BLANKROME

Energy

JUNE 8, 2020 • NO. 3

FERC Establishes Revised ROE Methodologies for Public Utilities and Pipelines

On May 21, 2020, the Federal Energy Regulatory Commission ("FERC") issued two orders addressing methodologies for analyzing the base return on equity ("ROE") components of rates of FERC-regulated entities. In Opinion No. 569-A, FERC revised the methodology used under section 206 of the Federal Power Act ("FPA") to evaluate the base ROEs of public utilities.[1] In a separate Policy Statement, FERC clarified that the methodology established in Opinion No. 569-A applies, with certain exceptions, to natural gas and oil pipelines.[2]

OPINION 569-A

To change a public utility's rates, including ROE, in a complaint proceeding under section 206 of the FPA, FERC must (i) make a finding that an existing rate is unjust and unreasonable; and (ii) determine a just and reasonable rate.[3]

FERC's recent order arose from two complaint proceedings challenging the base ROE of Midcontinent Independent System Operator, Inc. ("MISO") transmission owners.[4] In November 2019, FERC issued Opinion No. 569, establishing a revised methodology to determine whether the existing base ROE was unjust and unreasonable under the first prong of FPA section 206, and if so, to establish a new just and reasonable replacement ROE under the second prong.[5]

Among other things, Opinion No. 569 relied on the discounted cash flow model ("DCF")[6] and capital-asset pricing model ("CAPM")[7] in the first prong of its FPA section 206 analysis, and declined to use two other models—***i.e.***, the Expected Earnings[8] and Risk Premium[9] models. FERC adopted the use of ranges of presumptively just and reasonable ROEs that would be based on the risk profile of a utility or group of utilities. FERC gave equal weight to the DCF and CAPM models to establish composite zones of reasonableness. Absent evidence to the contrary, an ROE within the zone of reasonableness would be presumptively just and reasonable while an ROE outside this range would be presumptively unjust and unreasonable. FERC also relied on the DCF and CAPM models (and declined to use the Expected Earnings and Risk Premium models) in the second prong of its section 206 analysis in order to establish a new just and reasonable ROE.[10]

Opinion No. 569-A, which granted in part and denied in part requests for rehearing of Opinion No. 569, further revised FERC's ROE methodology by:

- Using the Risk Premium model under both prongs of its FPA Section 206 analysis, in addition to the DCF and CAPM models.[11]

- Deriving ranges of presumptively just and reasonable base ROEs by dividing the overall composite zone of reasonableness into equal thirds, as opposed to quartiles.

- Giving an 80 percent weighting to the short-term growth rate and a 20 percent weighting to the long-term growth rate in its two-step DCF model.

- Revising the high-end outlier test such that a proxy company would be a high-end outlier if its estimated cost of equity is more than 200 percent (as opposed to 150 percent) of the median result of all potential proxy group members under that model, subject to a natural break analysis.

- Indicating that it will consider the use of ***Value Line*** short-term earnings growth estimates under the CAPM model in future proceedings.

With respect to the complaint in ***Association of Businesses Advocating Tariff Equity v. MISO ("ABATE")***, FERC concluded under this revised methodology that the existing 12.38 percent ROE was unjust and unreasonable, and established a just and reasonable replacement ROE of 10.02 percent.

With respect to the complaint in ***Arkansas Electric Cooperative Corporation v. ALLETE, Inc.*** ("***Arkansas Electric***"), FERC determined that the ROE to be reviewed would be the 10.02 percent base ROE established in the ***ABATE*** proceeding. Finding that the 10.02 percent rate falls within the range of presumptively just and reasonable base ROEs and that no evidence in the proceeding rebutted such presumption, FERC dismissed the complaint in ***Arkansas Electric*** and declined to issue refunds.

POLICY STATEMENT FOR NATURAL GAS AND OIL PIPELINES

In its Policy Statement, FERC determined that the ROE methodology adopted in Opinion No. 569-A should also be applied to natural gas and oil pipelines, with the following exceptions to account for differences among the electric and oil and gas industries:

- FERC will average and give equal weight to the results of DCF and CAPM analyses in deriving just and reasonable ROEs for natural gas and oil pipelines but will ***not*** utilize the Risk Premium model.

- FERC will retain the current two-thirds/one-third weighting for short-term and long-term growth projections in the DCF analysis for pipelines, as opposed to the 80 percent/20 percent weighting established for public utilities in Opinion No. 569-A.

- FERC declined to adopt specific outlier tests and will continue to address outliers on a case-by-case basis.

The Policy Statement also clarified FERC's proxy group policy. Under existing policy, FERC has required that a company meet the following criteria to be included in a proxy group: (1) its stock must be publicly traded; (2) it must be recognized as a natural gas or oil pipeline company and its stock must be recognized and tracked by an investment information service such as ***Value Line***; and (3) pipeline operations must constitute a "high proportion" of its business (***i.e.***, generally at least 50 percent of assets or operating income over the most recent three-year period).[12] To accommodate concerns with obtaining sufficient proxy group members particularly in light of current market conditions, FERC noted that it will continue to relax the 50 percent standard as necessary, consider proposals to include Canadian entities, and consider other adjustments to ROE policies as necessary.

FERC also encouraged oil pipelines to file revised versions of FERC Form No. 6, page 700 for 2019 to reflect the revised ROE policy.

For additional information, please contact:

Mark R. Haskell, Washington, D.C. Office
Partner, Energy
202.420.2654 | mhaskell@blankrome.com

Brett A. Snyder, Washington, D.C. Office
Partner, Energy
202.420.2656 | bsnyder@blankrome.com

Lamiya N. Rahman, Washington, D.C. Office
Associate, Energy
202.420.2662 | lrahman@blankrome.com

See footnotes on the following page

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

2. ***Inquiry Regarding the Commission's Policy for Determining Return on Equity***, Policy Statement, 171 FERC ¶ 61,155 (2020) ("Policy Statement").

3. 16 U.S.C. § 824e (2018).

4. ***Ass'n of Businesses Advocating Tariff Equity v. MISO***, FERC Docket No. EL14-12-000; ***Ark. Elec. Coop. Corp. v. ALLETE, Inc.***, FERC Docket No. EL15-45-000.

5. ***Ass'n of Bus. Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc.***, 169 FERC ¶ 61,129 (2019) ("Opinion No. 569").

6. As FERC explains, the "DCF model is based on the premise that an investment in common stock is worth the present value of the infinite stream of dividends discounted at a market rate commensurate with the investment's risk. . . [FERC] uses the DCF model to determine the ROE . . . to be included in the utility's rates." ***See*** Opinion No. 569 at PP 87-88.

7. The CAPM methodology "derives the ROE through the risk premium observed from the risk premium of a DCF analysis of S&P 500 dividend-paying companies." ***See*** Opinion No. 569-A at P 4, n. 7.

8. The Expected Earnings model "calculate[s] the earnings that an investor expects to receive on the book value of a particular stock." ***Id.***

9. The Risk Premium model "examin[es] the risk premiums implied in the returns on equity allowed by regulatory commissions for utilities over some past period relative to the contemporaneous level of the long-term U.S. Treasury bond yield." ***See*** Opinion No. 569 at P 305.

10. Additionally, in Opinion No. 569, FERC reaffirmed its use of a two-step DCF analysis that gives one-third weight to a long-term growth rate based on projected growth in gross domestic product; held it would continue to rely exclusively on the Institutional Brokers' Estimate System ("IBES") as the preferred source for the DCF short-term growth projection, absent compelling reasons otherwise; held that only the short-term growth rate should be used to calculate the (1+.5g) adjustment to dividend yield in the DCF analysis for the CAPM; adopted a specific CAPM methodology and made other determinations with respect to DCF analysis; adopted a revised low-end outlier test that eliminates DCF and CAPM proxy group ROE results that are less than the yields of generic corporate Baa bonds plus 20 percent of the CAPM risk premium; adopted a high-end outlier test that treats as high-end outliers any proxy company whose cost of equity estimated 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 before any high or low-end outlier test is applied, subject to a "natural break" analysis; and reaffirmed its use of the midpoint, rather than the median, as the measure of central tendency for ROEs that applied to groups of utilities. ***See*** Opinion No. 569-A at PP 20-22.

11. FERC continued to decline to use the Expected Earnings model.

12. ***See*** Policy Statement at P 58.