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DC Circuit's *Emera Maine* Decision Creates Questions for Electric Utility ROE Policy

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On April 14, 2017, the U.S. Court of Appeals for the District of Columbia Circuit (D.C. Circuit) issued a decision in *Emera Maine v. FERC* regarding the appropriate return on equity (ROE) for transmission owners in New England. The court's decision vacated and remanded the Federal Energy Regulatory Commission's (FERC or Commission) precedent-setting Opinion No. 531, issued in 2014. In that opinion, FERC had reset the ROE for transmission owners in New England in response to a complaint, and had articulated a new approach for evaluating and setting electric sector ROEs.

Opinion No. 531

In 2011, transmission customers and state officials filed a complaint at FERC under section 206 of the Federal Power Act (FPA), alleging that the 11.14% base ROE collected by transmission owners in New England was unjust and unreasonable. In 2014, upon review of an initial decision by an Administrative Law Judge, FERC issued Opinion No. 531. That opinion made several key holdings. First, it shifted FERC policy to require use of a two-step discounted cash flow (DCF) analysis for electric utility ratemaking. Second, FERC held that a complainant could meet its initial burden of showing that an existing rate is unjust and unreasonable by demonstrating that the existing ROE is above the point estimate produced by the DCF analysis, even if the existing ROE is within the DCF-determined zone of reasonableness. Third, FERC declined to set the new ROE at the midpoint of the DCF zone of reasonableness, citing anomalous financial market conditions, and instead made an upward adjustment to the midpoint of the upper end (i.e., the midpoint between the midpoint of the zone of reasonableness and the top end of the zone). Fourth, the FERC held that total ROE (base ROE plus incentive ROE adders) was to be capped at the top end of the zone of reasonableness. On the basis of this updated analytical approach, FERC set the base ROE for New England transmission owners at 10.57%.

The transmission owners appealed this determination, arguing both that (1) because the existing 11.14% ROE fell within the newly-determined zone of reasonableness (7.03% - 11.74%), the existing rate was not unjust or unreasonable, and (2) FERC failed to specifically support a finding that 11.14% was unjust and unreasonable. The transmission customers also appealed, arguing that FERC had insufficiently supported its decision to place the new ROE at the midpoint of the upper half of the zone of reasonableness.

D.C. Circuit's *Emera Maine* Decision Vacating Opinion No. 531

In a unanimous decision, the D.C. Circuit found merit in the arguments raised by both transmission owners and transmission customers on appeal, and therefore vacated and remanded the underlying orders.

The court held that in a complaint proceeding under FPA section 206, FERC must first find that an existing rate is unjust and unreasonable *before* establishing a new rate that it determines to be just and reasonable. FERC had essentially conducted a single analysis in its 2014 opinion, finding that 10.57% ROE was just and reasonable, and therefore that the existing ROE of 11.14% was not. The court stressed that, under FPA section 206 and the principles of reasoned decision making, FERC cannot simply declare that an existing ROE is unjust and unreasonable because it exceeds the single ROE value produced by a DCF analysis. Instead, FERC must "make an explicit finding that [an] existing rate [is] unjust and unreasonable before proceeding to set a new rate."

The court did not agree with the transmission owners' position that a rate must fall outside the DCF-determined zone of reasonableness for a complainant to satisfy its burden in a section 206 proceeding, stating that "[n]either the language of the FPA nor our precedents compel FERC to accept all rates

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within the discounted cash flow zone of reasonableness as just and reasonable in a section 206 proceeding." However, the court also rejected FERC's argument that the *only* benchmark for determining whether an ROE within the zone of reasonableness is just and reasonable is the specific point the Commission determines in the second prong of its 206 analysis. Rather, the court held that the zone of reasonableness creates a broad range of potentially lawful ROEs rather than a single just and reasonable ROE. Thus, the court explained that "FERC's finding that 10.57% was a just and reasonable ROE, standing alone, 'did not amount to a finding that every other rate of return was not.'"

In response to the challenges from the transmission customers, the court found that making the upward adjustment to the midpoint of the upper end was not supported by reasoned decision making. The court did not question FERC's decision to make an upward adjustment from the midpoint of the range based on ROEs approved by state public utility commissions and alternative cost-of-equity analyses. However, the court found inadequate support for the Commission's decision to use the midpoint of the upper end to set the adjusted base ROE.

Implications

The *Emera Maine* decision leaves FERC's ROE policy and practice for electric utilities unsettled. The vacatur and remand of Opinion No. 531 and the related rehearing orders creates questions about the near-term status of policies adopted in that opinion. First, on remand, FERC will need to articulate and support a policy regarding which ROEs within the zone of reasonableness are just and reasonable, and which are not, for purposes of evaluating whether an existing ROE is subject to change under section 206.

Additionally, FERC will need to develop and support a method for making upward adjustments from the midpoint of the zone of reasonableness when warranted by market conditions. FERC had relied on several alternative cost-of-equity benchmarks for the purpose of determining whether an upward adjustment was necessary, but had explicitly not relied upon those benchmarks in setting the ROE in New England at 10.57%. If FERC decides to retain the same ROE in its order on remand, it will need to provide more justification for the use of the midpoint of the upper end. If FERC chooses a different approach, such as linking the ROE to one or more of the alternative cost-of-equity analyses or benchmarks, it will need to provide a robust explanation of its rationale.

The court's vacatur of Opinion No. 531 also raises questions about policies adopted in Opinion No. 531 that were not challenged in the Court of Appeals, such as the instruction that electric utility applicants move to a two-step discounted cash flow analysis. The remand will be addressed by a newly-constituted FERC with three or more new Commissioners. FERC will be required to address the particular issues identified by the court on remand; it also could use the proceeding to consider or reconsider other elements of its ROE policy and practice for electric utilities more broadly.

For more information

For assistance or additional information, please contact Doug Smith, Joe Nelson, Gabe Tabak or anyone within the firm's Electricity practice group.

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