

October 18, 2018

FERC ISSUES LONG-AWAITED ORDER ON RETURN ON EQUITY FOR NEW ENGLAND ELECTRIC UTILITIES

To Our Clients and Friends:

On October 16, 2018, the Federal Energy Regulatory Commission ("FERC") issued a long-awaited order on the return on equity ("ROE") to be used by electric utilities in New England for setting their transmission rates. The order has major implications for all electric utilities—not just those in New England—because the order establishes a new methodology for reviewing and setting ROEs that will be applied to all FERC-regulated electric utilities going forward. There is no indication in the order that FERC intends this methodology to apply to natural gas pipeline rates.

In Tuesday's order, FERC charted a wholly new course for setting ROEs by using neither a one-step or two-step discounted cash flow ("DCF") methodology as it has used historically. Implicitly responding to long standing criticism of the DCF model, FERC instead adopted a new approach in which it: (i) will first look to whether an existing ROE falls within a particular range of ROEs within a "zone of reasonableness" established through *three* separate financial models (one of which is the DCF) and then, if the ROE falls outside the range, (ii) it will establish a new ROE through application of *four* separate methodologies for estimating ROEs.

The order was issued in four separate but related proceedings initiated by complaints filed against the New England utilities. One of these proceedings was on remand from the U.S. Court of Appeals for the D.C. Circuit's 2017 decision in *Emera Maine v. FERC*. Three were pending before FERC on "exceptions" (*i.e.*, appeal) from FERC administrative law judge ("ALJ") decisions issued in 2016 and 2018.

These four related cases began with a complaint filed against New England's utilities on September 30, 2011 by Martha Coakley, the Attorney General of Massachusetts, and other entities and state agencies. FERC set that matter for hearing before an ALJ but, on appeal of the ALJ's decision, issued its then-seminal 2014 order in *Coakley v. Bangor Hydro* in which it changed its historic methodology for setting electric utility ROEs.

Prior to *Coakley*, FERC established electric utility ROEs based on a "one-step" DCF methodology that estimated actual ROEs of publicly traded electric utilities to determine the appropriate ROE for the subject utility. More specifically, the methodology calculated what investors in comparable utilities expected for ROEs (as evidenced by dividend yields and analyst earnings forecasts) and then set the ROE for the subject utility at either the midpoint or median of the range of ROEs of these comparable utilities (the so-called "zone of reasonableness").

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In *Coakley*, FERC instead used a "two-step" DCF methodology to set the ROEs for the New England utilities. This methodology, which had been used by FERC for natural gas pipelines for some time, looked not only at ROEs of comparable utilities but also at long-term economic growth forecasts. All things being equal, the two-step methodology thus resulted in a lower ROE than the one-step methodology because long-term forecast economic growth generally is lower than ROEs imputed from divided yields and earnings forecasts. However, in a major departure from precedent, FERC set the ROE for the New England utilities not at the median or midpoint of the zone of reasonableness, but at the midpoint of the upper half of the zone. FERC explained that anomalous capital market conditions justified this departure from precedent.

From 2012 to 2014, three additional complaints were filed against the New England utilities by a variety of entities seeking lower ROEs. FERC set all three for hearing before ALJs. All three resulted in ALJ decisions that were appealed up to FERC, where they remain pending, and partially rendered moot by yesterday's FERC order.

The *Coakley* decision was widely criticized as an opportunistic means to lowering overall returns at a time when lower interest rates were actually encouraging new infrastructure investment. The decision was appealed to the U.S. Court of Appeals for the D.C. Circuit by both the utilities and their customers.

The Court in 2017—in an order titled *Emera Maine v. FERC*—found in part for the utilities and in part for the customers. Finding for the customers, the Court held that an existing ROE that falls within the zone of reasonableness is not *per se* just and reasonable and, thus, may be changed by FERC. Finding for the utilities, the Court held that FERC had not adequately shown that the New England utilities' existing ROE was unjust and reasonable. The Court thus vacated the underlying *Coakley* decision and remanded the matter to FERC. But by vacating the underlying decision, the Court gave FERC wide berth in adopting a new and revised approach to establishing ROE policy.

Yesterday's FERC order addresses the *Coakley* decision's shortcomings identified by the Court in *Emera Maine v. FERC* by establishing a clear two-step approach to ROE complaint matters. But it goes much further by looking beyond DCF analyses and espousing a methodology that uses multiple financial models.

First, FERC proposes using three different financial models—the DCF, the CAPM, and the Expected Earnings models—to establish a zone of reasonableness of estimated ROEs enjoyed by utilities with comparable risk to that at issue (with risk generally indicated by credit ratings). The DCF model, as noted, has historically been the sole model used by FERC to establish the zone of reasonableness and, if necessary, the new ROE; parties, however, have often presented evidence of results from the CAPM or Expected Earnings models as additional evidence seeking to support or refute the DCF results.

Importantly, FERC held that if a utility's existing ROE falls within a particular range (*i.e.*, effectively a sub-zone) within the zone of reasonableness it will be presumed to be just and reasonable. As a result, FERC will dismiss a complaint if the ROE falls within the range unless other evidence sufficiently rebuts that presumption. Given the D.C. Circuit's ruling in *Emera Maine v. FERC*, this part of FERC's order will likely be challenged in court again.

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Second, if the existing ROE is found to be unjust and unreasonable, FERC will establish a new ROE based on four financial models—the three used to set the zone of reasonableness as well as the Risk Premium Model. More specifically, FERC will set the new ROE at the average of (i) the midpoints or medians of the zones of reasonableness established by the DCF, the CAPM, and the Expected Earnings models and (ii) the single numerical result of the Risk Premium Model (which, like the CAPM and Expected Earnings models, has been used in FERC proceedings as additional evidence). More detail on the models is provided in an appendix to the FERC order.

As FERC applied this new methodology to the pending New England utility cases, it found that the range for evaluating the current ROE is 9.60 percent to 10.99 percent and that the pre-*Coakley* 11.14 percent ROE for the utilities is unjust and unreasonable. FERC then applied the new composite methodology to setting ROEs and reached a "preliminary" finding that a 10.41 percent ROE is just and reasonable. FERC however established a "paper hearing" and invited parties to submit briefs regarding the proposed new approach to ROEs and its application to the four New England complaint proceedings. Initial briefs are due within 60 days of the date of the order and reply briefs are due 30 days thereafter.

The order was issued by Chairman McIntyre, and Commissioners LaFleur and Chatterjee. Commissioner Glick did not participate in the decision, but no reason was given. It is suspected that Commissioner Glick recused himself because he previously worked for Iberdrola, the parent of two of the New England electric utilities directly impacted by the order.

On balance, FERC's new approach, while complicated, appears to be a sounder approach to establishing ROEs than simply using the DCF method. However, the order fails to specify many implementation details that will need to be hashed out in the upcoming briefing process. How these details are determined will have a large impact on the end result of the new approach. And all of this will likely be done in the context of rising interest rates and the need to invest in new transmission infrastructure in a number of parts of the country.



Gibson Dunn's Energy, Regulation and Litigation lawyers are available to assist in addressing any questions you may have regarding the developments discussed above. To learn more about these issues, please contact the Gibson Dunn lawyer with whom you usually work, or the authors:

William S. Scherman - Washington, D.C. (+1 202-887-3510, wscherman@gibsondunn.com)

Jeffrey M. Jakubiak - New York (+1 212-351-2498, jjakubiak@gibsondunn.com)

Jennifer C. Mansh - Washington, D.C. (+1 202-955-8590, jmansh@gibsondunn.com)

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