasonable rate can be established.[56] In other words, finding that an existing rate is unjust and unreasonable is the condition precedent to the Commission's exercise of its section 206 authority to change that rate.[57]

49. *Emera*, 854 F.3d at 23. The Court relied on precedent ruling that: (1) the zone of reasonableness represents a broad range of "potentially" just and reasonable ROEs, "not an exact dollar figure" (quoting Panhandle E. Pipe Line Co. v. FERC, 777 F.2d 739, 746 (D.C. Cir. 1985)); (2) as long as the rate selected by the Commission is within the zone of reasonableness, FERC is not required "to adopt as just and reasonable any particular rate level" (quoting *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 767 (1968)); and (3) whether a "rate, even one within the zone of reasonableness," is unjust and unreasonable depends on the circumstances of the case (citing FPC v. Conway Corp., 426 U.S. 271, 278 (1976)). The Court further relied on FERC's precedent ruling that rates within the zone of reasonableness may not be just and reasonable (*Bangor Hydro-Elec. Co.*, 122 F.E.R.C. ¶ 61,038 at P 11 (2008)).

50. *Emera*, 854 F.3d at 23.

51. *Id.* at 24 (emphasis omitted).

52. Opinion No. 531-B, *supra* note 2, at PP 28–32.

53. *Emera*, 854 F.3d at 19.

54. *Id.*

55. *Id.*

56. *Id.* at 24-25.

57. *Id.* at 25.

Without a showing that the existing rate is unlawful, FERC has no authority to impose a new rate.[58]

Opinion No. 531 did not explain what circumstances rendered the New England TOs' ROE unlawful.[59] Instead, the Commission relied on its assumption that all ROEs other than the one FERC identifies as the utility's just and reasonable ROE are unlawful in a section 206 proceeding.[60] The Court explained that the zone of reasonableness creates a broad range of potentially lawful ROEs, rather than a single just and reasonable ROE, and held that the Commission's finding of a 10.57% ROE to be a just and reasonable rate, standing alone, did not show that the existing 11.14% ROE (a number within the DCF zone) was unjust and unreasonable.[61] To satisfy its dual burden under section 206, the Commission is required to do more than establish a new just and reasonable ROE; rather, the Commission must explicitly find the existing ROE of the utility to be unjust and unreasonable.[62] In other words, for purposes of meeting the burden of proof under section 206 of the FPA, not all rates within the zone are just and reasonable (as the New England TOs claimed), nor are all these rates – save one – unjust and unreasonable (as the Commission claimed).[63]

C. The Beginning of Emera's Aftermath

Following *Emera*, transmission owners in MISO and New England filed motions to dismiss the pancaked ROE complaints directed toward their respective transmission rates.[64] These motions allege that the Court's rejection of the single ROE theory changed the burden of proof applicable to complainants or the Commission in establishing a *prima facie* case that an ROE situated within the zone of reasonableness is not just and reasonable.[65] According to the transmission owners, *Emera* requires more than a DCF analysis showing a result below the existing rate in order to challenge such a rate under FPA section 206.[66]

The motions to dismiss also argue that *Emera* opens the door for the Commission to reconsider its policy of allowing pancaked complaints (*i.e.*, successive complaints following the end of each statutory refund period).[67] To support this position, transmission owners argued that: (1) the Court ruled that FPA section 206 provides additional protections to public utilities not found in FPA section 205, including the fifteen-month refund time-limit; and (2) under *Emera*, a complainant must first demonstrate that the "existing" ROE is unjust and

58. *Id*.

59. Opinion No. 531, *supra* note 2, at P 1.

60. *Id*. at P 50.

61. *Emera*, 854 F.3d at 23.

62. *Id*. at 24.

63. *Id*.

64. NETOs, Motion for Dismissal, Docket No. EL11-66-001 *et al.* (Oct. 5, 2017) [hereinafter NETOs' Motion]; MISO TOs, Motion to Dismiss, Docket No. EL15-45-000 (Sep. 29, 2017) [hereinafter MISO TOs' Motion].

65. NETOs' Motion, *supra* note 64, at 14-15; MISO TOs' Motion, *supra* note 64, at 9.

66. *Id.*

67. NETOs' Motion, *supra* note 64, at 24-25; MISO TOs' Motion, *supra* note 64, at 11-12.

unreasonable, but if a prior complaint proceeding is still pending when the new complaint is filed, the complainant and the Commission do not and cannot know what the "existing" ROE is as of the time of the next complaint filing.[68]

Complainant-aligned parties in New England and MISO filed responses challenging the transmission owners' interpretation of *Emera* in relation to these issues.[69] Notably, these parties argued that the transmission owners incorrectly interpret *Emera* as imposing evidentiary requirements to challenge existing rates under FPA section 206, and take out of context the Court's rulings regarding the protections (for both public utilities and consumers) provided in sections 205 and section 206 of the FPA.[70] According to these parties, nothing in *Emera* requires the Commission to dismiss the ongoing ROE complaints or requires the Commission to change its long-standing policies allowing pancaked complaints.[71] The motions to dismiss remain pending before FERC.

Finally, the NETOs recently filed an amended compliance filing, arguing that their base ROE should revert to the pre-existing 11.4% because *Emera* vacated Opinion No. 531 *et al.*, including Opinion No. 531-A that established the new 10.57% base ROE.[72] FERC rejected the NETOs amended compliance filing.[73] The Commission ruled that *Emera* does not require, as a matter of law, that the ROE immediately return to the pre-Opinion No. 531 levels.[74] Relying on the Supreme Court's decision in *Burlington Northern*, FERC explained that the "federal court['s] authority to reject rate orders for whatever reason extends to the orders alone and not to the rates themselves" and, therefore, the court lacks authority to dictate the rate.[75] As a result, the Commission concluded that "the fact that the D.C. Circuit vacated Opinion No. 531 *et seq.* cannot automatically reinstate the ROEs that NETOs were permitted to recover prior to Opinion No. 531."[76] With respect to its remedial authority, the Commission cited precedent authorizing it to order refunds or surcharges as necessary to make parties whole when a FERC order is vacated.[77]

III. FERC RELIANCE ON THE DCF METHODOLOGY – OPINION NOS. 531 AND 551

The Commission has relied for decades on the DCF model to determine the allowed ROE of public utilities.[78] The underlying premise of the DCF model is

68. *Id.*

69. Complainant-Aligned Parties, Answer, Docket No. EL11-66-001, *et al.* (Oct. 20, 2017) [hereinafter New England CAPs Answer]; Complainant-Aligned Parties, Answer, Docket No. EL15-45-000 (Oct. 16, 2017) [hereinafter MISO CAPs Answer].

70. New England CAPs Answer, *supra* note 69, at 5-8; MISO CAPs Answer, *supra* note 69, at 12-25.

71. New England CAPs Answer, *supra* note 69, at 10-15; MISO CAPs Answer, *supra* note 69, at 25-27.

72. *ISO New England Inc. v. Bangor Hydro-Electric Company*, 161 FERC ¶ 61,031, at P 11 (2017).

73. *Id.*, at P 1.

74. *Id.* at P 24.

75. *Id.* at P 25 (citing Burlington Northern, Inc. v. United States, 459 U.S. 131, 141 (1982)).

76. *Id.* at P 27.

77. *Id.* at PP 29-35.

78. *See, e.g.*, Opinion No. 531, *supra* note 2, at PP 14, 16, 41.

that an investment in common stock is worth the present value of the infinite stream of dividends discounted at a market rate commensurate with the investment's risk.[79] "[T]he formula for the DCF model is:

$$k=D/P * (1 + 0.5g) + g$$

where "'k' is the investors' required rate of return . . . 'D' is the current dividend, . . . 'P' is the price of the common stock, . . . and 'g' is the expected growth rate in dividends."[80] In following this formula, analysts: (1) calculate the company's dividend yield (D/P); (2) calculate its growth rate (g); (3) adjust the dividend yield by "[m]ultiplying the dividend yield by the" expression (1+.5g) to account for the fact that dividends are paid on a quarterly basis; and (4) add the adjusted dividend yield to the growth rate.[81]

In Opinion No. 531, the Commission adopted the two-step oil and gas DCF methodology for application to electric utilities.[82] The two-step DCF methodology: (1) uses a single six-month average dividend yield for each company in the proxy group, instead of calculating separate high and low estimates for each proxy company; and (2) averages short-term and long-term growth estimates, instead of relying on short-term growth projections by investment advisory services only.[83] The Commission specifically noted in Opinion No. 531 that the DCF methodology remained its preferred approach for determining the allowed rate of return.[84] However, ongoing litigation over ROE for the New England TOs and the MISO Transmission Owners (MISO TOs) involves several aspects of calculations and components included in the DCF analysis, along with the scope and consequences of market anomalies and their relationship to DCF inputs.[85]

A. Challenges Involving Specific DCF Components

1. Dividend Yield Calculations

In Opinion No. 510, the Commission determined that the dividend yield of each proxy company should be calculated by using a three-step process: "(1) averaging the high and low stock prices [as reported by the New York Stock Exchange or NASDAQ] for each of the . . . six months" in the study period; (2) calculating a dividend yield for each such month by dividing the company's indicated annual dividend by the company's average stock price for the month; and (3) averaging those monthly dividend yields.[86] The Commission reiterated this position

79. *Id.* at P 14 (citing Canadian Ass'n of Petroleum Producers v. FERC, 254 F.3d 289, 293 (D.C. Cir. 2001)).

80. *Id.* at P 15.

81. *Id.*

82. *Id.* at P 32.

83. Opinion No. 531, *supra* note 2, at P 17 (The Commission ruled that short-term growth estimates will be based on the five-year projections reported by the Institutional Brokers Estimate System (IBES) (or a comparable source) and the long-term growth projection on an average of the Gross Domestic Product (GDP) growth rates consistent with gas precedent).

84. *Id.* at P 41.

85. *Emera*, 854 F.3d at 15.

86. Opinion No. 510, *Portland Nat. Gas Transmission Co.*, 134 F.E.R.C. ¶ 61,129 at P 227 (2011) [hereinafter Opinion No. 510].

in Opinion Nos. 528 and 531.[87] In all three decisions, the Commission expressly found this "average-yield" method preferable to the "latest-dividend" approach, which calculates the estimated dividend yield for each proxy group member based on the latest dividend declared in the period.[88]

Transmission owners have advocated the use of the latest-dividend methodology in recent cases.[89] While the Commission actually calculated the proxy-group dividend yields component of the DCF analysis appended to Opinion No. 531 based on the latest-dividend methodology, it specifically rejected the use of that methodology in the body of the Order.[90] In the pending MISO ROE case, transmission owners argued that the latest-dividend approach is more consistent with the forward-looking assumptions underlying the Commission's DCF model, in that an average dividend yield based on the most recent dividend will better reflect investors' expectations.[91]

However, complainants and aligned parties in the case supported Commission precedent finding that such an approach for calculating dividend yields would result in overstated dividend yields, particularly when a firm raises its dividends or distributions during the six-month study period, because earlier stock prices do not reflect the increased value of the stock resulting from such raises.[92] In Opinion No. 551, the Commission did not expressly address this issue, but affirmed the Initial Decision's application of the DCF methodology, including rejection of the latest-dividend approach proposed by the MISO TOs.[93] The MISO TOs did not request rehearing on this point, so the dividend yield calculation issue appears to be resolved for now.

2. Growth Rate Data Sources

In describing the DCF analysis that will apply in future ROE proceedings for electric utilities, the Commission indicated that "the 'short-term growth [rate] estimate will be based on the five-year projections reported by IBES (or a comparable source).'"[94] In the MISO ROE case, one of the litigated issues was what constitutes a "comparable" growth data source and how these comparable data sources should be used in future ROE proceedings.[95] The MISO TOs argued for use of short-term growth rate estimates compiled by the Investment Survey (Value Line) rather than those compiled by IBES.[96]

87. Opinion No. 528, *El Paso Nat. Gas Co.*, 145 F.E.R.C. ¶ 61,040 at P 658 (2013) [hereinafter Opinion No. 528]; Opinion No. 531, *supra* note 2, at P 77.

88. Opinion No. 510, *supra* note 71, at P 234; Opinion No. 528, *supra* note 72, at P 658; Opinion No. 531, *supra* note 2, at P 78.

89. *See, e.g.*, Opinion No. 531, *supra* note 2, at P 78.

90. *Id.* at P 78.

91. *Id*. at PP 71-72.

92. *Id.* at P 78.

93. Opinion No. 551, *supra* note 3, at P 199.

94. Opinion No. 531, *supra* note 2, at P 49.

95. *Id*. at P 64.

96. *Id*. at P 17.

The MISO TOs contended that the Value Line-based DCF analysis was preferable in that case because it produced results more consistent with the results of alternative methodologies used by the Commission in Opinion No. 531, thus demonstrating that the Value Line-based DCF study was more reliable than an IBES-based study.[97] Complainants and aligned parties argued that Value Line was not a "comparable" data source that could be used in the pending MISO case or future proceedings as an alternative to IBES in order to support the position of parties seeking higher or lower ROEs.[98] In the authors' opinion, IBES and Value Line growth data sources are not comparable because: (1) IBES growth estimates have a higher potential to represent a broader consensus in the investor community than Value Line;[99] (2) Value Line growth rates use a substantially retrospective base period of up to four years before the publication date, while IBES has a shorter base period of only one year;[100] (3) Value Line does not follow IBES analyst standards and practices for normalizing reported past-year earnings; and (4) IBES growth data is more frequently updated than Value Line.[101] As a result of these differences, the use of Value Line in the MISO ROE cases produced a wider zone of reasonableness, while the use of IBES growth produced a less disparate spread of DCF results.[102]

Complainants and aligned parties argued that Value Line was a source of growth estimates tactically selected by the MISO TOs to inflate rates, while using IBES growth estimates is consistent with FERC's standard practice and precedent.[103] The MISO TOs responded that advocating for the use of IBES even when IBES-based DCF results are unrepresentative of the cost of equity (as purportedly demonstrated by alternative benchmarks in the case) is illogical.[104] This approach would use alternative benchmarks not only to guide the placement of the base ROE in the zone of reasonableness (as the Commission did in Opinion No. 531), but also to determine the appropriate short-term growth rate data source to be used

97. *Id*. at P 63.

98. *Id*. at P 64.

99. Opinion No. 551, *supra* note 3, at PP 21, 57, 64. IBES growth data represent a consensus aggregation of multiple analyst firms providing a representative sample of what investors saw during the study period. The MISO TOs argued that the record evidence did not support this position, given that neither the number nor identity of IBES analysts can be discerned from *Yahoo!* Finance. However, this information is available in IBES data published by Thomson Reuters.

100. Value Line short-term growth rate data can easily be distorted by virtue of including in the base period (used for growth projections) significant increases or declines in earnings that the company experienced in the not so recent past and that should already be reflected elsewhere in that company's dividend growth and accounted for in the DCF method. While all projections of growth are necessarily a function, in part, of historical data for the base period, Value Line's longer base period makes its short-term growth data projections more prone to distortions.

101. Because Value Line publishes on a rolling quarterly cycle, whereas IBES updates its database on a daily basis as participating analysts supply new inputs, Value Line is inherently less current than IBES.

102. Opinion No. 551, *supra* note 3, at P 7; Opinion No. 531, *supra* note 2, at P 27.

103. Opinion No. 551, *supra* note 3, at PP 54, 59.

104. *Id*. at PP 2, 3.

as an input to the DCF analysis.[105] However, while alternative benchmarks calculate the cost of equity using various methodologies, they do not estimate or evaluate the validity or reliability of data sources.[106]

In Opinion No. 551, the Commission declined to establish a presumption that Value Line and IBES are comparable short-term growth rate data sources that can be used interchangeably.[107] Subsequently, the Commission reiterated its preference for using IBES and explained that, unlike Value Line growth data, IBES growth data: (1) represent consensus growth estimates, on which investors are more likely to rely on; and (2) are more frequently updated.[108] The MISO TOs have asked for rehearing of Opinion No. 551 on this point, arguing that foreclosing Value Line as an acceptable source of short-term growth rate data was arbitrary and capricious.[109] Rehearing is currently pending.[110]

B. Challenges to the Anomalous Capital Market Conditions Theory

In Opinion No. 531, the Commission affirmed its reliance on the DCF methodology and adopted the two-step DCF methodology to establish the zone of reasonableness in electric ROE proceedings.[111] Once the zone of reasonableness is established, the Commission places the ROE at a just and reasonable point within the zone.[112] For a single utility, the Commission has long established the base ROE at the median, rather than the midpoint, of the zone of reasonableness.[113] The reason for this approach is that the median gives consideration to more of the companies in a proxy group, rather than only those at the top and the bottom.[114] This makes the median a better representation of the central tendency, lessening the impact of any single proxy group company with atypically high or low ROEs.[115] In other words, the median is less affected by extreme results of the DCF than the midpoint. [116]

However, the Commission has typically opted for the midpoint of the zone of reasonableness when selecting an ROE for a diverse group of utilities (such as the MISO TOs or the New England TOs).[117] The reason for this approach is to

105. *Id*. at PP 54, 272.

106. *See generally id*.

107. Opinion No. 551, *supra* note 3, at 64.

108. *Id*.

109. MISO Transmission Owners v. FERC, 156 F.E.R.C. ¶ 61,061 at P 40 (2016) [hereinafter MISO Rehearing].

110. *See generally id*.

111. Opinion No. 531, *supra* note 2, at P 9.

112. *Id*.; S. Cal. Edison Co. v. FERC, 717 F.3d 177, 179 (D.C. Cir. 2013).

113. *S. Cal. Edison Co.*, 131 F.E.R.C. ¶ 61,020, at P 32 n.152 (2010) ("The median is calculated by sorting the average of the high and low DCF results of each company in the proxy group from lowest value to highest value, and then selecting the central value of the sequence. Where there is an even number of results, the median is the average of the two central numbers. The midpoint is the average of the highest and lowest data points in the DCF range of reasonable returns").

114. *Id*. at P 82.

115. *Id*. at P 85.

116. *S. Cal. Edison Co.*, 717 F.3d at 182.

117. *Id*. at 183.

better reflect the range rather than the central tendency.[118] The Commission's goal in these joint ROE cases is not selecting the ROE for a single utility of average risk, but rather to set a just and reasonable base ROE for a group of utilities with diverse risks.[119] Each company in the group receives the same ROE.[120] The implication is that, in a heterogeneous risk group, some companies may receive a higher or lower ROE than they would if the Commission performed an individual ROE analysis.[121]

While reaffirming its reliance on the newly established DCF methodology, the Commission indicated that "any DCF analysis may be affected by potentially unrepresentative financial inputs to the DCF formula, including those produced by historically anomalous capital market conditions."[122] The Commission found that capital market conditions during the study period were "anomalous" and that the mere existence of these anomalous conditions made it more difficult to determine the return necessary to attract capital.[123] As an example of such conditions, the Commission noted that the yield on ten-year Treasury bonds, which had not fallen below 3% in the roughly fifty years preceding the 2008 financial crisis, had averaged below 2% during the study period.[124] The Commission acknowledged that Treasury bond yields were not an input into the DCF model, but reasoned that they were reflective of capital market conditions that could indirectly affect such inputs as the dividend yield and the growth rate.[125]

Given these "anomalous" conditions, the Commission was concerned that awarding the New England TOs a base ROE equivalent to the midpoint of the DCF zone of reasonableness may fail to meet the *Hope* and *Bluefield* standards.[126] Therefore, the Commission found it necessary to consider additional record evidence, including evidence of alternative benchmark methodologies and base ROEs approved by state public utility commissions as guidance as to the appropriateness of using the midpoint.[127] As such, the anomalous capital market conditions theory creates an exception to the Commission's reliance on the DCF results and opens the door to questioning the appropriateness of the midpoint or median placement of the base ROE.[128]

1. What Are Anomalous Capital Market Conditions?

In Opinion No. 531, the Commission relied on arguments made by both parties about anomalies in capital market conditions.[129] Specifically, Opinion No.

118. *Id.*
119. *Midwest Indep. Transmission Sys. Operator, Inc.*, 106 F.E.R.C. ¶ 61,302 at PP 10-11 (2004).
120. *Id.*
121. *Id.* at P 11.
122. Opinion No. 531, *supra* note 2, at P 41.
123. *Id.* at P 145.
124. *Id.* at P 145 n.285.
125. *Id.*
126. *Id.* at P 145.
127. Opinion No. 531, *supra* note 2, at P 145.
128. *Id.* at P 41.
129. *Id.* at P 145.

531 pointed to low bond yields as an example of a market anomaly.[130] The Commission, however, did not define what constitutes a market anomaly that would trigger in future proceedings a *lack of confidence* in the results of the DCF model.[131] This lack of confidence is significant because it calls into question the validity of the DCF model, on which the Commission has traditionally relied.[132] As a result, the process for estimating utilities' cost of equity has been greatly complicated by reliance on alternative metrics and extrinsic evidence, the value of which is disputed in relation to determining compliance with *Hope* and *Bluefield* standards.[133]

The Administrative Law Judge's (ALJ) initial decision in the MISO case preceding Opinion No. 551 proposed the use of the Oxford Dictionary's definition of "anomalous," as applied to market-conditions that are both unprecedented and unsustainable.[134] Opinion No. 551, however, did not adopt that definition.[135] Instead, the Commission's lack of confidence in the DCF model rested on record evidence regarding historically low interest rates and Treasury bond yields, as well as the Federal Reserve's intervention in markets for debt securities.[136] In finding that capital market conditions were anomalous, the Commission rejected the "new normal" theory propounded by complainants and aligned parties.[137] Nevertheless, the Commission's decision raises several concerns regarding identification of market anomalies that could support departure from reliance on the DCF model: How long must market anomalies last before investors account for these market conditions in their investment decisions? How do market anomalies impact the results of the DCF model and the results of alternative benchmarks?

a. Duration of the Market Anomaly

In the first and second MISO ROE complaint proceedings that preceded Opinion No. 551, complainants and aligned parties argued that capital market conditions lasting for several years could not be considered anomalous, but rather constituted a new normal.[138] Similar arguments were advanced by complainants in the New England ROE cases that followed Opinion No. 531.[139] The MISO TOs

130. *Id*. at P 145 n.285.

131. *Id*. at P 145.

132. *See, e.g.*, Opinion No. 531, *supra* note 2, at PP 14, 41 (recognizing the Commission's long-standing reliance on the DCF model and affirming future reliance on the DCF model, as modified, going forward); Bos. Edison Co. v. FERC, 885 F.2d 962 (1st Cir. 1989) (affirming the Commission's exclusive reliance on the DCF model); Midwest Indep. Transmission Sys. Operator, Inc., 99 F.E.R.C. ¶ 63,011 at PP 24-25 (2002), *aff'd*, 100 F.E.R.C. ¶ 61,292 (2002), *reh'g denied*, 102 F.E.R.C. ¶ 61,143 (2003), *on remand*, 106 F.E.R.C. ¶ 61,302 (2004), *aff'd in part sub nom*; Pub. Serv. Comm'n of Ky. v. FERC, 397 F.3d 1004 (D.C. Cir. 2005), *on remand*, 111 F.E.R.C. ¶ 61,355 (2005) (establishing exclusive reliance on DCF to set ROE).

133. Opinion No. 531, *supra* note 2, at P 145.

134. First MISO Initial Decision, *supra* note 17, at P 220.

135. Opinion No. 551, *supra* note 3, at P 124.

136. *Id*.

137. *Id*.

138. Opinion No. 531, *supra* note 2, at P 3.

139. Opinion No. 551, *supra* note 3, at P 113.

responded to the new normal theory, arguing that as long as Federal Reserve policies remain accommodative (*i.e.*, promoting lower interest rates on debt), market conditions would be anomalous.[140] In Opinion No. 551, FERC agreed with the MISO TOs and rejected the new normal theory, ruling that despite yields remaining low for several years, they are anomalous and could distort the results of the DCF model.[141]

Thus, it appears that the presence of particular conditions over a substantial period of time may not be enough to disprove the existence of an alleged "anomaly."[142] The record underlying Opinion No. 551 showed that market conditions had not changed significantly since October 2011, and that the Federal Reserve's "accommodative" policies allegedly causing, at least partially, these anomalous conditions may remain accommodative for a long period of time.[143] None of that swayed the Commission.[144] Based on FERC's decision in Opinion No. 551, it appears that as long as interest rate and bond yield levels are similar to those that prevailed during the Opinion No. 531 study period, the Commission may find that capital market conditions remain anomalous.[145]

Market conditions that have lasted for several years and that are not expected to change in the foreseeable future cannot reasonably be considered "anomalous."[146] If we assume that investors are rational and informed about market conditions and trends, it follows that they account for persistent market conditions in their investment decisions. Indeed, the Commission itself has previously found that the DCF model properly accounts for the various risk factors perceived by investors.[147] The D.C. Circuit has found that the stock market assimilates interest rate information "with lightning speed" and that if the market is unable to promptly reflect widely publicized information, such as risk-free interest rates, the DCF theory collapses.[148] In this context, the implicit definition of market anomaly in Opinion No. 551 – any market condition that arguably renders the DCF results unreliable, no matter how persistent over time – contradicts precedent and has been challenged on rehearing.[149]

b. Causal Link Between Anomalous Capital Market Conditions and Inputs to the DCF Model

In Opinion No. 551, the Commission ruled that it does not require a "mathematical demonstration" of how each anomalous capital market condition specifically distorts the DCF analysis.[150] The Commission stated that "it is uncertain

140. *Id*. at P 117.
141. *Id*. at P 124.
142. *Id*. at P 78.
143. Opinion No. 551, *supra* note 3, at PP 78, 112.
144. *Id*. at P 122.
145. *Id*. at P 78.
146. *Id*. at P 124.
147. *Transcon. Gas Pipeline Corp.*, 60 F.E.R.C. ¶ 61,246, at p. 61,825 (1992).
148. Tenn. Gas Pipeline Co. v. FERC, 926 F.2d 1206, 1210-11 (D.C. Cir. 1991).
149. *See generally* Opinion No. 551, *supra* note 3.
150. *Id*. at P 125.

whether such an analysis is even possible given the complexities of capital markets and how various phenomena could affect the DCF methodology results."[151] In fact, the Commission rejected the Initial Decision's causal link theory (*i.e.,* that low bond yields pushed yield-seeking investors toward utility equities, driving up utility stock prices, and depressing dividend yields) because of the "difficulty" of establishing a causal relationship between complex capital market conditions and the results of any particular financial model, as well as the lack of record evidence to support the Presiding Judge's theory.[152]

In short, the Commission abandoned its previous reliance on the DCF mid-point based on the belief that prevailing market conditions have distorted the DCF results, but then stated that the mechanism through which that distortion occurs cannot (and need not) be explained.[153] Basically, the Commission established a conclusory presumption that the DCF model is subject to risk of providing "unreliable outputs" in the presence of anomalous capital market conditions.[154] The presumption established in Opinion No. 551 has several flaws: (1) it is conclusive and therefore cannot be rebutted; (2) it assumes that the alternative benchmarks are not distorted by market anomalies; and (3) it leaves unexplained the question of why, if the utilities' cost of raising capital is low, the cost of equity is not also low.[155]

Proponents of straight application of the DCF model may not be able to rebut the presumption of the existence of a causal link between the anomalous conditions and the inputs to the DCF model.[156] In fact, the Commission itself stated that proving (or indeed disproving) that causal link may not be possible.[157] Furthermore, it is a fiction to assume that the "model risk" triggered by anomalous market conditions is unique to the DCF methodology.[158] Alternative benchmarks could also be distorted by the same anomalous capital market conditions.[159] And if all benchmarks are tainted by market anomalies, what is the reasoning for using them to challenge the DCF results when the Commission previously found these benchmarks to be inferior to the DCF model?[160] Finally, the presumption that anomalous capital market conditions render the DCF results unrepresentative is at odds with the First MISO Initial Decision's finding that the MISO TOs' costs of raising capital were low during the study period.[161] While rejecting the Presiding Judge's

151. *Id.*

152. First MISO Initial Decision, *supra* note 17, at P 216; Opinion No. 551, *supra* note 3, at P 125 n.289.

153. Opinion No. 551, *supra* note 3, at P 125.

154. *Id*.

155. *Id*.

156. Opinion No. 551, *supra* note 3, at P 125.

157. *Id*.

158. *Id*. at P 132.

159. *Id*. at P 134.

160. *Id*.

161. The First MISO Initial Decision found that, as a result of falling interest rates and dividend yields, the cost to electric utilities of raising capital by issuing stock was low, but it reasoned that the cost of common equity for utilities was not necessarily low because: (1) investors buy utility stock just for the yield and do not care about growth, so they are ready to divest their long-term positions as soon as normalization begins and short-term rates allow; and (2) the proxy group prices included in the DCF analysis reflect only what investors are paying to get

reasoning for distinguishing between the cost of raising capital and the utility's cost of equity, Opinion No. 551 offered no alternative explanation that would rebut the logical conclusion that the consequence of having low interest rates and yields is that the transmission owners' cost of equity is actually low.[162] Indeed, rather than distorting the DCF results, these conditions actually serve to push down the cost of raising capital, including equity capital, and the DCF model results accurately reflect this fact.

2. Who has the Burden of Proving the Existence of Anomalous Capital Market Conditions?

In the ROE proceedings that followed Opinion No. 531, one of the issues litigated was who bears the burden to prove that capital market conditions are anomalous; initial decisions in the cases involving both the New England TOs and the MISO TOs found that the party claiming the market anomaly must prove its existence.[163] The explanations that each ALJ gave as to why the burden is on the party claiming the anomaly are slightly different.[164] The New England Initial Decision found that once complainants had proved that the existing ROE was unjust and unreasonable and the Commission (represented by Trial Staff) offered evidence to establish a new just and reasonable ROE, the New England TOs had: (1) the burden of proof to establish that the ROE produced by a straight DCF analysis was insufficient to meet the *Hope* and *Bluefield* standards; and (2) the right to use alternative metrics to advance their argument that an ROE above the midpoint of the zone is warranted.[165]

The MISO Initial Decisions, however, found that to receive an ROE above the midpoint, the MISO TOs needed to show two things: (1) that there was a reasonable cause for concern that the financial inputs into the DCF analysis in the proceeding were unrepresentative (such as the anomalous capital market conditions described in Opinion No. 531); and (2) that credible alternative metrics justified the award of a base ROE higher than the midpoint.[166] While each of these decisions makes clear that alternative benchmarks can be used to justify placement of the base ROE above the midpoint of the zone, the New England Initial Decision did not make as clear that consideration of alternative benchmarks is only permitted to the extent that parties can prove the existence of anomalous market conditions.[167] The mere difference between the results of alternative benchmarks and the results of the DCF methodology is not itself proof of the existence of a market anomaly, much less proof that a market anomaly is affecting the DCF results.

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the yield. *See Ass'n of Businesses Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc.*, 156 F.E.R.C. ¶ 61,234 at PP 141, 151, 210, 216 (2016).

162. *See generally* Opinion No. 551, *supra* note 3.

163. *Env't Ne. v. Bangor Hydro-Elec. Co.*, 154 F.E.R.C. ¶ 63,024 at P 532 (2016) [hereinafter Bangor or New England Initial Decision]; First MISO Initial Decision, *supra* note 17, at P 120; Ark. Elec. Coop. v. Allete, Inc., 155 F.E.R.C. ¶ 63,030 at P 69 (2016) [hereinafter Arkansas or Second MISO Initial Decision]. I will refer to both of these decisions jointly as the MISO Initial Decisions.

164. Bangor, *supra* note 146, at P 528; Arkansas, *supra* note 146, at PP 18-20, 66-71.

165. Bangor, *supra* note 146, at P 532.

166. First MISO Initial Decision, *supra* note 17, at P 120.

167. *Id*. at P 230.

In Opinion No. 551, the Commission affirmed the conclusions of the First MISO Initial Decision regarding the existence of anomalous capital market conditions (implicitly including the ALJ's findings on the burden of proof issue).[168] The Commission, however, did not adopt the ALJ's reasoning behind the anomalous capital market conditions theory.[169] Instead, it established two presumptions: (1) that market conditions are "anomalous" for as long as the interest rate and yield levels found to be anomalous in Opinion No. 531 persist; and (2) that such anomalous capital market conditions distort inputs to the DCF model.[170]

These presumptions operate in practice to shift the burden of proof from parties claiming that an anomaly exists (as found appropriate by the ALJs in the cases involving the New England TOs and the MISO TOs) to the parties seeking straight application of the DCF methodology.[171] The presumptions impose on the latter the burden to establish: (1) that capital market conditions are no longer anomalous; and (2) that the DCF model is *not* rendered unrepresentative by purported anomalous market conditions.[172] Significantly, the First MISO Initial Decision found that it would be improper to require complainants and supporting intervenors to prove that anomalous market conditions do not exist because, contrary to D.C. Circuit precedent, it would be tantamount to requiring these participants to establish a negative.[173] The issue of who has the burden of proof to establish the existence of anomalous capital market conditions and the impact of those conditions on the DCF model is one of the issues being challenged on rehearing of Opinion No. 551.[174]

C. Challenges to the Use of Alternative Benchmarks and State ROE Determinations

In Opinion No. 531, the Commission held that, because capital market conditions were anomalous, it had "less confidence" in the results of the DCF analysis and it was appropriate to consider "additional record evidence" to inform its placement of the New England TOs' new base ROE within the zone of reasonableness.[175] The FERC considered the following alternative analyses: (1) risk premium analysis; (2) CAPM analysis; (3) expected earnings analysis; and (4) comparison of state commission-approved ROEs.[176] In Opinion No. 551, the Commission similarly found that evidence of anomalous capital market conditions

168. Opinion No. 551, *supra* note 3, at P 9.

169. *Id.* at P 125 n.289.

170. *Id.* This second presumption could, in theory, be overcome if the results of the DCF model are corroborated by alternative metrics.

171. Bangor, *supra* note 146, at P 701.

172. *Id.*

173. First MISO Initial Decision, *supra* note 17, at P 122 (citing Nat'l Motor Freight Traffic Ass'n v. United States, 242 F. Supp. 601, 605 (D.D.C. 1965)).

174. MISO Rehearing, *supra* note 92, at P 2.

175. Opinion No. 531, *supra* note 2, at P 145.

176. *Id.* at PP 145–46, 149–50; Opinion No. 531-B, *supra* note 2, at P 49.

warranted consideration of the same alternative analyses in relation to the MISO TOs' ROE.[177]

At the outset, complainants and supporting intervenors in the New England TOs and MISO TOs ROE proceedings argued that it was not appropriate for the Commission to use alternative analyses to challenge the results of the DCF analysis when the Commission had previously rejected these alternative analyses as inferior to the DCF.[178] The Commission's response to this argument was that alternative analyses are not used to determine placement of the base ROE within the zone of reasonableness, but simply act as a benchmark to determine whether the DCF midpoint meets the *Hope* and *Bluefield* standards.[179] This response does not explain why inferior analyses that are likely also affected by anomalous capital market conditions are adequate means to test the validity of the DCF results.[180] In addition to this general argument against the use of alternative benchmarks, several aspects of each specific analysis considered by the Commission have been challenged in rehearing of Opinion No. 551.[181]

1. CAPM

The CAPM analysis

> measure[s] . . . the cost of equity relative to risk. . . . [It] determines the cost of equity by taking the "risk-free rate" and adding to it the "market-risk premium" multiplied by "beta". . . . The market risk premium is calculated by subtracting the risk-free rate from the expected return. . . . A CAPM analysis is backward-looking if the expected return is determined based on historical, realized returns, . . . [and] is forward-looking if the expected return is based on a DCF study of a large segment of the market. 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.[182]

The CAPM analysis adopted by the Commission in the MISO case (Opinion No. 551) has been challenged primarily on the following grounds: (1) inappropriate application of size adjustments; (2) reliance on a composite of IBES and Value Line short-term rates; and (3) use of a one-step DCF analysis to calculate expected

177. Opinion No. 551, *supra* note 3, at PP 135-37.

178. *Orange & Rockland Utils, Inc.*, 44 F.E.R.C. ¶ 61,253, at pp. 61,951-52 (1988) (expected return on book equity does not represent investors' required return on market-priced equity); *ITC Holdings Corp.*, 121 F.E.R.C. ¶ 61,229 at P 43 (2007) ("The CAPM methodology, alone, [is] inappropriate for determining the ROE for an individual company"); *Consumers Energy Co.*, 85 F.E.R.C. ¶ 61,100, at p. 61,361 (1998); *Montaup Elec. Co.*, 38 F.E.R.C. ¶ 61,252, at p. 61,865 n.101 (1984) ("[A] risk-premium analysis can accentuate erratic market conditions and tends to over-emphasize recent market changes").

179. Opinion No. 531, *supra* note 2, at P 145; Opinion No. 531-B, *supra* note 2, at P 49.

180. Opinion No. 531, *supra* note 2, at P 145.

181. *Ass'n of Businesses Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc.*, 156 F.E.R.C. ¶ 61,060 at P 14 (2016) [hereinafter Order on Rehearing].

182. Opinion No. 551, *supra* note 3, at P 138 ("The risk-free rate is represented by a proxy, typically the yield on 30-year U.S. Treasury bonds. Betas, which are published by several commercial sources, measure a specific stock's risk relative to the market").

returns.[183] These challenges are currently pending on rehearing of Opinion No. 551.[184]

2. Risk Premium

The risk premium methodology is based on the premise that "investors in stocks take greater risk than investors in bonds," and therefore investors "expect to earn a return on [investment in stocks] that reflects a 'premium' over and above the return they expect to earn on a bond investment."[185] Prior to Opinion No. 531, the Commission refused to rely on risk-premium analyses.[186] In Opinion No. 531, the Commission found that "[t]he link between interest rates and risk premiums [(where investors' required risk premiums expand with low interest rates and shrink at higher interest rates)] provides a 'helpful indicator of how investors' required returns on equity have been impacted by the interest rate environment.'"[187]

The risk premium analysis adopted by the Commission in the MISO case (Opinion No. 551) has been challenged on various grounds.[188] For example, complainants and aligned parties have argued that

183. *Id.* at P 149. The CAPM analysis that Opinion No. 551 relied upon used an upward adjustment based on the rationale that differences in investors' required rates of return that are related to firm size are not fully captured by beta. Complainants and aligned parties argued that to accurately infer the required return for utilities from betas, it is best to either consider the size adjustment and the industry adjustment together, or consider neither, whereas considering the size adjustment without the industry adjustment distorts the relationship to the point where the result is less reliable than if neither adjustment had been made. Opinion No. 551 asserts that it would be inappropriate to add an industry risk premium to the CAPM analysis because the proxy group betas themselves already capture industry risk and required returns. The Commission, however, failed to explain why the proxy group betas already capture industry risk and required returns completely, but do not capture at all size-related risk and required returns. The CAPM analysis the Commission relied on in Opinion No. 551 – unlike the methodology the Commission relied on in Opinion No. 531 – calculates expected portfolio return using a DCF analysis with a composite of Value Line and IBES short-term rates. This methodology was challenged because the use of Value Line short-term data rendered the CAPM study unreliable the same way it rendered Transmission Owners' Value Line DCF unreliable. Opinion No. 551 dismissed this concern, stating that the use of growth rate data in the CAPM analysis is "fundamentally different" from how growth data is used in the DCF model because it is intended to provide a less precise cost-of-equity estimate than the DCF model. Opinion No. 551, *supra* note 3, at P 169. According to the Commission, such a "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." *Id.* On rehearing, complainants and aligned parties argued that it is arbitrary and capricious to require a lower degree of precision in analyses that essentially form the premise for the Commission rejecting the results of the more precise DCF method, even if the CAPM is just one of several analyses. The CAPM analysis that Opinion No. 551 relied on used a one-step DCF analysis (*i.e.*, using only short-term growth data) to calculate expected portfolio returns. This approach was challenged because it assumes that growth rates that were estimated for the next five years (as forecasted for the 400-stock portfolio of companies used in the analysis) will continue forever, a premise that is implausible. Opinion No. 551 dismissed these arguments because the companies were selected from the S&P 500 index and had a high market capitalization at that time. *Id.* at P 170. Whether high capitalization can insulate companies from the limitation of GDP growth as presumed in the Commission's response to CAPM challenges is at issue on rehearing.

184. Order on Rehearing, *supra* note 164, at P 42.

185. Opinion No. 551, *supra* note 3, at P 173.

186. *See, e.g., Sys. Energy Res., Inc.*, 92 F.E.R.C. ¶ 61,119, at p. 61,447 (2000).

187. Opinion No. 551, *supra* note 3, at P 173 (citing Opinion No. 531, *supra* note 2, at P 147).

188. *See generally* Request for Rehearing of the Organization of MISO States, *Ass'n of Businesses Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc.*, Docket No. EL14-12-003 (Oct. 28, 2016).

> reliance on a risk premium study – which inherently assumes a linear relationship between bond yields and the cost of equity – is incompatible with [the Commission's finding] in Opinion No. 531 that the relationship between equity costs and Treasury bond yields has become unreliable in "both . . . magnitude and direction," [to the extent that] reliance on such [correlations] can no longer be trusted to "produce a rational result."[189]

In addition, there are various flaws in the ROE data points used in risk premium analysis, such as: (1) the reliance on a one-step DCF analysis that the Commission no longer uses; (2) inclusion of ROE adders, settlements, and even ROEs that have been found to be unjust and unreasonable (such as the 12.38% MISO base ROE); and (3) lack of synchronicity between the ROE decisions considered and the bond yields to which they are compared to determine the premium.[190]

3. Expected Earnings

The expected "earnings analysis is a method of calculating the earnings an investor expects to receive on the book value of a particular stock."[191] This method uses estimates of earnings from "analysts' earnings forecasts for the company."[192] Opinion No. 531-B found that because "returns on book equity help investors determine the opportunity cost of investing in that particular utility instead of other companies of comparable risk," they 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."[193]

The expected earnings analysis adopted by the Commission in Opinion No. 551 has been challenged on the grounds that it relied on the book earnings of regulated utility-parent firms, rather than the book earnings of a comparable sample of competitive-sector firms.[194] Opinion No. 551 rejected such arguments because the expected earnings analysis reflected forecast utility-parent book returns, not historical utility-parent book returns.[195] The problem with this approach is that, whether historical or forward-looking, accounting returns are inherently disconnected from the actual cost of equity.[196] Because of this disconnect, support for a method based on accounting returns should be premised on appropriately distinguishing between expected returns on book equity and the return investors require on market-priced equity.[197] Compliance with the *Hope* and *Bluefield* standards requires setting the base ROE at the level that investors require, not at the level investors expect.[198]

189. *Id*. at 21.
190. *Id*. at 21-26.
191. Opinion No. 551, *supra* note 3, at P 201.
192. *Id.*
193. *Id*.; Opinion No. 531-B, *supra* note 2, at PP 128-129.
194. Opinion No. 551, *supra* note 3, at PP 234, 239.
195. *Id*. at P 231.
196. *Id*. at PP 218-20.
197. *Id*. at P 212.
198. *Hope*, 320 U.S. at 656-57; *Bluefield*, 262 U.S. at 694.

4. State ROE Determinations

Opinion No. 531 found that "the financial and business risks faced by investors in companies whose focus is electric *transmission* infrastructure" are risks higher than those faced by investors in state-regulated electric *distribution companies*.[199] On this basis, the Commission found that evidence of state-authorized ROEs above the midpoint of the DCF range justified placement of the base ROE for the New England TOs above the midpoint.[200] In Opinion No. 551, the Commission went a step further, finding that the risks of investing in FERC-regulated electric transmission "are 'at least as great' as those faced by investors in integrated electric utilities."[201] On this basis, the Commission found that a midpoint below state-authorized ROEs for integrated utilities such as the MISO TOs did not satisfy the *Hope* and *Bluefield* standards.[202]

The state-authorized ROE study adopted by Opinion No. 551 was challenged on rehearing because there was no record support for a finding that investments in integrated utilities entail risks that are similar to those faced by transmission developers.[203] And, even if that were true, adopting an ROE above those approved for utilities with similar risks is not consistent with the *Hope* and *Bluefield* comparable risk requirement.[204] Complainants and aligned parties also challenged the two-year state ROE study period because it differed from the DCF study period and because it diluted the downward trajectory of state-authorized ROEs in the data from the most recent six month period.[205]

IV. PLACEMENT OF THE BASE ROE

Determination of a just and reasonable base ROE for utilities relies on placement of that base ROE within the DCF zone of reasonableness.[206] In Opinion No. 531, the Commission acknowledged its normal practice of assigning multiple utilities operating under an independent system operator a base ROE at the midpoint of the zone of reasonableness.[207] The Commission, however, noted that placement at the midpoint is not just and reasonable if it "does not appropriately represent the utilities' risks," and concluded that alternative benchmarks in the record justified placing the base ROE above the midpoint.[208] Noting that it "has traditionally looked to the central tendency," the Commission placed the base ROE of the New England TOs at the upper midpoint of the DCF zone, and stated that this approach was consistent with FERC precedent.[209] Opinion No. 531, however, made clear

199. Opinion No. 531, *supra* note 2, at P 149 (emphasis added).

200. *Id.* at P 151.

201. Opinion No. 551, *supra* note 3, at P 250.

202. *Id.*

203. Request for Rehearing of the Resale Power Grp. of Iowa, *Ass'n of Businesses Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc*., Docket No. EL14-12-002 (Oct. 28, 2016).

204. *Id*. at 25.

205. *Id*. at 7-9.

206. Opinion No. 531, *supra* note 2, at P 146.

207. *Id.* at P 142.

208. *Id.* at PP 144, 147 (quoting Petal Gas Storage, L.L.C. v. FERC, 496 F.3d 695, 699 (D.C. Cir. 2007)).

209. Opinion No. 531, *supra* note 2, at PP 151–52.

that participants in future proceedings were not precluded from developing a record supporting an ROE placement at a point other than the upper midpoint.[210] In Opinion No. 551, the Commission also placed the base ROE at the upper midpoint for the MISO TOs.[211]

Complainants and supporting intervenors petitioned the D.C. Circuit for review of the Commission's decision in Opinion No. 531, *et al.* to place the base ROE for the New England TOs at the upper midpoint on the grounds that it was not supported by record evidence.[212] In both cases the Commission ruled, on the one hand, that alternative benchmarks and state-authorized ROEs supported its decision to place the base ROE above the midpoint, but on the other hand, it stressed that none of this evidence was used to place the base ROE of the New England TOs at the upper midpoint.[213] The lack of reliance on evidence concerning alternative benchmarks and state ROE determinations raises the question: what evidence does the Commission need to place the base ROE at the upper midpoint?

A. Automatic Placement at the Upper Midpoint Rejected – Emera

In *Emera*, the D.C. Circuit rejected the Commission's automatic placement of the base ROE at the upper midpoint, finding that "FERC [failed to make] a rational connection between the [evidence in the record] and [the] placement of the base ROE" at the upper midpoint.[214] Specifically, the Court noted that while the Commission found that the magnitude of an ROE reduction from the existing rate to the midpoint could undermine the transmission owners' ability to attract capital investments, it never explained: (1) how the upper midpoint would be adequate to meet the *Hope* and *Bluefield* standards; or (2) how the upper midpoint was just and reasonable when the alternative benchmarks and additional record evidence merely pointed to a base ROE somewhere above the midpoint.[215] The Court found that the failure to establish a rational connection between the evidence and the upper midpoint placement was "particularly troublesome in light of FERC's prior concerns over the reliability" of the DCF zone of reasonableness.[216] The Court also observed that rather than citing record evidence demonstrating that the upper midpoint was a just and reasonable base ROE, the Commission simply noted that it had "traditionally looked to the central tendency" to set an ROE and then chose the upper midpoint simply because it had done so in the past.[217] In base ROE determinations that depart from traditional placement at the midpoint

210. Opinion No. 531, *supra* note 2, at 74-75 n.306 (citing Opinion No. 414-A, *Transcon. Gas Pipe Line Corp.,* 84 F.E.R.C. ¶ 61,084, at p. 61,427 (1998)).

211. Opinion No. 551, *supra* note 3, at P 275.

212. *Emera*, 854 F.3d at 16 (The Commission's placement of the base ROE for MISO TOs at the upper midpoint was challenged on rehearing because it was not supported by record evidence).

213. Opinion No. 531, *supra* note 2, at PP 142, 145-46; Opinion No. 531-B, *supra* note 2, at PP 49–50; Opinion No. 551, *supra* note 3, at P 280.

214. *Emera*, 854 F.3d at 27.

215. *Id.* at 29.

216. *Id.* at 28.

217. Opinion No. 531, *supra* note 2, at P 151; Opinion No. 531-B, *supra* note 2, at P 55.

or the median of the DCF zone of reasonableness, the Commission should consider risk factors that justify placement above or below the central tendency of the zone of reasonableness.[218]

B. Risk Factors that May Affect Base ROE Determinations – Capital Structures, Formula Rates, and Capital Expenditure Levels

The Commission relied on two prior cases, *Southern California Edison Co.* and *Consumers Energy Co*. to place the base ROEs of the New England TOs and MISO TOs at the upper midpoint.[219] The D.C. Circuit found that those cases did not justify placing the base ROE at the upper midpoint because in those cases, the Commission found that the utility was more risky than companies in the proxy group; while in Opinion No. 531 the Commission expressly found that the transmission owners were comparable in risk to the proxy group.[220] In order to place the base ROE at the upper midpoint, the Commission would have needed to justify such placement by either relying on alternative benchmarks – thus completely departing from prior reliance solely on the DCF model – or by assessing risk factors affecting the New England TOs and the MISO TOs and finding that these transmission owners are riskier than proxy group companies.[221] In Opinion No. 551, the Commission addressed three types of risk factors that were claimed to affect appropriate ROE placement: (1) CAPEX, (2) capital structures, and (3) formula rates.[222]

1. CAPEX

Utilities participating in major transmission projects may require external financing when the necessary investment exceeds the utility's internal cash flow.[223] The need for external funding for CAPEX entails risks associated with difficulties in accessing capital, the high costs of maintaining back-up credit, and finding alternate sources of liquidity. In Opinion No. 551, the Commission considered the MISO TOs' high CAPEX requirements as a factor supporting placement of the base ROE above the midpoint of the DCF.[224]

2. Capital Structure

In determining the base ROE of public utilities, the Commission considers the financial risks associated with the use of leverage (*i.e*., the prevalence of debt

218. Opinion No. 531, *supra* note 2, at P 138.

219. Opinion No. 531, *supra* note 2, at P 152 n.307; Opinion No. 551, *supra* note 3, at P 91 n.206.

220. *Emera*, 854 F.3d at 29-30; Opinion No. 551, *supra* note 3, at P 91 n.206.

221. Opinion No. 551, *supra* note 3, at P 91 n.206.

222. *Id*. at PP 3, 248-49.

223. CAPITAL EXPENDITURE (CAPEX): INVESTOPEDIA, http://www.investopedia.com/terms/c/capitalexpenditure.asp (last visited Oct. 1, 2017).

224. Opinion No. 551, *supra* note 3, at P 254 (explaining that investment in MISO TOs' transmission entails additional risks – when compared to state-regulated integrated utilities – due to the TOs' high CAPEX requirements, and subsequently finding that state-authorized ROE levels above the midpoint supported placement of the base ROE for the MISO TOs above the midpoint).

in proportion to equity) in a utility's capital structure.[225] Debt financing imposes strict payment obligations (the payment of interests and principal when due), which must be satisfied before dividends can be paid to common stockholders.[226] The Commission has observed in this regard that the greater the percentage of debt in a company's capital structure, the more uncertain are the common stockholder's expected returns, because of the increased volatility of the residual earnings available to them with any given change in operating income.[227] As a result, a company that maintains a relatively higher debt-to-equity capitalization ratio is relatively more risky than a comparable firm with a lower debt-to-equity ratio.[228]

In the first and second MISO ROE proceedings, complainants and aligned parties argued for consideration of equity ratios in determining the appropriate base ROE.[229] The Commission rejected the need to adjust the ROE for each transmission owner on the basis of its individual equity ratio because: (1) the recommended adjustments considered only one risk factor as opposed to a range of factors impacting the business and financial risks of the transmission owner; (2) there was a lack of evidentiary support for specific quantitative adjustments; (3) the utilities' credit rating screen used in the formation of proxy groups already accounts for risks associated with equity ratios; and (4) as a policy matter, the Commission does not want to directly incentivize utilities to adjust their preferred capital structures or encourage additional leveraging of utilities.[230] While the Commission rejected the need for adjustments to the base ROE of each individual transmission owner based on its equity ratio, the Commission did not address directly whether equity ratios could be a factor to consider in relative risk analysis to determine whether placement of the ROE above the midpoint is justified.[231]

3. Formula Rates

Formula transmission rates provide for the recovery of costs charged to FERC accounts included in the formula without the need for successive section 205 rate filings.[232] To the extent that the formula is comprehensive, the utility and its investors have assurance that all costs which have been properly functionalized or allocated to transmission service will be recovered and that the company will actually earn its allowed return over time.[233] In other words, the return on common

225. *Id*. at P 288.

226. Generic Determination of Rate of Return on Common Equity for Public Utilities, 53 Fed. Reg. 3,339 (1988) (to be codified at 18 C.F.R. pt. 37).

227. *Id.*

228. *Id*.

229. Opinion No. 551, *supra* note 3, at P 288.

230. *Id.* at PP 286-89 ("[w]hile the Commission has indeed adjusted a company's base ROE above or below the central tendency of the zone of reasonableness based on the relative risk analysis, it does so only after a full evaluation of all relevant factors including both business and financial risk. 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. . .").

231. *Id*. at P 283.

232. Opinion No. 531, *supra* note 2, at P 67.

233. *Id*. at P 248.

equity earned through a formula rate has little or no volatility and is not subject to erosion through regulatory lag.[234] Accordingly, transmission owners that use formula rates enjoy predictable revenues and returns and, therefore, have far less exposure to operational business risk than do firms that must rely on conventional rate change procedures.[235]

The Commission has made downward adjustments to the base ROE allowed for public utility subsidiaries using formula rates because they were found to face less risk than their parent companies.[236] In 2015, the Commission ruled that risk-reducing attributes like formula rates may inform where in the zone of reasonableness the base ROE should be placed.[237] However, a year later, in Opinion No. 551, the Commission ruled that the use of formula rates does not warrant a lower base ROE because any associated lower risk would be reflected in the proxy group within the DCF analysis.[238] On rehearing, complainants and aligned parties argued that because the Commission opened the door for consideration of evidence extraneous to the DCF analysis (including its proxy group), evidence of risk factors should be considered when determining whether to place the base ROE above the DCF midpoint.[239] In any event, the Commission should also consider risk reducing factors, such as formula rates, when assessing the value of state-authorized ROE analyses in placing the base ROE above the midpoint.

V. ELIMINATION OF THE TREASURY BOND UPDATE – OPINION NO. 531

Prior to Opinion No. 531, the Commission established a just and reasonable ROE based upon test period evidence, and then updated the ROE at the time of the final decision to reflect changes in market conditions between the date the utility filed its case-in-chief and the date the Commission issued a final decision.[240] These post-hearing adjustments followed changes in U.S. Treasury bond yields ("*i.e.*, for every basis point change in the U.S. Treasury bond yield the Commission would adjust the ROE by one basis point").[241] These adjustments were based on the premise that the ROE, over time, tracks changes in U.S. Treasury bond yields.

In Opinion No. 531, the Commission stopped this practice because the record in that proceeding cast doubts not only on the magnitude but also on the direction of the relationship between U.S. Treasury bond yields and utility ROE.[242] Instead, the Commission will allow participants in future rate cases to present the most

234. *Id.* at P 290.

235. *Id.*

236. *See, e.g., Ind. & Mich. Power Co.,* 4 F.E.R.C. ¶ 61,316 (1978); *S.C. Generating Co.,* 40 F.E.R.C. ¶ 61,116 (1987); *W.V. Pub. Serv. Comm'n v. Allegheny Generating Co.,* 40 F.E.R.C. ¶ 61,117 (1987).

237. *PJM Interconnection, L.L.C.,* 153 F.E.R.C. ¶ 61,308 at P 13 (2015).

238. Opinion No. 551, *supra* note 3, at P 297 (stating that almost all electric utilities use formula rates and that the credit screens used in proxy group formation would capture any risk factor associated with the use of formula rates).

239. *See generally* Request for Rehearing of the Organization of MISO States, *supra* note 171.

240. Opinion No. 531, *supra* note 2, at P 157.

241. *Id.* at P 159.

242. *Id.*

recent financial data available at the time of the hearing, including post-test period financial data then available.[243] This issue was not raised in *Emera*, so it should not be affected by the vacatur.

VI. RELATIONSHIP BETWEEN INCENTIVE ADDERS AND THE ZONE OF REASONABLENESS – OPINION NOS. 531 AND 551

In Opinion No. 531, the Commission explained that when a public utility's ROE is changed – either under section 205 or section 206 of the FPA – the 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.[244] This ruling raised several issues concerning the interplay between sections 205, 206, and 219 of the FPA, including: (1) the impact of a narrower zone of reasonableness on approved transmission rate incentives and future rate incentives; (2) the type of rate incentives that need to be limited by the zone of reasonableness; and (3) the level of return for riskier projects that should be provided through section 219 incentives instead of base ROE determined under sections 205 or 206.

A. Impact on Approved Rate Incentives

The New England TOs (and later the MISO TOs) challenged the Commission's decision to limit the total ROE to the top of a narrower zone of reasonableness determined through the two-step DCF methodology.[245] The New England TOs asserted that FERC's decision to cap the previously approved incentives did not come within the scope of the section 206 complaint and, as a result, they were not given adequate notice that their approved incentives would be at issue, thus violating the Due Process Clause and the Administrative Procedure Act.[246] The Commission countered that it was merely following its well-established policy that a utility's total ROE – including any incentives – is capped at the top of the zone of reasonableness and that Opinion No. 531 did not change the transmission owners' incentives, just the zone of reasonableness limiting the ability of transmission owners to fully implement their incentives.[247] The D.C. Circuit did not consider this issue in *Emera* because of FERC's failure to satisfy its dual burden under section 206 of the FPA.[248] It is possible that the Commission will address this notice issue on remand of Opinion No. 531, *et al.*

In MISO, transmission owners were aware of the Commission's policy that a new zone of reasonableness determined through the new two-step DCF method-

243. *Id*. at P 160.

244. Opinion No. 531, *supra* note 2, at P 165.

245. Opinion No. 531-B, *supra* note 2, at P 134.

246. *Id*. at P 136.

247. *Promoting Transmission Inv. Through Pricing Reform*, 116 F.E.R.C. ¶ 61,057 at PP 2, 93 (2006) (noting that "the approved ROE, including the impact of an incentive, [must] be within the zone of reasonableness"); Opinion No. 531-B, *supra* note 2, at PP 139–141.

248. *Emera*, 845 F.3d at 26.

ology could impact their ability to implement approved transmission rate incentives.[249] Transmission owners made additional arguments concerning the potential chilling effect on future investments of limiting approved transmission incentives; however, these issues were not raised in their rehearing requests.[250]

B. Impact on Future Transmission Rate Incentives

Transmission owners have argued against limiting future transmission rate incentives to a narrower zone of reasonableness determined using the two-step DCF process.[251] They argue, among other things, that ROE adders must allow the utilities that receive the adders to earn returns greater than those otherwise necessary to satisfy the *Hope* and *Bluefield* requirements.[252] These transmission owners believe a narrower zone of reasonableness limits that possibility.[253]

In an attempt to provide a solution, the MISO TOs claim that incentive adders for RTO participation and Transco ROE adders should not be limited by the DCF zone of reasonableness.[254] They argue that these ROE adders should be evaluated as separate line-items within a utility's cost of service, not as part of the Commission's approach to establishing ROE.[255] At the other end of the spectrum, complainants and aligned parties advocated for reevaluation of the need for RTO participation and Transco ROE adders.[256] The Commission declined to reevaluate its incentive policies in MISO.[257] However, the controversy is not over. The Ninth Circuit is currently considering a petition for review filed by the California Public Utilities Commission challenging the need for an RTO participation adder.[258] The Commission should consider re-evaluating RTO participation and Transco ROE adders in light of ongoing policy and market developments that call into question the need and treatment of these incentives.

A parallel issue litigated in the MISO ROE case concerns the scope of normal risks that should be compensated with base ROE, as distinct from extraordinary risks that require compensation through transmission incentive adders.[259] The MISO TOs argued that a base ROE above the DCF midpoint was necessary to

249. *See generally* Opinion No. 551, *supra* note 3.

250. *Id*.

251. *See generally id*.

252. *Id*. at P 255.

253. *Id*.

254. Opinion No. 551, *supra* note 3, at PP 270-74. A Transco is a stand-alone transmission company that has been approved by the Commission and that sells transmission services at wholesale and/or on an unbundled retail basis, regardless of whether it is affiliated with another public utility. The Commission grants ROE adders to incentivize the formation of transcos as a mean to promote further investment in transmission infrastructure.

255. *Id*.

256. *Id*. at P 3.

257. Order on Rehearing, *supra* note 164, at P 41 (2016).

258. Brief of Respondent Federal Energy Regulatory Commission at 10, *Cal. Pub. Util. Comm'n v. FERC*, No. 16-70481 (9th Cir. 2016). The case questions whether the Pacific Gas and Electric Company RTO participation adder is appropriate given the fact that the company was required to join CAISO before that incentive adder was in place and cannot leave the CAISO without the CPUC's permission. Oral argument took place on October 13, 2017.

259. Order on Rehearing, *supra* note 164, at P 27.

support investments in certain riskier transmission projects selected in MISO's regional planning process.[260] Complainants and supporting intervenors argued that compensation for extraordinary project risks should be evaluated on a case-by-case basis in section 219 proceedings, but should not be a factor considered in base ROE determinations.[261] Further, because all transmission receives the same base ROE in MISO, setting the base ROE above the midpoint to support new investment in riskier transmission projects would also lead to overcompensation of existing transmission and less risky new transmission projects.[262] Opinion No. 551 did not address this issue and rehearing on this point is pending.[263]

While the Commission has drawn a distinction between its traditional ratemaking requirements established in *Hope* and *Bluefield* (for purposes of establishing a just and reasonable base ROE pursuant to section 205 or 206 of the FPA) and the approval of ROE incentive adders pursuant to section 219 of the FPA, this does not mean that the total ROE need not be constrained by the DCF zone of reasonableness.[264] Section 219 of the FPA provides that transmission incentives must be just and reasonable, as required by sections 205 and 206 of the FPA.[265] The Commission's policy of limiting all incentive ROEs granted under section 219 to the same zone of reasonableness used in section 205 or 206 ROE proceedings is consistent with this statutory requirement.[266] Yet, the Commission should not lose sight of the risks that a just and reasonable base ROE – approved pursuant to sections 205 or 206 of the FPA – is intended to compensate, and the distinct risks that a just and reasonable incentive adder – approved pursuant to section 219 – should compensate.

VII. POTENTIAL DOUBLE RECOVERY THROUGH DCF ROE AND FERC'S TAX ALLOWANCE POLICY— *UNITED AIRLINES* AND FERC NOTICE OF INQUIRY

The D.C. Circuit issued its opinion in *United Airlines* on July 1, 2016.[267] The Court addressed the issue of whether the combination of FERC's tax allowance policy and its DCF methodology for establishing ROE may result in potential double recovery of income taxes in certain cases.[268] Shippers argued that FERC's grant of an income tax allowance to SFPP, L.P. (SFPP), in conjunction with a tariff filing in which SFPP sought to increase rates on its West Line, was arbitrary and capricious.[269] Finding that the Commission had not adequately justified "its conclusion that there is no double recovery," the court granted the shippers' petition, remanded and vacated FERC's orders with respect to the double recovery issue.[270]

260. *Id*.
261. *Id*.
262. *Id*. at 35.
263. *See generally id*.
264. 16 U.S.C. § 824s (2005).
265. *Id*.
266. *Id*.
267. *See generally United Airlines*.
268. *Id*. at 127.
269. *Id*. at 134.
270. *Id*. at 136-37.

On December 15, 2016, the Commission issued a notice of inquiry regarding its income tax cost recovery policy.[271] Citing the D.C. Circuit's decision in *United Airlines*, FERC stated that it "recognizes the potentially significant and widespread effect of this holding upon the oil pipelines, natural gas pipelines, and electric utilities subject to the Commission's regulation."[272] Through the notice of inquiry, the Commission sought "comments regarding how to address any double recovery resulting from the Commission's current income tax allowance and rate of return policies."[273] The Commission identified two potential proposals parties may advocate: (1) "eliminating the income tax allowance for partnerships;" and (2) "reducing the DCF return to remove all investor-level tax costs."[274] A number of parties have filed comments.[275]

A. Evolution of Commission Tax Allowance Policy as Applied to Partnerships and Other Pass-Through Entities

Current FERC policy traces back to the early Commission precedent as summarized in its 1995 decision in *Lakehead*, where the Commission determined that the limited partnership should receive "an income tax allowance with respect to income attributable to its corporate partners."[276] The Commission stated that "the corporate tax is an extra layer of taxation" and that recovery of corporate income tax is necessary to ensure the entity earns its allowed return on equity.[277] The Commission found that Lakehead was entitled to a tax allowance to the extent of income attributed to its corporate partners because the tax cost passes from the partnership to the corporate partners.[278] However, the Commission denied any allowance for income tax recovery attributed to partners that are individuals who do not pay corporate income tax.[279]

The Commission's *Lakehead* policy was subjected to judicial review for the first time by the D.C. Circuit in *BP West Coast* in 2004.[280] Relying on its *Lakehead* policy, the Commission had allowed SFPP a 42.7% allowance for income taxes corresponding to the 42.7% partnership interest held by SFPP, Inc., a subchapter C corporation, but denied an allowance in proportion to the partnership interests held by "individuals, subchapter S corporations, trusts, or other entities that do not incur corporate income tax."[281] The Court vacated FERC's order with respect to the tax allowance, finding that the Commission had not supported its

271. *See generally* Tax NOI, *supra* note 5.

272. *Id*. at P 2.

273. *Id*. at P 1.

274. *Id*. at P 20.

275. Search Results, FERC ONLINE ELIBRARY, https://elibrary.ferc.gov/idmws/search/fercadvsearch.asp (parameters: Filed date fields: 01/01/2016 to the current date; Docket: PL17-1; Document Type (Class): Comments/Protest).

276. *Lakehead Pipe Line Co., L.P.*, 71 F.E.R.C. ¶ 61,338, at p. 62,314 (1995).

277. *Id.*

278. *Id.*

279. *Id.* at p. 62,315.

280. BP West Coast Products, L.L.C. v. FERC, 374 F.3d 1263, 1287 (D.C. Cir. 2004).

281. *Id.*

conclusions.[282] Specifically, with respect to the tax allowance the Commission did grant, the Court found that the partnership "is entitled to no allowance for the phantom income taxes it did not pay."[283]

The *BP West Coast* decision rejected FERC's explanation that corporate tax should "be included in the cost-of-service . . . because it is 'an extra layer of taxation,'" finding instead that such taxes should be included to the extent they are "costs."[284] The Court observed that individual owners pay income tax, as do corporations, and took issue with the Commission's rationale that drew on its "stand-alone entity" policy, which the Court found defensible in relation to subsidiaries within corporate groups with offsetting tax liabilities, but not in the case of partnerships that do not generate any tax liability.[285] The Court stated that the principles of *Hope* dictate that "where there is no tax generated by the regulated entity, either standing alone or as part of a consolidated corporate group, the regulator cannot create a phantom tax in order to create an allowance to pass through to the rate payer."[286]

While considering the D.C. Circuit's remand in *BP West Coast*, FERC "issued a notice of inquiry" that ultimately led to issuance of its Policy Statement on Income Tax Allowances on May 4, 2005.[287] The Commission considered four alternatives:

- provide an income tax allowance only to corporations, but not partnerships;
- give an income tax allowance to both corporations and partnerships;
- permit an allowance for partnerships owned only by corporations; and
- eliminate all income tax allowances and set rates based on a pre-tax rate of return.[288]

Ultimately, FERC "conclude[d] that it should return to its pre-*Lakehead* policy and permit an income tax allowance for all entities or individuals owning public utility assets, provided that an entity or individual has an actual or potential income tax liability to be paid on that income from those assets."[289] The policy provided for a proportional reduction of the tax allowance in the event that partners or members of pass-through entities (*i.e.*, individuals, partnerships, and limited liability companies) did not have such actual or potential tax liability.[290]

The D.C. Circuit revisited this issue in 2007, where the Court addressed FERC's order on the Court's remand of *BP West Coast*.[291] The Court stated that:

282. *Id*. at 1288.
283. *Id.*
284. *Id.*
285. *BP West Coast Products*, 374 F.3d at 1289.
286. *Id.* at 1291.
287. *Pol'y Statement on Income Tax Allowances*, 111 F.E.R.C. ¶ 61,139 at P 1 (2005).
288. *Id*. at P 31.
289. *Id.* at P 32.
290. *Id*.
291. ExxonMobil Oil Corp. v. FERC, 487 F.3d 945 (D.C. Cir. 2007).

"[w]hile we agree that the orders under review and the policy statement upon which they are based incorporate some of the troubling elements of the phantom tax we disallowed in *BP West Coast*, FERC has justified its new policy with reasoning sufficient to survive our review."[292] The Court upheld FERC's grant of a full income tax allowance to SFPP.[293] The Court deferred to FERC's judgment that disallowing the tax allowance in the case of pass-through entities would be a disincentive toward holding assets in partnerships by lowering partnership returns on equity below the returns realized by corporations and that this would be inconsistent with the "commensurate returns" or "parity" principles of *Hope*.[294]

B. The Relationship Between DCF ROE and Tax Allowances, the Potential for Double Recovery, and the D.C. Circuit's Direction to Ensure Parity between Partnership and Corporate Pipelines

The D.C. Circuit addressed the same FERC tax allowance policy in its 2016 *United Airlines* decision that it had addressed in *ExxonMobil*, but vacated and remanded the more recent FERC order in response to shippers' arguments that the combination of the Commission's DCF ROE methodology and its tax allowance policy yielded double recovery of taxes in the case of SFPP's partners.[295] The shippers argued that the DCF ROE "methodology already ensures a sufficient after-tax . . . return to attract investment capital" to the pipeline, and that adding a tax allowance resulted in double recovery.[296] The Court found that FERC was arbitrary or capricious in "fail[ing] to demonstrate that there is no double-recovery of taxes for partnership, as opposed to corporate, pipelines. . . ."[297]

In *ExxonMobil*, the D.C. Circuit accepted the grant of a tax allowance to a partnership pipeline.[298] However, in *United Airlines*, the Court rejected the argument that the shippers were presenting a collateral attack on the *ExxonMobil* decision by noting that "FERC averred . . . in *ExxonMobil* [and a related case] that it was addressing the double recovery issue in a separate proceeding," and that the Court had thus implicitly reserved the issue.[299] Thus, the Court remanded with instructions that FERC consider other approaches that would "demonstrate that there is no double recovery."[300] Procedurally, the Commission's approach appears to mirror its approach following *BP West Coast*, where it issued a notice of inquiry, followed by a policy statement, in advance of issuing its order on remand.[301] Thus, it seems likely that the Commission will issue a policy statement addressing the double recovery issue in advance of, or in conjunction with, issuing its order in response to the *United Airlines* remand.

292. *Id*. at 948.
293. *Id.* at 952-953.
294. *Id*. at 952 (citing *Hope*, 320 U.S. at 603).
295. *See generally United Airlines*.
296. *Id.* at 134.
297. *Id.*
298. *Id*. at 135.
299. *Id.*
300. *United Airlines*, 827 F.3d at 137.
301. *See generally* Tax NOI, *supra* note 5.

C. Comments on FERC's Notice of Inquiry

Potential approaches identified by the D.C. Circuit in *United Airlines* for FERC's consideration included: (1) "eliminating all income tax allowances and setting rates based on pre-tax returns;" and (2) "remov[ing] any duplicative tax recovery for partnership pipelines directly from the discounted cash flow return on equity."[302] The Commission presented essentially these same two alternatives for parties to consider in responding to its 2016 notice of inquiry.[303]

The Commission summarized the concern expressed in *United Airlines* as "permitting a partnership entity to have an income tax allowance results in a double recovery of investor-level tax costs because . . . the return estimated by the DCF methodology includes the cash flow necessary to cover investors' income tax liabilities and earn a sufficient after-tax return. . . ."[304] The Commission's summary continued by distinguishing partnership tax allowances from those involving corporations by noting that corporations pay their own taxes and that therefore, "the corporate income tax cost recovered in the income tax allowance is not reflected in the return estimated by the DCF methodology."[305] Thus, the Commission's inquiry is focused on avoiding "double recovery of *investor-level taxes* for partnerships or similar pass-through entities."[306]

Some commenters argued that the Commission should not change its current policy of providing a tax allowance for all pass-through entities where the investors face taxation on the public utility or pipeline income they receive.[307] They argued that double recovery does not occur in the case of pass-through entities with corporate owners any more than it does in the case of rate-regulated corporations.[308] These commenters argued that the Court in *United Airlines* focused on the wrong investor-level entities.[309] They believe the shareholders of an upstream corporation that owns an interest in a rate-regulated pass-through entity are comparably situated with the shareholders of a corporate pipeline or public utility.[310]

SFPP argued that the Commission's DCF ROE policy, as applied to liquids pipelines, does not cause double recovery of income tax costs.[311] SFPP stated that FERC "favors using a proxy group made up entirely of master limited partnership

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

303. Tax NOI, *supra* note 5, at P 19.

304. *Id.* at P 18.

305. *Id.*

306. *Id.* at P 17 (emphasis added).

307. *See* Notice of Inquiry Comments of American Transmission Company L.L.C. at 1, *Inquiry Regarding the Comm'n's Policy for Recovery of Income Tax Costs*, Docket No. PL17-1-000 (Feb. 15, 2017) [hereinafter Am. Transmission Comments]; *see also* Reply Comments of the Edison Electric Institute at 2, *Inquiry Regarding the Comm'n's Policy for Recovery of Income Tax Costs*, Docket No. PL17-1-000 (Apr. 7, 2017) [hereinafter Edison Comments].

308. Am. Transmission Comments, *supra* note 290, at 6.

309. *Id.*

310. *Id.*

311. Comments of SFPP, L.P. at 1, *Inquiry Regarding the Comm'n's Policy for Recovery of Income Tax Costs*, Docket No. PL17-1-000 (Mar. 8, 2017) [hereinafter SFPP Comments].

('MLP') pipeline companies for all liquids pipelines and results in an MLP unitholder return that is comparable to the return of a corporate shareholder."[312] SFPP also argued that the DCF methodology "generates an investor before-tax return that assumes only one level of income taxation (because an MLP unitholder's before-tax return and after-tax return are the same when an income tax allowance is included in the pipeline's cost of service). . . ."[313] SFPP argued that an income tax allowance for MLP pipelines ensures comparable after-tax returns, consistent with *Hope*.[314]

Shippers commenting on the NOI argue that double recovery results from the fact that partnerships do not pay entity-level income taxes, while corporations do.[315] The shippers believe that the DCF ROE accounts for income taxes and current Commission policy additionally provides for an income tax allowance.[316] Shippers argue that the DCF ROE "is a before-investor-tax ROE that ensures recovery of investor-level income taxes."[317] As a result, the shippers believe that "[t]he Commission should eliminate the cost-of-service tax allowance in transportation rates for partnerships."[318] The shippers view the alternative of eliminating tax recovery from partnership DCF ROE as impractical.[319]

In *United Airlines*, the Court acknowledged that the shippers were challenging the same tax allowance policy that the Court upheld in *ExxonMobil*, following the Court's rejection of FERC's less generous *Lakehead* policy in *BP West Coast*.[320] The *United Airlines* opinion summarizes the basis for the *ExxonMobil* decision as: "FERC did not create a 'phantom tax' because it did not arbitrarily distinguish between corporate and individual partners in a partnership pipeline, and the Commission adequately explained why partner taxes could be considered a pipeline cost."[321] It is difficult to see how remedying the discrimination against non-partnership pass-through entities inherent in the *Lakehead* policy remedies the "phantom tax" problem. The FERC's explanation of why partnership taxes are costs to the pipeline appeared more of a conclusory determination in support of its intent to avoid discouraging investment in partnership pipelines.

The Court's remand in *United Airlines* stops just short of affirmatively determining that double recovery of income taxes exists.[322] The Court's holding presents the Commission with a significant challenge: finding that there is double recovery of income taxes for partnership pipelines would reverse policy in place

312. *Id.*

313. *Id.* at 1-2.

314. *Id.* at 2.

315. *Id*. at 5.

316. Initial Comments of Liquids Shippers Group at 5, *Inquiry Regarding the Comm'n's Policy for Recovery of Income Tax Costs*, Docket No. PL17-1-000 (Mar. 8, 2017) [hereinafter Liquid Shippers Comments].

317. Initial Comments of the *United Airlines* Petitioners and Aligned Shippers at 3, *Inquiry Regarding the Comm'n's Policy for Recovery of Income Tax Costs*, Docket No. PL17-1-000 (Mar. 8, 2017) [hereinafter United Comments].

318. Liquids Shippers Comments, *supra* note 299, at 6.

319. *Id.* at 7.

320. *United Airlines*, 827 F.3d at 133.

321. *Id.* at 135.

322. *Id*. at 136.

for several decades and disrupt investment expectations. However, the attenuated support for existing policy is becoming increasingly difficult to sustain.

VIII. CONCLUSION

Recent decisions in *Emera* and *United Airlines* will shape the way FERC balances industry and consumer interests in ROE determinations. *Emera* makes clear that the Commission must: (1) make a preliminary finding that the existing ROE is unjust and unreasonable before proceeding to impose a new just and reasonable ROE in section 206 complaint proceedings; and (2) not approve an ROE at the top of the zone of reasonableness without connecting the ROE with evidence in the record showing that such ROE determination meets the *Hope* and *Bluefield* standards.[323] In *United Airlines,* the Court took issue with potential double recovery associated with the interaction between FERC tax and ROE policies.[324] The Commission should carefully address the shortcomings identified in these two decisions (and in pending ROE cases), and develop coherent policies for electric utilities and pipelines that are predictable and avoid endless litigation.

In Opinion No. 551, the Commission accepted the existence of anomalous market conditions over the objection that unusual market conditions are already accounted for in the investor expectations reflected in the DCF results.[325] The anomalous market conditions theory cannot become an excuse for invalidating the DCF methodology unless its results are corroborated by alternative benchmarks.[326] And, if the DCF methodology, on its own, is no longer reliable, then the Commission should explain: (1) how anomalous conditions affect the DCF inputs; (2) how and which alternative benchmarks will be used in making ROE determinations; and (3) why these alternative benchmarks are superior to the DCF methodology and not affected by the same market anomalies. Additionally, the Commission should make clear that the proponent of arguments claiming the existence of market anomalies bears the burden of proving its existence, and reverse its implicit determination to the contrary in Opinion No. 551.

The Commission should avoid endorsing alternatives to its established DCF methodology that lack foundation. Similarly, the Commission should carefully consider and fully explain its placement of the ROE within the zone of reasonableness, consistent with *Emera*. To the extent that the Commission considers risk factors that may justify elevating ROE placement within the zone, the Commission should simultaneously consider mitigating factors, such as the added certainty formula rates provide with respect to full rate recovery. The Commission is correct in maintaining the limits of the zone of reasonableness, even in the presence of incentive rate adders. However, the Commission should not lose sight of the fact that the base ROE is not intended to compensate for the higher risks borne by certain new transmission projects. Above-average risks borne by new transmis-

323. *Emera*, 854 F.3d at 25.

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

325. Opinion No. 551, *supra* note 3, at P 119.

326. *Id*. at P 137.

sion projects should be assessed on a case-by-case basis in section 219 proceedings, not in base ROE determinations. Finally, the Commission should ensure that no jurisdictional utility over-recovers the cost of income taxes.