



## FERC Issues Landmark Order Setting Forth a New Framework for Determining Public Utility ROEs

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On October 16, 2018, the Federal Energy Regulatory Commission (FERC) issued a [landmark order](#) setting forth a new methodology for (i) determining whether an existing return on equity (ROE) has become unjust and unreasonable under section 206 of the Federal Power Act (FPA), and (ii) establishing a new just and reasonable ROE for a public utility. Specifically, FERC:

- Outlined a new test to determine whether a public utility's existing ROE remains presumptively just and reasonable under FPA section 206. Namely, FERC established a rebuttable presumption that a public utility's ROE is just and reasonable if it falls within a specified "zone of reasonableness quartile." FERC stated its intent to dismiss an ROE complaint if the targeted utility's existing ROE falls within this presumptive range without the presumption being sufficiently rebutted.
- Proposed to rely upon four financial models—i.e., the Discounted Cash Flow (DCF), Capital Asset Pricing Model (CAPM), Expected Earnings, and Risk Premium models—to set a public utilities ROE by (i) calculating a single cost of equity estimate for each model, and (ii) averaging those four figures together to produce the just and reasonable ROE.
- Clarified that FERC will no longer make adjustments within the zone of reasonableness for anomalous market conditions because the use of multiple financial models will more accurately reflect how investors are making their investment decisions. Instead, as discussed below, any adjustments to a public utility's ROE will be based solely on the utility's relative risk profile

While the October 16 Order addressed on remand the U.S. Court of Appeals for the District of Columbia Circuit's (D.C. Circuit) decision in [Emera Maine v. FERC](#) regarding the appropriate ROE for electric transmission owners in New England, the Order may have far-reaching implications for both electric utilities and natural gas pipelines alike.

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

On April 14, 2017, the D.C. Circuit issued a decision in *Emera Maine v. FERC* vacating and remanding FERC's precedent-setting [Opinion No. 531](#). 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 made several key holdings:

- It shifted FERC policy to require use of a two-step DCF analysis for electric utility ratemaking.
- 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.
- 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).

- 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%. Both transmission owners and transmission customers appealed. In a unanimous decision, the D.C. Circuit 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 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 also found that making the upward adjustment to the midpoint of the upper end of the zone of reasonableness 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 FERC’s decision to set the base ROE at the midpoint of the upper end.

### FERC’s October 16 Order

FERC’s new methodology, announced in the October 16 Order, represents a drastic departure from FERC’s previous reliance on the DCF methodology to determine a public utility’s ROE. Going forward, FERC will accord equal weight to the results of four financial models—the DCF, CAPM, Expected Earnings, and Risk Premium. FERC justified its departure from prior precedent by finding that the DCF is no longer reliable as a single metric upon which to base ROE determinations. In addition, FERC sets forth a bright-line test to determine, under FPA section 206, whether a public utility’s existing ROE is presumed to be just and reasonable, and thus not subject to further investigation.

#### A. Evaluating an Existing ROE

In addition, FERC’s Order set forth a test to determine whether a public utility’s existing ROE is presumptively no longer be just and reasonable, and is thus susceptible to revision by FERC pursuant to FPA section 206. In particular, FERC proposed to:

- (1) rely on the three financial models that produce zones of reasonableness—the DCF, CAPM, and Expected Earnings models—to establish a composite zone of reasonableness (with the top and bottom of the composite zone equal to the average of the top and bottom of the three analyses); and
- (2) rely on that composite zone to establish a range of presumptively just and reasonable ROEs for a utility with the same risk profile of the target utility.

The presumed range of just and reasonable ROEs will be a single quarter of the zone of reasonableness, centered on the midpoint for a group of utilities.<sup>1</sup> Significantly, if a utility’s existing ROE is within that range, FERC stated that it will presume such ROE is just and reasonable, and will not institute an FPA investigation unless the presumption is adequately rebutted. What factors, if any, will be sufficient to rebut the presumption that an ROE is just and reasonable is yet to be determined, and will likely be addressed on a case-by-case basis going forward.

#### B. Determining A Just and Reasonable ROE

With regard to FERC’s new methodology for determining a public utility’s ROE, FERC’s October 16 Order had three major holdings:

1. **Relying on four financial models—DCF, CAPM, Expected Earnings, and Risk Premium—to determine a public utility’s just and reasonable ROE.** Specifically, FERC will calculate a

<sup>1</sup> The Commission will continue to use the median, as opposed to the midpoint, as the appropriate measure of central tendency for a single public utility.

separate cost of equity estimate under each of the four methodologies. Each such estimate will be accorded equal weight by averaging the four results to reach a single just and reasonable ROE.

Notably, FERC will no longer make adjustments for anomalous market conditions: “[W]hether a change in the capital market conditions is anomalous or persistent is of less importance, because relying on multiple financial models makes it more likely that our decision will accurately reflect how investors are making their investment decisions.”

2. **High end outliers.** FERC retained its existing screens for developing an appropriate proxy group, except that FERC re-instituted the high-end outlier test, previously found to be moot in Opinion No. 531. FERC will screen out any proxy group company from a particular analysis if its ROE under the model in question is more than 150 percent of the median result of all of the potential proxy group members in that model. For example, where the median ROE of all the proxy group companies is 10.2%, any proxy group company with an ROE over 15.3% would be excluded from the proxy group for that particular methodology.
3. **Accounting for risk profile of target utility.**

As discussed above, FERC will no longer adjust a public utility’s ROE for anomalous market conditions. Instead, FERC may make an upward or downward adjustment within a public utility’s zone of reasonableness based on whether the utility is high or low risk, as compared to the proxy group. Notably, the Commission in its October 16 Order did not elaborate or provide any guidance with regard to what factors will be relied upon in determining whether a public utility is of average, below-average, or above-average risk profile.

Finally, the Order institutes individual paper hearing proceedings to determine the implementation of this new approach in four pending New England proceedings. It is unclear, however, how this new framework for establishing a public utility’s ROE will be applied to other proceedings which are currently before the Commission.

## Implications

As a preliminary matter, it is not clear if, and how, FERC’s October 16 Order will be applied outside of the four New England proceedings, in which briefing on this issue has now been established. Unlike FERC’s Opinion No. 531, the October 16 Order does not include a clear statement indicating that the framework set forth in the Order will be generally applicable to all public utility rate proceedings going forward. Further, while this Order is literally about FERC’s review and revision of a public utility’s ROE under FPA section 206, the framework and analysis set forth in the Order seem to apply equally to FPA section 205 proceedings. Finally, given FERC’s rationale for moving away from the singular use of the DCF methodology for determining a public utility’s ROE (i.e., that “the DCF methodology alone no longer captures how investors view utility returns because investors do not rely on the DCF alone”), FERC’s analysis may have similar implications for natural gas pipeline rates set pursuant to the Natural Gas Act.

## For more information

If you are interested in additional information regarding FERC’s Order and its implications, please contact [Doug Smith](#), [Phil Mone](#), [Kelsey Bagot](#) 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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