

How To Assure Returns For New Transmission Investment

Law360, New York (September 05, 2013, 1:28 PM ET) -- In his initial decision in *Coakley v. Bangor Hydro-Electric Co.*,^[1] Presiding Administrative Law Judge Michael J. Cianci Jr. finds the New England transmission owners' (NETOs) current base return on equity (ROE) of 11.14 percent unjust and unreasonable. Relying on the Federal Energy Regulatory Commission's traditional discounted cash flow (DCF) analysis prepared on behalf of the NETOs, Cianci adopts the NETOs' zones of reasonableness for the locked-in refund period of from 6.0 percent to 15.2 percent and prospectively of from 6.1 percent to 13.2 percent.^[2]

Accordingly, he finds that the just and reasonable base ROE for the 15-month refund period is 10.6 percent, and prospectively, from the date of the commission's order fixing the new rate is 9.7 percent. Cianci leaves modifications to the DCF analysis and adoption of alternative financial models and adjustments to the ROE, for policy reasons, to the commission.

Application of Traditional DCF Analysis

In *Coakley*, the NETOs contends that the current base ROE of 11.14 percent should be retained merely because it falls within the zones of reasonableness resulting from their traditional DCF analyses.^[3] Cianci rejects the NETOs' contention, finding, "A bright line litmus test of this sort is contrary to FERC precedent and is simply illogical when applied to the facts of this case."^[4] He further finds that the commission has previously rejected this argument.^[5]

Cianci relies solely on the DCF analyses prepared on behalf of the NETOs, which he concludes are consistent with firm commission precedent and longstanding ratemaking principles.^[6] He "adopts [the NETOs] use of a national proxy group in this particular case on the basis that the current financial and market conditions are better served by use of a more diverse national proxy group."^[7] He "agrees with the NETOs that it appears as though the Commission has since 2010 favored national versus regional proxy groups."^[8]

Cianci finds the NETOs' proxy group screening criteria appropriate: inclusion as an electric utility in Value Line Investment survey; six months of dividends without a dividend cut; no ongoing merger and acquisition activity; corporate credit ratings one notch above and below the subject utilities; five-year growth rates from the Institutional Brokers Estimate System; and electric utilities covered by at least two industry analysts (where possible).^[9]

Finally, consistent with commission precedent, Cianci sets the just and reasonable ROEs at the midpoints of the zones of reasonableness.

No Deviations or Adjustments for Current Financial and Market Conditions

The NETOs contend “that the traditional DCF methodology has understated the NETOs [sic] true cost of equity in these unusual financial and economic times, arguing that alternate methods should be considered by the Commission.”[10] They assert that the commission’s traditional DCF analysis will understate the NETOs’ cost of equity due to the prevailing unusual economic conditions caused, in particular, by the actions taken by the Federal Reserve’s board of governors to set and maintain historically low interest rates.[11]

They argue for adjustments to the ROE as determined in accordance with the commission’s DCF precedent and ratemaking principles. In addition to their traditional DCF analyses, the NETOs’ included alternative financial models, including a capital asset pricing model approach, risk premium approach and expected earnings approach and a modified DCF analysis in support of their claim for such adjustments.

According to Cianci, the traditional DCF analysis takes market conditions into consideration. He finds that the alternative financial models “do not conform to Commission precedent, nor to any of the other modified notions of the DCF analysis.”[12]

Cianci “finds policy objectives should be left to the discretion of the Commission.”[13] He notes that “the Commission is free to consider any policy changes it believes are warranted to address the NETOs’ arguments.”[14]

Any “deviation from Commission precedent, exceptions to, or exemptions made, must necessarily come from the Commission itself,”[15] which “may raise or lower the ROE upon consideration of new alternative methods, or upon updating, as it deems appropriate.”[16]

Different ROE for 15-Month Refund Period

In a case of first impression, Cianci agrees with the NETOs that a separate higher ROE is appropriate for the 15-month refund period from Oct. 1, 2011, through Dec. 31, 2012. According to the NETOs, the base ROE established for this “locked in” period must be based on the cost of equity evidence that applies to that time period, i.e., the initial DCF and other financial analyses submitted by the parties.

The base ROE that will be established to be in effect prospectively from the date of the commission’s order fixing the new rate must be based on the updated DCF and other financial analyses submitted prior to the hearing. The NETOs’ DCF analysis for the defined refund period, from Oct. 1, 2011, through Dec. 31, 2012, supported a higher base ROE, in this case, of 10.6 percent.

According to Cianci, the base ROE for the locked-in/refund period must be based on the cost of equity evidence that applies to that time period “otherwise it would allow for a windfall and a return of excessive refunds, based upon supporting data which did not exist at the time.”[17] The prospective ROE should be based on the updated DCF analysis.

ROEs Necessary to Assure New Transmission Investment

FERC precedent and rate-setting principles regarding ROE are well-established and are likely to continue to be followed absent further direction from the commission. As Cianci states, any modification of that precedent or those principles or a change in commission policy is within the discretion of, and must come from, the commission.

When the commission set the NETOs' current base ROE of 11.14 percent, it included an upward adjustment in the base ROE to account for changes in capital market conditions — specifically, the monthly yields on 10-year constant maturity U.S. Treasury bonds — between the date of the issuance of the initial decision in that case and the date of the commission's order.[18]

The current rate for those U.S. Treasury bonds is up from that used in the NETOs' DCF analysis in support of the prospective ROE, and the rate could increase. By the time the commission issues its order in this proceeding,[19] the base ROE may be in the mid-10-percent range or even higher.

On Aug. 26, 2013, shortly after Cianci issued his initial decision, Southern California Edison Company (SCE) submitted an offer of settlement in its long-pending FERC rate case.[20] The settlement provides for a base ROE of 9.3 percent, plus an adder for independent system operator participation of 0.5 percent and facility-specific rate incentive adders as approved by the commission.[21]

ROE is set differently for individual transmission owners such as SCE (e.g., at the median of the range of reasonableness) than for groups of transmission owners such as the NETOs (e.g., at the midpoint). Nevertheless, SCE apparently felt that a base ROE of 9.3 percent reflected its current cost of equity and was sufficient to assure future investment in SCE.

It is in these circumstances that the commission ultimately will have to decide whether prospective ROEs set using its traditional DCF analysis and ratemaking principles, as adjusted, are at levels sufficient to attract the capital necessary to assure future electric utility company investment, including new transmission investment.[22]

Of perhaps more importance to the availability of new transmission investment will be whether and, if so, how, the commission takes into account the impact of the adoption and implementation of Order No. 100023 on its DCF precedent and ratemaking principles and the setting of base ROEs for new transmission facilities selected in a regional transmission plan for purposes of cost allocation.

In Order No. 1000, the commission required the removal from commission-jurisdictional tariffs and agreements of provisions that granted a federal right of first refusal (ROFR)[24] to incumbent transmission owners to construct such facilities.[25] While the commission had accepted federal ROFRs in some cases, and rejected them in others, it found persuasive its reasoning in the latter cases.

In particular, in Cleco Power LLC,[26] the commission rejected a ROFR based on the expectation that "[t]he presence of multiple transmission developers would lower costs to customers." [27] Accordingly, the commission found in Order No. 1000 "that federal rights of first refusal in favor of incumbent transmission providers deprive customers of the benefits of competition in transmission development, and associated potential savings." [28]

Thus, new transmission facilities selected in a regional transmission plan for purposes of cost allocation will be evaluated and selected increasingly in competitive regional planning processes on the basis of market proposals or competitive solicitations.[29]

In order to permit such evaluation and selection, the commission required each transmission provider to revise its open access transmission tariff to identify in sufficient detail the information necessary to allow a proposed transmission facility to be evaluated in the regional transmission planning process on a basis comparable to other transmission facilities that are proposed in that planning process.[30]

[Such providers] may require, for example, relevant engineering studies and cost analyses and may request other reports or information from the transmission developer that are needed to facilitate evaluation of the transmission project in the regional transmission planning process.[31]

The commission further noted that the selection by transmission providers of a transmission facility in a regional transmission plan for purposes of cost allocation will depend in part on their combined view of “whether the transmission facility is an efficient or cost-effective solution to their needs.”[32] According to the commission:

As noted above, for one solution to be chosen over another in the regional transmission planning process, there should be an evaluation of the relative efficiency and cost-effectiveness of each solution. If a nonincumbent transmission developer is unable to demonstrate that its proposal is the most efficient or cost-effective, given all aspects of its proposal, then it is unlikely to be selected as the preferred transmission solution within the regional transmission planning process for purposes of cost allocation.³³

Accordingly, regardless of the information that transmission providers may require for the evaluation of a proposed transmission facility, nonincumbent, as well as incumbent, transmission developers may include in their market proposals or competitive bids information regarding the returns required for such new transmission investment.

The commission will have to decide whether the ROEs for new transmission facilities selected in regional transmission plans for purposes of cost allocation evaluated and selected in a competitive regional planning process on the basis of market proposals or competitive solicitations, nonetheless, should be determined using the commission’s traditional DCF analysis and ratemaking principles.

On the other hand, should the ROEs for such new transmission facilities be set on the basis of the market proposals or competitive bids on which the facilities are evaluated and selected? If so, since the ROEs would be set on a facility-specific basis, should they be fixed for the life of the facilities? And, will ROEs set and fixed in a competitive regional planning process on the basis of market proposals or competitive bids be and remain just and reasonable under Federal Power Act Section 205?

The commission also will have to address, among other issues, whether transmission developers whose new transmission facilities selected in regional transmission plans for purposes of cost allocation are evaluated and selected in a competitive regional planning process on the basis of market proposals or competitive bids will be entitled to rate incentives and, if so, under which circumstances. Will such transmission developers be able to make the showings necessary to support the grant of such incentives?[34]

Finally, how might the ROEs for such new transmission facilities set in a competitive regional planning process on the basis of market proposals or competitive bids affect the ROEs of incumbent transmission owners for new local transmission facilities or upgrades for which such transmission owners retain their ROFR?

If the ROEs for new transmission facilities selected in a regional transmission plan for purposes of cost allocation were set on the basis of the market proposals or competitive bids on which such new transmission facilities will be evaluated and selected, new transmission investment would not be dependent on the results of traditional DCF analyses and ratemaking principles. Competing transmission developers would be able to propose returns on their investments that take into account current financial market conditions and competition for capital.

Also, if ROEs for such new transmission facilities were fixed on the basis of the transmission developers’ market proposals or competitive bids, investors’ returns would remain stable for the lives of the new transmission facilities.

ROEs for new transmission facilities selected in regional transmission plans for purposes of cost allocation set and fixed in this way would reflect current financial market conditions and should be sufficiently competitive and stable to attract the new investment necessary for a reliable and efficient transmission system.

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[1] 144 FERC ¶ 63,012 (2013).

[2] *Id.* at P 587.

[3] *Id.* at P 547.

[4] *Id.*

[5] *Id.*

[6] *Id.* at P 577 n.73.

[7] *Id.* at P 551 n.49.

[8] *Id.* at P 557.

[9] *Id.* at P 552.

[10] *Id.* at P 549.

[11] *Id.* at P 550.

[12] *Id.* at P 575.

[13] *Id.* at P 545.

[14] *Id.* at P 549.

[15] *Id.* at P 550.

[16] *Id.* at P 551.

[17] *Id.* at P 585.

[18] Bangor Hydro-Elec. Co., Opinion No. 489, 117 FERC ¶ 61,129 at P 81 (2006), order on reh'g, 122 FERC ¶ 61,265, order granting clarification, 124 FERC ¶ 61,136 (2008).

[19] Because the initial decision was filed sooner than called for in the procedural schedule, the parties asked for, and received, extensions for filing their briefs on and opposing exceptions to the initial decision until Sept. 20, 2013, and Oct. 24, 2013, respectively. Accordingly, the commission is not likely to

issue its order on initial decision before mid-2014.

[20] Southern Cal. Edison Co., Southern California Edison Company's explanatory statement and offer of settlement, filed Aug. 26, 2013, Docket No. ER11-3697-005.

[21] Interestingly, the settlement precludes, with certain exceptions, new SCE petitions requesting transmission rate incentives or commission grants of policy-based incentive rate treatment pursuant to its general discretionary authority prior to Jan. 1, 2018. The limitation on filing new incentive requests for ROE project adders applies only until July 1, 2015. Offer of settlement § 3.6.

[22] Cianci found the testimony of the NETOs' experts to the effect that "if ROE is set substantially below 10% for long periods ... it could negatively impact future investment in the NETOs ... to have moderate probative value. ... If transmission investment is substantially limited in the future, it will have a negative impact upon operational needs, reliability, and ultimately ratepayers' future costs." Initial decision at P 576.

[23] Transmission Planning & Cost Allocation by Transmission Owning & Operating Pub. Utils., Order No. 1000, FERC Stats. & Regs. ¶ 31,323 (2011), order on reh'g, Order No. 1000-A, 139 FERC ¶ 61,132, order on reh'g, Order No. 1000-B, 141 FERC ¶ 61,044 (2012).

[24] Federal ROFRs refer only to ROFRs that are created by provisions in Commission-jurisdictional tariffs or agreements. Order No. 1000-A at P 415.

[25] Order No. 1000 at PP 225, 253.

[26] Cleco Power LLC, 101 FERC ¶ 61,008 (2002), order on reh'g, 103 FERC ¶ 61,272 (2003), order terminating proceedings, 112 FERC ¶ 61,069 (2005) ("Cleco Power").

[27] Order No. 1000 at P 268 (citing Cleco Power at P 117); see also Carolina Power & Light Co., 94 FERC ¶ 61,273 at 62,009-10, order on reh'g and clarification, 95 FERC ¶ 61,282 at 61,995 (2001) (finding that a federal right of first refusal would unduly limit the planning authority and present the possibility of discrimination by self-interested transmission owners, potentially reduce reliability, and possibly preclude lower cost or superior transmission facilities or upgrades by third parties from being planned and constructed).

[28] Order No. 1000 at P 285.

[29] Id. at P 259.

[30] Id. at P 326.

[31] Id.

[32] Id. at P 331.

[33] Id. at n.307.

[34] The commission has indicated only that it would consider on a case-by-case basis granting incumbent transmission providers abandoned plant recovery when the provider may be called upon to complete a transmission facility that another entity has abandoned or has an obligation to build a new transmission facility selected in the regional transmission plan for purposes of cost allocation not sponsored by another transmission developer. Id. at P 267; Order No. 1000-A at P 489. All Content © 2003-2013, Portfolio Media, Inc.