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PRATT'S

# ENERGY LAW

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# Commission Initiates Broad Inquiries on ROE Determinations and Electric Transmission Incentives

*By A. Hunter Hodges, David B. Raskin, Richard L. Roberts, and Marc L. Spitzer\**

*The Federal Energy Regulatory Commission issued broad inquiries regarding its policies for evaluating just and reasonable returns on equity and for electric transmission incentives. The authors of this article explain the inquiries.*

The Federal Energy Regulatory Commission (“FERC”) issued broad inquiries regarding its policies for evaluating just and reasonable returns on equity (“ROE”) and for electric transmission incentives. Its two notices of inquiry (“NOI”) sought comments from all stakeholders on these policies.<sup>1</sup> The Commission allowed 90 days for initial comments and an additional 30 days after that for reply comments. Chairman Chatterjee emphasized in his remarks at the open meeting announcing the notices that these policies will have a major and widespread impact on the energy industry and that “getting these policies right” is critical. The notices cast a wide net in exploring issues relating to these policies.

## ROE INQUIRY

The notice of inquiry on ROE policy encompasses the key issues that FERC has addressed in recent ROE orders, issues that have been part of its ROE policy for years and novel questions that could change the way ROE is determined.<sup>2</sup> However, the initial question in the first sentence of the inquiry is “*whether*”

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<sup>1</sup> *Inquiry Regarding the Commission’s Policy for Determining Return on Equity*, 166 FERC ¶ 61,207 (2019) (“ROE NOI”); *Inquiry Regarding the Commission’s Electric Transmission Incentives Policy*, 166 FERC ¶ 61,208 (“Incentives NOI”).

<sup>2</sup> As an example, Question A4 in the inquiry considers whether an “ROE should reflect the cost of capital at the time of an investment.” ROE NOI at P 31. If applied to industry rate bases that reflect assets that predominantly have lifespans in the decades, this inquiry alone might represent more change in the Commission’s ROE policy than any ROE order it has issued since its inception in the 1970s.

FERC should modify its ROE policies at all<sup>3</sup>—leaving a reasonable possibility that, while FERC's wide ranging inquiry will leave no stone unturned in compiling a record, the outcome may end up being a familiar one. In other words, FERC's decision to provide a wide scope for its inquiry and to consider how its policies will apply in different circumstances does not necessarily mean that it doubts its recent ROE decisions or expects to significantly modify them.

The ROE NOI identified the U.S. Court of Appeals for the District of Columbia Circuit's decision in *Emera Maine v. FERC*<sup>4</sup> as the primary genesis for the inquiry.<sup>5</sup> It explained that although the inquiry overlaps with existing proceedings following *Emera Maine*, the significance of FERC's ROE policy "extends beyond the particular interests of the parties to the *Emera Maine* proceeding."<sup>6</sup> As FERC Staff explained in presenting the NOI at the FERC open meeting, the inquiry "will provide a broader opportunity for all interested stakeholders to comment on the Commission's ROE policy."

The FERC issued an order in the *Coakley* proceeding on remand from *Emera Maine* ("*Coakley* Briefing Order"<sup>7</sup>) that proposed a new approach to evaluating ROEs that would rely on four financial models—the DCF, CAPM, Expected Earnings, and Risk Premium models—to determine whether an ROE is just and reasonable, rather than rely solely on the DCF model. FERC presents the issues in the *Coakley/Emera Maine* proceeding and a description of the four models at issue there as the relevant background to the notice.<sup>8</sup> Commissioner LaFleur remarked that she hoped the briefing in existing ROE proceedings would provide a helpful starting point for the Commission's consideration of these issues.

In turn, the features of and performance of these models, their inclusion in the Commission's ROE evaluation, and the mechanics of implementing the models are all among the eight topic areas that FERC identified in the inquiry.<sup>9</sup> The Commission identified numerous questions in each of the eight areas, including a number that explore issues that have not surfaced in the *Coakley/Emera Maine* proceeding.<sup>10</sup>

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<sup>3</sup> ROE NOI at P 1.

<sup>4</sup> *Emera Maine v. FERC*, 854 F.3d 9 (DC Cir. 2017).

<sup>5</sup> ROE NOI at PP 2–3.

<sup>6</sup> *Id.*

<sup>7</sup> *Coakley v. Bangor Hydro-Elec. Co.*, 165 FERC ¶ 61,030 (2018).

<sup>8</sup> See ROE NOI at PP 4–27.

<sup>9</sup> See *id.* at PP 28–38.

<sup>10</sup> *Id.*

The eight areas, as listed in the ROE NOI, are:

- 1) The role of the Commission's base ROE in investment decision-making and what objectives should guide the Commission's approach;
- 2) Whether uniform application of our base ROE policy across the electric, interstate natural gas pipeline and oil pipeline industries is appropriate and advisable;
- 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) How the Commission determines whether an existing ROE is unjust and unreasonable under the first prong of the Federal Power Act Section 206; and
- 8) Model mechanics and implementation.<sup>11</sup>

Although FERC asks numerous questions in different areas, one critical recurring theme in the questions is the perception of FERC's policy by investors. The first two questions (A1 and A2) concern "the predictability of ROE determinations" and "an investor's ability to forecast" the results of FERC proceedings.<sup>12</sup> In addition to scattered inquiries throughout that focus on investors, their practices and expectations dominate the inquiry area regarding the choice of financial models, starting with the first question in that area: "What models do investors use to evaluate utility equities?"<sup>13</sup> FERC thus leaves little doubt that investors' practices and expectations remain as critical as they were in *Coakley*.<sup>14</sup>

The inquiries also reflect the Commission's understanding that it ultimately must reconcile its inquiries in circumstances that may not match those in *Coakley*. For example, its inquiries regarding whether its ROE policy should be uniform across the electric, natural gas identify questions (B2 and B3) about how two of the four models would apply to pipelines.<sup>15</sup> Similarly, in its

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<sup>11</sup> P 29.

<sup>12</sup> *Id.* at P 31.

<sup>13</sup> *Id.* at P 35 (question E1).

<sup>14</sup> *See, e.g., Coakley* at PP 33–38.

<sup>15</sup> ROE NOI at P 32.



inquiries regarding proxy groups, the Commission asks (Question D2.a) whether proxy group selection criteria should vary “depending on which financial models it considers.”<sup>16</sup>

Some of the inquiries suggest that the Commission’s primary aim is to ensure it raises all possible issues, even ones where its recent decisions suggest it is not especially likely to change its current approach. For example, the Commission asks two questions (E9 and E10) regarding how, “if at all,” it should consider state ROEs even though in the *Coakley* Briefing Order it confined the issue to a footnote and ruled that state ROEs would neither affect the composite zone of reasonableness nor receive equal weight with financial models.<sup>17</sup> Though FERC asked dozens of questions, that does not mean FERC necessarily will make dozens of changes in its ROE policy.

The Commission’s inquiries relating to the issue of how to determine the central tendency of a zone of reasonableness suggests that the Commission is uncertain about how it will deal with this issue in different contexts. In *Coakley*, it retained its position that central tendency in RTO-wide cases should be established by the midpoint of the zone of reasonableness and in individual utility cases by the median. The latter is usually lower. The Commission asks whether it should abandon its reliance on midpoints in determining RTO-wide ROEs and asks a sub-question that frames the inquiry as flowing from the use of multiple models in *Coakley* (D10). It does not ask the other side of the question—whether it should also use mid-points in single utility cases. However, in discussing the approach set forth in *Coakley* regarding whether an ROE has become unjust and unreasonable, FERC asks (in question G4) whether it should use mid-points to identify the central tendencies of the upper and lower halves of the zone of reasonableness to avoid an overly narrow middle quartile under the *Coakley* approach.

Finally, neither the ROE NOI itself nor the Commissioners’ statements at the public meeting addressed how this inquiry would affect pending cases. The long time that FERC allowed for comments creates a reasonable possibility that FERC will try to move those cases ahead based on their records and attempt to reach merits rulings prior to the outcome of this broader inquiry. This approach would be consistent with comments at prior meetings in which Commissioners have indicated that the parties in those cases deserve a resolution of their cases that have been pending for several years.

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<sup>16</sup> *Id.* at P 34.

<sup>17</sup> Compare ROE NOI at P 35 with *Coakley* at P 35 n.72.

## INCENTIVES INQUIRY

The Commissioners' and Staff's presentations regarding electric transmission incentives emphasized that the inquiry regarding incentives will be wide ranging and not necessarily tied to the Commission's existing incentive policies. The inquiry, echoing both the Chairman's and the Staff's presentations, seeks comment on whether criteria other than the past emphasis on the "risks and challenges" of a transmission project should be the focal point for analyzing incentives.<sup>18</sup> Instead, the inquiry seeks comment on whether the benefits from a transmission project should be the key basis for evaluating the availability of incentives.<sup>19</sup>

The inquiry also will address issues under existing criteria for incentives, encompassing among other topics (i) the requirements for, level of, and the design of ROE-adder incentives;<sup>20</sup> (ii) the design and value provided by non-ROE, risk-reducing incentives;<sup>21</sup> (iii) whether some incentives should be granted generically, rather than on a case-by-case basis;<sup>22</sup> and (iv) whether further analyses should be added to the evaluation process.<sup>23</sup> The Commission also specifically identified whether the method used to set a company's base ROE should affect incentive ROEs.<sup>24</sup>

Commissioner LaFleur noted the importance of ensuring that the Commission's incentive policies are meeting Congress's goals in enacting Section 219 of the Federal Power Act.<sup>25</sup> Commissioner Glick noted, however, that it is important to ensure that incentives are not provided for projects that would be built even without incentives—characterizing this situation as handing out "FERC candy."

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<sup>18</sup> Incentives NOI at P 14.

<sup>19</sup> *Id.* at P 16 (referring specifically to "benefits related to reliability and reductions in the cost of delivered power by reducing transmission congestion").

<sup>20</sup> *Id.* at PP 36–39.

<sup>21</sup> *Id.* at PP 40–43.

<sup>22</sup> *Id.* at P 45.

<sup>23</sup> *Id.* at P 48.

<sup>24</sup> *Id.* at P 46 (Q95).

<sup>25</sup> *See also* Incentives NOI at P 13 (explaining that FERC is issuing the NOI so that its incentives "policy continues to satisfy our obligations under section 219 of the FPA").