

DC Circuit Sends FERC Back to the Drawing Board on ROE Policy

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On April 14, the US Court of Appeals for the DC Circuit issued its opinion in *Emera Maine v. FERC*, vacating and remanding FERC's Opinion No. 531 in which FERC established a just and reasonable rate of return on equity (ROE) for transmission-owning utilities in the Northeast (NETOs) and adopted a new methodology for determining the ROE for FERC-jurisdictional electric utilities.

The DC Circuit found two grounds for sending the case back to FERC. First, because the proceeding began through a complaint filed under section 206 of the Federal Power Act (FPA), the court found that FERC failed to find that the existing ROE for the NETOs was unjust and unreasonable before proceeding to set a new just and reasonable ROE. Second, the court found that FERC had not adequately justified its determination of the new just and reasonable ROE.

The court's decision creates significant uncertainty in FERC ROE policy.

Background

In 2012, FERC set for hearing a complaint under section 206 of the FPA by customers who alleged that the NETOs' 11.14% base ROE used in regional transmission rates was unjust and unreasonable. After a hearing and an initial decision by an FERC administrative law judge, FERC issued Opinion No. 531, where it agreed with the customers that the NETOs' 11.14% ROE was unjust and unreasonable. However, FERC also found—based upon evidence submitted by the NETOs of anomalies in

capital market conditions and alternative indicators of the costs of capital to public utilities—that the results of the Discounted Cash Flow (DCF) model traditionally used by FERC to set ROEs were too low to be just and reasonable. Therefore, instead of setting the NETOs’ new ROE at the midpoint of the DCF range of reasonableness (FERC’s traditional approach), FERC found that the just and reasonable ROE for the NETOs was 10.57%—the midpoint of the upper half of the DCF range of reasonableness.

In concluding that the 11.14% base ROE of the NETOs was unjust and unreasonable, FERC relied upon its analyses that showed that 10.57% would be the just and reasonable ROE. FERC explained that the numerical difference between the two values showed that the 11.14% ROE was unjust and unreasonable.

To exercise its authority under section 206 of the FPA to change existing practices or rates, FERC must meet a dual burden of proof; this dual burden requires FERC to first find that a rate or practice is unjust and unreasonable under section 206 of the FPA before it can proceed to determining what the just and reasonable rate or practice should be. With regard to rates in particular, FERC and court precedent holds that there is a “range of reasonableness” that allows a substantial spread of potentially just and reasonable rates. Therefore, FERC’s finding in Opinion No. 531 that 10.57% is a just and reasonable ROE does not necessarily mean that an 11.14% ROE is unjust and unreasonable.

The DC Circuit’s Opinion

Noting the above, the DC Circuit concluded that Opinion No. 531 lacked an actual finding that the 11.14% ROE was unjust and unreasonable, and thus the FERC had exceeded its authority by setting the ROE at 10.57%.

The court also found that FERC’s analysis in Opinion No. 531 supporting 10.57% as the just and reasonable ROE was arbitrary and capricious. In Opinion No. 531, FERC found that the evidence in the record of anomalous capital market conditions and of the results of alternative methodologies of the costs of capital for public utilities—such as a capital asset pricing model and risk premium analysis—showed that following FERC precedent and setting the NETOs’ ROE at the median result of the DCF range (9.39%) was too low to be just and reasonable. Instead of using the median of the entire range of reasonableness as the ROE, FERC selected the median of the top half of the DCF range. FERC emphasized that its selection of 10.57% was based upon its traditional preference for measures of central tendency and that it was not based upon the alternative ROE methodologies that FERC considered when determining that 9.39% was too low. On review, the court concluded that there was no rational connection between FERC’s selection of 10.57% as the ROE and the record evidence. Noting that FERC did not consider the 10.57% ROE under the alternative ROE methodologies, the court found that FERC had not shown that the 10.57% ROE satisfied the same standards FERC used to conclude that 9.39% was unjust and unreasonable.

Takeaways

Opinion No. 531 was a landmark FERC decision. In Opinion No. 531, FERC announced

that, going forward, its policy for public utility ROEs would be to use a two-step DCF analysis, which averages short-term and long-term growth rates—the same approach used for natural gas pipeline ROEs at FERC. FERC also declared that it was ending its policy of updating ROEs based upon changes in US Treasury bond yields after the close of the record of a proceeding. More importantly, Opinion No. 531 marked a turning point—away from FERC’s traditional focus on only DCF analyses and the “relative risk” of a utility when setting ROEs and towards an apparent openness to consideration of evidence of capital market conditions and alternative methodologies to the DCF. In this respect, the reasoning and arguments in Opinion No. 531 have formed the basis for numerous settlements and litigated proceedings at FERC regarding public utility ROEs.

The DC Circuit’s decision in *Emera Maine* creates significant uncertainty in FERC ROE policy. On remand, FERC first will have to determine how the burden of proof can be met in a section 206 case on ROEs. In *Emera Maine*, the court agreed with FERC that an ROE does not have to fall outside the entire range of reasonableness—as indicated by the DCF range of returns—in order to conclude that the ROE is unjust and unreasonable. At the same time, however, the section 206 burden of proof is not met simply by proving that the DCF methodology produces a lower ROE than the existing ROE on file. An important question presented by *Emera Maine* is what evidence should be used to show an existing ROE is unjust and unreasonable in order to meet the first part of the section 206 burden of proof.

On remand, FERC also will have to consider how adjustments can be made upwards from the midpoint of the DCF range. The DC Circuit rejected FERC’s explanation for a “midpoint of the upper half” as the basis for the ROE because, among other things, FERC did not consider the resulting ROE against the alternative benchmark methodologies. This may lead FERC to reconsider what evidence of alternative benchmark methodologies may be used in ROE cases.

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