UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Association of Businesses Advocating Tariff Equity, *et al.*	)	
	)	Docket No. EL14-12-002
v.	)	
	)	
Midcontinent Independent System Operator, Inc., *et al.*	)	

BRIEF ON EXCEPTIONS
OF
THE ORGANIZATION OF MISO STATES

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GLOSSARY

Abbreviation	Full Term
Base ROE	ROE prior to application of ROE-increasing incentives
CAPM	Capital Asset Pricing Model
CWIP	Construction Work in Progress
DCF	Discounted Cash Flow
FOMC	Federal Open Market Committee
FPA	Federal Power Act
GDP	Gross Domestic Product
IBES	Thompson Reuters' Institutional Brokers' Estimate System
I.D.	Initial Decision
MEPs	Market Efficiency Projects
MISO	Midcontinent Independent System Operator
MVPs	Multi-Value Projects
ROE	Return on Equity
RRA	Regulatory Research Associates
RTO	Regional Transmission Organization
S&P 500	Standard and Poor's Stock Market Index
TO	Transmission Owner
Tr.	Hearing Transcript[1]

[1] References to the Hearing Transcript will be in the form of "Tr. X:Y", with X being the cited transcript page and Y being the cited line number(s).

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Pursuant to Rule 711 of the Rules of Practice and Procedure of the Federal Energy Regulatory Commission ("FERC" or "Commission"), 18 C.F.R. § 385.711 (2015), the Organization of MISO States ("OMS")[2] hereby submits this Brief on Exceptions to the Initial Decision issued in the captioned proceeding on December 22, 2015, *Association of Businesses Advocating Tariff Equity, et al. v. Midcontinent Independent System Operator, Inc., et al.,* 153 FERC ¶ 63,027 (2015) ("Initial Decision" or "I.D.").

[2] The OMS submits this Brief on Exceptions because the following members, which represent a majority, support its contents: Arkansas Public Service Commission, Illinois Commerce Commission, Indiana Utility Regulatory Commission, Iowa Utilities Board, Michigan Public Service Commission, Minnesota Public Utilities Commission, Mississippi Public Service Commission, Missouri Public Service Commission, Montana Public Service Commission, City of New Orleans, North Dakota Public Service Commission, South Dakota Public Utilities Commission, and Public Utility Commission of Texas. The Manitoba Public Utilities Board, the Wisconsin Public Service Commission, and the Louisiana Public Service Commission abstained.

I.
STATEMENT OF THE CASE AND SUMARY OF ARGUMENT

This case concerns whether the currently effective 12.38 percent base return on common equity ("Base ROE")[3] for the Transmission Owners ("TOs") in the Midcontinent Independent Transmission System Operator, Inc. ("MISO") region is just and reasonable, as required under Sections 205 and 206 of the Federal Power Act ("FPA").[4]

On November 12, 2013, the Joint Complainants[5] ("JC") filed a complaint pursuant to FPA § 206 against MISO and certain MISO TOs, concerning rates under the MISO Open Access Transmission, Energy and Operating Reserve Market Tariff ("Tariff"). By Order dated October 16, 2014 ("Hearing Order"),[6] the Commission set for trial-type hearing the issue of whether the current Base ROE of the MISO TOs is unjust and unreasonable, and if so, what the just and reasonable Base ROE authorized for inclusion in the MISO TOs' formula rates should be. The Commission directed the parties to follow the two-step Discounted Cash Flow ("DCF") methodology established in Opinion No. 531, *et al.*[7] when calculating the base cost of equity of the MISO TOs.[8]

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3 With the exception of American Transmission Company, LLC's Base ROE of 12.2 percent.

4 16 U.S.C. §§ 824d, 824e (2012).

5 The Association of Businesses Advocating Tariff Equity, the Coalition of MISO Transmission Customers, the Illinois Industrial Energy Consumers, Indiana Industrial Energy Consumers, Inc., the Minnesota Large Industrial Group, and the Wisconsin Industrial Energy Group (collectively, " Joint Complainants").

6 *Association of Businesses Advocating Tariff Equity, et al. v. Midcontinent Independent System Operator, Inc., et al.*, 148 FERC ¶ 61,049 (2014) ("Hearing Order").

7 *Martha Coakley, Massachusetts Attorney Gen., et al. v. Bangor Hydro-Elec. Co., et al.,* Opinion No. 531, 147 FERC ¶ 61,234 (2014), order *on paper hearing,* Opinion No. 531-A, 149 FERC ¶ 61,032 (2014), order *on reh'g*, Opinion No. 531-B, 150 FERC ¶ 61,165 (2015); *petition for review pending sub nom. Braintree Elec. Light Dept., et al v. FERC,* D.C. Cir. Docket No. 15-1119.

8 Hearing Order at P 180.

On December 22, 2015, the Honorable David H. Coffman, Presiding Administrative Law Judge, issued the Initial Decision in this proceeding. [9] In the Initial Decision, the Presiding Judge found that Joint Complainants had carried the burden of proof under FPA § 206 of demonstrating that the current 12.38 percent Base ROE is no longer just and reasonable. In determining the just and reasonable Base ROE to apply prospectively, the Presiding Judge first found that capital market conditions were anomalous during the period he determined to be the appropriate DCF study period in the case (January 1, 2015 through June 30, 2015),[10] and that the inputs to a DCF analysis of the MISO TOs' cost of equity may be distorted by those conditions such that the midpoint of the DCF-determined range of reasonableness would not reflect the MISO TOs' true cost of equity. On that basis, the Presiding Judge found that in order to satisfy the standards of the *Hope*[11] and *Bluefield*[12] decisions, it is necessary to set the new Base ROE for the MISO TOs at the midpoint of the upper-half of the DCF zone of reasonableness ("Upper Midpoint"),[13] which he determined to be 10.32 percent.[14] The Presiding Judge found support for this new Base ROE in the results of two alternative pricing studies submitted by the MISO TOs, and from a MISO TO analysis of ROEs awarded by state regulatory commissions. Finally, the Presiding Judge found that limiting the MISO TOs to a Base ROE that is no higher than the midpoint of the DCF range "could undermine their ability to attract capital for new investment in electric transmission that is currently planned."[15]

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9 A corrected Initial Decision was issued on December 29, 2015 and two subsequent errata were issued on December 31, 2015 and January 7, 2016.

10 *See* I.D. at P 61.

11 *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) ("Hope").

12 *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679 (1923) ("Bluefield").

13 Relying on Opinion No. 531, the Initial Decision identifies the "Upper Midpoint" as the value that is halfway between the midpoint of the zone of reasonableness and the top of that zone. *See* I.D. at P 117.

14 *See, e.g.*, I.D. at PP 118, 211, 229.

15 I.D. at P 478.

The key findings underlying the Presiding Judge's adoption of the 10.32 percent Base ROE are not supported by record evidence and are, for that reason, in error. Specifically, the premise of the finding that capital market conditions were "anomalous" during the study period is an expectation by investors that the Federal Reserve's "normalization" of its current monetary policies will trigger a sharp and substantial increase in interest rates and bond yields.[16] The record, however, instead shows that: (1) Federal Reserve policies are but one of several macroeconomic factors that affect interest rates and bond yields, and changes in Federal Reserve policy therefore have only limited impacts in those areas; (2) contemporaneous with the period during which the Federal Reserve was actively purchasing Treasury bonds and mortgage-backed securities as part of its "accommodative" monetary policy, new Federal debt was being issued to finance sharply increased deficits, which increased the supply of Federal debt securities and further dampened the impact of the Federal Reserve's purchases on interest rates and bond yields; and (3) during the DCF study period, there was no clear consensus in the investment community as to whether the expected normalization of Federal Reserve monetary policy would cause interest rates and bond yields to increase, or by how much. For these and the other reasons discussed more fully below, the record contradicts the Initial Decision's finding that Federal Reserve monetary policies caused capital market conditions to be anomalous during the study period.

Having reached the (erroneous) conclusion that capital market conditions were anomalous during the study period, the Initial Decision then considered the results of three alternative ROE methods which the MISO TOs filed, through their principal witness Dr. Avera, to support their argument that the Base ROE of the MISO TOs must be adjusted upward to the

[16] *See* I.D. at P 222.

Upper Midpoint. The Presiding Judge accepted the results of two of Dr. Avera's three "alternative method" studies: his Capital Asset Pricing Model ("CAPM")[17] and his Risk Premium analysis.[18] The Presiding Judge also accepted the 'benchmark" study of state-authorized ROEs prepared by MISO TO witness Ellen Lapson, which the Presiding Judge found to provide further support for increasing the Base ROE above the DCF midpoint.[19] Consideration of these materials ultimately led the Presiding Judge to recommend a 10.32 percent Base ROE for the MISO TOs.[20]

In getting to this recommendation, however, the Initial Decision erred by failing to give weight to the demonstrated flaws in Dr. Avera's CAPM and Risk Premium studies or those in Ms. Lapson's state-authorized ROE study. Specifically, as OMS will demonstrate below, Dr. Avera's CAPM study erroneously included only short-term growth rates, thereby assuming (in effect) that growth at the short-term rates would continue forever. Dr. Avera's risk premium analysis also is flawed because, by treating as a Commission ROE determination an order that was anything but that, the cost of equity he calculated was skewed upward. Finally, MISO TO witness Lapson's state-authorized ROE analysis is undermined by its failure either to: (1) take into account the downward trend in state-authorized ROEs that was shown even in Ms. Lapson's own materials, or (2) undertake a logically defensible comparison of the risks of investing in distribution and transmission infrastructure, as indicated by Opinion No. 531.

In light of these errors, it must be concluded that the Initial Decision's finding that a 10.32 percent Base ROE is just and reasonable for the MISO TOs is not supported by substantial evidence in the record, as the Administrative Procedure Act requires. Rather than adopting the

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17 I.D. at P 311.

18 I.D. at P 258.

19 I.D. at P 452.

20 I.D. at PP 2, 489.

recommendations in the Initial Decision, the Commission should reverse that decision and find, based on the record, that capital market conditions during the study period were *not* anomalous, and that no adjustment to the DCF midpoint result (whether to the "Upper Midpoint" or any other similarly inflated value) is supported by the evidence. A finding that capital market conditions were not anomalous would obviate the need for the Commission to address the various other issues that arise from the Presiding Judge's determination that a Base ROE at the Upper Midpoint of 10.32 percent is necessary to satisfy the *Hope* and *Bluefield* standards. If the Commission instead were to adopt the Initial Decision's finding that capital market conditions during the study period were anomalous, however, it should clarify whether and how the availability of FPA Section 219 incentives, which operate to offset project-specific risks, should be reflected in determining a just and reasonable Base ROE for transmission assets. In that regard, the Commission should confirm that the purported risks of large transmission construction projects shall be addressed *solely* through FPA Section 219 incentives, and that any such risks may not also do "double duty" as a consideration in determining whether the Base ROE should be set at a higher-than-midpoint value. Finally, given the inarguable fact that the availability of formula rates mitigates a utility's business risk, the Commission should confirm that the risk-mitigating effect of a formula rate is relevant in assessing whether, in a particular instance, pushing the Base ROE upward from the midpoint

II.
LIST OF EXCEPTIONS

Pursuant to Rule 711(b)(2)(ii) of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.711(b)(2)(ii) (2015), OMS submits the following exceptions to the Initial Decision:

1. The Initial Decision's finding that anomalous capital market conditions existed during the DCF study period (January 1, 2015 through June 30, 2015) is erroneous and unsupported by record evidence. (I.D. at PP 219-29).
2. The Initial Decision erred in ruling that the state-authorized ROE study submitted by the MISO TOs was an appropriate benchmark to use in placing the new Base ROE within the zone of reasonableness, because that ruling: (1) ignores substantial flaws in the MISO TOs' analysis, and (2) fails to give weight to factors that militate against pushing the Base ROE above the midpoint of the zone of reasonableness, including factors such as the availability of formula rates that greatly mitigate transmission business risks. (I.D. at PP 452-55).
3. The Initial Decision's ruling that it would be inappropriate to consider incentives granted under FPA Section 219 when deciding whether to place the MISO TOs' new Base ROE at or above the DCF midpoint is based on an erroneous and overbroad reading of Commission precedent. (I.D. at PP 378, 381).
4. The Initial Decision's ruling that reducing the Base ROE to the midpoint of the zone of reasonableness would undermine the ability of the MISO TOs to attract capital for new transmission projects is erroneous and unsupported by record evidence. (I.D. at P 478).

III.
POLICY CONSIDERATIONS THAT WARRANT COMMISSION REVIEW OF THE INITIAL DECISION

1. The Initial Decision defines "anomalous" capital market conditions as encompassing any "unsustainable" market conditions. [21] This definition renders the central indication of the Commission's Opinion No. 531 DCF methodology effectively meaningless — unless it exceeds alternative benchmarks. The Initial Decision's definition has this effect because practically every market condition can be considered "unsustainable" over one time period or another.

2. The Initial Decision found that investors acted against their purported expectations that capital market conditions will change significantly over the next few years.[22] They did so by purchasing utility stocks even though the jump in interest rates they supposedly anticipate would depress the price of those stocks. According to the Initial Decision, the reason investors acted in this manner is because they are only pursuing yield and no longer care about the dividend growth of their utility stock.[23] This finding disconnects investors' expectations from their actions, thereby rendering meaningless the Commission's long standing precedent of relying on investors' expectations to determine whether the *Hope* and *Bluefield* standards are met.

3. The Initial Decision posits that, in requiring that the equity return be set at a level sufficient to attract capital and maintain creditworthiness, *Hope* and *Bluefield* were "implicitly referring to capital contributed by long-term investors" because

[21] I.D. at P 220.
[22] I.D. at P 222
[23] I.D. at P 218.

"[s]hort-term investors will be much less interested in the utility's financial integrity and credit-worthiness."[24] The Initial Decision's distinction between the return expectations of long-term versus short-term investors in applying the *Hope* and *Bluefield* standards is not supported by Commission precedent and will effectively presume a distortion of the DCF analysis unless it is shown that long-term investors (whatever the Initial Decision intends that to mean) are satisfied with their stock's "Total Returns."[25]

4. The Initial Decision found irrelevant the relationship between, on the one hand, the ROE values indicated by one of the endorsed "alternative" cost of equity benchmarks, and, on the other hand, the Upper Midpoint.[26] Only by disregarding evidence showing the benchmark values to be lower than the Upper Midpoint[27] could the Initial Decision justify boosting the new ROE all the way up to the Upper Midpoint. This ruling tips the *Hope* and *Bluefield* balance nearly all the way toward industry interests; it treats the benchmark values as relevant for purposes of *increasing* the Base ROE above the DCF midpoint but disregards them for purposes of *reducing* the Base ROE to a value lower than the Upper Midpoint. If capital market conditions are found to be anomalous, the Commission should have the necessary flexibility to adopt a Base ROE that is

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24 I.D. at P 207. *See also*, I.D. at P 23 (*Hope* and *Bluefield* "necessarily" were referring to capital contributed by long-term investors).

25 *See* I.D. at P 210.

26 I.D. at PP 402-403. According to the Initial Decision (at P 403), "it does not matter that nearly all of the State-Authorized ROEs contained in Ms. Lapson's study are below the Upper Midpoint. All that is relevant is the relationship of those ROEs to the Midpoint."

27 *See* I.D. at P 401: The Upper Midpoint, 10.32 percent, is higher than 56 of the 59 State-Authorized ROEs for integrated electric utilities contained in Ms. Lapson's study. The Upper Midpoint is higher than the midpoint (9.95 percent) and the mean (9.50 percent) of those State-Authorized ROEs. The Upper Midpoint is higher than all of the State-Authorized ROEs for distribution-only utilities contained in the study.

higher than the midpoint of the DCF zone but lower than the Upper Midpoint. The Commission should not box itself into a "one-or-the-other" choice between the DCF midpoint and the Upper Midpoint, especially where one or more alternative methods or benchmarks point to a value somewhere in between.

5. The Initial Decision found that the state-authorized ROE study presented by MISO TO witness Lapson supports the adoption of a Base ROE that is higher than the midpoint of the DCF zone.[28] This finding is inconsistent with FERC precedent. Ms. Lapson's state ROE analysis did not compare the risks of distribution and electricity infrastructure as the Commission did in Opinion No. 531;[29] rather it compares the risks of integrated utilities (including those that provide generation service) with the risks of transmission infrastructure. Adjusting the Base ROE upward based on the notion that the risks associated with generation infrastructure are the same as or lower than those associated with transmission infrastructure[30] could have untoward capital allocation impacts that undermine rational planning and disserve the long-term interests of electricity consumers.

6. The Initial Decision found a "public interest" in utilities' use of formula rates (because they ensure that utilities don't over or under recover) and ruled that this interest would be contravened by recognizing, in where to place the Base ROE within the zone of reasonableness, the extent to which transmission owner

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[28] I.D. at P 452.

[29] Opinion No. 531 at PP 148-49.

[30] I.D. at P 453.

business risk is reduced by using a formula rate.[31] These findings mistakenly ignore the well-established fact that investors are risk-adverse and value certainty above all. From the point of view of investors' expectations, a greater value is placed on a utility with practically no risk to under-recover than on a utility with the possibility to over-recover. Public utilities that elect to use formula rates may be presumed to act with their eyes open to the ROE implications of the resulting business risk mitigation. Further, in the Hearing Order, the Commission specifically opened the door to considering formula rates in the Base ROE determination.[32]

7. The Initial Decision found that that it would be inappropriate to take incentives granted under FPA Section 219 into account when determining whether to place the MISO TOs' Base ROE at the DCF midpoint or at the Upper Midpoint.[33] Although this ruling in the Initial Decision purports to be based on Opinion No. 531-B, in reality it relies on an impermissibly overbroad reading of that precedent. In Opinion No. 531-B,[34] the Commission stated that ROE incentive adders are intended to encourage transmission development above the level provided for through the Base ROE, but it also acknowledged that nothing in FPA Section 219 relieves the Commission of compliance with *Hope* and *Bluefield* in setting a Base ROE. To be sure, the Commission did not rule that the risk-mitigating benefits of transmission rate incentives are irrelevant and must be ignored in Base ROE cases. In fact, to the extent that the Commission seeks to encourage the

31 I.D. at P 447.

32 Hearing Order at P 196.

33 I.D. at P 378.

34 Opinion No. 531-B at P 153.

development of more complex (and therefore riskier) projects such as Market Efficiency Projects ("MEPs") and Multi-Value Projects ("MVPs") ─ as advocated by the MISO TOs ─ it would be inappropriate to require that a blind eye be turned to incentive-related benefits.

IV.
ARGUMENT

A. THE INITIAL DECISION'S FINDING THAT ANOMALOUS CAPITAL MARKET CONDITIONS EXISTED DURING THE STUDY PERIOD IS NOT SUPPORTED BY RECORD EVIDENCE.

One of the key litigated points in this proceeding is whether capital market conditions were "anomalous" during the DCF study period. It should not surprise the Commission that, like so many other transmission owners, the MISO TOs sought to piggyback onto Opinion No. 531's ruling that, for the New England transmission owners, anomalous capital market conditions justified a higher-than-midpoint return. Here, the MISO TOs claimed that capital market conditions during the DCF study period were similar[35] to those considered "anomalous" in Opinion No. 531, and that the midpoint of the range produced by the Commission's DCF method would not reflect their true cost of equity.[36] Countering the MISO TOs' claim, Complainants and Supporting Intervenors[37] presented evidence showing that study-period capital market conditions were *not* anomalous and that a straight-up application of the two-stage DCF method is what best reveals the MISO TOs' true cost of equity.

35 Exh. No. MTO-39 at 8:8-11.

36 In particular, the MISO TOs pointed to the similarity in yields on 10-year constant maturity Treasury Bonds, 10-year BBB utility bonds, and 30-day Treasury Bills between the EL11-66 study period and the DCF study period here. *See*, *e.g.*, Exh. No. MTO-16 at 27:5-9.

37 The Supporting Intervenors include: the Joint Consumer Advocates ("JCA"), the Joint Customers ("JCI"), and Resale Power Group of Iowa ("RPG").

Notwithstanding the evidence presented by Complainants and Supporting Intervenors, the Initial Decision adopted the MISO TOs' view that capital market conditions during the study period (the six-month period ending June 30, 2015) were "anomalous." The Presiding Judge further found that these conditions "make it harder to determine whether a Base ROE equivalent to the midpoint accurately reflects the MISO TOs' risks."[38] As OMS demonstrates below, however, this crucial finding is not supported by the record evidence and for that reason, is in error.

1. By the Initial Decision's Own Definition of the Term, the Capital Market Conditions that Existed During the DCF Study Period Were Not "Anomalous."

Drawing on the Oxford Dictionary, the Initial Decision framed a definition of "anomalous" capital market conditions that subsumes market conditions which are, in the Presiding Judge's words, (1) unprecedented, and (2) unsustainable.[39] While it is questionable whether a definition very loosely based on a dictionary of general usage should be adopted as binding in a proceeding involving complex issues of finance and regulatory economics, the record evidence shows, in any event, that capital market conditions during the study period here were neither unprecedented nor unsustainable, which means they were not "anomalous" under the Initial Decision's own test.

(a) Capital Market Conditions During the Study Period Were Not Unprecedented.

In response to the MISO TOs' contention that interest rates during the study period were anomalously low, FERC Trial Staff submitted evidence showing historical bond yields going

[38] I.D. at P 229.
[39] I.D. at P 220.

back to the year 1919.[40] These data show that Moody's Baa bond yield averages were below 5 percent for a continuous period of twenty-six years (*i.e.* every year between 1939 and 1965). Further, in fifteen of the years within this twenty-six year period (*i.e.* from 1941 to 1956), the bond yield averages were below 4 percent — well below the Moody's Baa bond yield averages during the study period in this case.[41] This evidence leads ineluctably to the conclusion that the low bond yields seen during the study period in this docket are *not* unprecedented.[42]

The Initial Decision dismisses this evidence, instead finding that low yields during the study period are "unprecedented, because they are primarily the result, not of market forces, but of the Federal Reserve's unprecedented purchases of long-term debt and suppression of short-term rates."[43] Whether the Federal Reserve's purchases are, in fact, "unprecedented" is an open question in the record. The Federal Reserve was established in 1913 and has had the power to set monetary policy since then. Whether or not the Federal Reserve's purchases and monetary policies during the study period were "unprecedented" when compared to monetary policies throughout the Federal Reserve's history has not been established, at least not in the evidence of record in this case. But even if it were assumed *arguendo* that the Federal Reserve's post-Recession accommodative policies and associated purchases were "unprecedented," there is evidence in the record, discussed below, that casts doubt on the extent to which Federal Reserve

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40 Exh. No. S-1 at 12.

41 Exh. No. S-2, Schedule 2, at 2.

42 Neither is this the first time the Commission has seen low dividend yields on utility stocks. The Commission may properly take administrative notice that, for the proxy group companies in *Southern Cal. Edison Co.*, Docket No. ER08-375-000, the adjusted dividend yields during the six-month period ending November 30, 2007 averaged 3.52 percent. *See* Exh. No. SC-13, appended to the submittal available on eLibrary at Accession No. 20080506-5010 (PDF page 81 of 145). By comparison, the adjusted dividend yield for the proxy group here, as shown in Appendix B to the Initial Decision, averaged 3.68 percent, or 16 basis points *higher* than in *Southern Cal. Edison Co* Yet the DCF study period considered in *Southern Cal. Edison Co.* was not declared to be "anomalous," even though the average dividend yield of the proxy group companies was lower there than it is here.

43 I.D. at P 223.

policies and actions actually drive capital market conditions, as compared to other macroeconomic factors (such as expansion or contraction of the global economy, issuances of Federal debt to finance deficit spending, or default rates in the housing and student loan sectors) that also affect the availability and cost of investment capital.

(b) Capital Market Conditions During the Study Period Were Not Unsustainable.

Addressing the second part of his definition of "anomalous" conditions, the Presiding Judge stated that "the evidence establishes a strong likelihood that market-capital conditions are temporary, because they are unsustainable."[44] They are unsustainable, according to the Initial Decision, because "[i]nvestors expect the Federal Reserve to normalize and for interest rates to rise. Either these events will occur, or investors will cease to believe that they will."[45] In other words, capital market conditions are "anomalous" because they are unsustainable, and they are unsustainable because either interest rates will go up or investors will stop expecting them to go up. That rendering has the feel of a "heads I win, tails you lose" situation for parties who contest the claim that capital market conditions are anomalous.

Furthermore, the simple fact is that market conditions change over time because the market forces that shape those conditions change over time. There is no bright-line distinction between Federal Reserve actions or policies that investors perceive as temporary and "unsustainable" and any other market factor or force. In fact, when asked during the hearing to provide an example of a "permanent" market force that affects investor expectations, Ms. Lapson could think of only one example, the existence of the Federal income tax.[46] And even that purportedly "permanent" market force has an impermanent streak in that, as Ms. Lapson

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[44] I.D. at P 223.
[45] *Id*.
[46] Tr. 332:7-16.

acknowledged, income tax *rates* change over time, and Ms. Lapson was uncertain whether investors perceive the income tax *rate* as a permanent market force or not.[47]

As noted, the Initial Decision found a "strong likelihood that capital market conditions are temporary" because investors expect the Federal Reserve to normalize its policies and for interest rates to rise.[48] In the end, whether or not investors perceive the Federal Reserve's accommodative monetary policy as temporary is beside the point because, it can credibly be argued, *all* market forces are temporary. What actually matters is whether investors expect that the eventual ending of the Federal Reserve's current program of "accommodative" actions will significantly impact their investments, such as by causing interest rates and bond yields to spike. The answer, as we discuss below, is far less certain than the Initial Decision suggests.

2. The Record Does Not Support the Initial Decision's Finding that Investors Expect "Normalization" of Federal Reserve Policy Will Cause a Substantial Increase in Interest Rates and Yields.

The Initial Decision found that, during the study period, "many investors have expected that the Federal Reserve will normalize current market-capital conditions, and that interest rates will rise significantly over the next few years."[49] This finding, however, is contradicted by evidence in the record demonstrating the following: (1) termination of the Federal Reserve's Quantitative Easing program did not cause a dramatic change in market conditions; (2) during the study period there was, and still is, a distinct lack of consensus within the investment community about whether interest rates will sharply increase at the onset of "normalization," and, more broadly, a lack of consensus about the impacts of Federal Reserve actions on capital

[47] *Id.* Ms. Lapson testified that, in her view, even the existence of income taxes might constitute an impermanent market force "[i]f the legislature were currently contemplating a bill and there were proposed legislation that would change the way investment returns were treated." Tr. 334:6-13.

[48] I.D. at P 223.

[49] I.D. at P 222.

market conditions; (3) the Federal Reserve has made clear that any change in its current accommodative monetary policy will be measured and not drastic; and (4) investors have acted in a manner that contradicts the claim that they are expecting a sharp increase in interest rates.

(a) Termination of the Federal Reserve's Quantitative Easing Program.

In the Docket No. EL11-66 proceeding, the New England transmission owners argued that, when the Federal Reserve ended its Quantitative Easing program, interest rates would rise to more "normal" levels and bond yields also would increase.[50] That prediction did not come to pass. The record here demonstrates that, since the Federal Reserve ended its Quantitative Easing program in October 2014, bond yields and interest rates changed very little.[51] In fact, the MISO TOs rely on the similarity of bond yields during the study period here and the study period in EL11-66 in arguing that anomalous conditions have persisted.[52] But a more plausible reading of these facts is that investors now realize that the Federal Reserve can change its policies without its actions precipitating a dramatic change in the market for utility capital.

(b) Lack of Consensus within the Investment Community Regarding the Impact of Federal Reserve Policy "Normalization".

Contrary to the Initial Decision's findings, the record shows that during the study period there was no clear consensus within the investment community as to what specific actions the normalization of Federal Reserve policy would entail, or what impact those actions might have on interest rates and bond yields. In discussing how investors form their expectations about the effect on interest rates of a change in the Federal Reserve's monetary policies, Dr. Avera testified that investors look at "whatever indication they have of what the Federal Reserve's

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50 Opinion No. 531 at P 130.

51 Exh. No. S-1 at 63:21-22; Exh. No. JCI-1 at 27:9-14.

52 Exh. No. MTO-16 at 27.

actions will be,"[53] that "there are many voices counseling different actions," and that "you can find an article that says something about anything in terms of the Federal Reserve."[54] The Initial Decision, however, gave no weight to these admissions because, as it notes, Dr. Avera also stated that most investors rely on the sources he cited in his testimony, which predict significantly higher bond yields in response to Federal Reserve policy normalization.[55] Dr. Avera, however, acknowledged that investors also rely on published reports such as those prepared by investment banks,[56] formal and informal statements by Federal Reserve representatives,[57] and industry analyst studies.[58] That Dr. Avera pointed to one set of respected sources that inform investors' expectations ─ sources whose predictions also happen to support the MISO TOs' position ─ does not take away his admission that "there are many voices counseling different actions" or his acknowledgement of other possible sources on which investors rely.[59]

The diversity of views among members of the investment community become particularly relevant in light of Ms. Lapson's admission that she had not conducted any formal study of equity investor perceptions arising from the Federal Reserve monetary policies,[60] nor

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[53] Tr. 508:22-23.

[54] Tr. 509:13-14 and 23-24.

[55] See I.D. at P 196. The Initial Decision also correctly points out *(id.)* that OMS's Initial Brief attributed to Dr. Avera a statement made during the hearing by Staff witness Keyton. The misattribution was inadvertent and undersigned counsel regret the error.

[56] Tr. 509:18-23.

[57] Tr. 508:23-24.

[58] Tr. 508:25 and 509:1-2.

[59] One expression of the diversity of views in the investment community is a *Bloomberg Business* article that discusses the extent to which bond yields might increase if the Federal Reserve starts unwinding its long-term securities portfolio. According to the *Bloomberg* article, "JPMorgan's analysis suggests ***the increase isn't likely to be significant.*** If the Federal Reserve allowed all of its Treasuries that mature in 2016 to run off its balance sheet, 10-year yields would rise by about 0.05 percentage point." *See* Exh. No. OMS-23 at 2 (emphasis added). The Initial Decision dismissed this evidence because the *Bloomberg* article was published after the end of the DCF study period and because information about the JPMorgan study was second-hand. S*ee* I.D. at P 165. There is, however, no reason to think that the views expressed in the *Bloomberg* article were brand new, or that the article did not accurately portray the JPMorgan study.

[60] Tr. 331:3-9.

had she published any peer-reviewed articles addressing the relationship between equity investor perceptions and the Federal Reserve's monetary policies.[61] The contention, then, that a less accommodative monetary policy necessarily will translate into higher common equity costs is not credibly supported by Ms. Lapson's testimony, or by any other evidence in the record for that matter. The Initial Decision states that Ms. Lapson's testimony was not diminished by the fact that she had not conducted any study; indeed, the Initial Decision asserts that "it is not at all clear how one would conduct a 'formal study' of investors' perceptions in this context."[62] Ms. Lapson herself, however, testified that a form of formal analysis could be a regression analysis using a statistical process for estimating the relationships among variables (thus showing a probability of investors' expectations).[63] The truth is that pretty much any sort of analysis would have been more formal, and had more probative value, than what Ms. Lapson relied upon: an undisclosed number of conversations with unnamed equity investors and portfolio managers that took place during an unspecified period of time.[64]

(c) Changes to the Federal Reserve's Accommodative Monetary Policies Will Be Gradual.

Prior to or within the study period, the Federal Reserve reassured the investment community that any change in its accommodative monetary policy would not be drastic. The January 2015 minutes of the Federal Open Market Committee ("FOMC"), cited by Ms. Lapson[65] and included in the record,[66] include a resolution to maintain the Federal Reserve's policy of reinvesting principal payments from its holdings of agency debt and agency mortgage backed

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[61] Tr. 331:10-17.
[62] I.D. at P 182.
[63] Tr. 331:6-9.
[64] Tr. 331:3-6.
[65] Exh. No. MTO-39 at 17:14-15 and footnote 20.
[66] Exh. No. S-10.

securities because maintaining a sizable level of long-term securities "should help maintain accommodative financial conditions."[67] The minutes further state:

> When the Committee decides to begin to remove policy accommodation, it will take a ***balanced approach*** consistent with its longer-run goals of maximum employment and inflation of 2 percent. The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, ***for some time,*** warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run.[68]

The Initial Decision interpreted the FOMC minutes to support a finding that investors expect interest rates to rise because the minutes indicate that "normalization" could start at any time.[69] But the minutes can just as easily be understood to say that, even if investors believed that a change in the Federal Reserve's accommodative monetary policies was a certainty and that it would lead to higher interest rates, investors also knew that any such policy changes (1) could take some time to implement, and (2) would likely be carefully measured (not dramatic or sudden) because the Federal Reserve also was charged with pursuing a set of important economic objectives (*e.g.*, reducing unemployment) that were tied to promoting recovery from the recent recession.

(d) Investor Behavior Belies Any Expectation of Sharply Increased Interest Rates.

The MISO TOs' case is grounded on the proposition that investors are (and, during the study period, were) expecting an impending end to the capital market conditions that have prevailed for the past several years, once the Federal Reserve begins to "normalize" its post-Recession monetary policies.[70] The MISO TOs also contend that investors are expecting a sharp rise in interest rates and bond yields — an expectation that renders the current conditions

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[67] *Id.* at 20.

[68] *Id.* at 20-21 (emphasis added).

[69] I.D. at P 187.

[70] I.D. at P 222.

"anomalous." The Initial Decision accepts both premises of the MISO TOs' case. There is, however, a significant flaw in the TOs' theory.

A fundamental assumption of the DCF method is that investors are rational actors who manifest their knowledge and expectations about the market through the prices they are willing to pay for stock. Those prices reflect investors' informed expectations about a variety of factors that may affect the return they would receive on their investments. If investors in utility stocks are expecting an imminent jump in interest rates due to Federal Reserve policy normalization, the rational course would be for them to sell those stocks before the increases in interest rates begin. If the expectation were sufficiently widespread and enough investors pursue the path of rational self-interest, utility stock prices would fall as shares are sold into the market, which would cause the dividend yields on those stocks to increase. But, as the record evidence shows, that simply has not happened.

That yields on utility shares have not increased implies that investors have elected not to sell their shares. Their decision to remain invested in utility stocks can only mean that investors expect that the normalization of Federal Reserve monetary policy will be gradual. As investors accommodate themselves to each step (*e.g.*, increases in the Federal Funds Rate, disposition of securities held in the Open Market Account, etc.), a new equilibrium is reached, and interest rates thereby stay at, or close to, current levels. In short, the fact that investors have not begun to dump their shares into the market can only mean they are expecting that the normalization of Federal Reserve policies will have little or no adverse impact on the value of their holdings.

The Initial Decision, however, rejected the rational investor line of reasoning. Instead, the Presiding Judge posited that investor behavior is being driven by unusual factors ― specifically, that the goal of obtaining dividend growth over the long term is no longer guiding investors' decisions but, rather, investors may be purchasing utility stocks solely for their current yield.[71] The only reason investors are holding these shares, according to the Initial Decision's narrative, is that they are unsure of when normalization will begin.[72]

A significant problem with this aspect of the Initial Decision (apart from the paucity of supporting evidence) is that the findings summarized above go beyond the rational investor model and are premised instead on speculation about the reasons investors have not acted in a manner consistent with the expectations attributed to them. In this regard, it is again important to note the MISO TOs' admission that they had not conducted any studies focused on the equity markets in analyzing the conditions they portrayed as anomalous;[73] neither did they conduct any modeling or statistical analysis[74] that might have supported a finding that investors continue investing in utility stock because they have "no place else to go".[75] The Commission should not accept findings so thoroughly rooted in speculation about investor motivations, especially when those findings contradict long-standing FERC precedent that puts investor expectations at the center of determining whether, in particular cases, the *Hope* and *Bluefield* standards have been met.[76] Accordingly, the Commission should reject the Initial Decision's findings on this point.

3. <u>The Initial Decision Errs in Finding that the Federal Reserve's Actions Rendered the Results of the DCF Studies Unreliable.</u>

The Initial Decision found that anomalous market conditions existed during the refund period due to the actions of the Federal Reserve.[77] This finding, however, is contradicted by

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71 I.D. at PP 192, 218.

72 I.D. at P 193.

73 Tr. 324:6-8.

74 Tr. 331:3-9.

75 I.D. at P 193.

76 *See*, e.g., Opinion No. 531-B at P 71 (explaining that the cost of common equity to a regulated enterprise depends upon what the market expects, not upon precisely what is actually going to happen).

77 I.D. at P 223.

record evidence showing that: (1) the Federal Reserve's actions may not significantly influence the DCF analysis, and (2) the actions of the Federal Reserve may have been offset by the large issuance of Federal debt contemporaneous to Quantitative Easing.

The record evidence casts considerable doubt on the extent to which Federal Reserve policies actually affect the inputs to a DCF study. For example, the record includes an article written by former Federal Reserve Chair Ben Bernanke in which he questioned the ability of the Federal Reserve to affect interest rates over the long term. Dr. Bernanke stated in the article that real interest rates are determined by a broad array of economic factors (including prospects of economic growth), not solely by Federal Reserve actions.[78] The Initial Decision rejects this evidence, however, on the basis that Dr. Bernanke's article discusses the Federal Reserve's ability to control *real* long-term yields while the DCF analysis relies on *nominal* stock and bond yields.[79] The Initial Decision also states that, even if Dr. Bernanke's comments could be interpreted to support OMS' position, they conflict with statements made by current Federal Reserve chair Janet Yellen to the effect that normalization could cause a spike in long-term rates.[80] In the end, the Presiding Judge gave greater weight to Chair Yellen's comments than to Dr. Bernanke's article.[81] In fact, the Presiding Judge suggested that Dr. Bernanke's statements were less credible than Chair Yellen's because he was responding to accusations that, during his tenure as chair, Dr. Bernanke and the FOMC had thrown seniors "under the bus" by keeping interest rates low.[82]

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[78] Exh. No. JCI-6 at 2.

[79] I.D. at P 177.

[80] Exh. No. MTO-39 at 18:23-25.

[81] I.D. at PP 176-78.

[82] I.D. at P 178 *citing* Exh. No. JCI-6 at 2.

The Commission should reject the Initial Decision's findings on this issue. First, as to the criticism that Dr. Bernanke's article addresses the extent to which Federal Reserve actions affect *real* long-term yields while the DCF analysis relies on *nominal* yields, this is a distinction without a difference for purposes of the question at hand. Dr. Bernanke's broader point was that Federal Reserve policies and actions are one of a myriad of factors that affect capital market conditions, and that it would be a mistake to assume a direct and controlling relationship between Federal Reserve actions and market conditions. Second, the Commission should not join in impugning Dr. Bernanke's veracity, nor should it reject the substance of his article, based on speculation about his objectives, especially when the competing evidence is a second hand interpretation of Chair Yellen's speech in a conference by a Reuters reporter, included in Ms. Lapson's testimony as excerpts from that Reuters article—without any context as to actual discussions during the conference on which Chair Yellen spoke. At a minimum, the evidence of conflicting opinions from two Federal Reserve Chairs (one former, one sitting) precludes the Commission from concluding that substantial evidence in the record supports the Initial Decision's finding on the effects of Federal Reserve policy on DCF inputs.

Finally, the Initial Decision agrees with the MISO TOs' contention that Federal Reserve policy decreased yields on long-term treasury bonds by increasing the demand for (and prices of) those securities,[83] but it ignores the *supply* side of that equation. Overlapping in time with the Federal Reserve's "Quantitative Easing" program but swamping it in magnitude, large Federal deficits were being financed by the issuance of new Federal debt securities, to the extent that Federal debt as a share of Gross Domestic Product ("GDP") more than doubled after 2008.[84] So, even if Quantitative Easing bond purchases exerted a downward pressure on bond yields (by

[83] I.D. at P 123.

[84] Exh. No. JCI-7 at 84, figure 1.

pulling down the supply of Treasury bonds, driving up their price and pushing down yields), new Federal bond issuances to finance the growing deficit had the opposite effect; by adding to the supply of Federal debt securities, prices were pushed down and yields were driven up. The Initial Decision described as “intriguing” the prospect that new Federal debt issuances had an effect on bond yields that tended to offset any impact of Federal Reserve debt purchases; however, the Initial Decision elected not to pursue the matter based on a claimed lack of evidence on the point.[85] Even though no expert witness discussed the implications of the Moody’s report showing Federal debt to have doubled since 2008,[86] this fact is part of the record. The Commission should consider this factual evidence as an indication that, at a minimum, there is conflicting evidence in the record regarding the impact Federal Reserve actions purportedly had on DCF inputs. As a result, the Initial Decision’s finding that the Federal Reserve’s actions had a “distortive” effect on DCF inputs is not supported by substantial evidence.

4. <u>The Initial Decision Found that the Cost of Raising Equity Capital is Low, but Erred in Rejecting the Logically Necessary Conclusion that the Cost of Equity Also is Low.</u>

The Initial Decision found that, as a result of falling interest rates and dividend yields, the cost to electric utilities of raising capital by issuing stock is low.[87] The Initial Decision, however, rejects the conclusion that logically follows from that finding — namely, that the cost of common equity for utilities also is low. In rejecting that logically necessary conclusion, the Initial Decision found that the cost of equity is not low because: (1) the cost of equity is the return required to attract long-term investors, who in normal conditions invest in both yield and

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85 I.D. at PP 179-80.

86 Exh. No. JCI-7 at 84, figure 1.

87 I.D. at P 215.

growth;[88] (2) right now, investors are buying utility stock just for the yield and don't care about the growth because they are ready to divest their long-term positions as soon as normalization begins and short-term rates allow;[89] and (3) the proxy group prices included in the DCF analysis reflect only what investors are paying to get the yield;[90] and (4) the Total Returns of those companies are not necessarily equivalent to their cost of equity.[91]

These findings rely on the premise that to meet the *Hope* and *Bluefield* standards, the cost of equity must satisfy the total return requirements of a specific type of investor ─ the long-term investor.[92] To be clear, none of the testimonies prepared by the MISO TOs' expert witnesses' distinguish between the required returns of long-term versus short-term investors to satisfy the standards in *Hope* and *Bluefield*. That distinction was first included in the record during the hearing (after cross by Complainants and Supporting Interveners) as part of the ALJ's clarification questions to Ms. Lapson. Complainants and supporting interveners had no opportunity to include expert testimony in the record to address this new distinction and whether it is at all relevant to determining the cost of equity of the MISO TOs. Neither could they have anticipated such issue being raised during the hearing because: (i) the DCF does not distinguish between "short-term" and "long-term" investors; and (ii) there is no FERC precedent discussing the preposition that there is a difference between the results of the DCF study and the true cost of equity.

The finding that the DCF analysis does not reflect the true cost of equity because it does not satisfy the requirements of long term investors was developed by the Presiding Judge

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88 I.D. at PP 207, 210, 216, 218.

89 I.D. at P 200.

90 I.D. at P 210.

91 I.D. at P 216.

92 I.D. at P 207.

following Ms. Lapson's responses during the hearing in this proceeding. Indeed, the Presiding Judge appears to be uncertain himself about the validity of this theory as revealed by the equivocal language he uses in the Initial Decision.[93] The Commission should not affirm rulings that rely on such equivocal findings. In any case, Ms. Lapson's speculations with respect to the Base ROE needed to retain long-term investors (as opposed to short-term investors) are reduced to a generic assertion that the Base ROE cannot be "too low".[94] Notably, Ms. Lapson believes that a Base ROE at the Upper Midpoint will not necessarily retain the "hot money" equity investments,[95] but she does not specifically say whether the midpoint of the zone or the Upper Midpoint would be sufficient to retain long-term investors. For all we know, the midpoint of the DCF could be sufficient to retain long-term utility investors.

The record's many DCF studies indicating a low cost of equity are accurately capturing the capital market realities, not suffering from "distortion" that somehow masks the true cost of equity. As explained in this brief, Ms. Lapson's speculative answers to the Presiding Judge during the hearing are not backed by any prior analysis or study.[96] There is no credible evidence in the record showing that investors no longer care about divided growth and continue to invest in the utility stock just for the yield.

Moreover, if that theory is credited, then the Initial Decision contradicted itself in discarding as illogical two low-end proxy results (FirstEnergy Corporation at 5.01 percent, and Entergy Corporation at 5.36 percent) that exceeded the study-period Baa utility bond yield of

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[93] *See, eg.*, I.D. at P 216 (the total returns of proxy companies "are not necessarily" equivalent to their cost of equity), I.D. at P 218 (expectations of dividend growth "may" not be guiding investment decisions; investors "may" be purchasing stock only for the current yield; the proxy group stock prices "may" not reflect long-term investors satisfaction).

[94] Tr. 426:10-14.

[95] Tr. 426:2.

[96] Tr. 324:6-8 and Tr. 331: 3-9.

4.65%, but did so by less than 100 basis points.[97] The basis of the standard 100 basis point screen is a finding that investors in utility stocks require appreciably more yield than utility bonds provide.[98]

5. <u>The Initial Decision Errs in Concluding, If Capital Market Conditions are Found to be Anomalous, the ROE Must Then Be Set at the Upper Midpoint.</u>

Should the Commission find that anomalous market conditions existed during the study period — notwithstanding strong evidence to the contrary — it need not (and should not) default to placing the Base ROE at the Upper Midpoint. The Commission's charge in cases such as this is to set the new Base ROE at a level sufficient for the MISO TOs to attract capital on reasonable terms, *but no higher*. To comply with that mandate, the Commission must have the flexibility to set the Base ROE anywhere between the DCF midpoint and the Upper Midpoint. Noteworthy in this regard is that, in Opinion No. 531-B, the Commission rejected a proposal to allow a Base ROE at the 75th percentile of the zone of reasonableness on the grounds that Commission precedent supported use of the "central tendency" to determine an appropriate return in cases involving the placement of the Base ROE for a region-wide group of utilities.[99] Opinion No. 531-B also rejected arguments that FERC precedent requires the Commission to consider the distribution of results within the proxy group when determining where in the upper half of the zone the Base ROE should be placed.[100] Nevertheless, the Commission should not bind itself to an "either-or" choice between the DCF midpoint and the Upper Midpoint; rather, it must be able to set the Base ROE at other points of central tendency within the upper-half of the zone of

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[97] *See* I.D. at PP 65, 158.

[98] *See* Opinion 531 P 122 ("The purpose of the low-end outlier test is to exclude from the proxy group those companies whose ROE estimates are below the average bond yield or are above the average bond yield but are sufficiently low that an investor would consider the stock to yield essentially the same return as debt.").

[99] Opinion No. 531-B at P 55.

[100] *Id.*

reasonableness, such as the mean[101] or the median[102] of the upper-half of the zone. The Commission could also set the Base ROE at any point of central tendency within a range between the midpoint of the DCF and the Upper Midpoint (*i.e.* between 9.29 percent and 10.32 percent).[103]

Especially considering the conflicting evidence regarding purportedly "anomalous" capital market conditions and investor expectations, the Commission should take care to preserve maximum flexibility in establishing the new Base ROE for the MISO TOs. Only by preserving that flexibility can it protect consumers from paying excessive rates due to an artificial constraint on the Commission's choice of ROE outcomes. Therefore, the Commission should reject the notion that it is limited to a binary choice between the DCF midpoint and the Upper Midpoint, where capital market conditions have been proven "anomalous," and should clarify that it will not automatically default to the Upper Midpoint in those circumstances.

B. THE "ALTERNATIVE PRICING MODELS" ON WHICH THE INITIAL DECISION RELIES DO NOT SUPPORT SETTING THE BASE ROE ANY HIGHER THAN THE DCF MIDPOINT.

For the reasons discussed above, the Initial Decision erred in finding that anomalous capital market conditions existed during the DCF study period, and that these conditions distorted the inputs to the DCF analysis. Nevertheless, based on that erroneous finding, the Initial

[101] The mean of the upper-half of the DCF range in Appendix B of the I.D. is 9.62 percent. We note that this figure includes the DCF result for UIL. Because UIL was in the process of being acquired during the study period adopted in the I.D., UIL should have been excluded from I.D. Appendix B. *See Iberdrola, S.A.*, 151 FERC ¶ 62,148 (June 2, 2015) (Order issued in Docket No. EC15-103, authorizing Iberdrola's acquisition of UIL Holding Corp.)

[102] The median of the upper-half of the DCF range in Appendix B of the I.D. (again including UIL, but see the preceding footnote) is 9.44 percent.

[103] While OMS suggests in this pleading possible alternatives to an automatic adoption of the Upper Midpoint (upon a finding of anomalous market conditions), and believes that the 10.32 percent Base ROE recommendation is too high, OMS takes no position on the exact determination of a lower appropriate Base ROE for the MISO TOs in this Docket.

Decision further ruled that "prior to determining the appropriate Base ROE for the MISO TOs, it will be necessary to examine alternative pricing studies and ROEs recently authorized by state commissions."[104] Purportedly following Opinion No. 531, the Initial Decision then considered three alternative pricing models — the Risk Premium Analysis, the Capital Asset Pricing Model, and the Expected Earnings Analysis — "to inform the just and reasonable placement of the Base ROE within the zone of reasonableness established by the DCF methodology."[105] The Presiding Judge rejected the Expected Earnings analysis submitted by the MISO TOs[106] but found that the other two methods support placing the Base ROE above the midpoint of the DCF results. As OMS sets out below, however, there are fatal flaws in the Risk Premium and CAPM studies on which the Presiding Judge relied. As a result, these alternative methods do not support the Initial Decision's ultimate determination that a 10.32% Base ROE for the MISO TOs is just and reasonable.

1. Because the Risk Premium Study Adopted by the Initial Decision is Invalid, It Lends No Support to the Presiding Judge's ROE Recommendation.

The Initial Decision found that the historical risk premium analysis presented by MISO TO witness Avera "is valid and supports awarding the MISO TOs a Base ROE higher than the midpoint."[107] Dr. Avera's risk premium study (Exhibit No. MTO-29) begins by calculating average annual risk premiums during the period 2006-2014 by subtracting the average bond yield for each year from the average of the Base ROEs authorized by the Commission during the same year, and then averaging the calculated risk premiums for the period. He also applied an adjustment to the resulting value "to reflect the alleged tendency of risk premiums to rise as

[104] I.D. at P 229.
[105] I.D. at P 230.
[106] I.D. at P 323.
[107] I.D. at P 258.

interest rates fall."[108] The study is fatally flawed, however, by the inclusion of at least one data point that is demonstrably invalid for the purpose and that results in a grossly excessive risk premium.

In detail, one of the Base ROE decisions Dr. Avera included in his data set is the Commission's order in *ITC Holdings Corp.*, 143 FERC ¶ 61,257 (June 20, 2013), *on reh'g*, 146 FERC ¶ 61,111 P 25 (Feb. 20, 2014). In that order, the Commission allowed the Entergy operating companies — which then were about to become new MISO Transmission Owners — to place into effect rates that incorporated the 12.38% region-wide Base ROE that was (and, as of now, still is) available to any existing and new MISO TOs. Dr. Avera, however, treated that order as though it were a determination *on the merits* that the base cost of common equity of the Entergy companies is 12.38%, which simply is not the case. Rather, as the rehearing order and the June 2013 order both made clear, the Commission ruled only that, once they were integrated as new MISO TOs, the Entergy companies were entitled to develop their rates using the standard Base ROE effective for MISO TOs in general.[109] The Commission also stated that parties protesting the Entergy companies' use of the 12.38% ROE would be required to challenge that Base ROE as to *all* MISO TOs, not just the Entergy companies, and then noted that such a complaint (the complaint that initiated the instant proceeding) had already been filed.

At bottom, the *ITC Holdings Corp.* order was merely a docketing order insofar as ROE is concerned; it established that litigation of a just and reasonable ROE for the Entergy companies' transmission assets would be determined prospectively in the instant proceeding, rather than in Entergy transmission rate docket. The order did nothing more than allow the existing MISO-wide ROE to be extended to a new set of transmission owners, just as the Commission has done

[108] I.D. at PP 233-234.

[109] *ITC Holdings Corp.*, 143 FERC ¶ 61,257 at PP 60-62 (June 20, 2013).

for other incoming MISO TOs. In no way can that action be considered a "determination" of the Entergy companies' cost of equity, and, so, it had no place in Dr. Avera's data set of historic risk premiums. But by treating *ITC Holdings Corp.* the same as other orders where the Commission actually calculated a just and reasonable return for a company, Dr. Avera grossly inflated the historical risk premium. In fact, by subtracting the average yield on Baa utility bonds in 2013 (5.08%) from the 12.38% ROE that the Entergy companies were allowed to collect essentially as a matter of course, a *730 basis point differential* was lumped in with the calculated risk premiums in determining the overall average risk premium for 2013. Including that value in the calculation of the 2006-2014 average risk premium skewed the overall result upward by a significant amount. It was clear error for the Initial Decision to give weight to Dr. Avera's overall Risk Premium result in deciding where to place the new Base ROE within the zone of reasonableness.

The irony here should be readily apparent. The Initial Decision adopts a risk premium analysis that treats *ITC Holdings Corp.* as though it were a merits determination of the just and reasonable ROE for the Entergy companies. Yet, at the same time, the Initial Decision found that 12.38% is *not* a just and reasonable ROE for the Entergy companies or any other MISO TOs. The Commission must not adopt Initial Decision findings that proceed from such logically incompatible premises.

It is a straightforward matter, and one that requires no special accommodation, to correct that and like errors committed by Dr. Avera and perpetuated by the Initial Decision. The Commission may take administrative notice of its past decisions and those decisions' underlying bases to the extent necessary to consider the corrected version of Exhibit No. MTO-29 provided as Attachment 1 to this brief. It demonstrates as a matter of straightforward, reproducible[110] mathematics that the 2006-2014 average risk premium — calculated using Exhibit No. MTO-29 but limiting the data points to actual base ROE determinations — produces a value significantly lower than 10.32% (indeed, lower than 10.0%). The exercise confirms that Dr. Avera's risk premium study provides no logical corroboration for the Initial Decision's ROE recommendation.

2. Because the CAPM Study Adopted by the Presiding Judge Uses a Flawed Methodology, It Cannot Support the Initial Decision's Recommended ROE.

In addition to the Risk Premium evidence, the Presiding Judge also evaluated competing CAPM studies submitted by the "Non-Utility Participants" and by the MISO TOs. In the end, the Presiding Judge found that "Dr. Avera's CAPM is credible and supports allowing the MISO TOs to collect a Base ROE above the Midpoint."[111] Dr. Avera's CAPM study, however, does not support the Initial Decision's decision to place the new Base ROE higher than the DCF midpoint because, like his Risk Premium analysis, Dr. Avera's CAPM study was defective.

As the Initial Decision observes, the CAPM method proceeds from the premise that the market-required rate of return for a security is equal to the risk-free rate plus a risk premium associated with the specific security.[112] Although Dr. Avera's application of the method is a several-step process, his starting point was to calculate, through a DCF calculation, an expected market return on a fixed portfolio of approximately 400 companies, identified as the dividend-paying companies that were included in the Standard and Poor's 500 index (S&P 500) as of a

[110] To reproduce its calculations, the Regression function of Microsoft Excel is applied to the annual bond yield and risk premium columns of page three, with the annual bond yields providing the x-values and the annual risk premiums providing the y-values, and the Regression function output then becomes page six. As was the case in Exhibit MTO-29, the resulting page six "X Variable 1" coefficient is then carried forward to page one as the "Risk Premium/Interest Rate Relationship."

[111] I.D. at P 311.

[112] I.D. at P 259, quoting Exh. JC-9 at 41:2-10.

specific date.[113] As the Initial Decision recounts, Dr. Avera added the weighted average dividend for those companies (2.4%) to the average of the weighted average growth rates projected for the companies by IBES and Value Line (8.9%), producing an expected portfolio return of 11.3%.[114] The growth component of the portfolio return calculation thus was composed of only the short-term growth rates forecasted by IBES and Value Line, weighted 100%, rather than reflecting a $^2/_3 - ^1/_3$ weighting of short and long-term forecasted growth rates, as in the Commission's two-stage DCF method.

By including only short-term growth rates (fully weighted) in the portfolio return DCF calculation, Dr. Avera's method assumes that the rates of growth over the next five years (as forecasted for the 400-stock portfolio used in the analysis) will continue forever. That premise is implausible, and it flies in the face of the Commission's determination in Opinion No. 531 to use a weighted average of short and long-term growth rates. Indeed, the failure to incorporate a blended growth rate is the precise reason the Presiding Judge rejected Dr. Avera's DCF study of non-utility companies. In that context, the Presiding Judge observed that "[Dr. Avera's] decision to include only dividend yields and short-term growth components inevitably skews his zone of reasonableness upward."[115] The same is true of Dr. Avera's decision to include only dividend yields and short-term growth rates in the portfolio DCF portion of his CAPM study. It is arbitrary and capricious for the Initial Decision to reject one of Dr. Avera's studies for its failure to incorporate long-term growth rates while adopting another of Dr. Avera's studies that, in a similar "dividend plus growth" DCF calculation, suffers from precisely the same fatal flaw.

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[113] I.D. at P 260.

[114] *Id.*

[115] I.D. at P 328.

OMS acknowledges that this issue surfaced in Docket No. EL11-66, and that Opinion No. 531-B rejected the charge that the Commission had erred by adopting a CAPM formulation that failed to include a second-stage growth rate. The same basis on which the Commission rejected the charge in Opinion No. 531-B was adopted by the Presiding Judge here — namely, that "[w]hile an individual company cannot be expected to sustain high short-term growth rates in perpetuity, the same cannot be said for a stock index like the S&P 500 that is regularly updated to contain only companies with high market capitalization."[116] Unfortunately, that reasoning makes no more sense as replicated in the Initial Decision than it did before, for several reasons:

- First, the rationale, as stated in Opinion No. 531 and adopted by the Initial Decision here, *simply doesn't apply*. The portfolio Dr. Avera used in his CAPM study was *not* the S&P 500 itself, with a constantly updated cast of high-capitalization companies; rather, it was a *fixed portfolio* of 400 stocks. They were selected because they happened to be dividend paying stocks included in the S&P 500, but they should not be confused with the S&P 500 itself. Of critical importance is that the 400 stock portfolio will not be "regularly updated" to include only companies with high market capitalizations. So, even if it were assumed that the S&P 500 (as regularly refreshed with high-cap companies) can sustain long-term growth essentially unconstrained by GDP, there is no reason to expect that the fixed group of 400 stocks in Dr. Avera's portfolio also will enjoy long-term growth at short-term rates without being affected by changes in the economy as a whole.
- Second, in rejecting Dr. Avera's non-utility DCF for its failure to incorporate a second-stage growth factor, the Presiding Judge implicitly recognized what is undoubtedly true: that, over time, each individual

[116] I.D. at P 304, *quoting* Opinion No. 531-B at P 113.

company in the Avera portfolio will see its rate of growth trend downward toward the long-term GDP growth rate. And, if each company in the portfolio will see its growth rate trend toward the GDP growth rate, so also will the portfolio as a whole. For that reason, the failure to include a second-stage growth rate in the CAPM's portfolio DCF calculation is illogical and indefensible.

- Third, the claim that the beta component in the CAPM formulation "serves the same purpose of [*sic*] the long-term growth-rate component of the two-step DCF composite growth-rate calculation"[117] is simply wrong. Beta serves a purpose wholly unrelated to the inclusion or exclusion of a second stage growth factor. Beta is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole; in the context at hand, it compares the susceptibility of the proxy group's returns to market volatility with that of the New York Stock Exchange, over the past five years.[118] While for utility stock it consistently averages well below 1.0, exceptions in which a utility stock's beta exceeds 1.0, and thus increases that proxy's CAPM result, are common.[119] The second-stage growth rate, on the other hand, is necessary to incorporate the effect of changes in the general economy (as represented by GDP growth) in forecasting the long-term growth of an individual company or group of companies. The second-stage growth rate is part of getting to a reliable number for the expected long-term return on a fully diversified equity portfolio — an essential ingredient for a CAPM study to produce any sort of useful result. To equate the two values simply because in this particular instance "[e]ach serves to lower

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[117] I.D. at P 305.

[118] *See* Andrew J. Cueter, "Using Beta," Value Line Educational Article (Oct. 2, 2012), *available at* http://www.valueline.com/Tools/Educational_Articles/Stocks/Using_Beta.aspx#.Vp5VhZorJaQ.

[119] *See* Richard A. Michelfelder and Panayiotis Theodossiou, "Public Utility Beta Adjustment and Biased Costs of Capital in Public Utility Rate Proceedings, Electricity L. J., Nov. 2013, at 60, 66 (Figure 1, showing that the top decile of utility betas exceeded 1.0 for some years and the highest utility beta exceeded 1.0 in most years).

the top of the zone of reasonableness"[120] is not well-reasoned. That the two values may (in some or most cases) have a similar effect does not make them functional equivalents that may be freely substituted for one another. To treat the beta factor as a substitute for the second-stage growth factor, as the Initial Decision did, is plain error.

- Finally, Dr. Avera's CAPM study for this proceeding differs materially from his CAPM study cited in Opinion No. 531, in sourcing the short-term growth rates used to develop the DCF-based projected market return for its 400-company portfolio. In his prior CAPM study, those growth rates were taken from Yahoo Finance reporting of IBES estimates.[121] In the present study, those growth rates incorporate Value Line growth estimates,[122] which are substantially backward-looking,[123] and which the Initial Decision, in a separate passage addressing the same data source, rightly found to be inferior.[124]

In sum, Dr. Avera's CAPM study is too flawed and unreliable to serve as corroboration for the Initial Decision's ROE recommendation. But even if those flaws somehow could be set aside, the fact is that Dr. Avera's CAPM study *still* wouldn't support the Initial Decision's recommendation for this simple reason: the midpoint of Dr. Avera's CAPM results based on historical bond yields, as shown in Exhibit No. MTO-30, is 10.06%, a non-trivial amount lower than the Initial Decision's recommended Base ROE of 10.32%.

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[120] I.D. at P 305.

[121] *See* Opinion No. 531-B, P 110.

[122] *See* Exh. No. MTO-30 at 1, note (b).

[123] *See, e.g.,* Exhibit No. MTO-54 at 30 (9% Value Line "annual rates of change" for earnings per share in June 2015 report represented trend from baseline of 2012-14, and thus included past earnings per share growth from 2012 to 2015).

[124] *See* I.D. at PP 48-49.

C. THE INITIAL DECISION ERRED BY RELYING ON THE MISO TOS' STATE-AUTHORIZED ROE STUDY AS JUSTIFICATION FOR AN UPWARD ADJUSTMENT FROM THE MIDPOINT.

The Initial Decision found that the state-authorized ROE study presented by MISO TO witness Ellen Lapson also supports a Base ROE for the MISO TOs above the midpoint of the DCF range of reasonableness.[125] OMS submits that, as with the Initial Decision's reliance on Dr. Avera's CAPM and Risk Premium studies, the Commission need not and should not consider Ms. Lapson's state ROE study for the simple reason that, contrary to the Initial Decision's erroneous finding, capital market conditions during the DCF study period were not anomalous. But even if the Commission were to affirm the Initial Decision's finding of anomalous market conditions, it still should find that the Presiding Judge erred by relying on Ms. Lapson's state ROE study because the study is flawed in two crucial respects: (1) it failed to account for the continuing downward trajectory in state-authorized ROEs; and (2) it failed to give weight to the differences in return requirements associated with transmission service versus integrated utility service, as is necessary to apply the risk comparison implemented in Opinion No. 531.[126] We discuss these critical shortcomings in turn.

1. <u>Downward Trend in State-authorized ROEs.</u>

In our briefs to the Presiding Judge, OMS argued that Ms. Lapson's state-authorized ROE analysis is flawed because it failed to reflect the strong downward trend in state-authorized ROEs.[127] The Initial Decision rejected the argument based on a reading of Opinion No. 531-B that is incorrect. Specifically, the Initial Decision interpreted P 86 of Opinion No. 531-B as requiring that the Presiding Judge give more weight to the fact that the average state-authorized

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[125] I.D. at P 452.
[126] *See* Opinion No. 531 at P 149.
[127] OMS Reply Brief at 30-31.

ROE exceeded the DCF midpoint than to the demonstrated downward trajectory in state-authorized ROEs.[128] In this regard, the Initial Decision misconstrues Opinion No. 531-B. The Commission did not, in that instance, consider and dismiss a proven downward movement in state ROEs; rather, it simply found that the EL11-66 record lacked proof of such a downward trend.[129] The record in the instant proceeding, however, is a different story.

Here, the evidence clearly shows a downturn in state-authorized ROEs over the past decade and continuing through the DCF study period. As the Complainants' witness Mr. Gorman explained in his Rebuttal Testimony, the average state-authorized ROEs for all electric utilities dropped from 9.76% in 2014 to 9.67% in the first quarter of 2015.[130] In addition, two of the SNL Financial/ Regulatory Research Associates ("RRA") reports on which Ms. Lapson herself relied in her state ROE study — those for calendar years 2013 and 2014[131]— point out that "since 1990 the authorized ROEs have generally trended downward, reflecting the significant decline in interest rates and capital costs that has occurred over this time frame."[132] When asked during the hearing about RRA's observation of the downward trend in state ROEs, Ms. Lapson admitted that she had not examined trends in state authorized ROEs over any time period.[133]

Ms. Lapson's failure to account for the downward trend in state-authorized ROEs is a fatal flaw in her analysis that precludes its use as support for moving the Base ROE above the midpoint. Furthermore, the downward trend in state-authorized ROEs should alleviate concerns about capital being shifted away from transmission investments into distribution investments.

[128] I.D. at P 363.
[129] Opinion No. 531-B at footnote 176.
[130] Exh. No. JC-9 at 30:6-8.
[131] Tr. 348:2.
[132] Tr. 350:21.
[133] Tr. 351:1-2.

Investors deciding where to place their money (or utilities deciding how to allocate their capital) may be presumed to be aware of the trend and to shape their decisions accordingly. Investments in transmission will be viewed as more attractive as state-authorized ROEs for distribution service and other services continue to slide. For these reasons, any use of state ROEs as a benchmark for evaluating the adequacy of FERC-allowed transmission ROEs must recognize and give weight to the ongoing downward trend in state-authorized ROEs. The Initial Decision's failure to do so was in error.

2. Risk Comparability.

In Opinion No. 531, the Commission compared the investment risks of electric transmission infrastructure with those of electric distribution infrastructure and concluded that the FERC-approved ROE for transmission assets should be higher than the state-authorized ROEs for distribution assets.[134] The basis for the finding was the Commission's determination that investing in transmission carries greater risk than investing in distribution.[135] Ms. Lapson's analysis, however, is based solely on state-authorized ROEs for *integrated* utilities; she consciously avoided using data from distribution-only companies.[136] In explaining her choice of data, Ms. Lapson said that comparing the risks of the MISO TOs' business with that of integrated utilities is more "appropriate" than using the state-authorized ROEs for distribution-only companies.[137] OMS found Ms. Lapson's explanation unpersuasive, and therefore argued to the Presiding Judge that her exclusive use of integrated company state ROE data fails to give proper effect to the transmission vs. distribution risk comparison set forth in Opinion No. 531.[138]

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[134] Opinion No. 531 at P 149.
[135] *Id.*
[136] Exh. No. MTO-16 at 54:5-14.
[137] Exh. No. MTO-16 at 54:13-14.
[138] OMS Reply Brief at 31.

The Initial Decision compared Ms. Lapson's state ROE numbers for the all-electric utility group (including integrated and distribution-only utilities) and her ROE numbers for integrated utilities to determine the ROEs for the distribution-only utilities.[139] The Initial Decision found that the mean, median and the midpoint of the state-authorized ROEs for distribution-only utilities (9.45 percent, 9.55 percent, and 9.41 percent, respectively) are above the midpoint of the DCF analysis adopted in the Initial Decision (*i.e.*, 9.29 percent).[140] Yet, the mean and the midpoint of the state-authorized ROE numbers for distribution-only utilities are *below* the Base ROE of 9.54 percent recommended by Mr. Gorman, and the median is only 0.01 percent above Mr. Gorman's proposed ROE for the MISO TOs.[141] These data therefore confirm that, to the extent state-authorized ROEs for distribution-only utilities are a meaningful consideration in setting transmission ROEs, the Base ROE proposed by the Complainants in this proceeding is reasonable and sufficient.

The Initial Decision also found that investing in the MISO TOs' FERC-regulated electric transmission entails risks that are *at least as great* as the risks of investing in the integrated electric utilities analyzed by Ms. Lapson. On this basis, the Initial Decision concludes that it would be illogical to award a Base ROE for the MISO TOs that is below the state-authorized ROEs of these integrated electric utilities.[142] The Commission should reject the Initial Decision's findings in this regard. There is no evidence in the record that supports the proposition that the risks assumed by the MISO TOs or by transmission companies, in general are at least as great as those of the integrated utilities studied by Ms. Lapson. On the contrary, evidence presented by Joint Consumer Advocates witness Hill indicates that the risks of transmission service are *less*

[139] I.D. at PP 399, 400 and footnote 521.
[140] I.D. at P 400.
[141] Exh. No. JC-1 at 2:13 and Exh. No. JC-9 at 32:7-8.
[142] I.D. at P 453.

than the risks of integrated utility operations, which include the risks of competitive operations.[143] The Initial Decision discounted Mr. Hill's proof based essentially on Ms. Lapson's discussion of the MISO TOs' capital expenditure ("capex") commitments.[144] Yet, Ms. Lapson admitted that she conducted no analyses or studies to measure the claimed impact of relative capex requirements on the cost of equity.[145] That being so, Ms. Lapson's contention that the risks of the integrated utilities she studied are at least as great as those assumed by the MISO TOs is one that bears little weight; hence, it was an error for the Initial Decision to rely on her testimony in this regard as support for a higher-than-midpoint ROE recommendation.[146]

Finally, should the Commission find that the MISO TOs are largely or predominantly integrated or that the MISO TOs have risks "at least as great" as those of integrated utilities, an upward adjustment from the DCF midpoint based on comparing utilities having similar risk profiles would not be supportable here. As OMS argued to the Presiding Judge, an upward adjustment of the Base ROE in reliance on Ms. Lapson's state ROE benchmark study would not compensate investors by an amount that is in any way linked to the risks that purportedly exceed those associated with distribution investments. Rather, it would simply confer on investors in transmission infrastructure a premium, but one that has no nexus to the risks it is meant to address.[147]

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[143] Exh. No. JCA-1 at 35:17–22.

[144] I.D. at PP 384-395.

[145] Exh. No. JCA-12 (Lapson response to Data Request JCA-MTO-1-101b.).

[146] The Initial Decision also found that the record lacked evidence showing that the MISO TOs are themselves integrated utilities. *See* I.D. at P 354. It necessarily follows that, to that extent, the record also would lack evidence that the MISO TOs and the integrated utilities analyzed by Ms. Lapson have similar or even comparable risk characteristics. The absence of such evidence would undercut the use of data drawn from Ms. Lapson's integrated company group as any sort of benchmark for evaluating a proposed Base ROE for the MISO TOs.

[147] OMS Reply Brief at 32.

Over-compensating investors for transmission risks is not without its own adverse impacts. In addition to exploiting consumers, over-compensation can be expected to pull too much capital toward transmission-build, thereby reducing the amount of capital available for other necessary electric infrastructure investments, including investments in needed new generation. The Commission should be extremely reluctant to go in that direction, especially considering the disquieting amount of generation expected to be retired in response to Federal and state environmental requirements, as well as the fact that transmission is not always or infinitely substitutable for new generation. For these reasons, the Initial Decision erred by relying on the MISO TO's state ROE evidence as a basis for increasing the MISO TOs' Base ROE above the DCF midpoint.

D. THE INITIAL DECISION ERRED BY FAILING TO ACCOUNT FOR THE RISK-MITIGATING EFFECT OF FORMULA RATES IN DETERMINING WHERE TO PLACE THE NEW BASE ROE.

The Commission has explained that in determining the ROE for public utilities, its evaluation of investment risk focuses on the two major sources of uncertainty to a company: the business risk and the financial risk. Business risk relates to the uncertainty of expected income flows to a company and may be viewed as a function of the variability in a company's operating income over time.[148] In general, a formulaic transmission rate allows a public utility to recover actual or projected costs charged to FERC accounts included in the formula without the need of filing successive FPA Section 205 rate change filings to fully recover its costs. Because the formula with its true-up provisions provides assurance that all costs that have been properly functionalized or allocated to transmission service will be recovered through rates, it greatly

[148] *See Generic Determination of Rate of Return on Common Equity for Electric Utilities,* 47 Federal Reserve. Reg. 38332-01, at 38,338-38339 (1982). Financial risk, on the other hand, is the uncertainty introduced by the methods a utility uses to finance its assets, and, in particular, the extent of leverage in its capital structure. *Id*.

mitigates the business risk (that is, uncertainty as to income flow and cost recovery) to which the public utility otherwise would be exposed.

In the proceedings before the Presiding Judge, OMS and others argued that Attachment O to the MISO tariff — a comprehensive formula transmission rate — substantially mitigates the business risk to which the MISO transmission owners are exposed, and that this reduction in risk must be considered and given effect in determining a just and reasonable return on equity for the MISO TOs.[149] The Initial Decision rejected those arguments, citing three reasons why the availability of formula rates should not be a factor in the ROE determination. Each of the three reasons relied upon by the Initial Decision is erroneous.

First, the Initial Decision appears to have adopted the MISO TOs' contention that formula rates are a double-edged sword: they eliminate the need for utilities to file rate cases when costs are increasing, but do not eliminate the risk of retroactive downward adjustments to rates when the formula has operated to over-recover costs.[150] Accordingly, the Initial Decision found that a utility with rising costs may benefit from a formula rate, but a utility whose costs are declining would benefit more from a stated rate (since, in the absence of a FPA Section 206 complaint, the stated rate would allow the company to recover more than its actual costs).[151]

That a utility with declining costs may fare better with a stated rate than a formula rate in no way undercuts the facts that: (i) formula rates provide an assurance of prompt cost recovery when costs are going up, and (ii) in so doing, formula rates greatly reduce the business risks to which a utility is exposed. To be sure, the inability to enjoy a windfall when costs are declining is not a factor that should be thought to balance out the mitigation of business risk formula rates

149 OMS Initial Brief at 34-35.
150 I.D. at P 446.
151 *Id.*

provide in an increasing-cost environment. In fact, as the Initial Decision seems to recognize,[152] regulated utilities have no entitlement to recover a penny more than their actual costs of service. For that reason, investors should have no expectation that the utility in which they invest may occasionally recover more than its actual, prudently incurred costs. Depriving a company and its investors of the opportunity to *over*-recover the company's costs when costs are declining cannot reasonably be considered a downside that offsets the clear benefits of prompt and complete cost recovery when costs are going up.

Second, the Initial Decision found that formula rates serve the "public interest" because they ensure that a utility earns no more and no less than its authorized base ROE.[153] This interest would be adversely affected, according to the Initial Decision, if Base ROEs were reduced to reflect the lower business risk faced by company with a formula rate.[154] The Initial Decision's finding in this regard misses the point that was argued by OMS and others because it focuses on the pros and cons of formula rates from the point of view of *utilities*, not from the perspective of *investors*. Investors care more about the certainty of cost recovery over time than they do about the opportunity for short-term windfalls. For that reason, investors require less of a return from companies that offer a certainty of cost recovery than they do from companies offering instead the remote chance for an occasional windfall.[155] By failing to give effect to this fact, the Initial Decision confers a Base ROE that is higher than the actual risk-adjusted cost of equity for companies with full-cost recovery formula rates.

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[152] *Id.*

[153] I.D. at P 447.

[154] I.D. at P 448.

[155] It is well-established in the financial literature that investors are generally "risk-averse." This means that the required return for an investment that has symmetric expectations of gains and losses is greater than the required return for an investment with certainty of no gains or losses.

Finally, in rejecting arguments for an ROE adjustment to reflect the availability of formula rates, the Initial Decision relies on the fact that "the Commission has recently ignored without comment contentions that it should reduce a utility's Base ROE based on its utilization of allegedly less risky formula rates." Initial Decision at P 445, citing *Potomac-Appalachian Transmission Highline, L.L.C.*, 122 FERC ¶ 61,188 (2008) ("*PATH*"). Obviously, the Commission's silence in *PATH* cannot be construed as a determination on the merits of the question. Indeed, the Commission made very clear in a more recent incarnation of the *PATH* proceedings that "silence is not evidence of Commission policy." *Potomac-Appalachian Transmission Highline, L.L.C.*, 153 FERC ¶ 61,308, P 13 (2015). Furthermore, in *PATH* and the other orders to which the Initial Decision alludes[156] (save one), the Commission declined to expressly recognize the risk-mitigating effects of formula rates in the context of considering ROE *incentives*, not in the context of determining a just and reasonable, properly risk-adjusted *Base* ROE. When the Commission grants ROE incentives, though, it is seeking to offset an entirely different set of risks than those it considers in establishing the Base ROE and to promote an entirely different public policy.[157] That the Commission did not expressly give effect to the risk-mitigating impact of formula rates in ROE adder cases says nothing about the ability of formula rates to mitigate the risks that are relevant in Base ROE cases (uncertainty of income flows). The only case cited in the Initial Decision[158] that specifically addressed a utility's Base ROE is *Virginia Electric & Power Company*, where the Commission reduced the requested

[156] I.D. at n. 570.

[157] For example, in granting an ROE adder to a transmission owner for joining an RTO, FERC seeks to offset the risks and uncertainties associated with turning over operational control of the transmission owner's assets to a third party (the RTO). In granting a project-specific ROE adder, FERC considers the particular risks and challenges of a project that are not already accounted for in Base ROE and are not susceptible to being mitigated through other incentives (such as CWIP or recovery of pre-commercial costs). On the other hand, when establishing the Base ROE of a public utility, the Commission focuses on business risks associated with the uncertainty of expected income flows to the company.

[158] I.D. at n. 570.

11.27 percent Base ROE to 10.9 percent without expressly addressing, one way or the other, the argument that formula rates mitigate risks.[159] Since (as noted) silence is not evidence of Commission policy, the Initial Decision's reliance on these orders is not well-founded.

In short, the Commission has *not* ruled that formula rates may not be considered in establishing the Base ROE of public utilities. In fact, in the Hearing Order, when discussing the risk mitigating effects of formula rates advocated by the Joint Consumer Advocates, FERC explained that "the amount of risk faced by a company contributes to the Commission's determination of its Base ROE"[160] For these reasons, the Commission should view the MISO TOs' use of the Attachment O formula rate as a risk-reducing factor that undercuts any claim that the Base ROE must be set above the midpoint of the zone of reasonableness. The Initial Decision's failure to give weight to this factor therefore was in error.

E. THE INITIAL DECISION ERRED IN FAILING TO TAKE INTO ACCOUNT THE FACT THAT MANY PROJECT SPECIFIC RISKS ARE ADDRESSED THROUGH THE COMMISSION'S TRANSMISSION RATE INCENTIVE POLICIES.

In proceedings before the Presiding Judge, the MISO TOs asserted that limiting their Base ROE to the DCF midpoint would make it difficult for them to fund new transmission projects due to the adverse impacts on their cash flows and credit ratings.[161] In response, OMS pointed out that the Commission, acting under authority of FPA Section 219, already provides transmission-building companies with a number of rate treatments and incentives — including CWIP, current recovery of project development costs, accelerated depreciation, assurance of recovering prudently incurred abandonment costs and ROE adders — that protect transmission

[159] *Virginia. Elec. & Power Co.*, 123 FERC ¶ 61,098, at P 58 (2008).
[160] Hearing Order at P 196.
[161] *See* I.D. at PP 463-470 and the MISO TO evidence discussed therein.

owners from adverse financial impacts during and after the completion of large construction projects.[162] On this basis, OMS argued that the Presiding Judge should give little or no weight to the MISO TOs' claims that setting the Base ROE higher than the midpoint is necessary for transmission infrastructure development.[163]

The Initial Decision rejects OMS' position but does so based on a misreading, or misapplication, of Commission precedent. Specifically, the Initial Decision interprets Opinion No. 531 as ruling that it is inappropriate to consider Section 219 incentives *in any way* when determining a Base ROE for transmission owners. As stated by the Presiding Judge, "[i]n Opinion No. 531, the Commission explained that incentives granted under FPA section 219 were irrelevant to the determination of Base ROEs."[164] After quoting at length from Paragraph 153 of Opinion No. 531, the Presiding Judge stated that "[t]he foregoing language makes clear that it would be inappropriate to consider incentives granted under FPA section 219 when determining whether to select the MISO TOs' Base ROE at the midpoint or Upper midpoint."[165]

The Initial Decision adopts and applies too broad a reading of Opinion No. 531, and, in so doing, fails to give weight to factors that cut against increasing the Base ROE to a level higher than the DCF midpoint. Above all, the Commission must allow a rate that is just and reasonable pursuant to the *Hope* and *Bluefield* standards. In doing so, the Commission should not allow the Base ROE to be increased above the midpoint of the DCF in order to account for risks that already are (or should be) addressed through project-specific transmission rate incentives. Indeed, as noted below, the MISO TOs themselves did not claim that a reduction of the ROE to the midpoint of the DCF would prevent them from attracting sufficient capital to be able to

[162] OMS Initial Brief at 28-32 and OMS Reply Brief at 37.
[163] OMS Initial Brief at 34 and OMS Reply Brief at 37-38.
[164] I.D. at P 378.
[165] *Id.*

discharge their public service obligations. But by arguing that project-related financial impacts are among the risks the Commission should consider in determining whether the Base ROE should be pegged at the midpoint or something higher, the MISO TOs assure themselves of securing a higher level of equity return than comports with *Hope* and *Bluefield*. And by adopting the overbroad reading of Opinion No. 531 that it does, the Initial Decision facilitates that result.

What the Commission did say in Opinion No. 531 is that, while FPA Section 219 gives FERC authority to provide incentives in addition to a just and reasonable Base ROE, nothing in in the statute relieves FERC from first setting the Base ROE at a level that meets the *Hope* and *Bluefield* standards.[166] With respect to these standards,[167] the Commission emphasized the purpose of the Base ROE to enable the utility to attract investments.[168] In other word, the Base ROE must allow the MISO TOs to *attract enough capital* to discharge its "public duties".[169]

As OMS pointed out in its briefs to the Presiding Judge,[170] the MISO TOs did not plead an inability to satisfy their franchised public service obligations if the Base ROE were reduced. In fact, the MISO TOs clearly stated that they would continue to invest capital in ensuring the provision of reliable service.[171] Rather, the MISO TOs' contention was that a reduction of the Base ROE would result in a greater focus on development of Baseline Reliability Projects and

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[166] Opinion No. 531 at P 153.

[167] Under the *Hope* and *Bluefield* standards, a utility's return is just and reasonable if it allows a utility to *attract enough capital* to discharge its public duties, and to *maintain and support its credit.* In addition, the return must be *comparable* to that of other business undertakings with similar risks and uncertainties. The comparability of risks is addressed through the appropriate selection of a proxy group. With respect to the ability to maintain credit, the MISO TO acknowledge that lower ROEs will not necessarily have direct impact on their credit ratings and that credit rating agencies frequently assert that they do not base their ratings (including upgrades and downgrades of existing ratings) on ROE decisions. *See* Exh. No. MTO-16 at 62:6-7. The core issue is, as the Commission pointed in Opinion No. 531, is whether the MISO TOs have the ability to attract capital to discharge their public duties.

[168] Opinion No. 531 at P 153.

[169] *Bluefield* at 693.

[170] OMS Initial Brief at 26-27.

[171] Exh. No. MTO-21 at 28:4-6.

other local projects in lieu of MEPs and MVPs that "present *greater risk* due to their larger scale, greater cost, broader scope, and greater likelihood of involvement by multiple owners and multiple state regulatory authorities."[172] The MISO TOs, however, have no public service obligation to build MVPs and MEPs because the selection of project developers for these types of projects is now conducted through a competitive process.[173] Further, the project-specific risks cited by the MISO TOs as possibly deterring investments in MVPs and MEPs can and should be addressed through applications for transmission rate incentives.[174] That is, to the extent a specific transmission project presents risk that exceeds the company-wide business and financial risk already addressed in Base ROE, the developer has the opportunity to demonstrate those higher risks to FERC and obtain project-specific transmission rate incentives mitigating such risks. Considering the same project-based risks in determining whether to increase the Base ROE above the DCF midpoint inarguably is a double-count. And, it should go without saying, compensating a utility for the same risk twice is neither just and reasonable nor consistent with *Hope* and *Bluefield*.[175] .

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[172] Exh. No. MTO-21 at 28:7-10. (Emphasis added).

[173] Section VIII of Attachment FF of the MISO Tariff.

[174] For example: (1) CWIP addresses timing issues associated with the recovery of financing costs for large transmission investments and allows recovery of a return on construction costs during the construction period rather than delaying cost recovery until the plant is placed into service; (2) recovery of 100 percent pre-commercial costs that are not otherwise included in CWIP improves early stage project cash flows; (3) accelerated depreciation allows a utility to depreciate a new transmission facility over a period of time shorter than the expected service life of the facility enabling faster recovery of a capital investment; (4) recovery of 100 percent of prudently incurred costs of projects that are cancelled or abandoned for reasons beyond the developer's control. With respect to this incentive ameliorates risks associated with the scope and size of a project, and with various federal and state siting approvals; and (5) ROE adders address any other risks not accounted for in Base ROE or mitigated through risk-mitigating incentives.

[175] The Initial Decision (at P 477) also states that OMS did not prove that MVPs and MEPs are riskier-than-usual projects. OMS, however, need not prove the higher risks of MVPs and MEPs because it is the premise of the MISO TOs' contention that investors will not put capital in these projects if the Base ROE is lowered. *See* Exh. No. MTO-21 at 28:8. Moreover, there is evidence in the record discussing the riskier nature of MVP projects. *See, e.g.,* Exh. No. OMS-2 at 32-33.

The Initial Decision also attributes to OMS a concern about whether the costs of MVPs are fairly allocated, and then states that ratemaking issues of that nature are outside the scope of the proceeding.[176] The Initial Decision thereby reveals a fundamental misunderstanding of OMS' point. The issue is not one of how the costs of MVPs or any other projects are allocated. The issue is whether the purpose of setting the level of the Base ROE should be to address project-specific risks that the Commission can and should address on a focused case-by-case basis through FPA Section 219 incentives. As noted, the outcome of setting a Base ROE above the midpoint to compensate for the higher risks of a new transmission project is to over-compensate the transmission owner, not only because the risk may already be addressed through a FPA Section 219 incentive, but also because the higher-than-midpoint ROE applies to existing transmission as well as the new project. From either perspective, the result is a consumer-funded windfall for transmission owners, and an impermissible tilting of the *Hope* and *Bluefield* balance toward rewarding investors and away from protecting consumers against exploitation. For all these reasons, the Initial Decision's finding that reducing the Base ROE to the midpoint of the zone of reasonableness would undermine the ability of the MISO TOs to attract capital for new projects[177] is erroneous and unsupported by record evidence.

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[176] I.D. at P 477.

[177] I.D. at P 478.

V.
CONCLUSION

WHEREFORE, for the reasons set forth above, OMS respectfully requests that the Commission reverse the Initial Decision issued in this proceeding with respect to the erroneous findings discussed herein and enter findings consistent with the positions supported by OMS above and in the record.

Respectfully submitted,

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Dated: January 21, 2016

Attachment 1

Partial Correction of Exhibit No. MTO-29

RISK PREMIUM - FERC ROE

HISTORICAL BOND YIELDS

		5.90%
Current Equity Risk Premium		
(a)	Average Yield Over Study Period	5.90%
(b)	Baa Utility Bond Yield - Historical	4.55%
	Change in Bond Yield	-1.35%
(c)	Risk Premium/Interest Rate Relationship	-0.6197
	Adjustment to Average Risk Premium	0.84%
(a)	Average Risk Premium over Study Period	4.55%
	Adjusted Risk Premium	**5.39%**

Implied Cost of Equity

(b)	Baa Utility Bond Yield - Historical	4.55%
	Adjusted Equity Risk Premium	5.39%
	Risk Premium Cost of Equity	**9.94%**

(a) See Partial Correction of Exhibit No. MTO-29, p. 3.
(b) Six-month average yield for Aug. 2014 - Jan. 2015 based on data from Moody's Investors Service, www.moodys.credittrends.com.
(c) See Partial Correction of Exhibit No. MTO-29, p. 6.

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Page 2 of Exhibit No. MTO-29
was based on projected bond yields, and was
rejected in the Docket No. EL14-12 Initial Decision, P 257

RISK PREMIUM - FERC ROE

IMPLIED RISK PREMIUM

Year	(a) Average Base ROE	(b) BBB Utility Bond Yield	Risk Premium
2006	10.89%	6.32%	4.57%
2007	10.96%	6.33%	4.63%
2008	10.64%	7.25%	3.39%
2009	10.85%	7.06%	3.79%
2010	10.44%	5.98%	4.46%
2011	10.38%	5.57%	4.82%
2012	10.25%	4.86%	5.40%
2013	9.78%	4.98%	4.79%
2014	9.89%	4.80%	5.09%
		5.90%	4.55%

(a) Partial Correction of Exhibit No. MTO-29, pp. 4-5.
(b) Moody's Investors Service, www.credittrends.com.

ALLOWED ROE

Date	Docket No.	Utility	Base ROE	
Apr-06	ER05-515	Baltimore Gas & Elec.	10.80%	
Apr-06	ER05-515	Baltimore Gas & Elec.	11.30%	
Oct-06	ER04-157	Bangor Hydro-Elec. Co.	11.14%	
Oct-06	ER04-157	Bangor Hydro-Elec. Co.	10.40%	Refund-period Base ROE (before 10-yr Treasury Yield trending)
Nov-06	ER05-925	Westar Energy Inc.	10.80%	
May-07	ER07-284	San Diego Gas & Elec.	11.35%	
Aug-07	ER06-787	Idaho Power Co.	10.70%	
Sep-07	ER06-1320	Wisconsin Elec. Pwr. Co.	11.00%	
Nov-07	ER08-10	Pepco Holdings, Inc.	10.80%	
Jan-08	ER07-583	Commonwealth Edison Co.	11.00%	
Feb-08	ER08-374	Atlantic Path 15	9.94%	Predetermined base; median of DCF array referenced in Order
Mar-08	ER08-396	Westar Energy Inc.	10.80%	
Mar-08	ER08-413	Startrans IO, LLC	9.71%	Predetermined base; median of DCF array referenced in Order
Apr-08	EL05-19	Southwestern Public Service	9.33%	
Apr-08	EL05-19	Southwestern Public Service	9.27%	Refund-period Base ROE also established in Opinion 501
Apr-08	ER08-92	Virginia Elec. & Power Co.	10.90%	
May-08	EL06-109	Duquesne Light Co.	10.90%	
Jun-08	ER07-549	NSTAR Elec. Co.	10.90%	
Jul-08	ER07-562	Trans-Allegheny	11.20%	
Jul-08	ER07-1142	Arizona Public Service Co.	10.75%	
Aug-08	ER08-1207	Virginia Elec. & Power Co.	10.90%	
Aug-08	ER08-686	Pepco Holdings, Inc.	11.80%	Median of Deficiency Letter Response DCF, See Order P 116
Sep-08	ER08-1233	Public Service Elec. & Gas	11.18%	
Oct-08	ER08-1423	Pepco Holdings, Inc.	10.80%	
Oct-08	EL08-74	Central Maine Power Co.		Predetermined base, found in ER04-157 and already accounted for above
Oct-08	ER08-1402	Duquesne Light Co.		Predetermined base; Order based on fresh DCF analysis but its median not transparent
Nov-08	ER08-1548	Northeast Utils Service Co.		Predetermined base, found in ER04-157 and already accounted for above
Nov-08	EL08-77	Central Maine Power Co.		Predetermined base, found in ER04-157 and already accounted for above
Dec-08	ER09-14	NSTAR Elec. Co.		Predetermined base, found in ER04-157 and already accounted for above
Dec-08	ER09-35/36	Tallgrass / Prairie Wind	10.80%	
Dec-08	ER07-694	New England Pwr. Co.		Predetermined base, found in ER04-157 and already accounted for above
Feb-09	ER08-1584	Black Hills Power Co.	10.80%	
Mar-09	ER09-75	Pioneer Transmission	10.54%	
Mar-09	ER09-548	ITC Great Plains	10.66%	
Mar-09	ER09-249	Public Service Elec. & Gas		Predetermined 11.18% -- found in 2008, not 2009, and already accounted for above
Apr-09	ER09-681	Green Power Express	10.78%	
May-09	ER09-745	Baltimore Gas & Elec.		Predetermined base; Order based on fresh DCF analysis but its median not transparent
Jun-09	ER08-552	Niagara Mohawk Pwr. Co.	11.00%	
Jun-09	ER07-1069	AEP - SPP Zone	10.70%	
Jun-09	ER08-1457	PPL Elec. Utilities Corp.	11.10%	
Jun-09	ER08-1457	PPL Elec. Utilities Corp.	11.14%	
Jun-09	ER08-1457	PPL Elec. Utilities Corp.	11.18%	
Jun-09	ER08-281	Oklahoma Gas & Elec.	10.60%	

ALLOWED ROE

Date	Docket No.	Utility	Base ROE	
Aug-09	ER07-1344	Westar Energy Inc.	10.80%	
Nov-09	ER08-1588	Kentucky Utilities Co.	11.00%	
Nov-09	ER09-1762	Westar Energy Inc.	10.80%	
Dec-09	ER08-313	Southwestern Pub. Serv. Co.	10.77%	
Jan-10	ER09-628	National Grid Generation LLC	10.75%	
Apr-10	ER08-375	So. Cal Edison (a)	9.54%	MTOs' dating to Jul-08 inconsistent with other study data points
Oct-10	ER08-1329	AEP - PJM Zone	10.99%	
Dec-10	ER10-230	Kansas City Power & Light Co.	10.60%	
Dec-10	ER11-1952	So. Cal Edison	10.30%	
Feb-11	ER11-2377	Northern Pass Transmission	10.40%	
Apr-11	ER10-355	AEP Transcos - PJM	10.99%	
Apr-11	ER10-355	AEP Transcos - SPP	10.70%	
May-11	EL10-80	Ameren		12.38% at issue in EL14-12 and determined in 2002, not 2011
May-11	EL11-13	Atlantic Grid Operations	10.09%	
Jun-11	ER11-3352	PJM & PSE&G		Predetermined 11.18% -- found in 2008, not 2011, and already accounted for above
Aug-11	ER10-992	Northern States Power Co.	10.20%	
Oct-11	ER10-1377	No. States Power Co. (MN)	10.40%	
Oct-11	ER11-2895	Duke Energy Carolinas	10.20%	
Oct-11	ER11-4069	RITELine	9.93%	
Oct-11	ER10-516	South Carolina Elec. & Gas	10.55%	
Dec-11	ER12-296	PJM & PSE&G		Predetermined 11.18% -- found in 2008, not 2011, and already accounted for above
Feb-12	ER08-386	PATH	10.40%	
Apr-12	ER09-187	So. Cal Edison (b)	10.04%	MTOs' dating to Aug-09 inconsistent with other study data points
Apr-12	ER10-160	So. Cal Edison (c)	10.33%	MTOs' dating to Sep-10 inconsistent with other study data points
Jun-12	ER11-2853	Public Service Co. of Colorado	10.10%	
Jun-12	ER11-2853	Public Service Co. of Colorado	10.40%	
Jun-12	ER12-1593	DATC Midwest Holdings		12.38% at issue in EL14-12 and determined in 2002, not 2012
May-13	ER12-778	Puget Sound Energy	9.80%	
May-13	ER12-778	Puget Sound Energy-PSANI		10.30% settled ROE for PSANI project was in nature of a project-specific incentive adder
May-13	ER11-3643	PacifiCorp	9.80%	
May-13	ER11-2560	Entergy Arkansas	10.20%	
May-13	ER12-2554	Transource Missouri	9.80%	
Jun-13	ER12-2681	ITC Holdings		12.38% at issue in EL14-12 and determined in 2002, not 2013
Aug-13	ER12-1650	Maine Public Service Co.	9.75%	
Nov-13	ER11-3697	So. Cal Edison	9.30%	
May-14	ER13-941	San Diego Gas & Electric	9.55%	
May-14	ER14-1608	Public Service Electric & Gas		Predetermined 11.18% -- found in 2008, not 2014, and already accounted for above
Jun-14	EL11-66	Bangor Hydro-Elec. Co.	10.57%	Conservatively retained, but appeal pending and based partly on risk premium, so circular
Oct-14	ER12-1589	Public Service Co. of Colorado	9.72%	
Oct-14	EL13-86	Public Service Co. of Colorado	9.72%	

(a) Order issued April 15, 2010, with ROE applied for March 1, 2008 through December 31, 2008.
(b) Order issued April 19, 2012, with ROE applied for January 1, 2009 through May 31, 2010.
(c) Order issued April 19, 2012, with ROE applied for June 1, 2010 through December 31, 2010.

RISK PREMIUM - FERC ROE

REGRESSION RESULTS

SUMMARY OUTPUT

Regression Statistics	
Multiple R	0.91870
R Square	0.84402
Adjusted R Square	0.82173
Standard Error	0.00262
Observations	9

ANOVA

	df	*SS*	*MS*	*F*	*Significance F*
Regression	1	0.000260	0.000259937	37.87620439	0.000465545
Residual	7	0.000048	6.86279E-06		
Total	8	0.000308			

	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*	*Lower 95.0%*	*Upper 95.0%*
Intercept	0.08208	0.00601	13.66168194	2.65143E-06	0.06787	0.09628	0.06787	0.09628
X Variable 1	-0.61967	0.10069	-6.154364662	0.000465545	-0.85777	-0.38158	-0.85777	-0.38158

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary of the Federal Energy Regulatory Commission in this proceeding.

Dated at Washington, D.C. this 21st day of January, 2016.

/s/ filed electronically

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