

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

**Inquiry Regarding the Commission’s)
Policy for Determining Return on Equity)**

Docket No. PL19-4-000

COMMENTS OF THE ORGANIZATION OF MISO STATES

On March 21, 2019 the Federal Energy Regulatory Commission (“FERC” or “Commission”) issued a Notice of Inquiry (“NOI”) seeking information and stakeholder views regarding whether, and if so how, it should modify its policies concerning the determination of the return on equity (“ROE”) to be used in designing jurisdictional rates charged by public utilities.

The Organization of MISO States, Inc. (“OMS”)¹ hereby respectfully submits comments on the Commission’s inquiry.² OMS is actively participating in the litigation proceedings involving the MISO region-wide ROE (Docket Nos. EL14-12 and EL15-45) where many of the questions the Commission asks in the NOI have been addressed. The OMS appreciates this opportunity to provide the Commission with an overview of OMS’ positions concerning the appropriate framework for determining just and reasonable base ROEs.

¹ OMS is a non-profit, self-governing organization of representatives from each retail regulator with jurisdiction over entities participating in the Midcontinent Independent System Operator, Inc. (“MISO”) and serves as the regional state committee in the region. The purpose of the OMS is to coordinate regulatory oversight among the states, including recommendations to MISO, the MISO Board of Directors, FERC, other relevant government entities, and state commissions as appropriate to express the positions of OMS member agencies.

² The OMS submits these comments after they were approved by a majority of its Board of Directors. The Illinois Commerce Commission abstained. The Manitoba Public Utilities Board did not participate. Nothing in these comments should be read as assertions or arguments by state and local regulators that are applicable to state and local return on equity proceedings. Individual state and local regulators have their own proceedings and applicable precedent regarding return on equity.

OMS Comments
Docket No. PL19-4-000
Page 2 of 22

I. BACKGROUND

State and local regulators have a mandate to ensure that retail customers pay just and reasonable rates.³ Because of this mandate, they often participate in FERC ROE proceedings to ensure that the wholesale rates passed through to retail customers are just and reasonable. Consistent with the Supreme Court decisions in *Hope* and *Bluefield*, a utility's return must be commensurate with the returns of companies facing similar risks, in the same geographic region and at the same time.⁴ The risk profile of each utility is different and varies over time. While ratemaking is not an exact science, any new ROE framework should endeavor to improve the accuracy of the risk profile used to determine the just and reasonable base ROE of utilities. The Commission should balance the administrative burden imposed by using a case-by-case approach with the goal of authorizing just and reasonable rates that properly reflect the risk profile of the utility at issue. In this context, the Commission should avoid blanket ROE authorizations for groups of utilities with very diverse risk profiles because such an approach will inevitably result in overcompensating the least risky utilities in the group while undercompensating the most risky utilities in the group. If the Commission, nevertheless, decides to maintain group ROEs, then it should establish clear criteria to allow for ROE adjustments for individual outliers within the

³ Supplemental Comments of the Organization of MISO States, Inc., Docket Nos. EL14-12-003 EL15-45-000 (February 13, 2019) ("OMS Supplemental Comments").

⁴ *Bluefield Waterworks & Imp. Co. v. Pub. Serv. Comm'n*, 262 U.S. 679, 692 (1923) ("*Bluefield*") (the Supreme Court ruled that the returns a public utility earns must be "equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding, risks and uncertainties. . . ."); *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) ("*Hope*") (ruling that "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks").

OMS Comments
Docket No. PL19-4-000
Page 3 of 22

group. These adjustments can be used to prevent over- and under- compensation of utilities in a group ROE.⁵

Next, as will be discussed below, the OMS supports continuing reliance on the discounted cash flow (“DCF”) model consistent with FERC precedent. As the OMS has argued in the ongoing MISO ROE litigation in Docket Nos. EL14-12 and EL15-45, changing market conditions have not affected the validity of the DCF model or exposed any new model risk. Averaging the DCF results with those produced by inferior financial models will not result in just and reasonable ROEs. However, to the extent that the Commission insists on using other financial models besides the DCF, it should not calculate the just and reasonable ROE using three separate zones of reasonableness for the DCF, the capital asset pricing model (“CAPM”) and the Expected Earnings. Instead, the Commission should establish a composite zone of reasonableness by calculating the composite ROE for each proxy group company within the composite zone. In estimating the ROE for each proxy company, the results of the DCF should be given more weight than the results of the CAPM and the risk premium method. The Expected Earnings method should not be relied on at all because it does not produce market-based results. The just and reasonable ROE in a framework that uses several financial models would be the midpoint of the composite zone for average risk utilities.

Finally, the Commission should not establish presumptive immunity zones limiting the ability of rate payers to challenge ROEs that have become unjust and unreasonable. Such an approach is unlawful because it violates the due process rights of customers and establishes a

⁵ OMS Supplemental Comments at 1-2.

OMS Comments
Docket No. PL19-4-000
Page 4 of 22

higher standard of review for rate reductions under Section 206 of the Federal Power Act (“FPA”) than for rate increases under section 205 of the FPA.

II. COMMENTS

A. Role and Objectives of the Commission’s Base ROE Policy

The NOI asks for comments on the role of base ROE in investment decision-making and what objectives should guide the Commission’s approach to base ROE policy apart from the basic *Hope* and *Bluefield* standard.⁶ At the outset, any consideration the Commission decides to add to the ROE framework should be consistent with the *Hope* and *Bluefield* standard. The Commission should not consider any expansion of the ROE scope that goes beyond the clear limits and requirements set forth by the Supreme Court.

1. Predictability and Litigation Costs

The ROE framework the Commission proposed in the *Coakley* Briefing Order and the MISO Briefing Order,⁷ which calls for reliance on three additional models in addition to reliance on the DCF model, would negatively impact the predictability of rates because it relies on four financial models instead of only one model (i.e. the DCF). Reliance on four models broadens the scope of potentially contested issues in ROE proceedings making it even more difficult for analysts to predict the outcome on any ROE litigation. This heightened complexity of the ROE framework

⁶ *Inquiry Regarding the Commission’s Policy for Determining Return on Equity Notice*, 166 FERC ¶ 61,207, at P 31 (2019) (“ROE NOI”).

⁷ *Martha Coakley v. Bangor Hydro-Elec. Co.*, 165 FERC ¶ 61,030 (2018) (“Coakley Briefing Order”); *Ass’n of Businesses Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc.*, 165 FERC ¶ 61,118 (2018) (“MISO Briefing Order”).

OMS Comments
Docket No. PL19-4-000
Page 5 of 22

significantly increases the cost and length of litigation and complicates parties' ability to settle cases.

Nonetheless, if the Commission does decide to expand the ROE framework to include other financial models besides the DCF, it should only include financial models producing market-based results. The Expected Earnings method is not a market-based method that informs investors in the capital markets and should not be considered in ROE determinations. Furthermore, because of the many methodological flaws of the Expected Earnings method, reliance on this method will exponentially increase litigation and regulatory risk and, in turn, reduce the predictability of the ROE outcome.

In an ROE framework relying on multiple financial models, the Commission could improve predictability and reduce litigation risks by giving the DCF substantial weight over other models. Investors and parties in ROE proceedings are more familiar with the Commission's DCF method developed over several decades than with any other financial method. Greater reliance on the DCF method, therefore, has two benefits: (1) it will reduce litigation over the appropriate implementation of less familiar methods; and (2) it will increase the predictability of the outcomes of ROE cases because investors have much more experience with the Commission DCF method than with the other methods.

2. Duration of the ROE

Adoption of a "vintage approach" whereby the Commission establishes an ROE fixed for the life of the asset runs against the ruling of the Supreme Court in *Bluefield*, that "A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities

OMS Comments
Docket No. PL19-4-000
Page 6 of 22

for investment, the money market, and business conditions generally.”⁸ Furthermore, an ROE that cannot be changed for the life of the asset would improperly limit the rights of complainants under section 206 of the FPA to challenge rates that have become unjust and unreasonable and the rights of utilities under section 205 of the FPA to propose new rates. The ROE cannot be static. It can be rendered unjust and unreasonable within the life of the asset by changing market conditions, and the Commission does not have the authority under the FPA or Supreme Court precedent to insulate investors from changing market conditions. Any additional objectives guiding the Commission’s approach to ROE policy should operate in conjunction with, if not in deference to, the *Hope* and *Bluefield* standards with the guiding principle being that investors need not be insulated from changes in market conditions.

The ROE should reflect the contemporary ROE required by investors at the time a section 205 or 206 filing is made. This approach is consistent with the language of the statute referring to the change of rates “then in force” (i.e. at the time of the section 206 filing) and the application of new rates “to be thereafter observed.”⁹

3. Geographic Scope of ROE Applicability

The OMS has previously argued that RTO-wide or national ROEs severely impair the ability of state and local regulators to challenge the FERC-jurisdictional ROE of transmission utilities located in their respective states.¹⁰ This is because once a proxy group is established, the presumption that the proxy group represents the risk-profile for all the utilities in an RTO becomes

⁸ *Bluefield*, 262 U.S. 679, at 692.

⁹ 16 U.S.C. § 824e(a).

¹⁰ OMS Supplemental Comments at 2.

OMS Comments
Docket No. PL19-4-000
Page 7 of 22

much more difficult to challenge.¹¹ An RTO-wide ROE does not result from proxy groups that appropriately reflect the risk-profiles of individual transmission owners based on their own credit ratings or other risk-related characteristics. Efforts to adjust individual utilities' ROE in RTO-wide ROE proceedings have been rejected by the Commission based on the presumption that the credit rating risk band used to establish the proxy group appropriately reflects most (if not all) the risk factors of each individual utility, such as whether an individual utility in the group has an actual equity rich capital structure.¹² Establishing the base ROE using a risk bandwidth that includes utilities with credit ratings between S&P A+ to BB- is not consistent with the requirement of *Hope* and *Bluefield* to establish a return based on the utility's risk profile.¹³ Using the midpoint rather than the median does not overcome this fatal flaw because the bounds of the range resulting from a given methodology are not necessarily set by the riskiest and least risky companies in the proxy group (per their credit rating).¹⁴ The Commission should focus on improving the accuracy of the risk profile of proxy companies and narrow the geographic scope to the greatest extent possible.

If the Commission retains the RTO-wide base ROE, the OMS recommends flexibility for states or transmission customers challenging an individual utility's FERC-approved RTO-wide base ROE to account for certain conditions that may be present for a particular company or state. That is, a complaint challenging the application of the RTO-wide base ROE to a specific

¹¹ *Id.* at 6.

¹² *Id.*

¹³ *Bluefield*, 262 U.S. at 692 (the Supreme Court ruled that the returns a public utility earns must be "equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding, risks and uncertainties. . . ."); *Hope*, 320 U.S. 591, at 603 (ruling that "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks").

¹⁴ OMS Supplemental Comments at 5.

OMS Comments
Docket No. PL19-4-000
Page 8 of 22

transmission owner should not be outright rejected, and FERC should allow for individual fluctuations in the base ROE for specific companies if circumstances warrant. Thus, over time, there may be variation of ROEs among transmission owners within the RTO to account for company-specific operating, financial, and risk profiles.

B. Performance of the DCF model

The Commission's two-step DCF is a well-established method for estimating the cost of equity for regulated utilities. The DCF remains the most robust and accurate market-based method to use in the determination of just and reasonable ROEs.¹⁵ The Commission's two-step DCF model has been carefully developed over years of agency proceedings and upheld by the courts. The Commission's DCF method produces reasonable estimates that appropriately reflect changing market conditions and expectations. The DCF method relies on market prices that efficiently incorporate capital market and economic conditions, and it has been applied over a wide variety of situations.¹⁶

OMS is concerned that the proposed new framework would all but discard the DCF equity cost estimation method, on which the Commission has relied for decades.¹⁷ If the Commission moves away from exclusive reliance on the DCF, it should not rely on three separate zones of reasonableness for the DCF, CAPM and Expected Earnings methods and average the results of each method with the single risk premium result. Instead, the Commission should establish a composite zone of reasonableness by estimating the composite ROE for each individual proxy

¹⁵ MISO Complainant Aligned Parties, Initial Paper Hearing Brief of the MISO Complainant-Aligned Parties, Docket No. EL14-12-003 at 12-27 (Feb. 13, 2019) ("Initial Brief").

¹⁶ Initial Brief at 9.

¹⁷ *Id.*

OMS Comments
Docket No. PL19-4-000
Page 9 of 22

group company. This composite zone of reasonableness approach is consistent with the current practice of relying on a single zone of reasonableness and placing the base ROE at a given point within that single zone as supported by the record in each case. In estimating the composite ROE for each proxy group company, the Commission should give the DCF greater weight than the other methodologies, and it should not rely on the Expected Earnings method.

The use of the DCF method has supported capital attraction.¹⁸ Construction of electric transmission facilities has boomed, and transmission owners tout to investors the extent to which their income is determined by FERC's favorable regulation.¹⁹ Further, the use of the DCF cost estimation method has not harmed consumers or utility investors, and recent market conditions have not rendered the DCF method unreliable.²⁰ It is not the result of rational decision-making to abandon or limit reliance on a tried and true market method of valuation such as the DCF while relying on other possible methods that have far less history and far less tangible support for producing consistent and verifiable results.

The OMS has not seen any compelling data that shows the Commission should not continue to rely on the DCF model going forward. Because the market cost of capital has declined in recent years, it logically follows that the ROE produced by any market-based measure of equity would be lower.²¹ Efforts to inflate the ROE by overhauling the ROE

¹⁸ *Id.*

¹⁹ There was a 3.1% increase in transmission investment between 2014 and 2015, and there were approximately 150 projects totaling \$41 billion in transmission investment scheduled through 2019. Edison Electric Institute, *Transmission Projects: At a Glance* (Dec. 2016) ("EEI Transmission Projects"), available at http://www.eei.org/issuesandpolicy/transmission/Documents/Trans_Project_lowres_bookmarked.pdf.

²⁰ MISO Complainant Aligned Parties Reply Paper Hearing Brief of The MISO Complainant-Aligned Parties, Docket No. EL14-12-003 at 2 (Apr. 10, 2019) ("Reply Brief").

²¹ *Id.* at 8.

OMS Comments
Docket No. PL19-4-000
Page 10 of 22

methodology, despite evidence of market data indicating reductions in the cost of capital, are unnecessary to attract capital for transmission investment and undermine the FPA's consumer protection aim.²² It also distorts capital markets in a manner that may prevent appropriate investment in other electricity assets such as generation and distribution while promoting over-investment in overcompensated transmission assets. If the Commission is concerned about the accuracy of ROEs created using the DCF method, it could compare them to ROEs disclosed in competitively bid transmission projects to verify the accuracy of the DCF model. For example, MISO's Selection Report for its first competitively bid transmission project, MISO cited the "limited return on equity for the life of the project (9.8%)" as a reason for its selection of the Duff-Coleman project proposed by a subsidiary of LS Power.²³ And in the Commission's Competitive Transmission Development Technical Conference docket, LS Power wrote that it, "does not believe that changes to the Commission's current application of the DCF analysis are needed for competitive transmission" just two months before it was selected to build this project.²⁴

The market-based DCF approach remains the most appropriate way to determine allowable rates of return that meet the standards set out in *Bluefield* and *Hope*.²⁵ Only the DCF method has direct, current utility stock investor input through the use of recent, competitive market-determined stock prices.²⁶ Thus, the DCF remains a sound approach that reliably and accurately measures the cost of capital.

²² *Id.*

²³ Selection Report: Duff-Coleman EHV 345 kV Competitive Transmission Project available at <https://cdn.misoenergy.org/Duff-Coleman%20EHV%20345kv%20Selection%20Report82339.pdf> (Last accessed on June 26, 2019).

²⁴ Post-Technical Conference Initial Comments of LSP Transmission Holdings, LLC, Docket No. AD16-18-000 at 50 (October 3, 2016).

²⁵ Reply Brief at 9.

²⁶ *Id.*

OMS Comments
Docket No. PL19-4-000
Page 11 of 22

C. Proxy Groups

1. Inclusion of Regulated and Unregulated Businesses in Assessing Transmission Risks

The OMS encourages the Commission to use more comparable proxy groups with similarly regulated business lines and to limit the inclusion of integrated utilities with riskier generation businesses in the proxy group. To the extent that using transmission-only regulated business data is challenging, the OMS suggests that the Commission conduct a technical conference to discuss appropriate adjustments to the risk profiles of integrated utilities in order to distill their transmission risk for purposes of proxy group formation.

2. Scope of Risk Profile Consideration

Risk should be considered in both establishing the proxy group and in the ROE placement process. Because credit ratings are not the only measure of risk that investors consider, proxy groups formed on the basis of credit ratings' risk bands do not always accurately reflect the risk profile of the subject utility as perceived by investors. To mitigate this margin of error, the Commission should also look at other relevant risk factors when placing the base ROE within the zone of reasonableness.

3. Measure of Central Tendency

The Commission should use the median in calculating the replacement ROE. The midpoint is inherently inferior to the median as a measure of central tendency because it depends upon only the two most extreme, unrepresentative observations—the highest point and the lowest point in the proxy group results—and ignores the distribution of proxy group results, making it more

OMS Comments
Docket No. PL19-4-000
Page 12 of 22

susceptible to being skewed by outlier values.²⁷ This characteristic of the midpoint compromises the Commission's attempts to address purported model risk because the most extreme results of each model (those most affected by model risk and least likely to represent the MISO TOs' actual cost of equity) become the determinants of what customers pay.²⁸

Given the Commission's correct and judicially-affirmed finding that the median best represents investor requirements in average risk single-utility cases,²⁹ the Commission should determine that the median should be applied in all cases concerning average risk utilities.³⁰ Because the proxy company estimates cluster predominantly at the central or lower end of the range, the median better represents the profile of average risk utilities. The midpoint is not the central or typical value of a given distribution of data.³¹ In addition, the use of the midpoint in group ROE proceedings does not address the Commission's concern about ensuring that the resulting group ROE accounts for the diverse risk profiles of the companies in the group. As OMS has explained, there is no apparent correlation between the credit rating of the proxy company with the highest ROE and the credit rating of the riskiest MISO TO. By the same token, there is no correlation between the credit rating of the proxy company with the lowest ROE and the credit rating of the least risky MISO TO.³² A base ROE calculated using the highest and the lowest ROE in the proxy group does not reflect the risk diversity of the group of utilities, but it does render the

²⁷ *Id.* at 40.

²⁸ *Id.* at 40-41.

²⁹ *S. Cal. Edison Co. v. FERC*, 717 F.3d 177, 181-87 (D.C. Cir. 2013).

³⁰ Reply Brief at 42.

³¹ *Id.*

³² OMS Supplemental Comments at 4-5.

OMS Comments
Docket No. PL19-4-000
Page 13 of 22

base ROE less representative of the central tendency and more susceptible to being skewed by outliers.

The Commission should not rely on the midpoint and should use the median for calculations under the proposed base ROE framework of average risk utilities. If the Commission determines that a utility faces above-average or below-average risks, other placements may be appropriate as determined pursuant to the record in each case.

4. Outliers

The OMS encourages the Commission to retain its long-standing Low-End Outlier test. Concerning the High-End Outlier test, the OMS encourages the Commission to adopt the two standard deviation proposal or the Grubbs test.³³ The OMS encourages the Commission to establish clear and objective standards regarding the manner in which it intends to perform its “natural break” in screening high-end and low-end outliers. Specifically, the Commission should adopt the two-part natural break test proposed by the MISO Complainant Aligned Parties.³⁴ As the Commission has recognized, appropriate screening of 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.”³⁵

5. Credit Ratings

Finally, credit ratings do not determine in absolute terms utilities’ risks and the corresponding returns required by investors, but the Commission should continue using credit ratings in proxy group formation as a first layer of risk assessment. There is no need to change the

³³ Reply Brief .at 60.

³⁴ Initial Brief at 63-65.

³⁵ MISO Briefing Order at P 55.

OMS Comments
Docket No. PL19-4-000
Page 14 of 22

credit rating screen. Particularly, FERC should not include all investment-grade utilities in the proxy group. Such an action would broaden even further the risk bandwidth, leading to less accurate ROE determinations.

D. Financial Model Choice

As stated above, the Two-Step DCF remains the appropriate methodology for measuring the cost of equity. The Commission's Two-Step DCF is a well-established method for estimating the cost of equity for regulated utilities.³⁶ The DCF remains the most robust and accurate market-based method to use in the determination of just and reasonable ROEs. Therefore, reliance on the median of the two-step DCF method is OMS' recommended approach for determining base ROE for average risk utilities. Additionally, a reasonably implemented CAPM method may estimate equity costs comparably to the DCF model.³⁷ However, if the Commission does decide to incorporate other methods, it should afford the DCF model greater weight.

OMS is concerned that the Risk Premium, CAPM, and Expected Earnings methods are subject to significant model risk. These methods have not been subjected to decades of regulatory scrutiny, have not been extensively analyzed in the record in this proceeding, and are prone to being applied in ways that do not capture the cost of equity, particularly if implemented in the manner that transmission owners in MISO are proposing. Below, OMS offers a high-level summary of the issues each non- DCF financial model presents.

³⁶ Reply Brief at 6.

³⁷ *Id.* at 26.

OMS Comments
Docket No. PL19-4-000
Page 15 of 22

1. Risk Premium Method

The Risk Premium method seeks to extrapolate a present cost of equity from past regulatory decisions by identifying a linear relationship between the cost of equity and cost of debt implicit in those decisions and then adding the implied difference to the present cost of debt to estimate the current cost of equity.³⁸ This method is inherently less accurate than a well-constructed DCF or properly performed CAPM method, as it relies on echoes of the market-based methods applied in past cases, whereas the DCF and CAPM methods, done properly, apply a market-based method to primary data.³⁹ Moreover, a Risk Premium-based finding will tend to replicate the regulatory lag and inertial continuation of past returns that affected past regulatory decisions.⁴⁰ Consequently, in this period of declining equity costs, the Risk Premium method will tend to produce an excessive estimate of the current cost of equity.⁴¹ If the Commission is to rely on the Risk Premium model, it should ensure that the parameters of the market information used to perform a proper Risk Premium study use: (1) ROE determinations made by FERC or state commissions at the time of the order; (2) observable market evidence of risk differentials; and (3) a comparison of utility stock yields to utility bond yields and Treasury bond yields.⁴²

2. CAPM Method

A properly performed CAPM analysis considers limitations on S&P 500 growth rates (used in DCF results), such as using U.S. GDP growth rates as a weighted component in DCF growth

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.* at 26-27.

⁴² Initial Brief at 34-39.

OMS Comments
Docket No. PL19-4-000
Page 16 of 22

rates. Many utilities perform CAPM analysis with growth rates 3-4 times the long-term GDP growth rate, which significantly inflates the CAPM results. It is not possible for the S&P 500 aggregate growth rate to be so much greater than the GDP growth rate. The proper implementation of a CAPM analysis requires the market growth rate to include both short-term and long-term growth rates (as is done in the Commission's Two-Stage DCF Model). In addition, the Commission should reject size premium adjustments that result in mismatched betas.⁴³

3. Expected Earnings Method

The Expected Earnings method is based entirely on expected accounting returns *per book value equity*, without any consideration of utility stocks' actual market prices or what investors must pay in order to share in those returns.⁴⁴ The central flaw in the Expected Earnings methodology is that it does not measure the rate of return investors require to invest in the market-priced common equity capital of a utility, which is the utility's cost of capital.⁴⁵ Rather, it measures expectations of what the utility will earn on the book value of its common equity.⁴⁶

The Expected Earnings method is a fundamentally inappropriate method to determine a just and reasonable ROE for public electric utilities for three primary reasons.⁴⁷ First, because the method is not market-based and does not provide the market cost of common equity capital, the Expected Earnings methodology produces erroneously inflated measures of investors' required level of return. Second, there is no evidence that investors rely on the Expected Earnings method.

⁴³ *Id.* at 27-34.

⁴⁴ *Id.* at 40-41.

⁴⁵ *Id.*

⁴⁶ *Id.* .

⁴⁷ Reply Brief at 32.

OMS Comments
Docket No. PL19-4-000
Page 17 of 22

Finally, the Expected Earnings approach is circular and self-fulfilling because if expected returns, greater than the cost of equity, are used to set the allowed ROE, then the future earned ROE, and future expected return, will likely be higher than the cost of equity.⁴⁸

In sum, the Expected Earnings method is a fundamentally inappropriate way to determine a cost-based ROE, as it is not a market-based tool, does not provide the market cost of common equity capital, and is wholly inconsistent with standards employed by the Commission for many decades.⁴⁹ It should play no role in determining transmission owners' just and reasonable ROE.

E. The Mismatch Between Market-Based ROE Determinations and Book-Value Rate Base

The Expected Earnings methodology proposed by the Commission is a form of the comparable earnings methodology that examines a company's expected accounting return on the book-value of its common equity.⁵⁰ However, the Commission has long held that its obligations under the FPA and *Hope* and *Bluefield* require it to set a regulated return that reflects the *market cost* of equity capital.⁵¹ When a company's market-to-book ratio is significantly greater than 1.0, it is an indication that investors' required rate of return for investing in the common stock of that company is less than the expected earnings on book value for that company.⁵² In other words, investors bid up the price of the stock above the underlying book value because they are expecting the company to earn a return in excess of its cost of equity.⁵³

⁴⁸ *Id.*

⁴⁹ Initial Brief at 44.

⁵⁰ *Id.* at 40.

⁵¹ *Id.*

⁵² *Id.* at 42.

⁵³ *Id.*

OMS Comments
Docket No. PL19-4-000
Page 18 of 22

Because an investor cannot purchase a utility's common stock at book value and must instead pay the prevailing market price for common equity, the utility's expected earned return on book value is indicative of neither what an investor can expect to earn on an investment in the utility's common stock (at the stock market price) nor what return an investor requires to invest in the utility's common stock.⁵⁴

For stocks whose market value exceeds their book value, the Expected Earnings methodology produces an erroneously inflated measure of investors' required level of return.⁵⁵ Only when investors bid the stock price of a company to equal or near its book value (a market-to-book ratio at or near 1.0) may the expected earned rates of return on the company's book value be considered a reasonable estimate of its cost of common equity capital, or investors' required rate of return.⁵⁶

For example, in Order No. 461, the Commission found "compelling economic justification for relying on the market cost of capital as the standard for rate of return decisions."⁵⁷ "Accounting rates of return are not reliable measures of the current market cost of capital since they do not reflect the current market prices that are determined in competitive capital markets."⁵⁸ In fact, in Opinion No. 429, the Commission found that no "direct market-determined cost rate can be derived from [the comparable earnings methodology] because the nature of the analysis is related

⁵⁴ *Id.* at 41.

⁵⁵ *Id.* at 41-42.

⁵⁶ *Id.* at 42

⁵⁷ *Generic Determination of Rate of Return on Common Equity for Pub. Utils.*, Order No. 461, 52 F.R. 11 (Jan. 2, 1987), FERC Stats. & Regs. ¶ 30,499, at 30,722 (1987) & n.189, citing Kolbe, Reed, Jr. and Hall, *The Cost of Capital: Estimating the Rate of Return for Public Utilities* at 21 (1984).

⁵⁸ *Generic Determination of Rate of Return in Common Equity for Pub. Utils.*, Order No. 420, FERC Stats. & Regs. ¶ 30,644, at 31,367 (1985).

OMS Comments
Docket No. PL19-4-000
Page 19 of 22

to book values.”⁵⁹ The Commission should not depart from this precedent. The mismatch between the market-based and book-value ROEs remains a relevant concern and supports a finding that the Expected Earnings method cannot be relied on in any ROE framework.

F. How the Commission Determines Whether an Existing ROE is Unjust and Unreasonable Under the First Prong of the FPA Section 206

OMS strongly disagrees with establishing a zone of presumptive reasonableness that would presume ROEs within the zone to be lawful even when the preponderance of the evidence shows that they are not.⁶⁰ A presumptive immunity zone also heightens the burden of proof faced by consumers, thereby creating an unlawful asymmetry between the burden of proof that utilities must meet to raise rates under FPA section 205 and the burden of proof that customers must meet to obtain lower rates under FPA section 206.⁶¹ At its essence, the immunity zone creates a conclusive presumption that violates customers’ due process rights.⁶²

Because the immunity zones thwart the ability of customers to lower unjust and unreasonably high ROEs, they violate the Commission's statutory duty to protect customers from excessive rates, and this improperly tilts the balance between industry and customers’ interests in favor of industry. The just and reasonable standard of FPA sections 205 and 206 exists to protect consumers completely from excessive rates and charges, and it is a strict standard.⁶³ The Commission has acknowledged that its “statutory mandate under the FPA entails protecting

⁵⁹ *Consumers Energy Co.*, Opinion No. 429, 85 FERC ¶ 61,100 at 61,362 (1998) ("Opinion No. 429").

⁶⁰ Initial Brief at 72.

⁶¹ *Id.* at 76.

⁶² *Id.*

⁶³ *Id.* at 72.

OMS Comments
Docket No. PL19-4-000
Page 20 of 22

consumer interests”⁶⁴, and, in doing so, the Commission must always “relate its action to the primary aim of the Act to guard the consumer against excessive rates.”⁶⁵ The customer protection purpose of section 206 requires the Commission to reduce existing rates that are shown to have become unjust, unreasonable, or unduly discriminatory. The proposed immunity presumption squarely conflicts with that mandate.⁶⁶

Furthermore, the Commission has consistently explained that *Hope* and *Bluefield* require the Commission to balance the interests of investors and ratepayers.⁶⁷ In fact, the D.C. Circuit ruled that “[t]he zone of reasonableness is intended to balance the interests of investors and consumers.”⁶⁸ A presumption that insulates utilities from challenges to high ROEs allows exploitation of customers.⁶⁹

When a complainant submits evidence showing an ROE lower than the existing ROE, the Commission should continue to consider that the burden to establish a *prima-facie* case has been met and set the matter for hearing and settlement judge procedures. If, after hearing, the complainant has shown by a preponderance of the evidence that a just and reasonable ROE would be below the existing ROE, then the Commission should find that the existing ROE is unjust and unreasonable and establish a new lower ROE to be effective thereafter.

⁶⁴ *New England Power Generators Ass'n v. ISO New England Inc.*, 146 FERC ¶ 61,039 at P 52 & n.83 (2014).

⁶⁵ *City of Detroit v. FPC*, 230 F.2d 810, 817 (D.C. Cir. 1955).

⁶⁶ Initial Brief at 73.

⁶⁷ *See, e.g.*, Opinion No. 531 at P 166; *Portland Nat. Gas Transmission Sys.*, Opinion No. 524-A, 150 FERC ¶ 61,107 at P 190 (2015).

⁶⁸ *Emera Maine* at 20 (citing *Pac. Gas & Elec. Co. v. FERC*, 306 F.3d 1112, 1116 (D.C. Cir. 2002)).

⁶⁹ Initial Brief at 73.

OMS Comments
Docket No. PL19-4-000
Page 21 of 22

G. Successive Complaints

The Commission's existing policy of allowing successive complaints is appropriate. If a complainant is able to produce a new DCF analysis that shows that a company's ROE is set too high, then the Commission should set the case for hearing and find the current ROE to be unjust and unreasonable if it is shown to be by a preponderance of the evidence. To deny parties the right to file successive complaints would introduce an unlawful asymmetry between section 205 and 206 proceedings, in which utilities can file for successive rate increases even if a prior section 205 case is still pending but customers cannot file successive rate decreases while previous section 206 complaints are pending.

III. Conclusion

To realize its aim of protecting consumers from exploitative rates, the FPA contemplates a rate-making process that "involves a balancing of the investor and consumer interests."⁷⁰ Against this duty the Commission should establish a ROE framework that: (1) relies on proxy groups that accurately reflect the risk profile of utilities; (2) uses market-based financial models; and (3) places the ROE at the median of the zone of reasonableness for average risk utilities. The Commission should not: (1) establish blanket ROE authorizations applicable to utilities with diverse risk profiles, (2) rely on the Expected Earnings financial model, or (3) create immunity zones that thwart the right of consumers to challenge unlawful ROEs under the FPA.

⁷⁰ *Hope*, 320 U.S. 591, 603 (1944) ("[t]he rate-making process under the Act, i.e., the fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests.").

OMS Comments
Docket No. PL19-4-000
Page 22 of 22

The OMS submits these comments because a majority of the members have agreed to generally support them. Individual OMS members reserve the right to file separate comments regarding the issues discussed in this pleading.

Respectfully submitted,

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Dated June 26, 2019

CERTIFICATE OF SERVICE

I HEREBY certify that I have this day caused the foregoing document to be served, *via* electronic mail, upon each person designated on the Official Service List compiled by the Secretary in these proceedings.

DATED at Madison, Wisconsin this the 26th day of June, 2019.

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Document Content(s)

OMS_Comments_PL19-4.PDF.....1-23