

Client Alert

May 2020

FERC Again Revises Methodology Governing Public Utility Return on Equity: Opinion No. 569-A

On May 21, 2020, the Federal Energy Regulatory Commission (“FERC”) issued Opinion No. 569-A¹ – the latest step in the recent evolution of FERC’s policies governing the determination of public utilities’ base return on equity (“ROE”) under Section 206 of the Federal Power Act (“FPA”). In recent years, FERC has been revising its long-standing policies when addressing complaints challenging the base ROEs of transmission-owning, FERC-jurisdictional public utilities in the ISO New England, Inc. (“ISO-NE”) and Midcontinent Independent System Operator (“MISO”) regions. In particular, FERC has modified its policies regarding the use of various models to estimate ROE to account for various changes in capital market conditions since the 2008-09 recession.

In Opinion No. 569-A, FERC granted partial rehearing of Opinion No. 569,² which addressed two complaints concerning the base ROE for transmission owners in the MISO region. Although these orders are subject to further rehearing requests and judicial appeal, they are precedent for future proceedings considering the ROEs of FERC-jurisdictional public utilities. As discussed in greater detail below, the major changes to FERC’s ROE methodology established by Opinion No. 569-A, include the following:

- FERC will use three, equally weighted financial models to produce a composite zone of reasonableness for determining the ROE: the Discounted Cash Flow (“DCF”) model, the capital-asset pricing model (“CAPM”), and a Risk Premium model. FERC will implement these models pursuant to specific requirements and adjustments outlined in Opinion Nos. 569 and 569-A.
- Within the zone of reasonableness, FERC will create three ranges of presumptively just and reasonable ROEs based on the risk profile of a utility or a group of utilities.
- FERC will apply a rebuttable presumption that an ROE that falls within the applicable range of a presumptively just and reasonable ROE is just and reasonable, while one that falls outside is unjust and unreasonable. FERC must make an explicit finding based on the particular circumstances of the case concerning the ROE, including whether evidence provided by a party rebuts the presumption.

Ultimately, the new methodology set forth in Opinion No. 569-A reduces the ROE for utilities in MISO from 12.38% to 10.02%. This is an increase from the 9.88% determined under the methodology previously established by Opinion No. 569. FERC also declined to require refunds for a 15-month period from February 2015 to May 2016 for the MISO region when customers were paying rates based on the 12.38% ROE.

¹ *Ass’n of Businesses Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc.*, Opinion No. 569-A, 171 FERC ¶ 61,154 (2020) (“Opinion 569-A”).

² *Ass’n of Businesses Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc.*, Opinion No. 569, 169 FERC ¶ 61,129, at P 18 (2019) (“Opinion 569”).

Background

In determining the base ROE for jurisdictional rates charged by public utilities, FERC must, pursuant to the Supreme Court holdings in the seminal *Hope* and *Bluefield* cases, “set a rate of return commensurate with other enterprises of comparable risk and sufficient to assure that enough capital is attracted to the utility to enable it to meet the public's needs.”³ Historically, FERC used a DCF model to develop a zone of reasonableness based on a range of returns earned on investments in companies with corresponding risks and then identified the ROE at the midpoint of the zone. However, following the financial crisis of 2008-2009, FERC began to reexamine whether this approach continued to be appropriate in light of changed capital market conditions. This included revisiting how FERC applies the DCF methodology to public utilities, considering the use of various other models in addition to the DCF, and reexamining how FERC chooses a specific ROE from the range of possible results produced by the models.

In reviewing base ROEs under Section 206 of the FPA, FERC must first determine whether the existing value is unjust and unreasonable. If so, then, FERC must determine a replacement that is just and reasonable. FERC's initial attempt to revise its base ROE methodology, as set forth in its Opinion No. 531 in 2014, was rejected and vacated by the U.S. Court of Appeals for the D.C. Circuit in 2017 in *Emera Maine v. FERC*.⁴ *Emera Maine* found that FERC had not adequately supported its determinations under the two prongs of Section 206 that (1) the existing ROE at issue in the proceeding was unjust and unreasonable, and (2) that the placement of the replacement ROE at the midpoint of the upper half of the zone of reasonableness was just and reasonable. In response, FERC sought additional briefing on an alternative ROE methodology in the proceedings concerning the base ROEs for transmission owners in the ISO-NE and MISO regions and initiated a Notice of Inquiry (“NOI”) proceeding to examine potential modifications to its ROE policies.⁵

On November 21, 2019, FERC issued Opinion No. 569 addressing two complaints submitted under Section 206 of the FPA concerning the base ROE for transmission owners in the MISO region. In the order, FERC revised its methodology for determining the base ROE for public utilities, including revisions to account for the *Emera Maine* decision. In response to requests for rehearing, the Commission issued Opinion 569-A on May 21, 2020, which further modified the methodology. In addition, as is discussed in FERC Revises Policy for Analyzing Pipeline Return on Equity (under [Alerts](#) on our website), concurrent with its issuance of Opinion No. 569-A, FERC issued a policy statement in the NOI proceeding applying its public utility ROE policies to FERC-jurisdictional pipelines with certain variations and exceptions.⁶

Opinion No. 569-A's Changes to the ROE Methodology for Public Utilities

Opinion No. 569, as modified on rehearing by Opinion No. 569-A, establishes FERC's current methodology for analyzing the base ROE component of public utility rates under Section 206 of the FPA.

³ *Boroughs of Ellwood City, Grove City, New Wilmington, Wampum, & Zelienople, Pa. v. FERC*, 731 F.2d 959, 967 (D.C. Cir. 1984) (citing *FPC v. Hope Nat. Gas Co.*, 320 U.S. 591, 603 (1944) and *Bluefield Waterworks Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n, of W.V.*, 262 U.S. 679 (1923)).

⁴ *Emera Maine v. FERC*, 854 F.3d 9 (D.C. Cir. 2017).

⁵ Following the decision in *Emera Maine*, FERC issued two briefing orders in which it proposed to change its approach to determining base ROE for public utilities by giving equal weight to four financial models instead of primarily relying on the DCF methodology. See *Coakley v. Bangor Hydro-Elec. Co.*, 165 FERC ¶ 61,030, at PP 15-17 (2018); *Ass'n of Businesses Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc.*, 165 FERC ¶ 61,118, at PP 16-18 (2018). FERC also issued a NOI to examine (i) whether, and if so how, it should modify its policies concerning the determination of the ROE to be used in designing jurisdictional rates charged by public utilities, and (ii) whether any changes to its policies concerning public utility ROEs should be applied to interstate natural gas and oil pipelines. See *Inquiry Regarding the Commission's Policy for Determining Return on Equity*, Notice of Inquiry, 166 FERC ¶ 61,207 (2019). While the NOI was pending, on November 21, 2019, FERC issued Opinion No. 569.

⁶ See *Inquiry Regarding the Commission's Policy for Determining Return on Equity*, Policy Statement on Determining Return on Equity for Natural Gas and Oil Pipelines, 171 FERC ¶ 61,155 (2020).

Pursuant to the revised methodology, FERC will use three financial models to produce a composite zone of reasonableness: the DCF model,⁷ the CAPM,⁸ and the Risk Premium model.⁹ FERC will use these three models for its analysis under both prongs of Section 206 of the FPA, with each model receiving an equal one-third weighting.

FERC established certain requirements and adjustments for each of the three financial models. These requirements include, among other things, the following:

- FERC will use a two-step DCF model using both short-term and long-term growth projections, giving the short-term growth rate 80% weighting, and the long-term 20%.
- FERC will use Institutional Brokers' Estimate System ("IBES") as the source of short-term earnings growth projections in the DCF and CAPM models. It will also consider the use of *Value Line* short-term earnings growth estimates in the CAPM in future proceedings.
- FERC will apply high- and low-end outlier tests to the DCF and CAPM models, subject to natural break analysis to the outlier screens that provide it with flexibility to retain or eliminate cost of equity estimates that may otherwise be excluded or retained under the screens.¹⁰ For the high-end test, FERC will treat any proxy company as a high-end outlier if its cost of equity estimated under the model is more than 200% of the median. For the low-end test, FERC will eliminate from the proxy group ROE results that are less than the yields of generic corporation Baa bonds plus 20% of the CAPM premium.
- As the Risk Premium model does not create a zone of reasonableness, FERC will create one by imputing the average width of the zone produced by the DCF and CAPM models on the ROE produced by the risk premium model.

FERC also adopted the use of ranges of presumptively just and reasonable ROEs within the zone of reasonableness based on the risk profile of a utility or group of utilities to inform its decision of the justness and reasonableness of the ROE. FERC will calculate the range of presumptively just and reasonable base ROEs by dividing the overall composite zone of reasonableness into three equal portions based on risk profile. FERC will use the midpoint of the overall range (*i.e.*, the midpoint of the middle third of the overall range) to determine the central tendency of the zone of reasonableness in cases involving RTO-wide ROEs. The midpoint will be the starting point for the range for the average risk utilities; the starting points for the ranges for below-average and above-average risk utilities will be the midpoint of the lower and upper thirds of the zone respectively. FERC illustrated this approach as follows:¹¹

⁷ The DCF model estimates the required rate of return for each member of the proxy group using a formula under which an investor's required return is estimated to equal current dividend yield (adjusted to account for the fact that dividends are paid on a quarterly basis) plus the projected future growth rate of dividends (based upon the weighted averaging of short-term and long-term growth estimates). See, e.g., Opinion 569 at PP 88-89; NOI at pp 4, 7-12.

⁸ The CAPM "derives the ROE through the risk premium observed from the risk premium of a DCF analysis of S&P 500 dividend-paying companies." Opinion 569-A at n 7; see also Opinion 569 at P 229 (detailing the background and general methodology of CAPM). Opinion 569, as modified by Opinion 569-A, establishes the specific inputs for the performance of the CAPM. See generally Opinion 569 at PP 229-303; Opinion 569-A at PP 61-86.

⁹ The Risk Premium model "estimates cost of equity using the implied premium that provided over Baa-rated utility bonds by regulatory decisions and settlements." Opinion 569-A at n. 7; see generally Opinion 569-A at PP 87-114.

¹⁰ As described by FERC, "[t]he natural break analysis determines whether certain proxy group companies screened as outliers, or those almost screened as outliers, truly represent outliers and should thus be removed from the proxy group. Typically this involves examining the distance between that proxy group company and the next closest proxy group company, and comparing that to the dispersion of other proxy group companies." Opinion 569 at P 390. FERC declined set forth a rigid formula for the application of the natural break analysis. See Opinion 569 at P 397.

¹¹ Order No. 569-A at P 194.



FERC stated that base ROEs that fall within the applicable range of presumptively just and reasonable ROEs will be presumed to be just and reasonable and those that fall outside of the applicable range will be presumed to be unjust and unreasonable. However, these are rebuttable presumptions. In response to the *Emera Maine* decision, FERC stated that its ultimate determination will depend on the particular circumstances of the case. FERC will make an explicit finding as to whether the other evidence provided by the parties rebuts that presumption. Such evidence can include state ROEs, ROEs of non-utility companies, ROEs produced by other methodologies, non-utility stock prices, investor expectations for non-utility stocks, various types of bond yields and their relation to stock prices, investor and other expert testimony, or testimony regarding the effect of rates on customers.

FERC also rejected arguments that it should not have developed generally applicable public utility ROE policies in the MISO rate complaint proceedings and should have instead acted in its generic NOI proceeding. FERC emphasized that it was entitled to manage its own dockets and procedures. It emphasized that: “Any party in other proceedings will be free to argue, just as the parties to these proceedings were, that the base ROE methodology applied in any of these proceedings should be modified or applied differently because of the specific facts and circumstances of the proceeding involving that party.”¹²

Commissioner Glick issued a strongly-worded partial dissent to Opinion 569-A, characterizing the FERC majority’s modifications to the ROE methodology as a purely results-oriented decision “disguised” as a balanced evaluation of technical issues. He complained that frequent changes to the ROE methodology were creating uncertainty and urged the majority to stop “tinkering” with its policies. At the same time, he was open to the possibility that Opinion No. 569 may have produced ROEs that were too low for the MISO utilities in the underlying litigation and that Opinion No. 569-A’s might be just and reasonable. Finally, he objected to FERC’s decision not to require refunds in the underlying MISO rate cases. The intensity of Commissioner Glick’s criticism reflects the unusually and increasingly sharp partisan divide at FERC on ROE issues and many other matters.

Conclusion

Opinion 569-A marks the latest in FERC’s evolving policies governing the determination of public utilities’ base ROE under Section 206 of the FPA. The methodology established by Opinion 569, and further modified by Opinion 569-A, supplements FERC’s DCF model approach with additional financial models to create a composite zone of reasonableness and establishes a rebuttable presumption that ROEs that fall within set ranges in that zone based on the utilities’ risk profile are just and reasonable (or are unjust and unreasonable if they fall outside of the range). Given the recent history concerning FERC’s ROE policies and Commissioner Glick’s dissent, it is unlikely that this will be FERC’s final statement on this methodology.

¹² Order No. 569-A at P 205.

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