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 DELAWARE MUNICIPAL ELECTRIC CORPORATION, INC.

Delaware Municipal Electric Corporation, Inc. ("DEMEC") respectfully submits these comments to the Federal Energy Regulatory Commission ("Commission") in response to the Commission's Notice of Inquiry ("NOI") issued on March 21, 2019,[1] seeking comments on 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, as well as interstate natural gas and oil pipelines. In support thereof, DEMEC states as follows:

I. DESCRIPTION OF DEMEC

DEMEC is a joint action agency formed under Delaware law. The Members of DEMEC are the Delaware Cities and Towns of Newark, Milford, New Castle, Seaford, Lewes, Smyrna, Clayton, Middletown, and Dover. DEMEC is a generation owner and the PJM Interconnection L.L.C. ("PJM") Load Serving Entity ("LSE") for eight of these municipal utilities. In total, DEMEC's Members have a peak load of over 470 MW. DEMEC is a transmission customer taking service under the Open Access Transmission

[1] *Inquiry Regarding the Commission's Policy for Determining Return on Equity*, 166 FERC ¶ 61,207 (2019) ("NOI").

Tariff administered by PJM at the Delmarva Power and Light Company ("Delmarva" or "DPL") zone rate.[2]

II. INTRODUCTION AND SUMMARY OF COMMENTS

The NOI seeks comments to help the Commission explore whether, and if so how, it should modify its policies concerning the determination of a just and reasonable ROE to be used in designing jurisdictional rates charged by public utilities.

Broadly, DEMEC supports the Commission's continued use of the traditional two-step Discounted Cash Flow ("DCF") methodology for all regulated entities. The traditional two-step DCF methodology allows for more predictable results while involving the least amount of subjectivity and bias. Thus, the two-step DCF methodology provides for an adequate balance of customer and utilities' interests. *See* Section III.A-B, below. In addition, the DCF methodology has proven successful over time and remains the most appropriate way to determine allowable rates of return that meet the capital attraction standards set out in the seminal Supreme Court cases of *Bluefield*[3] and *Hope*.[4] *See* Section III.C, below.

In its comments, DEMEC provides responses to a miscellaneous set of specific questions in the NOI. *See* Section IV.A-H, below.

III. GENERAL COMMENTS

The NOI seeks comments on eight general topics regarding potential modifications to the Commission's approach to determining a just and reasonable ROE.

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[2] Delmarva has a formula rate which uses a template populated with entries taken from Delmarva's FERC Form 1 using the Uniform System of Accounts.

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

[4] *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) ("*Hope*").

In Section IV below, DEMEC responds to some of these questions in detail. In this section, however, DEMEC provides its general comments regarding the approach the Commission should take with respect to its policies concerning the determination of a just and reasonable ROE.

A. The Commission Should Not Depart From the Traditional Two-Step DCF Methodology

The instant NOI stems from the U.S. Court of Appeals for the District of Columbia Circuit's ("Court") decision in *Emera Maine v. FERC*,[5] wherein the Court vacated and remanded Opinion No. 531.[6] In Opinion No. 531, the Commission modified the long-standing and preferred DCF approach from a one-step to a two-step methodology, and considered other ROE methods and approaches used to select the just and reasonable placement of the base ROE. Following *Emera Maine*, the Commission issued two orders proposing a new methodology for addressing the issues that the Court remanded to the Commission.[7] Particularly, the Commission proposed to depart from decades of precedent for public utilities relying exclusively on the DCF model to determine a just and reasonable ROE. The Commission proposed to rely on the DCF, Capital Asset Pricing Model ("CAPM"), Expected Earnings, and Risk Premium models to produce four separate base ROE estimates that would then be averaged to produce a specific just and reasonable base ROE. In the *Coakley* and MISO Briefing Orders, and now in the instant NOI, the Commission seems to make the ROE determination more

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5 *Emera Maine v. FERC*, Case No. 15-1118 (D.C. Cir. Apr. 14, 2017).

6 *See Coakley v. Bangor Hydro-Elec. Co.*, 144 FERC ¶ 63,012 (2013) ("ALJ Decision"), aff'd in part, rev'd in part, Opinion No. 531, 147 FERC ¶ 61,234 (2014) ("Opinion No. 531"), order on paper hearing, Opinion No. 531-A, 149 FERC ¶ 61,032 (2014) ("Opinion No. 531-A"), order on reh'g, Opinion No. 531-B, 150 FERC ¶ 61,165 (2015) ("Opinion No. 531-B").

7 *See 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").

complex, which would increase subjectivity and decrease the level of predictability for outcomes by market participants. This in turn would make litigation more lengthy, complex, and costly.

Departing from the Commission-preferred traditional two-step DCF methodology and instead relying on three additional ROE methodologies presents three primary adverse consequences. First, the use of four methodologies will complicate and further prolong the ROE litigation process. The determination of a just and reasonable ROE is generally one of the larger, if not the largest, component of a public utility transmission provider's filing for an increase in rates. A new ROE methodology, if implemented, will make the process more complicated and expensive. While utilities are able to recover their litigation costs from customers, the customers will be unnecessarily burdened with higher litigation costs. Second, the subjective and complex ROE determination process will result in very little, if any, predictability of the final ROE outcome. Third, as a result of the highly complex proposed ROE determination process, the resulting rates may not be just and reasonable.

Even with the use of the traditional two-step DCF approach, the litigation process involving the ROE determination remains long and expensive. Nonetheless, unlike the proposed new ROE methodology, the traditional two-step DCF methodology is straightforward based on a mathematical formula involving the least amount of subjectivity and bias in the ROE computed by the various market participants. As such, DEMEC submits that the Commission maintain the traditional two-step DCF methodology for determining a just and reasonable ROE.

B. The Commission Should Appropriately Balance The Interests of Customers and Investors

In considering whether and how to revise its ROE policies, the Commission should appropriately balance the interests of customers and public utility transmission providers. Particularly, the Commission should not lose sight of its statutory responsibility to protect customers under the Federal Power Act, the Natural Gas Act, and long-standing precedent.

The Supreme Court cases of *Hope* and *Bluefield* articulate the consumer-protection standards by which utilities recover their costs, and generally require rates that balance the interests of both investors and ratepayers. *Hope* and *Bluefield* establish that this balance is reached by an ROE that is no higher than what is required to: (1) achieve a return proportionate to the returns earned by comparable risk enterprises in order to fairly compensate investors for capital they have invested in the utility; (2) enable the utility to attract sufficient new capital; and (3) maintain the financial integrity of the utility.[8] Additionally, in *Hope*, the Supreme Court noted that "[t]he primary aim of this legislation [the Natural Gas Act] was to protect consumers against exploitation at the hands of natural gas companies."[9] Similarly, in Opinion No. 531-B, the Commission stated that the Federal Power Act "was intended to be a consumer-protection statute."[10]

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[8] *Bluefield*, 262 U.S. 679, 693 ("The return should be reasonably sufficient to assure confidence in the financial soundness of the utility 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."); *Hope*, 320 U.S. 591, 603 (A just and reasonable return is "commensurate with returns on investments in other enterprises having corresponding risks" and "should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain [a utility's] credit and to attract capital.").

[9] *Hope*, 320 U.S. 591, 610.

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

The Commission has recognized that the balance between investor and ratepayer interests is best measured by the current market cost of common equity.[11] For many years, until approximately 1987 when interest rates started increasing, the ROEs based on the previously prevalent Price Earnings ("PE") approach did not increase as much the interest rates did. Accordingly, the Commission adopted the DCF methodology for determining ROE because it resulted in higher ROEs than those based on the previously used PE approach. Over the years, the Commission also made it standard practice to use the midpoint of the range of the DCF based ROEs from a selected proxy group of comparable utilities. Subsequently, in order to increase the ROE amounts, the Commission started using the median of the ROE range. However, when interest rates and the cost of capital substantially declined, utilities began receiving ROEs less than 10% based on the DCF model. This result prompted utilities to argue for higher ROEs in order to allegedly attract capital. As such, the Commission departed from its primary responsibility of balancing the interests of investors and ratepayers, and its long-standing practice of setting ROEs based on the median of the ROE range. Particularly, in Opinion No. 531, the Commission changed the traditional, preferred DCF approach, permitting ROEs of more than 10%.[12] The Commission's Opinion No. 531 failed to properly take into consideration the fact that utilities already may receive a number of transmission incentives, including 50 to 150 basis point ROE adders, the inclusion of Construction Work in Progress ("CWIP") amounts in rate base, the use of hypothetical capital structures, and 100% recovery of a transmission project's abandonment costs.

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[11] *Generic Determination of Rate of Return on Common Equity for Pub. Utilities*, Order No. 420, 50 Fed. Reg. 21,802 (1985), FERC Stats. and Regs., Regulations Preambles 1982-1985 ¶ 30,644 at 31,336 (1985) (footnotes omitted), reh'g denied, Order No. 420-A, 50 Fed. Reg. 34,086 (1985).

[12] Opinion No. 531, at P 8.

Additionally, the NOI proposes using the Expected Earnings methodology which, besides being highly speculative, will result in added costs to customers. The central flaw in the Expected Earnings methodology is that it is completely devoid of any market input, which, in turn produces outlier results.[13] Accordingly, employing such a methodology will, *inter alia*, produce an erroneously inflated measure of investors' required level of return. This would artificially raise the top of the zone of reasonableness, inflate the base ROE, and result in higher costs to customers. DEMEC reasserts that a simple and straightforward approach such as the DCF methodology, the only mathematical based approach with the least subjectivity, should be used.

C. Utilities Face Very Little Transmission Business Risks

In the *Coakley* and MISO Briefing Orders, the Commission reasons that using four different approaches will more accurately inform 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.[14] However, it is unclear as to which investors' expectations the Commission refers. On the one hand, every day investors trade millions of utility shares at rate of return significantly less than 6%. On the other hand, while utilities frequently claim that the transmission business is highly risky, various Commission allowances result in actual ROEs close to 20%, which result in a low risk business. Moreover, most of the public utility transmission providers use a formula for computing their transmission rates, which have true-up mechanisms that allow utilities to true-up the

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[13] *See Ass'n of Businesses Advocating Tariff Equity, et al.*, Docket No. EL14-12-003, Exh. No. JCI-200 at 26-27.

[14] MISO Briefing Order at P 38; Coakley Briefing Order at P 35.

actual revenues they receive from customers, virtually guaranteeing recovery of their annual costs.

Additionally, by using the DCF model, the Commission is already awarding ROEs that meet the capital attraction standard set forth in *Hope* and *Bluefield*.[15] According to an Edison Electric Institute Report, there has been a significant increase in transmission investment. Specifically, 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.[16] Accordingly, the DCF methodology has proven successful, and there is no rational for abandoning this long-standing methodology to establish just and reasonable ROEs and tilting further the balance in favor of investors.

IV. SPECIFIC COMMENTS ON NOI

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

Q A1: **To what extent would the ROE methodology described in the *Coakley* and MISO Briefing Orders impact the predictability of ROE determinations and the costs for market participants of making or intervening in such proceedings?**

Introducing a new ROE methodology other than the traditional two-step DCF approach will needlessly add complexity resulting in prolonged litigation that would add to the unpredictability of the litigation's outcome and would significantly increase litigation costs. Utilities would ultimately pass these higher litigation costs on to customers. The high costs could deter parties from intervening in ROE proceedings. A

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[15] *See Hope*, 320 U.S. 591, 603; *see also Bluefield*, 262 U.S. 679, 693.

[16] 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.

lack of sufficient participating by different market participants may not result in just and reasonable ROE.

Q A2: How would using the ROE methodology described in the *Coakley* and MISO Briefing Orders affect an investor's ability to forecast the ROE the Commission would establish in a litigated proceeding and the ability of participants to propose, contest, and settle base ROEs as compared to using only the DCF methodology?

If the Commission only uses the traditional two-step DCF methodology, the results would be more predictable and easier to forecast. Introducing other subjective approaches will lead to increased litigation and reduced predictability.

Q A3: Currently, public utilities in different Independent System Operators (ISOs) or RTOs may receive different ROEs, despite all using national proxy groups, due primarily to differences in when FPA section 205 or 206 proceedings were initiated. Are such variations justified, and, if not, should the Commission consider applying the same ROE to all utilities in RTOs/ISOs based on the most recent proceeding?

DEMEC submits the Commission should establish ROEs on a case-by-case basis, in order to produce just and reasonable results. Applying the same ROE to all utilities in different RTOs/ISOs based on the most recent proceeding would erroneously ignore the unique differences among different utilities in a RTO/ISO. Particularly, such an approach would disregard the unique risks faced by the utilities in various RTOs/ISOs, such as, for example, wildfire-related risks which make California utilities uniquely risky when compared to utilities in other regions. Additionally, variations to ROEs are justified and expected given that investors' expectations change over time.

Q A4: Should the ROE reflect the cost of capital at the time of the investment or be subject to adjustment to reflect the contemporary ROE required by investors?

Q A4.a: Should the Commission consider a "vintage approach," with ROE fixed for the life of the asset at the time that each asset was completed?

As DEMEC understands it, under a vintage approach the ROE will be fixed at the time a facility was originally installed. This approach presents two primary issues. First, different ROEs will be used for the facilities depending upon the time of their installation, which would add complexity to an already complicated process. Second, the vintage approach assumes that the capital cost of continuing to own an asset is fixed at the cost of capital prevailing when the asset was built or completed. However, long-standing precedent acknowledges that ROEs are not static and will in fact vary over time: "A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally."[17] As such, DEMEC submits that a vintage approach should not be adopted.

Q A4.b: Would such a "vintage approach" need to be coupled with an annual national default ROE for investments made in that year, so as to minimize the need for numerous annual litigated ROE proceedings for each public utility that made an investment during that year? What procedure should be used to determine such a default ROE?

As stated above, a vintage approach will needlessly complicate the ROE determination and accounting/bookkeeping processes without much, if any, benefit to customers and investors. Tracking the ROE for each asset would further add complications and does not serve any useful purpose.

B. ROEs For Different Commission-Regulated Industries

Q B1: **In Opinion No. 531, the Commission found that the same DCF methodology should be used to determine an ROE for all its regulated industries, including public utilities, as well as gas and oil pipelines. If the Commission departs from our sole use of a two-step DCF methodology for public utilities,**

[17] *See Bluefield*, 262 U.S. 679, 693.

should the new method or methods also be used to determine natural gas and oil pipeline ROEs?

The Commission should continue to use its traditional two-step DCF methodology for all regulated utilities as they all compete for capital from similar capital markets.

Q B3: Given the tendency of the Expected Earnings methodology to produce more high-end outliers than the other methodologies, would there be a sufficient number of natural gas and oil pipeline proxy members to implement the Expected Earnings methodology for gas and oil pipelines?

As discussed in Section III.B. above, the Expected Earnings methodology produces outlier results, which do not reflect the market cost of equity capital envisioned in *Hope* and *Bluefield*.[18] The Commission's statement that this approach produces "more high-end outliers than the other methodologies," acknowledges the fact that the Expected Earnings methodology is not a suitable approach. As such, this methodology should not be used.

C. Performance of the DCF Model

Q C2: Have current and projected proxy company earnings over the last 10 to 20 years increased in a manner that would justify any increases in their stock prices over the same period, consistent with DCF model assumptions?

The changes in the utilities' stock prices are affected by a number of other factors, such as utilities' earnings and their operational performance, and changes in investors' risk perceptions of utilities,[19] and not by the ROE determination and assumptions used by

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[18] *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).

[19] *See e.g., Ass'n of Businesses Advocating Tariff Equity, et al.*, Docket No. EL14-12-003, Exh. No. JCI-100, at 22-23 (The required rate of return for which the DCF formula solves "certainly changes over time and is influenced by a myriad of factors in addition to expected growth in earnings/dividends. Such factors include expected opportunity costs, or expected returns that might be earned on alternative investments, changes in risk perceptions, changes in risk tolerance, changes in a desire for

the Commission. As such, utility stock prices can rise if any of these numerous factors change, even with no change to realized or expected utility earnings.

Q C3: How does the DCF methodology perform over a wide range of interest rate conditions?

Q C3.a: What specific assumptions of the DCF model, if any, do not work well in low or high interest rate environments?

DEMEC is not aware of any specific assumption which would not work well with a change in interest rates. The results of the DCF methodology will vary appropriately with changes in interest rates.

D. Proxy Groups

Q D1: Should proxy groups for electric utilities, as well as natural gas and oil pipelines, consist only of companies with corresponding regulated businesses?

Under Opinion No. 531, utilities in the proxy group must "be *comparable* to the regulated firm whose rate is being determined. In other words, as the court emphasized in *Petal*, the proxy group must be risk-appropriate."[20] Accordingly, DEMEC submits that the proxy group for electric utilities, as well as natural gas and oil pipelines, should consist only of companies with corresponding regulated businesses, *i.e.*, electric utilities with transmission service as a primary business should be included in the proxy group.

Q D2: **Should risk be considered both in the proxy group selection and in the placement within the zone of reasonableness?**

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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 as well as expectations about the global economy, among others. Under the DCF theory, as those factors change, stock prices will change even if earnings or expected growth in earnings/dividends do not change.").

[20] Opinion No. 531, n.184 (citing Petal Gas Storage, L.L.C. v. F.E.R.C., 496 F.3d 695, 699 (D.C. Cir. 2007)) (emphasis added); *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048, at P 48 (2008) (internal quotation marks omitted).

Yes, in accordance with Commission precedent, risk should be considered both in the proxy group selection and in the placement within the zone of reasonableness. Particularly, as stated above, under Opinion No. 531, in forming proxy groups, utilities must be representative of the subject utility's risk.[21]

Q D2.a: **Should the Commission's approach to proxy group selection change depending on which financial models it considers when determining the just and reasonable ROE and, if so, how?**

Given that DEMEC strongly recommends the continued use of the traditional two-step DCF methodology, there would not be any need for selecting a proxy group based on the other ROE models.

Q D3: **Should the Commission consider non-energy companies when selecting proxy groups?**

No, consistent with Commission precedent and the *Coakley* and MISO Briefing Orders, energy companies in the proxy group should not include non-regulated utility companies. The Briefing Orders set forth criteria for developing proxy groups, which included, *inter alia*, the use of a national group of companies considered *electric utilities* by Value Line.[22] Accordingly, non-energy companies should not be considered when selecting the correct proxy group.

Q D3.a: What non-energy industries or securities have comparable risk to public utilities and natural gas and oil pipelines, if any?

DEMEC is not aware of any non-energy or any other industry which provides similar opportunities to recover costs as does the electric industry.

Q D3.b: Do certain non-energy industries or securities feature fewer outliers?

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[21] Opinion No. 531, n.184.

[22] Coakley Briefing Order, at P 49 (footnotes omitted); MISO Briefing Order, at P 50 (emphasis added).

Allowing the use of non-energy industries as a part of the proxy group should not be allowed as such industries are much riskier than natural gas and oil pipelines.

Q D.4: **What, if any, are appropriate high- and low-end outlier tests?**

Q D4.a: The Commission currently excludes from the proxy group companies whose ROE fails to exceed the average 10-year bond yield by approximately 100 basis points. Should the low-end outlier test continue to be based on a fixed value relative to the costs of debt or (a) should it be based on its value relative to the median (i.e., less than 50 percent of the median); or (b) still reflect the cost of debt but vary based on interest rates?

The above cited high- and low-end outlier tests should continue to be used.

Q D4.b: How, if at all, should the Commission's approach to outliers vary among different financial models?

Given that DEMEC recommends the use of only the preferred two-step DCF methodology, there should only be one criterion, described by the Commission in question D4.a, for determining outliers. Notwithstanding, even if the Commission decides to use different financial models, the Commission should still remove outliers in order to produce a zone of reasonableness that accurately and fairly estimates a utility's current market cost of equity.

Q D5: **How, if at all, does the Commission's use of credit ratings in ROE determinations incentivize public utilities to behave in certain ways, such as issuing more debt, and does this affect public utilities' credit ratings?**

Higher ROEs encourage utilities to have more equity, which in turn result in higher rates. As such, ROEs should not be needlessly inflated. In general, debt cost is significantly less than the cost of equity. Further, debt cost is tax deductible, whereas equity cost is not. In fact, the return on equity is taxable, which further increases the costs to customers. As such, the debt amount should be to the maximum level which does not significantly affect the credit rating. Further, the Commission should

discontinue using standalone capital structure which generally has more equity than does the holding or parent company whose capital structure is the only investors consider when making investment decisions.

Q D8: The Commission excludes from the proxy group companies with merger activity during the six-month study period that is significant enough to distort study inputs. Should the Commission continue using our existing merger screen?

Yes, the Commission should continue to use its existing merger screen.

Q D8.a: If so, should the Commission revise its standards for what conduct constitutes merger and acquisition activity?

No, there is no need to revise the Commission's current merger and acquisition screen.

Q D9: What circumstances or factors, if any, warrant an adjustment from the midpoint/median to other points within the zone of reasonableness (*e.g.*, lower or upper midpoint/median)?

Under no circumstances should an adjustment be made to the ROE based on the median of the zone of reasonableness. DEMEC is concerned that once the Commission starts allowing adjustments, there would not be any end to parties proposing adjustments above the proxy group median.

Q D10: **The Commission currently uses midpoints to determine the central tendency of the zone of reasonableness when determining RTO-wide ROEs. Should the Commission adopt a policy of using medians for this purpose?**

DEMEC submits that, in accordance with long-standing Commission precedent and practice, the median should be applied in all cases. Broadly, the median more accurately describes the central tendency of the proxy group results than the midpoint. Additionally, Commission precedent for using the median in setting an ROE is well established. The Commission has previously explained that the median is preferable to applying the midpoint or mean because it aids the Commission in its effort to treat all

companies that face average risk equally.[23] Accordingly, the median, and not the midpoint, should be used to determine the central tendency of the zone of reasonableness when determining RTO-wide ROEs.

Q D10.a: Would the use of multiple ROE methodologies, as proposed in the *Coakley* Briefing Order, undercut the Commission's current rationale for using the midpoint in RTO-wide base ROE?

DEMEC reasserts its position that methodologies other than the DCF methodology should not be used.

Q D10.b: Should the size of the proxy group be considered in this decision?

No, the size of the proxy group should not be considered because it may affect other ROE determination approaches. Currently, in spite of the consolidation of the gas and electric transmission businesses, there are still sufficient enough regulated utility companies from which to complete a proxy group selection criterion.

E. Financial Model Choice

Q E1: What models do investors use to evaluate utility equities?

DEMEC is not aware of actual investors relying on any models. Their investment decisions are based, among other things, on the utilities' financial strength, operational performance, and the actual earnings and actual dividends they receive on utilities' stocks.

Q E6: To the extent that investors use multiple models, should the Commission combine them in its analysis or use the "best" one that would apply in all market conditions?

As stated above, there is no evidence that actual investors rely on any financial model. For decades, investors have been relying on the ROEs allowed based on the DCF methodology.

[23] *N.W. Pipeline Corp.*, 99 FERC ¶ 61,305, at 62,276-277 (2002).

Q E7: If the Commission were to consider multiple models, how should it weigh them?

Actual investors do not use any models and rely upon the factors listed in response to Question E.1. Accordingly, the Commission should consider no model other than the DCF model.

Q E8: To what extent is it reasonable for the Commission to use a simplified version of a model that does not reflect all the variables that investors consider?

Q E8.a: Is the use of a simplified model justified for ease of administration and predictability of result?

The traditional two-step DCF methodology is a simple model and it is the only model primarily relied upon by market participants. The continued use of the DCF model would provide predictability of result and ease of administration.

Q E9: **How, if at all, should the Commission consider state ROEs?**

Q E9.a: How and why do state ROEs vary by state?

Q E9.b: How are certain state ROEs more or less comparable to Commission ROEs?

The Commission may consider state-authorized ROEs, but it should not allow FERC-jurisdictional transmission ROEs higher than the state allowed ROE for two primary reasons. First, unlike in the transmission business, the retail business does not guarantee any cost recovery. Second, the retail business is generally much bigger than the transmission business and, thus, has more impact on the financial indicators reported to the public and investors. Therefore, retail ROEs would reflect the different market factors better than the ROEs based on transmission business.

Q E10: **If the Commission considers state ROEs, how should it compare FERC-jurisdictional transmission ROEs with state ROEs that apply to utilities that are (a) distribution and transmission companies; or (b) distribution, generation, and transmission companies?**

For comparison purposes, and establishing the state-authorized ROE as an upper limit, the utilities could have any retail business such as distribution, transmission, generation or any combination thereof as it will have no bearing when using the state level ROE as a cap.

Q E11: **To what extent, if any, should the Commission exercise judgment in using financial models to set ROEs under various capital market conditions?**

If the DCF methodology is used, no judgment is needed as the DCF model results in a just and reasonable ROE even in a wide range of capital market conditions. To use judgment in order to negate the DCF methodology's results would amount to allowing preconceived notions of what ROEs should be. As such, the DCF methodology should be used under all market conditions with no application of regulatory judgment.

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

Q F1: **Does the mismatch between market-based ROE determinations and a book value rate base support current market values? Is this mismatch a problem?**

There is hardly any relationship between book value included in rate base and market value. No matter what model is used, the model will be primarily affected by the market value. If a consistent ROE determination based on the DCF methodology without any adjustment is used, then the mismatch should not present a problem.

Q F2: Why have most or all utility market-to-book ratios consistently exceeded one?

For many years, utilities' market-to-book ratios have exceeded one because the utilities' dividends have been consistent, increasing with time and generally exceeding

the returns on other investments. The returns on utilities' stocks have resulted in higher stock prices resulting in market value to exceed the book value. This is yet another indication that the current allowed ROEs are very reasonable and that there is no need to adopt speculative ROE determination approaches.

Q F3: How should the ROE level be set relative to the cost of equity?

Allowable ROEs should be based on the DCF approach, which is in turn based on the actual yield reflecting the actual market conditions and investors' perception.

Q F4: Should the Commission revise our use of these models to account for the mismatch between market-based ROE determinations and book-value rate base? If so, how? For example, should the Commission adjust the dividend yield used in the DCF model to represent a yield on book value rather than a yield on stock price?

DEMEC submits that there is no need to revise the traditional two-step DCF model and no other model should be used. In addition, yields on stock prices should continue to be used. To do otherwise would violate the basic principles of the DCF method and Commission precedent.[24]

Q F5: Should the Commission consider adjusting ROEs to account for market-to-book ratios above or below one? Would doing so introduce circularity into Commission ROEs by setting the ROE at whatever level of earnings the market expected, rather than making an independent assessment of the appropriate ROE?

No; once any adjustment is allowed, many more adjustments would be proposed. Further, as the above question acknowledges, adjusting ROEs to account for market-to-book ratios above or below one would introduce "circularity."

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[24] *Orange & Rockland Utilities, Inc.*, Opinion No 313, 44 FERC ¶ 61,253, at 61,951-952 (1998) ("O&R's proposal that the Commission modify the DCF model to use the utility's book value per share rather than market price in the denominator of the dividend yield calculation must be rejected because it abandons the Commission's cost-based approach to ratemaking. Under O&R's proposal, market determinations of capital costs would no longer be reflected in the allowed rate of return on common equity.").

G. First Prong of ROE Determination

Q G1: How should the Commission determine if existing ROEs are just and reasonable?

For decades, ROEs based on the traditional DCF methodology have been deemed to be just and reasonable. Nothing has changed that could affect this outcome.

Q G2: **Is the quartile approach that the Commission proposed in the *Coakley* and MISO Briefing Orders appropriate? If not, how should the Commission revise this methodology?**

The Commission's proposed quartile approach in the Coakley and MISO Briefing Orders is not appropriate. The Commission's traditional approach of using the median of the ROE range should continue to be used.

Q G4: **In single utility rate cases, the Commission determines the central tendency of the zone of reasonableness based on the median of the proxy group ROEs. Is the approach outlined in the *Coakley* and MISO Briefing Orders appropriate in single utility rate cases given that the proxy company ROEs tend to cluster near the center of the zone of reasonableness, making the middle quartile relatively narrow?**

Q G4.a: Would it be reasonable to determine the central tendencies of the upper and lower halves of the zone of reasonableness for single utilities based on a midpoint analysis, so as to produce approximately equal ranges of presumptively just and reasonable ROEs for below average, average, and above average risk utilities?

As stated in response to Question G2, the traditional approach of using the median should apply for a single utility and multiple utilities as well. Unlike the median approach, the midpoint does not accurately measure the central tendency of the proxy group results. This is so because the midpoint depends upon only the two most extreme, unrepresentative observations (*i.e.*, the highest point and the lowest point in the proxy group results), and ignores the distribution of proxy group results, making it more

susceptible to being skewed by outlier values that can distort the estimate of the zone of reasonableness.[25]

H. Model Mechanics and Implementation

Q H1.1: Are IBES data a good proxy for "investor consensus?"

Yes, IBES data are a good proxy for investor consensus.

Q H1.1.a: If not, are there better alternatives, such as Bloomberg, Zacks, S&P Capital, Morningstar, and Value Line?

The Commission has consistently expressed its preference for reliance on IBES data.[26] DEMEC submits there are no better alternatives for IBES data.

Q H1.1.b: **Should the Commission combine data from multiple sources?**

The IBES growth rates are the average of the growth rates determined by more than one authority, whereas the other growth rates are determined primarily by one authority. As such, the Commission should not combine data from multiple sources, and should instead use IBES data in order to more accurately reflect growth rate estimates.

Q H1.3: The DCF model incorporates data at the parent/holding company level (*e.g.*, stock price). The Commission adjudicates cases at the operating company level, for which there is no public data like stock prices, growth rates, and betas. What impact does this disparity have on the results of the DCF and other models?

As most of the utilities are owned by holding companies, the DCF model using the data of the holding company would not, if at all, distort the results as this is the only publicly available data which investors generally rely upon. In fact, the use of the

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[25] *See Arkansas Elec. Cooperative Corp., et al.*, Docket No. EL15-45-000, Exhibit No. OMS-208 at P 4.

[26] *Enbridge Pipelines (KPC)*, 100 FERC ¶ 61,260, at P 234 (2002) ("The IBES data is a compilation of projected growth rates from various knowledgeable financial advisors within the industry."); *Nw. Pipeline Corp.*, 92 FERC ¶ 61,287, at 62,002 (2000) ("IBES data is the preferred data source for computing the short-term growth rate.").

operating company's capital structure distorts the results as their equity level is artificially set by the holding companies.

Q H1.4: Should the Commission continue to rely on the efficient market hypothesis, which underlies the DCF and CAPM models? Why or why not?

As DEMEC has recommended, only the DCF methodology should be used.

Q H1.4.a: If yes, should the Commission continue to employ outlier screens, M&A screens, etc., for the DCF and CAPM models since these models need to incorporate all relevant information?

Yes, the Commission should continue to employ outlier screens and other types of screens for the DCF model because such screens can help minimize the skewing of the results of the central tendency of the proxy group estimates.

Q H1.5: Should growth rates be based on Value Line, IBES, or alternative estimates?

As stated above, growth rates should be based only on IBES estimates.

Q H2.a.1: Should the Commission continue to use a dividend DCF model or should the Commission use a different DCF model, for example, one based on free cash flow?

The Commission should continue to use a dividend DCF model as there is no evidence that the methodology produces unjust and unreasonable results.

Q H2.a.3: Do investment analysts project earnings/dividends growth beyond five years, and if not, why not, and is GDP an appropriate proxy for long-term growth?

GDP is an appropriate proxy for long-term growth. The use of a long-term growth beyond a five-year period, however, is highly speculative. Investment analysts make their forecasts/projections based on the best available data at the time of the forecast. As such, longer-term growth projections are highly uncertain and speculative, and can be significantly impacted by changes in market conditions and other factors.

Q H2.a.5: The Commission uses a constant growth DCF model. Should the Commission consider using a multi-stage DCF model? If so, how would the Commission determine the length of each stage of a proxy company's growth?

No, the Commission should continue using a constant growth two-step DCF model. There is no need to needlessly complicate the model.

Q H2.a.6: **Are six months of average high/low historical monthly stock prices an appropriate measure for the current stock price "P"?**

The Commission has consistently found that the use of six months of data is a "reasonable and appropriate time frame for determining a rate of return on equity."[27] Similarly, DEMEC believes that six months of average high/low historical monthly stock prices are an appropriate measure for the current stock price "P." There is no compelling reason to change the Commission's long-standing approach of using six months as its standard DCF study period length.

[27] *Boston Edison Co*., 42 FERC ¶ 61,374 at 62,093 (1988).

V. CONCLUSION

WHEREFORE, DEMEC respectfully requests that the Commission consider these comments and the positions and recommendations made herein.

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Respectfully submitted,

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