

UNITED STATES OF AMERICA  
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Pat Wood, III, Chairman;  
Nora Mead Brownell, Joseph T. Kelliher,  
and Suedeen G. Kelly.

Midwest Independent Transmission System  
Operator, Inc.

Docket No. ER02-485-003

ORDER ON REMAND

(Issued March 26, 2004)

1. This case is before the Commission on voluntary remand from the United States Court of Appeals for the District of Columbia Circuit (D.C. Circuit Court).<sup>1</sup> At issue is the Commission's prior determination in this proceeding to utilize the midpoint approach, further explained below, in setting the return on common equity component (ROE) used in the formula calculation of transmission service rates for the Midwest Independent Transmission System Operator, Inc. (Midwest ISO) transmission owners (TOs).<sup>2</sup> In this order, we further discuss and reaffirm our decision to utilize the midpoint approach in calculating the ROE for entities that have ceded operational control of their transmission facilities to the Midwest ISO. Our action in this order helps to ensure just and reasonable rates for customers in the Midwest region.

**Background**

2. On December 3, 2001, pursuant to Section 205 of the Federal Power Act<sup>3</sup> (FPA), the Midwest ISO filed proposed revisions to its Open Access Transmission Tariff

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<sup>1</sup> Public Service Commission of the Commonwealth of Kentucky, v. Federal Energy Regulatory Commission, (Nos. 03-1092 and 03-1097 (Consolidated) D.C. Cir. January 21, 2004).

<sup>2</sup> Midwest Independent Transmission System Operator, Inc., 100 FERC ¶ 61,292 (2003) (September 23 Order), order denying reh'g, Midwest Independent Transmission System Operator, Inc., 102 FERC ¶ 61,143 (2003) (February 5 Order).

<sup>3</sup> 16 U.S.C. § 824d (2000).

(OATT), in order to, among other things, increase the ROE from 10.5 to 13 percent for all Midwest ISO pricing zones, except one.<sup>4</sup> The Commission accepted and suspended for a nominal period the proposed ROE, to become effective, subject to refund, on February 1, 2002, and established expedited hearing procedures.

3. For reasons detailed in the Initial Decision, the Administrative Law Judge (ALJ) found that the ROE should be set at 12.38 percent.<sup>5</sup> Briefly summarized, the ALJ accepted a discounted cash flow (DCF) analysis of a proxy group consisting of nine Midwest ISO TOs; calculated a zone of reasonable returns for that proxy group, which ranged from 8.79 to 15.96 percent; and relied upon the midpoint of that zone of reasonableness to establish the 12.38 percent ROE. The ALJ found this approach to be consistent with Commission precedent in Consumers Energy,<sup>6</sup> SoCal,<sup>7</sup> and Systems Energy.<sup>8</sup>

4. In the September 23 Order, the Commission affirmed the methodology used by the ALJ in determining the ROE. With particular regard to the ALJ's reliance upon the midpoint, the Commission rejected arguments that the median or mean<sup>9</sup> of the zone of reasonableness should be used instead. The Commission stated:

Our review of the [ALJ's] reasoning and the underlying record, as well as the parties' arguments on and opposing exceptions, leads us to summarily affirm the [ALJ's] finding that the midpoint [as opposed to the mean or median] of the zone

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<sup>4</sup> American Transmission Company, LLC did not join in the filing.

<sup>5</sup> Midwest Independent Transmission System Operator, Inc., 99 FERC ¶ 63,011 (2002) (Initial Decision).

<sup>6</sup> Consumers Energy Co., 98 FERC ¶ 61,333 (2002) (Consumers Energy).

<sup>7</sup> Southern California Edison, 92 FERC ¶ 61,070 (2000), reh'g pending (SoCal).

<sup>8</sup> Systems Energy Resources, Inc., 92 FERC ¶ 61,119 (2000), reh'g denied, 96 FERC ¶ 61,165 (2002) (Systems Energy).

<sup>9</sup> The midpoint of all the estimates of ROE of a proxy group is the average of the highest and lowest estimated ROE of all members of the group. The median is that point within the zone of reasonableness where half the returns have a higher value and half the returns have a lower value. The mean, or average, is the sum of all the high and low estimates of each member of the proxy group, divided by the number of estimates.

of reasonableness represents the appropriate ROE in this case. The Commission has consistently used the midpoint in setting the ROE for electric utilities,<sup>10</sup> and we see no reason to depart from our precedent here. We are unpersuaded by appeals to use the methodology utilized in setting the ROE for gas pipelines, for we have also consistently emphasized that significant differences exist between the electric and gas industries.<sup>11</sup> Furthermore, we reject the Intervenor Group's argument that UtiliCorp's inclusion in the Midwest ISO TO proxy group improperly skews the midpoint upward. As we previously stated, we find that the Midwest ISO TO proxy companies properly represent the Midwest ISO TOs, for the reasons set forth in the Initial Decision.<sup>12</sup>

5. Several parties requested rehearing of the September 23 Order. Those parties reiterated their arguments that the median, not the midpoint, should be used in determining the appropriate ROE. In the February 5 Order addressing the rehearing requests, we found that the parties raised no new arguments regarding use of the midpoint, which were not discussed at an earlier stage of the proceeding. Accordingly, we did not substantively address those rehearing arguments in the February 5 Order.

6. The Public Service Commission of the Commonwealth of Kentucky, the Coalition of Midwest Transmission Customers, Dairyland Power Cooperative, Industrial End Users-Ohio, and the Midwest TDUs<sup>13</sup> (collectively, Petitioners) filed a petition for review with the D.C. Circuit Court.

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<sup>10</sup> See Consumers Energy, 98 FERC at ¶ 62,416; SoCal, 92 FERC ¶ 61,266.

<sup>11</sup> See Consumers Energy, 98 FERC at ¶ 61,261-62; Systems Energy, 92 FERC at ¶ 61,443-45.

<sup>12</sup> September 23 Order, 100 FERC ¶ 61,292 at P 30. In the September 23 Order, the Commission also implemented an upward adjustment to the ROE of 50 basis points, for the turning over of operational control of transmission facilities to the Midwest ISO. Id. at P 31.

<sup>13</sup> The Midwest TDUs include: the Blue Ridge Power Agency, Central Minnesota Municipal Power Agency, Central Virginia Electric Cooperative, City of Dowagiac, Michigan, City of Sturgis, Michigan, City of Wyandotte, Michigan, Craig-Botetourt Electric Cooperative, ElectiCities of North Carolina, Inc., Iowa Association of Municipal Utilities, Minnesota Municipal Utilities Association, Missouri Basis Municipal Power Agency, Virginia Municipal Electric Association, Virginia.

7. Upon the Commission's motion, the D.C. Circuit remanded the record to allow further explanation of the basis for the Commission's decision to use the midpoint of the zone of reasonableness in calculating the ROE. We next turn our attention to that issue.

### **Discussion**

8. The Commission reaffirms its decision to use the midpoint of the zone of reasonableness in determining the appropriate ROE for the Midwest ISO TOs. As an initial matter, we emphasize that the primary question to be considered here is not what constitutes the best overall method for determining ROE generically (*i.e.*, the midpoint versus the median or mean); it is whether use of the midpoint is most appropriate in this case. We believe that, in this case, the midpoint, as compared to the mean or median, is the most appropriate measure for calculating the ROE. Indeed, as discussed below, this case presents a unique set of circumstances that are relevant to our determination that the midpoint is the most appropriate measure here.

9. Unlike traditional cases in which a ROE is set for one gas pipeline or electric utility, here the applicants proposed setting a single ROE for across-the-board application to all but one of the Midwest ISO TOs. Accordingly, while in the past we have selected a proxy group that best represents the risks and business profile of a single utility, in this case, we must calculate a single ROE for application to a broad group of utilities with diverse risks and business profiles. Given that the ROE will apply across-the-board to all members of the Midwest ISO, rather than to a single company of average risk, we must consider their full range of risks and business profiles. To that end, the proxy group used to define the range of reasonableness in this case consists of a subset of the Midwest ISO TOs to which the ROE will actually apply. This is a departure from prior ROE cases, in which the selected proxy group is deemed to be comparable to the risks faced by a single gas pipeline or electric utility. Here, we are dealing with a group of utilities with differing risks and business rankings. In our view, the differing ROEs in this group fairly brackets the range of reasonableness for all Midwest ISO TOs. We believe it is important to note that the highest and lowest values should be included in this range of reasonableness as likely representative of other Midwest ISO members that, because they are non-publicly traded companies, could not be analyzed and included in the group analysis.

10. Because the ROE in this case will apply to a diverse group of companies, the entire range of results yielded by the subset is relevant here. Thus, we find that using the midpoint is the most appropriate measure for determining a single ROE for all Midwest ISO TOs, since it fully considers that range. Selecting the most refined measure of central tendency, as might be achieved with use of the median, is not the Commission's goal in this case, given that we are not selecting a ROE for a single utility of average risk. Thus, we are not as concerned here that the high or low results represent different risks from the single company because the range encompasses only publicly traded Midwest

ISO TOs. Rather, we must use the measure that produces the most just and reasonable ROE for all of the Midwest ISO TOs.<sup>14</sup>

11. Petitioners assert that the midpoint wholly ignores the numbers between the outliers of the range of reasonableness. We disagree. As the D.C. Circuit Court has previously stated, “[t]he midpoint doesn’t completely disregard the middle . . . numbers; the highest and lowest number achieve their status by reference to all [of the other] numbers.”<sup>15</sup> Each measure (median, average and midpoint) has advantages and drawbacks. The median may be a more refined measure for a utility facing average risk, but it places more weight on the middle values, thus, potentially producing a value that is not appropriate for application to a diverse group of utilities. While a simple average evenly weighs each number in the proxy group, the midpoint relies on the high and low values to take into account the widest range of results. Relying on the midpoint to calculate the ROE is appropriate in this case, since the ROE applies to a diverse group of TOs.

12. While it may be true that, under certain circumstances, the midpoint may be inappropriate because of egregious distortion by the highest or lowest number, such distortion is not a concern here and, therefore, the median is not a more appropriate measure. Contrary to the example presented in Staff’s brief on exceptions<sup>16</sup> and similar assertions made by the Intervenor Group<sup>17</sup>, the midpoint here does not result in a skewed ROE based on the range of the distribution. Staff’s hypothetical distribution shows a series of numbers consisting of nine identical company ranges of reasonableness (11.0 to 11.3) and one company range that is considerably out of line with the rest (15.0 to 16.0). This looks nothing like the distribution in this case. Here, the distribution is not substantially skewed, and the high-end value, 15.96, is not an extreme outlier. The distribution is adequately balanced and the high and low values reasonably bracket the middle of the data. An analysis of the percentage change in each value to the next shows that there are no unreasonable jumps in the upper end of the range. Rather, the three

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<sup>14</sup> The results of our proxy group yielded a midpoint of 12.38, a median of 11.85, and a mean of 11.74. Relying on the median or the mean in this case would result in an unreasonably low ROE in light of the high end values in the proxy group and could substantially under-compensate those utilities at the upper end of the range.

<sup>15</sup> Canadian Ass’n of Petroleum Producers v. FERC, 254 F.3d 289, 298 (D.C. Cir. 2001).

<sup>16</sup> See Staff’s Brief on Exceptions at 10.

<sup>17</sup> See Intervenor Group’s Brief on Exceptions at 16.

highest steps above the midpoint, *i.e.*, 12.38 percent, (5.78 percent, 6.96 percent and 7.11 percent) are not considerably higher than those below the midpoint (5.6 percent, 15.44 percent, and 5.82 percent).

Proxy Company (high or low)	Value	% Change
Alliant (low)	8.79	N/A
DTE (low)	8.90	1.25%
Otter Tail (low)	9.10	2.25%
Vectren (low)	9.61	5.60%
Aquila (low)	9.77	1.66%
Otter Tail (high)	9.91	1.43%
Xcel (low)	11.44	15.44%
Cinergy (low)	11.50	0.52%
Allete (low)	11.51	0.09%
Alliant (high)	12.18	5.82%
Cinergy (high)	12.28	0.82%
DTE (high)	12.28	0.00%
Allete (high)	12.99	5.78%
Montana Dakota Utilities (low)	13.02	0.23%
Vectren (high)	13.20	1.38%
Xcel (high)	13.93	5.53%
Montana Dakota Utilities (high)	14.90	6.96%
Aquila (high)	15.96	7.11%

13. We are also mindful that this proceeding marks a foray into setting the ROE for a generic regional transmission organization (RTO) pool. We must ensure that the base ROE sufficiently supports those entities that have ventured into RTO membership and effects a reasonable rate of return as applied to all Midwest ISO TOs. With that goal in mind, we are guided by the principle, enunciated by the Supreme Court, that an approved ROE should be “reasonably sufficient to assure confidence in the financial soundness of the utility [or, in this case, utilities] and should be adequate under efficient and economical management, to maintain and support its credit, and enable it to raise the money necessary for the proper discharge of its public duties.”<sup>18</sup> The Supreme Court has further stated that:

From the investor or company point of view, it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock . . . . By that standard[,] the return to the equity should be commensurate with returns on

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<sup>18</sup> Bluefield Water Works & Improvement Co., 262 U.S. 679 (1923).

investments in other enterprises having corresponding risks. The return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital.<sup>19</sup>

14. In this case, we believe that the midpoint approach results in a ROE that is sufficient to assure confidence in the financial integrity of the member companies, so as to maintain credit and attract capital. To this end, the midpoint does not have as deleterious an effect as the median on those Midwest ISO TOs whose returns are higher than what we allow for the Midwest ISO TOs here. In our view, that offers additional incentive for such companies to join RTOs. We find that the midpoint results in a just and reasonable ROE for the diverse group of all Midwest ISO TOs.<sup>20</sup>

15. For all of the foregoing reasons, we believe that the midpoint is the appropriate measure for determining the ROE in this case.

The Commission orders:

The September 23 Order and February 5 Order are hereby affirmed, without modification, for the reasons discussed above.

By the Commission.

( S E A L )

Magalie R. Salas  
Secretary

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<sup>19</sup> Federal Power Commission, 320 U.S. 591 (1944).

<sup>20</sup> The proxy group used in this case yielded a range of reasonableness with a midpoint of 12.38, a median of 11.85, and a mean of 11.74.