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
TRANSMISSION DEPENDENT UTILITY SYSTEMS

Pursuant to the Federal Energy Regulatory Commission's ("Commission" or "FERC") Notice of Inquiry, issued March 21, 2019 in the above-captioned docket, the Transmission Dependent Utility Systems ("TDU Systems") respectfully submit their comments addressing the Commission's *Inquiry Regarding the Commission's Policy for Determining Return on Equity*, 166 FERC ¶ 61,207 (2019) (the "NOI"). TDU Systems welcome this opportunity to respond to the Commission's questions regarding its polices for determining the return on equity ("ROE") to be used in jurisdictional rates charged by public utilities.

I. INTRODUCTION

The TDU Systems participating in these comments consist of the following rural electric Generation and Transmission ("G&T") cooperatives: Central Electric Power Cooperative, Inc., Golden Spread Electric Cooperative, Inc., Kansas Electric Power Cooperative, Inc., North Carolina Electric Membership Corporation, PowerSouth Energy Cooperative, and Seminole Electric Cooperative, Inc. Through their member distribution cooperatives and other wholesale customers, these G&T cooperatives serve approximately 6.5 million residential customers and businesses in eight states. All of the TDU Systems are, first and foremost, load-serving entities ("LSEs"), and they and their distribution cooperative members were formed to provide reliable service to their member-owners at the lowest reasonable cost.

While some of the TDU Systems own substantial transmission facilities, they all rely on the transmission systems of their neighboring investor-owned, Commission-regulated public utility transmission owners to move power supplies to their member distribution cooperatives' loads.

II. COMMENTS

TDU Systems have reviewed and support the comments jointly filed this day by the Aluminum Association, American Chemistry Council, American Forest and Paper Association, American Public Power Association, Electricity Consumers Resource Council, Industrial Energy Consumers of America, National Rural Electric Cooperative Association, and Transmission Access Policy Study Group (collectively, the "Associations").[1] As the Associations' Comments thoroughly explain, the bond of consumer protection afforded by the Federal Power Act ("FPA") dictates that the Commission's policies must ensure that, to remain just and reasonable, a public utility's ROE must correspond to that company's actual capital attraction costs as those costs change over time. TDU Systems believe that the responses submitted by the Associations, if adopted by the Commission, would serve to ensure that the ROE component of jurisdictional rates remain just and reasonable.

TDU Systems write independently to emphasize the following issues of critical concern:

- The two- step Discounted Cash Flow ("DCF") analysis should remain the primary, if not the exclusive, method used to identify a transmission owner's cost of equity. While the Capital Asset Pricing Model ("CAPM") and Risk Premium models can, when properly applied, corroborate the results of the DCF analysis, they should not be relied upon as primary analyses and should not dilute the DCF results. Under no circumstances should the non-market based Expected Earnings model be used.

[1] Comments of the Aluminum Association, American Chemistry Council, American Forest and Paper Association, American Public Power Association, Electricity Consumers Resource Council, Industrial Energy Consumers of America, National Rural Electric Cooperative Association, and Transmission Access Policy Study Group, Docket No. PL19-4-000 (June 26, 2019).

- The Commission should not deviate from its current policy by imposing additional burdens on complainants bringing an action against an existing ROE under section 206 of the FPA. Where a complainant makes a *prima facie* showing that ROE collected of the date of the complaint exceeds the public utility's cost of equity, the Commission is obligated by the Federal Power Act to investigate and, if necessary, replace the existing ROE with a just and reasonable one.

TDU Systems address each of these items in detail below.

A. **<u>The DCF Analysis Should Remain the Primary, if Not the Exclusive, Method Used To Identify a Transmission Owner's Cost of Equity</u>.**

As explained in the NOI, the Commission has long relied on the DCF model to determine an investor's required return on investment based on market-based measurements.[2] In Order No. 489,[3] the Commission stated:

> There is compelling economic justification for relying on the market cost of capital as the standard for rate of return decisions. Furthermore, a market cost of capital approach addresses both the comparable earnings and attraction of capital standards of the *Hope* decision. In the Commission's judgment, the DCF method is the best available means of estimating the market cost of capital.[4]

By using market-based measurement methods—including specifically the DCF—the Commission has met the capital attraction standard of *Hope*[5] and *Bluefield*.[6] This attraction is clearly established by the recent upswing in transmission investment. According to a recent Edison Electric Institute ("EEI") Report, there was a 3.1% increase in transmission investment between 2014 and 2015, and there were approximately 150 projects totaling $41 billion in

---

[2] NOI at PP 4-12.

[3] *Generic Determination of Rate of Return on Common Equity for Public Utilities*, Order No. 489, FERC Stats. & Regs. ¶ 30,795 (1988) ("Order No. 489").

[4] Order No. 489 at 30,993.

[5] *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) ("*Hope*").

[6] *Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n of W. Va.*, 262 U.S. 679 (1923) ("*Bluefield*").

transmission investment scheduled through 2019.[7] The EEI Report goes on to demonstrate that the spending level in recent years has surpassed projections and that future investment continues to be robust and may continue to increase.[8]

Despite the demonstrable success of the market-based DCF method, the Commission in in the Coakley Briefing Order[9] and the MISO Briefing Order[10] (together, the "Briefing Orders") proposed to dilute its significance by turning to other methods, one of which—the Expected Earnings method—is not market-based at all.[11] Specifically, in the Briefing Orders, the Commission proposed to rely on the DCF, CAPM and Expected Earnings models, and to weight each model equally to determine whether an existing ROE is no longer just and reasonable.[12] Once an existing ROE is found to be unjust and unreasonable, the Commission proposed to set the replacement base ROE by relying on those three models as well as the Risk Premium model, again weighting equally each of the utilized models.[13] In the NOI, the Commission "seeks comment on other financial models that investors use to evaluate utility equities…and whether

---

[7] 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..

[8] *Id*.

[9] *Coakley, et al. v. Bangor Hydro-Elect. Co.*, et al., Order Directing Briefs, 165 FERC ¶ 61,030 (2018) ("Coakley Briefing Order").

[10] *Ass'n of Businesses Advocating Tariff Equity, et al., v. Midcontinent Indep. Sys. Operator, Inc.*, Order Directing Briefs, 165 FERC ¶ 61,118 (2018) ("MISO Briefing Order").

[11] The Expected Earnings method 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. The Commission, however, 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. *Generic Determination of Rate of Return on Common Equity for Public Utilities*, Order No. 461, FERC Stats. & Regs. ¶ 30,722 at 30,499 ("Order No. 461"), *reh'g denied*, Order No. 461-A, 38 FERC ¶ 61,160 (1987).

[12] Coakley Briefing Order at PP 15, 17; MISO Briefing Order at PP 16-19.

[13] NOI at P 35.

the Commission should weigh certain financial models over other models based on their respective characteristics."[14]

TDU Systems believe that seeking input about the appropriate weight to give to alternative models begs the question of whether there is any need to look beyond the DCF method that has been employed with success for years by the Commission. Notwithstanding the concerns expressed by the Commission in the Briefing Orders regarding the exclusive reliance on the DCF methodology, the DCF method still remains the most robust and instructive market-based method to use in the determination of just and reasonable ROEs. The Commission determined several decades ago—after extensive input from all segments of the electric utility industry—that a market-cost of capital analysis, and specifically the DCF method, was the most appropriate way to determine allowable rates of return that meet the standards set out in *Bluefield* and *Hope*. TDU Systems believe that this approach, which the Commission has refined over the years, remains the best way to meet the *Bluefield-Hope* standards. Although the CAPM and Risk Premium methods have at least some capital market input, only the DCF method has direct, current utility stock investor input through the use of recent, competitive market-determined stock prices. Accordingly, while the results of properly applied CAPM and Risk Premium models can, when properly applied, corroborate the results of the DCF analysis, they should not be relied upon as primary analyses.

Much of the justification for the Commission's proposed reliance on alternate financial models is driven by concerns about a persistent, low-interest rate environment. As noted in the NOI, in Opinion Nos. 531[15] and 551,[16] the Commission concluded that "capital market

---

[14] *Id*.

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

conditions prevailing after the financial crisis – in particular, the low yields on bonds, including U.S. Treasury bonds – rendered the Commission less confident that a mechanical application of the midpoint of the DCF-produced zone of reasonableness would provide a risk-appropriate ROE….”[17] Similarly, in the MISO Briefing Order, the Commission pointed to differences in capital market conditions today as opposed to conditions in the 1960s. In particular, the Commission expressed concern that “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.”[18] This argument, however, fails to draw any rational connection between low bond yields and the reliability of the DCF method. During the decades when the Commission relied exclusively on the DCF method, it never intimated that its reliance was conditioned on 10-year U.S. Treasury bond yields remaining above 3.0 percent or any other threshold. To the contrary, it was not until the issuance of Opinion No. 531, in 2014, well after yields on 10-year U.S. Treasury bonds had fallen below 3.0 percent, that the Commission declared the two-step DCF method its preferred method for calculating ROEs for public utilities.[19] Thus, while it is indisputable that yields on 10-year U.S. Treasury bonds are lower now than they were in the 1980s, it is not at all clear why the Commission has concluded that the decline in yields has affected the reliability of the DCF method as an accurate measure of the cost of capital.

The Commission also claimed in the MISO Briefing Order that, in recent years, “utility stock prices appear to have performed in a manner inconsistent with the theory underlying the

---

[16] *Ass'n. of Businesses Advocating Tariff Equity, et al., v. Midcontinent Indep. Sys. Operator, Inc., et al.*, Opinion No. 551, 156 FERC ¶ 61,234 (2016)

[17] NOI at P 18.

[18] MISO Briefing Order at P 44.

[19] Opinion No. 531 at P 41.

DCF methodology."[20] In particular, the Commission stated (without citation) that the DCF method predicts that "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."[21] Then, relying on the Coakley Briefing Order, the Commission stated that "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."[22] This, the Commission concluded in the MISO Briefing Order, supports its theory that exclusive reliance on the DCF creates "model risk."[23]

The Commission's claim that utility stock prices increase only when there is an actual or projected increase in earnings is simply inaccurate. Indeed, it is contradicted by the MISO Briefing Order itself, which notes, correctly, "[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."[24] This recognition that factors other than stock-specific earnings projections affect stock prices also appears in prior Commission orders. For example, in Order No. 489, the Commission explained that the DCF model "shows the relationship between stock prices and dividends, growth rate of dividends, and shareholders' required rate of return. It does not assume

[20] MISO Briefing Order at P 47.

[21] *Id*.

[22] *Id*.

[23] *Id*.

[24] *Id*. at P 31. In this regard, it is noteworthy that, during the period of October, 2012 to December, 2017 cited by the Commission, the S&P 500 index rose more than 83%, from 1440.90 to 2645.10. Docket No. EL15-45-000, Exhibit No. JCI-200 at 23:16-20.

that price is primarily determined by dividends alone."[25] The Commission further noted that the term "k" in the DCF model, representing shareholders' required rate of return, comprised several components "including expectations about the real interest rates, the expected rate of inflation, and the "risks" associated with owning a particular stock."[26] Similarly, the D.C. Circuit noted in *Tennessee Gas Pipeline Co. v. FERC* the Commission's own statement regarding a "drastic drop in interest rates attract[s] capital away from bonds and into stocks, causing a rise in stock prices and a decline in dividend yields."[27] Thus, the increase in utility stock prices from 2012 to 2017 likely reflected the historically low interest rates the Commission itself noted in the MISO Briefing Order, as opposed to "model risk." In a similar vein, there is testimony in the record in the MISO ROE complaint proceedings that the increase in utility stock prices reflected a "flight to safety" at a time of considerable market uncertainty.[28] Rather than simply reflecting changes in actual or projected earnings growth in a linear manner, investors' required rate of return can change as a result of numerous factors, including changes in expected returns that might be earned on alternative investments, changes in risk perception, changes in risk tolerance, changes in desire for current income versus longer-term capital gains, expectations about inflation, expectations about real interest rates, expectations about the U.S. economy in general and various sectors of the U.S. economy specifically, and expectations about the global economy.[29]

---

[25] Order No. 489 at 30,990.

[26] *Id*.

[27] 926 F.2d 1206, 1029 (D.C. Cir. 1991) (quoting *Tennessee Gas Pipeline Co*., 46 FERC ¶ 61,089 at 61,383 (1989)).

[28] Docket No. EL14-12-000, Exhibit No. MTO-16 at 26:1-7; Docket No. EL15-45-000, Exhibit No. MTO-16 at 29:19-22.

[29] Docket No. EL15-45-000, Exhibit No. JCI-200 at 21:20-22:1.

Any ROE established by the Commission should allow a utility "to adequately compete for the investor's dollar."[30] By reflecting changes in market conditions and adjusting the permitted ROE to account for fluctuations in interests rates, the traditional DCF approach permits public utilities to compete on comparable terms for investor dollars. The NOI, without any evidence, inappropriately assumes that the change in prevailing capital market conditions disproportionately affected public utility in their attempts to secure capital investment from investors. Absent compelling evidence to this effect, there is no reason for the Commission to abandon the DCF and rely on alternative models as suggested in the NOI.

B. <u>The Commission Should Not Abandon the Standard for Section 206 ROE Complaints.</u>

The NOI asks a series of question concerning whether the Commission should impose additional burdens on section 206 complainants. These include the "quartile approach" proposed in the Briefing Orders[31] and a heightened standard – *i.e.*, a required showing of "sufficient changes in market conditions" – when an ROE complaint is filed "while the current ROE is being adjudicated…."[32] There is, however, no basis or authority for the Commission to impose additional burdens where a complainant makes a *prima facie* showing that the current ROE exceeds the public utility's cost of equity. The Commission should not break from this long-standing precedent. The "just and reasonable" standard of FPA sections 205 and 206 is meant to "afford consumers a complete, permanent and effective bond of protection from excessive rates and charges,"[33] and permits "not even 'a little unlawfulness.'"[34] FPA section 206 therefore

---

[30] *See Anaheim v. FERC*, 669 F.2d 799, 801, 803 (D.C. Cir. 1981).

[31] NOI at P 37.

[32] *Id.*

[33] *Atl. Refining Co. v. Pub. Serv. Comm'n*, 360 U.S. 378, 388 (1959).

[34] *Consumers Fed'n of Am.*, 515 F.2d 347, 358 n. 64 (D.C. Cir. 1975) (quoting *FPC v. Texaco, Inc.*, 417 U.S. 380, 399 (1974)).

mandates that whenever a rate is found to be unjust, unreasonable, or unduly discriminatory, the Commission "*shall*" fix a substitute rate.[35] Contrary to this obligation, the questions raised by the Commission in the NOI suggests that there are circumstances in which the ROE on file with the Commission may be unjust and unreasonable, however, not subject to change because an additional threshold test cannot be met by the complainant. Imposing additional burdens – whether in the form of a "quartile approach"[36] or a "sufficient change in market conditions test" on successive ROE complaints – is entirely inconsistent with the Commission's mandate under section 206.

The Commission, employing its current standard, has rejected several ROE complaints that failed to present a *prima facie* showing that the current ROE exceeds the public utility's cost of equity.[37] This should remain the standard for ROE complaints, including successive ROE complaints filed while a public utility's current ROE is being adjudicated. The unavoidable fact is that the allowed ROE resulting from a first-filed complaint, which will be pegged to a study period corresponding to the refund period for that complaint, may exceed the cost of equity that would result from a second-filed complaint.

Notably, the NOI does not suggest that section 205 filing rights should be curtailed during the pendency of an ROE proceeding. Such asymmetry would contravene the 1988

---

[35] 16 U.S.C. § 824e(a) (emphasis added).

[36] TDU Systems fully support the Associations' Comments which demonstrate that a policy of dismissing complaint unless the existing ROE, having been shown to exceed the cost of equity, was further shown to exceed the cost of equity by an arbitrarily wide margin would be a plain violation of the Commission's statutory obligation to reduce existing rates that are shown to have become unjust, unreasonable, or unduly discriminatory.

[37] *See, e.g., Louisiana Public Service Commission v. System Energy Resources, Inc.*, 124 FERC ¶ 61,003, P 15 (2008) (dismissing ROE complaint that failed to present essential supporting data, "such as a list of the utilities in the comparison group or the DCF methodology used for the DCF analysis," and "only provided statistical evidence of a change in bond yields, without making clear what effect this information alone has on [the target utility's] cost of equity.).

Regulatory Fairness Act,[38] which, the Commission has found, and the legislative history makes clear, was "'intended to add symmetry' between the Commission's treatment of section 205 rate increase filings and section 206 complaints seeking rate decreases."[39] Specifically, the Regulatory Fairness Act was intended to make "the system for bringing utility rates down…similar to the system for bringing rates up."[40] That is, "[w]hen utility costs go up, utilities deserve a rate adjustment….But … when the economic factors go in the other direction, consumers deserve just and reasonable rate reductions," in "the same way that utilities receive just and reasonable rate increases."[41] As the Commission has noted, "[u]tilities are free to file for successively higher rate increases based on later common equity cost data without regard to the status of their prior requests, and a fair symmetry requires that complainants also be free to file complaints requesting further rate decreases based on later common equity cost data without regard to the status of their prior complaints."[42]

Moreover, any kind of "one complaint at a time" rule, under which the pendency of a section 206 proceeding would impose a heightened standard for an additional section 206 proceeding, would provide a perverse incentive for respondents to drag out complaint

---

[38] 1988 Regulatory Fairness Act, Pub. L. No. 100-473, 102 Stat. 2299 (1988).

[39] *Env't NE v. Bangor Hydro-Elec. Co.*, 151 FERC ¶ 61,125 at P 28 (2015) (quoting *Consumer Advocate I*, 67 FERC ¶ 61,288 at 62,000, *order on reh'g, Consumer Advocate II*, 68 FERC ¶ 61,207 at 61,997 (1994), and citing 133 Cong. Rec. S10925 (daily ed. July 30, 1987) (statement of Sen. Chafee) ("[u]nder the current law, … section 205 and section 206 filings are not treated in the same manner, and this inequality serves to favor the wholesale supplier over the wholesale customers and their residential and commercial customers"); 134 Cong. Rec. H9030 (daily ed. Oct. 27, 1987) (statement of Rep. Bruce) (the Regulatory Fairness Act, in setting a "refund effective date for consumers … [uses] essentially the same system used to grant rate increases"); 134 Cong. Rec. H8095 (daily ed. Sept. 23, 1988) (statement of Rep. Gejdenson) ("[t]his legislation represents an attempt to make the current regulatory process more equitable, giving electric consumers the same protections and considerations that supplying utilities currently receive")).

[40] *Regulatory Fairness Act: Hearing Before the Comm. on Energy and Natural Resources*, 100th Cong. 2 (Nov. 18, 1987) (Statement of Sen. Bumpers).

[41] *Id*. at 26 (Statement of Rep. Bruce).

[42] *Consumer Advocate Div'n v. Allegheny Generating Co.*, 67 FERC ¶ 61,288, at 62,000, *on reh'g*, 68 FERC ¶ 61,207 (1994).

proceedings, by, *e.g.*, insisting that they be litigated rather than settled, or by petitioning for appellate review of unfavorable Commission orders regardless of the likelihood of success. Finally, TDU Systems note that the questions raised in the NOI presuppose that the only way an existing ROE can become unjust and unreasonable is through a change in market conditions. This is incorrect. For example, where utility-specific changes have resulted in the subject utility becoming less risky since the filing of a prior complaint, a subsequent section 206 should be permitted where a complainant can make a *prima facie* showing that such changes have resulted in the current ROE exceeding the public utility's actual cost of equity. The Federal Power Act mandates that the Commission address the impact of these changes on the ROE included in jurisdictional rates regardless of whether a prior complaint – concerning a different time period and a different set of circumstances – remains pending before the Commission.

III. CONCLUSION

TDU Systems appreciate the opportunity to provide feedback to the Commission on these important issues and respectfully request that the Commission take their views into consideration as it considers the issues raised in the NOI.

Respectfully submitted,

By: *_/s/ Barry Cohen_*

Barry Cohen
Kevin J. Conoscenti
Phyllis G. Kimmel
Sean T. Beeny
McCarter & English, LLP
1301 K Street, NW
Suite 1000 West
Washington, DC 20005
(202) 753-3400

Attorneys for
Transmission Dependent Utility Systems

June 26, 2019