

Public Utilities Fortnightly (June 2013) INVESTOR SEQUESTER

State complaints over FERC-granted equity returns could dry-up funding for transmission expansion

By Bruce W. Radford

Massachusetts Attorney General Martha Coakley's landmark complaint against New England's electric transmission owners (the NETOs) finally went to trial last month, over the four days May 6 through 9. The complaint—filed at the Federal Energy Regulatory Commission back in September 2011, and joined by all six New England state public utility commissions (PUCs), plus assorted public advocates, industrial users, and consumer groups—alleges that New England's RTO-wide base-level 11.14-percent return on equity no longer qualifies as just and reasonable.

If the past is any guide—that is, if presiding administrative law judge Michael J. Cianci, Jr., should favor the generally accepted FERC case precedents for applying the discounted cash flow (DCF) model to calculate an allowed ROE—the case looks pretty much open and shut: a slam dunk for consumers. That's because, of the various expert ROE witnesses who have testified in the case, all have come in with recommended ROEs that lie significantly below the current FERC-authorized rate, provided you apply FERC's standard DCF model to data they have collected, and follow FERC precedent regarding statistical outliers, calculation of mean, median, and midpoint, and so forth. The witnesses:

- J. Randall Woolridge, for the complainants, recommending 8.9 percent, using a FERC-sanctioned model, mostly, except for a custom treatment for high-end outliers;
- John W. Wilson, testifying for the EMCOs, the Eastern Mass. Consumer-Owned Systems, advocating 8.5 percent, derived (contrary to FERC practice) by marking down the 8.95-percent midpoint (of the 6.1-percent to 11.8-percent range) by nearly 50 basis points, to reflect Wilson's view that an ROE collected through a formula transmission rate implies less risk than a tariff set in a conventional rate case, and thus justifies an ROE below the midpoint of the range;
- Sabina U. Joe, for the FERC trial staff, at 8.93 percent, the exact midpoint of her recommended range of reasonableness of 6.12 to 11.74 percent, which adheres strictly to FERC precedent; and

William E. Avera, for the NETOs, at 9.2 percent, but only if you revamp his
findings from top to bottom to comport with FERC's DCF model, and
ignore completely his many proposed adjustments to correct for what he
terms an "anomalous" market that has distorted the usual financial
measures.

By contrast, in his most recently updated data set, covering his suggested nationwide proxy group of 44 electric utilities, and using his own, non-compliant methodology, Avera proposed a much higher 11.7-percent ROE. He derived that figure—the implied cost of equity, or ICOE—from stock prices, dividend yields, and earnings growth expectations reported by financial analysts over the six-month period October 2012 through March 2013. But he was able to recommend this competitive ROE only after referencing a last-minute web posting, a new, higher projected earnings growth rate for UIL Holdings announced by IBES that supposedly appeared on *Yahoo! Finance* several days after the April 17 deadline, when final evidence was due to have been filed with Judge Cianci. (See, Motion of NETOs to File Supplemental Update, FERC Dkt. EL11-66-001, filed Apr. 26, 2012.)

As you might expect, the complainants and the FERC trial staff dismissed Avera's 11.7-percent figure out of hand. As they explained in their pre-trial briefs, filed April 29, even if Judge Cianci should accept the late-filed claim (which he appeared to do in a pretrial order that was later issued), Avera's 11.7-percent ICOE shouldn't stand. As they added, if Avera's numbers were crunched in scrupulous adherence to all of the guidelines that make up FERC's DCF computational model, his out-of-period-but-judge-allowed 11.7-percent ROE recommendation would have collapsed to 10.3 percent.

All this would seem to lead to an inescapable conclusion: that ISO New England's RTO-wide, 11.14-percent ROE in no longer just and reasonable. That's the base-level ROE, without a 50-basis-point bonus for RTO participation, or a 100-basis-point incentive for region-wide infrastructure expansions. FERC could end up ordering refunds, forced by its own rate-making policy to trim investor rewards—the very incentives that have helped fuel the greatest grid expansion in decades.

Until now, the commission has decided only two cases setting an RTO-wide ROE for all the transmission owners in a given region.

In the first of those two cases, decided in 2002, FERC set a 12.38-percent base-level ROE for transmission-owning members of the Midwest ISO, recently renamed as the MidContinent ISO. (See, Dkt. ER02-485, 100 FERC ¶61,292, aff'd on remand, Mar. 2004, 106 FERC ¶61,302 from D.C.Cir. appeal.)

The second instance came in 2006, in Opinion 489, when the commission set a 10.2-percent base-level ROE for transmission-owning members of ISO New England, and later adjusted that rate in a 2008 rehearing order to 10.4 percent, and updated it by 74 basis points to 11.14 percent to reflect new data on average bond yields. (See, Dkt. ER04-157-004, 117 FERC ¶61,129; on rehearing, 122 FERC ¶61,265; on clarification, 124 FERC ¶61,136.)

Given that history, the New England transmission owners certainly recognize the import of the Coakley complaint. As they have noted, the complainants propose

(and they are joined on this point by the FERC trial staff) to reduce the NETO base-level ROE by such a degree—under 9 percent—that it would fall below the level of every state-PUC-approved ROE set in the nation over the past two years, and more than 400 basis points below the average ROE approved by FERC for natural gas pipelines in cases decided in 2012. (See, Pre-Trial Brief of NETOs, p. 2, FERC Dkt. EL11-66-001, filed Apr. 29, 2013.)

NETO financial witness Ellen Lapson put it bluntly:

"If the commission were to set the ... base ROE at such levels the message to the investment community would be unmistakable: Invest elsewhere."

Given the scope of the current transmission build out, both in New England and across the nation, the transmission owners fear that such FERC action would suggest "inconstancy" and "engender a lack of trust."

Avera himself had foreseen this likelihood in testimony he had filed earlier, back in November of last year:

"An about-face in the form of an ROE that is out of touch with financial realities and investors' opportunities would have a chilling effect...

"In contrast to planning and investment over wholesale generation ... the allowed base ROE is the primary lynchpin in determining the flow of investment capital to new transmission facilities.

"In the present docket, the commission faces the acid test of whether it will follow through on its announced policies."

One point of note for context in these pages:

In working on our last issue, this reporter had a hand preparing for press the feature article, "<u>Transmission Policy in Flux</u>" (*May 2013*), penned by the attorney and author David Raskin, in which were raised many of these same issues, especially the idea that a FERC-ordered ROE cut might pull the rug out from under utility investors and derail grid expansion.

As it happens, however, Raskin's day job is at Steptoe & Johnson—representing his clients, including the very same New England transmission owners targeted by the Coakley complaint.

In a perfect world, this column would've appeared last month, to serve as a counterweight to the Raskin piece, which arguably represented a form of advocacy. Yet the one-month delay has provided the opportunity for a more objective look at the technical sufficiency of the evidence submitted in the case. Raskin wasn't interviewed for this column, which will focus instead on the finer points of FERC's DCF model, and the liberties the ROE witnesses are taking.

Anomalous Indicators

In preparing their case, the transmission owners, perhaps sensing the weight of evidence allayed against them, have thrown caution to the wind by openly and admittedly submitting an ROE analysis that doesn't comport with FERC precedent.

To justify this stance, the NETO witnesses Avera and Lapson allege that the nation's current economic condition, with its lagging unemployment, historically low rates for U.S. Treasuries and utility bonds (see Figure 1), and the Fed's aggressive bond buybacks have created an anomalous market—one that demands a different approach from how FERC has set ROE in the past.

NETO witness Lapson explains:

"The current abnormally low yields on U.S. Treasury securities distort not only bond market yields and the prices of dividend-paying utilities, but also distort the results of the FERC standard DCF model." (Exhibit NET-400, p. 39, FERC Dkt. EL11-66-001, filed Nov. 20, 2012.)

Thus, in presenting the NETOs answering case, and the various rebuttals and updates, expert witness Avera bends the rules in a number of ways, by submitting various items in evidence as relevant to the setting of a new ROE, though not recognized as valid considerations under FERC's DCF model: First, a proxy group of non-utility companies—including such stalwarts as Coca-Cola, General Mills, Kellogg, McDonald's, PepsiCo, Procter & Gamble, and Wal-Mart—produced a range of reasonableness of 7.7 to 16.8 percent, with a midpoint of 12.3 percent, which Avera touted as highly relevant to FERC's ROE inquiry:

"There is no basis to conclude that DCF results for a group of utilities would be inherently more reliable than those for firms in the competitive sector. "In fact, considering [their] the prominence, the diversification afforded by considering multiple industries, and the scrutiny that analysts afford, the divergence between the DCF estimates ... suggests that both should be considered to ensure a balanced result." (Exh. NET-300, p.64.)

Second, a study of gas pipeline company ROEs set by FERC in at least some 70 or more pipeline rate cases, running from February 2006 through last year, show an average gas pipeline ROE figure of 12.65 percent for 2012. Avera said that figure, coupled with a suggested 2.08-percent average ROE spread between

FERC-authorized ROEs for pipes versus TO's, should imply at least a 10.56 -

percent ROE for the NETOs. (Exh. NET-307, p. 1.)

Third, studies of retail-level utility ROEs set by state PUCs were submitted to support ROEs exceeding 10 percent. Avera found that the utilities included in the proxy groups selected separately by Woolridge (34 companies) and Wilson (38 companies) carried PUC-granted ROE allowances of 10.36 percent and 10.43 percent, respectively—figures higher than their recommended NETO ROEs (8.9 percent and 8.5 percent)—and offered these findings to FERC as relevant to any NETO ROE finding.

Ellen Lapson offered similar evidence, showing that ROEs granted by state PUCs during the two years from October 2010 through September 2012, fell largely within a narrow range (9.8 percent to 10.74 percent), both for vertically integrated utilities (90 percent) and for all electric utilities, including distribution-only companies (84 percent), with the very lowest allowance for either group coming in at 9.2 percent—above the recommendations of Woolridge, Wilson, and Joe. (See Figure 2.)

As she explained, "It would be expected that base transmission ROEs would either fall at the upper end of the [PUC-granted] range or above the range, given that electric transmission investment is subject to special investment risks." (Exh. NET-400, p.26.)

Fourth, selecting the midpoint of the upper half of the zone of reasonableness (e.g., the 75th percentile), rather than the midpoint of the full range, as is the

customary FERC practice in setting ROE for a group of utilities, such as for RTO members. Avera defended his choice as consistent with commission practice, as described in a FERC Opinion No. 445 (92 FERC ¶61,070), but in fact that case applies only upon proof that the target utility (or target group of utilities) is riskier than the overall proxy group.

Fifth, low-end ICOE outliers were excluded based on comparisons with higher, projected future average BBB utility bond yields (pegged at over 7 percent), rather than lower, historic BBB yield (4.8 percent, in this case), as mandated by FERC practice.

Sixth, low-end ICOE outliers were asymmetrically excluded without a compensating exclusion of the paired-up, high-end ICOE for the same proxy utility company, in defiance of FERC's generally accepted practice. As Avera notes (Exh. NET-300, p. 41.), "I do not believe that it is necessary or appropriate to remove a company from the proxy group altogether when just one of its DCF values fails the test of logic."

Benchmarks and Proxies

To be fair, NETO expert Avera isn't the only ROE witness in the case to have leaned on the elements of FERC's DCF model.

For example, the complainants' witness Woolridge has proposed to adjust the commission's apparent policy on eliminating high-end outliers. In Opinion 489—the case that set ISO New England's base-level ROE—FERC had found, without categorizing its decision as fixed policy, that an estimated 17.7-percent cost of equity for PPL was "extreme," and would "skew" results, and so had eliminated the ICOE as a high-end outlier, along with a 13.3-percent growth rate also estimated for PPL.

But that finding came years ago, back when the average yield for 30-year utility bonds was 5.67 percent.

With utility bond yields having dropped significantly, Woolridge proposed to cut FERC's years-old 17.7 and 13.3 benchmarks to reflect that fact, so that a DCF ROE estimate above 12.46 percent would be excluded as an outlier, as would any DCF growth estimate of 9.36 percent or more. (Exh. SC-100, p. 33, filed Oct. 1, 2012.)

EMCO witness Wilson agreed (*Exh. EMC-1*, filed Oct. 1, 2012), saying that such benchmarks shouldn't remain fixed over extended periods of time when money costs change substantially, and witness Sabina Joe did too, believing that FERC's high-end outlier benchmarks should be market-sensitive. (*Pre-hearing brief of FERC Trial staff, p.18, filed April 29, 2013.*) But Avera didn't, noting that the Woolridge high-end outlier adjustment wrongly assumed that as interest rates fall, the risk premium remains constant. (*Pre-Trial Brief of NETOs, p.21.*) More importantly, the complainants found fault with the FERC staff's insistence that any DCF proxy group should include only utilities from the same region, as did the proxy group that was used in the initial New England ROE case in Opinion 489.

FERC Trial Staff witness Sabina Joe had employed a proxy group of electric utilities in ISO-NE, PJM, and the New York ISO, that were screened for

comparability with New England transmission owners on the basis of objective market factors.

And the staff endorsed that choice, arguing that "a national proxy group comprised of the entire investment grade electric utility industry, which has been used to establish ROEs for limited single electric utilities, but never before for establishing a single RTO-wide ROE for a diverse group of electric utilities, is inappropriate." (Prehearing Brief of Commission Trial Staff, p.3, filed April 29, 2013.)

Yet, as the complainants argued, "while sometimes helpful, a 'regional' parameter is problematic here because several 'northeastern' firms are only nominally so. For example, while NextEra owns New Hampshire Transmission, it is quite preponderantly the owner of Florida Power & Light." (Complainants' Prehearing Brief, p.12, filed April 29, 2013.)

A New Normal

On March 27, the parties in the case filed a "Joint Statement of Issues," listing three key questions for Judge Cianci to consider that speak volumes on how the transmission owners seek to broaden the scope of the case beyond a mechanical application arithmetic formulas:

- What policy objectives should be taken into account in determining the just and reasonable RTO-wide base ROE?
- Should the existing ROE be retained if it's within the zone of reasonableness?
- What is the impact of current capital markets on the ROE calculation? On the first issue, the NETOs argue that since the 2005 Energy Policy Act directed FERC to provide rate incentives to reverse decades of underinvestment and encourage the industry to expand the grid infrastructure, it should be recognized that a low ROE "would be contrary to the expressed policies of the Commission and Congress." (NETOs Pretrial Brief, p.5.)

But the complainants have a good answer ready, urging the judge not to mix incentives in with the base-level rate. Otherwise, they say, the owners would be rewarded even without undertaking any new investments. The only valid and "legally controlling policy objective," the complainants say, is to protect consumers from paying such overcharges.

The second issue invites a claim that even if FERC's DCF model implies a cost of equity below the currently authorized 11.14-percent base-level ROE, the owners shouldn't owe refunds, and indeed should be entitled to retain the current rate, as long as that rate still falls within the range of reasonableness established in the complaint case.

For example, the present 11.14-percent ROE would fall within the range of reasonableness 6.12 percent to 11.74 percent calculated by FERC trial witness Joe, and so would still stand as just and reasonable, even if far above the 8.93-percent midpoint of that range.

On this point as well, the complainants have an answer: namely, that the NETOs made and lost this same argument when it came up in the first RTO-wide New England ROE case.

There, the owners had argued that reasonableness is an abstract quality that embraces many different acceptable rates, such that FERC had no basis for ordering refunds if ROEs still fell within the still applicable reasonable range. (See, Dkt. ER04-157-021, Jan. 17, 2008, 122 FERC ¶61,038.) But the commission scotched that idea, explaining, as the complainants put it (Complainants' Brief, p.7.), that if every ROE within the zone were deemed equally reasonable, there would be no basis for FERC to select a particular rate from within the zone, and thus no reason not to reduce rates to the very bottom of the range!

The last of the three issues suggests that markets are still far enough off their historic norms as to warrant an entirely different approach. But there again, as FERC staff witness Joe has noted, the commission already has squarely rejected claims that "anomalous" or "unrepresentative" market conditions justify a departure from FERC's DCF model for setting ROEs. (See, Dkt. ER08-375-004, Oct. 6, 2011, 137 FERC ¶ 61,016.)

Or as the FERC trial staff summed up in its pre-trial brief: "Lower future returns are widely expected as the new normal."