165 FERC ¶ 61,118
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Neil Chatterjee, Chairman;
                        Cheryl A. LaFleur and Richard Glick.

Association of Businesses Advocating Tariff Equity   Docket No. EL14-12-003
Coalition of MISO Transmission Customers
Illinois Industrial Energy Consumers
Indiana Industrial Energy Consumers, Inc.
Minnesota Large Industrial Group
Wisconsin Industrial Energy Group

                        v.

Midcontinent Independent System Operator, Inc.
ALLETE, Inc.
Ameren Illinois Company
Ameren Missouri
Ameren Transmission Company of Illinois
American Transmission Company LLC
Cleco Power LLC
Duke Energy Business Services, LLC
Entergy Arkansas, Inc.
Entergy Gulf States Louisiana, LLC
Entergy Louisiana, LLC
Entergy Mississippi, Inc.
Entergy New Orleans, Inc.
Entergy Texas, Inc.
Indianapolis Power & Light Company
International Transmission Company
ITC Midwest LLC
Michigan Electric Transmission Company, LLC
MidAmerican Energy Company
Montana-Dakota Utilities Co.
Northern Indiana Public Service Company
Northern States Power Company-Minnesota
Northern States Power Company-Wisconsin
Otter Tail Power Company
Southern Indiana Gas & Electric Company

Arkansas Electric Cooperative Corporation   Docket No. EL15-45-000
Mississippi Delta Energy Agency
Clarksdale Public Utilities Commission
Public Service Commission of Yazoo City
Hoosier Energy Rural Electric Cooperative, Inc.

                          v.

ALLETE, Inc.
Ameren Illinois Company
Ameren Missouri
Ameren Transmission Company of Illinois
American Transmission Company LLC
Cleco Power LLC
Duke Energy Business Services, LLC
Entergy Arkansas, Inc.
Entergy Gulf States Louisiana, LLC
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Northern Indiana Public Service Company
Northern States Power Company-Minnesota
Northern States Power Company-Wisconsin
Otter Tail Power Company
Southern Indiana Gas & Electric Company

ORDER DIRECTING BRIEFS

(Issued November 15, 2018)

1.   Two complaint proceedings involving the return on equity (ROE) of Midcontinent Independent System Operator, Inc.'s (MISO) transmission-owning members (MISO TOs) are currently pending before the Commission. The Commission set these proceedings for hearing after it issued Opinion No. 531, concerning the ROE of the New

England Transmission Owners (New England TOs).[1] In the order setting the first MISO proceeding for hearing, the Commission stated that it "expect[ed] the participants' evidence and [Discounted Cash Flow (DCF)] analyses to be guided by our decision in Opinion No. 531."[2] Subsequently, in *Emera Maine v. FERC*,[3] the U.S. Court of Appeals for the District of Columbia Circuit (D.C. Circuit) vacated and remanded Opinion No. 531. On October 16, 2018, the Commission issued an order proposing a methodology for addressing the issues that were remanded to the Commission in *Emera Maine* and establishing a paper hearing on how that methodology should apply to the proceedings before the Commission involving New England TOs' ROE.[4] In this order, we similarly establish a paper hearing on whether and how this methodology should apply to the proceedings pending before the Commission involving MISO TOs' ROE.

I.   **Background**

A.   **Opinion No. 531 *et seq.***

2.   In Opinion No. 531, the Commission adopted certain changes to its use of the DCF methodology for evaluating and setting the Commission-allowed ROE for the New England TOs. In particular, the Commission elected to replace the "one-step" DCF model, which considers only short-term growth projections for a public utility, with a "two-step" model that considers both short- and long-term growth projections.[5] The Commission also departed from its typical practice of setting the just and reasonable ROE of a group of utilities at the midpoint of the zone of reasonableness. The Commission explained that evidence of "anomalous" capital market conditions, including

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[1] *Coakley v. Bangor Hydro-Elec. Co*., Opinion No. 531, 147 FERC ¶ 61,234 (Opinion No. 531), *order on paper hearing*, Opinion No. 531-A, 149 FERC ¶ 61,032 (2014) (Opinion No. 531-B) (Opinion No. 531-A), *order on reh'g*, Opinion No. 531-B, 150 FERC ¶ 61,165 (2015), *rev'd, Emera Maine v. FERC*, 854 F.3d 9 (D.C. Cir. 2017) (*Emera Maine*).

[2] *Ass'n of Bus. Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc.* 149 FERC ¶ 61,049, at P 186 (2014) (MISO I Hearing Order), *order on reh'g*, 156 FERC 61,060 (2016) (MISO I Rehearing Order).

[3] *Emera Maine*, 854 F.3d 9.

[4] *See Coakley v. Bangor Hydro-Elec. Co.*, 165 FERC ¶ 61,030 (2018) (*Coakley* Briefing Order).

[5] *See generally*, Opinion No. 531, 147 FERC ¶ 61,234 at PP 8, 32-41, Opinion No. 531-A, 149 FERC ¶ 61,032, Opinion No. 531-B, 150 FERC ¶ 61,165, *rev'd, Emera Maine*, 854 F.3d 9.

"bond yields [that were] at historic lows," made the Commission "less confiden[t] that the midpoint of the zone of reasonableness . . . accurately reflects the [ROE] necessary to meet the *Hope* and *Bluefield* capital attraction standards."[6] The Commission therefore looked to four alternative benchmark methodologies: Three financial models—a risk premium analysis, a capital-asset pricing model (CAPM) analysis, and an expected earnings analysis—as well as a comparison with the ROEs approved by state public utility commissions.[7] In considering those methodologies, the Commission emphasized that it was not departing from its long-standing reliance on the DCF model, but rather relying on those methodologies only to "inform the just and reasonable placement of the ROE within the zone of reasonableness established . . . by the DCF methodology."[8] Based on these alternative methodologies, the Commission determined that an ROE of 10.57 percent, the midpoint of the upper half of the zone of reasonableness produced by the DCF, would be just and reasonable. Because that figure differed from the New England TOs' existing 11.14 percent ROE, the Commission concluded that the existing base ROE had become unjust and unreasonable and it therefore set New England TOs' base ROE at 10.57 percent, pending a paper hearing concerning the long-term growth projection to use in the DCF analysis. Following that hearing, in Opinion No. 531-A the Commission reaffirmed its conclusion that 10.57 percent was the just and reasonable ROE and that New England TOs' existing ROE was unjust and unreasonable. The Commission required New England TOs to submit a compliance filing to implement their new ROEs effective October 16, 2014—the date of Opinion No. 531-A.

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[6] Opinion No. 531, 147 FERC ¶ 61,234 at PP 144-145 & n.285. "*Hope*" and "*Bluefield*" refer to a pair of U.S. Supreme Court cases that require the Commission "to 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." *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) (*Hope*) and *Bluefield Waterworks Improvement Co. v. Pub. Serv. Comm'n of W.V.*, 262 U.S. 679 (1923) (*Bluefield*)).

[7] Opinion No. 531, 147 FERC ¶ 61,234 at PP 147-149.

[8] *Id.* P 146.

B.   Opinion No. 551 *et seq.*

3.   On November 12, 2013, multiple complainants[9] filed a complaint (First Complaint) pursuant to section 206 of the Federal Power Act (FPA),[10] alleging, among other things, that MISO TOs' base ROE reflected in MISO's Open Access Transmission, Energy and Operating Reserve Markets Tariff (Tariff) was unjust and unreasonable.[11] At the time of the First Complaint, MISO TOs (except for ATC) had a base ROE of 12.38 percent, and their total ROE—i.e., the base ROE plus any ROE adders approved by the Commission—was not permitted to exceed 15.96 percent. The Commission established the MISO TOs' preexisting 12.38 percent ROE in a 2002 decision.[12] That ROE was

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[9] The First Complaint complainants consist of a group of large industrial customers: Association of Businesses Advocating Tariff Equity (ABATE); Coalition of MISO Transmission Customers (Coalition of MISO Customers); Illinois Industrial Energy Consumers; Indiana Industrial Energy Consumers, Inc.; Minnesota Large Industrial Group; and Wisconsin Industrial Energy Group.

[10] 16 U.S.C. § 824e (2012).

[11] The following MISO transmission owners were named in the First Complaint: ALLETE, Inc. for its operating division Minnesota Power (and its subsidiary Superior Water, L&P); Ameren Services Company, as agent for Union Electric Company, Ameren Illinois Company, and Ameren Transmission Company of Illinois; American Transmission Company LLC (ATC); Cleco Power LLC; Duke Energy Corporation for Duke Energy Indiana, Inc.; Entergy Arkansas, Inc.; Entergy Louisiana, LLC; Entergy Gulf States Louisiana, L.L.C.; Entergy Mississippi, Inc.; Entergy New Orleans, Inc.; Entergy Texas, Inc.; Indianapolis Power & Light Company; International Transmission Company; ITC Midwest LLC; METC; MidAmerican Energy Company; Montana-Dakota Utilities Co.; Northern Indiana Public Service Company; Northern States Power Company, a Minnesota corporation, and Northern States Power Company, a Wisconsin corporation, subsidiaries of Xcel Energy Inc.; Northwestern Wisconsin Electric Company; Otter Tail Power Company; Southern Indiana Gas & Electric Company; and Wolverine Power Supply Cooperative, Inc. Intervenor Xcel Energy Services Inc. did not join certain of the MISO Transmission Owners' pleadings in this proceeding, but generally supports this brief on behalf of respondents Northern States Power Company, a Minnesota corporation, and Northern States Power Company, a Wisconsin corporation.

[12] *See Midwest Indep. Transmission Sys. Operator, Inc.*, 99 FERC ¶ 63,011, *initial decision affirmed as to base ROE*, 100 FERC ¶ 61,292 (2002), *reh'g denied*, 102 FERC ¶ 61,143 (2003), *order on remand*, 106 FERC ¶ 61,302 (2004). ATC's base ROE of 12.2 percent was established as part of a settlement agreement that was filed with the Commission on March 26, 2004. In Docket No. ER04-108-000, the Commission

based on a DCF analysis using financial data for the six-month period ending February 2002.[13]

4.   On October 16, 2014, the same date that the Commission issued Opinion No. 531-A, it set the First Complaint for hearing before an Administrative Law Judge and established a refund effective date of November 12, 2013.[14]

5.   Following the hearing, the Commission issued Opinion No. 551.[15] In Opinion No. 551, the Commission calculated the just and reasonable ROE using the two-step DCF methodology from Opinion No. 531 and financial data for the period January 1 through June 30, 2015. The Commission affirmed the conclusions of the Initial Decision, finding that the Presiding Judge correctly applied the two-step DCF analysis required by Opinion No. 531.[16] The Commission also affirmed the Presiding Judge's determination that, as in Opinion No. 531, there were anomalous capital market conditions such that the Commission had less confidence that the midpoint of the zone of reasonableness produced by a mechanical application of the DCF methodology satisfied the capital attraction standards of *Hope* and *Bluefield*.[17] The Commission found that the Presiding Judge reasonably considered evidence of alternative methodologies for determining the ROE and the ROEs approved by state regulatory commissions, for purposes of deciding to set the ROE at the central tendency of the upper half of the zone of reasonableness, setting the base ROE for MISO TOs at 10.32 percent.[18] The Commission required MISO TOs to submit a compliance filing to implement their new ROEs effective September 28,

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approved the uncontested settlement. *Am. Transmission Co. LLC*, 107 FERC ¶ 61,117 (2004).

     [13] *Midwest Indep. Transmission Sys. Operator, Inc.*, 99 FERC ¶ 63,011, Appendix A.

     [14] MISO I Hearing Order, 149 FERC ¶ 61,049 at P 188. On July 21, 2016, the Commission denied requests for rehearing and clarification of the MISO I Hearing Order. MISO I Rehearing Order, 156 FERC ¶ 61,060. In the MISO I Rehearing Order, the Commission clarified that non-public utility transmission owners are subject to the outcome of that proceeding. *Id.* PP 47-48.

     [15] *Ass'n of Businesses Advocating Tariff Equity*, Opinion No. 551, 156 FERC ¶ 61,234 (2016).

     [16] *See generally* Opinion No. 551, 156 FERC ¶ 61,234 at P 9.

     [17] *Id.*

     [18] Opinion No. 551, 156 FERC ¶ 61,234 at P 9.

2016, the date of Opinion No. 551, and to provide refunds for the November 13, 2013-February 11, 2015 refund period. Following the issuance of Opinion No. 551, numerous parties submitted requests for rehearing, which are currently pending.

C.   Subsequent Complaint against MISO TOs' ROE

6.   On February 12, 2015, a new set of complainants[19] filed a complaint (Second Complaint) also alleging that the MISO TOs' base ROE, of 12.38 percent was unjust and unreasonable.[20] Relying on an updated two-step DCF analysis, the Second Complaint complainants argued that the base ROE should be no higher than 8.67 percent.[21] On June 18, 2015, the Commission established hearing procedures and set a refund effective date of February 12, 2015.[22]

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[19] Complainants for the Second Complaint consist of: Arkansas Electric Cooperative Corporation (Arkansas Electric Cooperative); Mississippi Delta Energy Agency and its two members, Clarksdale Public Utilities Commission of the City of Clarksdale, Mississippi and Public Service Commission of Yazoo City of the City of Yazoo City, Mississippi; and Hoosier Energy Rural Electric Cooperative, Inc. (Hoosier Cooperative).

[20] The following MISO transmission owners were named in the Second Complaint: ALLETE, Inc. (for its operating division Minnesota Power, Inc. and its wholly-owned subsidiary Superior Water Light, & Power Company; Ameren Illinois Company; Union Electric Company (identified as Ameren Missouri); Ameren Transmission Company of Illinois; ATC; Cleco Power LLC; Duke Energy Business Services, LLC; Entergy Arkansas, Inc.; Entergy Gulf States Louisiana, LLC; Entergy Louisiana, LLC; Entergy Mississippi, Inc.; Entergy New Orleans, Inc.; Entergy Texas, Inc.; Indianapolis Power & Light Company; International Transmission Company, ITC Midwest LLC, and Michigan Electric Transmission Company, LLC; MidAmerican Energy Company; Montana-Dakota Utilities Co., Northern Indiana Public Service Company; Northern States Power Company-Minnesota; Northern States Power Company-Wisconsin; Otter Tail Power Company; and Southern Indiana Gas & Electric Company.

[21] *Ark. Elec. Coop. Corp. v. ALLETE, Inc.*, 151 FERC ¶ 61,219, at P 1 (2015) (MISO II Hearing Order), *order on reh'g*, 156 FERC ¶ 61,061 (2016) (MISO II Rehearing Order).

[22] *Id.*

7.   Parties filed requests for rehearing of the MISO II Hearing Order, and on July 21, 2016, the Commission generally denied these rehearing requests.[23] Following the MISO II Hearing Order, the Presiding Judge issued the Initial Decision on June 30, 2016.[24] The Presiding Judge adopted a zone of reasonableness of 6.76 percent to 10.68 percent based on financial data for the period July 1, 2015 through December 31, 2015. The Presiding Judge also determined that the anomalous market conditions identified in Opinion No. 531 persisted and, after considering the alternative benchmark methodologies, that the just and reasonable ROE was 9.70 percent–halfway between the midpoint and the upper bound of the zone of reasonableness. The participants filed briefs on and opposing exception, which are currently pending before the Commission.

D.   *Emera Maine*

8.   On April 14, 2017, the D.C. Circuit issued its *Emera Maine* decision, vacating and remanding Opinion No. 531 *et seq.* As an initial matter, the D.C. Circuit rejected New England TOs' argument that an ROE within the DCF-produced zone of reasonableness could not be deemed unjust and unreasonable. The D.C. Circuit explained that the zone of reasonableness established by the DCF is not "coextensive" with the "statutory" zone of reasonableness envisioned by the FPA.[25] Accordingly, the D.C. Circuit concluded that the fact that New England TOs' existing ROE fell within the zone of reasonableness produced by the DCF did not necessarily indicate that it was just and reasonable for the purposes of the FPA.[26]

9.   Nevertheless, the D.C. Circuit found that the Commission had not adequately shown that their existing ROE was unjust and unreasonable. The D.C. Circuit explained that the FPA's statutory "zone of reasonableness creates a broad range of potentially lawful ROEs rather than a single just and reasonable ROE" and that whether particular ROE is unjust and unreasonable depends on the "particular circumstances of the case."[27] Thus, the fact that New England TOs' existing ROE did not equal the just and reasonable ROE that the Commission would have set using the current DCF inputs did not necessarily indicate that New England TOs' existing ROE fell outside the statutory zone

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[23] MISO II Rehearing Order, 156 FERC ¶ 61,061.

[24] *Ark. Elec. Coop. Corp. v. ALLETE, Inc.*, 155 FERC ¶ 63,030 (2016).

[25] *Emera Maine*, 854 F.3d at 22-23.

[26] *Id.* at 23.

[27] *Id.* at 23, 26.

of reasonableness.[28] As such, the D.C. Circuit concluded that Opinion No. 531 "failed to include an actual finding as to the lawfulness of [New England TOs'] existing base ROE" and that its conclusion that their existing ROE was unjust and unreasonable was itself arbitrary and capricious.[29]

10.   The D.C. Circuit found that the Commission had not adequately shown that the 10.57 percent ROE that it set was just and reasonable. Although recognizing that the Commission has the authority "to make 'pragmatic adjustments' to a utility's ROE based on the 'particular circumstances' of a case," the D.C. Circuit nevertheless concluded that the Commission had not explained why setting the ROE at the upper midpoint was just and reasonable.[30] The D.C. Circuit noted, in particular, that the Commission relied on the alternative models and state-regulated ROEs to support a base ROE *above* the midpoint, but that it did not rely on that evidence to support an ROE *at* the upper midpoint.[31] Similarly, the D.C. Circuit noted that the Commission had concluded that a base ROE of 9.39 percent—the midpoint of the zone of reasonableness—might not be sufficient to satisfy *Hope* and *Bluefield* or to allow the utility to attract capital, but that the Commission had not similarly explained how a 10.57 percent base ROE was sufficient to meet either of those conditions. Because the D.C. Circuit found that the Commission had not pointed to record evidence supporting the specific point at which it set New England TOs' ROE, the D.C. Circuit held that the Commission had not articulated the "rational connection" between the evidence and the rate that the FPA demands.[32]

11.   Based on those two conclusions—that the Commission had not met its burden either under the first or the second prong of FPA section 206—the D.C. Circuit vacated and remanded Opinion No. 531 *et seq.*[33] Thus, the current state of affairs concerning the

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[28] *Id.* at 27 ("To satisfy its dual burden under section 206, FERC was required to do more than show that its single ROE analysis generated a new just and reasonable ROE and conclusively declare that, consequently, the existing ROE was per se unjust and unreasonable.").

[29] *Id.*

[30] *Id.* (quoting *FPC v. Nat. Gas Pipeline Co.*, 315 U.S. 575, 586 (1942)).

[31] *Id.* at 29 ("FERC's reasoning is unclear. On the one hand, it argued that the alternative analyses supported its decision to place the base ROE above the midpoint, but on the other hand, it stressed that none of these analyses were used to select the 10.57 percent base ROE.").

[32] *Id.* at 28-30.

[33] *Id.* at 30.

MISO TOs' ROE is this: There are two currently pending complaints against their ROE, both of which have been fully litigated before a Presiding Judge. The D.C. Circuit vacated the Commission's determinations in Opinion No. 531, upon which the Commission relied extensively in its order on the First MISO Complaint (i.e. Opinion No. 551), meaning that Opinion No. 531 is no longer precedential,[34] even though the Commission remains free to re-adopt those determinations on remand as long as it provides a reasoned basis for doing so.[35] In the meantime, MISO TOs are continuing to collect their 10.32 percent ROE, although the Commission has broad remedial authority to correct its legal error in order to make whatever ROE it sets on rehearing effective as of the date of Opinion No. 551.[36]

E.   Briefing Order in New England TO ROE Proceedings

12.   On October 16, 2018, the Commission issued an order proposing a methodology for addressing the issues that were remanded to the Commission in *Emera Maine* and establishing a paper hearing on whether and how this methodology should apply to the four complaint proceedings concerning the New England TOs' ROE.[37] In that order, the Commission proposed to change its approach to determining base ROE by giving equal weight to four financial models, instead of primarily relying on the DCF methodology. The Commission stated that evidence indicates that investors do not rely on any one model to the exclusion of others. Therefore, relying on multiple financial models makes it more likely that our decision will accurately reflect how investors make their investment decisions.

13.   Specifically, the Commission proposed to rely on three financial models that produce zones of reasonableness—the DCF model, the CAPM model, and the expected earnings model—to establish a composite zone of reasonableness. The zone of reasonableness produced by each model would be given equal weight and averaged to determine the composite zone of reasonableness. The Commission proposed a framework for using the composite zone of reasonableness in evaluating whether an existing base ROE remains just and reasonable.

14.   For purposes of establishing a new just and reasonable base ROE when the existing base ROE has been shown to be unjust and unreasonable, the Commission

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[34] *ISO New England Inc. v. Bangor Hydro-Electric Co.*, 161 FERC ¶ 61,031, at P 28 (2017).

[35] *Emera Maine*, 854 F.3d at 30.

[36] *See ISO New England Inc. v. Bangor Hydro-Electric Co.*, 161 FERC ¶ 61,031 at PP 24, 34.

[37] *See Coakley* Briefing Order, 165 FERC ¶ 61,030.

proposed to rely on four financial models—the DCF model, the CAPM model, the expected earnings model, and the risk premium model—to produce four separate base ROE estimates that would then be averaged to produce a specific just and reasonable base ROE. The risk premium model produces a single numerical point rather than a range; therefore it cannot be used in establishing a composite zone of reasonableness.

15.   The Commission established a paper hearing and directed the participants in the four complaint proceedings to submit briefs regarding this proposed new approach and how to apply it to those four proceedings.

II.   **Determination**

16.   Below we describe how the Commission proposes to address, in the two proceedings involving the MISO TOs' ROE, the issues that the D.C. Circuit remanded to the Commission in *Emera Maine*. In short, we propose to adopt the same approach recently proposed in the *Coakley* Briefing Order,[38] which gives equal weight to the results of the four financial models in the record instead of primarily relying on the DCF model. In relying on a broader range of record evidence to estimate MISO TOs' cost of equity, we can ensure that our chosen ROE is based on substantial evidence and bring our methodology into closer alignment with how investors inform their investment decisions.

17.   We begin with the Commission's proposed framework for determining whether an existing ROE remains just and reasonable (i.e., the first prong of the FPA section 206 analysis). Specifically, we propose (1) relying on the three financial models that produce zones of reasonableness—the DCF, CAPM, and Expected Earnings models—to establish a composite zone of reasonableness; and (2) relying on that composite zone of reasonableness as an evidentiary tool to identify a range of presumptively just and reasonable ROEs for utilities with a similar risk profile to the targeted utility. Under this approach, we would dismiss an ROE complaint if the targeted utility's existing ROE falls within the range of presumptively just and reasonable ROEs for a utility of its risk profile unless that presumption is sufficiently rebutted.

18.   We then turn to the Commission's proposed framework for establishing a new just and reasonable ROE, where the existing ROE has been shown to be unjust and unreasonable (i.e., the second prong of the FPA section 206 analysis). At that stage, we propose to rely on all four financial models in the record—i.e., the three listed above, plus the Risk Premium model[39]—to produce four separate cost of equity estimates. We

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[38] *Id.*

[39] Unlike the DCF, CAPM, and Expected Earnings models, the output of the Risk Premium model is a numerical point and therefore, it does not produce a range which can be used to determine a zone of reasonableness. Accordingly, we propose to use the Risk Premium model output in the second prong of the FPA section 206 analysis where we

propose to then give them equal weight by averaging the four estimates to produce the just and reasonable ROE. For each of the DCF, CAPM, and Expected Earnings models, we propose to use the central tendency of the respective zones of reasonableness as the cost of equity estimate for average risk utilities.[40] We would then average those three midpoint/median figures with the sole numerical figure produced by the Risk Premium model to determine the ROE of average risk utilities. We would use the midpoint/medians of the resulting lower and upper halves of the zone of reasonableness to determine ROEs for below or above average risk utilities, respectively. Because our current policy is to cap a utility's total ROE, i.e., its base ROE plus incentive ROE adders, at the top of the zone of reasonableness, we propose to use the composite zone of reasonableness produced by the DCF, CAPM, and Expected Earnings to establish the cap on a utility's total ROE.

19.   After explaining our proposed frameworks for the first and second prongs of our FPA section 206 analysis, we then perform an illustrative calculation using record evidence from the First Complaint proceeding. That calculation indicates that, for the time period at issue in the First Complaint, (1) the range of presumptively just and reasonable ROEs for MISO TOs is 9.55 percent to 10.95 percent; (2) MISO TOs' preexisting ROE of 12.38 percent is therefore unjust and unreasonable; (3) the just and reasonable ROE is 10.28 percent; and (4) the cap on MISO TOs' total ROE is 13.06 percent. However, these findings are merely preliminary.

20.   We conclude by establishing a paper hearing on whether and how our proposed frameworks should apply to the two complaint proceedings involving MISO TOs' ROE. In this order, as in the *Coakley* Briefing Order, we do not make any final determinations with respect to the proposed new methodology for analyzing the base ROE component of rates under section 206 of the FPA. The scope of the paper hearing established in this order includes all aspects of this order's proposed methodology. Accordingly, the briefs directed by this order may address the justness and reasonableness of any aspect of the proposed methodology. The participants are free to present evidence supporting the proposed new methodology or supporting a different or revised new methodology.

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determine a specific just and reasonable ROE, but not in the first prong of the analysis, which requires models that produce a range that can be used to determine a zone of reasonableness.

    [40] The Commission will continue to use the midpoint of the zone of reasonableness as the appropriate measure of central tendency for a diverse group of average risk utilities and the median as the measure of central tendency for a single utility. *See Coakley* Briefing Order, 165 FERC ¶ 61,030 at P 17 n.46. *See also S. Cal. Edison Co.*, 131 FERC ¶ 61,020, at P 91 (2010), *remanded on other grounds sub nom. S. Cal. Edison Co. v. FERC*, 717 F.3d 177, 183-87 (D.C. Cir. 2013).

A. Determining Whether an Existing ROE has Become Unjust and Unreasonable

21.   In this section, we describe the approach recently explained in the *Coakley* Briefing Order, which represents the Commission's new proposed approach for determining whether an existing ROE remains just and reasonable.[41] That new approach reflects the Commission's proposed policy for addressing this issue in the proceedings currently pending before the Commission. Before outlining that approach, however, we review the guidance that the D.C. Circuit has provided regarding this task.

1. Background

22.   The D.C. Circuit has explained that, to satisfy the first prong of an FPA section 206 inquiry into an ROE, the Commission must "make an explicit finding that [an] existing [ROE is] unjust and unreasonable before proceeding to set a new rate."[42] Although *Emera Maine* held that a difference between the existing ROE and the just and reasonable ROE that the Commission would set under current circumstances is, by itself, insufficient to show that the existing ROE is unjust and unreasonable, the D.C. Circuit has also held that a comparison between the existing ROE and the just and reasonable ROE that the Commission would establish under current circumstances is relevant—and, in some cases, determinative—for whether the existing ROE remains just and reasonable.[43] In addition, the D.C. Circuit has explained that, although showing that an existing ROE is entirely outside a zone of reasonableness produced by a financial model, such as the DCF methodology, is one way of demonstrating that an existing ROE is unjust and unreasonable, it is not the *only* way in which the Commission can satisfy its

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[41] *Coakley* Briefing Order, 165 FERC ¶ 61,030 at P 19.

[42] *Emera Maine*, 854 F.3d at 24.

[43] *Papago Tribal Util. Auth. v. FERC*, 723 F.2d 950, 957 (D.C. Cir. 1983) (*Papago*) (concluding that the difference between the existing ROE and the just and reasonable ROE that the Commission would have set was sufficient *as a matter of law* to show the existing rate was unjust and unreasonable); *see also Emera Maine*, 854 F.3d at 26 (explaining that the Commission's "finding that 10.57 percent was a just and reasonable ROE, *standing alone*, 'did not amount to a finding that every other rate of return was not'" (citing *Papago*, 723 F.2d at 957) (emphasis added)).

burden under the first prong of FPA section 206.[44] The Commission may also find that an existing ROE—even one that is within the zone of reasonableness produced by its financial analysis—is unjust and unreasonable based on the "particular circumstances" of the case.[45]

23.   The D.C. Circuit has not discussed in detail what "particular circumstances" are relevant to that determination in the context of an FPA section 206 proceeding. Nevertheless, it has, in the context of an FPA section 205 proceeding, noted factors that may be relevant to determining whether an ROE is just and reasonable.[46] Chief among those factors is the company's risk profile, with a riskier profile indicating that a higher ROE may be appropriate.[47] As the Supreme Court explained in *Hope*, when describing what has become the standard for evaluating whether an ROE is just and reasonable under the FPA, a utility's ROE "should be commensurate with returns on investments in other enterprises *having corresponding risks*."[48] Indeed, the D.C. Circuit has explained that failing to consider a utility's risk profile, at least relative to the proxy group

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[44] *Emera Maine*, 854 F.3d at 24; *see also Pub. Serv. Comm'n of State of N.Y. v. FERC*, 642 F.2d 1335, 1350 n.27 (D.C. Cir. 1980) (finding that the fact that an existing ROE was outside the zone of reasonableness was sufficient to carry the Commission's burden to show that an existing rate was unjust and unreasonable under the analogous section 5 of the Natural Gas Act).

[45] *Emera Maine*, 854 F.3d at 23, 26.

[46] *See, e.g., NEPCO Mun. Rate Comm. v. FERC*, 668 F.2d 1327, 1344 (D.C. Cir. 1981) (*NEPCO*) (observing in the context of a challenge to the Commission approval of an FPA section 205 filing, which, among other things, established an ROE, that "[r]atemaking is a complicated process involving many factors, e.g., money market conditions, financial health of the utility, and financial risks.") (*NEPCO*).

[47] *Petal Gas Storage, L.L.C. v. FERC*, 496 F.3d 695, 700 (D.C. Cir. 2007) (*Petal Gas)*; *Canadian Ass'n of Petroleum Producers (CAPP) v.* FERC, 254 F.3d 289, 295 (D.C. Cir. 2001) (noting that, after establishing a proxy group, the Commission "then determin[es] where [the filing entity] belong[s] within that group, in large part on the basis of . . . business risk"); *Williston Basin Interstate Pipeline Co. v. FERC*, 165 F.3d 54, 57 (D.C. Cir. 1999) ("Once the Commission has defined a zone of reasonableness . . . , it then assigns . . . a rate within that range to reflect specific investment risks . . . as compared to the proxy group companies."); *see also Emera Maine*, 854 F.3d at 29-30 (discussing instances in which the Commission had awarded a higher ROE because "the utility at issue was riskier than the proxy group.").

[48] *Hope*, 320 U.S. 591 at 603 (emphasis added); *Petal Gas*, 496 F.3d at 698 (discussing this standard in the context of whether rates are just and reasonable).

companies, can itself be arbitrary and capricious.[49] In addition, the D.C. Circuit has noted that financial considerations, such as the state of the capital markets, the financial condition of the utility in question, and other "financial risks" may also be relevant.[50]

2.   **Proposed Approach**

24.   As recently proposed in the *Coakley* Briefing Order, here, we also propose to adopt a new framework for evaluating whether an existing ROE remains just and reasonable for purposes of the first prong of FPA section 206. In sum, we propose to establish a range of presumptively just and reasonable ROEs, within the zone of reasonableness indicated by the record evidence. As explained below, this framework reflects the D.C. Circuit's guidance, both in *Emera Maine* as well as in the D.C. Circuit's other decisions regarding the determination of a just and reasonable ROE.

25.   The Commission has long relied on a financial model to guide its evaluation of whether an ROE is just and reasonable.[51] As explained below, we propose to continue using an analysis of the relevant financial considerations to establish an initial zone of reasonableness. However, as the D.C. Circuit observed in *Emera Maine*, even where the Commission's financial analysis produces an initial zone of reasonableness, the presence of that record evidence is not necessarily the end of the inquiry, and it is not a proxy for the just and reasonable standard in the FPA. Instead, the Commission may look to the particular circumstances of the case to determine whether an ROE—even one that falls within that zone—is just and reasonable for purposes of the first prong of FPA section 206.[52]

26.   Consistent with the Commission's established practice and the D.C. Circuit's guidance, we continue to find that a utility's risk profile remains the "particular

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[49] *Petal Gas*, 496 F.3d at 700.

[50] *See, e.g.*, *Aera Energy LLC v. FERC*, 789 F.3d 184, 194 (D.C. Cir. 2015) (observing that, in general, "'the higher the proportion of equity capital, the lower the financial risk . . . and thus, in this respect, the lower the necessary rate of return' on equity." (quoting *Mo. Pub. Serv. Comm'n v. FERC*, 215 F.3d 1, 2 (D.C. Cir. 2000))); *NEPCO*, 668 F.2d at 1344 (listing considerations for setting the ROE, including the health of the utility and its "financial risk").

[51] *See generally Emera Maine*, 854 F.3d at 21 (explaining the Commission's approach to setting ROE); *Canadian Ass'n of Petroleum Producers v. FERC*, 308 F.3d 11, 15 (D.C. Cir. 2002) (similar); *Tenn. Gas Pipeline Co. v. FERC*, 926 F.2d 1206, 1209 (D.C. Cir. 1991) (similar) (*Tenn. Gas*).

[52] *Emera Maine*, 854 F.3d at 23, 27.

circumstance[]" most relevant to determining whether a point within a zone of reasonableness is a just and reasonable ROE for that utility. In particular, as noted, the courts have held that, to be just and reasonable, an ROE must be "commensurate" with the returns on investments in other enterprises having "corresponding risks." By the same token, an ROE—even one within the zone of reasonableness—that is *not* commensurate with the returns on investments in other enterprises having "corresponding risks" will not be just and reasonable. Accordingly, we conclude that a utility's relative risk profile should be the most critical consideration when identifying the "broad range of potentially lawful ROEs" that *Emera Maine* contemplates within the overall zone of reasonableness produced by the DCF when determining whether an existing ROE remains unjust and unreasonable.

27.   The Commission has historically accounted for a utility's risk profile in two ways. First, it has attempted to compare that utility to other utilities facing similar risks by establishing a proxy group of comparable risk companies. Thus, for example, the Commission has limited the composition of the proxy group to utilities with a credit rating similar to that of the utility in question.[53] Second, recognizing that, nevertheless, the particular circumstances facing a utility may differ from some or all of the proxy group companies, the Commission has adjusted the ROE within the zone of reasonableness derived from the proxy group, increasing the ROE for a riskier utility and decreasing it for one that is less risky. Thus, as the D.C. Circuit explained in *Emera Maine*, the Commission has in multiple instances set a utility's ROE at the midpoint of the upper half of the zone reasonableness after finding "that the utility at issue was riskier than the proxy group, meaning that the utility's costs fell somewhere above the midpoint of the zone of reasonableness."[54] The D.C. Circuit has approved this approach, noting that, when dealing with a relatively risky utility, "the midpoint of the upper half [of the zone of reasonableness] was 'an obvious place to begin'" the analysis of what constitutes a just and reasonable ROE.[55] Similarly, the Commission has also held that, where a utility's risks are significantly less than those of the proxy group companies, an ROE at the relevant measure of central tendency for the lower half of the zone of reasonableness represents a just and reasonable ROE.[56]

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[53] *See, e.g.*, Opinion No. 531, 147 FERC ¶ 61,234 at PP 106-108 (citing *Tallgrass Transmission, LLC*, 125 FERC ¶ 61,248, 62,240 n.79 (2008)); *see also Petal Gas*, 496 F.3d at 699 ("[P]roxy group arrangements must be risk-appropriate . . . [t]hat principle is well-established.").

[54] *Emera Maine*, 854 F.3d at 29-30.

[55] *Id.* at 30 (quoting *Tenn. Gas*, 926 F.2d at 1213).

[56] *See Potomac-Appalachian Transmission Highline, LLC*, 158 FERC ¶ 61,050, at PP 270, 273 (2017).

28.   Those longstanding determinations form the basis of the Commission's proposal to evaluating whether an existing ROE may be found unjust and unreasonable under the first prong of FPA section 206. In particular, we believe that the principal consideration for determining whether an existing ROE within the overall zone of reasonableness has become unjust and unreasonable is the risk profile of the utility or utilities for which the Commission is setting the ROE. This is consistent with the Commission's well-established policy on relative risk analysis, in which the presumptively just and reasonable ROE for an average-risk utility is the relevant measure of central tendency for the entire zone of reasonableness while the presumptively just and reasonable ROE for an above- or below-average risk utility is the relevant measure of central tendency for either the upper or lower half of the zone of reasonableness, respectively. Following that approach, logic dictates that it typically would be unjust and unreasonable for an average-risk utility to receive an ROE that is closer to the ROE that would be just and reasonable for a utility of above- or below-average risk.

29.   With these principles in mind, we believe that, for an average risk utility, the "broad range of potentially lawful ROEs" that the D.C. Circuit contemplated in *Emera Maine* should correspond to those points that are closer to the ROE that the Commission would set for that utility than to the ROE for a utility of a different risk profile. As illustrated below in Figure 1, for a diverse group of average risk utilities, such as MISO TOs, this range constitutes one quarter of the zone of reasonableness, centered on the midpoint. Every potential ROE within that range is closer to the current just and reasonable ROE for an average-risk utility than the current just and reasonable ROE for a utility of a different risk profile.[57]

Figure 1: Zone of Reasonableness Quartiles

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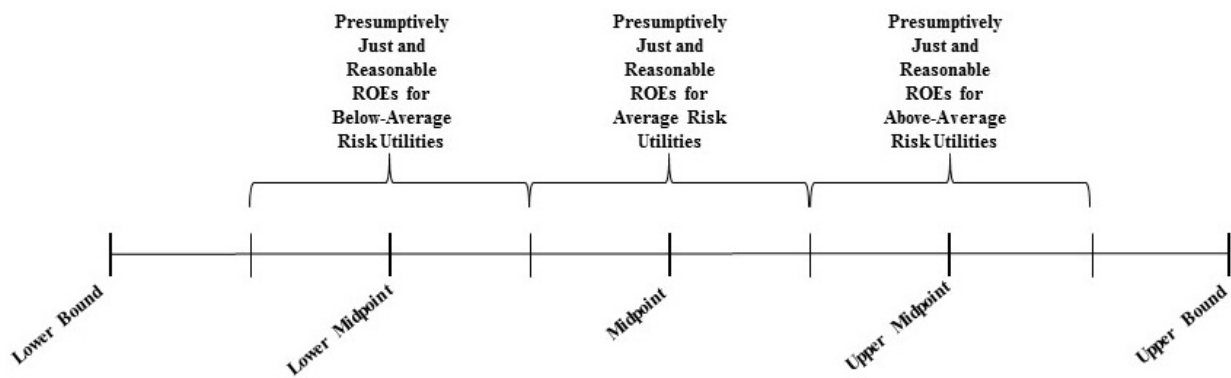
[57] In cases where the ROE of a single utility is at issue, the quartiles will be centered on the median of the overall zone of reasonableness for a single utility of average risk and the medians of the lower and upper halves of the zone of reasonableness for single utilities of below and above average risk, respectively.

30.   Pursuant to this framework, a finding that the existing ROE of an average risk utility falls within the applicable range of presumptively just and reasonable ROEs (in the case of an average risk utility, the middle quartile of the newly-calculated zone of reasonableness)[58] would support a holding that the existing ROE has not been shown to be unjust and unreasonable under the first prong of FPA section 206, at least absent additional evidence to the contrary. By the same token, a finding that the existing ROE of an average risk utility falls outside that range may support a holding that that the ROE has become unjust and unreasonable.

31.   In evaluating whether an existing ROE has become unjust and unreasonable, the Commission may, in addition to applying the above framework, consider other indications of a change in capital market conditions since the existing ROE was established. For example, since the existing ROE was established, a significant decrease in financial indicators, such as prime interest rates and U.S. Treasury and public utility bond yields as well as changes in the returns on investments in other enterprises having corresponding risks, may indicate that the existing ROE has become unjust and unreasonable. A utility's cost of equity is determined, at least in part, by comparison with other potential investments. As the return on those investments fluctuates, so too will the utility's cost of equity and, by extension, the ROE needed to service that cost of equity.

32.   Lastly, it is important to explain how we propose to calculate the predicate, evidentiary zone of reasonableness that we will use to identify the range of presumptively just and reasonable ROEs. The Commission previously relied solely on the DCF model to produce the evidentiary zone of reasonableness. As explained below, we are concerned that relying on that methodology alone will not produce just and reasonable results. Therefore, we propose to expand the evidence on which we rely. Specifically, we propose to use the composite zone of reasonableness produced by the DCF, CAPM, and Expected Earnings models. Each of these three methodologies relies on a proxy group to determine a zone of reasonableness, and thus the top and bottom of the zone of reasonableness produced by each methodology can be averaged to determine a single composite zone of reasonableness. After determining the composite zone of reasonableness, we would then calculate the lower midpoint/median, midpoint/median, and upper midpoint/median of that zone. The presumptively just and reasonable ROEs for below-average-, average-, and above-average-risk utilities would then be the quartile of the zone corresponding to the lower midpoint/median, midpoint/median, and upper midpoint/median, respectively.

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[58] Similarly, for a utility of above-average risk, the zone of presumptively just and reasonable ROEs is the quartile centered on the upper midpoint/median; for a utility of below-average risk, the zone of presumptively just and reasonable ROEs is the quartile centered on the lower midpoint/median.

33.   As discussed below, because we are proposing to adopt a new approach to meeting the Commission's burden under the first prong of the FPA section 206 inquiry, we will institute a paper hearing on whether and how our approach should apply to the records assembled in the two complaints against MISO TOs' ROE.

B.   Determining a Just and Reasonable ROE

34.   The Commission has relied upon the DCF methodology to determine a just and reasonable ROE for a public utility since the 1980s. However, as the D.C. Circuit has repeatedly observed, the Commission is not required to rely upon the DCF methodology alone or even at all.[59] For the reasons that follow, we believe that, in light of current investor behavior and capital market conditions, relying on the DCF methodology alone will not produce a just and reasonable ROE. Instead, we propose to rely upon the results of all four financial models in the records for these proceedings: the DCF, CAPM, Expected Earnings, and Risk Premium models. We propose to give each of those four models equal weight by calculating a single cost of equity estimate for each model and then averaging those four figures together to produce the just and reasonable ROE. To determine the cost of equity figure for average risk utilities using the DCF, CAPM, and Expected Earnings models, we propose to calculate the midpoint or median of the zone of reasonableness produced by each model, depending upon whether we are determining the ROE of a diverse group of utilities or a single utility. Those three midpoint/median figures would then be averaged with the single numerical figure produced by the Risk Premium model. We propose to use the midpoint/medians of the resulting lower and upper halves of the zone of reasonableness to determine ROEs for below or above average risk utilities, respectively.

1.   Use of Multiple Financial Models

35.   In *Hope*, the Supreme Court held that "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial

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[59] *Tenn. Gas*, 926 F.2d at 1211 (explaining that the Commission is free to reject the DCF methodology, provided it adequately explains its reasons for doing so); *Elec. Consumers Res. Council v. FERC*, 747 F.2d 1511, 1514 n.6 (D.C. Cir. 1984) ("neither statutes nor decisions of this court require that the Commission utilize a particular formula or a combination of formulae to determine whether rates are just and reasonable"); *NEPCO*, 668 F.2d at 1345 ("FERC is not bound 'to the service of any single formula or combination of formulas.'" (quoting *FPC v. Natural Gas Pipeline Co.*, 315 U.S. at 586)); *see also Emera Maine*, 854 F.3d at 27 (noting that the Commission has authority to make "'pragmatic adjustments' to a utility's ROE" based on the facts of the particular case (quoting *FPC v. Nat. Gas Pipeline Co.*, 315 U.S. at 586)).

integrity of the enterprise, so as to maintain its credit and to attract capital."[60] Thus, a key consideration in determining just and reasonable utility ROEs is determining what ROE a utility must offer in order to attract capital, i.e., induce investors to invest in the utility in light of its risk profile.[61] As the Commission stated in Opinion No. 414-B,[62] "the cost of common equity to a regulated enterprise depends upon what the market expects not upon precisely what is going to happen."[63] Thus, in determining what ROE to award a utility, we must look to how investors analyze and compare their investment opportunities.

36.   The record in these proceedings includes four traditional methods investors may use to estimate the expected return from an investment in a company. These are the DCF, CAPM, Expected Earnings, and Risk Premium methodologies.[64] The DCF analysis provides a market-based approach based upon market-determined dividend yields and expected dividend growth. The CAPM provides a market-based approach determined by beta, a measure of the risk based upon the volatility of a company's stock price over time in comparison to the overall market, and the risk premium between the risk-free rate (generally, long-term U.S. Treasury bonds) and the market's return (generally, the return of the S&P 500 or another broad indicator for common stocks). The Expected Earnings methodology provides an accounting-based approach that uses investment analyst estimates of return (net earnings) on book value (the equity portion of a company's overall capital, excluding long-term debt). Finally, the Risk Premium methodology is a market-oriented methodology based on the premium investors require above the return they expect to earn on a bond investment to reflect the greater risk of a stock investment. In New Regulatory Finance, a leading academic text, Roger Morin explains that none of these methods "conclusively determines or estimates the expected return for an individual firm. Each methodology possesses its own way of examining investor behavior, its own premises, and its own set of simplifications of reality. Each

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[60] *Hope*, 320 U.S. at 603. *See also CAPP v. FERC*, 254 F.3d at 293 ("In order to attract capital, a utility must offer a risk-adjusted expected rate of return sufficient to attract investors.").

[61] *See Bluefield*, 262 U.S. at 692-93 (discussing factors an investor considers in making investment decisions).

[62] *Transcontinental Gas Pipe Line Corp.*, Opinion No. 414-B, 85 FERC ¶ 61,323 (1998) (Opinion No. 414-B).

[63] *Id.* at 62,268. *See also Kern River Gas Transmission Co.*, Opinion No. 486-B, 126 FERC ¶ 61,034, at P 120 (2009).

[64] *See, e.g.*, Roger A. Morin, *New Regulatory Finance* 428 (Public Utilities Reports, Inc. 2006) (Morin). These methods are described in the appendix to this order.

method proceeds from different fundamental premises that cannot be validated empirically."[65]

37.   Investors have varying preferences as to which of these or other methods they may use to inform their investment decisions. As Morin states, "Investors do not necessarily subscribe to any one method, nor does the stock price reflect the application of any one single method by the price-setting investor. There is no monopoly as to which method is used by investors."[66] While some investors may give some weight to a DCF analysis, it is clear that other investors place greater weight on one or more of the other methods for estimating the expected returns from a utility investment, as well as taking other factors into account. Thus, cost of equity estimates based on all four of the methods described above are a reasonable measure of investor expectations, since they are among the information that investors rely upon when making investment decisions.[67]

38.   In these circumstances, we believe that averaging the results of the three methods that produce zones of reasonableness—the DCF, CAPM, and Expected Earnings methodologies—will produce a composite zone of reasonableness that most accurately

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[65] Morin at 429. *See also* Docket No. EL15-45-000, Ex. MTO-1 at 12 ("Different methodologies have been developed to estimate investors' expected and required return on capital, but all such methodologies are merely theoretical tools and generally produce a range of estimates, based on different assumptions and inputs."); Docket No. EL15-45-000, Ex. MTO-1 at 28 ("While it is true that every approach to estimating the cost of equity is founded on a theoretical abstraction, each model is based on its own set of assumptions regarding investors' behavior and uses different capital market inputs."); Docket No. EL15-45-000, Ex. S-3 at 500 ("Theories are simplifications of reality and the models articulated from theories are necessarily abstractions from and simplifications of the existing world so as to facilitate understanding and explanation of the real world.") (quoting Morin at 255).

[66] Morin at 429. *See also* Docket No. EL15-45-000, Ex. MTO-1 at 13 ("The DCF method . . . is only one theoretical approach to gain insight into the return investors require; there are numerous other methodologies for estimating the cost of capital and the ranges (or zones) produced by the different approaches can vary widely.").

[67] We note that we will not consider the level of state ROEs when we are determining the composite zone of reasonableness, nor will we weight it equally with the financial models in establishing a new just and reasonable ROE. We will, however, consider evidence of state ROEs to the extent that the record adequately demonstrates that investors are using it to inform their investment decisions.

captures the cost of equity[68] that informs the ROE that the Commission must award to a utility so that the ROE can provide the return to investors necessary to satisfy their expectations. Additionally, the Risk Premium methodology should be included in the calculation of the average return of the composite zone of reasonableness for the same reason. Giving equal weight to all four of these methodologies in determining a utility's ROE is supported by Morin:

> In the absence of any hard evidence as to which method outdoes the other, all relevant evidence should be used and weighted equally, in order to minimize judgmental error, measurement error, and conceptual infirmities. A regulator should rely on the results of a variety of methods applied to a variety of comparable groups, and not on one particular method. There is no guarantee that a single DCF result is necessarily the ideal predictor of the stock price and of the cost of equity reflected in that price, just as there is no guarantee that a single CAPM or Risk Premium result constitutes the perfect explanation of that stock price.[69]

39.   Record testimony also supports using multiple methodologies to determine a utility's ROE. For example, Mr. Adrien M. McKenzie testified on behalf of MISO TOs that "the Commission should consider alternative methods and ROE benchmarks in all conditions and in all cases, because the DCF model – like any model . . . is not infallible."[70] Similarly, Ms. Ellen Lapson testified on behalf of MISO TOs that "it is wise to consider a broader set of evidence from alternate models and methods of estimating investors' cost of equity . . . . Although all such methods are potentially subject to error, the use of multiple models that are based on different underlying assumptions provides a check on the reasonableness of the results of the DCF model and the placement of the [MISO TOs'] base ROE with the DCF range."[71]

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[68] A utility's cost of equity is the return that the utility must provide its shareholders in order to induce them to invest their capital in that utility. A utility's ROE is the return that the utility generates by using that invested capital in its operations.

[69] Morin at 429.

[70] Docket No. EL15-45-000, Ex. MTO-22 at 21; *see also* Docket No. EL15-45-000, Tr. 283:16-284:2 (McKenzie) (explaining "that alternative benchmarks should be considered, even when conditions are not anomalous….[as] that's widely done in other jurisdictions. And I think given the fact that no particular method is infallible, it makes sense to check the results of any method with the results of other approaches.").

[71] Docket No. EL14-12-001, Ex. MTO-39 at 37.

40.   Moreover, any methodology has the potential for errors or inaccuracies. Therefore, relying exclusively on any single methodology increases the risk that the Commission could authorize an unjust and unreasonable ROE. For example, in discussing "model risk," Mr. McKenzie explained that "when conditions associated with a model are outside of the normal range, there is a risk . . . that the theoretical model will fail to predict or represent the real phenomenon that is being modeled."[72] There is significant evidence indicating that combining estimates from different models is more accurate than relying on a single model.[73] We conclude that, by providing four different approaches to estimating the cost of equity and determining ROEs, using these models together reduces the risk associated with relying on only one model; that is, the risk of misidentifying the just and reasonable ROE by relying on a flawed cost of equity estimate.

41.   In the briefs directed by this order, the participants may address the merits of these models and whether there should be any adjustments in the manner these models were implemented in Opinion No. 551. In Opinion No. 551, the Commission emphasized that it was using the alternative methodologies only for the purpose of corroborating the

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[72] Docket No. EL15-45-000, Ex. MTO-22 at 18-19 (citations omitted). *See also* Morin at 428 ("Reliance on any single method or preset formula is inappropriate when dealing with investor expectations because of possible measurement difficulties and vagaries in individual companies' market data."); *id.* at 429-30 ("If a regulatory commission relies on a single cost of equity estimate or on a single methodology, that commission greatly limits its flexibility and increases the risk of authorizing unreasonable rates of return. The results from one methodology . . . are likely to contain a high degree of measurement error and may be distorted by short-term aberrations.").

[73] *See, e.g.*, *In re. Connect Am. Fund*, 28 FCC Rcd. 7123, 7147 (2013) ("As the cost of equity reflects the uncertain expectations of investors, there is potential for introducing significant errors into the estimates, and no single model can be counted on exclusively to provide a precise estimate of the cost of equity."); *Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry's Cost of Capital*, STB Ex Parte No. 664 (Sub-No. 1), 2009 WL 197991, *11 (S.T.B. Jan. 23, 2009) ("As the Federal Reserve Board noted in its testimony in STB Ex Parte No. 664, academic studies had demonstrated that using multiple models will improve estimation techniques when each model provides new information. In addition, there is robust economic literature confirming that, in many cases, combining forecasts from different models is more accurate than relying on a single model.") (citations omitted); EL15-45-000, Ex. MTO-1 at 28 ("Rather, reference to the results of a number of well accepted methodologies provides greater clarity regarding the extent to which DCF results may be distorted, and the use of multiple benchmarks is useful in guiding the determination of a just and reasonable ROE within the zone of reasonableness.").

decision to place the ROE above the midpoint of the zone of reasonableness,[74] and therefore, in discussing the alternative methodologies, the Commission explained that it was "appropriate to look at other record evidence to inform the just and reasonable placement of the ROE within the zone of reasonableness produced by the DCF methodology."[75] The fact that the Commission is now proposing to give equal weight to the alternative models along with the DCF methodology raises the issue of whether there should be any adjustments in how we implement them.

2.   Difficulties with Sole Reliance on the DCF Methodology

42.   Our proposal to rely on multiple methodologies in these two complaint proceedings is based on our conclusion that the DCF methodology may no longer singularly reflect how investors make their decisions. We believe that, since we adopted the DCF methodology as our sole method for determining utility ROEs in the 1980s, investors have increasingly used a diverse set of data sources and models to inform their investment decisions.[76] Investors appear to base their decisions on numerous data points and models, including the DCF, CAPM, Risk Premium, and Expected Earnings methodologies.[77] As demonstrated in Figure 2 below, which shows the ROE results

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[74] *See, e.g.*, Opinion No. 551, 156 FERC ¶ 61,234 at PP 66, 135.

[75] *Id.* P 137. For example, the Commission found that "MISO TOs' risk premium analysis is sufficiently reliable to corroborate our decision to place MISO TOs' base ROE above the midpoint of the zone of reasonableness produced by the DCF analysis." *Id.* P 195.

[76] *See, e.g.*, Docket No. EL15-45-000, Ex. MTO-22 at 92 ("The risk premium, CAPM, and expected earnings benchmarks . . . are generally accepted and widely referenced by investors, analysis, and regulators as useful methodologies to estimate the cost of equity"); Docket No. EL15-45-000, Ex. MTO-1 at 66 ("As explained in *New Regulatory Finance*, '[r]eliance on any single method or preset formula is inappropriate when dealing with investor expectations because of the possible measurement difficulties and vagaries in individual companies' market data") (quoting Morin at 428).

[77] *See, e.g.*, Docket No. EL14-12-001, Ex. MTO-1 at 96 ("The CAPM approach generally is considered to be the most widely referenced method for estimating the cost of equity among academicians and professional practitioners . . . ."); *id.* at 99 ("[The risk premium approach] is routinely referenced by the investment community and in academia and regulatory proceedings . . . ."); *id.* at 94 ("the expected earnings approach provides a direct guide to ensure that the allowed ROE is similar to what other utilities of comparable risk will earn on invested capital.").

from the four models over the two test periods at issue in these proceedings,[78] the DCF model does not always correspond to movements or lack thereof in other models. In addition, as illustrated in the Coakley Briefing Order, over longer periods, the four models can diverge from each other even more, underscoring the problem of only relying on one of them.[79] In fact, in some instances, their cost of equity estimates may move in opposite directions over time. Although we recognize the greater administrative burden on parties and the Commission to evaluate multiple models, we believe that the DCF methodology alone no longer captures how investors view utility returns because investors do not rely on the DCF alone and the other methods used by investors do not necessarily produce the same results as the DCF. Consequently, it is appropriate for our analysis to consider a combination of the DCF, CAPM, Risk Premium, and Expected Earnings approaches.

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[78] The midpoints are used for the DCF, CAPM, and Expected Earnings analyses; however, the Risk Premium model does not produce a range from which to calculate a midpoint, so the actual Risk Premium output is the numerical point plotted for that model in the figure. This chart reflects the ROE models removing high-end and low-end outliers, as discussed below.

[79] *See Coakley* Briefing Order, 165 FERC ¶ 61,030 at Figure 2. The test periods in the four complaint proceedings involving the New England TOs' ROE include four six-month periods within the five years from October 2012 to October 2017. Specifically, those six month periods were October 2012 to March 2013, September 2013 to February 2014, November 2014 to April 2014, and May to October 2017. The two test periods at issue in this case are the first and second halves of 2015.

Figure 2: ROE Results from ROE Models
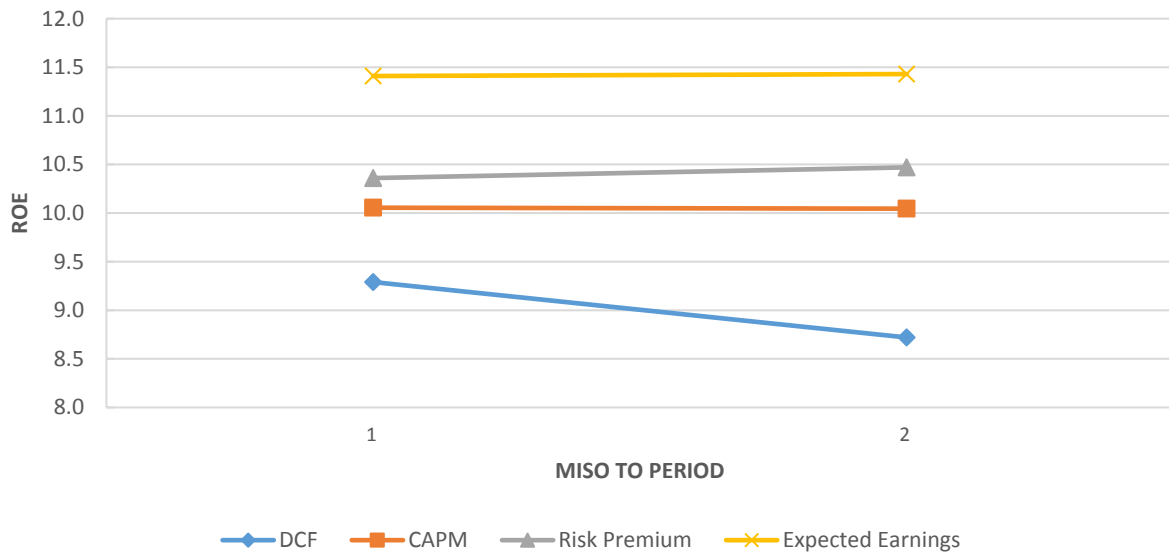
43.   During the periods used for the DCF analyses in these two complaint proceedings, capital market conditions differed significantly from those during the mid-1980s, when the Commission began relying exclusively on the DCF methodology to set ROEs, through the mid-2000s, when the Commission set MISO TOs' preexisting 12.38 percent ROE. For example, except for brief periods in 2002-2004, the 10-year U.S. Treasury bond never fell below 4.00 percent during that entire period until January 2008, and its lowest rate was 3.33 percent in June 2003.

44.   In contrast, the 10-year U.S. Treasury bond rates, beginning with the recession of 2008/2009 and continuing through the periods at issue in these proceedings, are the lowest since the early 1960s.[80] In December 2008, the 10-year U.S. Treasury bond rate fell below 3.00 percent for the first time since June 1958.[81] During the six-month periods used for the DCF analyses in these two complaint proceedings, the 10-year U.S. Treasury bond rate was always below 2.50 percent. During the January to June 2015 period at issue in the First Complaint, the 10-year U.S. Treasury bond rate ranged from 1.88 to

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[80] *See* Aswath Damodaran, *Equity Risk Premiums: Determinates, Estimation and Implications – The 2014 Edition* 81 (7th ed. 2014) (submitted as part of Workpapers of J. Randall Woolridge in Docket Nos. EL13-33-002 and EL14-86-000).

[81] *See* Docket No. EL14-12-001, Ex. S-1 at 13.

2.36 percent.[82] During the July to December 2015 period at issue in the Second
Complaint, the 10-year U.S. Treasury bond rate ranged from 2.07 to 2.32 percent.[83]

45.   In Opinion No. 551, the Commission relied on the low 10-year U.S. Treasury
bond yields during the January to June 2015 period to find that capital market conditions
were "anomalous" during that period.[84] The Commission found that, in those
circumstances, the Commission had "less confidence" that the midpoint of the zone of
reasonableness determined by the DCF analysis satisfied the *Hope* and *Bluefield* capital
attraction standards.[85] The Commission then considered the alternative cost of equity
models to corroborate the Commission's determination to set MISO TOs' ROE "at a
point above the midpoint" of the DCF analysis' zone of reasonableness, i.e., the midpoint
of the upper half of the zone.[86] However, the Commission emphasized that it was not
departing from the use of the DCF methodology to determine the zone of
reasonableness.[87] At the hearings on the Second Complaint, the participants devoted a
substantial portion of their evidentiary presentations to debating whether the continuing
low-interest rate capital market conditions should be considered "anomalous" and
whether those conditions distort the results of a DCF analysis.[88]

46.   Those issues are largely irrelevant under the approach to determining just and
reasonable ROEs that we are proposing in this order. Under this approach, we are
averaging the cost of equity results produced by the DCF model and the other three
models, using the midpoint/medians of the models that produce zones of reasonableness,
to get one average figure for the cost of equity. We are not making an adjustment above

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[82] During this six-month period, the average 10-year U.S. Treasury bond rate was
2.07 percent and the average 30-year U.S. Treasury bond rate was 2.72 percent. *See*
Docket No. EL14-12-001, Ex. JC-16 at 1; *see also* Docket No. EL15-45-000, Ex. S-5 at
1.

[83] During this six-month period, the average 10-year U.S. Treasury bond rate was
2.21 percent and the average 30-year U.S. Treasury bond rate was 2.96 percent. *See*
Docket No. EL15-45-000, Ex. S-5 at 8.

[84] Opinion No. 551, 156 FERC ¶ 61,234 at P 121.

[85] *Id.* P 122.

[86] *Id.* P 135.

[87] *Id*. P 137.

[88] *See, e.g.*, Docket No. EL15-45-000, Exs. JCA-1 at 6-18, JCI-1 at 29-32, 38,
ICG-15 at 18-30, MTO-1 at 21-28, 102-105, MTO-16 at 16-38.

the midpoint/median as we did in Opinion No. 551. There is thus no need to find that low-interest rate capital market conditions distort the results of a DCF analysis so as to justify adjusting the ROE for average risk utilities above the midpoint. To the contrary, our primary reason for proposing to average the results of a DCF analysis with the results of the CAPM, Expected Earnings, and Risk Premium analyses is that investors use those models, in addition to the DCF methodology, to inform their investment decisions. Under this approach, whether 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. As discussed above, a key consideration in determining just and reasonable utility ROEs is determining what ROE a utility must offer in order to attract capital, i.e., induce investors to invest in the utility in light of its risk profile. For this purpose, we must look to the methods investors use to analyze and compare their investment opportunities in determining what ROE to award a utility consistent with the *Hope* and *Bluefield* capital attraction standards, and those methods include methods other than the DCF methodology.

47.   We also note that, in recent years, utility stock prices appear to have performed in a manner inconsistent with the theory underlying the DCF methodology.[89] Under that theory, increases in a company's actual earnings or projected growth in earnings would ordinarily be required to justify an increase in the company's stock price. However, as described in the *Coakley* Briefing Order, although the Dow Jones Utility Average increased by almost 70 percent from October 1, 2012 through December 1, 2017, there was not an increase in either utility earnings or projected earnings during that period that would justify the substantial increase in stock prices. This is an example of what MISO TOs have described as "model risk" —the risk that in some circumstances a model will produce results that do not reflect real world experience.[90] It appears that, for whatever the reason, investors have seen greater value in utility stocks than the DCF methodology

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[89] *See Coakley* Briefing Order, 165 FERC ¶ 61,030 at P 45.

[90] *See* Docket No. EL15-45-000, Ex. MTO-16 at 36 ("There is 'model risk' associated with the excessive reliance or mechanical application of a model when the surrounding conditions are outside of the normal range. 'Model risk' is the risk that a theoretical model that is used to value real-world transactions fails to predict or represent the real phenomenon that is being modeled. Although the concept of model risk was originally applied to derivative instruments and hedging transactions, it applies equally to models used to value companies, to manage investment portfolios, to assign credit ratings, or in this case, to determine the ROE that will provide a fair return and encourage investment in critical infrastructure.").

would predict. This suggests that the ROE estimated by that methodology may be correspondingly inaccurate.

48.   We are also generally concerned with the low number of current IBES three to five-year earnings growth projections available for use in a two-step DCF analysis. The Commission has based the short-term growth projection in the two-step DCF analysis on IBES three to five year earnings growth projections because those growth projections represent the consensus projection of a number of investment analysts.[91] For example, the Commission's 1999 decision in *Northwest* found that the IBES data "reflects an average of *numerous* projections of short-term growth of the proxy companies."[92] In that same decision, the Commission rejected the use of Value Line growth projections because those projections are made by a single analyst.[93] Although IBES growth projections represented a consensus in the past, we are concerned that they may not reflect as robust a consensus, or perhaps any consensus, now. The majority of investment analysts that make and publish quarterly and annual earnings estimates no longer make and publish three-to-five year short-term projections of earnings growth. The *Coakley* Briefing Order described evidence that in recent years the IBES data for many proxy companies have reflected only one to three analyst short-term growth projections.[94]

49.   The reduced number of current IBES growth projections raises the question of whether the IBES growth rates reflect a consensus among investors. Further, the reduced number of short-term growth projections means that a significant change in a single analyst's growth projection for a particular proxy company can have a major effect on the DCF analysis result for that company.[95] Accordingly, the decreased number of short-term growth projections necessary to perform a DCF analysis of the proxy companies reduces our confidence in the results of that analysis and its suitability as the sole basis for our ROE determinations. However, because at least some investors continue to use

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[91] Opinion No. 414-B, 85 FERC ¶ 61,323 at 62,268-69. *Northwest Pipeline Corp.* 87 FERC ¶ 61,266, at 62,058-9 (1999) (*Northwest*). *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048, at PP 75-76 (2008).

[92] *Northwest*, 87 FERC at 62,059 (emphasis added).

[93] *Id*.

[94] *See Coakley* Briefing Order, 165 FERC ¶ 61,030 at P 47.

[95] *See e.g., id.* P 48 (noting, for example, that one analyst's error involving the growth projection for Portland General Electric Company (Portland General) reduced the overall Reuters consensus projected short-term percentage growth in earnings for Portland General from 10.96 percent to 7.80 percent).

the DCF model, we believe that it is reasonable to give that model some weight, along with other models used by investors, in the overall approach to determining ROE proposed in this order.

3.   Proxy Groups to be used for DCF, CAPM, and Expected Earnings Analyses

50.   As described above, three of the four methodologies that we discussed above for determining the cost of equity use proxy groups to determine a range of reasonable returns. These include the DCF, CAPM, and Expected Earnings analyses. In selecting these proxy groups, the Commission intends to continue to use the same screens for developing a proxy group as the Commission has used in recent cases, including Opinion Nos. 531[96] and 551.[97] These screens are: (1) the use of a national group of companies considered electric utilities by Value Line;[98] (2) the inclusion of companies with credit ratings no more than one notch above or below the utility or utilities whose ROE is at issue;[99] (3) the inclusion of companies that pay dividends and have neither made nor announced a dividend cut during the six month study period;[100] (4) the inclusion of companies with no merger activity during the six-month study period that is significant enough to distort the study inputs;[101] and (5) companies whose ROE results pass threshold tests of economic logic, including both a low-end outlier test and a high-end outlier test, as discussed below.

51.   The first four screens listed above evaluate particular characteristics of the companies in question that do not vary depending upon the results of the DCF, CAPM, or Expected Earnings analyses. Accordingly, those screens may be used to develop a single group of proxy companies eligible for inclusion in the proxy group to be used for the purposes of DCF, CAPM, and Expected Earnings analyses, subject to the availability of data such as three-to-five year growth rates, betas, and earnings estimates, respectively. However, application of the last screen—whether the company's cost of equity estimate passes threshold tests of economic logic—depends upon the cost of equity estimate each

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[96] 147 FERC ¶ 61,234 at P 97.

[97] 156 FERC ¶ 61,234 at P 20.

[98] Opinion No. 531, 147 FERC ¶ 61,234 at PP 96 and 100-102.

[99] The Commission requires use of both Standard and Poor's corporate credit ratings and Moody's issuer ratings when both are available. *Id.* P 107.

[100] *Id.* P 112.

[101] *Id.* P 114; Opinion No. 551, 156 FERC ¶ 61,234 at PP 37-43.

of the three models produces. Thus, in determining the zone of reasonableness produced by each of these models, the low-end and high-end outlier tests must be applied separately to each model.

52.   Under the low-end outlier test, the Commission excludes from the proxy group companies whose ROE fails to exceed the average 10-year bond yield by approximately 100 basis points, taking into account any natural break between the cost of equity estimates of the companies excluded from the proxy group and the lowest cost of equity estimate of the companies included in the proxy group.[102] The Commission excludes these low-end outliers on the ground that investors generally cannot be expected to purchase a common stock if debt, which has less risk than a common stock, yields essentially the same expected return.[103] The Commission will continue to use this test for purposes of the CAPM and Expected Earnings analyses as well as the DCF analysis.

53.   As noted in the *Coakley* Briefing Order with respect to use of the high-end outlier test, neither the CAPM nor Expected Earnings analyses include a long-term growth projection based on GDP that would normalize the ROEs produced by the model, similar to that used in the two-step DCF methodology. Moreover, the Commission recognizes that in unusual circumstances the two-step DCF methodology may produce unsustainably high results for a particular proxy company. Accordingly, given these facts and our decision to give the same weight to the CAPM and Expected Earnings analyses as to the DCF analysis, we believe that a high-end outlier test should be applied to the results of each of these three methods.

54.   Consistent with the *Coakley* Briefing Order, we propose to treat as high-end outliers any proxy company whose cost of equity estimated with a given model 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 similar to the approach the Commission uses for low-end DCF analysis results.[104] This test should identify those companies whose cost of equity under the model in question is so far above the cost of equity of a typical proxy company as to suggest that it is the result of atypical circumstances not representative of the risk profile of a more normal utility.

55.   To illustrate how this high-end outlier test would be applied, in the First Complaint, this test would exclude two companies from the proxy group used for the Expected Earnings analysis. The median ROE under that methodology of all the companies eligible for inclusion in the proxy group after applying the first four screens

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[102] Opinion No. 531, 147 FERC ¶ 61,234 at P 123.

[103] *S. Cal. Edison Co.*, 92 FERC ¶ 61,070, at 61,266 (2000).

[104] *Coakley* Briefing Order, 165 FERC ¶ 61,030 at P 53.

described above is 10.20 percent. One hundred fifty percent of 10.20 percent is 15.30 percent. Dominion Resources Inc.'s (Dominion) and ITC Holding Corp.'s (ITC Holdings) cost of equities under the Expected Earnings analysis are 18.24 percent and 16.37 percent, respectively, and therefore this test would exclude Dominion and ITC Holdings in the determination of the Expected Earnings zone of reasonableness for the First Complaint. The next highest Expected Earnings ROEs in that proceeding is 15.21 percent for Vectren Corp. Thus, there is a 116 basis point break between ITC Holding's 16.37 percent ROE and Vectren Corp's 15.21 percent, which is large enough to constitute a significant break under the proposed high-end outlier test. In the First Complaint, this high-end outlier test does not eliminate any company from the proxy groups used in the DCF or CAPM analyses. The elimination of such outliers is particularly important where the Commission uses the midpoint of the zone of reasonableness because a single outlier can dramatically affect the resulting ROE.

C.   **Preliminary Results of Applying Proposed Approach to the First Complaint**

56.   Having described, above, our proposed approaches to determining whether (1) an existing ROE is unjust and unreasonable under the first prong of FPA section 206 and (2) if so, what the replacement ROE should be under the second prong of FPA section 206, we now explain how those approaches would apply in the First Complaint. This description represents the Commission's preliminary determinations as to how we should resolve the issues remanded by the D.C. Circuit in *Emera Maine*. However, as described in the next section, we are also directing participants to file briefs regarding our proposed approaches to the FPA section 206 inquiry and how they should apply to the Second Complaint.

57.   Under our proposed framework for determining whether MISO TOs' preexisting 12.38 percent ROE is unjust and unreasonable under the first prong of FPA section 206, we must first determine what a composite zone of reasonableness would be. For this purpose, we find that the DCF zone of reasonableness, as determined in Opinion No. 551 based on financial data from the period January to June 2015, is 7.23 percent to 11.35 percent.[105] Similarly, the CAPM zone of reasonableness as determined in Opinion No. 551 is 7.50 percent to 12.61 percent.[106] With the adjustment discussed in the preceding section, the Expected Earnings approach's zone of reasonableness is 7.61 percent to 15.21 percent. Averaging these results, we determine that the composite zone of reasonableness is 7.45 percent to 13.06 percent. The top of this new composite zone of

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[105] Opinion No. 551, 156 FERC ¶ 61,234 at P 65.

[106] *Id.* PP 140, 165.

reasonableness would also determine the cap for the total ROE, i.e., the base ROE plus any ROE incentives.

58.   It is undisputed that MISO TOs are of average risk. Accordingly, the range of presumptively just and reasonable ROEs for MISO TOs is the middle quartile of the composite zone of reasonableness.[107] As discussed above, this represents the "broad range of potentially lawful ROEs" for MISO TOs that the D.C. Circuit contemplated in *Emera Maine* for purposes of determining whether an existing ROE is unjust and unreasonable under the first prong of FPA section 206. Here, that range specifically corresponds to the one quarter of the overall zone of reasonableness centered around the 10.26 percent midpoint of the zone of reasonableness. That quarter of the 7.45 percent to 13.06 percent zone of reasonableness is 9.55 percent to 10.95 percent. MISO TOs' preexisting 12.38 percent ROE is outside this range of potentially lawful ROEs; it is closer to the current just and reasonable ROE for a utility of above average risk than for utilities of average risk such as MISO TOs. This supports a finding that a 12.38 percent ROE is unjust and unreasonable for average risk utilities, such as MISO TOs. If any total ROEs—i.e., base ROE plus incentive ROE adders—exceed 13.06 percent, we would find those ROEs unjust and unreasonable as well.

59.   Moreover, a finding that MISO TOs' preexisting 12.38 ROE has become unjust and unreasonable is buttressed by the substantial change in capital market conditions since the Commission established that ROE. The 12.38 percent ROE was based on a DCF analysis using financial data from August 2001 to January 2002.[108] During the August 2001 to January 2002 period, average Baa corporate bond yields ranged from 7.81 percent to 8.05 percent. By contrast, during the January to June 2015 period at issue in the First Complaint, Baa corporate bond yields ranged from 4.45 percent to 5.13 percent. The substantial reduction in Baa corporate bond yields since MISO TOs' preexisting 12.38 percent ROE was established buttresses a finding that capital market conditions have so changed as to render that ROE unjust and unreasonable. Based on these facts, we would reaffirm our holding in Opinion No. 551 that MISO TOs' preexisting ROE is unjust and unreasonable.

60.   We thus turn to selecting a replacement just and reasonable ROE for MISO TOs. Under the approach outlined above, to select a replacement just and reasonable ROE, we average the central tendencies of the zones of reasonableness produced by the DCF, CAPM, and Expected Earnings analyses together with the estimated cost of equity produced by the Risk Premium method, with each figure being given equal weight. Accordingly, we average the 9.29 percent midpoint of the DCF analysis, the 10.06

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[107] MISO TOs being a diverse group of average risk utilities, the relevant central tendency is the midpoint. *See supra* n.40.

[108] *Midwest Indep. Transmission Sys. Operator, Inc.*, 99 FERC ¶ 63,011 at P 33, *aff'd,* 100 FERC ¶ 61,292.

percent midpoint of the CAPM analysis, the 11.41 percent midpoint of the Expected Earnings analysis, and the 10.36 percent result of the Risk Premium analysis to arrive at a preliminary 10.28 percent just and reasonable ROE for MISO TOs, exclusive of incentives. Further, we would cap any preexisting incentive-based total ROE above 13.06 percent at 13.06 percent.

61.   If the Commission adopts this finding in its order following the briefing directed by this order, the Commission will exercise its "broad remedial authority" to correct its legal error in order to make the 10.28 percent ROE, exclusive of incentives, effective as of the September 28, 2016 date of Opinion No. 551, and the Commission will order refunds of amounts collected in excess of 10.28 percent pursuant to the 10.32 percent ROE established by that opinion.[109] Accordingly, the issue to be addressed in the Second Complaint is whether the ROE established on remand in the First Complaint remained just and reasonable based on financial data for the six-month period July to December 2015 addressed by the evidence presented by the participants in the Second Complaint.

D.   **Briefing**

62.   As discussed above, we are directing the participants to these proceedings to submit briefs regarding the proposed approaches to the FPA section 206 inquiry and whether and how to apply them to the First and Second Complaints. The participants should submit separate briefs regarding each of the two complaints. In addition, the participants may supplement the record with additional written evidence as necessary to support the arguments advanced in their briefs.[110] However, to the extent that participants submit additional financial data or evidence concerning economic conditions in any proceeding it must relate to periods before the conclusion of the hearings in the relevant complaint proceeding. Any additional evidence shall be submitted in the form of affidavits accompanying the relevant brief(s). Initial briefs shall be due 60 days from the

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[109] Opinion No. 551, 156 FERC ¶ 61,234 at PP 9, 67.

[110] *See Consolidated Edison of N.Y., Inc. v. FERC*, 315 F.3d 316, 323 (D.C. Cir. 2003) (holding that the Commission may apply a new policy "retroactively to the parties in an ongoing adjudication, so long as the parties before the agency are given notice and an opportunity to offer evidence bearing on the new standard") *Town of Norwood, Mass. v. FERC*, 80 F.3d 526, 535 (D.C. Cir. 1996) (holding that, "the Commission takes account of changes that occur between the ALJ's decision and the Commission's review of that decision . . . the Commission may not depart from the zone of reasonableness on the basis of the change without giving parties an opportunity to reopen the record" (citing *Union Elec. Co. v. FERC,* 890 F.2d 1193, 1201-04 (D.C. Cir. 1989))); *see also Clark-Cowlitz Joint Operating Agency v. FERC*, 826 F.2d 1074, 1081 (D.C. Cir. 1987) (*en banc*) (discussing factors that the D.C. Circuit considers when determining whether it would be inappropriate to apply new policy retrospectively).

date of this order. Responses to those initial briefs shall be due 30 days later. No answers or additional briefs will be permitted.

The Commission orders:

    The participants are directed to submit supplemental briefs and additional written evidence, as discussed in the body of this order.

By the Commission. Commissioner McIntyre is not voting on this order.

(S E A L)

                              Nathaniel J. Davis, Sr.,
                                Deputy Secretary.

Appendix

The four traditional methods investors may use to estimate the expected return from an investment in a company.

DCF Methodology

With simplifying assumptions, the formula for the DCF methodology reduces to: P = D/k-g, where "P" is the price of the common stock, "D" is the current dividend, "k" is the discount rate (or investors' required rate of return), and "g" is the expected growth rate in dividends. For ratemaking purposes, the Commission rearranges the DCF formula to solve for "k", the discount rate, which represents the rate of return that investors require to invest in a company's common stock, and then multiplies the dividend yield by the expression (1+.5g) to account for the fact that dividends are paid on a quarterly basis. Multiplying the dividend yield by (1+.5g) increases the dividend yield by one half of the growth rate and produces what the Commission refers to as the "adjusted dividend yield." The resulting formula is known as the constant growth DCF methodology and can be expressed as follows: k=D/P (1+.5g) + g. Under the Commission's two-step DCF methodology, the input for the expected dividend growth rate, "g," is calculated using both short-term and long-term growth projections.[111] Those two growth rate estimates are averaged, with the short-term growth rate estimate receiving two-thirds weighting and the long-term growth rate estimate receiving one-third weighting.[112]

CAPM

Investors use CAPM analysis as a measure of the cost of equity relative to risk.[113] The CAPM methodology is based on the theory that the market-required rate of return for a security is equal to the risk-free rate, plus a risk premium associated with the specific security. Specifically, the CAPM methodology estimates the cost of equity by taking the "risk-free rate" and adding to it the "market-risk premium" multiplied by "beta."[114] The risk-free rate is represented by a proxy, typically the yield on 30-year U.S. Treasury bonds.[115] Betas, which are published by several commercial sources, measure a specific stock's risk relative to the market. The market risk premium is calculated by subtracting

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[111] Opinion No. 531, 147 FERC ¶ 61,234 at PP 15-17, 36-40; Opinion No. 531-A, 149 FERC ¶ 61,032 at P 10.

[112] Opinion No. 531, 147 FERC ¶ 61,234 at PP 17, 39.

[113] *Id.* P 147.

[114] Morin at 150.

[115] *Id.* at 151.

the risk-free rate from the expected return. The expected return can be estimated either using a backward-looking approach, a forward-looking approach, or a survey of academics and investment professionals.[116] A CAPM analysis is backward-looking if the expected return is determined based on historical, realized returns.[117] A CAPM analysis is forward-looking if the expected return is based on a DCF analysis of a large segment of the market.[118] Thus, in a forward-looking CAPM analysis, the market risk premium is calculated by subtracting the risk-free rate from the result produced by the DCF analysis.[119]

Risk Premium

The risk premium methodology, in which interest rates are also a direct input, is "based on the simple idea that since investors in stocks take greater risk than investors in bonds, the former expect to earn a return on a stock investment that reflects a 'premium' over and above the return they expect to earn on a bond investment."[120] As the Commission found in Opinion No. 531, investors' required risk premiums expand with low interest rates and shrink at higher interest rates. The link between interest rates and risk premiums provides a helpful indicator of how investors' required rate of return have been impacted by the interest rate environment.

Multiple approaches have been advanced to determine the equity risk premium for a utility.[121] For example, a risk premium can be developed directly, by conducting a risk premium analysis for the company at issue, or indirectly by conducting a risk premium analysis for the market as a whole and then adjusting that result to reflect the risk of the company at issue.[122] Another approach for the utility context is to "examin[e] 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.

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[116] *Id.* at 155-162.

[117] *Id.* at 155-156.

[118] *Id.* at 159-160.

[119] *See id.* at 150, 155.

[120] Opinion No. 531, 147 FERC ¶ 61,234 at P 147 (citing Morin at 108).

[121] *See generally* Morin at 107-130.

[122] *Id.* at 110.

Treasury bond yield."[123]

Expected Earnings

A comparable earnings analysis is a method of calculating the earnings an investor expects to receive on the book value of a particular stock. The analysis can be either backward looking using the company's historical earnings on book value, as reflected on the company's accounting statements, or forward-looking using estimates of earnings on book value, as reflected in analysts' earnings forecasts for the company.[124] The latter approach is often referred to as an "Expected Earnings analysis." The returns on book equity that investors expect to receive from a group of companies with risks comparable to those of a particular utility are relevant to determining that utility's cost of equity, because those returns on book equity help investors determine the opportunity cost of investing in that particular utility instead of other companies of comparable risk.[125] Because investors rely on Expected Earnings analyses to help estimate the opportunity cost of investing in a particular utility, we find this type of analysis useful in determining a utility's ROE.

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[123] *Id.* at 123.

[124] *See* Opinion No. 531-B, 150 FERC ¶ 61,165 at P 125.

[125] *Id.* P 128.