UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Arkansas Electric Cooperative Corp., *et al.*,	)	
Complainants,	)	
	)	
v.	)	Docket No. EL15-45-000
	)	
ALLETE, Inc., *et al.*,	)	
Respondents	)	

BRIEF ON EXCEPTIONS
OF
ORGANIZATION OF MISO STATES
AND
JOINT CONSUMER ADVOCATES

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GLOSSARY

Abbreviation	Full Term
ATC	American Transmission Company
Base ROE	ROE prior to application of ROE-increasing incentives
CAPEX	Capital Expenditure
CAPM	Capital Asset Pricing Model
CAPs	Complainant-Aligned Parties
COE	Cost of Equity
CWIP	Construction Work in Progress
DCF	Discounted Cash Flow
DJUA	Dow Jones Utility Average
FERC	Federal Energy Regulatory Commission
FPA	Federal Power Act
IBES	Thompson Reuters' Institutional Brokers' Estimate System
ICG	Industrial Customer Groups
I.D.	The Initial Decision in this proceeding (EL15-45-000)
JCA	Joint Consumer Advocates
JCI	Joint Customer Complainants
MEPs	Market Efficiency Projects
MISO	Midcontinent Independent System Operator
MISO TOs	MISO Transmission Owners
MOMS	Missouri-Mississippi Parties
MVPs	Multi-Value Projects
OMS	Organization of MISO States
QE2	Federal Reserve Second Quantitative Easing Program
ROE	Return on Equity
RPG	Resale Power Group of Iowa
RRA	Regulatory Research Associates
S&P	Standard & Poor's
SOMA	System Open Market Account
Staff	Commission Trial Staff

TO	Transmission Owner
Tr.	Hearing Transcript[1]
U.S.	United States
Value Line	Value Line Investment Survey

[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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BRIEF ON EXCEPTIONS
OF
ORGANIZATION OF MISO STATES
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JOINT CONSUMER ADVOCATES

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] and Joint Consumer Advocates ("JCA") hereby submit this Brief on Exceptions to the Initial Decision issued in the above-captioned proceeding on June 30, 2016, *Arkansas Electric Cooperative Corp., et al. v. ALLETE, Inc., et al.*, 155 FERC ¶ 63,030 (2016) ("Initial Decision" or "I.D.").

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[2] OMS files this Brief on Exceptions because it is consistent with the policy positions approved by a majority of its Board of Directors. The Manitoba Public Utilities Board, the Wisconsin Public Service Commission, and the Louisiana Public Service Commission abstained. Nothing in this Initial Brief should be read as assertions or arguments by state Commission members of OMS applicable to state ROE proceedings. Individual state commissions have their own proceedings and applicable precedent guiding state ROE determinations.

I. STATEMENT OF THE CASE

On February 12, 2015, the Joint Customer Complainants ("JCI" or "Complainants")[3] filed a complaint against the MISO TOs contending that the current 12.2 percent Base ROE for American Transmission Company ("ATC") and the 12.38 percent Base ROE for other MISO TOs are unjust and unreasonable. Based on information available at the time, JCI further contended that the Base ROE should instead be set at no higher than 8.67 percent.[4] In addition, JCI requested that this complaint proceeding be consolidated with an earlier complaint proceeding challenging the current Base ROE for the MISO TOs in Docket No. EL14-12-002.

By Order dated June 18, 2015, FERC set the merits of JCI's complaint for investigation and trial-type hearing under Section 206 of the Federal Power Act ("FPA").[5] FERC set a refund effective date of February 12, 2015 for JCI's complaint in this proceeding, whereas a refund effective date of November 12, 2013 was established in the earlier complaint proceeding in Docket No. EL14-12-002.[6] FERC left the decision of whether to consolidate these proceedings to the Chief Administrative Law Judge and, by Order dated June 24, 2015, the Chief Administrative Law Judge denied JCI's request to consolidate proceedings.

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[3] The Joint Customer Complainants are Arkansas Electric Cooperative Corporation, Mississippi Delta Energy Agency, Clarksdale Public Utilities Commission of the City of Clarksdale (Mississippi), Public Service Commission of Yazoo City of the City of Yazoo City (Mississippi), and Hoosier Energy Rural Electric Cooperative, Inc.

[4] *See Arkansas Electric Cooperative Corp., et al. v. ALLETE, Inc., et al.*, 151 FERC ¶ 61,219, at P 1 (2015)

[5] 16 U.S.C. § 824e (2012).

[6] *See Association of Businesses Advocating Tariff Equity, et al. v. Midcontinent Independent System Operator, Inc., et al.*, 148 FERC ¶ 61,049, at P 1 (2014) ("*ABATE*"), *order on reh'g*, 156 FERC¶ 61,060 (2016) ("*ABATE Rehearing Order*").

An evidentiary hearing was conducted from February 16 through February 22, 2016. On June 30, 2016, the Honorable David H. Coffman, Presiding Administrative Law Judge, issued the Initial Decision in this proceeding.

In the Initial Decision, the Presiding Judge found that the Complainants met their burden of proof, under FPA Section 206, by demonstrating that the current 12.38 percent Base ROE of the MISO TOs and ATC's 12.2 percent Base ROE are no longer just and reasonable. In determining the just and reasonable Base ROE to apply prospectively, the Presiding Judge first found that during the Discounted Cash Flow ("DCF") study period in the case (*i.e.*, July 1, 2015 through December 31, 2015), there was cause for concern that the inputs to a DCF analysis of the MISO TOs' cost of equity may be distorted by anomalous capital market 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*[7] and *Bluefield*[8] 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"), which he determined to be 9.70 percent.[9] Notably, the Initial Decision's DCF analysis uses short-term growth data from Thompson Reuters' Institutional Brokers' Estimate System ("IBES"), rather than the Value Line short-term growth data advocated by the MISO TOs.

In placing the MISO TOs' Base ROE at the Upper Midpoint, the Initial Decision relies on the results of: (1) three alternative pricing studies submitted by the MISO TOs (*i.e.*, Mr. McKenzie's risk premium analysis, Capital Asset Pricing Model ("CAPM"), and expected

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

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

[9] I.D. at PP 2 and 698.

earning analysis), (2) a study of State-Authorized ROEs submitted by the MISO TOs (*i.e.*, Ms. Lapson's State-Authorized ROE study), and (3) the State-Authorized ROEs for distribution-only utilities.[10] The Presiding Judge, however, declined to account for the risk reducing attributes of formula rates[11] and certain capital structures[12] in deciding to place the Base ROE at the Upper Midpoint. Similarly, the Presiding Judge declined to rule on whether the higher risks of certain types of transmission projects should be accounted for in determining the Base ROE, or rather, should be considered by the Commission on a case-by-case basis.[13]

II. SUMMARY OF ARGUMENT

The key findings underlying the Initial Decision's adoption of the 9.70 percent Base ROE are in error because they are not supported by record evidence and lack reasoned analysis of conflicting evidence. Specifically, the finding that capital market conditions were "anomalous" during the study period relies on the fact that yields and interest rates were similar in the study period of this case to those existing during the EL11-66 study period,[14] while ignoring the duration of those conditions and the impact of such persistent conditions on investors' expectations. The Initial Decision also relies on evidence of the supposed "artificiality" of low long-term bond yields due to Federal Reserve actions,[15] while ignoring evidence that: (1) Federal Reserve actions are not the sole or primary driver of capital market conditions, (2) Federal Reserve accommodative policies are unlikely to change given global market conditions, and (3)

[10] I.D. at P 39.
[11] I.D. at P 684.
[12] I.D. at P 693.
[13] I.D. at P 633.
[14] I.D. at PP 123-124.
[15] I.D. at P 125.

investors had information during the study period that capital market conditions could remain the same for a long time.

Having reached the erroneous conclusion that anomalous capital market conditions during the study period could have rendered the inputs to the DCF analysis unrepresentative,[16] the Initial Decision then considered the results of four flawed alternative ROE methods, filed by MISO TOs' witnesses Mr. McKenzie and Ms. Lapson. Notably, the Initial Decision finds that potentially unrepresentative inputs to the DCF analysis warrant consideration of alternative benchmarks regardless of whether capital market conditions are found to be anomalous,[17] which is inconsistent with FERC precedent.[18] As OMS and JCA explain below, Mr. McKenzie's risk premium analysis inappropriately relies on cases where FERC specifically declined to determine whether the stated Base ROE was just and reasonable, thereby skewing upwards the cost of equity he calculated in this analysis. Mr. McKenzie's CAPM study inflates the implied cost of equity by: (1) including only short-term growth rates, thereby assuming (in effect) that growth at the short-term rates would continue forever; and (2) using an unnecessary size adjustment. [19] Mr. McKenzie's CAPM is also flawed because it uses a self-calculated market risk premium of 8.8 percent rather than the 6.2 percent risk premium independently calculated and published by Morningstar.[20] Mr. McKenzie's expected earnings analysis cannot be relied on as a benchmark for the cost of equity of the MISO TOs because it does not reflect market expectations of

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16 I.D. at P 72.

17 I.D. at P 62.

18 *Martha Coakley, Massachusetts Attorney Gen., et al. v. Bangor Hydro-Elec. Co., et al.*, Opinion No. 531, 147 FERC ¶ 61,234 at P 145 (2014) (finding that it was appropriate to look at evidence of alternative benchmarks because capital market conditions were anomalous.), *on paper hearing*, Opinion No. 531-A, 149 FERC ¶ 61,032 (2014), *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.*

19 RPG-9 at 34-36 and ICG-15 at 41-42.

20 JCA-14 at 29-46.

investors; rather it perpetuates an expectation based on approved ROEs. Finally, Ms. Lapson's State-Authorized ROE analysis is undermined by its reliance on stale data and failure to: (1) take into account the downward trend in State-Authorized ROEs depicted in Ms. Lapson's own materials; (2) undertake a logically defensible comparison of the risks of investing in distribution and transmission infrastructure, as indicated by Opinion No. 531; and (3) account for the differences between State and FERC regulatory practices resulting in: (i) state ROEs actually earned being frequently lower than State-Authorized ROEs, or (ii) state commissions increasing the authorized ROE as a result of taking into account risks associated with state ratemaking practices (*e.g.*, regulatory lag) and/or other risks not pertaining to distribution investments (*e.g.*, generation risks).

In light of these errors, it must be concluded that the Initial Decision's finding that a 9.70 percent Base ROE for the MISO TOs is just and reasonable is not supported by substantial evidence in the record, as the Administrative Procedure Act requires. Rather than adopting the 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 arising from the Presiding Judge's determination that a Base ROE at the Upper Midpoint of 9.70 percent is necessary to satisfy the *Hope* and *Bluefield* standards.

If the Commission were to adopt the Initial Decision's finding that capital market conditions during the study period were anomalous, it should not rely on the MISO TOs' flawed benchmarks to determine whether the inputs to the DCF analysis were representative of the MISO TOs' cost of equity. The Commission should instead consider evidence of the risk-mitigating attributes of formula rates and certain capital structures. Finally, the Commission should clarify that the purpose of the Base ROE is not to address the greater risks of certain transmission projects, but rather to account for general transmission risks. On this basis, the Commission should find that there is no evidence that anomalous conditions have rendered the inputs to the DCF model unrepresentative and place the Base ROE at the Midpoint of the DCF range.

Finally, if the Commission finds that not only were capital market conditions anomalous, but also that those conditions rendered the inputs to the DCF analysis unrepresentative of the MISO TOs' cost of equity, it should clarify that the Commission is not bound to either the midpoint or the Upper Midpoint of the DCF range as the only reasonable benchmarks for placement of the Base ROE. The Commission has the ability to place the Base ROE at any point within the zone of reasonableness that meets the *Hope* and *Bluefield* standards based on the evidence in the record.

III. 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 and JCA submit the following exceptions to the Initial Decision:

1. The Initial Decision's findings that anomalous capital market conditions existed during the DCF study period and that such anomalies rendered the inputs to the DCF analysis

unrepresentative (I.D. at PP 72, 128, 134, 144, 152, 153, 160, 170, 267 and 308) are erroneous and unsupported by record evidence. *See* section V.A, *infra.*

2. The Initial Decision's reliance on Mr. McKenzie's flawed benchmarks (I.D. at PP 39, 391, 473 and 515) is erroneous and unsupported by record evidence. *See* section V.B *infra*.

3. The Initial Decision's reliance on Ms. Lapson's flawed State-Authorized ROE analysis (I.D. at PP 39, 610, 611 and 612) is in error and unsupported by record evidence. *See* section V.B, *infra.*

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 (I.D. at PP 634 and 635) is erroneous and unsupported by record evidence. *See* section V.C, *infra.*

5. The Initial Decision's failure to account for the risk-reducing attributes of formula rates (I.D. at P 684) is in error, contrary to FERC precedent, and in violation of the *Hope* and *Bluefield* requirements. *See* section V.D, *infra.*

6. The Initial Decision's failure to account for the risk-reducing attributes of certain capital structures (I.D. at P 692) is in error and violates *Hope* and *Bluefield* requirements. *See* section V.E, *infra.*

7. The Initial Decision's rejection without explanation of arguments that evidence and cross-examination of the MISO TOs' witness outside of the study period should have been admitted and allowed (I.D. at P 697) is in error, contrary to FERC precedent, and violates fundamental principles of due process. *See* section V.F, *infra.*

8. The Initial Decision's ruling that upon finding that anomalous capital market conditions rendered DCF inputs unrepresentative the Base ROE must be set at the Upper Midpoint (I.D. at P 696) is in error and violates the *Hope* and *Bluefield* standards. *See* section V.G, *infra.*

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

Various findings of the Initial Decision depart from Commission policy or require clarification of the Commission's policies for future ROE proceedings.

1. The Initial Decision finds evidence of anomalous capital market conditions in the fact that during the study period, 10-year U.S. Treasury bonds yields averaged below 2.21 percent and, in Opinion No. 531, the Commission expressed concern about bond yields below 3 percent.[21] This finding establishes a presumption that average bond yields below 3 percent during any study period is evidence of a market anomaly regardless of the duration of such low yields. As such, the validity of the Commission's DCF methodology will be at issue in every ROE proceeding for as long as low yields persist, even though U.S. Treasury yields have been low for the past four years and there is evidence that they may remain low for a prolonged period of time. The Commission should clarify that Opinion No. 531, *et al.*, did not intend to set a presumption that yields below 3 percent are evidence of market anomaly.
2. The Initial Decision finds evidence of anomalous capital market conditions in the "artificiality" of the long-term bond yields due to Federal Reserve actions.[22] Such finding presumes that Federal Reserve actions are the primary driver of capital market conditions,

[21] I.D at P 123.
[22] I.D. at P 125.

while ignoring significant evidence in the record that many other factors and drivers impact capital market conditions and even offset Federal Reserve actions. In Opinion No. 531, the Commission did not specifically find that the Federal Reserve Quantitative Easing program (or the impact of expected termination of such program) caused the market anomaly. The Commission simply relied on a general consensus in the EL11-66 proceeding that market conditions were anomalous.[23] In this proceeding, the Commission should reject the notion that Federal Reserve actions necessarily rendered capital market conditions anomalous. Rather, the Commission should look at all the evidence in the record discussing the impact of inflation outlooks, new debt issuance by the Federal Government, international trends, as well as the opinions of reputable economists describing current market conditions as a new normal.[24] Indeed, particularly now that approximately four years have passed since the DCF study period in the EL11-66 proceeding without a substantial rise in interest rates or yields on U.S. Treasury Bonds and the Chair of the Board of Governors of the Federal Reserve System herself has begun using the phrase "new normal,"[25] we respectfully submit that it would be unreasonable for the Commission to continue deviating from its general policy of setting the Base ROE at the midpoint of the DCF range and instead placing it at the Upper Midpoint, to the detriment of consumers.

3. The Initial Decision draws a distinction between long-term DCF Investors (*i.e.,* investors that care about the growth of utilities and their financial integrity)[26] and short-term Yield

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23 Opinion No. 531 at P 145.

24 S*ee infra* discussion at Section V.A.3).

25 *See* n.76, *infra.*

26 I.D. at P 142.

Investors (*i.e.*, investors that care only about current yield).[27] On the basis of such distinction, the Initial Decision defines "cost of equity" as the return necessary to attract DCF Investors.[28] Such definition of cost of equity has no basis in Commission or court precedent and has the potential of perpetuating litigation because it requires evidence of subjective motivations of individual investors leading them to act against their own expectations (in this case, namely the purported expectation that interest rates would increase). Furthermore, it conflicts with the Commission's two-part DCF methodology. If the Commission were to link the attraction of capital standard of *Hope* and *Bluefield* exclusively to DCF Investors, then the DCF methodology should only account for long-term growth projections or at least weight such long-term growth projections more than one third. The Commission, therefore, should reject the Initial Decision's distinction between DCF Investors and Yield Investors as well as its definition of cost of equity.

4. The Initial Decision finds that the risks of investing in integrated utilities are equivalent to the risks of investing in the MISO TOs[29] and, on that basis, accepts Ms. Lapson's State-Authorized ROE study for integrated utilities as a benchmark justifying placement of the Base ROE at the Upper Midpoint.[30] The record does not support a finding that the MISO TOs have equal risks to those of integrated utilities. Moreover, even if there was such evidence, using a comparison of the MISO TOs' risks with the risks of other utilities with "equal" risk-profiles to justify placing the Base ROE ***above*** the midpoint of the DCF range

[27] I.D. at P 144.
[28] I.D. at P 247.
[29] I.D. at P 547.
[30] I.D. at P 610.

violates the *Hope* and *Bluefield* requirements to balance the interests of investors and consumers.

5. The Initial Decision finds that there is a public interest in utilities' use of formula rates (because they ensure that utilities don't over or under recover) and rules that this interest would be contravened by recognizing the risk-reducing attributes of formula rates in determining the placement of the Base ROE.[31] This finding is not supported by record evidence or Commission precedent and, indeed, contravenes Commission precedent stating that the risk-reducing attributes of formula rates may be considered in Base ROE proceedings.[32] Further, the Initial Decision ignores the fact that investors are risk-adverse and place greater value on a utility having little to no risk of under-recovery than on a utility's potential for over-recovery. The Commission should take into account the record evidence regarding the risk-mitigating attributes of formula rates and reject the Initial Decision finding that the use of formula rates is in the public interest.

6. The Initial Decision declines to address the issue of whether it is appropriate to account for the higher risk of certain transmission projects in setting the Base ROE or whether those risks should be addressed by the Commission on a case-by-case basis in Section 219 proceedings.[33] The Initial Decisions finds, however, that the size of the ROE reduction from the current Base ROE to the midpoint is sufficient to support a finding that placing the Base ROE at the midpoint of the DCF range could undermine the MISO TOs' ability to attract capital for new projects.[34] The Commission should clarify that the purpose of the Base ROE

[31] I.D. at PP 650-652.

[32] *Midcontinent Indep. Sys. Operator, Inc.*, 154 FERC ¶ 61,004, P 36 (2016).

[33] I.D. at P 633.

[34] I.D. at PP 634-635.

is not to address the higher risks of certain transmission projects, and reject the notion that the size of the drop by itself is sufficient evidence that placing the Base ROE at the midpoint of the DCF range will in fact undermine the ability to attract capital for new transmission investment.

7. The Initial Decision finds that if the midpoint of the DCF range does not meet the *Hope* and *Bluefield* requirements, the Base ROE must be placed at the Upper Midpoint.[35] The Commission should reject the presumption that the Base ROE must be placed at the Upper Midpoint and clarify that it is not bound by a binary placement of the Base ROE (either at the midpoint or the Upper Midpoint) because its mandate is to set a just and reasonable Base ROE that meets the *Hope* and *Bluefield* requirements, wherever that point is within the DCF zone of reasonableness.

V. <u>ARGUMENT</u>

A. THE INITIAL DECISION'S FINDINGS WITH REGARD TO "ANOMALOUS" CAPITAL MARKET CONDITIONS DURING THE STUDY PERIOD ARE NOT SUPPORTED BY THE RECORD EVIDENCE.

One of the key litigated points in this proceeding is whether capital market conditions were "anomalous" during the DCF study period. The MISO TOs claimed that capital market conditions during the DCF study period were similar to those considered "anomalous" in Opinion No. 531, and that the midpoint of the range produced by the Commission's DCF method therefore would not reflect their true cost of equity. Notwithstanding the evidence offered by Trial Staff and Complainants-Aligned Parties ("CAPs"), the Initial Decision finds "cause for concern" that during the study period, anomalous capital market conditions "may have rendered

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[35] I.D. at PP 694-696.

financial inputs into the DCF model unrepresentative."[36] This equivocal finding forms the basis for the Initial Decision's determination to place the Base ROE at the Upper Midpoint (*i.e.*, 9.70%) rather than relying on the midpoint of the range itself (*i.e.*, 8.72%). Yet, even this hedged and equivocal finding—which has enormous implications for the magnitude of costs that consumers in the MISO region ultimately will bear through rates—is contradicted by the record evidence and for that reason, is in error. OMS and JCA support the exceptions to this finding filed by CAPs in a separate brief. In addition, OMS and JCA wish to highlight certain erroneous aspects of this finding that, if allowed to stand by the Commission, could operate to seriously compromise the analytical integrity of ROE determinations in future proceedings.

1) The Initial Decision errs in establishing a lower burden of proof for participants that claim market conditions are anomalous than for participants that claim capital market conditions are normal.

The Initial Decision establishes that the burden of proof for parties claiming that capital market conditions are anomalous is to "demonstrate the existence of reasonable cause for concern that the financial inputs into the DCF analysis in this proceeding are unrepresentative."[37] The Initial Decision further finds that once such "cause for concern" has been established, participants contesting the claim of anomalous market conditions must present "compelling evidence" that the examination of alternative benchmarks is not warranted.[38] These rulings concerning the burden of proof have no support in Commission precedent or the law and, for that reason, are in error.

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[36] I.D. at P 72.

[37] I.D. at P 68.

[38] I.D. at P 170.

In Opinion No. 531, the Commission expressed a concern that anomalous capital market conditions in the record made the Commission "less confident" that the midpoint of the DCF range would reflect the equity returns necessary to meet the *Hope* and *Bluefield* capital attraction standards.[39] This does not mean, however, that the burden of proof to show the existence of "anomalous" capital market conditions is merely to demonstrate a "cause for concern" that DCF inputs may be distorted. In fact, reliance on Opinion No. 531 on this basis is misplaced because the existence of anomalous capital market conditions was not a contested issue in the EL11-66 case. The Commission just took as a fact the existence of such anomalous conditions[40] and as a result of these anomalous conditions decided to look at other evidence beyond the DCF analysis "to gain insight into the potential impacts of these unusual capital market conditions on the appropriateness of using the resulting midpoint."[41] Placing the Base ROE above the midpoint of the DCF range is a departure from long-standing FERC precedent, however. The Commission therefore should impose a more demanding standard than the conjectural standard applied by the Initial Decision. In OMS's and JCA's view, parties seeking a deviation from FERC precedent should be required to demonstrate through substantial evidence that rates based on the midpoint of the DCF range would be unjust and unreasonable, and to propose and support the smallest adjustment to the midpoint that is necessary to render the rates just and reasonable. Movement to what the Initial Decision calls the "Upper Midpoint" as the default adjustment is unwarranted and unlawful where a smaller adjustment would satisfy the *Hope* and *Bluefield* standards.

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39 Opinion No. 531 at P 145.

40 *Id.* stating that "[p]arties on both sides of the instant ROE issue argue that the unique capital market conditions have impacted the level of equity return the NETOs' require to meet the capital attraction standards of *Hope* and *Bluefield*."

41 *Id.*

Parties supporting the placement of the ROE at the midpoint of the DCF range need only show that the midpoint of the DCF range is just and reasonable, not offer "compelling evidence" that the DCF inputs are not distorted and that there is no need for examination of alternative benchmarks. Requiring Complainants and supporting intervenors to prove a negative is inconsistent with the FPA's assignment of evidentiary burdens and is contrary to the Presiding Judge's own ruling in the EL14-12 case where he indicated that "[t]o require the Non-Utility Participants to establish that these conditions do not exist would be improper, because it would require these participants to establish a negative."[42] Here, the Complainants have met their burden of proof under Section 206 by showing that the current Base ROE of the MISO TOs is unjust and unreasonable.[43] Although not required to do so under Section 206,[44] Complainants also offered the median or the midpoint of their DCF range as just and reasonable replacement rates.[45] Asking the Complainants and supporting intervenors to provide "compelling evidence" to refute the MISO TOs' alternative benchmarks is inappropriate. The Commission did not establish in Opinion No. 531 a presumption that the benchmarks and underlying methodologies relied on in that case are appropriate for consideration in all future ROE proceedings. Complainants and supporting intervenors have a right to challenge those benchmarks anew, without the need to overcome any presumption that such benchmarks are acceptable or to offer "compelling evidence" showing that the Commission was wrong to accept those benchmarks in Opinion No. 531.

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[42] *Association of Businesses Advocating Tariff Equity, et al. v. Midcontinent Indep. Sys. Operator, Inc*., 153 FERC ¶ 63,027 at P 122 (2015) (citing *National Motor Freight Traffic Ass'n v. United States*, 242 F. Supp. 601, 605 (D.C. 1965).

[43] I.D. at P 59.

[44] *FirstEnergy Service Co. v. F.E.R.C.*, 758 F.3d 346, 353 (2014).

[45] JCI-1 at 12:9-17.

2) The Initial Decision errs in failing to give weight to the significant differences between the record in this proceeding and the record in EL11-66.

The MISO TOs' principal argument to support the existence of anomalous capital market conditions is that conditions have not changed since the record in EL11-66 (supporting the Commission's ruling in Opinion No. 531, *et al.).*[46] The Initial Decision essentially adopts this view and errs by not giving appropriate weight to evidence showing important differences between the record in this proceeding and the record in EL11-66.

a) Lack of Consensus.

One of the significant distinctions between the record in this proceeding and the record in the EL11-66 proceeding is that, while in Opinion No. 531 the Commission found consensus among participants that capital market conditions were anomalous,[47] in this proceeding there is no such consensus. The Initial Decision finds this lack of consensus to "mean[] only that the participants will have to argue that issue."[48] This understanding of Opinion No. 531, however, understates the significance of the consensus in the EL11-66 proceeding. Because it appears that all parties in EL11-66 agreed that capital market conditions were anomalous, the Commission did not have to assess any record evidence disproving Ms. Lapson's theories about the drivers of market conditions and their impact on the DCF analysis. As such, Opinion No. 531 cannot be considered as: (1) establishing precedent as to what factors or indicators are determinative of whether capital market conditions are anomalous in other litigated ROE proceedings; or (2) establishing a conclusive presumption that, if interest rates or bond yields are in the same range as the levels extant during the Opinion No. 531 study period, market conditions remain

[46] MTO-16 at 16.
[47] Opinion No. 531 at P 145.
[48] I.D. at P 177.

"anomalous." This is essentially what the Initial Decision did, however. Based on findings in Opinion No. 531 at P 145 and n.285,[49] the Initial Decision identifies the 2.21 percent average yield on 10-year U.S. Treasury bonds as proof of the continuation of anomalous capital market conditions. But the fact that such yields were considered to be sign of a market anomaly in Opinion No. 531,[50] does not mean that the Commission intended to establish a presumption in future ROE proceedings whereby yields on 10-year U.S. Treasury bonds below 3 percent would automatically be evidence of anomalous conditions. The Commission should reject any interpretation of Opinion No. 531 in the Initial Decision that results in establishing a bright-line test defining anomalous conditions without consideration of time and other economic factors.

b) <u>End of Quantitative Easing Program.</u>

In the EL11-66 proceeding, the New England TOs argued that, after termination of the Federal Reserve's second Quantitative Easing program ("QE2"), interest rates would rise to more "normal" levels and bond levels would increase.[51] Ms. Lapson testified in the EL11-66 proceeding that "the current market environment is historically quite unusual, volatile, and unlikely to persist in the current extreme situation for long."[52] She made that assertion on November 20, 2012. Yet, contrary to that assertion, the record in this proceeding shows that interest rates have remained low and bond yields have not gone up significantly, even though the Federal Reserve ended its QE2 in October 2014.[53]

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49 I.D. at P 123.

50 Opinion No. 531 at n. 285.

51 Opinion No. 531 at P 130.

52 OMS-24 at 36:3-5.

53 JCI-4 at 38-39; MTO-16 at 16, table 1.

The end of the Quantitative Easing program did not materially affect capital market conditions. The aftermath of QE2's end is important for at least two reasons. First, it highlights that Federal Reserve actions do not have the direct and significant impact on capital market conditions that the MISO TOs claim. If the MISO TOs' analytical perspective were correct, one would have expected a significant jump in bond yields or large scale portfolio rebalancing to follow the end of QE2, but (as the record shows) it simply never happened. Second, because the capital markets' response was essentially a yawn, the aftermath of QE2's end highlights Ms. Lapson's poor track record in predicting the effect of such events. In other words, when coupled with earlier failed predictions of investor behavior (discussed below), it fits into a pattern of inaccuracies in Ms. Lapson's testimony that calls into question her testimony in this docket about equity investors' expectations.[54] The Initial Decision dismisses the relevance of this distinction, stating that "the Commission did not ground its finding that anomalous capital-market conditions existed on the likelihood of interest rates rising in the near future,"[55] and on that basis, rejected arguments that cited Ms. Lapson's prior testimony in an effort to impeach her testimony in this proceeding.[56] The Commission, however, should consider evidence of Ms. Lapson's prior testimony in the EL11-66 proceeding and in the EL12-14 proceeding, and, on that basis: (1) give no weight to her testimony in this proceeding, and (2) reject the Initial Decision's finding that long-term bond yields during the Study Period were "artificially" low (due to the Federal

[54] *See* CAPs Initial Brief at 52-58. On March 24, 2016, the Complainant-Aligned Parties submitted for filing both a Public Version and a Protected Version of their Initial Brief in this proceeding. Any reference to the "CAPs Initial Brief" herein is to the Public Version (Accession No. 20160324-5175).

[55] I.D. at P 215.

[56] I.D. at P 314.

Reserve policies) and that such "artificiality" is evidence of anomalous capital market conditions.[57]

c) Evidence of Secular Trends.

Another important difference between the record in this proceeding and the record in EL11-66 is that the evidence in this proceeding shows that low bond yields are not anomalous, but rather they are consistent with long-term economic cycles.[58] The Initial Decision rejected the notion that low bond yields in the study period are part of an economic cycle or a downward secular trend since the 1980s, finding that the 53.1 percent drop in average yields between 2007 and 2015 was "appreciably larger than during the eight-year period ending prior to 2008".[59] The Initial Decision, however, misses the point. OMS's and JCA's position is that low bond yields are not unusual or anomalous; they existed in the past, they exist now, and they will exist again in the future as part of macroeconomic cycles of considerable duration. For example, the record shows that following the Great Depression of the 1930s, bond yields gradually fell for a period of 13 years, reaching a low of 3.03 percent in 1946. This cycle was followed by a cycle of increases in bond yields, peaking at 16.6 percent in 1981. Since then, bond yields have been consistently falling.[60] The fact that the drop in bond yields accelerated in recent years does not take away the fact that bond yields have been consistently falling since the 1980s or belie the existence of these cycles.

57 I.D. at 125.
58 S-2, Schedule 2.
59 I.D. at P 183.
60 S-2, Schedule 2.

3) The Initial Decisions errs by placing undue importance on the impact of Federal Reserve policies on prevailing economic conditions.

The Initial Decision finds that the "artificiality" of long-term bond yields due to Federal Reserve actions is evidence of anomalous capital market conditions.[61] Such finding is in error because Federal Reserve policies alone do not dictate long-term bond prices and yields, nor do they dictate utility stock prices and dividend yields. There are many factors that shape and affect capital market conditions, of which the Federal Reserve's fiscal policies are but one.[62] And while the Federal Reserve's actions may influence long-term bond and utility stock prices and yields to some degree, the MISO TOs failed to demonstrate a direct cause-and-effect relationship between the two. The Commission therefore should reject the notion that the Federal Reserve's actions and policies created anomalous capital market conditions, or that the duration of any anomaly may be determined simply by examining the arc of the Federal Reserve's actions and policies.

The Initial Decision further errs by finding that CAPs' "sole support" for this point is a few statements by Ms. Lapson and an article by former Treasury Secretary, Dr. Lawrence Summers.[63] This finding is incorrect and simply shows that the Initial Decision failed to pay heed to persuasive evidence in the record showing that capital market conditions are not solely (or predominantly) driven by Federal Reserve actions—as the MISO TOs contend—but by an array of economic conditions. For example:

- Mr. Gorman explains in his Rebuttal Testimony that low yields on utility securities are largely driven by lower inflation outlooks (as opposed to Yield Investors seeking refuge

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[61] I.D. at P 125.

[62] *See, e.g.,* S-1 at 34-36 (discussing the role of the global economy on capital market conditions); JCI-4 at 42:15-18 (explaining that various domestic and international factors play a role in shaping capital market conditions); and ICG-15 at 23 (explaining the impact of inflation outlooks on interest rates).

[63] I.D. at 187.

in utility stock due to the Federal Reserve accommodative policies). He explains that inflation outlooks are a component of both the expected ROE and the expected return in utility bond yield. As a result, when inflation outlooks drop – all else being equal – returns on both utility debt and equity securities decrease. [64]

- Mr. Solomon discusses in his Rebuttal Testimony empirical evidence from Trial Staff showing that from September 30, 2008 to September 30, 2015, the total U.S. debt rose from $10 trillion to approximately $18.2 trillion, providing plenty of opportunity for the investors from whom the Federal Reserve purchased the $3.6 trillion securities to invest in other U.S. government high quality securities.[65]
- Besides Dr. Summers' article, Mr. Solomon further discusses comments by: (1) a Morgan Stanley strategist opining that interest rates follow levels of economic growth and that, because we are in an economic environment of lower growth, we should expect interest rates to also remain low;[66] (2) former Chairman of the Federal Reserve, Dr. Ben Bernanke, opining that low interest rates are not part of a short term aberration, but part of a long-term trend;[67] and (3) economist Dr. Paul Krugman opining that if interest rates were artificially low then inflation should have accelerated, but it has not.[68]

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[64] ICG-15 at 2, 23-26.
[65] JCI-4 at 48 (discussing S-1 at 149).
[66] *Id.* at 39.
[67] *Id.* at 40.
[68] *Id.* at 41-42.

- Mr. Hill discusses a report from Bloomberg Business, dated August 2015, indicating that interest rates would not rise appreciably with a reduction of the Federal Reserve System Open Market Account ("SOMA") holdings.[69]

The Initial Decision only addresses evidence from Dr. Summers' article and Ms. Lapson's admissions. The Initial Decision rejects evidence discussing Dr. Summers' opinion that real interest rates are expected to be close to zero for the next decade[70] because it interprets Dr. Summers' words to refer to real short-term interest rates controlled by the Federal Reserve.[71] Even if that reading of Dr. Summers' statements were correct, the evidence remains pertinent because it proves that, during the study period, investors had access to an opinion by a prestigious economist stating that interest rates will remain low for the next decade. The Initial Decision also rejects CAPs' interpretation of each of Ms. Lapson's assertions on this point.[72] However, Ms. Lapson's assertions (whatever weight the Commission may afford them) simply emphasize that not even the MISO TOs can hold on to the theory that Federal Reserve actions/inactions predominantly or solely drive capital market conditions and continue to render them anomalous.

Finally, it is important to note that Opinion No. 531 did not establish a direct cause-and-effect nexus between Federal Reserve actions and the capital market conditions the parties in that case deemed anomalous. Neither, to our knowledge, has the Commission ever done so, nor should it do so here for the reasons explained above.

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[69] JCA-14 at 77-78.

[70] JCI-4 at 41

[71] I.D. at P 200.

[72] I.D. at PP 188-197.

4) The Initial Decision errs by failing to give appropriate weight to the persistence of low-yield capital market conditions.

Market conditions that have lasted for four years and are expected to continue in the foreseeable future are not anomalous. The I.D. errs in finding that the duration of the purported anomaly is irrelevant, just as it errs in reading Opinion No. 531 to say that the only pertinent factor is whether current yields are in the range of pre-2008 yields.[73] The Commission should reject such a narrow interpretation of its ruling in Opinion No. 531.

Duration matters when considering whether a set of market conditions are anomalous, especially where investor expectations play such an important role in the determination. The first definition of "anomalous" given by the Merriam-Webster online dictionary is "inconsistent with or deviating from what is usual, normal, or expected"[74] Market conditions that have lasted for almost four years cannot be perceived by investors as unusual or abnormal; particularly, when there is no expectation that such conditions are temporary and will change in the near future. The Initial Decision, however, recognizes that investors had information during the study period indicating that interest rates will remain low in the foreseeable future and that any increase in interest rates will be gradual.[75] Without an expectation that persistent market conditions will change markedly in the near future, there can be no "anomaly." There is, instead, a renewed state of ***market equilibrium at a lower level*** **–** or, in the recent words of Federal Reserve Chair Yellen, a "new normal."[76] The Commission should take public notice of these remarks of Chair Yellen,

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[73] I.D. at P 217.

[74] *See* OMS-25.

[75] I.D. at P 191.

[76] *See* Transcript of Chair Yellen's Press Conference dated June 15, 2016 at: https://www.federalreserve.gov/monetarypolicy/fomcpresconf20160615.htm (stating that the factors causing the neutral rate (*i.e*,. the level of federal funds rate that is consistent with the economy growing roughly at trend and operating near full employment) to be low in a historical context are not going to be rapidly disappearing but will

published by a sister agency, which confirm Mr. Hill's testimony and his interpretation of Dr. Summers', Dr. Bernanke's and other prominent economists' opinions regarding the expected long-term duration of current capital market conditions.

The Initial Decision adopts the MISO TOs' theory that investors expect that, at some undefined point in the future, the Federal Reserve will fully normalize its policies and that, once some (also undefined) level of normalization has been achieved,[77] "Yield Investors" will divest their utility stock holdings.[78] At that juncture, we presume, even Ms. Lapson would declare the anomaly at an end. But the reality is that market conditions change constantly—a fact that investors certainly realize—and it is unreasonable to think investors adjust their holdings for every expectation of a market change. The expectation must be compelling (*e.g.*, an imminent and substantial change in conditions) before investors will incur the risk and expense of reallocating their holdings. So, even if it could be shown that investors believe the Federal Reserve's "normalization" of monetary policy ***someday*** will have a sufficient impact on yields to incent the divestment of utility stock, that expectation is irrelevant to investment decisions now and in the foreseeable future because: (1) no one can know in advance when that change will happen, and (2) investors (as the record demonstrates) do not expect it to happen any time soon. Again, the duration of market conditions matters.

be part of a "new normal.") *See also* Bloomberg Article titled "Yellen Says Forces Holding Down Rates May Be Long lasting" at: http://www.bloomberg.com/news/articles/2016-06-15/yellen-seems-to-sign-on-to-summers-view-of-lingering-low-rates (interpreting Chair Yellen's new normal theory as an agreement with Dr. Summers' position that current capital market conditions will be long-lasting, which Mr. Hill discusses in his testimony and the Initial Decision rejects at PP 187, 198-203.)

[77] Tr. 267:22-25 (McKenzie describing Federal Reserve fund rates of 3 percent as normal); Tr. 268:10-14 (McKenzie describing 4-700 million as levels of SOMA holdings that the MISO TOs could consider normal).

[78] I.D. at PP 144-148.

In OMS's and JCA's view, both the persistence of low bond yields and investors' expectation that low yields will continue for the foreseeable future are factors which belie the notion that low yields are an anomaly that renders conventional DCF results unreliable. The Initial Decision, however, erred in rejecting CAPs' argument in this regard, stating that (1) "[t]he likelihood that current low yields will continue for some period in the future does not make them any less anomalous, at least as the Commission appears to be using that term"[79] and (2) "[m]ore importantly, in Opinion No. 531, the Commission expressed concern that the current anomalously low yields might reflect capital-market conditions that could affect the DCF analysis. Neither the continued persistence of such yields nor the likelihood of their continuation renders that concern any less valid."[80]

What the Initial Decision fails to recognize is this: the fact that interest rates and dividend yields are low only means that ***the cost to electric utilities of raising capital (debt and equity) is low***. It does not necessarily mean that market conditions are "anomalous" or that the inputs to the DCF analyses are distorted and unreliable. In fact, the Presiding Judge's reading of Opinion No. 531 would reject all conventional DCF results until some undefined point in the future when "Yield Investors" become satisfied with short-term bond yields, thus causing them to stop buying utility stock as a substitute and thereby stop "artificially" depressing the yield of utility stocks. Specifically, the I.D. at P 153 states:

> One additional point needs to be made. Record evidence creating cause for concern that Yield Investors may be determining the price of utility stocks justifies examination of alternative metrics ***regardless of whether the capital-market conditions out of which the behavior would have arisen are deemed anomalous.*** The

[79] I.D. at P 217.

[80] I.D. at P 218 (citing Opinion No. 531 at P 145 and n. 285).

> likelihood of such investor behavior erodes confidence in the reliability of the DCF model in any economic climate. [Emphasis added.]

The Initial Decision's view of the matter goes far beyond anything the Commission itself has ever suggested and, indeed, the Initial Decision directly conflicts with Commission precedent in at least two respects: (1) it demotes the DCF method to the same standing as the various other methods the Commission has declined to adopt over the years, and in so doing ignores the Commission's long-standing preference for the DCF analysis;[81] and (2) it suggests that alternative benchmarks should be used to test the validity of the DCF analysis ***regardless*** of market conditions (at least for as long as there are "Yield Investors"), which is inconsistent with the Commission's more limited view (as stated in Opinion No. 531, *et al.*[82]) of the role alternative benchmarks should play in ROE determinations. The Initial Decision's overly expansive view of the role of benchmarks should be rejected.

5) The Initial Decision errs by drawing a distinction between "Yield Investors" and "DCF Investors" unsupported by evidence or FERC precedent.

The Initial Decision errs by drawing a distinction between "Yield Investors" (*i.e.*, investors that purportedly care only about yield)[83] and DCF Investors (*i.e.*, investors that care about growth and as such about the financial integrity of the utility).[84] The premise of such distinction is the theory that, by keeping the yields on Treasury bonds low, the Federal Reserve forces yield-seeking investors to take refuge in utility equities, and that these investors (1) are driving up utility stock prices and pushing down stock yields; and (2) will stop using utility stocks as a substitute yield vehicle as soon as the normalization of Federal Reserve fiscal policy

[81] Opinion No. 531 at 146; *Tenn. Gas Pipeline Co. v. FERC*, 926 F.2d 1206, 1211 (D.C. Cir. 1991).

[82] Opinion No. 531 at PP 145-150; Opinion No. 531-B at PP 37, 49 and 98.

[83] I.D. at P 144.

[84] I.D. at P 142.

causes bond yields to rebound. The problem with the Initial Decision's analysis is that the distinction between "Yield Investors" and "DCF Investors" is a fiction. Neither the Commission nor the Courts have drawn this distinction, nor is there evidence in the record to support it. In fact, it is unclear what type of evidence might have proved: (1) the subjective motivations of a group of investors as distinguishable from the subjective motivations of other investors, (2) the proportion of Yield Investors and DCF Investors in every utility's stock, (3) that such proportion of Yield Investors was sufficient to drive the price of utility stock up, and (4) that the increase of utility stock price caused by Yield Investors was sufficient to cause DCF Investors to lose confidence in the financial integrity of utilities in the proxy group.

On the flip side, there is abundant record evidence that *disproves* the existence of Yield Investors by showing that: (1) there was no significant movement into utility equities during the height of the Federal Reserve's accommodative actions (when the Federal Reserve was loading up the SOMA with Treasury bills and mortgage-backed securities);[85] (2) utility stock prices have not been bid up to artificial levels;[86] (3) stock dividend yields are not abnormally low;[87] (4) yields on short-term investments did not increase (which would have been the expected result if investments moved away from short-term instruments);[88] and (5) as the Federal Reserve began to "normalize" its monetary policy in late 2015, investors were *buying* utility stocks rather than selling them (as the "Yield Investor" notion predicts they would do).[89]

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85 *See* CAPs Initial Brief at 69-70.

86 *Id.* at 70-73.

87 *Id.* at 73.

88 *Id.* at 74.

89 JCI-4 at 35, Figure 4.

Even if there were empirical evidence in the record (which there is nott) showing that implementation of the Federal Reserve's accommodative policies caused investors to load up on utility equities thereby driving their prices up, accepting the existence of Yield Investors would be contrary to the Commission's long standing policy of relying on investors' expectations when determining the Base ROE of utilities. This is because the purported existence of Yield Investors relies on the premise that such investors purchased utility stocks seeking a higher yield even though the jump in interest rates they supposedly anticipated[90] would depress the price of those stocks. In other words, the Yield Investors would act against their purported expectations.

In the end, the only basis for the purported distinction between "Yield Investors" and "DCF Investors" is the testimony of the MISO TOs' witness Ms. Lapson, which the Initial Decision exclusively cites as support for key findings.[91] Troublingly, the Initial Decision treats Ms. Lapson's testimony as inherently more credible than the testimony of every one of the "Non-Utility Participant" expert witnesses—including the Commission Trial Staff's expert witness—whose credentials are every bit as sound as Ms. Lapson's.[92] In doing so, the Initial Decision overlooks the fact that most of Ms. Lapson's professional experience is on the credit side of the business, not the equity side. [93] The Initial Decision also repeatedly goes out of its way to patch

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[90] I.D. at P 231 (citing to Ms. Lapson's MTO-16 at 21, Figure 2; Mr. McKenzie discusses same Figure 2 at MTO-1 at 22-23.)

[91] I.D. at PP 88, 162-169, 339-341.

[92] *See, e.g.*, I.D. at PP 83-84 (stating that Ms. Lapson's experience "sets Ms. Lapson apart from the Non-Utility Participant witnesses" and describing Ms. Lapson as "uniquely qualified to discuss issues of risk and investor behavior in the utilities sector"). The Initial Decision made these findings without discussing the background and experience of the individual Non-Utility Participant witnesses or comparing their qualifications to Ms. Lapson's.

[93] Tr. 515:9-14; OMS-19; OMS-20; and OMS-21.

holes in Ms. Lapson's testimony,[94] even at one point offering "[w]hat she should have said" in lieu of what she actually said during a testimonial "stumble" in another proceeding.[95] At the same time, the Initial Decision summarily and systematically rejects the testimony and empirical evidence presented by CAPs and Trial Staff.[96] On exceptions, the Commission should carefully evaluate all the evidence in the record and avoid placing excessive reliance on the opinions and conclusions of a single witness, especially where the implications for consumers in the MISO region are so great.

Finally, the Commission should consider the implications for future ROE proceedings of adopting the fictional distinction between "Yield Investors" and "DCF Investors" and letting its rulings be guided by the behavior or purported motivations of either group. Setting aside the obvious evidentiary challenges, the level of subjectivity it would inject into the Commission's ROE determinations could do nothing other than increase the prospects for long and costly ROE litigation. The Commission emphasized its policy of moving away from subjective judgements

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94 *See, e.g.*, I.D. at P 332 (reconciling discrepancy between Ms. Lapson's testimony in different proceedings); P 326 (dismissing an asserted inconsistency between what Ms. Lapson predicted would occur following a Federal Reserve interest rate increase and what actually occurred, based on the wholly unsupported finding that the magnitude of the increase was insufficient to trigger the changes Ms. Lapson had described), and P 277 (responding to arguments that Ms. Lapson's testimony regarding investor behavior was largely anecdotal, and stating that during Ms. Lapson's career "she surely would have developed contacts with valuable expertise" and that "the information she has obtained from those contacts [has] … considerable value").

95 I.D. at P 342. Similarly, *see* P 288 (recognizing Staff's observation that Ms. Lapson admitted she did not know the total volume of long-term debt securities available currently or in 2012 as "valid", but minimizing the admission with the unsupported finding that "it is reasonable to conclude that taking over $2.38 trillion of such securities out of circulation would have materially affected long-term interest rates and that that effect would have persisted into the Study Period.").

96 *See, e.g.,* I.D. at P 343 (accusing CAPs of "false disparagement" of Ms. Lapson, and stating that CAPs' "mischaracterizations of her testimony and of other parts of the record do them little credit"), P 309 (stating that CAPs' efforts to impeach Ms. Lapson's testimony "diminish the credibility of the CAPs"), P 327 (charging that CAPs "mischaracterize or fail to understand Ms. Lapson's testimony"), P 291 (stating that CAPs "seem to forget that transactions involve sellers as well as buyers"), P 330 (stating that CAPs' contention is "flatly false"), P 322 (referring to CAPs' "misleading assertion"); and P 337 (stating that CAPs "oversimplify Ms. Lapson's testimony").

in setting rates.[97] Drawing a distinction between Yield Investors and DCF Investors would be a step in the opposite direction.

6) The Initial Decision errs by defining the Cost of Equity as the return required to attract capital from DCF investors.

Mr. Parcell and Mr. Keyton explained that low interest rates, low yields and low rates of inflation indicate a lower COE.[98] The Initial Decision agrees that the COE is declining,[99] but found that low interest rates and low yields provide little guidance as to the level of COE in this proceeding.[100] According to the Initial Decision, *Hope* requires that the Base ROE be sufficient to attract capital from an investor demanding a return sufficient to assure the utility's financial integrity.[101] On this basis, the Initial Decision holds that the "cost of equity" is the rate of return that DCF Investors require when investing in a company.[102] This proposed definition of cost of equity is in error for at least two reasons. First, the record shows that the MISO TOs have the

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[97] *See e.g., Transcontinental Gas Pipe Line Corp.*, Opinion No. 414-A, 84 FERC ¶ 61,084 at 61,412 (1998) (ruling that judging the worthiness of a corporate parent's motivations and then establishing an appropriate capital structure based largely on that process involves a degree of subjectivity that is ill-suited to fulfilling the Commission's obligation to protect ratepayers through its ratemaking process), *petition for review denied,* D.C. Cir. 99-1037 (2000).

[98] RPG-1 at 12:1-15; S-1 at 23-27.

[99] I.D. at P 241.

[100] *Id.*

[101] I.D. at 135-137. Specifically the I.D. at P 136 finds that "*Hope* links "confidence in the financial integrity of the enterprise" to, as relevant here, the attraction of capital. If the Court had viewed the creation of confidence in the financial integrity of the enterprise, the maintenance of credit and the attraction of capital as three separate requirements, the Court could have deleted the phrase "***so as to***" and inserted the word "and" between "to maintain credit" and "to attract capital." By writing the sentence as it did, the Court required that the source of the attraction of capital be the confidence in the utility's financial integrity that is, in turn, brought about by the utility's Base ROE." (Emphasis added). The Initial Decision fails to recognize that Bluefield did not have the "so as to" language relied on by the Presiding Judge and, indeed, used the word "and" to separate the financial integrity from the credit and capital attraction requirements. *Bluefield* at 693 states: "[t]he return should be reasonably sufficient to assure confidence in the financial soundness of the utility ***and*** should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties." (Emphasis added).

[102] I.D. at 247.

ability to raise capital at low cost.[103] Such ability to attract capital at low cost maintains the financial integrity of a utility regardless of the type of investor that invests such capital. *Hope* and *Bluefield* do not draw a distinction between sources of capital. Indeed, Ms. Lapson admitted that *Hope* and *Bluefield* do not distinguish between short-term and long-term investors.[104] Second, if the cost of equity had to be set at a level sufficient to attract investors who value long-term dividend growth (*i.e.*, the DCF Investors),[105] then the two-stage DCF methodology would not weight the long-term growth factor by only one-third; it would weight it 100 percent and ignore the short-term growth rate. But that is not the case. For these reasons, the Commission should reject the Initial Decision's proposed definition of cost of equity.

B. THE INITIAL DECISION ERRONEOUSLY RELIES ON THE MISO TOS' FLAWED ALTERNATIVE BENCHMARKS.

Upon erroneously finding that anomalous capital market conditions rendered the financial inputs into the DCF model unrepresentative,[106] the Initial Decision considers the following alternative metrics to place the Base ROE at the Upper Midpoint of the DCF range: a risk-premium COE of 10.47 percent;[107] an adjusted CAPM COE of 9.67 percent;[108] an expected earnings COE of 11.43 percent;[109] State-Authorized ROEs for integrated electric utilities with a Midpoint of 9.85 percent;[110] and State-Authorized ROEs for electric distribution utilities with a

[103] RPG-1 at 12:1-15, S-1 at 243-27.

[104] Tr. at 523:23-25, 524:1.

[105] I.D. at P 128.

[106] I.D. at P 72.

[107] I.D. at PP 348-391.

[108] I.D. at PP 392-474.

[109] I.D. at PP 475- 521.

[110] I.D. at PP 39 and 537. The midpoint listed in the I.D. for Ms. Lapson's State-Authorized ROEs for integrated utilities of 9.85 percent is taken from Ms. Lapson's testimony (MTO-43 at 11:9-11), but OMS and JCA respectfully submit that her midpoint is incorrect and, hence, the Initial Decision is also incorrect. The midpoint

Midpoint of 9.40 percent or 9.38 percent.[111] To the extent that the Commission adopts the Initial Decision's finding of anomalous capital market conditions, any benchmark or metric relied on to question the validity of the DCF analysis should be carefully scrutinized, not presumed to: (i) be correct just because a similar benchmark was considered by the Commission in Opinion No. 531, *et al*., or (ii) require placement of the Base ROE at the Upper Midpoint. As further explained in this Brief and in the CAPs Brief on Exceptions, evidence in this proceeding shows that the benchmarks offered by Ms. Lapson and Mr. McKenzie—on which the Initial Decision relies—suffer significant flaws that require Commission rejection of those benchmarks.

At the onset, a general error in the Initial Decision is to establish a presumption that those alternative benchmarks considered by the Commission in Opinion No. 531 are the only appropriate benchmarks for consideration in this case and in future ROE proceedings.[112] The validity of those benchmarks was not as heavily litigated in the EL11-66 proceeding as it is in this case because the significance that the Commission placed on those benchmarks in Opinion No. 531, *et al.,* was unprecedented. As such, the Commission should look with fresh eyes at the

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of State-Authorized ROEs for integrated utilities (calculated using data from MTO-44 at 4) is instead 9.78 percent. To calculate a midpoint, the lowest value and highest value in a range of numbers are totaled, then divided by two. Using Ms. Lapson's data in this calculation, the equation is as follows: (9.30+10.25) ÷ 2 = 9.78.

[111] I.D. at PP 39 and 540. Notably, the I.D. at P 39 uses a midpoint for distribution-only utilities of 9.40, whereas the I.D. at P 540 uses a midpoint for distribution-only utilities of 9.38 percent. The I.D. is therefore inconsistent. To calculate a midpoint, the lowest value and highest value in a range of numbers are totaled, then divided by two. As shown in P 540 of the Initial Decision, the lowest value is 9.00 and the highest value is 9.75 and, when divided by two, this results in a midpoint of 9.375, which the Presiding Judge appeared to round up to 9.38. As the I.D. correctly points out, CAPs stated that the midpoint of the range of State-Authorized ROEs for distribution-only utilities was 9.48 percent (CAPs Initial Brief at 125), but such number reflects a typographical error that should have been 9.38 percent. The correct midpoint of the range of State-Authorized ROEs for distribution-only utilities is 9.38 percent as indicated in the I.D. at P 540 and will be the midpoint number used in this Brief going forward.

[112] *See, e.g.,* I.D. at P 391 (finding Mr. McKenzie's risk premium analysis is valid and substantially similar to that accepted in Opinion No. 531); I.D. at PP 473-474 (finding the Mr. McKenzie's CAPM analysis valid because in Opinion No. 531 the Commission found useful a CAPM analysis using identical format as that of McKenzie); I.D. at P 478(finding that Mr. McKenzie's expected earnings analysis is "identical in all material respects" to the analysis the Commission approved in Opinion No. 531); and I.D. at P 599 (finding that Ms. Lapson's testimony in this proceeding is "virtually identical" to the testimony she provided in the EL11-66 proceeding).

validity of the benchmarks accepted in the Initial Decision and consider the evidence in the record of this proceeding showing significant flaws in the data and methodologies used by Mr. McKenzie and Ms. Lapson.

1) The Initial Decision errs in finding that Ms. Lapson's State-Authorized ROE analysis supports placing the Base ROE above the midpoint of the DCF range.

The Initial Decision finds that Ms. Lapson's State-Authorized ROE study supports placing the MISO TOs' Base ROE above the midpoint of the DCF range.[113] This finding is in error because it inappropriately dismisses the following crucial flaws of Ms. Lapson's study: (1) it uses stale data and fails to account for the continuing downward trajectory in State-Authorized ROEs; (2) it fails to reflect the differences in return requirements associated with transmission service versus distribution service to reasonably address the concern expressed by the Commission in Opinion No. 531;[114] and (3) it fails to acknowledge regulatory lag and other differences in state v. FERC ratemaking practices.

a) <u>The Initial Decision errs by dismissing evidence on the downward trajectory of State-Authorized ROEs.</u>

Citing Opinion No. 531-B at P 86, the Initial Decision finds that the fact that the average State-Authorized ROE for the most recent period exceeds the DCF midpoint is more significant than the alleged downward movement of State-Authorized ROEs.[115] This finding is in error for several reasons. First, it questions the ability of the DCF midpoint to satisfy the *Hope* and *Bluefield* requirements any time the State-Authorized ROEs exceed the midpoint, regardless of the size of the differential. Not every differential between State-Authorized ROEs and the

[113] I.D. at P 610.
[114] Opinion No. 531 at P 149.
[115] I.D. at P 564.

midpoint of the DCF will place transmission utilities at a competitive disadvantage to attract capital. This is particularly true in this case because, as explained herein, Ms. Lapson's State-Authorized ROE data reflects the risks of integrated utilities, not simply distribution-only utilities. Second, allowing any difference between the State-Authorized ROEs and the midpoint to trigger an upward adjustment of the Base ROE is using the State-Authorized ROEs to set the Base ROE of FERC regulated utilities (not as a benchmark). Such approach is contrary to FERC precedent rejecting the use of State-Authorized ROEs to establish the Commission's Base ROE for public utilities.[116]

Finally, the Commission did not dismiss the downward trajectory of State-Authorized ROEs; rather, it simply found that the EL11-66 record lacked proof of such downward trajectory.[117] The Initial Decision finds that footnote 176 of Opinion No. 531—where the Commission stated that there was no evidence of a downward trajectory—is an aside, not a statement central to the Commission's ruling.[118] Such interpretation of the Commission decision is in error. Just because the Commission addressed the lack of evidence of a downward trajectory in the EL11-66 proceeding in a footnote, it does not mean that such footnote was not relevant in the Commission's decision-making process or that the Commission intended to completely disregard any evidence of a downward trajectory in future ROE proceedings. Indeed, it would be arbitrary and capricious for the Commission to ignore that evidence here.

In a rather inconsistent application of this determination that footnotes are not central to the Commission's decision, the Initial Decision heavily relies on footnote 285 of Opinion No.

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116 Opinion No. 531 at P 148, n 296.
117 Opinion No. 531-B at n.176.
118 I.D. at P 568.

531—stating that a U.S. Treasury bond yield below 3 percent is a sign of anomalous capital market conditions—in finding that capital market conditions are anomalous in this case.[119] The Initial Decision lacks reasoned explanation as to why footnote 285 of Opinion 531 is a central part of the Commission's decision-making, while footnote 176 of Opinion No. 531 is just a mere aside. This unexplained inconsistency renders the Initial Decision on this point arbitrary and capricious.

The downward trajectory of State-Authorized ROEs is clearly established in the record of this proceeding. The latest Regulatory Research Associates ("RRA") reports in the record here show that the average State-Authorized ROEs for the All-electric Group[120] was 10.01% in 2012, dropping to 9.79 percent in 2013, 9.76 percent in 2014, and 9.58 percent in 2015.[121] Even comparing the average State-Authorized ROE for All-electric utilities in Ms. Lapson's initial study (*i.e.*, 9.78 percent)[122] with the average State-Authorized ROE for All-electric utilities in her updated study (*i.e.*, 9.70 percent)[123] results in a ROE reduction of 8 basis points. If we use Ms. Lapson's data to determine the average ROE for distribution-only utilities in her initial study and her updated study,[124] and then compare the initial data with the updated data, there is a ROE reduction for distribution-only utilities of 4 basis points.

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119 *See, e.g.*, I.D. at P 123.

120 The All-Electric RRA Group includes State-Authorized ROEs for integrated utilities and distribution-only utilities.

121 *See, e.g.*, JCI-1 at 34, ICG-2, ICG-1 at 28:3-6, ICG-22 at 12-14, ICG-26, RPG-9 at 49-51.

122 MTO-19 at 5 (reporting on State- authorized ROEs decided between 7/1/2013 and 6/30/2015).

123 MTO 44 at 5 (reporting on State-Authorized ROEs decided between 1/1/2014 and 12/31/2015).

124 By comparing data for Integrated utilities (adjusted for Virginia decisions) and data for All-electric utilities (adjusted for Virginia decisions) in MTO-19 to determine which ROE decisions correspond to distribution-only utilities, and then average those ROE determinations for distribution-only utilities we obtain an average ROE for distribution-only of 9.43 percent. By following the same process with updated data in MTO-44 we obtain an average State-Authorized ROE for distribution-only utilities of 9.39 percent.

The downward trajectory is also clear when comparing the gaps between the midpoint of the DCF and State-Authorized ROE numbers in the EL11-66 proceeding and in this proceeding. The Initial Decision shows that 74 percent of the State-Authorized ROEs for distribution-only utilities in this proceeding are between 9 percent and 9.62 percent.[125] The difference or gap between the midpoint of the Initial Decision's DCF zone of reasonableness (8.72 percent), and: (i) the average State-Authorized ROE for distribution-only utilities (9.39 percent) is 67 basis points, (ii) the highest State-Authorized ROE in the subsection above (9.62 percent) is 90 basis points, and (iii) the lowest ROE number in the subsection above (9.0 percent) is 28 basis points. In Opinion No. 531, the Commission found relevant that over 85 percent of the state-approved ROEs in the record were between 9.8 percent and 10.74 percent.[126] The gap between the midpoint in the EL11-66 case (9.39 percent) and the: (i) average State-Authorized ROE in the record (10.24 percent)[127] was 85 basis points, (ii) the highest State-Authorized ROE in the subsection above (10.74 percent) was 135 basis points, and (iii) the lowest State-Authorized ROE in the subsection above (9.8 percent) was 41 basis points.

GAP	EL11-66	EL15-45
Differential between midpoint and average state ROE	85	67
Differential between midpoint and highest state ROE	135	90
Differential between midpoint and lowest state-ROE	41	28

In summary, the gap between the midpoint of the DCF range and the State-Authorized ROE data in EL11-66 is significantly larger than the gap between the midpoint and State-Authorized ROEs for distribution-only utilities in this proceeding. Particularly in view of the downward trajectory

[125] I.D. at P 540.
[126] Opinion No. 531 at P 148.
[127] Opinion No. 531-B at n. 176.

of State-Authorized ROEs, the Commission should not rely on a gap that is narrowing and may no longer be significant to deviate from its policy to set the Base ROE at the midpoint of the DCF range. Such downward trajectory also makes the Initial Decision's recommendation to set the Base ROE at the Upper Midpoint in reliance upon Ms. Lapson's State-Authorized ROE study unreasonable because Ms. Lapson used stale State ROE data that goes back two years and far precedes the study period in this proceeding.[128] It is important that the Commission use the most recent data in a State-Authorized ROE study, if such study is a benchmark for placing the Base ROE of the MISO TOs.

b) <u>The Initial Decision errs by interpreting Opinion No. 531 as setting a precedent that evidence of the difference between the mean, median and midpoint of State-Authorized ROEs and the Upper Midpoint is irrelevant.</u>

Citing Opinion No. 531-B at P 85 the Initial Decision finds that the relationship between the State-Authorized ROEs and the Upper Midpoint is not relevant and that all that is relevant is the relationship of those ROEs to the midpoint.[129] Such a narrow interpretation of Opinion No. 531 is in error because it ignores the underlying reasoning of the Commission, which was to make sure that the Base ROE complies with the *Hope* and *Bluefield* requirements. A gap between the Upper Midpoint and the state ROE data that shows over-compensation for transmission investment is not in compliance with the *Hope* and *Bluefield* requirement to balance the interests of customers and investors. It is, therefore, in error to interpret Opinion No. 531 as finding any gap between the DCF midpoint and the midpoint, mean and median of State-Authorized ROEs irrelevant.

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[128] *See, e.g.*, MTO-16 at 59:22.
[129] I.D. at PP 603- 604.

c) The Initial Decision errs by finding that comparing ROEs of companies with similar risks can be the basis for an upward adjustment of the DCF midpoint.

The Initial Decision finds the risks of investing in the MISO TOs' electric transmission and the risks of investing in integrated utilities to be equal.[130] Such finding goes beyond the risk comparability drawn in Opinion No. 531, *et al*. and is not supported by record evidence. In Opinion No. 531, the Commission sought to avoid a Base ROE that fell far below State-Authorized ROEs for distribution because the Commission believed that "transmission entails unique risks that state-regulated electric distribution does not."[131] The Commission stated that the "financial and business risks faced by investors in companies whose focus is electric transmission infrastructure differ in some key respects when compared to other electric infrastructure investment, particularly state-regulated electric distribution."[132] It then found that several factors increased "the NETOs' risk relative to state-regulated ***distribution*** companies"[133] and allowed the Base ROE to be set above the midpoint to prevent a competitive disadvantage in attracting capital for transmission versus distribution.[134]

The Initial Decision takes the Commission's risk comparability a step further and rules that the risks of investing in integrated utilities with generation assets are similar to the risks of investing in transmission utilities. To support this finding, the Initial Decision states that because the risks of investing in the MISO TOs are equivalent to the risks of investing in the DCF proxy

[130] I.D. at PP 547, 571.
[131] Opinion No. 531 at P 148.
[132] *Id.* at P 149.
[133] *Id.* (emphasis added)
[134] *Id.* at P 150.

group[135] and, in turn, the DCF proxy group serves as a reasonable representative for all integrated utilities,[136] it follows that the risks of investing in the MISO TOs are equivalent to the risks of investing in integrated electric utilities.[137]

As explained herein, there is no support in the record for such finding. In fact, the record supports a finding that the MISO TOs face lower investment risks than fully integrated utilities; and, in any event, accepting the Initial Decision's finding that the DCF proxy group represents the risks of integrated utilities would necessarily mean that the DCF midpoint represents the Base ROE required to invest in integrated utilities. Such a finding renders meaningless (for purposes of an adjustment above the midpoint) Ms. Lapson's State-Authorized ROE study showing ROEs for utilities with purportedly similarly situated risk exposure. The Commission must reject this finding and Ms. Lapson's State-Authorized ROE study in its entirety.

Although the RRA reports provide data on State-Authorized ROEs for ***distribution-only*** utilities, Ms. Lapson's study utilizes RRA data on: (i) State-Authorized ROEs for the ***integrated utilities*** group (*i.e.*, utilities with regulated power generation assets regulated on a cost of service basis, some of which may also have transmission assets), and (ii) State-Authorized ROEs for the ***all-electric utilities*** group (*i.e.*, both integrated and distribution-only utilities). 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 because, in her professional experience, the risks of electric transmission

[135] I.D. at PP 544-545 (relying on MTO-1 at 39:4-8).
[136] I.D. at P 546 (relying on JCA-1 at 41:5-8).
[137] I.D. at P 547.

ownership are either equivalent to, or somewhat greater than, those of fully-integrated electric utilities.[138]

The record in this proceeding shows that credit rating agencies conclude that MISO TOs present rather low business risk and lower risk than fully integrated electric utilities.[139] There is no credible evidence that contradicts this finding. As CAPs explained in its Initial Brief, contrary to Ms. Lapson's unsupported opinion, Mr. Hill offered evidence showing that transmission utilities bear lower risks than fully integrated utilities with generation assets, including several references to *S&P* and *Moody's* reports supporting his testimony.[140] Specifically,

(i) The Initial Decision dismisses the 2013 Moody's report cited by Mr. Hill (which states that, generally, integrated utilities have a higher level of business risk, due to higher risks in construction and operation of their generation component) because it interprets the report to not be applicable to FERC electric transmission.[141] Even if the report did not compare directly the risks of FERC transmission with those of integrated utilities, it is clear that the credit rating agency sees higher than normal risks in the operation and construction of generation assets. Significantly, the Initial Decision fails to address an April 2015 Moody's report included in the record describing FERC formula rates as a "material credit positive" because it is a ratemaking framework that is "more stable and predictable than state-regulated utility businesses."[142]

[138] MTO-16 at 60:21-22 and 61:1-3.
[139] CAPs Initial Brief at 142-144.
[140] JCA-1 at 41-42.
[141] I.D. at PP 578-581.
[142] JCA-14 at 64:1-5.

(ii) The Initial Decision rejects Mr. Hill's reliance on a 2011 *S&P*'s rating report on ITC (which states that transmission has lower technological and operational risk than generation) because it is four years old and it may not represent *S&P's* current view given the high levels of CAPEX of the MISO TOs included in the record.[143] The level of CAPEX of some MISO TOs described in the record is unlikely to change *S&P's* views of the risks of the entire transmission sector as compared to integrated utilities with generation assets, particularly, given that integrated utilities can also have high CAPEX due to the increasing need for investment in generation assets to address, for example, retirements, increased demand, *etc*.

(iii) The Initial Decision further dismisses Mr. Hill's reliance on another *S&P* report because – placing network businesses with low operating risk at the low end of the utility risk spectrum – the credit service does not say that all network businesses operate in this low risk environment.[144] Even if it could be established (although not supported in the record) that some network businesses have higher operational risks than others, still some of these network businesses are – according to *S&P* – in the low-end of the utility-risk spectrum. As such, Mr. Hill's evidence should not be completely dismissed.

The Commission should consider the implications in this and future ROE proceedings of a finding that integrated utilities with generation assets face risks equal to those of electric transmission. In particular, the Commission should carefully consider the impact of such finding on much needed generation investments with no guaranteed returns.

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[143] I.D. at P 575.

[144] I.D. at P 577.

Should the Commission find that the MISO TOs' risks are "similar" to those of Ms. Lapson's integrated utility group, it would not be just and reasonable to allow an upward adjustment of the Base ROE for the MISO TOs above the DCF midpoint using the State-Authorized ROEs of a group of utilities with similar risk profiles as a benchmark. Companies with similar risk profiles compete on an equal footing for capital in the marketplace. Setting the Base ROE above the midpoint of the DCF range on the basis of comparing Ms. Lapson's State-Authorized ROE data for integrated utilities with the risks of the MISO TOs 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 a premium on investors in transmission infrastructure—one that has no nexus to the risks a premium, such as a transmission rate incentive, is meant to address. The Commission should be reluctant to overcompensate investors for transmission risks. Such overcompensation results in unjust and unreasonable rates that exploit consumers in plain violation of the *Hope* and *Bluefield* standards.

Furthermore, state commissions typically have a statutory mandate to ensure reliability of retail services. If the Commission would not lower public utilities' Base ROE because the State-Authorized ROEs for integrated utilities are higher than the DCF midpoint and, in turn, the state commissions do not lower their ROEs because the Commission's Base ROE is significantly higher than the midpoint of their DCF analysis – creating a risk that state-regulated utilities are unable to attract necessary capital for distribution and generation investments – there is a risk of circular bias where neither the Commission-approved Base ROEs nor the State-Authorized ROEs reflect the reality of the capital market. Rather, they would reflect risk comparability based on each other's ROE determinations.

Significantly, with respect to Ms. Lapson's State-Authorized ROE data for all-electric utilities, the Initial Decision finds that,

> … the fact that the State-Authorized ROEs of electric utilities presenting investment risks equivalent to (integrated) or lower than (distribution) those presented by the MISO TOs produce metrics approximating the Upper Midpoint supports assigning the MISO TOs a Base ROE at that level.[145]

Such finding is in error because it does not use the State-Authorized ROEs as a benchmark, but rather to set the Base ROE. It unabashedly suggests that because the midpoint of Ms. Lapson's State-Authorized ROE for the All-electric group is 9.7 percent[146] and the Upper Midpoint is also 9.7 percent, it is appropriate to place the Base ROE at the Upper Midpoint. This is not the treatment the Commission gave State-Authorized ROE data in Opinion No. 531 as the Initial Decision itself recognizes in a separate paragraph.[147] Just because the midpoint of State-Authorized ROEs for a group of utilities (with purported equivalent or lower risks than the MISO TOs) is 9.7 percent, it does not automatically follow that the midpoint of the DCF analysis (for a proxy group reflecting equivalent risks to those of the MISO TOs) fails to satisfy the *Hope* and *Bluefield* standards. As the Commission has recognized, it is not appropriate to establish the Base ROE based on State-Authorized ROEs because these ROEs are "established at different times in different jurisdictions which use different policies, standards, and methodologies in setting rates."[148] Nevertheless, the Initial Decision finds that,

> the differences between Commission and state ratemaking practices do not preclude consideration of Ms. Lapson's survey for the limited ***purpose of***

[145] I.D. at P 584.

[146] MTO-43 at 12:9.

[147] I.D. at P 586.

[148] Opinion No. 531 at P 148.

> ***determining the placement*** of the MISO TOs' Base ROE within the zone of reasonableness.[149]

Using Ms. Lapson's State-Authorized ROE data to determine the placement of the Base ROE is the same as using the State-Authorized ROEs to set the Base ROE. The Commission should reject these portions of the Initial Decision as contrary to FERC precedent.

d) The Initial Decision errs in rejecting evidence of different rate making practices that render State-Authorized ROE data a meaningless benchmark for setting the Base ROE.

CAPs introduced evidence challenging the comparability of State-Authorized ROEs with the Base ROE of transmission utilities for purposes of determining whether the *Hope* and *Bluefield* standards are met. CAPs explained that formula rates approved by the Commission allow the MISO TOs to collect costs based on annual rate changes (either based on historical costs or based on projected costs with a true-up to actual costs), ensuring that the MISO TOs actually earn the ROE included in the formula rates. Many state commissions, however, have not adopted mechanisms similar to formula rates that can address the regulatory lag associated with their ratemaking practices. As a result, utilities often either: (i) earn less than the State-Authorized return, or (ii) the state commissions increase the allowed ROE to make up for the lag.[150] As noted above, these ratemaking differences are why credit rating agencies currently regard federally-regulated transmission as less risky than state-regulated utility businesses.

With respect to the actual State-Authorized ROE earned by utilities, Mr. Solomon discussed a May 28, 2015 data dispatch titled "Authorized and earned ROE in 2014," that SNL Financial compiled.[151] The data show that, of a group of 38 cases, 29 companies earned less than

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[149] I.D. at P 597 (emphasis added).

[150] JCI-4 at 52; CAPs Initial Brief at 126-128.

[151] JCI-6 at 103-106.

their State-Authorized ROE. The Initial Decision rejects this evidence finding that it covers state ROEs awarded for a single year, 2013, that is outside of Ms. Lapson's study period[152] and that a number of state-commissions provide adjustment clauses and trackers that enable utilities to recover in subsequent years earnings shortfalls such as those described by SNL.[153] This finding is in error and should be rejected by the Commission for several reasons.

First, the fact that Ms. Lapson's study does not cover State-Authorized ROEs during year 2013 does not diminish the probative value of the evidence for the purpose of showing that State-Authorized ROEs and earned ROEs are two different things and that, as a result of this difference, there may not be a real threat that capital will be diverted away from transmission investments enjoying the rate stability provided by formula rates. Second, the evidence cited by the Initial Decision about the existence of trackers and true-up mechanisms in some state proceedings does not prove that State-Authorized ROEs are collected in subsequent years. Contrary to the Initial Decision's speculation, Mr. Hill, relying on his decades of experience in the field of state utility regulation, indicated that he is unaware of any tracker or state ratemaking mechanism allowing utilities to recover their authorized ROE in a manner comparable to the MISO TOs' formula rate structure.[154] The MISO TOs introduced no evidence to the contrary.

With respect to the practice of increasing the State-Authorized ROE to make up for regulatory lag or other risks unrelated to the distribution business, the Initial Decision finds that, neither this difference, nor other ratemaking differences with State-Authorized ROEs invalidate the use of Ms. Lapson's study as a benchmark.[155] Such finding is in error because it rejects

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[152] I.D. at P 593.
[153] I.D. at P 594.
[154] JCA-14 at 65:21-23.
[155] I.D. at P 586.

evidence showing that, in addition to the operational and technological risks of investing in distribution, State-Authorized ROEs may reflect regulatory risks associated with specific state ratemaking practices as well as risks associated with the integrated nature of the utilities studied by Ms. Lapson. For example, on August 15, 2014, the Arkansas Public Service Commission approved a 9.5 percent ROE for Entergy Arkansas, Inc. ("Entergy Arkansas"), above the midpoint of the zone of reasonableness resulting from the DCF analyses in that proceeding, to address (among other things) risks and uncertainties associated with the company joining the MISO and starting to conduct its own generation planning.[156] The Commission's finding that transmission investment is riskier than distribution investment was based on factors unrelated to ratemaking risks or risks associated with owning generation. As such, comparing the midpoint of the DCF with Ms. Lapson's State-Authorized ROE data to determine if the *Hope* and *Bluefield* standards are met is inappropriate in this case.

2) The Initial Decision errs by accepting Mr. McKenzie's risk premium, CAPM and expected earnings analyses despite their significant flaws.

OMS and JCA support CAPs' exceptions to the risk-premium, CAPM, and expected earnings benchmarks relied on by the Initial Decision. Particularly, OMS and JCA wish to highlight a few of the flaws that render Mr. McKenzie's benchmarks unreliable and the Initial Decision's reliance on them in error:

1. Mr. McKenzie's risk premium analysis: (i) inappropriately relies on Base ROEs mentioned in prior FERC cases where the Commission declined to determine whether the stated Base ROE was just and reasonable; (ii) inflates the COE results by applying nominal yields as opposed to inflation adjusted yields as Mr. Gorman's adjusted risk-

[156] *In the Matter of the Application of Entergy Arkansas, Inc. for Approval of Changes in Rates for Retail Electric Service*, Slip Copy , 2014 WL 10385679 (Ark.P.S.C.) at 10 (August 15, 2014).

premium analysis does;[157] and (iii) does not adjust COE results to account for regulatory lag between the underlying record of the cases and the dates FERC issued Orders as Mr. Parcell's adjusted analysis does.[158] The Initial Decision improperly rejects evidence in Appendix H of the CAPs Initial Brief adjusting Mr. McKenzie's risk premium to account for cases where the Commission actually made a determination as to the justness and reasonableness of the Base ROE.[159]

2. Mr. McKenzie's CAPM artificially inflates the implied COE by: (i) using an 8.8 percent market risk premium rather than the independently published Morningstar market risk premium of 6.2 percent; (ii) not using a long-term growth rate, thereby assuming that the 5-year growth forecasted for the stock portfolio will continue forever; and (iii) using an unnecessary size adjustment.

3. Mr. McKenzie's expected earnings analysis is inappropriately applied to a group of regulated utilities, creating a circularity problem that perpetuates favoring established ROEs rather than estimating the current market cost of equity. The Initial Decision draws an unsupported distinction between Comparable Earnings Analysis and Expected Earnings Analysis when assessing the relevance of Dr. Morin's recommendation to use data only from unregulated companies.[160] Indeed, such finding is contrary to the Commission's express reliance on New Regulatory

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[157] ICG-19.

[158] RPG-9 at 24-26; RPG-15.

[159] I.D. at PP 380-384.

[160] I.D. at P 484.

> Finance's discussion of comparable earnings methodology for application to the expected earnings method.[161]

Accordingly, OMS and JCA respectfully submit that it would be unreasonable and an abdication of the Commission's responsibility under the FPA to protect consumers[162] if the Commission were to adopt a Base ROE in this proceeding in reliance upon the benchmarks derived by Mr. McKenzie. Instead, the Commission should set the Base ROE at the midpoint of the DCF range.

C. THE INITIAL DECISION ERRS IN FINDING THAT SETTING THE BASE ROE AT THE MIDPOINT OF THE DCF RANGE WOULD UNDERMINE THE MISO TOS' ABILITY TO ATTRACT CAPITAL FOR INVESTMENT IN NEW TRANSMISSION PROJECTS.

1) The Commission should not rely on conjectures about the impact of a lower ROE on new investments to place the Base ROE above the midpoint of the DCF range.

There is no evidence in the record establishing that a reduction of the Base ROE to the midpoint of the DCF range will result in a lack of capital available for investment in new transmission projects. Mr. Kramer (the MISO TOs' witness addressing impacts on new transmission development) simply speculates that reducing the Base ROE to the midpoint of the DCF range "***could*** reduce the capital available to invest in larger and more widely beneficial transmission projects."[163] Nothing in the record shows what specific MVPs and MEPs currently being built by the MISO TOs would be negatively affected by a ROE reduction. In fact, empirical evidence in the record shows that: (1) the number of developers on MISO's Qualified

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[161] Opinion No. 531 at n. 294.

[162] *See, e.g., Morgan Stanley Capital Grp. Inc. v. Pub. Util. Dist. No. 1 of Snohomish Cnty., Wash.,* 554 U.S. 527, 564 (2008) ("Congress enacted the FPA precisely because it concluded that regulation was necessary to protect consumers from deficient markets.").

[163] MTO-20 at 27:22-25.

Developer list (a requirement to participate in competitive proceedings to build future MVPs and MEPs)[164] has increased significantly, despite these proceedings to reduce the ROE;[165] (2) the level of capital investments in the utility industry doubled during a time of increasing rate case activity and declining authorized ROEs;[166] and (3) credit rating agencies see investments in electric utilities as stable, despite ROE reductions.[167] The Initial Decision, however, finds that in Opinion No. 531, the Commission did not require that there be a causal connection between a reduction of the Base ROE and a decrease of funds available for new transmission investment.[168] Such finding is in error because it misinterprets the Commission policy as one that allows reliance on conjectures concerning how investors in MVPs and MEPs may react to a rate reduction as a basis for adjusting the Base ROE above the midpoint. Indeed, the Supreme Court ruled that "[t]he Commission cannot confine its enquiries to… conjectures about the prospective response of capital markets."[169] Relying on such conjectures is particularly unsuitable in this case because, as the MISO TOs recognize, investors in new transmission projects are not solely driven by the Base ROE but also by FERC-approved transmission rate incentives.[170]

2) The magnitude of the rate reduction by itself does not support placing the Base ROE above the midpoint of the DCF range.

The Initial Decision finds that a reduction of the Base ROE by 366 basis points[171] is proof that the MISO TOs' ability to attract capital for new projects could be undermined.[172] The Initial

164 *See* Attachment FF to the MISO Tariff at Section VIII.B.1.
165 OMS-1 (Mr. Kramer admits that 13 new developers have joined the MISO Qualified Developer List).
166 ICG-1 at 14:7-9.
167 OMS-6 at 1; JCA-14 at 63-64.
168 I.D. at P 628.
169 *In re Permian Basin Area Rate Cases,* 390 U.S. 747, 791 (1968).
170 MTO-20 at 14; MTO-1 at 107:14-20.
171 The difference between the 12.38 percent currently authorized ROE and the 8.72 percent Midpoint.

Decision reasons that the Commission found a reduction of 175 basis points to be a cause for concern in Opinion No. 531 and, therefore, a larger reduction in this case justifies the same concern and supports placing the Base ROE at the top half of the DCF range.[173] The Initial Decision is in error because it misinterprets Opinion No. 531 as establishing a bright-line whereby a ROE reduction of 175 basis points or higher is a cause for concern that supports placing the Base ROE at the Upper Midpoint of the DCF range. Such interpretation is erroneous and contrary to FERC precedent. Significant rate reductions and rate increases are not unprecedented. The Initial Decision recommends a Base ROE of 9.7 percent; this is a drop of 268 basis points. The Commission has approved return reductions much higher than 175 basis points and even higher than 366 basis points in the past,[174] including significant return reductions approved after Opinion No. 531 was issued.[175] The Commission has also approved rate increases above 175 basis points.[176] Because of this precedent, it is erroneous for the Initial Decision to rely on the magnitude of the rate reduction to find that the MISO TOs' ability to attract capital for new projects will be undermined if the Base ROE is set at the midpoint of the DCF range.

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[172] I.D. at PP 634-635.

[173] *Id.*

[174] *See, e.g., Kinder Morgan Interstate Gas Transmission LLC*, 133 FERC ¶ 61,157, PP 5, 6, 8 (2010) (provisionally finding that an over 1,000 basis point reduction of Kinder Morgan's ROE could be justified based on preliminary Commission findings and instituting Natural Gas Act section 5 proceedings. Ultimately, a 27 percent reduction of rates was agreed upon by the parties and accepted by FERC under Docket No. RP11-1494); *Overthrust Pipeline Co.*, 53 FERC ¶ 61,118, 61,372 (1990) (approving an ROE reduction of 280 basis points).

[175] *See, e.g., Municipal Electric Utilities Association of New York v. Niagara Mohawk Power Corporation and New York Independent System Operator, Inc.*, 151 FERC ¶ 61,121 (2015) (approving a Base ROE of 9.8 percent, a reduction of 170 basis points from initial 11.5 percent Base ROE); PJM Interconnection, L.L.C., *et al.*, 151 FERC ¶ 61,029 (2015) (approving a Base ROE of 10.88 percent, a reduction of 150 basis points from initial 12.38 percent Base ROE); *MidAmerican Central California Transco, LLC*, 151 FERC ¶ 61,251 (2015) (approving a Base ROE of 9.8 percent, a reduction of 100 basis points from initial 10.8 percent Base ROE); and *ATX Southwest, LLC*, 155 FERC ¶ 61,143 (2016) (approving a Base ROE of 9.9 percent, a reduction of 100 basis points from initial 10.9 percent Base ROE).

[176] *See e.g., Midwest Indep. Transmission Sys. Operator, Inc.*, 100 FERC ¶ 61,292 (2002) (approving an ROE increase of 238 basis points for the MISO TOs).

Further, the magnitude of the drop is naturally higher for the MISO TOs (when compared to the drop in Opinion No. 531 at P 150 cited in the Initial Decision) because their Base ROE is 124 basis points higher than the New England transmission owners' Base ROE prior to Opinion No. 531-A.[177]

The magnitude of the reduction alone is not proof that capital cannot be attracted for new transmission projects or support the placement of the Base ROE at the Upper Midpoint of the DCF range. It simply shows the disparity between a reasonable rate and the current rate, such that the more unreasonable the current rate is, the larger the reduction necessary to comply with the FPA requirement to set a just and reasonable rate. This is particularly true in the case of the MISO TOs because their current unjust and unreasonable Base ROE is based on the results of a DCF study period that included the September 11, 2001 turbulent financial-market aftermath.[178] From this perspective, considering the magnitude of the rate reduction as evidence in support of a higher ROE favors utilities with highest disparities. In other words, contrary to law, it favors utilities with more unjust and unreasonable rates.

3) A Base ROE at the midpoint of the DCF range will support new transmission investment.

It is important to highlight that Mr. Kramer's testimony is not that a Base ROE at the midpoint of the DCF range will undermine the MISO TOs' ability to attract capital for new transmission projects. His testimony is that a Base ROE at the midpoint of the DCF range will lead the MISO TOs to undertake less risky projects such as BRPs, instead of larger regional and interregional MVPs and MEPs. Specifically, Mr. Kramer testifies that:

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[177] The Base ROE of the New England TOs prior to Opinion No. 531 was 11.14 percent (Opinion No.531 at P 2).

[178] *See Midwest Indep. Transmission Sys. Operator, Inc.*, 99 FERC ¶ 63,011, P 33 & Appendix A, *aff'd in relevant part*, 106 FERC ¶ 61,292, P 17 (2002), *aff'd sub nom. Pub. Serv. Comm'n of Ky. v. FERC*, 397 F.3d 1004 (D.C. Cir. 2005).

> Without an adequate base ROE, MISO Transmission Owners will be pressured to devote relatively more of their limited capital resources to ensuring continued compliance with NERC Reliability Standards and state retail service obligations. This would result in a greater focus on development of BRPs and other local projects in lieu of MEPs or 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. As stated previously, BRPs address narrowly defined local reliability issues. BRPs are generally smaller in scope and cost less than MEPs or MVPs.[179]

It is clear from this testimony that a Base ROE at the midpoint of the DCF range will still allow for construction of new transmission projects. The question is whether it is necessary to approve a Base ROE at the top of the DCF range to enable construction of MVPs and MEPs by the MISO TOs "that present greater risk."

4) The return adder necessary to attract capital for riskier transmission projects must be established on a case-by-case basis through Section 219 proceedings.

An upward adjustment of the Base ROE is not necessary to allow for construction of MVPs and MEPs that present greater risks because: (1) while investors might require higher returns to invest in some transmission projects with greater risks, investors do not require higher returns to invest in other transmission projects with normal risks, and the Base ROE is the same for all transmission projects in MISO; and (2) Section 219 proceedings are designed to evaluate the level of return investors require to undertake riskier transmission projects following approval of appropriate risk-mitigation incentives.

a) <u>Overcompensation for certain transmission investments.</u>

The premise of Mr. Kramer's above testimony is the undisputed understanding that, all things being equal, investors demand higher returns to undertake greater risks. The MISO TOs' proposed solution, however, does not follow from such a premise. A higher Base ROE will not

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[179] MTO-20 at 29: 5-12 (emphasis added).

prompt investors to undertake riskier MVPs and MEPs if they can choose to build less risky transmission projects that pay the same Base ROE. A Base ROE designed to compensate for the greater risks of certain MVPs and MEPs will, however, overcompensate for existing transmission and new transmission projects that face general transmission risks (as opposed to greater risks).

The Initial Decision discusses evidence presented by the MISO TOs regarding the benefits that the existing portfolio of MVPs and MEPs will provide over the next couple of decades and the need for new investment in the transmission system at the regional and interregional levels.[180] OMS and JCA support the greater benefits that can be accomplished with certain regional and interregional transmission projects. The way to realize these benefits, however, is not by approving a Base ROE above the midpoint of the DCF range and overcompensating investors for the risks of owning existing transmission or building other new transmission projects. Overcompensation would result in shifting capital away from other electric infrastructure investments (*e.g.,* generation) necessary to support the long-term reliability of the grid, while providing no additional benefit to customers. This would violate the *Hope* and *Bluefield* requirement to appropriately balance the interests of consumers and industry. Furthermore, such placement of the Base ROE would violate the D.C. Circuit's ruling that, if the Commission contemplates increasing rates above cost (*i.e.,* overcompensation) on public policy grounds,

> it must see to it that the increase is in fact needed, and is no more than is needed, for the purpose. Further than this we think the Commission cannot go without additional authority from Congress.[181]

[180] I.D. at PP 615-617.
[181] *City of Detroit v. Federal Power Comm'n*, 230 F. 2d 810, 817 (D.C. Cir. 1955), *cert. denied* 77 S. Ct. 37(1956).

Indeed, Congress later gave the Commission, in Section 219 of the FPA, the power to approve incentives to achieve its policy goals. In other words, a Base ROE at the midpoint of the DCF range will not threaten regional and interregional benefits because the Commission has the ability to appropriately compensate investors for any "greater risk" associated with certain MVPs and MEPs on a case-by-case basis through Section 219 proceedings.

b) Availability of transmission rate incentives.

The Base ROE is designed to compensate for general risks of transmission projects, not to compensate for the greater risks associated with certain MVPs and MEPs. The Initial Decision finds that it was not up to the Presiding Judge to "second-guess whether the MISO TOs should fund beneficial projects through their Base ROE or through case-by-case incentives."[182] The Commission, however, has the responsibility to set policies that result in just and reasonable rates and should address this issue. The Initial Decision cites to Opinion No. 531,[183] where the Commission ruled that:

> The purpose of the Commission's Base ROE analysis is to determine a level of return sufficient to satisfy *Hope* and *Bluefield*. Under that precedent, we are tasked with ensuring that the base ROE, among other things, enables the utility to attract investment. In contrast, ROE incentive adders are intended to encourage transmission investment above the level produced by a base ROE due to the circumstances of a certain project or projects. Although section 219 of the FPA gives us authority to provide incentives above the base ROE, nothing in section 219 relieves us from first setting the base ROE at a place that meets *Hope* and *Bluefield*.[184]

In this paragraph, the Commission responded to arguments raised in the EL16-66 proceeding that: (1) the DCF methodology is designed to attract investment and that ROE adders are

[182] I.D. at P 633.
[183] I.D. at P 630.
[184] Opinion No. 531 at P 153.

available if the Base ROE fails in that respect; and (2) policy considerations for placing the Base ROE above the midpoint are only appropriate when the Commission considers rate incentives. OMS and JCA are not arguing that the Base ROE must be placed at the midpoint of the DCF range even if such placement fails to meet the *Hope* and *Bluefield* standards or that placing the Base ROE above the midpoint is only appropriate in Section 219 proceedings. Of course, the Base ROE must meet the *Hope* and *Bluefield* standards and the Commission has the ability to place the Base ROE above the midpoint of the DCF range if necessary to meet such standards. The Commission ruling above does not address the concern of OMS and JCA in this proceeding, however.

The record shows that a Base ROE at the midpoint of the DCF range will appropriately compensate for general transmission investment risks in accordance with the *Hope* and *Bluefield* standards, which simply require that the return be: (1) comparable to the return of other companies with similar risks,[185] (2) sufficient to attract capital,[186] and (3) sufficient to support the credit of the utility.[187] With respect to the ability to attract capital, the Supreme Court established that the return must be sufficient to enable a utility to "raise the money necessary for the proper discharge of its public duties."[188] Here, the MISO TOs do not claim that placement of the Base ROE at the midpoint of the DCF range would prevent them from raising capital necessary to meet their public duties. On the contrary, the MISO TOs make clear that they will meet their obligations, but claim that they ***might*** divert capital towards less risky transmission investments

[185] *Bluefield* at 692; *Hope* at 603.
[186] *Bluefield* at 693; *Hope* at 603.
[187] *Id.*
[188] *Id.*

to meet such obligations.[189] This testimony shows that placing the Base ROE at the midpoint of the DCF range will allow the MISO TOs to attract capital to meet their obligations. With respect to the requirement to support the credit of the utility, the Initial Decision points to Ms. Lapson's testimony contending that the reduction of cash-flow that would result from placing the Base ROE at the midpoint of the DCF range would particularly affect MISO TOs with large CAPEX budgets and ***could*** trigger a negative credit watch status or a downgrade.[190] This argument has no merit. The parties in this proceeding generally agreed with the composition of the proxy group used in the DCF analysis.[191] An upward adjustment of the Base ROE based on the specific CAPEX budgets of some of the MISO TOs would be inappropriate because, as the Initial Decision recognizes, "the method for selecting the proxy group in this proceeding has assured that the group presents investment risks no greater and no less than those presented by the MISO TOs."[192] Should the Commission decide to adjust the placement of the Base ROE on the basis of Ms. Lapson's testimony on CAPEX associated risks, OMS and JCA respectfully submit that the Commission should also consider downward adjustments based on the specific capital structures of the MISO TOs (reducing financial risks)[193] and use of formula rates (reducing business

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[189] MTO-20 at 29:5-11

[190] I.D. at P 624.

[191] I.D. at PP 50-53.

[192] I.D. at P 642. The Initial Decision raises the proxy group issue with respect to consideration of formula rates as reducing the business risk of utilities and supporting FERC's adherence to its standard policy of placing the Base ROE at the midpoint of the DCF range. Here, the MISO TOs attempt to use CAPEX as evidence in support of departing from FERC standard policy to place the base ROE at the midpoint of the DCF range.

[193] *Generic Determination of Rate of Return on Common Equity for Electric Utilities*, 47 Fed. Reg. 38332-01, at 38,338-38339 (1982) (defining "financial risk" for purposes of determining the Base ROE as the uncertainty introduced by the method of financing an investment. Such financing risk is a risk above general business risk that arises because the use of debt requires a company to pay fixed interest charges prior to paying dividends to common stockholders. The Order further explains that the fixed and senior nature of interest charges increases the risk of equity in two ways. First, the greater the debt burden, the greater the risk that the company will default on its interest payments and be forced into bankruptcy. Second, the greater the percentage of debt in a

risks).[194] Without specific adjustments, however, the midpoint of the DCF range allows the MISO TOs to attract capital to meet their public obligations and support their credit. As such, the midpoint of the DCF range meets the *Hope* and *Bluefield* requirements.

At bottom, the MISO TOs are seeking a ROE above the midpoint of the DCF range to enable construction of certain greater risk MVPs and MEPs. The Commission has acknowledged its responsibilities under Section 205 to establish a just and reasonable Base ROE and under Section 219 to incentivize transmission investment (while remaining within the zone of reasonableness). In Order No. 679-A, the Commission explained:

> While section 219 requires us to do more than maintain the status quo for transmission pricing, we recognize that our traditional ratemaking authority also requires us to establish a return on a public utility's assets that is "reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate to maintain and support its credit and enable it to raise money necessary for the proper discharge of its public duties" and "should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." Thus, ***a base-level ROE sufficient to promote capital investment in transmission facilities historically has not been considered an "incentive,"*** but a requirement of establishing a just and reasonable rate. In this regard, we recognize that our responsibilities under section 205 and our responsibilities under section 219 overlap in significant ways.[195]

The Commission further clarified that "[i]n contrast to a base-level ROE that reflects the financial and regulatory risks of an investment, an 'incentive' has been more typically associated

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company's capital structure, the more uncertain are common stockholder's expected returns, because of the increased volatility of the residual earnings available to them with any given change in operating income.)

[194] *Id* at 38,338 (defining "business risks" for purposes of determining the Base ROE as such risk relating to the uncertainty of expected income flows to the company. This uncertainty may be viewed as a function of the variability in a company's operating income over time, and such statistical techniques as standard deviation and standard error can be used to measure this variability for some defined period.

[195] *Promoting Transmission Investment Through Pricing Reform*, Order No. 679, 2006-2007 FERC Stats. & Regs., Regs. Preambles ¶ 31,222, *order on reh'g*, Order No. 679-A at P 15 (emphasis added) (footnotes omitted), 2006-2007 FERC Stats. & Regs. Preambles ¶ 31,236 (2006), *order on reh'g*, Order No. 679-B, 119 FERC ¶ 61,062 (2007); *policy statement*, 141 FERC ¶ 61,129 (2012) .

with specific basis point additions to a base ROE to satisfy discrete policy objectives."[196] While MVPs and MEPs may promote greater efficiencies and benefits associated with regional and interregional transmission planning, it is inappropriate to set the Base ROE at a level that compensates investors for greater risks assumed in certain MVPs and MEPs investments. The appropriate mechanism to evaluate and compensate for this greater risk is through Section 219 proceedings. This is particularly true here because such "greater risk" is not uniform among all MVPs and MEPs[197] and appropriate compensation for greater risks cannot be adjudicated generically without overcompensating less risky transmission investments.

c) <u>Other considerations.</u>

The Commission should also consider the following negative implications of a policy that uses the Base ROE to compensate investors for transmission projects involving risks greater than standard transmission risks. First, a Base ROE at the Upper Midpoint limits the Commission's flexibility to approve ROE adders because, consistent with FERC precedent, such incentives once added to the Base ROE must stay within the DCF zone of reasonableness. [198] This limited flexibility will be problematic as the Commission attempts to encourage development of large regional and interregional projects with demonstrable unique risks. Second, such policy would allow the MISO TOs to bypass the Commission's scrutiny of project-specific risks and prevent challenges to the level of compensation for those risks by customers, state commissions, and consumer advocates. Indeed, the MISO TOs challenged Mr. Hill's testimony that the MISO TOs

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[196] Order No. 679-A at P 12, n.19.

[197] Tr. 432:12-15.

[198] *See, e.g.,* Opinion No. 531 at P 164; Order No. 679-A at P 15; *Midcontinent Indep. Sys. Operator, Inc.*, 150 FERC ¶ 61,004, P 2 (2015) ; *Midcontinent Indep. Sys. Operator, Inc.*, 150 FERC ¶ 61,252, P 41 (2015); *Trans Bay Cable LLC,* 145 FERC ¶ 61,151, P 19 (2013); *Pac. Gas & Elec. Co.,* 141 FERC ¶ 61,168, PP 4, 26 (2012); *Atl. Path 15, LLC*, 135 FERC ¶ 61,037, P 20 (2011).

have not sought incentive ROEs for many MVPs,[199] claiming that Mr. Hill ignores the "incentives or other measures the MISO Transmission Owners would need to seek if the Base ROE were reduced to the unjust and unreasonable level advocated by Mr. Hill and other witnesses in this proceeding."[200] The Base ROE, however, should not reflect the greater risk of certain MVP and MEP projects so that the MISO TOs can avoid having to apply for transmission rate incentives. Finally, there are competitive concerns that support keeping the Base ROE at the midpoint of the DCF range. Unlike incumbent transmission developers (such as the MISO TOs), non-incumbent developers cannot offset under-compensation for riskier new investments with overcompensation of existing transmission for the simple reason that they do not own significant existing transmission assets in MISO. A Base ROE that compensates investors for greater transmission risks would place non-incumbent transmission developers in MISO at a competitive disadvantage. Thus, what is at stake is not whether MVPs or MEPs will get built; but rather whether they will get built by the MISO TOs or other developers.

D. THE INITIAL DECISION ERRS BY FAILING TO CONSIDER FORMULA RATES WHEN PLACING THE BASE ROE ABOVE THE MIDPOINT OF THE DCF RANGE.

Hope and *Bluefield* require that the MISO TOs' Base ROE be "commensurate with returns on investments in other enterprises having corresponding risks."[201] In determining the ROE for public utilities, the Commission's evaluation of investment risk focuses on the two major sources of uncertainty for a company: business risk and financial risk.[202] Business risk relates to the uncertainty of expected income flows to a company and may be viewed as a

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[199] JCA-1 at 51-52.

[200] MISO TOs Initial Brief at 108.

[201] *Hope*, 320 U.S. at 603; *Bluefield*, 262 U.S. at 692-693.

[202] *Generic Determination of Rate of Return on Common Equity for Electric Utilities*, 47 Fed. Reg. 38,332-01, at 38,338-38,339 (1982)

function of the variability in a company's operating income over time.[203] Financial risk relates to the source of financing of investments (debt v. equity).[204] The use of formula rates ensures prompt revenue recovery and thus mitigates business and financial risk by allowing the MISO TOs to achieve the earnings and cash flow amounts included in the revenue requirement, meet investors' return outlooks, and reinvest earnings in their company to meet growth targets. The ability of formula rates to mitigate risks is particularly significant with respect to the business risks of the MISO TOs because formula rates ensure that all costs that have been properly allocated to transmission service will be recovered and that the allowed return will be earned. All MISO TOs utilize formula rates and can choose between historically-based or forward-looking formula rates.[205]

In the proceedings before the Presiding Judge, CAPs argued that MISO's formula transmission rate substantially mitigates the business and financial risk to which the MISO TOs are exposed, and that this reduction in risk supports a finding that—even if capital market conditions were anomalous—a Base ROE above the center of the DCF range is not necessary to attract investment.[206] The Initial Decision rejects CAPs' argument, concluding that the availability of formula rates should not be a factor in the ROE determination. This conclusion is erroneous because it: (1) rejects consideration of the MISO TOs' use of formula rates while, at the same time, considering the MISO TOs' higher CAPEX risks and as such is arbitrary and capricious under the Administrative Procedural Act; (2) departs, without reasoned explanation, from Commission precedent stating that formula rates are a factor to consider in determining the

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[203] *Id* at 38,338.
[204] *Id*
[205] *See*, JCI-18, JCA-23 at 6-7, and Tr.300:9-23.
[206] CAPs Initial Brief at 132-148; CAPs Reply Brief at 90-97.

Base ROEs of the MISO TOs; and (3) finds that there is a public interest in the use of formula rates that would be jeopardized if formula rates are considered in determining the Base ROE without any support of such finding in record evidence. The Commission cannot ignore relevant evidence regarding the risk-reducing attributes of formula rates. Failure to consider such evidence does not meet the requirement for reasoned decision-making.

1) The Initial Decision errs by considering the CAPEX risks of the MISO TOs while rejecting consideration of the risk-mitigating effect of formula rates.

The Initial Decision finds that, because the MISO TOs and the proxy group have equivalent bond ratings, neither formula rates nor CAPEX warrant independent risk assessment when comparing the investment risks of the two groups of utilities.[207] Inconsistently, the Initial Decision then uses evidence regarding the high CAPEX budgets of some of the MISO TOs to reject Mr. Hill's evidence that integrated utilities with generation assets face higher risks than transmission utilities.[208] This error is compounded by the failure of the Initial Decision to recognize evidence provided by CAPs' witnesses showing that: (1) the level of capital investment undertaken by the MISO TOs is not significantly different from that of the national proxy group,[209] and (2) credit rating agencies currently regard transmission-only utilities as low risk and less risky than state-regulated utilities as discussed more fully herein. Instead, the Initial Decision finds that the investment risk of integrated utilities is equivalent to that of the MISO TOs and, upon such finding, accepts Ms. Lapson's testimony comparing State-Authorized ROEs for integrated utilities to the midpoint of the DCF range (reflecting the investment risks of the

[207] I.D. at P 644.

[208] I.D. at PP 575 and 577.

[209] JCA-14 at 84:12-21 (citing MTO-18).

proxy group).[210] At the same time, the Initial Decision rejects CAPs' argument that—even if capital market conditions were anomalous—an upward adjustment above the midpoint of the DCF range would not be warranted because all the MISO TOs use formula rates, finding that:

> To provide the offset the CAPs seek based on the MISO TOs' formula rates would be to determine that the credit-rating agencies had failed to adequately consider those rates when issuing their ratings. It is difficult to view such a determination as anything other than a rejection of the Commission's assumption that its credit-rating screen will produce a proxy group that poses investment risks comparable to those posed by the subject utilities. Thus, to provide the offset that the CAPs seek would be to reject one of the underlying premises of the Commission's DCF model.[211]

This finding is in error and should be rejected by the Commission. The Initial Decision got it backwards. CAPs did not challenge the risk screen of proxy group companies used in DCF analysis. On the contrary, CAPs defended the results of the DCF analysis, relying on a proxy group of companies with comparable risks selected according to the Commission's credit rating screens. OMS and JCA are not proposing herein—nor did they propose as part of CAPs—any downward adjustment to the DCF midpoint in consideration of formula rates' risk mitigation attributes. The risk "offset" sought applies to any risk assessment beyond the DCF inputs, upon a finding of anomalous capital market conditions. At the end of the day, the Commission found that anomalous capital market conditions could render the DCF financial inputs "unrepresentative" of the cost of equity,[212] and that it was appropriate to look at other evidence beyond the DCF analysis upon a finding of anomalous capital market conditions.[213] If the Commission is to look at evidence beyond the DCF analysis to ensure that the capital attraction

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[210] I.D. at P 584.
[211] I.D. at P 648.
[212] Opinion No. 531 at P 41.
[213] Opinion No. 531 at P 145.

requirements of *Hope* and *Bluefield* are met, it should not only look at benchmarks – such as those relied on in Opinion No. 531, *et al*. – but also at other evidence of investment risk mitigation – such as the use of formula rates – showing that there is no need for an upward adjustment of the Base ROE. Consideration of the MISO TOs' formula rates' risk-reducing attributes does not challenge the Commission's credit-rating screens for DCF proxy group formation. Instead, OMS's and JCA's proposed consideration of formula rates challenges the need for an adjustment of the DCF midpoint upon a finding of anomalous capital market conditions.

2) The Initial Decision errs by rejecting FERC precedent establishing that formula rates are a factor to consider in Base ROE determinations.

The Commission recently found that the risk-reducing attributes of formula rates may be considered in determining the placement of the Base ROE within the zone of reasonableness.[214] The Initial Decision does not give much weight to this precedent, finding that the Commission did not address how, or under what circumstances, formula rates might inform such placement of the Base ROE.[215] Just because the Commission did not prescribe how the risk-mitigating impacts of formula rates shall be accounted for in placing the Base ROE, does not mean that the precedent is not clear as to the relevance of evidence regarding the risk-mitigating properties of formula rates. CAPs also cited to the Commission's Order setting the MISO TOs' Base ROE for hearing in Docket No. EL14-12, where the Commission responded to JCA's arguments that the MISO TOs – as vertically integrated utilities with formula rates – had lower risks and merited lower common equity. The Commission indicated that "the amount of risk faced by a company contributes to the Commission's determination of its Base ROE and not of its capital structure."

[214] *Midcontinent Indep. Sys. Operator, Inc.*, 154 FERC ¶61,004, P 36 (2016).
[215] I.D. at P 674.

[216] The Initial Decision rejects this precedent because, in that Order, the Commission indicated that JCA failed to show that integrated utilities with formula rates, in general, or the MISO TOs, in particular, are subject to lower than normal risk.[217] In setting this issue for hearing, the Commission allowed the development of a full record regarding a just and reasonable Base ROE for the MISO TOs, including consideration of the relative investment risk of MISO TOs. The Commission's preliminary findings in *ABATE* do not foreclose a different determination on the basis of a more fully developed record in the current evidentiary hearing process. First, as explained herein, the record in this proceeding contains substantial evidence, not only from JCA's witnesses Mr. Hill and Mr. Muñoz, [218] but also from other CAPs witnesses,[219] about the risk-reducing attributes of formula rates. Second, the evidence of these lower risks is used for a different purpose. Instead of seeking an overall cap on capital structure, the evidence of risk-reducing attributes of formula rates is used here to justify placement of the Base ROE at the midpoint of the DCF range should the Commission be concerned about potential market anomalies.

The Initial Decision further rejects prior precedent, discussed in Mr. Hill's testimony, wherein FERC specifically accounted for the risk-mitigating effects of formula rates based on alleged distinctions between those cases and the present case.[220] The Commission has indicated that formula rates may be considered in the determination of a just and reasonable ROE for a

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[216] *ABATE*, 148 FERC¶ 61,049, at P 196.

[217] I.D. at P 675.

[218] JCA-1 at 46-50; JCA-14 at 64; and JCA-26 at 5-9.

[219] JCI-1 at 35, JCI-4 at 14-16; ICG-15 at 56-57, RPG-9 at 13-15.

[220] I.D. at PP 657-684.

MISO TO,[221] which suggests that the Commission did not wish to limit the consideration of formula rates in setting Base ROE to the exact fact pattern in precedent involving contractual purchase terms between a public utility and an affiliate generator. Whether or not such cases are sufficiently similar to the present case, the truth is, despite the Initial Decision's finding to the contrary,[222] the Commission has used evidence of formula rates in setting the Base ROE of public utilities. Importantly, the record in this case establishes that formula rates enable and assure that the MISO TOs' promptly recover their costs for providing transmission service, including the authorized Base ROE, despite fluctuations in sales volumes and cost changes.

Instead of acknowledging this clear precedent, the Initial Decision places greater relevance on the Commission's lack of response to comments regarding the risk-mitigating effect of formula rates submitted in various cases cited by the MISO TOs concerning applications for ROE adders.[223] The Commission's silence in those cases is not proof that the risk-reducing attributes of formula rates should not be considered in Base ROE proceedings. All of the cases cited by the Initial Decision, except one, concern incentive rate treatment for specific regional transmission projects.[224] Furthermore, the only case that did not concern rate incentives for a specific transmission project resulted in the Commission approving a Base ROE at the median of the DCF range as proposed by the same consumer groups that advocated for accounting for the

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[221] *Midcontinent Indep. Sys. Operator, Inc.*, 154 FERC ¶61,004, P 36 (2016).

[222] I.D. at P 653.

[223] *Id.*

[224] I.D. at n. 743 citing: (1) *Potomac-Appalachian Transmission Highline, L.L.C.*, 122 FERC ¶ 61,188 at P 104 (2008) *order on reh'g*, 133 FERC ¶ 61,152 (2010) (concerning incentive rate treatment for the PATH project); (2) *PJM Interconnection, L.L.C.*, 137 FERC ¶ 61,253, at PP 54, 60, 62 (2011) (concerning incentive rate treatment for the Northeast Grid Reliability project); and (3) *Green Power Express LP*, 127 FERC ¶ 61,031, at P 81 (2009)(concerning incentive rate treatment for the Green Power Express project).

risk-reducing attributes of formula rates.[225] Most importantly, the Commission's silence is not evidence of Commission policy.[226] The Initial Decision rejects this premise, reasoning that the case CAPs cited addresses a different factual pattern[227] and, instead, finds that the cases cited by the MISO TOs - where the Commission did not address arguments concerning formula rates - support "the inference that the Commission believed the argument so lacking in merit that no discussion of it was necessary."[228] The Commission should reject this finding as contrary to its precedent. As explained herein, the Commission has specifically found that evidence of the risk-reducing attributes of formula rates is relevant in Base ROE proceedings.[229] The fact that the Commission did not address those arguments in the incentive-rate proceedings cited by the MISO TOs has no weight in the instant case because incentive-rate proceedings do not address the same investment risks that Base ROE proceedings address.[230]

Despite the Commission's guidance with respect to the value of formula rate evidence, the Initial Decision fails to consider credible evidence that the formula rates of MISO TOs materially contribute to their lower investment risk. The Presiding Judge found evidentiary deficiencies concerning complainants' evidence on this issue in Docket No. EL14-12-002.[231] Recognizing these concerns, in the instant proceeding, CAPs developed a record that contains more recent and relevant evidence from credit rating agencies concerning the business risks of

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[225] I.D. at n. 743 citing *Virginia. Elec. & Power Co.*, 123 FERC ¶ 61,098, at PP 56-59 (2008) (approving a Base ROE at 10.09 percent, median of the DCF range, as recommended by Indicated Customers) the party claiming that the Base RO).

[226] CAPs Initial Brief at 148, n.611 (citing *PJM Interconnection, LLC and Potomac-Appalachian Transmission Highline, L.L.C,* 153 FERC¶ 61,308 at P 13 (2015)).

[227] I.D. at P 655.

[228] I.D. at P 656.

[229] *Midcontinent Indep. Sys. Operator, Inc.*, 154 FERC ¶ 61,004, P 36 (2016).

[230] Opinion No. 531 at P 153 (explaining that "ROE incentive adders are intended to encourage transmission investment above the level produced by a base ROE due to the circumstances of a certain project or projects.").

[231] EL14-12 I.D. at PP 382-444.

transmission owners operating under federal regulation and MISO formula rates.[232] Pertinently, Moody's most recent credit report (dated April 15, 2015) on ITC Holdings Corp touts FERC formula rates as "a material credit positive," because it is a ratemaking framework that is "more stable and predictable than state-regulated utility businesses."[233] In addition to Mr. Hill's evidence: (1) Mr. Solomon and Mr. Gorman offered evidence discussing the risk-reducing attributes of formula rates;[234] (2) Mr. McKenzie conceded during cross-examination that FERC formula rates afford utilities' financial profiles greater stability and support for strong investment-grade ratings;[235] and (3) Ms. Lapson similarly admitted that formula rates reduce investment risk by avoiding lag in the receipt of revenue, and that avoidance of such lag is important to investors in the MISO TOs.[236] The Initial Decision does not recognize or discuss this additional evidence on the risk-reducing attributes of formula rates. For example, rather than addressing the new Moody's evidence cited above, the Initial Decision[237] essentially recites its critique of credit rating report evidence offered by CAPs in Docket No. EL14-12,[238] while ignoring CAPs' additional evidence provided in the instant proceeding.

3) The Initial Decision errs by finding, contrary to FERC precedent, that formula rates should not be considered in Base ROE determinations.

The Initial Decision finds that formula rates serve the public interest because the Commission does not wish to see a utility earn more or less than its authorized Base ROE.[239] The

232 CAPs Initial Brief at 135 (n. 557) -137, 142-144; CAPs Reply Brief at 91 (n. 354) - 92.
233 JCA-14 at 64:1-5; JCA-23 at 8-16.
234 JCI-1 at 35:6-14; JCI-4 at 14-16; ICG-1 at 15:19-20; ICG-15 at 56:18-22.
235 Tr. 264 and 265:19-24.
236 Tr. 623:16 to 624:10.
237 I.D. at PP 573-582.
238 EL14-12 I.D. at PP 382-394.
239 I.D. at PP 651-652.

Initial Decision's finding in this regard misses the point. 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.[240] 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.

Furthermore, CAPs provided substantial evidence to counter the notion that formula rates are superior to traditional cost of service regulation practices and represent a public policy that should be exempt from consideration in setting a just and reasonable rate for the MISO TOs. CAPs explained that formula rates do not encourage operational efficiencies and cited concrete examples of inefficiencies.[241] Against this evidence and without addressing it, the Presiding Judge finds that the use of formula rates is in the public interest and that accounting for the risk-mitigating attributes of formula rates in ROE proceedings would jeopardize such public interest.[242] The Commission should carefully consider the implications of such a finding in this proceeding and future proceedings seeking to apply formula rates.

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.[243] Accordingly, the Initial Decision finds that a

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[240] 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. *See also*, CAPs Initial Brief at 141.

[241] CAPs Initial Brief at 142; Reply Brief at 93.

[242] I.D. at PP 650-652.

[243] I.D. at PP 595-596.

utility with rising costs may benefit from a formula rate, but a utility whose costs are declining would benefit more from a stated rate.[244] That a utility with declining costs may fare better with a stated rate than a formula rate in no way undercuts the fact that: (i) all the MISO TOs use formula rates; (ii) formula rates provide an assurance of prompt cost recovery when costs are going up; and (iii) in so doing, formula rates greatly reduce the investment 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 investment risk-mitigating attributes of formula rates. 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 (or lawfully) be considered a downside that offsets the clear benefits of prompt and complete cost recovery when costs are rising.

In conclusion, the Presiding Judge is reluctant to consider evidence of the risk-reducing attributes of formula rates because he finds that: (1) there is a public interest in the use of formula rates that may be jeopardized,[245] and (2) the Commission has provided no guidance as to how to consider the risk-reducing attributes of formula rates in ROE proceedings.[246] As explained above, CAPs demonstrated that the MISO TOs formula rate terms support a finding of lower business risk that warrants a reduced Base ROE under relevant Commission precedent.[247]

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[244] I.D. at P 595.

[245] I.D. at PP 650-652.

[246] I.D. at P 674.

[247] CAPs Initial Brief at 145-147; CAPs Reply Brief at 91-92 (addressing Commission precedent in *Consumer Advocate Div. v. Allegheny Generating Co.*, Opinion No. 281, 40 FERC ¶ 61,117 (1987), *order on reh'g*, Opinion No. 281-A, 42 FERC ¶ 61,248 (1988); *S.C. Generating Co., Inc.*, Opinion No. 280, 40 FERC ¶ 61,116

Although the Commission has indicated that the risk-reduction provided by formula rates may be considered in placing the ROE within the zone of reasonableness, the Initial Decision forecloses the possibility of such proof,[248] and for that reason, the Initial Decision is in error. In this proceeding, OMS and JCA urge that the MISO TOs' lower investment risk be taken into account in placing the Base ROE and that, upon such consideration, if the Commission finds that capital market conditions are anomalous, place the Base ROE at the midpoint of the DCF range.

E. THE INITIAL DECISION ERRS BY NOT CONSIDERING THE CAPITAL STRUCTURE OF THE MISO TOS PRIOR TO PLACING THE BASE ROE AT THE UPPER MIDPOINT.

Capital structure determines how a utility finances its overall operations and growth by using different sources of funds. As such, the capital structure of a utility has a direct impact on its financial risk.[249] Financial risk, in turn, is an important factor considered by the Commission in Base ROE determinations.[250] As Mr. Hill clearly explains in his testimony,[251] when a company lowers the relative amount of debt capital in its capital structure, the total fixed payments that must be made on that debt decline. As the fixed payments decline, the volatility of residual earnings available to common equity holders is reduced and becomes less risky as the firm reduces its financial leverage. That, in turn, causes stockholders to require a lower return on equity. Because of this direct correlation between capital structure and financial risk, Mr.

(1987), *order on reh'g*, Opinion No. 280-A, 43 FERC ¶ 61,217 (1988), *order on reh'g*, Opinion No. 280-B, 44 FERC ¶ 61,008 (1988); *Ind. & Mich. Power Co.*, Opinion No. 27, 4 FERC ¶ 61,316 (1978)

[248] I.D. at P 684.

[249] *Generic Determination of Rate of Return on Common Equity for Electric Utilities,* 47 Fed. Reg. 38,332-01, at 38,338-38,339 (1982)

[250] *Id.*

[251] JCA-1 at 43:8-13.

Gorman and Mr. Hill provided testimony proposing ROE adjustments for MISO TOs with common equity ratios above 55 percent.[252]

The Initial Decision rejects such adjustments for two main reasons: (1) it considers the adjustments to be contrary to the Commission ruling in *ABATE* [253] because the adjustments indirectly achieve the capital structure cap rejected by the Commission in such Order;[254] and (2) it finds that such adjustments challenge the Commission's credit rating screens for the formation of DCF proxy-groups.[255] These findings are in error and should be rejected by the Commission. OMS and JCA generally support CAPs' Brief on Exceptions on this issue, but wish to highlight the following specific errors.

First, the Initial Decision errs by finding that it is contrary to the Commission ruling in *ABATE* to consider the risk attributes associated with the MISO TOs' capital structures in Base ROE proceedings.[256] In *ABATE,* the Commission stated:

> "To the extent that parties contend that some of [the] MISO TOs' capital structures cause unjust and unreasonable costs to ratepayers because they compound what they argue is an unjust and unreasonable base ROE for [the] MISO TOs, then such concerns are best addressed with respect to that ROE, which the Commission is setting for hearing."[257]

The Initial Decision interprets this paragraph to mean that the parties could address whether the capital structures at issue exacerbated the effects of an unjust and unreasonable rate; but could

[252] ICG-1 at 3-4; JCA-9; JCA-10; JCA-1 at 42-53 (Mr. Hill proposed a symmetrical adjustment for MISO TOs that maintain lower common equity ratios).

[253] *ABATE*, 148 FERC ¶ 61,049.

[254] I.D. at P 687.

[255] I.D. at PP 691-692.

[256] I.D. at P

[257] *ABATE*, 148 FERC¶ 61,049 at P 199.

not use the capital structure as basis for reducing the Base ROE.[258] This interpretation is inconsistent with the *ABATE* Rehearing Order, wherein the Commission states that "the amount of risk faced [by utilities] relates to the base ROE determination, where the capital structure is based on the actual amounts of debt and equity employed by the utility."[259] The record shows that there are grounds for considering the lower investment risks resulting from capital structures of some MISO TOs.[260] Adjustments to the Base ROE on the basis of a risk assessment of a utility's capital structure are consistent with FERC policy.[261] As such, the Initial Decision's understanding of FERC's policy is in error and should be rejected.

In any event, a Base ROE at the Upper Midpoint of the DCF range is unjust and unreasonable as demonstrated in the record of this proceeding. The unjustness and unreasonableness of such rate is exacerbated by the demonstrated risk-reducing attributes of certain capital structures. Even following the Initial Decision's misunderstanding of FERC's policy, evidence of the risk-reducing attributes associated with certain MISO TOs' capital structures should have been considered before placing the base ROE at the Upper Midpoint. The Initial Decision's refusal to consider such evidence renders its findings on this point arbitrary and capricious.

Second, the Initial Decision errs by finding that consideration of capital structures would amount to a rejection of the Commission's assumption that its credit-rating screen will produce a proxy-group with investment risks comparable to those posed by the MISO TOs.[262] This finding

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258 I.D. at P 689.
259 *ABATE Rehearing Order*, 156 FERC¶ 61,060 at P 39.
260 ICG-1 at 3-4; JCA-1 at 42-46; JCA-9; and JCA-10.
261 *ABATE*, 148 FERC¶ 61,049 at P 190; *ABATE Rehearing Order*, 156 FERC¶ 61,060 at PP 31 and 39.
262 I.D. at P 692.

is in error because OMS and JCA are not challenging the DCF results. Rather, OMS and JCA are challenging the need for a separate assessment of risks (beyond the DCF analysis) upon a finding that capital market conditions are anomalous. If the Commission, however, finds market anomalies and engages in an independent assessment of the MISO TOs' risks to ensure compliance with the *Hope* and *Bluefield* requirements, the Commission must, on balance, also look at risk-reducing attributes of the MISO TOs' capital structures to ensure that any upward adjustment of the Base ROE for the MISO TOs is just and reasonable for each of the MISO TOs.

F. THE INITIAL DECISION ERRS BY REJECTING WITHOUT EXPLANATION ARGUMENTS THAT ADMISSION OF EVIDENCE OUTSIDE OF THE STUDY PERIOD IS APPROPRIATE AND CONSISTENT WITH FERC PRECEDENT.

The Initial Decision errs by dismissing without explanation CAPs' arguments[263] asking for reconsideration of the Presiding Judge ruling not to allow cross-examination or admit evidence outside of the study period offered by OMS.[264] This dismissal is in error because: (1) the evidence and questioning rejected were relevant to the issues of whether market conditions are anomalous and placement of the base ROE within the DCF range; (2) the ruling contravenes Commission policy in support of a complete record and fundamental principles of due process; (3) the ruling is inconsistent with Commission precedent regarding using data available after the test period to assess the accuracy of or adjust forecasts/estimates made during the test period; and (4) the evidence and questioning should have at least been admitted or allowed to impeach the credibility of the MISO TOs' witnesses.

One of the MISO TOs' core arguments - supporting their claim that capital market conditions are anomalous - is that investors expect interest rates to rise once the Federal Reserve

[263] CAPs Initial Brief at 76-81.
[264] I.D. at P 697.

normalizes its monetary policies.[265] OMS attempted to introduce into evidence a Wall Street Journal Article (dated February 10, 2016) discussing the unlikelihood that the Federal Reserve would increase target fund rates any time soon given global market conditions and use it to cross-examine Mr. McKenzie with respect to his testimony on this point. The Presiding Judge rejected the evidence.[266] OMS later tried to cross-examine Ms. Lapson on the same issue and had prepared a SNL article (dated January 29, 2016) discussing investors' expectations that interest rates will stay low for a long period of time to use in her cross examination, but was cut off before the exhibit could even be introduced.[267] The Presiding Judge instructed OMS counsel to refrain from asking questions regarding information outside of the study period.[268] MOMS counsel had also prepared data concerning DJUA and its movement against S&P 5000 updated to the hearing date to cross Ms. Lapson, but was similarly instructed to restrict his cross examination to data within the study period. In contrast, MISO TOs' evidence outside of the study period was admitted.[269]

In Opinion Nos. 531, *et al.*, the Commission did not mandate that evidence be restricted to the study period. On the contrary, the Commission explained that "because capital market conditions can change between the date the utility files its case-in-chief and the date the Commission issues a final decision, the Commission updates the ROE within the zone of reasonableness at the time of the final decision to reflect those capital market changes."[270] Until

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[265] *See, e.g.*, MTO-1 at 22:10-13 and 23:1-2; MTO-16 at 10:13-20.

[266] Tr. 261:6-14, and 262:1-15.

[267] Tr. 603:13 to 607:18 and 609:22-25.

[268] Tr. 262: 16-25, 607:19 to 609:17, and 609:22-25.

[269] *See* MTO-51 (a Yahoo Finance article dated February 3, 2016) admitted into evidence at Tr. 48:21-24; and MTO-106 (an article by Liz McCormick dated January 18, 2016) admitted into evidence at Tr. 73:16-19.

[270] Opinion No. 531 at P 157.

Opinion No. 531, the Commission accepted evidence of changing U.S. Treasury Bond yields to adjust the base ROE estimated during the DCF study period.[271] In Opinion No. 531 the Commission changed its policy of updating the base ROE by relying on changes to Treasury Bond Yields but allowed "participants in a rate case to present the most recent financial data available at the time of the hearing, ***including post-test period financial data*** then available" to determine whether post-hearing adjustments to the cost of equity are necessary.[272] The Commission explained that:

> This approach will ensure that all participants have an opportunity to present evidence and argument concerning the financial data used to determine the public utility's ROE, while allowing the ROE to be based on ***the most recent financial data available at the time of the hearing*** consistent with the due process rights of the participants.[273]

Because the Commission used evidence concerning the existence of anomalous capital market conditions as basis for placing the Base ROE at the Upper Midpoint in Opinion Nos. 531, *et al.*, any evidence submitted to prove that capital market conditions are not anomalous is relevant to determine the Base ROE. The U.S. Court of Appeals for the D.C. Circuit has ruled that: (1) a utility must demonstrate that its estimates and projections (made during the test period) are reasonable and could do so "by comparing its estimates with actual data;" and (2) the Commission has an obligation to consider "the magnitude of disparity between expectations and reality."[274] The Commission's primary duty under the FPA is to ensure that rates set prospectively are just and reasonable, even if this means that evidence outside the study period

[271] *See, e.g.,* Opinion No. 531 at P 157 and n.310 (citing S. *Cal. Edison Co.,* 131 FERC ¶ 61,020 (2010); *City of Vernon, Cal*., Opinion No. 479, 111 FERC ¶ 61,092 (2005); *Jersey Cent. Power & Light C*o., Opinion No. 408, 77 FERC ¶ 61,001 (1996).

[272] Opinion No. 531 at P 160 (emphasis added).

[273] *Id.* (emphasis added).

[274] *Delmarva Power & Light Co. v. FERC*, 770 F.2d 1131, 1139 (D.C. Cir. 1985), citing *Villages of Chatham and Riverton,, Ill. et al. v. FERC*, 662 F.2d 23, 29-30 (D.C. Cir. 1981)

(but available before the close of the record) must be considered to do so. Because the Presiding Judge ruling is contrary to FERC and court precedent, the Commission cannot accept it without appropriate explanation.

When the Commission issued Opinion Nos. 531, *et al.*, departing from its general policy of setting the Base ROE at the midpoint of the DCF range, it relied upon testimony submitted by the same witness that appeared here on behalf of the MISO TOs.[275] In that NE ROE proceeding, the same witness - Ms. Lapson - disagreed with the position of the complainants' witness that low interest rates were a new norm that would persist for several years.[276] Ms. Lapson represented to the Commission that low interest rates were not sustainable[277] and that such an allegedly abnormal condition was expected to change imminently, rather than persist for several more years.[278] She made that representation over three years ago[279] and, contrary to her prior testimony, low interest rates persisted for several more years and continue to persist.

Had OMS been allowed to cross-examine the witness further about investor expectations and interest rates after the study period, OMS could have shown that investors still expect low interest rates to persist for a long period of time. Investors have already factored the ongoing low interest rates into their decision-making and federally-regulated utilities, such as the MISO TOs, continue to attract capital from those investors, thereby obviating any justification for the Commission to deviate from its standard policy. Simply stated, there is no end to low interest rates in sight in the short term that justifies a temporary deviation from the Commission's

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275 Tr. 599:17-22
276 Tr. 601:1-6; OMS-24 at 36-38.
277 Tr. 600: 16-21; OMS-24 at 36.
278 Tr. 601:1-15; OMS-24 at 36-38.
279 Tr. 601:16-18.

standard policy. Indeed, the mere fact that interest rates have remained low and are expected to continue to remain low, in and of itself excludes them from the common definition of "anomalous," which means "not expected or usual."[280]

The Commission places great importance on having a complete record upon which to base its decisions.[281] Accepting the Presiding Judge's evidentiary ruling will set a bad precedent because it will restrict the Commission's record in future ROE proceedings to evidence that may be unrepresentative of market conditions when setting prospective rates. While OMS and JCA believe that there is sufficient evidence in the record of this proceeding showing that capital market conditions were not (and are not) anomalous, should OMS and other participants have had the ability to use evidence available before the close of the record in cross-examination, the Commission would have had a more complete record upon which reaching the necessary conclusion that capital market conditions are not anomalous.

Finally, OMS and JCA respectfully submit that the evidence offered by OMS should have been admitted and questioning should have been allowed for purposes of impeachment pursuant to Rule 607 of the Federal Rules of Evidence. The I.D. finds that CAPs' attempts to impeach the credibility of Ms. Lapson failed;[282] but does not acknowledge or inform the Commission that that cross-examination of the MISO TOs' witnesses was restricted by the Judge. Cross-examination of the MISO TOs witnesses using evidence outside of the study period could have proved that, once again, those witnesses' opinions and interpretations of investors'

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[280] OMS-25.

[281] *See, e.g.*, *Pub. Utils. Comm'n of the State of California v. Sellers of Long-Term Contracts*, 152 FERC ¶ 63,007 at 66,043 (2015); *Central Hudson Gas & Electric Corp.*, 92 FERC ¶ 63,004, at 65,008 (2000); *Power Mining, Inc.*, 45 FERC ¶ 61,311, at 61,972 n.1 (1988).

[282] I.D. at PP 309-345.

expectations (including the importance investors place on Federal Reserve actions) were simply wrong.[283]

G. THE INITIAL DECISION ERRS IN CONCLUDING THAT IF CAPITAL MARKET CONDITIONS ARE ANOMALOUS, THE ROE MUST THEN BE SET AT THE UPPER MIDPOINT.

Should the Commission find that market conditions during the study period were anomalous and that such anomaly rendered the inputs to the DCF analysis unrepresentative of the cost of equity of the MISO TOs—notwithstanding strong evidence to the contrary—it need not (and should not) default to placing the Base ROE at the Upper Midpoint of the DCF range. The Commission's duty in cases such as this is to set the new Base ROE at a level sufficient to sustain the financial integrity of the MISO TOs so as to allow them to maintain their credit and attract capital to meet public service obligations, but not to overcompensate utility investors to the detriment of consumers. To comply with that mandate, the Commission must have the flexibility to set the Base ROE anywhere between the DCF midpoint and the top of the DCF range. CAPs proposed to use a 75th percentile approach or another point of central tendency in the upper half of the DCF range that is not as high as the Upper Midpoint.[284] CAPs explained that, unlike the Upper Midpoint, the 75th percentile and other points of central tendency do not rely on extremes of range and are not so susceptible to distortion by the measurement error embedded in outlier values.[285]

The Initial Decision rejects the 75th percentile approach, finding it inconsistent with Opinion No. 531 and expressing a concern that the resulting 9.4 percent Base ROE could

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[283] CAPs Initial Brief at 80-81.
[284] CAPs Initial Brief at 167.
[285] *Id.*

produce a result contrary to the prescriptions of *Hope* and *Bluefield*. [286] This finding is in error because it applies a level of upward adjustment that is not justified by record evidence. In Opinion No. 531, Commissioner Norris, correctly stated in his partial dissent that:

> in future ROE cases, if parties wish to argue for an upward adjustment, they should make their case for the appropriate level of the adjustment. The Commission should then determine whether or not the record evidence in each individual proceeding warrants an adjustment, and if so, to what level.

To balance the interests of consumers and investors as required in *Hope* and *Bluefield*, the Commission cannot and should not systematically adopt in this and future ROE proceedings the Upper Midpoint upon finding that the DCF inputs may be distorted. The record must support the level of any upward adjustment. Indeed, as the Commission pointed out in its Rehearing Order in this docket that it would be contrary to the "consumer protection purpose of the FPA" to limit the Commission to accepting any ROE proposed by a utility as long as it is within the zone of reasonableness.[287] In this proceeding, the record does not show that the MISO TOs require an upward adjustment all the way to the Upper Midpoint. Even if the Commission finds that the DCF inputs are distorted by market anomalies, the MISO TOs' witness testified that they will be able to attract capital to meet their obligations at the midpoint of the DCF range.[288]

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 ROE cases involving the placement of the Base ROE above the central tendency of the zone of

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[286] I.D. at P 696.

[287] *Arkansas Electric Cooperative Corporation, et al. v ALLETE, Inc., et al.*, 156 FERC ¶ 61,061 at P 16 (2016).

[288] MTO-20 at 29:5-77 (stating that MISO TOs would devote capital resources to "ensuring continued compliance with NERC Reliability Standards and state retail service obligations).

reasonableness.[289] 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.[290] But, the Commission should not bind itself to an "either-or" choice between the DCF midpoint and the Upper Midpoint.

To fulfill its statutory duty to protect consumers and balance their interests with those of investors, the Commission must be able to set the Base ROE at other points of central tendency within the upper-half of the zone of reasonableness such as the mean,[291] or the median[292] 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 8.72 percent and 9.7 percent).

Considering the conflicting evidence regarding purported "anomalous" capital market conditions and investor expectations in this proceeding, the Commission should preserve maximum flexibility in establishing the new Base ROE for the MISO TOs. Only by preserving that flexibility can the Commission 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, in cases where capital market conditions are found "anomalous," and should clarify that it will not automatically default to the Upper Midpoint in those circumstances.

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

[290] *Id.*

[291] The mean of the upper-half of the DCF zone of reasonableness adopted in the I.D. at P 54 is 9.51 percent.

[292] The median of the upper-half of the DCF zone of reasonableness adopted in the I.D. at P 54 is 9.40 percent.

VI. CONCLUSION

WHEREFORE, OMS and JCA respectfully request that the Commission reject the Initial Decision's finding that capital market conditions were anomalous during the study period and place the Base ROE of the MISO TOs at the midpoint of the zone of reasonableness. Should the Commission find that capital market conditions were anomalous, OMS and JCA respectfully request that the Commission: (1) reject Mr. McKenzie's and Ms. Lapson's flawed alternative benchmarks; (2) consider evidence of the risk-reducing attributes of formula rates and certain capital structures; (3) reject the notion that a significant reduction of the Base ROE necessarily undermines investment in new transmission projects; (4) find that there is no evidence that the DCF inputs have been distorted by such anomaly; and (5) place the Base ROE of the MISO TOs at the midpoint of the DCF range. Finally, should the Commission conclude that anomalous capital market conditions rendered the inputs to the DCF analysis unrepresentative, OMS and JCA respectfully request that the Commission reject the notion that the Base ROE must be placed at the Upper Midpoint. Rather, the Commission should place the Base ROE at a point between the midpoint and the Upper Midpoint reflecting the return necessary (and no more) to comply with *Hope* and *Bluefield* requirements.

Respectfully submitted,

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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 9th day of August, 2016.

/s/ filed electronically

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