



## Energy ADVISORY ■

**MARCH 29, 2019**

### FERC Issues Notices of Inquiry on Electric Transmission Incentives and Calculating Return on Equity

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The Federal Energy Regulatory Commission (FERC) on March 21, 2019, issued two Notices of Inquiry (NOI) related to [transmission incentives for electric utilities](#) and [return on equity](#) (ROE) policies for electric utilities and natural gas and oil pipelines. Section 219 of the Federal Power Act (FPA) directs FERC to use transmission incentives to help ensure reliability and reduce congestion, which in turn will reduce the cost of delivered power. FERC opened the NOI on transmission incentives to ensure it continues to meet its FPA Section 219 statutory obligations. Initial comments for both NOIs are due June 26, with a reply comment deadline of July 26.

#### **NOI on Transmission Incentives**

The NOI addressing transmission incentives on electric utilities intends to address the changes in transmission planning, development, operations, and maintenance since FERC first addressed the issue in 2006, when FERC issued [Order No. 679](#) in response to congressional approval of Section 219 of the FPA. Section 219 directed FERC to use transmission incentives to help ensure reliability and reduce the cost of delivered power by reducing transmission congestion. More recently, FERC issued a transmission incentives policy statement in 2012, providing guidance on FERC's interpretation of Order No. 679. But the 2012 policy statement left intact Order No. 679's basic approach to granting transmission incentives.

The NOI on transmission incentives seeks stakeholder comments on a range of issues related to FERC's transmission incentive policies.

#### *Incentives granted based on a project's risks and challenges or expected benefits*

FERC seeks comments on whether incentives should continue to be granted based on a project's risks and challenges. Under the Order No. 679 regulatory framework, each transmission utility seeking incentives must demonstrate a nexus between the requested incentives and the risks and challenges of the investment itself. If transmission incentives should no longer be granted based on risks and challenges, FERC requests comments on whether it should instead evaluate incentive requests based on a project's expected benefits, including

reliability benefits and reductions in the cost of delivered power by reducing transmission congestion. As an alternative to a direct examination of a project's expected benefits, FERC also seeks comments on using project characteristics as a proxy for such benefits.

#### *Incentives based on measurable criteria*

FERC also requests stakeholder comments on what should be incentivized to satisfy FPA Section 219's directives. The benefits or project characteristics on which FERC seeks comment include reliability benefits, economic efficiency benefits, persistent geographic needs, facilitating more flexible operation of the transmission system, enhancing the physical and cybersecurity of the transmission system, improving resilience by allowing the transmission system to better withstand disruptive events, improvements to the efficient operation of existing transmission facilities, interregional transmission projects, unlocking locationally constrained resources, and addressing barriers to transmission ownership by nonpublic utilities. The NOI also requests comments on whether FERC should grant blanket pre-approval of certain incentives for transmission projects selected through a regional planning process that complies with Order No. 1000, as well as whether additional types of incentives could encourage the development of transmission projects in regions not governed by a regional transmission organization (RTO) or independent system operator (ISO).

#### *Existing incentives*

Commenters are also invited to address a range of issues related to incentives that FERC has previously awarded. For example, FERC found in Order No. 679 that transmission-only companies (also known as "transcos") were justified in receiving ROE adder incentives because of their willingness and ability to invest in transmission, and FERC now seeks comments on whether such transco-related incentives should continue to be available and if they should remain available to transcos affiliated with a market participant. The NOI notes that the U.S. Court of Appeals for the Ninth Circuit has also remanded to FERC a case involving the granting of an ROE incentive adder for RTO/ISO participation to explain how that incentive is consistent with FERC's policy that incentives should be granted to induce future behavior. FERC seeks comment on whether it should revise or limit its RTO/ISO participation incentives. FERC also seeks comment on incentives to better encourage the deployment of advanced transmission technology.

FERC also seeks comment on a range of non-ROE incentives allowed under Order No. 679, including 100 percent of construction work in progress (CWIP) in rate base, recovering 100 percent of pre-commercial costs as an expense or regulatory asset, permitting hypothetical capital structures, recovering 100 percent of prudently incurred costs of transmission facilities that are canceled or abandoned due to factors beyond control of the utility (also known as "abandoned plant incentive"), and accelerated depreciation.

### *Mechanics and implementation of transmission incentives*

FERC seeks comments on the future implementation of transmission incentives. For example, FERC is considering whether incentives should be revisited if a project experiences a material modification or a significant change occurs to the project's expected benefits. FERC also asks whether certain types of incentives, such as RTO/ISO participation or transco formation incentives, should sunset after a number of years. In addition, FERC currently reviews applications for incentives on a case-specific basis, but comments are requested on whether certain incentives should instead be automatically granted.

The interaction between different potential incentives in determining the correct ROE level is also under consideration, as FERC acknowledges that it has provided limited guidance on what level of transmission incentives should be provided or how to ensure that the combination of transmission incentives is appropriate, producing rates that are just and reasonable. Finally, FERC invites comment on how much discretion it should retain for the appropriate level of ROE incentives, or if its discretion should fall within a pre-determined range.

### *Possible metrics for evaluating the effectiveness of incentives*

FERC requests stakeholder views on whether it should expand the metrics used to determine an incentive's effectiveness to go beyond the current annual Form FERC-730 reporting requirements. FERC suggests that all public utility transmission providers might also be required to submit comparable reports. Additional data, according to FERC, could better help understand the effectiveness of transmission incentives.

## **NOI on ROE**

In its NOI on ROE policies, FERC seeks information and comments on whether, and if so how, FERC should modify its policies on determining the ROE used in rates charged by public utilities, and whether any such changes should be applied to FERC-jurisdictional rates for interstate natural gas and oil pipelines. The NOI on ROE was issued following the U.S. Court of Appeals for the District of Columbia Circuit decision in [Emera Maine v. FERC](#), which reversed and vacated FERC's [Opinion No. 531](#), a significant 2014 opinion addressing FERC's policies for determining public utility ROEs.

### *Background*

Under Supreme Court precedent stretching back to the first part of the twentieth century, the allowed return to equity owners in utility rates "should be commensurate with the return on investments in other enterprises having corresponding risks" and "should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." Since the 1980s, FERC has used a discounted cash flow (DCF) model to develop a range of returns to determine an ROE for regulated entities. FERC has periodically made changes to its implementation of the model. In Opinion No. 531, which addressed an FPA Section 206 complaint involving the ROE of the New England transmission owners (NETOs), FERC first used the same two-step, constant-growth DCF model to set public utility ROEs that it uses in natural gas and oil pipeline ROE cases.

While FERC has relied primarily on the DCF models in the ROE context, investors use other financial models (in addition to the DCF) to evaluate potential investments, including the capital asset pricing model (CAPM), expected earnings model, and risk premium method.

Following the financial crisis of 2008–2009, FERC concluded in Opinion No. 531 that prevailing capital market conditions (and specifically, the low yield on bonds, including U.S. Treasury bonds), made FERC less confident that mechanically using the midpoint of the DCF-produced zone of reasonableness would provide a risk-appropriate base ROE for a group of public utilities in an RTO or ISO. A base ROE is a utility's ROE before any ROE incentive adders are applied. In Opinion No. 531, FERC also decided to consider (but did not primarily rely on) ROE methodologies other than the DCF, including the CAPM, expected earnings, and risk premium. After comparing the DCF results to these additional financial models, FERC determined it was justified in setting the ROE above the midpoint of the DCF-produced zone of reasonableness, ultimately placing the ROE at the midpoint of the upper half of the DCF-produced zone of reasonableness.

On appeal, the District of Columbia Circuit reversed and vacated Opinion No. 531 in *Emera Maine*. The court in *Emera Maine* rejected the argument that any ROE within the DCF-produced zone of reasonableness could not be deemed unjust and unreasonable; found that FERC could not rely on a single-point base ROE determination to demonstrate that the NETOs' existing ROE was unjust and unreasonable and should be reduced under FPA Section 206; and determined that FERC did not adequately demonstrate that the new base ROE it established at the upper midpoint of the DCF zone was just and reasonable.

Following the *Emera Maine* decision, FERC issued two orders in late 2018 proposing a methodology for addressing the issues that were remanded to FERC. These two orders, *Martha Coakley v. Bangor Hydro-Electric Co.* ("NETO briefing order") and *Association of Businesses Advocating Tariff Equity v. Midcontinent Independent System Operator Inc.* ("MISO briefing order"), propose to change FERC's approach to determining whether a base ROE was unjust and unreasonable in an FPA Section 206 proceeding by giving equal weight to the DCF, CAPM, and expected earnings methodologies to establish a composite zone of reasonableness and determining a range of presumptively just and reasonable ROEs as a quartile of that composite zone of reasonableness. If an existing base ROE is found to be unjust and unreasonable, FERC proposes to give equal weight to the DCF, CAPM, expected earnings, and risk premium models, averaging four separate cost of equity estimates to produce a single just and reasonable base ROE. The NETO briefing order and the MISO briefing order established paper hearings in the proceedings born out of Opinion Nos. 531 and 551, respectively, on these equal weighting approaches. In a recent press release, FERC confirmed that the issuance of the NOI on ROE policies will not affect these paper hearing processes.

#### *Comments requested in the NOI on ROE*

The NOI on ROE policies is intended to provide all interested stakeholders with the opportunity to comment on FERC's ROE policy following *Emera Maine*.

FERC seeks comments on the following general topics relating to its ROE policy:

- The role of the base ROE included in FERC rates in investment decision-making and what objectives should guide FERC's approach.
- Whether applying a single ROE policy across the electric and interstate natural gas and oil pipeline industries is appropriate, including whether the methodologies proposed in the NETO and MISO briefing orders should apply to natural gas and oil pipeline rates.
- The performance of the DCF model historically used to set ROEs.
- Appropriate guidelines for the composition of proxy groups used in ROE analyses, along with the use of "outlier" tests to eliminate ROE estimates for proxy group members that are deemed too high or too low and the placement of base ROEs within a zone of reasonableness.
- The choice of a financial model or models used to set ROEs.
- The mismatch between market-based ROE determinations and book-value rate base, whether this mismatch is a problem, and how FERC should address this issue.
- How FERC determines whether an existing ROE is unjust and unreasonable under the first prong of FPA Section 206, and whether the quartile approach proposed in the NETO and MISO briefing orders is reasonable.
- The mechanics and implementation of the DCF, CAPM, expected earnings, and risk premium models.

Those seeking to file comments on either NOI must do so by June 26, with reply comments due by July 26.

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If you have any questions or would like additional information, please contact your Alston & Bird attorney or any member of our [Energy Group](#).

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