



MARCH 2019 • NO. 5

FERC to Review Its Policies Regarding the Determination of the Return on Equity in Jurisdictional Rates

FERC is conducting a comprehensive review of its method for determining the appropriate return on equity in jurisdictional rates across the energy industry. Comments are due no later than 90 days, and reply comments no later than 120 days, after the publication of the NOI in the Federal Register.

On March 21, 2019, the Federal Energy Regulatory Commission (“FERC” or “the Commission”) issued a Notice of Inquiry (“NOI”) as to whether it should modify its policies (and, if so, how) for calculating the return on equity (“ROE”) for jurisdictional rates.¹ Although ostensibly directed at policies applicable to public utilities, the NOI also seeks comment as to whether those policies should also be applied to interstate natural gas pipelines and oil pipelines.

Shareholders of public utilities are permitted to recover a return on their investment “commensurate with the return on investments in other enterprises having corresponding risks [that is] sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.”² Since the 1980s, FERC has used the discounted cash flow (“DCF”) method for determining the appropriate ROE for ratemaking purposes. FERC uses the following formula:

k (discount rate) = D (current dividend)/ P (stock price at the relevant time) + g (expected growth rate in dividends)

According to FERC, using that computation, “the investor’s required return is estimated to equal current dividend yield (dividends divided by share price) plus the projected future growth rate of dividends.”³

FERC explained in the NOI that, since the financial crisis of 2008-2009, it has struggled with whether the DCF methodology continues to provide appropriate ROEs in light of “anomalous capital market conditions” (particularly the low yields on bonds).⁴ In Opinion No. 531,⁵ the Commission used a two-step DCF analysis to set the New England Transmission Owners’ ROE at the midpoint of the upper half of the zone of reasonableness⁶ (as opposed to simply the midpoint) to address those “anomalous capital market conditions.” In *Emera Maine v. FERC*,⁷ the U.S. Court of Appeals for the District of Columbia Circuit vacated that opinion because FERC insufficiently explained its rationale and failed to cite to record evidence supporting its approach to use the upper midpoint, as opposed to the midpoint, of the zone of reasonableness to set the base ROE.⁸ Although it stems

from the *Emera Maine* decision, the NOI goes further to give stakeholders “the opportunity to comment on the Commission’s ROE policy in light of the decision in *Emera Maine*.”⁹

The NOI seeks comments on a number of questions relating to eight general topics:¹⁰

- The role of FERC’s base ROE in investment decision-making and what objectives should guide FERC’s approach.
- Whether FERC should apply its base ROE policy uniformly to public utilities, interstate natural gas pipelines, and oil pipelines.
- How the DCF model has performed over time.
- The appropriate guidelines for the composition of proxy groups, eliminating outliers, and placing the base ROE within a zone of reasonableness.
- Other financial models used to evaluate utility stocks and whether they should be considered by FERC.

- The mismatch between market-based ROE determinations and book-value rate base, whether this is a problem, and how it should be addressed.
- How FERC should determine whether an existing ROE is unjust and unreasonable.
- The mechanics and implementation of the DCF and certain other models.

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¹ *Inquiry Regarding the Commission’s Policy for Determining Return on Equity*, 166 FERC ¶61,207 (2019) (“NOI”)

² *Id.* at P 4 (quoting *Fed. Power Comm’n v. Hope Natural Gas Co.*, 320 U.S. 591, 605 (1944)).

³ NOI at P 6.

⁴ *Id.* at P 18.

⁵ *Coakley, Mass. Attorney Gen. v. Bangor Hydro-Elec. Co.*, Opinion No. 531, 147 FERC ¶ 61,234, *order on paper hearing*, 149 FERC ¶ 61,032 (2014), *order on reh’g*, 150 FERC ¶ 61,165 (2015).

⁶ The “zone of reasonableness” “informs FERC’s selection of a just and reasonable rate” and “represents a ‘broad’ range of potentially just and reasonable ROEs” *Emera Maine v. FERC*, 854 F.3d 9, 23 (D.C. Cir. 2017).

⁷ *Id.*

⁸ *Id.* at 28-29.

⁹ NOI at P 28.

¹⁰ *Id.* at P 29.