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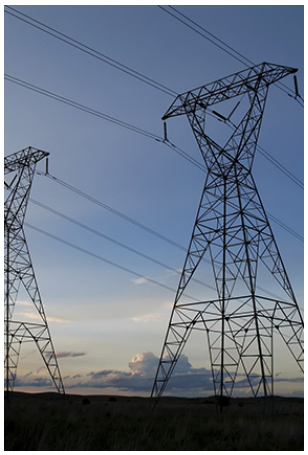

FERC Adopts New Return on Equity Methodology for Electric Utility Ratemaking

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On June 19, 2014, the Federal Energy Regulatory Commission (FERC) issued a long-awaited order on an initial decision regarding the allowed return on equity (ROE) of the New England Transmission Owner (NETO) members of ISO New England, Inc. In a switch from its long-standing policy of using a one-step discounted cash flow (DCF) methodology to determine an electric utility's ROE for purposes of calculating transmission rates, FERC announced that it will now use the two-step DCF methodology—the same approach that it uses for natural gas and oil pipelines. Further, FERC chose an ROE that was above the midpoint of the "range of reasonableness," citing unusual capital market conditions. On these bases, FERC declined to adopt Administrative Law Judge Michael J. Cianci Jr.'s recommended 9.7% ROE for the NETOs, instead tentatively adopting an ROE of 10.57%.

Background

New England state attorney generals and other state and consumer interests (Complainants) filed a complaint alleging that the NETOs' base ROE of 11.14%, established in 2006, had become unjust and unreasonable because of changed capital market conditions related to the 2008 financial crisis. An administrative hearing on the NETOs' ROE was held before Judge Cianci, and an initial decision adopting prospectively an ROE of 9.7% was issued on August 6, 2013. This ROE was based on the midpoint of the zone of reasonableness determined in accordance with the Commission's one-step DCF methodology.

Opinion No. 531

Opinion No. 531 represents a substantial adjustment in FERC policy. In short, the order: (i) establishes a two-step DCF methodology for determining an electric utility's base ROE; (ii) holds that complainants in a proceeding under section 206 of the Federal Power Act (FPA) may satisfy their burden of proof to show that an existing ROE is unjust and unreasonable without demonstrating that the existing ROE is outside the zone of reasonableness; (iii) makes a case-specific placement of the NETOs' base ROE at the midpoint of the upper end of the zone of reasonableness; and (iv) eliminates FERC's practice of making post-hearing adjustments to ROE based on changes to US Treasury bond yields.

Change to the Two-Step DCF Analysis

Prior to the order, FERC set electric utility ROEs based on a one-step DCF methodology. The one-step DCF methodology generally relies on short-term growth rates to determine an electric utility's base ROE. The so-called "two-step" DCF methodology on the other hand, accounts for a long-term growth estimate in addition to a short-term growth rate estimate. FERC has used the two-step DCF methodology to calculate regulated natural gas and oil pipeline ROEs for many years, but until now has declined to utilize that methodology for electric utilities. For purposes of calculating the long-term growth rate, FERC has traditionally used projected gross domestic product (GDP) growth as a proxy for the long-term growth rate. FERC tentatively proposed using estimated GDP growth for the long-term growth rate estimate in this proceeding, contingent on the findings of a paper hearing on the appropriate long-term growth rate estimate.

Burden of Proof

FERC affirmed Judge Cianci's determination that Complainants hold the burden under Section 206 of the FPA to establish that the current ROE is unjust and unreasonable. However, FERC rejected the NETOs'

argument that the Commission does not have Section 206 authority to change the existing base ROE unless the evidence shows that it is outside the zone of reasonableness. FERC found that the zone of reasonableness produced by a DCF analysis does not create a zone of immunity for a utility's ROE where every rate within the zone is considered just and reasonable.

Placement of the Base ROE within the Zone of Reasonableness

In this case, FERC's placement of the NETOs' base ROE at the midpoint of the upper end of the zone of reasonableness was based on record evidence demonstrating unusual capital market conditions during the period when the DCF analyses were performed. FERC found instructive alternative ROE benchmarks presented by the NETOs which pointed to a higher base ROE, including the Capital Asset Pricing Model ("CAPM"), risk premium analysis, expected earnings analysis, and state commission-approved ROEs.

Elimination of the Treasury Bond Update

The order eliminates FERC's practice of adjusting the ROE based on U.S. Treasury bond yield changes between the date of the analysis and the FERC order. FERC's revised approach allows for ROE to be reflective of the most recent financial data available at the time of the hearing, while providing all parties the opportunity to present evidence and argument concerning the most appropriate financial data.

Implications

FERC's adoption of the two-step DCF methodology represents a significant shift in policy. The two-step DCF methodology will produce a narrower zone of reasonableness compared to use of the one-step DCF methodology because long-term growth rates are more stable than short-term growth rates, and the two-step DCF methodology does not calculate a high-end estimate and low-end estimate for each proxy group company's cost of equity, but rather calculates one estimate for each company. While pipeline ROEs have historically trended higher than electric utility ROEs, it is not clear that use of the two-step DCF analysis is the reason for the discrepancy. In fact, the midpoint of the Commission's two-step DCF analysis in this case was 9.39%, which is lower than the 9.7% midpoint determined by Judge Cianci's one-step DCF analysis.

FERC's placement of the NETOs' ROE above the midpoint of the zone of reasonableness is potentially more significant and impactful. While FERC has not announced a departure from its past precedent of using the midpoint or median (for groups of utilities and single utilities respectively) of the zone of reasonableness as the default measure of a utility's ROE, Opinion No. 531 signals a willingness by FERC to place the ROE higher in the zone when financial market conditions warrant. Importantly, FERC will not mechanically place the ROE at the midpoint of the zone of reasonableness when such ROE would be insufficient to attract investment in interstate electric transmission under the applicable *Hope* and *Bluefield* Supreme Court standard.

Moving forward, FERC noted that, with respect to other pending ROE cases set for hearing, "[n]othing in this order precludes participants in those proceedings from developing a record in those cases supporting a different point in the range of reasonable returns than the midpoint of the upper half of the range."

For More Information

Van Ness Feldman represents energy clients in FERC and state regulatory proceedings and provides counsel on cost-based ratemaking and transmission tariff development. If you are interested in additional information regarding FERC's ruling, please contact Rich Bonnifield, Evan Reese, Harold Bulger, Justin Moeller, Emily Pitlick, or any member of the firm's Electric Practice at (202) 298-1800 in Washington, D.C. or in Seattle at (206) 623-9372.

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