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 PJM TRANSMISSION OWNERS

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I. INTRODUCTION AND SUMMARY

The PJM Transmission Owners[1] submit these Comments in response to the Commission's March 21, 2019 Notice of Inquiry in the above-referenced docket.[2]

The Commission's return on equity ("ROE") policies have significant effects on transmission-owning public utilities, including the PJM Transmission Owners. These policies must recognize and fairly compensate transmission owners for the business and financial risks they face in an environment characterized by changes in the mix of generating resources and new technologies that the grid must support. Those risks are particularly acute for electric utilities, like the PJM Transmission Owners, that have delegated significant operational and planning responsibilities for their transmission assets to a regional transmission organization or independent system operator.[3] The Notice of Inquiry presents an opportunity for the Commission to address these important ROE-related issues. As discussed below, the PJM Transmission Owners generally support the approaches that the Commission has recently proposed, but believe certain adjustments are needed.

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[1] The PJM Transmission Owners joining in these comments are: American Electric Power Company, Inc.; The Dayton Power and Light Company; Dominion Energy Services, Inc. on behalf of Virginia Electric and Power Company d/b/a Dominion Energy Virginia; Duke Energy Corporation on behalf of its affiliates Duke Energy Ohio, Inc., Duke Energy Kentucky, Inc., and Duke Energy Business Services LLC; Duquesne Light Company, Exelon Corporation; FirstEnergy Service Company, on behalf of its affiliates American Transmission Systems, Incorporated, Jersey Central Power & Light Company, Mid-Atlantic Interstate Transmission LLC, West Penn Power Company, The Potomac Edison Company, Monongahela Power Company, and Trans-Allegheny Interstate Line Company; PPL Electric Utilities Corporation; and Public Service Electric and Gas Company.

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

[3] The PJM Transmission Owners in these Comments refer to regional transmission organizations and independent system operators collectively as "RTOs."

In determining whether an existing ROE is just and reasonable, the Commission has proposed to establish a range of presumptively just and reasonable ROEs within a zone of reasonableness.[4] Although the PJM Transmission Owners do not disagree with the use of a band around the measure of the central tendency to identify the range of presumptively reasonable ROEs, they believe that the Commission's approach defines that band too narrowly. The D.C. Circuit has reminded the Commission that it must recognize the existence of "a broad range of potentially lawful ROEs."[5] The Commission can best do so by treating each of the three segments of the composite zone of reasonableness as being equal-sized, so that the middle third of the composite zone should comprise the range of presumptively reasonable ROEs for average risk utilities.

Also, the Commission should take this opportunity to implement measures that would more efficiently manage section 206 challenges to existing ROEs. In addition to defining the range of presumptively reasonable ROEs, the Commission should seek to avoid repetitive, "pancaked" section 206 challenges to existing ROEs by placing a substantial burden on the complainant in seeking to rebut the presumption that an ROE within that range is just and reasonable under the first prong of section 206. Further, the Commission should review any ROE complaint with a critical eye in order to determine whether the complainants have established through clear and convincing evidence that an existing ROE is unjust and unreasonable.

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[4] In the Notice of Inquiry, the Commission refers to the ROEs calculated for the proxy group of comparable utilities as the composite "zone" of reasonableness and the ROEs that are presumed to be just and reasonable for purposes of the first prong of the Commission's review under section 206 of the Federal Power Act ("FPA"), 16 U.S.C. § 824e, as the "range" of presumptively just and reasonable ROEs. *See* Notice of Inquiry at PP 25, 37. The PJM Transmission Owners have adopted this convention in these Comments.

[5] *Emera Maine v. FERC*, 854 F.3d 9, 26 (D.C. Cir. 2017) ("*Emera Maine*").

The Notice of Inquiry raises a number of issues concerning ROE calculation mechanics and implementation. The PJM Transmission Owners urge the Commission to address the issues by bearing in mind that the fundamental purpose of the ROE analysis must be to determine the returns that investors require to provide the capital necessary for transmission infrastructure investments. This requires the Commission to consider the information that investors rely upon to make investment decisions. These principles should lead the Commission to do all of the following, as explained below:

- The PJM Transmission Owners support the Commission's proposal to use the average of the four methodologies with equal weighting in setting ROEs. It makes sense to use multiple models to establish ROEs because, as the Commission has noted, investors use multiple models, in addition to the discounted cash flow ("DCF") model, to inform their investment decisions. Moreover, the use of multiple approaches provides a hedge against the shortcomings of any one approach in particular financial conditions. (*See* section III(B)(1))

- The Commission should return to the use of the single-step constant growth DCF model for public utilities, since there is no evidence that investors rely on long-term forecasts of growth in the gross domestic product in deciding to invest in electric utilities, as the two-step DCF model assumes. Further, the circumstances of electric utilities are quite different from those that motivated the Commission to shift from the constant growth model to the two-step DCF model for gas and oil pipelines. (*See* section III(B)(2)(a))

- Since investors do not rely on a single source of earnings forecasts to project dividend growth, the Commission should consider all sources of analysts' forecasts that are widely relied upon in the investment community. (*See* section III(B)(2)(b))

- For the dividend yield component of the DCF model, the PJM Transmission Owners agree with the Commission's use of six months of average high/low historical monthly stock prices. The six-month historical average stock price is an appropriate measure, which adds robustness to the model results and is a practical accommodation to even out short-term volatility in a utility's stock price. (*See* section III(B)(2)(c))

- The PJM Transmission Owners support the Commission's proposal to use results of the Capital Asset Pricing Model ("CAPM") in determining the just and reasonable ROE for electric utilities. They urge the Commission to recognize the empirical work demonstrating that the CAPM tends to underestimate returns for certain low beta companies, such as electric utilities, and incorporate an

adjustment for that tendency in the CAPM-based ROE estimates. (*See* section III(B)(3))

- The PJM Transmission Owners also strongly support the use of the Expected Earnings model as part of the multi-model ROE estimation framework with one change to compute an average rate of return. The model is a valid and complementary approach to the DCF model and CAPM in estimating the zone of reasonableness. (*See* section III(B)(4))

- The PJM Transmission Owners also support the use of the Risk Premium model, together with the other models, to determine just and reasonable ROEs. The capital market relationship upon which the model is based is appropriate for any market conditions, and the Risk Premium analysis is compatible as long as the appropriate adjustment is made to account for both (i) the current capital market conditions, and (ii) those conditions that were present at the time of the study (used to calculate the relationship between bond yields and equity risk premiums). The Commission should incorporate both the historical and projected Risk Premium analyses by using the midpoint of the results of these analyses as the Risk Premium value in the ROE calculation. (*See* section III(B)(5))

- The Commission should modify its approach to screening proxy group results for low-end outliers. The PJM Transmission Owners agree that implausibly low results should be excluded, but believe that a screen based on a fixed level of approximately 100 basis points above bond yields does not reflect expectations of equity investors. Instead, the Commission should employ a dynamic threshold that reflects changes in interest rates, which would account for the inverse relationship between interest rates and the equity risk premium. (*See* section III(B)(6))

- For high-end outliers, the Commission should eliminate screens altogether. There is no economic basis for either a 150 percent threshold test or the proposed "natural break" test. (*See* section III(B)(7))

- The Commission should not employ a vintage approach under which the base ROE is fixed for the life of each asset at the time the asset is completed. Because transmission assets are long-lived assets, the base ROE at the time of development may not be adequate to attract investment over time or recognize that the transmission system is constantly being upgraded and expanded. Also, requiring a vintage approach would result in unnecessary burdens on transmission owners, regulators and customers. (*See* section III(B)(8))

The PJM Transmission Owners urge the Commission to modify its current practices for measuring the central tendency of the zone of reasonable ROEs. The Commission should set the just and reasonable ROE at the midpoint of the zone of

reasonable returns whether the proceeding involves a single electric utility or all of the transmission owners in an RTO. If the Commission is not willing to employ that approach in all cases, it should at least adopt a uniform midpoint approach for all electric utilities participating in an RTO regardless of whether the proceeding concerns a single ROE that will apply to all transmission owners in the RTO or an individual ROE for an individual transmission owner. There is no valid basis for distinguishing between the just and reasonable ROEs of transmission owners in neighboring RTOs based on the fact that in one RTO, the same ROE applies to all transmission owners, while in the other, individual ROEs are set.

The PJM Transmission Owners support the Commission's historic approach of limiting proxy groups for ROE analysis of electric utilities to comparable electric utilities and using credit rating screens to limit the composition of the proxy group to electric utilities with credit ratings that differ by no more than one "notch" from the credit rating of the target utility. However, if this approach yields a proxy group with too few members for the results to constitute a reasonable and representative sample of companies, the Commission should be willing to expand the breadth of the credit rating screen to generate a robust sample size.

Finally, the PJM Transmission Owners believe that state-determined ROEs should not be included in the calculation of ROEs for FERC-jurisdictional transmission companies. Investors in companies whose focus is electric transmission infrastructure face financial and business risks that differ in key respects when compared to other electric infrastructure investment, particularly state-regulated electric distribution. In

short, FERC-jurisdictional transmission companies face unique risks that state-regulated electric distribution companies do not.

II. BACKGROUND

On March 21, 2019, the Commission opened a Notice of Inquiry into whether, and if so how, to revise its policies on determining the ROE used in setting rates charged by jurisdictional public utilities. The Notice of Inquiry also seeks comment on whether to change ROE policies for interstate natural gas and oil pipelines.

The Notice of Inquiry follows the 2017 decision by the U.S. Court of Appeals for the District of Columbia in *Emera Maine*. In that decision, the court reversed and vacated the Commission's Opinion No. 531, which set the ROE for the New England Transmission Owners at the midpoint of the upper half of the zone of reasonableness produced by a two-step DCF analysis.[6] Subsequently, the Commission issued two orders proposing an alternative ROE methodology, which would give equal weight to four financial models instead of primarily relying on the DCF methodology for determining base ROEs.[7] In those orders, the Commission established paper hearing procedures to address whether and how the alternative methodology should apply to ROE complaint proceedings in New England and the Midcontinent Independent System Operator.

In the Notice of Inquiry, the Commission recognizes that the importance of ROE policy extends beyond the particular interests of the parties to the pending ROE

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

[7] *Martha Coakley v. Bangor Hydro-Elec. Co.*, 165 FERC ¶ 61,030 (2018) ("*Emera* Briefing Order"); *Ass'n of Businesses Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc.*, 165 FERC ¶ 61,118 (2018) ("*MISO* Briefing Order") (together, the "*Briefing Orders*").

proceedings, and therefore establishes a broader inquiry. It seeks comment on numerous questions in eight general areas:

1. Role and objectives of the Commission's base ROE policy;
2. Uniform Application of base ROE policy for different Commission-regulated industries;
3. Performance of the DCF model;
4. Proxy groups;
5. Financial model choice;
6. Mismatch between market-based ROE determinations and book-value rate base;
7. First prong of ROE determination; and
8. Model mechanics and implementation.

In these comments, the PJM Transmission Owners will address selected issues raised in the Notice of Inquiry. Some of the PJM Transmission Owners are also filing individual comments that may expand on these comments, address additional issues, or both.

III. DISCUSSION

The Commission's ROE policies have significant effects on transmission-owning public utilities, including the PJM Transmission Owners. These policies must recognize and address the business risks that transmission owners are facing, which are changing as the mix of generating resources and new technologies that the grid must support evolve. Those risks are particularly acute for electric utilities like the PJM Transmission Owners that have delegated significant operational and planning responsibilities for their transmission assets to an RTO. By providing open and nondiscriminatory access to their transmission facilities on a regional basis and by supporting the RTO's regional planning, these public utilities provide a reliable platform for regional electricity markets for the future needs of their regions.

It is important that the Commission establish ROEs at levels that fairly compensate electric utilities for the risks they undertake when they invest in transmission facilities in these circumstances. It should foster administrative efficiency and ensure predictability and stability for transmission owner ROEs. Just and reasonable returns strengthen investors' perception of the regulatory environment and support transmission owners' ability to attract capital. And, reasonably stable earnings for transmission investments are necessary in order for transmission owners to continue to expand and modernize regional electricity grids and support the current diversification of electric generation resources and integration of new technologies.

The Notice of Inquiry provides an opportunity for the Commission to address these important ROE-related issues. As discussed below the PJM Transmission Owners generally support the approaches that the Commission outlined in the *Briefing Orders*, with certain adjustments.

A. Determining Whether Existing ROEs Are Just and Reasonable

1. Quartile Approach[8]

In *Emera Maine*, the D.C. Circuit held that, to satisfy the first prong of an FPA section 206 inquiry into an ROE, the Commission must make "an explicit finding that [an] existing [ROE is] unjust and unreasonable before proceeding to set a new rate."[9] Such a finding is "the 'condition precedent' to FERC's exercise of its section 206 authority."[10] The court rejected the Commission's assumption that all ROEs other than the one FERC identifies as just and reasonable are "*per se* unlawful in a section 206 proceeding . . .

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8 Notice of Inquiry at P 37. The discussion in this section addresses questions G1 and G2.

9 *Emera Maine*, 854 F.3d at 24.

10 *Id.* at 25 (quoting *FPC v. Sierra Pac. Power Co.*, 350 U.S. 348, 353 (1956)).

[because] the zone of reasonableness creates a *broad range* of potentially lawful ROEs, rather than a single just and reasonable ROE."[11]

This direction from the Court prompted the Commission to propose a new framework for evaluating whether an existing ROE remains just and reasonable for purposes of the first prong of FPA section 206. In short, the Commission proposed to establish a range of presumptively just and reasonable ROEs within the composite zone of reasonableness indicated by the record evidence.[12]

In the *Briefing Orders*, the Commission proposed a "quartile approach" to identify the range of presumptively just and reasonable ROEs required by the *Emera* decision. The proposed approach establishes a composite zone of reasonableness averaging results of the DCF methodology, the CAPM model, and the Expected Earnings model. This composite zone of reasonableness is then divided into four portions, or quartiles, each constituting one-quarter of the composite zone. Three of the quartiles would determine ranges of presumptively just and reasonable ROEs for (1) average risk utilities (the quartile centered on the median or midpoint of the zone), (2) below-average risk utilities (the quartile below the middle quartile), and (3) above-average risk utilities (the quartile above the middle quartile). The fourth quartile is divided in two equal parts, one of which constitutes the lowest 12.5 percent of the zone and the other constitutes the highest 12.5 percent.

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[11] *Id.* at 26 (emphasis added).

[12] *Emera* Briefing Order at P 22. As noted above, in the Notice of Inquiry, the Commission refers to the ROEs calculated for the proxy group of comparable utilities as the composite "zone" of reasonableness and the ROEs that are presumed to be just and reasonable for purposes of the first prong of the Commission's review under section 206 of the FPA as the "range" of presumptively just and reasonable ROEs.

Under this framework, a finding that the existing ROE of an average risk utility falls within this middle quartile establishes a rebuttable presumption that the existing ROE has not been shown to be unjust and unreasonable under the first prong of section 206. The Commission will dismiss an ROE complaint if "the targeted utility's existing ROE falls within the range of presumptively just and reasonable ROEs for a utility of its risk profile—unless that presumption is sufficiently rebutted."[13] On the other hand, a finding that the existing ROE of an average risk utility falls outside that range may support a holding that the ROE has become unjust and unreasonable.[14]

As noted above, the *Briefing Orders'* quartile proposal would establish a range of reasonableness equal to one-quarter of the composite zone, centered on the median or midpoint for an average risk utility or group of utilities. Although the PJM Transmission Owners do not disagree with the use of bands around the measure of the central tendency to identify the range of presumptively reasonable ROEs, they believe that a range of presumptively reasonable ROEs equal to one-quarter of the composite zone generates a band that is too narrow and is inconsistent with the *Emera Maine* court's requirement that the Commission must find a utility's existing ROE lies outside the "broad range of potentially lawful ROEs" in order to exercise its authority under section 206.[15]

The Commission has concluded that "the principal consideration for determining whether an existing ROE within the overall zone of reasonableness has become unjust and unreasonable is the risk profile of the utility or utilities for which the Commission is

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13 *Id.* at P 16.

14 *Emera* Briefing Order at P 28; *MISO* Briefing Order at P 22.

15 *Emera Maine*, 854 F.3d at 26.

setting the ROE."[16] Based on this consideration, the Commission has determined that "logic dictates" that it typically would be unjust and unreasonable for an average-risk utility to receive an ROE that is closer to the ROE that would be just and reasonable for a utility of above- or below- average risk.[17] Thus, the proposed approach divides the composite zone of reasonableness into three parts for an average risk utility: (i) ROEs that are presumptively too low; (ii) ROEs that are presumptively just and reasonable; and (iii) ROEs that are presumptively too high.

Although the Commission refers to this approach as a "quartile" approach, for average risk utilities it is really a "tertile" approach, with the composite zone of reasonableness divided into three unequal segments. Under this approach, the range of presumptively reasonable ROEs constitutes only the central one-quarter of the zone, while ROEs in the lowest 3/8 of the composite zone of reasonableness and the highest 3/8 of the zone are treated as being outside the range of presumptively reasonable ROEs. Absent some compelling reason to do otherwise, the Commission logically should treat each of the three segments of the composite zone as being equal-sized, so that the middle third of the composite zone should comprise the range of presumptively reasonable ROEs for average risk utilities. Nothing in the reasoning underlying the Commission's proposed approach (*i.e.*, that the principal consideration is the risk profile of the utility or utilities for which the Commission is setting the ROE) suggests that the approach, which inappropriately limits the range of presumptively just and reasonable ROEs to one-quarter of the composite zone of reasonableness, is justified.

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16 *Emera* Briefing Order at P 26.

17 *Id*.

In particular, the proposed approach's narrow range of presumptively just and reasonable returns is not supported by the Commission's statement that it typically would be unjust and unreasonable for an average risk utility "to receive" an ROE that is closer to the ROE for an above-average or below-average risk utility.[18] First, as the *Emera Maine* holding made clear, the question of the extent of the "broad range" within which a utility's existing ROE may not be disturbed under section 206 is distinct from the just and reasonable ROE the utility might "receive" under section 205 or the second step of a section 206 investigation.[19]

Second, even if the ROEs that different utilities might "receive" were relevant under the first prong of the section 206 analysis, the comparison between the ROEs that might be awarded to average-risk utilities and above-average or below-average risk utilities ignores the fact that the proposed approach is premised on the selection of a proxy group of utilities that are comparable from a risk perspective to the utility or utilities whose ROE is at issue. It should be rare for a utility not to be considered to be average-risk in comparison with a proxy group of utilities that are, by design, comparable to it. Indeed, the Commission has stated that it places "a heavy burden" on claims that a jurisdictional entity is not of average risk relative to the proxy group.[20] Since the utilities in the proxy group are selected to be comparable to the utility whose ROE is at issue, a comparison between the ROE that the utility of interest might "receive" and those that might be awarded to utilities with different risk profiles does not logically dictate that the

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18 *Id*.

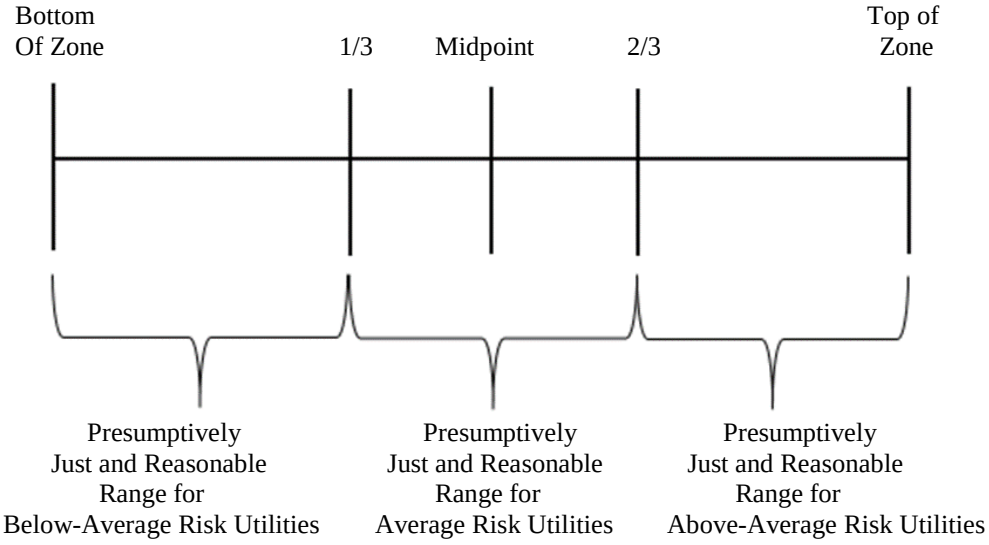
19 *Emera Maine*, 854 F.3d at 25.

20 *El Paso Nat. Gas. Co.*, 145 FERC ¶ 61,040 at P 688 (2013). The PJM Transmission Owners note that the Commission did not address in the *Briefing Orders* the circumstances that would lead it to conclude that a utility is not of average risk.

range of presumptively just and reasonable ROEs must be limited to one-quarter of the composite zone of reasonableness based on an analysis of the proxy group.

Accordingly, instead of dividing the entire composite zone of reasonableness into quartiles, the Commission should divide it into three equal parts. As such, the presumptively just and reasonable ROEs for an average risk utility would comprise the middle third. This approach is shown in Figure No. 1 below (using the midpoint of the composite zone as the measure of the central tendency).

Figure No. 1



2. Managing Section 206 Challenges to ROE[21]

One of the goals of the Commission's ROE policies should be to foster administrative efficiency and ensure predictability and stability for transmission owner ROEs. A reasonably stable earnings outlook for transmission investments is necessary in order for transmission owners to continue to expand and modernize regional electricity grids and support diversified electric generation resources and the integration of new

[21] Notice of Inquiry at P 37. The discussion in this section addresses questions E11 and G1 through G3.

technologies. As evidenced by the *Emera* proceeding, in recent years, transmission ROEs have been challenged frequently and repeatedly through so-called "pancaked" ROE proceedings initiated under section 206 of the FPA.

These pancaked proceedings result in years of extensive litigation, creating administrative costs and burdens and uncertainty with respect to transmission owner rates and their opportunity to earn a return on their investments. In addition, pancaked ROE proceedings undermine the statutory 15-month refund period set forth in FPA section 206(b). Congress made a considered decision to include a 15-month refund period – no more and no less – for protection and rate certainty during the investigation of a claim.[22] Because pancaked ROE complaints are virtually identical in all relevant aspects and present no different factual or legal allegations, permitting them effectively extends the refund period for the earlier complaints beyond 15 months.[23] This allows complainants to circumvent the clear limits set by Congress in FPA section 206.

One way that the Commission can remove these burdens and this uncertainty is to seek to avoid repetitive section 206 challenges to existing ROEs, as discussed below. The proposed quartile approach, whether as proposed in the *Briefing Orders* or as modified as proposed in section III(A)(1), above,[24] creates a rebuttable presumption that a current ROE is just and reasonable if it falls within the range of the presumably just and

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[22] *See, e.g.*, legislative history found at S. Rep. No. 100-491 at 6 (1988), as reprinted in 1988 U.S.C.C.A.N. 2684, 2688; *see also, Regulatory Fairness Act: Hearings on S. 1567 and H.R. 2858 Before the S. Comm. on Energy and Nat. Res.*, 100th Cong. 74-76, 85-87, 91-92, 99-100, 107-08, 115-17, 138, 295-97 (1987).

[23] *Allegheny Electric Coop., Inc. v. Niagara Mohawk Power Corp.*, 58 FERC ¶ 61,096 at p. 61,349 (1992).

[24] As discussed in section III(A)(1), the PJM Transmission Owners believe that the quartile approach generates a band that is too narrow and recommend that the Commission establish a range of reasonableness equal to one-third of the composite zone.

reasonable ROEs. This approach establishes the threshold that must be met before the Commission will act on an ROE complaint. As such, it is an improvement upon the current practice of setting all ROE complaints for hearing simply upon a showing that the DCF model produces an ROE lower than the existing ROE.[25] Although the quartile approach (either as the Commission proposed or modified as suggested above) is a good start, the Commission must do more to discourage repetitive and burdensome ROE litigation.

Namely, the Commission should place a substantial burden on the complainant in seeking to rebut the presumption that an ROE within that range is not unjust and unreasonable under the first prong of section 206. The Commission has long recognized that a complainant must do more than make unsubstantiated allegations.[26] Although it is true that a section 206 complainant already has the burden of proof,[27] this has not resulted in limited and discrete challenges to existing ROEs. Rather, it has been the practice in recent years for parties to file frequent and multiple complaints challenging existing ROEs.

Thus, prior to proceeding with a section 206 complaint challenging an existing ROE, the Commission should require that the complainant produce clear and convincing evidence to establish that an ROE within the range of presumptively reasonable returns is

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[25] *See* Suedeen G. Kelly & Edison Electric Institute, *To Ensure That Its Policies Support the Continued Development of Reliable and Resilient Transmission Infrastructure, FERC Should Discontinue Its Practice of Allowing Pancaked Complaints*, p. 8 (August 2018).

[26] *See National Energy & Trade, L.P. v. Texas Gas Transmission, LLC*, 121 FERC ¶ 61,064 at P 60 (2007) ("Unsubstantiated allegations without more do not provide the basis, either in law or in fact, for ordering a hearing or a Commission-initiated investigation."); *Interstate Power and Light Co. v. ITC Midwest, LLC*, 135 FERC ¶ 61,162 at P 18 (2011); *San Diego Gas & Electric Co. v. Century Power Corp.*, 50 FERC ¶ 61,285 at p. 61,916 (1990) (evidentiary hearing requires more than mere allegations, but rather an adequate proffer of evidence that such a hearing is warranted).

[27] *See, e.g., Blumenthal v. FERC*, 552 F.3d 875, 881 (D.C. Cir. 2009).

nevertheless unjust and unreasonable. Further, it should require that the complainant produce this evidence in the initial complaint in order to provide the utility with a reasonable opportunity to address all of the evidence and arguments presented. If the complainant does not produce such evidence in its initial complaint, then the Commission should dismiss the complaint without prejudice.

Further, in reviewing the complaint and accompanying evidence, the Commission should review the complaint with a critical eye in order to determine whether the complainants have established through clear and convincing evidence that an existing ROE is unjust and unreasonable. The Commission should consider such topics as: (1) whether the utility's financial standing and ability to attract capital outweigh its current risk profile; (2) whether the benefits of adjusting an existing ROE outweighs the cost of pursuing the change, given the time and expense of protracted hearings; and (3) whether a sufficient amount of time has passed since the establishment of the challenged ROE to warrant a further adjustment.

B. ROE Calculation Mechanics and Implementation

1. The PJM Transmission Owners Support the Use of the Average of Four Methodologies To Establish the Just and Reasonable ROE.[28]

Although the Commission has used the DCF model to determine ROEs for electric utilities and natural gas and oil pipelines since the 1980s, investors use other financial models in addition to the DCF model to evaluate investments. In the Notice of Inquiry, the Commission is proposing to consider certain other financial models when determining the just and reasonable ROE for public utilities. These other financial models are the

[28] Notice of Inquiry at P 35. This discussion responds to questions A1, A2, C3 and E1 through E7.

CAPM, the Expected Earnings Model, and the Risk Premium method. The PJM Transmission Owners support the Commission's proposal to use the average of the four methodologies with equal weighting in setting ROEs.

As the Commission has noted, the primary reason for proposing to average the results of a DCF analysis with the results of the CAPM, Expected Earnings, and Risk Premium analyses is that "*investors use those models*, in addition to the DCF methodology, to inform their investment decisions."[29] The DCF and CAPM are market-based models; investors also use the Expected Earnings analysis of expected returns on book equity to inform their investment decisions. Indeed, this analysis is used because returns on book equity help investors to estimate the opportunity cost of investing in a particular utility instead of other companies of comparable risk.[30]

Moreover, the use of multiple approaches provides a hedge against the shortcomings of any one approach in particular financial conditions. Using the four financial models together more accurately estimates the cost of equity for determining ROEs because this approach reduces risk associated with relying on a single model. That is, the risk of misidentifying a just and reasonable ROE by relying on a flawed cost of equity estimate is mitigated by relying on the DCF, CAPM, Risk Premium, and Expected Earnings analyses together.[31] Thus, it is necessary to average various methodologies and benchmark results with observable market trends in order to smooth over deficiencies in any methodology's inputs.

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29 *Emera* Briefing Order at P 44 (emphasis in original).

30 Opinion No. 531-B at P 129 ("Because investors rely on expected earnings analyses to help estimate the opportunity cost of investing in a particular utility, we find this type of analysis useful in corroborating [the Commission's decision]").

31 *Emera* Briefing Order at P 38.

The use of multiple approaches will restore administrative efficiency and regulatory certainty to transmission owner ROE proceedings. Predictability and stability for ROEs is critical for transmission owners to attract the capital required to expand and enhance the nation's energy grid to accommodate changes in the mix of generating resources and new technologies that the grid must support. By adopting a broader set of methodologies and analyses, the Commission will make important strides in mitigating the instability of transmission rates and the regulatory uncertainty generated through years of extensive litigation. It also will reduce administrative costs and burden to the ultimate benefit of customers. The Commission's adoption of multiple approaches will reflect the breadth of data considered by investors when making investment choices and provide the necessary predictability for transmission owners and customers.

Finally, the use of multiple models will allay the Commission's concerns over how the DCF methodology performs under various circumstances.[32] All of the proposed methodologies contain strengths and limitations in their application because not all inputs or underlying assumptions can accurately reflect market conditions or investor expectations in every situation. As the Commission has recognized,[33] the DCF methodology has such limitations. For example, the DCF methodology is particularly sensitive to varying market conditions, including interest rates, as it assumes conditions will remain in perpetuity[34] and therefore was unduly affected by anomalous market

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32 *See e.g.*, Notice of Inquiry at P 33, question C3.

33 *Id.* Questions C1-C3.b

34 *See* Roger A. Morin, PhD, New Regulatory Finance at pp. 432-33 (Public Utilities Reports Inc., Arlington, VA, 2006) ("*New Regulatory Finance*").

conditions that persisted following the 2008 recession. In short, the limitations inherent in the DCF methodology suggest that it is prudent to also consider other methodologies.

2. DCF Model[35]

a. The Commission Should Employ the Single-Step Constant Growth DCF Model[36]

As the Commission notes in the Notice of Inquiry, in Opinion No. 531, it decided to shift from the single-step constant growth DCF model it had long employed in public utility cases to the two-step DCF model it used in pipeline rate cases.[37] Under the two-step approach, the Commission combines a short-term dividend growth rate, based on security analysts' earnings forecasts, with a long-term dividend growth rate based on the long-term growth of the economy as a whole, as measured by projections of growth in gross domestic product ("GDP").

The PJM Transmission Owners respectfully urge the Commission, as part of the investigation it undertakes in this proceeding, to revisit that decision. As explained briefly below, the two-step DCF model is an inappropriate and unfounded measure of investors' dividend growth expectations for electric utilities, while the single-step constant growth model is consistent with the theory underlying the DCF model and the available evidence regarding investors' dividend growth expectations.[38] The PJM Transmission Owners

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[35] Notice of Inquiry at P 38. The discussion in this section addresses question H.2.a.6.

[36] Notice of Inquiry at P 38. The discussion in this section addresses questions H.2.a.1, H.2.a.3, H.2.a.4 and H.2.a.5.

[37] *Id.* at P 7 (citing Opinion No. 531 at P 8).

[38] In this discussion, the PJM Transmission Owners reference evidence introduced in the pending proceedings in Docket Nos. EL14-12-03 and EL11-66-01, *et al*. Rather than burden the record of this investigation with copies of that evidence or new testimony making the same points, the PJM Transmission Owners ask the Commission to take official notice of the material in its files cited in this discussion.

believe that the single-step constant growth DCF model should be used as part of a multiple-model approach to setting just and reasonable ROEs for electric utilities.[39]

The PJM Transmission Owners submit that the two-step DCF growth model is inappropriate for use in the determination of electric utilities' ROEs primarily because the two-step model is inconsistent with the purpose of the growth component of the DCF model, which is to estimate *investors' expectations* of dividend growth. In fact, there is no reason to believe investors base their dividend growth expectation on long-term economic projections.

Use of the two-step DCF model mistakes the theoretical underpinning of the DCF model – the expectation of an "infinite stream of dividends"[40] – with the relevant practical question, which concerns investor expectations. That is, how do investors project the growth in the dividends they expect to receive when they buy equity of an electric utility? The relevant growth rate is the growth rate used by investors, not the growth rate that matches the theoretical time horizon of the DCF model. There is no evidence that investors look to forecasts of GDP growth extending into the distant future when they make decisions about purchases of public utilities' stock.[41]

If the premise of the two-step DCF model's use for analysis of electric utility ROEs were correct, one would expect to see financial publications discuss long-term GDP growth forecasts in connection with their analyses of the electric utility industry or

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[39] As discussed below, the DCF model is also employed as one step in the CAPM methodology. The PJM Transmission Owners urge the Commission to use the single-step constant growth DCF model in the CAPM calculations of ROE as well as in ROE estimates based directly on the DCF model.

[40] Notice of Inquiry at P 5.

[41] Supplemental Initial Brief of The MISO Transmission Owners, Appendix 2, Affidavit of Adrien M. McKenzie, Docket No. EL14-12-003 (filed February 13, 2019) at pp. 43-44.

individual electric utilities. But, as Adrien McKenzie recently testified in Docket No. EL14-12, this is not the case:

> In contrast to this notion, the financial media typically refers to three-to-five year EPS growth forecasts for individual companies and only rarely, if ever, mentions long-term GDP forecasts in commenting on investment prospects. Long-term GDP growth rates are simply not discussed within the context of establishing investors' expectations for individual firms. For example, Value Line reports are routinely cited as a reliable source of investment-related information, but Value Line does not even mention long-term trends in GDP in its evaluation of the firms in the electric utility industry. Value Line's singleness of purpose is to inform investors of the pertinent factors that impact future expectations specific to each of the common stocks it covers. If a fifty-year trajectory of GDP growth had direct relevance to investors' evaluation of electric utility common stocks, it would be logical to expect Value Line or other securities analysts would give at least passing mention to this fact. But they do not.[42]

There is an additional reason why the two-step DCF model should not be used to estimate investors' dividend growth expectations for electric utilities. The notion that investors expect utilities' dividend growth to mirror long-term GDP growth is inconsistent with the capital-intensive nature of the electric utility industry. A key driver of growth in the electric utility industry is investment in the infrastructure required to provide safe and reliable service. There is no reason to believe that investors expect dividend growth to be capped at long-term GDP growth rates. Instead, those expectations are driven by current security analysts' earnings forecasts, which take into account the same information about infrastructure investment and other factors that is available to investors.

Finally, the circumstances for electric utilities are quite different from those that motivated the Commission to shift from the constant growth to the two-step DCF model for gas and oil pipelines. The Commission was originally motivated to adopt the two-step

[42] *Id.* at pp. 45-46 (footnotes omitted).

DCF model due to concerns that Institutional Brokers Estimate System ("IBES") growth rates were atypically high for pipelines.[43] As the Presiding Judge noted in *Northwest Pipeline*,

> [f]or many years growth in the [pipeline] industry was sluggish and the IBES predictions were accordingly modest, but after the issuance of Order No. 636, IBES forecasts reflected higher expectations of growth for the proxy group companies in the years ahead. Suddenly confronted with unusually high DCF rates of return recommendations based upon these higher projections for revenue growth, the Commission balked, and sought to offset short run optimism with more conservative estimates for the long run.[44]

The magnitude of the disparity between the near-term growth rates for pipelines and growth in GDP that prompted the use of the two-step model bears no similarity to the current circumstances of electric utilities. The Commission recognized this in Opinion No. 531, when it held that the IBES growth projections of electric utilities continue to reflect "a different pattern" from those of natural gas and oil pipelines.[45] This "different pattern" has significant implications with respect to the validity of the two-step DCF model as applied to electric utilities.[46] The Commission's original adoption of the two-step DCF model envisioned a "short-term transition stage," after which the relatively high near-term IBES growth rates for pipelines would be expected moderate and reach "a state of maturity."[47] There is no indication that analysts' EPS growth rates for the electric utilities are characterized by the "short run optimism" that led the Commission to adopt

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43 *Id.* at p. 50.

44 *Nw. Pipeline Corp.*, 77 FERC ¶ 63,007 at p. 65,014-15 (1996), *rev'd*, Opinion No. 396-B, 79 FERC ¶ 61,309, *reh'g denied*, Opinion No. 396-C, 81 FERC ¶ 61,036 (1997).

45 Opinion No. 531 at P 38.

46 Supplemental Initial Brief of The MISO Transmission Owners, Appendix 2, Affidavit of Adrien M. McKenzie, Docket No. EL14-12-003 (filed February 13, 2019) at pp. 50-51.

47 *Ozark Gas Transmission Sys.*, 68 FERC ¶ 61,032 at p. 61,105 (1994), *order on reh'g*, 71 FERC ¶ 61,138 (1995).

the two-step DCF model, particularly in light of long-term expectations of continued high levels of capital investment.[48]

The PJM Transmission Owners accordingly urge that, for electric utilities, the Commission once again employ the single-step constant growth DCF model that is in line with investors' dividend growth expectations for the electric utility industry.

b. The Commission Should Be Receptive to Multiple Sources of Analysts' Earnings Forecasts to Project Dividend Growth[49]

As noted in the Notice of Inquiry, the Commission uses security analysts' three- to five-year earnings forecasts, as published by IBES, to project short-term dividend growth for purposes of the DCF analysis.[50] The PJM Transmission Owners support basing dividend growth projections on analysts' forecasts. They urge the Commission, however, not to limit those projections to the analysts' forecasts published by IBES. Rather, the Commission should explicitly confirm that it is receptive to considering other sources of growth rate estimates, such as Value Line or Zacks.

Consideration of all sources of analysts' forecasts that are widely relied upon in the investment community is consistent with the rationale underlying the use of such forecasts in the DCF methodology, which is that investors base their expectations about dividend growth based on analysts' forecasts.[51] There is no evidence that investors rely exclusively on the analysts' forecasts reported by IBES for this purpose.

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[48] Supplemental Initial Brief of The MISO Transmission Owners, Appendix 2, Affidavit of Adrien M. McKenzie, Docket No. EL14-12-003 (filed February 13, 2019) at p. 51.

[49] Notice of Inquiry at P 38. The discussion in this section addresses questions H.1.1, H.1.5 and H.1.6.

[50] *Id.* at P 8. This issue also applies to the CAPM.

[51] *See, e.g., Emera* Briefing Order at P 48; *Transcon. Gas Pipe Line Corp*., Opinion No. 414-B, 85 FERC ¶ 61,323 at p. 62,269 (1998).

To the contrary, the Commission has recognized that investors do not rely exclusively on the earnings forecasts that IBES reports. In the *MISO* Briefing Order, the Commission questioned "whether the IBES growth rates reflect a consensus among investors."[52] And, in Opinion No. 531, the Commission "reaffirm[ed] that there may be more than one valid source of growth rate estimates," and acknowledged that "a comparable source" to IBES could be used as the basis of growth rate projections.[53] It is also noteworthy that, in Opinion No. 551, the Commission accepted the use of both IBES and Value Line as sources of analysts' growth projections when the DCF methodology is used as part of the forward-looking CAPM analysis. It specifically found that "Value Line is a valid source of general financial data."[54]

To be sure, the Commission also stated that the "use of growth rate data [in the CAPM] is fundamentally different from how growth rate data is used in our DCF model."[55] The PJM Transmission Owners respectfully suggest that any difference is not material. In the Notice of Inquiry the Commission correctly stated that a forward-looking CAPM analysis bases "the expected return . . . on a DCF analysis of a large segment of the market."[56] Whether the DCF model is used to estimate investors' return requirements directly or as a step in the CAPM analysis, the question is the same: which security analysts' earnings growth forecasts to use as the basis of dividend growth projections. Logically, a reliable source of analysts' forecasts when answering that question for

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52 *MISO* Briefing Order at P 49.

53 Opinion No. 531 at PP 39, 90-91.

54 *Ass'n of Businesses Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc.,* Opinion No. 551, 156 FERC ¶ 61,234 at P 169 (2016) ("Opinion No. 551").

55 *Id.*

56 Notice of Inquiry at P 14.

purposes of CAPM analyses is no less reliable for DCF-based estimates of equity investors' return requirements. Likewise, because the PJM Transmission Owners support the use of the multiple-model approach, the Commission should use the same growth rate sources across all models to determine the ROE.[57] No growth rate source is inherently more dependable for one model than another.

Finally, it is very important that the Commission specify how the forecast data are combined. It is most appropriate to calculate the measure of central tendency for each individual analyst source first, and then average those measures of central tendency to get the overall measure of central tendency for that particular model (i.e. DCF, CAPM, and Expected Earnings).[58] If the analysts' estimates are averaged prior to calculating the measure of central tendency, this can have the unintended consequence of reducing the zone of reasonableness.

c. Dividend Yield Component

For the dividend yield component of the DCF model, the Commission derives a single, average dividend yield based on the indicated dividend and the average of the monthly high and low stock prices over a six-month period.[59] The PJM Transmission Owners believe that six months of average high/low historical monthly stock prices are an appropriate measure for the current stock price ("P") component of the DCF model. The

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57 Notice of Inquiry at P 38, question H.1.6.

58 *See* Prepared Direct Testimony of Adrien M. McKenzie, on Behalf of Pacific Gas and Electric Co., Docket No. ER19-13-000 (filed October 1, 2018) at p. 1.

59 Notice of Inquiry at P 7 (citing *Portland Natural Gas Transmission Sys.*, Opinion No. 510, 134 FERC ¶ 61,129 at PP 232-34 (2011)).

six-month historical average stock price adds robustness to the model results and is a practical accommodation to even out short-term volatility in a utility's stock price.[60]

3. Capital Asset Pricing Model[61]

a. Overview

As described in the Notice of Inquiry, investors use the CAPM as a measure of the cost of equity relative to risk. The CAPM methodology is based on the theory that the market-required rate of return for a security is equal to the risk-free rate plus a risk premium associated with the specific security. The fundamental idea underlying the CAPM is that risk-averse investors demand higher returns for assuming additional risk, and higher-risk securities are projected to yield higher expected returns than lower-risk securities. The CAPM quantifies the additional return, or risk premium, required for bearing incremental risk. The CAPM methodology estimates the cost of equity by taking the "risk-free rate" and adding to it the "market-risk premium" multiplied by "beta." The risk-free rate is represented by a proxy, typically the yield on 30-year U.S. Treasury bonds. Betas, which are published by several commercial sources, such as Value Line, measure a specific stock's risk relative to the market. The market risk premium is calculated by subtracting the risk-free rate from the expected return.[62]

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60 Answering Testimony of Adrien M. McKenzie on Behalf of The MISO Transmission Owners, Docket No. EL15-45-000 (filed October 20, 2015) at p. 84.

61 Notice of Inquiry at P 38. The discussion in this section addresses questions H.2.b.1, H.2.b.3 and H.2.b.4.

62 Notice of Inquiry at P 14. The expected return can be estimated either using a backward-looking approach, a forward-looking approach, or a survey of academics and investment professionals. A CAPM analysis is backward-looking if the expected return is determined based on historical, realized returns. It is forward-looking if the expected return is based on a DCF analysis of a large segment of the market. Thus, in a forward-looking CAPM analysis, the market Risk Premium is calculated by subtracting the risk-free rate from the result produced by the DCF analysis. *Id.* (citations omitted).

The PJM TOs agree with the Commission's proposal to consider the CAPM when determining the just and reasonable ROE for electric utilities, with one modification. As discussed below, the Commission should recognize the empirical work demonstrating that the CAPM tends to underestimate returns for certain low beta companies, such as electric utilities, and incorporate an adjustment for that tendency in the CAPM-based ROE estimates.

When analysts have compared empirical results to results predicted by the CAPM, they have found that the CAPM systemically underestimates returns for companies with low beta securities (those with beta values less than 1, such as electric utilities).[63] That is, empirical research has shown that low-beta securities earn returns somewhat higher than the CAPM would predict, and high-beta securities earn less than predicted.[64] A number of refinements and expanded versions of the original CAPM theory have been proposed to explain the empirical findings. These revised CAPMs usually produce a risk-return relationship that is flatter than the standard CAPM prediction.[65]

Accordingly, the Commission should incorporate the use of a version of the CAPM that takes these empirical observations into account. This version of the CAPM is sometimes referred to as the "Empirical CAPM" or "ECAPM." The ECAPM takes into

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63 A company's beta generally reflects equity market participant's perception of the risk associated with that company. This perception, however, has no relation to the company's actual risk profile. And, in particular with respect to transmission owners in RTOs, such as the PJM Transmission Owners, it certainly does not reflect the significant risks associated with RTO participation and loss of control over the planning and operation their transmission assets.

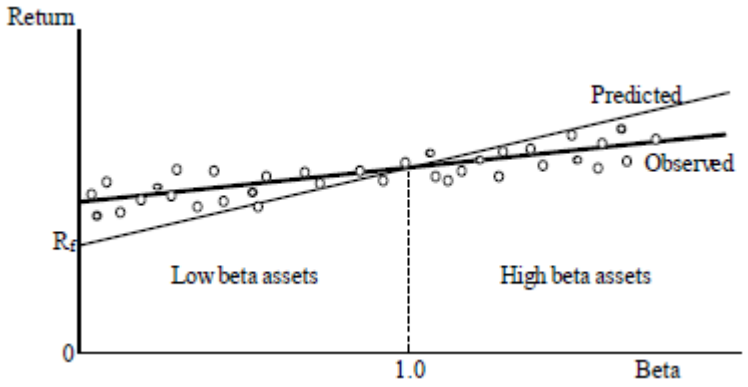
64 *New Regulatory Finance*, Chapter 6.

65 *In the Matter of the Application of Oklahoma Gas and Electric Company for an Order of the Commission Authorizing Applicant to Modify its Rates, Charges, and Tariffs for Retail Electric Service in Oklahoma*, Cause No. PUD 201700496, Direct Testimony of Roger A. Morin, PhD, on Behalf of Oklahoma Gas and Electric Company, Appendix A at p. 3.

consideration the empirical findings noted above in order to estimate a more accurate cost of capital.[66] This is illustrated graphically in Figure No. 2 below.

Figure No. 2

CAPM – PREDICTED VS. OBSERVED RETURNS



b. CAPM and ECAPM Mechanics

It is important that the Commission apply the appropriate mechanics in its application of the CAPM and ECAPM model or risk finding an ROE that is far below the standards established in *Hope* and *Bluefield*.[67] In short, an inappropriate application of the CAPM can produce an ROE estimate that is not just and reasonable.

First, as discussed above, the Commission should employ the single-step constant growth DCF model, not the two-step growth model, when using the DCF model to calculate the market risk premium in CAPM calculations. In their assessment of future growth expectations, investors distinguish between industry groups and individual firms.[68]

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[66] The ECAPM has been referenced in several recent filings before the Commission. *See, e.g.*, Prepared Direct Testimony of Adrien M. McKenzie on Behalf of Pacific Gas and Electric Co., Docket No. ER19-13-000 (filed October 1, 2018) at pp. 97-100.

[67] *FPC v. Hope Nat. Gas Co.*, 320 U.S. 591 (1944); *Bluefield Water Works & Improvement Co. v. Pub. Serv. Comm'n*, 262 U.S. 679 (1923).

[68] Answering Testimony of Adrien M. McKenzie on Behalf of The MISO Transmission Owners, Docket No. EL15-45-000 (filed October 20, 2015) at p. 52.

There is no support for the proposition that investors base their future growth expectations on long-term GDP growth forecasts, so those forecasts should not be incorporated in the calculation of the CAPM market risk premium.[69] Both the CAPM and ECAPM should calculate the market risk premium by using a forward-looking market single-step DCF analysis.[70]

Second, the size premium is an important component of the CAPM model that must be retained in order to appropriately estimate the cost of equity. Because small market-cap stocks experience higher returns than large market-cap stocks with equivalent betas, the CAPM understates the risk of smaller utilities. Thus, a cost of equity based purely on a CAPM beta will be too low for small companies.[71] This has led some analysts to add a premium to the estimated cost of equity for smaller companies under the CAPM, which accounts for the level of a firm's market capitalization in determining the cost of equity[72] This "size adjustment" accounts for the fact that "differences in investors' required rates of return that are related to firm size are not fully captured by beta."[73] In Opinion No. 531-B, the Commission stated that the use of a size adjustment was "a generally accepted approach to CAPM analyses."[74] It explained that the purpose of the size adjustment is to make the CAPM analysis useful in estimating the cost of equity for

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69 *Id.* at pp. 52-53.

70 *Id.* at pp. 23-25.

71 *New Regulatory Finance* at pp. 181-87.

72 *Id. See also*, Supplemental Reply Brief of The MISO Transmission Owners, Reply Affidavit of Adrien M. McKenzie, Docket No. EL14-12-003 (filed April 10, 2019) at pp. 35-42 (Arguing for the inclusion of the size premium).

73 *Id.*

74 Opinion No. 531-B at P 117. *See also*, Opinion No. 551 at PP 165-167.

companies that are smaller than the companies that were used to determine the market risk premium in the CAPM analysis.[75]

Third, it is important that the appropriate data source be used for the beta value used in the CAPM and ECAPM models. The most appropriate data source for the beta value is Value Line. It is the largest and most widely circulated independent investment advisory service and influences the expectations of many institutional and individual investors.[76] The Commission has relied upon Value Line betas, which are computed on a theoretically sound basis using a broadly-based market index, for years.[77] It should continue to do so.

Finally, as discussed above, the Commission should implement a more specific version of the CAPM model, specifically, the ECAPM. The Commission should implement the ECAPM model in conjunction with the traditional CAPM. This could be done by using a 50/50 weighting of the results of the traditional CAPM and the ECAPM. This is demonstrated below:

Final CAPM = (CAPM + ECAPM)/2

Using this weighting would enable a more robust cost of equity estimation, recognizing both the theory and empirical evidence. In summary, the Commission should integrate the ECAPM approach into its analysis to produce the most reasonable CAPM-based ROE estimate.

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75 *Id.*

76 *New Regulatory Finance* at p. 71.

77 *Id.*

4. Expected Earnings Model[78]

As explained in the Notice of Inquiry, a comparable earnings analysis is a method of calculating the earnings an investor expects to receive on the book value of a particular stock. The analysis can be either backward looking using the company's historical earnings on book value or forward-looking using estimates of earnings on book value, as reflected in analysts' earnings forecasts for the company. The Commission refers to the forward-looking approach as the "Expected Earnings" model. The returns on book equity that investors expect to receive from a group of companies with risks that are comparable to those of a particular utility are relevant to determining that utility's cost of equity. This is because those returns on book equity help investors determine the opportunity cost of investing in that particular utility instead of other companies of comparable risk.[79] The PJM Transmission Owners strongly support the use of the Expected Earnings model as part of the multi-model ROE estimation framework that the Commission has proposed. The model is a valid and complementary approach to the DCF model and CAPM in estimating the zone of reasonableness.

The Commission, academic experts, and financial analysts recognize the Expected Earnings model as a valid ROE benchmark. A comparable earnings approach, such as the Expected Earnings model, has been referred to as the "granddaddy" of cost of equity methods.[80] Further, the amount of subjective judgment required to implement capital

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78 Notice of Inquiry at P 38. This section discusses questions H.2.c.2, F1 and F4.

79 Notice of Inquiry at P 15.

80 Testimony of William E. Avera and Adrien M. McKenzie on Behalf of The MISO Transmission Owners, Docket No. EL14-12-000 (filed January 6, 2014) at p. 85 (citing David C. Parcell, The Cost of Capital: A Practitioner's Guide 115-16 (2010)).

earnings approaches is minimal.[81] In addition, comparable earnings approaches are "easily understood" and firmly anchored in the regulatory tradition of the *Bluefield* and *Hope* cases, as well as sound regulatory economics.[82] Moreover, ROE experts have used the comparable earnings approach for 35 years, and it has been widely referenced in regulatory decision-making.[83]

In the *Emera* proceeding, certain parties advanced arguments seeking to cast doubt on the inclusion of the Expected Earnings model in an ROE analysis.[84] The PJM Transmission Owners strongly disagree with those arguments. For example, objections to the Expected Earnings method on the grounds that there are fundamental differences between it and the other three proposed methods are misplaced. In fact, the differences between the Expected Earnings method and the other methods serve the critical function of acting as a check on the possibility that a faulty common input could undermine the results of the other three models.[85] Likewise, claims that the Commission should not even consider the Expected Earnings method because it is circular and analyzes book equity, not the market cost of equity, are without merit, as explained below.

As the Commission has recognized, the Expected Earnings model requires the inclusion of the average rate of return in place of end-of-year book values. In *Southern California Edison Co.*, the Commission recognized that if the rate of return was based on

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81 *Id.*

82 *Id.*

83 *Id.* (footnote omitted).

84 *See, e.g.*, Affidavit of Trial Staff Witness Robert J. Keyton, Docket Nos. EL11-66, *et al.* (filed January 11, 2019).

85 Reply Paper Hearing Brief of The New England Transmission Owners, Docket Nos. EL11-66, *et al*. (filed March 8, 2019) at p. 29.

end-of-year book values, such as those reported by Value Line, it would understate actual returns because of growth in common equity over the year.[86] Accordingly, consistent with the Commission's findings, it is necessary to incorporate an adjustment into the Expected Earnings model to compute an average rate of return. The use of an average return in developing the rate of return is well supported.[87]

Further, in the Notice of Inquiry, the Commission requests comment on whether there are any concerns regarding circularity with using the Expected Earnings analysis to determine the base ROE, as opposed to using the analysis for corroborative purposes.[88] The PJM Transmission Owners believe there are no such concerns. Circularity issues arise when historical analyses use historical earnings and historical book ROEs that are based on past actions of regulatory commissions.[89] The Expected Earnings model is a forward-looking approach. That is, historical comparable earnings analyses rely upon the stock's historical earnings on book value, as reflected in the company's accounting statements, while the forward-looking Expected Earnings model uses estimates of earnings on book value, as reflected in analysts' earnings forecasts for the company.[90] In Opinion No. 551, the Commission held that circularity concerns are avoided through the use of the forward-looking Expected Earnings analysis.[91]

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86 *See* Prepared Direct Testimony of Adrien M. McKenzie, on Behalf of Pacific Gas and Electric Co., Docket No. ER19-13-000 (filed October 1, 2018) at p. 85 (citing *Southern California. Edison Co.*, 92 FERC ¶ 61,070 at p. 61,263 and n. 38 (2000)).

87 *Id.* at p. 86 (citing *New Regulatory Finance* at pp. 305-06 (supporting the use of an average return in developing the rate of return and the need to adjust Value Line's end-of-year data, consistent with the Commission's prior findings)).

88 *See* Notice of Inquiry at P 38, questions H.2.c.2 and H.2.c.2.i.

89 Reply Paper Hearing Brief of The New England Transmission Owners, Docket Nos. EL11-66, *et al*., at p. 93 (filed March 8, 2019).

90 *Emera* Briefing Order at P 34.

91 *See* Opinion No. 551 at P 231.

Finally, the Expected Earnings model provides a direct measure of observable investor expectations for future returns because it provides a measure of the projected returns on book value for the firms in the proxy groups using published analyst forecasts provided by Value Line.[92] While the PJM Transmission Owners do not believe the Commission should credit concerns about mismatches between market-based rate ROE determinations and book-value rate base, the Expected Earnings model ameliorates any such potential concerns, since the Expected Earnings model is based on returns on book value.[93]

5. Risk Premium Model[94]

In the Notice of Inquiry, the Commission asks a series of questions with respect to the Risk Premium model.[95] The Risk Premium model is based on the idea that since investors in stocks undertake greater risk than investors in bonds, the former expect to earn a return on a stock investment that reflects a "premium" over and above the return they expect to earn on a bond investment.[96] Investors' required risk premiums are inversely related to interest rates; that is, they expand as interest rates fall and shrink as interest rates rise. The link between interest rates and risk premiums provides a helpful indicator of how the interest rate environment affects investors' required rates of return.[97]

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92 *See* ScottMadden, Inc. & Edison Electric Institute, *Transmission Investment: Revisiting the Federal Energy Regulatory Commission's Two-Step DCF Methodology for Calculating Allowed Returns on Equity* (December 2017) at p. 12.

93 *Id.* at pp. 34-35 ("The market value, except under very rare circumstances, is not equal to the book value. Given this mismatch, it is useful to consider a direct measure of the expected return on the book value, versus market value, of electric utility stocks.").

94 Notice of Inquiry at P 38. This discussion responds to questions H.2.d.1 through H.2.d.3.

95 *Id.*

96 *Id.* at P 16 (citing Opinion No. 531 at P 147).

97 *Id.*

The PJM Transmission Owners support the use of the Risk Premium model, together with other models, to determine just and reasonable ROEs. The Risk Premium model does not depend on any particular market conditions (i.e., it is compatible with a finding of anomalous capital market conditions, which the Commission has consistently made in recent years). The capital market relationship upon which the model is based is appropriate for any market conditions, and the Risk Premium analysis is compatible as long as the appropriate adjustment is made to account for both (i) the current capital market conditions and (ii) those conditions that were present at the time of the study (used to calculate the relationship between bond yields and equity risk premiums).[98]

As Adrien McKenzie testified in Docket No. ER19-13-000 "[t]here is evidence that the magnitude of equity risk premiums is not constant and that equity risk premiums tend to move inversely with interest rates."[99] The Commission noted in the Notice of Inquiry that investors' required risk premiums expand with low interest rates and shrink at higher interest rates.[100] The implication of this inverse relationship is that the cost of equity does not move as much as, or in lockstep with, interest rates.[101] Therefore, when implementing the Risk Premium method, adjustments may be required to incorporate this inverse relationship if current interest rate levels have diverged from the average interest rate level represented in the data set.[102] As the Commission has concluded, "[t]he link

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98 *See* Prepared Direct Testimony of Adrien M. McKenzie on Behalf of Pacific Gas and Electric Co., Docket No. ER19-13-000 (filed October 1, 2018) at p. 80.

99 *Id.*

100 Notice of Inquiry at P 16.

101 *See* Prepared Direct Testimony of Adrien M. McKenzie on Behalf of Pacific Gas and Electric Co., Docket No. ER19-13-000 (filed October 1, 2018) at p. 80.

102 *Id.*

between interest rates and risk premiums provides a helpful indicator of how investors' required returns on equity have been impacted by the interest rate environment."[103]

Finally, the Commission should incorporate both the historical and projected Risk Premium analyses by using the midpoint of the results of these analyses as the Risk Premium value in the ROE calculation. As Adrien McKenzie recently testified in Docket No. EL14-12, although in the *MISO* Briefing Order the Commission referenced only the results of the Risk Premium approach using average historical bond yields,[104] there was "no justification to ignore the investment community's expectations for higher bond yields" in evaluating the just and reasonable ROE in that proceeding, including in the application of the Risk Premium model.[105] Accordingly, in evaluating the results of the Risk Premium model, Mr. McKenzie relied on the average of the historical and forward-looking cost of equity estimates.[106] Likewise in the *Emera* Briefing Order, the Commission effectively used both historical and projected bond yields when it stated that it relied on a range of cost of equity estimates produced by the Risk Premium model.[107] Thus, the Commission should give equal consideration to an historical Risk Premium analysis and a forward-looking Risk Premium analysis by including an average of the two in the Risk Premium component of the multiple-model approach.

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103 Opinion No. 531 at P 147.

104 *MISO* Briefing Order at P 60.

105 *See* Supplemental Initial Brief of The MISO Transmission Owners, Appendix 2, Affidavit of Adrien M. McKenzie, Docket No. EL14-12-003 (filed February 13, 2019) at pp. 26-27.

106 *Id.*

107 *Emera* Briefing Order at P 59, n. 115. *See also*, Opinion No. 531 at P 147.

6. Low-End Outlier Screens[108]

The PJM Transmission Owners believe that the Commission should modify its approach to identifying ROE estimates that should be excluded as extreme outliers at the low-end of the proxy group. 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. This low-end outlier test should be modified in light of changes in capital market conditions. The Commission should recognize that a fixed value of 100 basis points does not represent a reasonable risk premium threshold for low-end outliers due to the steady decline in utility bond yields.[109]

Instead, the Commission should employ a dynamic threshold that reflects changes in interest rates, which would account for the inverse relationship between interest rates and the equity risk premium.[110] A dynamic threshold would allow the Commission greater flexibility in the test for low-end results.[111] Further, a low-end threshold that takes into account the changing spread over time between utility bond yields and utility equity would improve the accuracy of the Commission's ROE determinations.[112]

In the Notice of Inquiry, the Commission asks whether its approach to outliers should vary among different financial models.[113] The PJM Transmission Owners believe

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[108] Notice of Inquiry at PP 34 and 38. The discussion in this section addresses questions D4, D4.b. and H.1.4.a.

[109] *See* Supplemental Initial Brief of The MISO Transmission Owners, Appendix 2, Affidavit of Adrien M. McKenzie, Docket No. EL14-12-003 (filed February 13, 2019) at p. 29.

[110] Supplemental Initial Brief of MISO Transmission Owners, Docket No. EL14-12-003 (filed February 13, 2019) at pp. 7-8.

[111] Opinion No. 531 at P 122.

[112] *See* Supplemental Initial Brief of The MISO Transmission Owners, Appendix 2, Affidavit of Adrien M. McKenzie, Docket No. EL14-12-003 (filed February 13, 2019) at pp. 28-29.

[113] Notice of Inquiry at P 34, question D4.b.

that the Commission should apply a uniform low-end outlier test across the three methodologies (DCF model, CAPM and Expected Earnings model). Applying an outlier test that yields different low-end outlier thresholds for each model can result in thresholds that are illogical. That is, an equivalent cost of equity estimate may be included in one model but removed from another due to it being an "outlier" in that other model.[114]

7. High-End Outlier Screens[115]

In Opinion No. 531, the Commission determined that it was unnecessary to exclude any estimates produced by the two-step DCF model on the ground that they were too high to be credible.[116] In the Notice of Inquiry, the Commission asks for comment on appropriate high-end outlier tests, which include a new high-end results test that it proposed in the *Briefing Orders*.[117] In the *Briefing Orders*, the Commission proposes to treat as high-end outliers "any proxy company whose cost of equity estimated under the model in question is more than 150 percent of the median result of all of the potential proxy group members in that model before any high or low-end outlier test is applied."[118] This proposed 150 percent threshold screen would be subject to a "natural break" analysis similar to the approach the Commission uses for low-end DCF analysis results.[119] The PJM Transmission Owners do not believe that the Commission should exclude any ROE results from the average on this basis. There is no basis in economics or logic for

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114 *See* Supplemental Reply Brief of The MISO Transmission Owners, Appendix 2, Reply Affidavit of Adrien M. McKenzie, Docket No. EL14-12-003 (filed April 10, 2019) at p. 105.

115 Notice of Inquiry at P 34. The discussion in this section addresses question D4.

116 Opinion No. 531 at P 118.

117 Notice of Inquiry at P 34, question D4. *See also Emera* Briefing Order at P 52; *MISO* Briefing Order at P 54.

118 *Emera* Briefing Order at P 53.

119 *Id.*

applying the 150 percent threshold screen or the "natural break" test. Accordingly, the Commission should eliminate all high-end outlier screens from its evaluation of just and reasonable ROEs.

First, there is no economic basis behind the 150 percent threshold screen that the Commission had proposed. As noted by Adrien McKenzie in Docket No. EL14-12-003, the application of the 150 percent high-end test is based on "the erroneous premise that the median of the DCF results presents a meaningful guide to investors' required range of returns for the proxy group companies."[120] In Opinion Nos. 531 and 551, the Commission recognized that the results of any DCF application can differ substantially from investors' expectations and are subject to potential distortion. For example, in Opinion Nos. 531 and 551, the Commission determined that the 9.39% and 9.29% midpoints of its DCF ranges violated the *Hope* and *Bluefield* standards, and thus concluded that these values were unjust and unreasonable outcomes.[121]

Thus, the finding that the central tendency of the DCF results is not a meaningful basis to evaluate a just and reasonable ROE directly contradicts any reliance on the median as a guide to what values might be considered logical or illogical to include in the range.[122] As a result, the dispersion of individual DCF values above the downward-biased median of a group of distorted DCF values is not a reasonable way of determining how well a specific DCF estimate reflects investors' expectations at the high end of the zone.[123]

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120 See Supplemental Initial Brief of The MISO Transmission Owners, Appendix 2, Affidavit of Adrien M. McKenzie, Docket No. EL14-12-003 (filed February 13, 2019) at p. 34.

121 Opinion No. 531 at PP 148, 150; Opinion No. 551 at PP 250, 256.

122 Supplemental Initial Brief of The MISO Transmission Owners, Appendix 2, Affidavit of Adrien M. McKenzie, Docket No. EL14-12-003 (filed February 13, 2019) at p. 34.

123 *Id.* at p. 35.

In short, because there is no basis in economics or logic for applying any high-end outlier screens, the Commission should eliminate them from its evaluation of just and reasonable ROEs.

Second, there is no economic basis for the proposed "natural break" screen. The purpose of the "natural break" test would be to exclude economically illogical results from the proxy group analysis.[124] The analysis compares the gaps between two ROE estimates throughout the proxy group to judge whether any ROE estimates are economically illogical. However, the relative magnitude of rank-ordered results for adjacent companies in a proxy group has no bearing on a determination of whether a particular cost of equity estimate is economically illogical because relative dispersion of individual ROE values is not useful in making inferences about the reasonableness of the individual values in the proxy group or determining how well a specific ROE reflects investors' expectations and required returns.[125] There could be many reasons why there may be a gap between the cost of equity estimated for two companies. Thus, it is not clear that the magnitude of any particular gap demonstrates where the boundary lies between economically logical and illogical results.[126]

Moreover, the magnitude of the "natural break" test is highly arbitrary and subjective. While the test relies on comparing the numerical results of two companies' rank-ordered ROE estimates, the determination as to whether the numerical difference reflects a divide between what is logical and illogical is a purely qualitative exercise.

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124 *Emera* Briefing Order at PP 49, 51 and 53.

125 Supplemental Initial Brief of The MISO Transmission Owners, Appendix 2, Affidavit of Adrien M. McKenzie, Docket No. EL14-12-003 (filed February 13, 2019) at pp. 39-40.

126 *Id*.

Evaluating the results of the financial models requires objective criteria and guidance by the Commission. The "natural break" test offers neither.[127]

8. Use of a Vintage Approach[128]

In the Notice of Inquiry, the Commission asks if it should consider a vintage approach, with the base ROE fixed for the life of each asset at the time the asset is completed. The PJM Transmission Owners strongly disagree with the use of a vintage approach for base ROE.[129] First, such an approach does not recognize that, because transmission assets are long-lived assets, the base ROE at the time of development may not be adequate to attract investment throughout the asset's life or the life of the company. The vintage approach also ignores the fact that the transmission system consists of long-lived assets that are constantly being upgraded and expanded. Over time, it becomes increasingly likely that circumstances and market conditions will differ markedly from those prevailing when an asset entered service.

Second, requiring a vintage approach would result in unnecessary burdens on transmission owners, regulators and customers, who would have to track, for accounting purposes, a multitude of different transmission projects having different returns within the same company. Accordingly, it would be less likely to generate an adequate and fair ROE that will permit a transmission owner to attract capital over time. Likewise, implementation of a vintage approach requires wholesale modifications to transmission formula rates in order to track individual project vintages. Finally, as discussed in more detail in the PJM Transmission Owners' response to the incentives Notice of Inquiry filed

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127 *Id.* at pp. 38-41.

128 Notice of Inquiry at P 31. The discussion in this section addresses questions A4, A4.a and A4.b.

129 *Id.*

concurrently in Docket No. PL19-3-000, project-specific ROE incentives should continue to be applied for the life of the project for which the ROE incentive was awarded in order to provide certainty to investors.

C. Proxy Group Issues

1. Measure of Central Tendency[130]

After using three of the four models (DCF, CAPM, and Expected Earnings) to establish a zone of reasonableness, the Commission then determines the central tendency of the zone and uses that point to set the just and reasonable ROE for a utility of average risk. The Commission uses two different approaches for this purpose. When determining a single ROE that will apply to all average risk electric utilities whose transmission facilities are used to provide transmission service within an RTO, the Commission sets the just and reasonable ROE at the midpoint of the zone of reasonableness.[131] When determining the ROE for a single electric utility of average risk, whether or not that utility participates in an RTO, it uses the median of the zone for that purpose.[132] The PJM Transmission Owners believe that, at the very least, the Commission should use midpoints to determine the central tendency of the zone of reasonableness in selecting the ROEs for transmission owners in an RTO in all cases.

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130 Notice of Inquiry at P 34. The discussion in this section addresses questions A3, D10 and D10a.

131 *See S. Cal. Edison Co. v. FERC*, 717 F.3d 177, 181-182 (D.C. Cir. 2013).

132 The midpoint of all the estimates of ROE of a proxy group is the average of the highest and lowest estimated ROE of all members of the group. The median is that point within the zone of reasonableness where half the returns have a higher value and half the returns have a lower value. The mean, or average, is the sum of all the high and low estimates of each member of the proxy group, divided by the number of estimates. *Midwest Independent Transmission System Operator, Inc.*, 106 FERC ¶ 61,302 at P 4, n. 9 (2004) ("*Midwest ISO*").

In adopting the midpoint versus median distinction, the Commission has stated that where the applicants proposed setting a single ROE for across-the-board application to all transmission owners, it must calculate a single ROE for application to a broad group of utilities with diverse risks and business profiles.[133] In those circumstances, the Commission considers their full range of risks and business profiles and recognizes that the differing ROEs in the group fairly brackets the zone of reasonableness for all transmission owners.[134] Accordingly, the entire zone of results yielded by the group is relevant, meaning that using the midpoint is the most appropriate measure for determining a single ROE for all transmission owners in an RTO, since it fully considers that zone.[135]

The PJM Transmission Owners respectfully urge the Commission to move away from its use of two different measures to establish the just and reasonable ROE from within the zone of reasonable returns. Regardless of whether the proceeding involves the ROE of a single utility or the ROE of all transmission owners in an RTO, the proxy group encompasses only utilities that present investment risks comparable to those associated with the utility or utilities at issue, so the entire zone of results yielded by analysis of the proxy group is relevant. Accordingly, the Commission should set the just and reasonable ROE at the midpoint of the zone of reasonable returns whether the proceeding involves a single electric utility or all of the transmission owners in an RTO.

If the Commission is not prepared to do so in all cases, it should at least adopt a uniform midpoint-based approach for all electric utilities participating in an RTO regardless of whether the proceeding concerns a single ROE that will apply to all

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133 *Midwest ISO*, 106 FERC at P 9.

134 *Id.*

135 *Id.* at P 10.

transmission owners in the RTO or an individual ROE for an individual transmission owner. There is no valid basis for distinguishing between the just and reasonable ROEs of transmission owners in neighboring RTOs based on the fact that in one RTO, the same ROE applies to all transmission owners, while in the other, individual ROEs are set. This difference does not alter the business or financial risks faced by utilities in different RTOs, so it does not affect the returns that investors require to support their investments in the transmission facilities upon which the RTOs rely. This difference therefore should not cause the ROEs established for transmission owners to diverge based on the use of different measures of the central tendency of the zone of reasonableness.

The Commission's rationale for using the midpoint of the zone to establish a uniform ROE for electric utilities in an RTO applies with equal force to RTO-member utilities for which the Commission sets individual ROEs. In both cases, the participating transmission owners share common obligations and risks arising from their participation in the RTO. The variety of different ROE results for the proxy group members fairly brackets the zone of reasonableness for all transmission owners in the RTO, whether the issue concerns a single ROE for all of them or an ROE for just one of them. Under these circumstances, it is reasonable for the Commission to use midpoints to determine the central tendency for placement of those ROEs within the zone of reasonableness in selecting the ROEs for transmission owners in an RTO in all cases.[136]

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[136] With that being said, the right to choose whether to employ a single, uniform ROE or individual ROEs within an RTO or ISO clearly rests with the individual transmission owners. *Atlantic City Elec. Co. v. FERC*, 295 F.3d 1, 9-10 (D.C. Cir. 2002); *Atlantic City Elec. Co. v. FERC*, 329 F.3d 856, 858-59 (D.C. Cir. 2003) (Transmission owners have the statutory right to file individual rates for service over their transmission facilities). And, the Commission has no statutory power to take away the FPA section 205 filing rights of a transmission owner. *Id.*

Finally, the PJM Transmission Owners believe that adoption of the multi-model approach would not undercut the Commission's current rationale for using the midpoint in determining RTO-wide base ROEs,[137] or the extension of the midpoint approach, as the PJM Transmission Owners advocate. The CAPM and Expected Earnings model serve the same function as the DCF model in that, as with the DCF model, they estimate a zone of reasonable returns for the target electric utility, using proxy groups to determine the zone.[138] And, the Commission uses the same screens for developing the proxy group for all three models. These factors suggest that the use of the midpoint is appropriate under the multi-model approach.

2. Proxy Group Composition[139]

The application of the Commission's DCF analysis involves the determination of a risk-comparable proxy group. The Commission employs a credit rating screen to limit the composition of the proxy group to electric utilities with a credit rating similar to that of the utility in question.[140] This approach includes utilities with credit ratings that differ by no more than one "notch" from the credit rating of the subject utility or utilities. The PJM Transmission Owners support the approach based on electric utilities that pass the credit rating screen where it yields a proxy group with enough members for the results to

137 Notice of Inquiry at P 34, question D10.a.

138 *Emera* Briefing Order at P 49.

139 Notice of Inquiry at P 34. The discussion in this section addresses questions D1, D1.b, D3, D8 and D8.a.

140 *See, e.g.*, Opinion No. 531 at PP 106-108 (citing *Tallgrass Transmission, LLC*, 125 FERC ¶ 61,248 at p. 62,240, n.79 (2008)).

constitute a reasonable[141] and representative sample of companies comparable to the subject utility.[142]

However, due to changes in the industry, the lack of a large, representative comparison group has become an increasing concern in recent years. Eliminating electric utilities with credit ratings more than one notch above or below the subject electric utility's credit rating can result in proxy groups that are too small to constitute a reasonable and representative sample of companies comparable to the regulated firm whose ROE is being evaluated and fail to take into account the evolution of an electric utility's credit rating.[143]

Therefore, in the cases where the proxy sample is too small, the Commission should expand the proxy group to electric utilities with credit ratings more than one notch above or below the subject electric utility's credit rating in order to generate a robust sample size. For example, the Commission could expand the group to include electric utilities with credit ratings up to two or three notches above or below the subject electric utility, as necessary, or, in an extreme case, all investment grade electric utilities. The

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141 *See Kern River Gas Transmission Company*, Opinion No. 486, 117 FERC ¶ 61,077 at P 139 (2006) (noting the need to depart from historical proxy group standards for pipelines in one way or another "in order to have a reasonable number of companies to include in the proxy group."); *Kern River Gas Transmission Company*, Opinion No. 486-B, 126 FERC ¶ 61,034 at P 104 (2009) (finding that a five firm proxy group was sufficient to avoid concerns about too small a proxy group resulting in a distorted sample).

142 The Court of Appeals for the D.C. Circuit explained in *Petal v. FERC* that the purpose of the proxy group is to "provide market-determined stock and dividend figures from public companies comparable to a target company for which those figures are unavailable. Market-determined stock figures reflect a company's risk level and when combined with dividend values, permit calculation of the 'risk-adjusted expected rate of return sufficient to attract investors.'" *Petal Gas Storage, L.L.C. v. FERC*, 496 F.3d 695 at 699 (D.C. Cir. 2007), quoting *Canadian Association of Petroleum Producers v. FERC*, 254 F.3d 289 at 293 (D.C. Cir. 2001). It is thus crucial that the firms in the proxy group be comparable to the regulated firm whose rate is being determined. In other words, the proxy group must be "risk-appropriate." *Id.*

143 *See, e.g.,* Opinion No. 551 at P 41 (unnecessarily shrinking the group of representative companies makes the proxy group and the resulting DCF analysis a less reliable tool for ensuring that the allowed ROE satisfies the requirements of *Hope* and *Bluefield*).

Commission has in the past permitted comparable risk bands as wide as five credit notches.[144] If a proxy group is too small, it will not constitute a reasonable and representative sample of companies comparable to the regulated target company, accurately reflect the true comparability of risks among the group or be sufficiently reliable for the ROE analysis.[145] To ensure that the sample is sufficiently robust, the proxy group should be expanded, as necessary.

Finally, the PJM Transmission Owners urge the Commission to take a more flexible approach to the exclusion from the proxy group of companies with merger activity. Currently, the Commission excludes all companies with significant merger activity during the six-month study period.[146] The PJM Transmission Owners believe the Commission should be less inclined to exclude companies from the proxy group using this screen. First, mechanical application of the merger activity screen significantly reduces the pool of proxy group companies, which can affect the zone of reasonableness. As the Commission has noted, "unnecessarily" shrinking the group of representative companies makes the proxy group and the resulting DCF analysis "a less reliable tool for ensuring that the allowed ROE satisfies the requirements of *Hope* and *Bluefield*."[147] Second, excluding companies engaged in merger activity from the proxy group effectively lowers the investment attractiveness of the proxy group as a whole, which results in downward

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144 *See, e.g., Tallgrass Transmission, LLC*, 125 FERC ¶ 61,248 at P 77, n.79 (2008) ("For both projects, the Commission screened the proxy group for companies with corporate credit ratings of BBB- to A.").

145 Although the Commission should relax the credit rating thresholds for proxy group composition, it only should consider other types of companies, including unregulated companies, on a case-by-case basis, as appropriate, for secondary support.

146 Opinion No. 531 at P 114.

147 Opinion No. 551 at P 41.

pressure on the target company's ROE.[148] Third, there are many circumstances in which merger activity will not affect the suitability of a company for inclusion in the proxy group as a company with risks comparable to those faced by the subject utility. For example, the Commission has concluded that the acquisition or sale of small business units is "not the type of input-distorting transaction that the [merger] screen is intended to address."[149]

The PJM Transmission Owners support the use of a *de minimis* threshold for merger activity in considering whether to disqualify companies from the proxy group. For example, the Commission could compare the magnitude of the merger activity with the size of the parties to the proposed transaction. If the merger activity is relatively small in relation to the companies involved (i.e., approximately 5-10% of market capitalization), then the Commission should not eliminate the company from the proxy group.[150] In addition, even where the threshold is exceeded, the Commission should eliminate the company from the proxy group only if the merger activity has appreciably affected the stock price.

D. State ROE Issues

In the Notice of Inquiry the Commission asks whether and if so how it should consider state ROEs in the determination of ROEs for FERC-jurisdictional public

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148 *See* ScottMadden, Inc. & Edison Electric Institute, *Transmission Investment: Revisiting the Federal Energy Regulatory Commission's Two-Step DCF Methodology for Calculating Allowed Returns on Equity*, p. 20 (December 2017).

149 Opinion No. 551 at P 41.

150 *See, e.g.*, Cross-Answering Testimony and Exhibits of Adrien M. McKenzie on Behalf of System Energy Resources, Docket No. EL17-41, *et al.* (filed June 14, 2019) at p. 20 (Given the small scale of an asset sale relative to the company as a whole, there is no basis to conclude that the asset sale would have a material impact on investors' expectations or the inputs to the financial models used to estimate the cost of equity).

utilities.[151] Namely, it seeks comment on how and why state ROEs vary by state and whether they are comparable to Commission ROEs. Finally, the Commission seeks comment on whether it should consider state ROEs, and, if so, how it should compare state ROEs that apply to companies with distribution, generation and transmission with FERC-jurisdictional transmission ROEs companies.[152]

The PJM Transmission Owners believe that the Commission should continue to use state ROEs as reference points.[153] However, in doing so, the Commission should continue to recognize that investors in companies whose focus is electric transmission infrastructure face financial and business risks that differ in key respects when compared to other electric infrastructure investment, particularly state-regulated electric distribution,[154] and that transmission entails unique risks that state-regulated electric distribution does not.[155] Accordingly, state-determined ROEs should not be included in the calculation of ROEs for FERC-jurisdictional transmission companies. Long-standing Commission policy prohibits contract provisions requiring that a state-determined ROE be used as the cost of equity in a Commission-approved wholesale rate.[156]

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151 Notice of Inquiry at P 35. The discussion in this section addresses questions E9 and E10.

152 *Id.*

153 *See* Opinion No. 531 at P 148.

154 *Id.* at P 149.

155 *Id.* at P 148.

156 *See Carolina Power & Light Co.*, 67 FERC ¶ 61,074 at p. 61,205 (1994) ("The Commission does not allow the return component of a formula rate to be set without Commission review, even when the return tracks a state-approved return . . ."). *See also Jersey Central Power & Light Co.*, 77 FERC ¶ 61,001 at p. 61,009 (1996); *Green Mountain Power Corp.*, 46 FERC ¶ 61,164 at p. 61,571 (1989).

IV. CONCLUSION

The PJM Transmission Owners appreciate this opportunity to present their views on the important questions presented in the Notice of Inquiry. The PJM Transmission Owners respectfully request that the Commission take the foregoing comments into account as it considers improvements in its ROE policies for public utilities.

Respectfully Submitted,

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