UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Association of Businesses Advocating Tariff Equity, *et al.*	)	
Complainants	)	
	)	
v.	)	**Docket No. EL14-12-003**
	)	
Midcontinent Independent System Operator, Inc., *et al.*	)	
Respondents	)	

SUPPLEMENTAL REPLY BRIEF OF THE RESALE POWER GROUP OF IOWA

James H. Holt
David E. Crawford
Betts & Holt LLP
1100 17th St., N.W.
Suite 901
Washington, D.C. 20036

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Pursuant to the Order Directing Briefs, issued herein by the Federal Energy Regulatory Commission ("Commission") on November 15, 2018 (the "Briefing Order"),[1] as amended by the Notice of Extension of Time, issued herein on December 12, 2018, the Resale Power Group of Iowa ("RPGI") hereby submits this supplemental reply brief.

INTRODUCTION

In this brief, RPGI responds to the Initial Supplemental Brief (Corrected) ("MTO Brief") of the MISO Transmission Owners ("MISO TOs"), filed on February 13, 2019. RPGI focuses on the four reasons given by the MISO TOs for replacing the Commission's long-preferred Discounted Cash Flow ("DCF") approach for setting returns on equity ("ROEs") and the five modifications they suggest to the four-model ROE-setting methodology proposed in the Briefing Order. In addition, RPGI responds to the Commission's Trial Staff brief to support Staff's proposed elimination of the Expected Earnings model from consideration by the Commission.

[1] *Association of Businesses Advocating Tariff Equity v. Midcontinent Independent System Operator, Inc.*, 165 FERC ¶61,118 (2019).

However, before delving into the specific errors in the MISO TOs' argument, RPGI believes it is helpful to recall that the Briefing Order directed the parties to address two issues: whether the proposed four-model methodology should be applied to in this case and if so, how.[2] The MTO Brief skips lightly over the first question to focus on the second. In doing so, it essentially ignores the very serious legal and evidentiary issues implicated by the first issue. The Commission, in contrast, does not have that luxury. Before the Commission can adopt the four-model approach, it must grapple with the plethora of issues arising from its abandonment of decades of precedent through which the Commission and the courts have honed, case-by-case, the two-step Discounted Cash Flow ("DCF") methodology into a valuable rate-setting tool that the Commission has consistently referred to as its "preferred" approach. It must also justify its move to a new, multi-model approach that incorporates other ROE methodologies the Commission previously has rejected based on their inaccuracy or unreliability.

To the Commission's credit, on March 21, 2019, it issued a Notice of Inquiry to solicit comments from a broad range of stakeholders on the efficacy of all ROE-setting methodologies, including the DCF model.[3] The record in that policymaking docket will provide the Commission with a detailed record for deciding how to set ROEs in future proceedings. But in this case, the Commission does not write on a blank slate. It must not only set a just and reasonable ROE that is anchored firmly in this case's well-developed evidentiary record but must also make certain that it establishes a direct, logical, and fact-supported linkage between the evidence and the new ROE. The lack of this type of rational connection led the court in *Emera Maine* to vacate

[2] Briefing Order at P. 62.

[3] *Inquiry Regarding the Commission's Policy for Determining Return on Equity*, 166 FERC ¶61,207 (2019) ("NOI").

Opinion No. 531.[4] RPGI does not wish to see a similar outcome in this case and for that reason, it submitted its Initial Supplemental Brief ("RPGI Brief") and is submitting the following reply to the MTO Brief.

SUPPLEMENTAL STATEMENT OF THE CASE AND BACKGROUND

In addition to the ROE NOI, the Commission decided another case since the submission of the RPGI Brief that warrants discussion here. On February 21, 2019, the Commission issued its order in *Trailblazer*,[5] which suggested that the Commission was willing to consider evidence supporting application in that case of at least some of the Briefing Order's reasoning and proposed four-model methodological approach. The *Trailblazer* order indicated that these measures would be adopted for a time period significantly more recent (test period ending December 31, 2018) than those at issue in the electric public utility cases, including the case at hand.[6] It appears from the order that none of the *Trailblazer* parties claimed that unusual or unique financial market conditions were in effect during the case's test period. The four-model approach proposed in the Briefing Order thus appears to have no residual mooring in the factual findings embedded in Opinion No. 531, where the Commission found that unusual financial-market conditions caused it to question the DCF results. Discarding the rationale used in that order ratifies a fundamental point made in the RPGI Brief: the Commission must independently explain and justify its departure from the long-standing, DCF-based ROE model and must not rely on generalizations drawn from evidence in one case to support the outcome in another.

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[4] *Coakley v. Bangor-Maine Hydro Elec. Co.*, Opinion No. 531, 147 FERC ¶61,234 (2014) ("Opinion No. 531"), *vacated*, *Emera Maine v. FERC*, 854 F.3d 9 (D.C. Cir. 2017) ("*Emera Maine*").

[5] *Trailblazer Pipe Line Co., LLC,* 166 FERC ¶ 61,141 (2019) ("*Trailblazer*").

[6] *Trailblazer*, 166 FERC ¶61,141, at P 48.

SUMMARY OF ARGUMENT

1. The MTO Brief provides neither justification nor support for abandoning the Commission's longstanding DCF-based ROE-setting methodology, in whole or in part.

2. The modifications to the proposed four-model methodology sought by the MISO TOs are unsupported and would ensure that the resulting rates are unjust and unreasonable.

3. The MISO TOs' proposed application of the four-model approach ignores, and fails to satisfy, the standards set in *Hope* and *Bluefield*.

ARGUMENT

I. THE MTO BRIEF PROVIDES NO JUSTIFICATION OR SUPPORT FOR ABANDONING THE COMMISSION'S LONGSTANDING DCF-BASED ROE POLICY, IN WHOLE OR IN PART

The RPGI Brief showed that the Commission cannot abandon its long-standing DCF-based ROE approach absent an explanation, supported by evidence, that this change in policy is warranted.[7] The Briefing Order fails to furnish any such rationale, and in fact, exceeds the limited scope of the *Emera Maine* remand. The MTO Brief offers nothing more than arguments and justifications for the Commission's wholesale policy change, none of which fortifies the Commission's proposal or satisfies applicable standards for agency decisions.

In fact, the MISO TOs' arguments rest on an implicit, and false, presumption: that the issue of how the Commission should use financial data to compute an ROE allowance is a matter of first impression. It is not, and the Commission cannot treat the issues as being of first impression. The Commission must account for its prior decisions, especially those in which the same factual claims have been advanced and evaluated: neither the Briefing Order nor the MISO TOs have done so. The Commission's determination of a new base ROE in this case must be

[7] RPGI Brief, pp. 11-15.

supported by substantial evidence and must either be consistent with past practice or adequately justified.[8] The proposed use of a four-model approach remains unjustified, in whole and in its various constituent parts, and is not supported by substantial evidence.

A. The MISO TOs' Proposed Policy Change Is Promoted As A Remedial Response To "Atypical Market Conditions."

As their first reason to buttress the Commission's proposed abandonment of the long-standing DCF-based ROE methodology, the MISO TOs attempt to label the DCF as an "unreliable indicator of investor expectations":

> First, reduced reliance on the DCF model is prudent because recent cases (including this one and EL15-45) have shown the model to be an unreliable indicator of investor expectations, *particularly in atypical capital market conditions*. As the Commission stated previously, the record in this case "demonstrates the presence of unusual capital market conditions such that we have less confidence that the central tendency of the DCF zone of reasonableness (the midpoint in this case) accurately reflects the equity returns necessary to meet *Hope* and *Bluefield*."[9]

The MISO TOs, however, have exaggerated the scope of the Commission's statement. The Commission, having relied on the DCF methodology for over twenty years as its preferred approach for setting ROE allowances, expressed concern that unusual capital market conditions had caused the midpoint of the DCF zone of reasonableness *in this case* not to reflect a just and reasonable equity return. The MISO TOs take this limited concern and expand to include all capital market conditions at all times. That is *not* what the Commission clearly meant, yet throughout the MTO Brief, the MISO TOs draw on this language to extrapolate sweeping generalizations about the use of multiple models in this and all future cases. None of these generalizations acknowledge the Commission's decades of experience with the DCF – a methodological evolution in electric, gas, and oil cases that cannot be cast aside flippantly

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[8] *Town of Norwood v. FERC*, 80 F.3d 526, 533 (D.C. Cir. 1996) ("*Town of Norwood*").

[9] MTO Brief, p. 3 (emphasis added; footnotes omitted).

without extensive analysis and sound reasoning. The MTO Brief offers nothing more cheerleading when the law requires thorough investigation, well-grounded findings of fact, and logical reasoning. In short, the Commission must engage in reasoned decision-making which it cannot achieve in this case because it does not have the evidentiary record to cast off or supplement its DCF methodology. To adopt sweeping "reforms" when none is needed would represent an unreasoned approach to ratemaking.

In fact, in the case at hand, the Commission does not have the evidentiary record to make such a finding. As RPGI pointed out in its Brief on Exceptions, during the evidentiary hearing, the MISO TOs failed to sustain their burden of proving that unusual market conditions had skewed the DCF inputs – a failure that the MISO TOs did not correct in the MTO Brief.[10] In similar situations, where successive cases pertain to unusual market conditions, the Commission has taken pains to explain the applicability of one versus another evidentiary record.[11] Here, if the Commission continues down the path of combining the DCF and other methodologies in the manner strongly supported by the MISO TOs, it will be committing exactly the same error it committed in Opinion No. 531 that led to the outcome in *Emera Maine*: failing to establish a "rational connection" between the record evidence and its decision.[12]

This is an inexplicable and fatal flaw, given that the very purpose of the Briefing Order was to invite the submission of evidence necessary to determine whether the Commission's multi-model methodology should be applied in this case. The MTO Brief contains no basis for questioning the results of the DCF methodology and why the DCF midpoint should not be

[10] Brief on Exceptions of the Resale Power Group of Iowa, FERC Accession No. 20160121-5207 (filed January 21, 2016) at p. 11.

[11] *SFPP, L.P.*, Opinion No. 522, 140 FERC ¶61,220, at P 45 (2012); *Portland Natural Gas Transmission System*, Opinion No. 510, 134 FERC ¶61,129, at P 247 (2011).

[12] *Emera Maine*, 854 F.3d at 27-28.

utilized as a measure of an average-risk utility ROE. The MISO TOs allude to the presence of "atypical market conditions," but even if those conditions existed during the updated test period, the MISO TOs have not shown - either in their evidence presented during the hearing or in the MTO Brief - exactly how those conditions affected the DCF results, why such effect requires the Commission to abandon decades of DCF precedent to apply a new four-model methodology, and how averaging three models produces a more just and reasonable result than the DCF alone. Without such evidentiary nexus, the Commission must apply the DCF methodology in this case and set the ROE at the midpoint of the DCF zone of reasonableness.

B. THE MISO TOs HAVE NOT SHOWN THAT OTHER FINANCIAL MODELS ARE COMPARABLE TO THE DCF FOR ANY TIME PERIOD OR ARE SUITABLE FOR THE PROPOSED USE IN A REVISED ROE APPROACH

The second reason offered by the MISO TOs to support the proposed four-model approach is that the three additional models under consideration represent widely-used and transparent financial techniques. The MISO TOs appear to take a "four is better than one" approach to setting the ROE in this case, but never give a reason for why that might be true. The MISO TOs opt instead nothing more than a bare-bones assertion:

> Second, the new approach will utilize three additional, reliable tools for determining zones of reasonableness and fixing new base ROEs: the Risk Premium method, the Capital-Asset Pricing Model ("CAPM"), and an Expected Earnings analysis rather than relying on the single, inflexible DCF model. These three analytical tools are widely relied upon by investors, and present transparent cost-of-capital estimates.[13]

The MISO TOs offer no explanation of why the three additional methodologies should be considered "reliable tools." They do not, in particular, explain why the results of these models would capture the effects of the phenomenon that they presented as the reason for doubting the DCF results: utility bond investors responding to unique, historical financial market conditions,

[13] MTO Brief, p. 4.

and seeking out higher returns in equity shares of utilities.[14] No reference to this phenomenon appears in any of the MISO TOs' argumentation in this paper hearing. Thus, the three models now touted as a remedy for some unspecified deficiency of the DCF are not shown to have any necessary linkage to the unique factual circumstances that are supposed to have dominated the financial landscape in this case. None of the other arguments advanced by the MISO TOs furnishes any additional support.

1. The Expected Earnings Model Remains Wholly Unsupported as a Measure of Equity Costs Here and Should Be Dispensed With, as Recommended by the Commission's Trial Staff

The RPGI Brief noted that the Expected Earnings methodology proposed in the Briefing Order suffers from significant flaws and should be employed only if it is modified to ensure its methodological integrity through the use of certain essential data.[15] The MTO Brief furnishes no such data, nor does any other participant advance any affirmative reason to include the Expected Earnings model in any revised, multi-model approach, should the Commission adopt the Briefing Order's methodology.

The Commission's Trial Staff supports elimination of the Expected Earnings approach from the proposed four-model (which would become a three-model) approach.[16] In light of the significant issues relating to the availability of data required to properly implement this methodology (discussed in the RPGI Brief) and the questionable access of participants in cases such as these to such data, the Staff recommendation is sound. RPGI endorses it as a balanced conclusion relating to the issues posed in the Briefing Order.

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[14] *See, e.g.*, Prepared Answering Testimony and Exhibits of Ellen Lapson ("Lapson Testimony"), Exh. MTO-16 at 22:6-12.

[15] RPGI Brief, pp. 17 and 29-37.

[16] Initial Supplemental Brief of the FERC Trial Staff, FERC Accession No. 20190213-5136, pp. 6-10.

2. The Risk Premium Model Offers No Solution to the Issues Presented On Remand From The *Emera Maine* Court

The MTO Brief's hearty endorsement of the proposed four-model methodology includes its support of the risk premium model – but only if it is changed in the ways they identify. The MISO TOs' support for this model and the changes they propose, however, shift the focus away from the most important matters in this proceeding. This paper hearing is intended to address specific issues that the Commission found to afflict the reliability of the DCF midpoint as a measure of average utility costs, issues that the MISO TOs characterized as market distortions during a particular time period. By focusing on the mechanics of the risk premium model, the MISO TOs avoid the tougher question: if "atypical market conditions" make DCF model's less reliable, is the risk premium model immune to distortions caused by such conditions?

The Commission has specifically held that the risk premium model is *not* immune from distortion. In *Pennsylvania Power Co.*, the Commission noted: "[I]t has become apparent that the [risk premium approach] can produce distortions during certain time periods. . . ."[17] There is no evidence demonstrating affirmatively that that the time period in issue here did not feature similar distortions. Consequently, the risk premium methodology enjoys no demonstrated superiority over the DCF in the particular circumstances of this case.

C. THE USE OF A QUARTILE APPROACH HAS NO INHERENT ADVANTAGE OVER THE USE OF ADJUSTMENTS FROM THE MEASURE OF CENTRAL TENDENCY, WHICH HAS BEEN ENDORSED BY THE COMMISSION AND THE COURTS

The third reason offered by the MISO TOs in support of the revised ROE approach detailed in the Briefing Order concerns the proposed use of a specific technique to measure risk differentials among proxy group companies: the division of the applicable range of ROEs into quartiles.

[17] *Pennsylvania Power Co.*, 26 FERC ¶61,354, at 61,779 (1984),

> Third, the Commission's new approach adopts a method for the evaluation and selection of base ROEs within the traditional zone of reasonableness that both retains the Commission's preference for reliance on points of central tendency and appropriately accounts for the risk profile of the utility or utilities under consideration. Unlike the Commission's earlier approach of setting ROEs in anomalous capital market conditions at [sic] a measure of central tendency in the upper half of the traditional zone of reasonableness, the Commission's new method sets a base ROE at the measure of central tendency reflective of returns appropriate for utilities with a similar risk profile.[18]

The MISO TOs thus characterize the use of a central-tendency measure within quartiles as an advantage over the use of the central tendency of the DCF as a reasonable representative of the equity cost for an average-risk utility, with adjustments made to account for risk differentials. The traditional, DCF-based approach, however, has a significant advantage that the MISO TOs do not even mention: its repeated acceptance by courts that have reviewed its application in a variety of factual contexts.[19]

Not surprisingly, the *Emera Maine* court did not question or criticize the use of risk-calibrated adjustments within the DCF zone of reasonableness. Rather, the court found fault with the Commission's specific upward ROE adjustment in Order No. 531 and its failure to explain how that adjustment quantified in some way the Commission's concerns with the DCF midpoint, that is, how the adjustment corresponded to the distortions that the Commission purported to perceive in the DCF results.

To address this shortcoming by averaging the DCF model's results with those of other financial models is a *non sequitur* absent any investigation of the underlying reasons, or any showing that the alternative financial models actually cure the perceived shortcoming. For the MISO TOs to applaud the division of the resulting multi-model ranges of ROE into quartiles in

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[18] MTO Brief, p. 5 (footnote omitted).

[19] *United Airlines, Inc. v. FERC*, 827 F.3d 122, 128 (D.C. Cir. 2016); *S. Cal. Edison Co. v. FERC*, 717 F.3d 177, 179 (D.C. Cir. 2013); *Williston Basin Interstate Pipeline Co. v. FERC*, 165 F.3d 54, 61 (D.C. Cir. 1999); *Town of Norwood*, 80 F.3d, at 533 (D.C. Cir. 1996).

the absence of such investigation invites the Commission to go far beyond the scope of correcting the errors in the now-invalidated Opinion No. 531 methodology and commit the same failure to establish a rational connection that the *Emera Maine* court condemned. In short, the third of the arguments raised by MISO TOs in support of the four-model approach is that it resolves an issue that the *Emera Maine* court did not raise, and a flaw that the court did not identify.

The MISO TOs' argument also highlights a fundamental inconsistency in their argument. On the one hand, the MISO TOs dispute any correlation between the central tendency of any ROE model and a utility of average risk.[20] On the other hand, however, they endorse the Commission's proposed approach for locating ROE allowances within the central tendency of returns "appropriate for utilities with a similar risk profile," a measure that uses the central tendency as the point of origin of the quartile/risk approach.

D. The Presumptive Zone of Reasonableness Cannot Be Adopted As Proposed

The fourth argument offered by the MISO TOs in support of the Briefing Order's four-model approach is that the creation of a zone of ROE values within which an existing ROE allowance would be presumptively immune from challenge or invalidation under Section 206 of the Federal Power Act.[21]

> Fourth, the Commission's proposed rebuttable presumption (i.e., that an existing base ROE that falls within the range of returns commensurate with the subject utility's risk profile remains just and reasonable), provides an objective and much-needed mechanism for evaluating ROE complaints under section 206 of the Federal Power Act.[22]

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[20] MTO Brief, p. 5.

[21] 16 U.S.C. §821e.

[22] MTO Brief, p. 5 (footnotes omitted).

For reasons identified in the RPGI Brief, this comment has no applicability in this case.[23] The Initial Decision explicitly found that the existing base ROE allowance of 12.38% was unjust and unreasonable. The MISO TOs did not file an exception to that finding.[24] Therefore, the Initial Decision's determination became the decision of the Commission in Opinion No. 551. The MISO TOs did not seek rehearing of this narrow, but critical aspect of Opinion No. 551. There is no issue pending on rehearing regarding the unjust and unreasonable nature of the 12.38% ROE. The MISO TO's argument therefore has no place or purpose in this case.

E. SUMMARY

In sum, the four reasons offered by the MISO TOs in support of the broad-ranging changes proposed in the Briefing Order fail to pass the test of reasoned decision making. An agency must provide a detailed justification for reversing course and adopting a policy that "rests upon factual findings that contradict those which underlay its prior policy."[25] The Commission has not furnished such an explanation and based upon the critical gaps in the evidentiary record discussed above, it is doubtful that such an explanation is possible, given the legal imperative of establishing a rational connection between the evidence and the Commission's findings.

II. THE MODIFICATIONS THAT THE MISO TOS SEEK WOULD ENSURE THAT THE PROPOSED FOUR-MODEL APPROACH GENERATES RATES THAT ARE UNJUST AND UNREASONABLE

The MISO TOs propose five modifications to the four-model ROE-setting methodology

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[23] RPGI Brief, pp. 8-9.

[24] Brief on Exceptions of the MISO Transmission Owners, FERC Accession No. 20160121-5224, at p. 2.

> he Initial Decision provides a thorough review and analysis of the evidence and of the participants' arguments in this case. Consequently, the MISO Transmission Owners take exception only to limited aspects of the Initial Decision, and do not challenge the Presiding Judge's principal conclusions supporting his recommended new base rate of return on equity ("Base ROE") for the MISO Transmission Owners of 10.32 percent."

[25] *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515 (2009).

delineated in the Briefing Order: two changes to the proposed method for establishing the upper and lower boundaries of the zone of reasonable returns and three changes to the DCF model.[26] None of these proposed modifications are warranted or supported and, indeed, they would ensure that the Commission's proposed methodology produces rates that are unlawful.

A. The Commission's Proposed Use of A High-End Outlier Screen Is Reasonable and Has No Inappropriate Or Impermissible Impacts on the Analyses In This Case

The MISO TOs make two different, but related arguments in opposition to the proposed high-end outlier described in the Briefing Order.[27] Neither of these arguments presents any valid basis for modifying or eliminating this screen from the Commission's proposed approach.

1. The Proposed High-End Outlier Does Not "Artificially" Contain the Zone of Reasonableness.

The high-end outlier screen described in the Briefing Order would operate to exclude ROE values that exceed 150% of the median results under the DCF, CAPM and Expected Earnings models, respectively. The MISO TOs argue that this screen would "narrow artificially the zone of reasonableness."[28] This argument misstates both the purpose and the effect of the proposed outlier test.

The zone of reasonableness is just that, a zone of ROE allowances within which the Commission might *reasonably* locate an acceptable allowance that corresponds to the risks of the utility or utilities whose rates are in issue. It is a tool of estimation, not precision. Indeed, the terminology is significant; it is not referred to either as the "zone of precision" or the "zone of all possible outcomes." Rather, it incorporates the Commission's exercise of judgement as to how

[26] MTO Brief, pp. 12-24.

[27] MTO Brief , pp. 12-16 (Section III.C.1) and 18-19 (Section III.C.3).

[28] MTO Brief, p. 14.

the data that it employs relates to the estimated cost of equity under both the Commission's traditional DCF model and the four-model methodology proposed in the Briefing Order.

It is neither any more nor any less artificial for the Commission to employ a high-end outlier test than a low-end outlier test. The MISO TOs complain that there is no evidence that equity investors use a high-end outlier as a factor in their decision to invest. However, if that assertion is true, it is equally true to that there is no evidence that equity investors actually invest on the theory that equity is riskier than debt. The low-end outlier is based purely on the financial theory that equity investors *must* demand a higher return than debt, but that theory does not furnish a specific figure, such as the 100-basis point spread that the Commission has used and proposes to continue to use.

The high-end outlier, according the MISO TOs' witness Mr. McKenzie, serves to screen out proxy companies whose growth rates are "obviously higher, but not excessive"[29] Even this formulation clearly demonstrates the role of informed judgment based on the record evidence in an individual case, since what is "obvious" to one is not obvious to all and rates that "excessive" in one opinion are excessive because the Commission determines them to be so, using the *Hope* and *Bluefield* standards. The high-end outlier test demands no greater skepticism or precision in order to be adopted as a tool for estimating the cost of equity for a utility than the Commission has furnished.

The MISO TOs specifically protest the exclusion of the 16.37% ROE estimate for ITC Holdings from the zone of reasonable returns under the Expected Earnings analysis. To support their protest, the MISO TOs rely on the McKenzie Affidavit in which Mr. McKenzie claims that

[29] MTO Brief, Appendix 2, Affidavit of Adrien M. McKenzie on Behalf of the MISO Transmission Owners ("McKenzie Aff.") at 21:8-9.

investors would use this estimate in evaluating an appropriate return and that therefore, the Commission should retain it without regard for the high-end screen. Mr. McKenzie states:

> During the study period at issue in this proceeding, investors' evaluation of risk and required returns for ITC was based primarily on their expectation regarding the transmission operations and investments at issue in this case. [30]

According to Mr. McKenzie, Value Line recognized this close relationship:

> In its December 2013 report for ITC, Value Line observed that, "[i]n November, a complaint was filed against ITC and some other transmission owners that their allowed return on equity, common equity ratio, and incentive "adders" to the allowed ROE were too high. The stock price declined 6% on the day of the news, and has weakened a bit since then." Value Line (Dec. 20, 2013).[31]

Although Mr. McKenzie cites a report issued over a year before the test period (January – June 2015) to support a test period-based assertion, he nevertheless urges that the estimated ROE values for ITC Holdings should be included in computing the zone of reasonableness for the reason that investors viewed the referenced complaint (presumably the one that initiated this proceeding) as having an actual or potential impact on "incentive 'adders'" as well as the capital structure of ITC Holdings.

The MISO TOs argued exactly the opposite earlier in this proceeding. In their Brief Opposing Exceptions, the MISO TOs asserted that incentive adders are "wholly unrelated" to a utility's cost of equity:

> ROE incentive adders awarded under [Federal Power Act] section 219 are wholly unrelated to a utility's "cost of equity," or to the risks of raising capital in the equity markets, and therefore are properly separated from the determination of a base ROE that will meeting the *Hope* and *Bluefield* requirements.[32]

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[30] MTO Brief, pp. 18-19; McKenzie Aff. at 22:15-18.

[31] McKenzie Aff. at 22 fn. 53.

[32] Brief Opposing Exceptions of the MISO Transmission Owners, FERC Accession No. 20160210-5166 p. 34.

The cited portion of the McKenzie Affidavit thus contradicts the position that the MISO TOs have taken and should be disregarded. Moreover, the Value Line report in December 2013 did not purport to distinguish between investor evaluations of how the complaint might differentially affect ITC's incentive adders versus its base ROE or its capital structure. Consequently, it may not be accurate to conclude, as Mr. McKenzie appears to have done, that the cited investor response related to the "transmission operations and investments at issue in this case."

The Value Line report cited by Mr. McKenzie, however, highlights an important point, namely, that the financial data compiled in each of the models that the Commission uses likely incorporates investors' assessments of the impact of incentive revenues in addition to traditional, risk-based ROE allowances. Indeed, Mr. McKenzie's own analysis indisputably implies that the stock price of ITC Holdings was influenced by exactly such considerations. Presumably, those same investors would not distinguish between revenues and earnings that derive from incentive adders as opposed to base ROE revenues. The Commission may wish to investigate how these data problems affect its overall ROE approach. Here, there are sound grounds – furnished in the McKenzie affidavit – for questioning the applicability of ITC Holdings as representative of the financial data used to set a **base** ROE.

2. The Proposed High-End Outlier Does Not Produce Arbitrary or Capricious Results in the Expected Earnings Analysis.

Related to the general argument that the high-end outlier has an "artificial" impact on the zone of reasonableness, the MISO TOs raise a more specific claim that application of the high-end outlier test to ITC Holdings, and the resulting exclusion of ITC Holdings from the computation of the range, produces an "arbitrary and capricious effect" on the Expected Earnings analysis. They argue that the 16.37% ROE figure representing the estimate for ITC Holdings is not unreasonable, again, relying on portions of the McKenzie Affidavit[33] and claiming that this ROE is "within the bounds of ROE ranges approved by the Commission in the past."[34] To support their claims, the MISO TOs cite the 16.9% upper-end of the DCF range that the Commission approved in *Tallgrass Transmission, LLC/Prairie Wind Transmission, LLC* ("*Tallgrass*")[35] and the 16.4% upper-end ROE that the Commission approved in *Northern Pass Transmission LLC*.[36]

These cases do not support the argument that the high-end outlier test proposed by the Commission produces an unreasonable result. In fact, they serve to underscore the utility of employing a high-end screen such as the Commission has proposed. In *Tallgrass*, the Commission based its decision on financial data that originated during the Great Recession.[37] As the Commission has noted, data derived from the beginning of Great Recession is unlikely to be representative for purposes of setting an ROE allowance under other market conditions.[38] *Tallgrass* cannot be used as precedent for evaluating a reasonable upper-end of the zone of reasonableness.

Mr. McKenzie's citation to *Northern Pass* points to an exhibit that is not included either in his testimony or in the Commission's order. The cited exhibit (attached to this brief as Attachment A), however, reveals that the 16.4% high-end ROE was more than 200-basis points higher than the next highest ROE value in the proxy group DCF analysis. In that context,

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[33] McKenzie Aff. at 21:1 - 23:18.

[34] MTO Brief, pp 18-19.

[35] *Tallgrass Transmission, LLC/ Prairie Wind Transmission LLC*, 125 FERC ¶ 61,248, at P 78 (2008).

[36] *Northern Pass Transmission LLC*, 134 FERC ¶ 61,095, at P 53 & Attachment NPT-603 (2011).

[37] *Tallgrass*, 125 FERC ¶ 61,248, at P 76 fn 76 (2008) ("The Commission used in its discounted cash flow analysis six months of market data ending October, 2008, as available.").

[38] *Portland Natural Gas Transmission System*, Opinion No. 510-A, 142 FERC ¶61,198, at PP 217-218, 233 (2013).

including the 16.4% ROE would have produced an overstated, and hence unjust and unreasonable, midpoint ROE.

The cases and the evidence cited in the McKenzie Affidavit, demonstrate the wisdom of employing a high-end outlier screen such as the Commission has proposed. They in no way undermine the Briefing Order's screen here because the precedents fail to show that the result here would be unreasonable.

The MISO TOs' position on this issue is nothing other than a self-justifying argument that just because the Commission adopted an ROE allowance in an order issued eight years ago in which it did not apply a high-end outlier test based on the same approach it now proposes, it is precluded from doing so here. The Commission should reject that reasoning.

B. THE MISO TOS CRITICISMS OF THE PROPOSED LOW-END SCREEN ARE UNSUPPORTED

The MISO TOs also attack the Commission's proposed low-end screen for being a "static test."[39] The MISO TOs urge that a fixed 100-basis point differential between the yields of utility bonds and estimated equity returns is inappropriate, based on what they characterize as an inverse relationship between interest rates and the risk differential required by investors to account for the incremental risk of equity investment. This argument suffers warrants no modification of the low-end screen as proposed in the Briefing Order.

The MISO TOs argue that Commission adopted the low-end screen using data from 2007 and 2008.[40] The MISO TOs, however, overlook several relevant aspects of the Commission's precedent on this topic. The *Southern California Edison* order cited by the MISO TOs includes the following review of the then-recent decisions on the topic:

[39] MTO Brief, p. 7.

[40] MTO Brief, p. 8 ("The Commission adopted its 100-basis point risk premium threshold for low-end outliers in several ROE cases that used data from 2007 and 2008.").

> A review of the Commission's precedent regarding low-end returns indicates that in Opinion No. 489, the Commission eliminated companies whose ROEs were below the bond yield for that particular rating. In Opinion No. 445, the Commission eliminated companies whose ROEs were less than 36 basis points above the average Moody's bond yield for that particular rating. In *Atlantic Path 15* and *Startrans*, the Commission eliminated companies whose ROEs were less than 100 basis points above Moody's bond yield for that particular rating. More recently, in *Pioneer Transmission, LLC*, the Commission excluded from the proxy group companies whose low-end ROEs were within about 100 basis points above the cost of debt.[41]

Thus, the Commission has employed at least three different risk differentials in crafting an appropriate screen for the low end of the zone of reasonableness: (1) Opinion No. 489, that imputed no spread between the bond yield and the lowest ROE estimates; (2) Opinion No. 445, that used a 36 basis-point spread; and (3) *Southern California Edison* that used a 100-basis point spread proposed by the utility itself. Consequently, the proposal described in the Briefing Order to use a 100-basis point spread represents a significant increase over at least two cases cited in the MTO Brief from the 2007-2010 period.

In fact, the Commission adopted and applied a 100 basis point low-end screen for the DCF model at least thirteen years earlier than the cases cited by the MISO TOs as the original source of this technique.[42] For at least the past 25 years the Commission has based its ROE awards on the use of a DCF analysis that incorporates a spread somewhere between zero and 100 basis points. There is *no evidence* that this technique has produced insufficient ROE allowances. The proposed 100 basis point spread above company bonds is a proven and reasonable measure of the differential risks borne by equity investors over debt instruments. *Hope* and *Bluefield* require no more than this.

The MISO TOs also assert that by the time of the test period in this case (which occurred

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[41] *Southern California Edison Co.*, 131 FERC ¶61,020, at P 54 (2010).

[42] *See, e.g.*, *Young Gas Storage Co.*, 66 FERC ¶ 61,280, at 61,797 (1994); *Crossroads Pipeline Co.*, 71 FERC ¶61,076, at 61,263 (1995).

after the cases cited above), bond yields had decreased to the point that equity investors required "widening equity premiums" in evaluating the low-end cost of equity estimates with the result that a 100 basis point screen will understate the low-end threshold.[43] Yet, according to the testimony of a key witness for the MISO TOs, it was the influx of debt investors into utility stocks that drove the price of equity shares up during this same time period.[44] It remains an unexplained paradox of the MISO TO's case that these same investors would have demanded an increase in the differential between these investments when they were willingly assuming the greater risks of owning shares rather than bonds. The MTO Brief does not acknowledge, let alone resolve this paradox, which means that the Commission does not have an evidentiary basis for changing its low-end threshold proposal in this proceeding.

C. THE MISO TOs' PROPOSED RETROGRESSION TO A SINGLE-STEP DCF MODEL IS UNFOUNDED AND DOES NOT ADDRESS THE REASONS UNDERLYING THE ADOPTION OF THE TWO-STEP MODEL

As previously noted, in *Emera Maine*, the court accepted the FERC's finding that unusual, unique financial conditions undermined the use of the DCF midpoint as a suitable measure of an average-risk utility. The court did not, nor was it asked to, impugn the DCF methodology itself, nor any of its constituent elements. In formulating a response on remand to the *Emera Maine* proceeding, there is no reason to examine or critique the Commission's formulation of the DCF over the past thirty years, and even less reason to revisit the criticisms that have been considered and rejected. Nevertheless, the MISO TOs argue that, even if the Commission decides to employ a high-end outlier screen, it should only apply such screen to the CAPM and Risk Premium models and not to the two-step DCF analysis.[45] They alternatively

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[43] McKenzie Aff. at 28:10 – 30:12.

[44] Lapson Testimony, Exh. MTO-16 at 22:6-12.

[45] MTO Brief, pp. 16-18.

argue that if the Commission adheres to the proposed use of a high-end outlier screen for the DCF results, it should adopt a constant-growth DCF model.[46] In doing so, the MISO TOs retrieve from the archives a number of arguments that the Commission has considered and rejected and frame an argument that suggests a wholesale disregard for the cases in which the DCF has been examined, customized, and adapted to the Commission's uses. The Commission need not respond to such a position, other than to note that the various issues raised here in promoting the return to a single-stage DCF model have all been put to the test of reasoned analysis and decided.

For example, in a family of decisions over a period of years, the Commission expressed its preference for the two-step DCF method, and then expanded upon it, explaining that the theoretical assumptions of the DCF formula require the use of a two-stage growth component, for reasons that squarely rebut the cited passages from Mr. McKenzie's affidavit here.[47] *See Ozark Gas Transmission System,* 68 FERC ¶ 61,032, at 61,105-07 (1994); *Wyoming Interstate Co.*, 69 FERC ¶ 61,259, at 61,992 (1994); *Northwest Pipeline Corp.*, 71 FERC ¶ 61,253, at 61,992 (1995). *See also, Panhandle Eastern Pipe Line Corp.*, 71 FERC ¶61,228, at 61,833-35 (1995); *Williston Basin Interstate Pipeline Co.,* 72 FERC ¶61,074, at 61,376 (1995).

The MISO TOs offer nothing new to fortify their claim that a single-stage DCF serves as a valid measure of the cost of equity capital. The proposed use of a single-stage DCF therefore should be rejected out of hand.

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[46] MTO Brief, pp. 19-22.

[47] McKenzie Aff. at 42:3-52:14.

III. THE MISO TOS' PROPOSED APPLICATION OF A FOUR-MODEL APPROACH IGNORES, AND FAILS TO SATISFY, THE *HOPE* AND *BLUEFIELD* STANDARDS

Throughout this proceeding, the MISO TOs have argued that the Commission's established DCF-based approach to setting ROE allowances failed to produce a just and reasonable result because it did not adhere to or satisfy the *Hope and Bluefield* standards.[48] They repeatedly characterized the application of the two-step DCF methodology, with its various constituent elements, as a "mechanical" approach that failed to take into account the views and interests of investors vis-à-vis the results of DCF analyses under prevailing financial market conditions.[49] The *Emera Maine* court did not explicitly endorse this claim but appeared to accede to the Commission's findings that it had misgivings about the DCF results, if not its theoretical basis.

In the MTO Brief, however, the MISO TOs have produced several modifications of the approach set forth in the Briefing Order, with the end result representing a "mechanical" recommendation – one that wholly disregards the results of those recommendations. When viewed from the perspective of the end result, the MISO position fails to satisfy the *Hope* and *Bluefield* standards, which served as the keystone of the *Emera Maine* court's opinion and defined the scope and tenor of the remand and, in turn, this paper hearing.

For example, Mr. McKenzie's affidavit encompasses two different computations of a range of presumptively reasonable ROE allowances. Using what he describes as an application of the Briefing Order's approach, he computed a composite zone of reasonableness of 7.45 % to

[48] *See, e.g.,* Answering Testimony of William E. Avera on behalf of the MISO Transmission Owners ("Avera Testimony"), Exh. MTO-1 at 10:1-6.

[49] *See, e.g.,* Avera Testimony, Exh. MTO-1 at 13:16-20.

13.07%.[50] Using the same methodology, as modified to incorporate his recommended low-end screen and his proposed use of Value Line growth estimates, he computed a zone of reasonableness of 7.47% to 13.45%.[51]

Mr. McKenzie did not compare either of these presumptive zones of reasonableness with the actually-awarded ROE allowances that appear elsewhere in his own affidavit.[52] Such a comparison is instructive, however. If he had, he would see that some ROEs that had been awarded prior to the study period in this case would be unjust and unreasonable as being *too low*. They would fall outside the presumptively reasonable range under his computations.

There is no evidence that any of these utilities were claimed to have, or were found to have, unusually low risks. There is no evidence that they had failed to secure needed equity investment. Absent any such evidence, Mr. McKenzie's recommended ranges are too high to be considered realistic as a portrayal of actual market conditions – in short, his evidence fails the *Hope* and *Bluefield* tests. The MISO TOs' proposed adjustments are merely "mechanical" and have no support other than McKenzie's theoretical reconfiguring of the data.

CONCLUSION

The MISO TOs have not given the Commission any legally viable reason to adopt the four-model ROE-setting methodology described in the Briefing Order. Changing decades of Commission precedent to remedy two limited defects identified by the *Emera Maine* court (one of which does not even apply in this case) would be using an administrative sledgehammer to swat a ratemaking fly: the method utilized far exceeds the one required. The evidentiary record of this proceeding is replete with data on which the Commission can base its ROE determination

[50] MTO Brief, p. 26; McKenzie Aff. at 8:5 – 9:2.

[51] MTO Brief, pp. 25-26; McKenzie Aff. at 11:9 – 12:11.

[52] McKenzie Aff., Attachment 6, pp. 4-5.

without engaging in a sweeping restructuring of its ROE-setting approach that would skew the *Hope* and *Bluefield* balance of interests decidedly in the utilities' favor. This path is the most legally sound and practicably expeditious. RPGI respectfully requests the Commission to choose that path.

Respectfully submitted,

BETTS & HOLT LLP

/s/ James H. Holt
James H. Holt
David E. Crawford
1100 17th St., N.W.
Suite 901
Washington, D.C. 20036
(202) 530-3380 (voice)
(202) 530-3389 (facsimile)
jhh@bettsandholt.com
dcrawford@bettsandholt.com

Counsel for the Resale Power Group of Iowa

Date: April 10, 2019

CERTIFICATE OF SERVICE

I hereby certify that I have, on this date, caused a copy of the foregoing document to be served upon all persons listed on the official service list in this proceeding.

/s/ James H. Holt
James H. Holt

April 10, 2019

ATTACHMENT A

FERC DCF MODEL

NATIONAL PROXY GROUP

		(a)		(b)		(c)	(d)				
		6 Mo.Div. Yield		Adjusted Div. Yield		Growth Rates		Implied Cost of Equity			
	Company	Low	High	Low	High	br + sv	IBES	Low		High	Average
1	Ameren Corp.	5.5%	5.9%	5.4%	6.0%	2.5%	-3.9%	1.5%	--	8.5%	--
2	American Elec Pwr	4.7%	5.0%	4.7%	5.1%	4.5%	3.9%	8.6%	--	9.6%	9.1%
3	Avista Corp.	4.6%	5.0%	4.7%	5.1%	3.6%	4.5%	8.3%	--	9.6%	8.9%
4	Black Hills Corp.	4.4%	5.0%	4.5%	5.1%	1.7%	6.0%	6.2%	--	11.1%	--
5	CenterPoint Energy	5.0%	5.5%	5.2%	5.7%	8.0%	5.8%	11.0%	--	13.7%	12.4%
6	Cleco Corp.	3.3%	3.5%	3.3%	3.7%	6.2%	3.0%	6.3%	--	9.8%	--
7	CMS Energy	3.6%	4.0%	3.7%	4.1%	5.3%	6.0%	9.0%	--	10.1%	9.5%
8	DTE Energy Co.	4.5%	4.9%	4.6%	5.0%	4.2%	5.0%	8.9%	--	10.0%	9.4%
9	Edison International	3.5%	3.8%	3.6%	3.9%	5.5%	3.5%	7.1%	--	9.4%	--
10	Great Plains Energy	4.4%	4.7%	4.5%	5.0%	2.7%	13.0%	7.1%	--	18.0%	--
11	Hawaiian Elec.	5.2%	5.6%	5.2%	5.8%	2.3%	8.0%	7.5%	--	13.8%	--
12	IDACORP, Inc.	3.3%	3.5%	3.3%	3.6%	5.5%	4.7%	8.0%	--	9.1%	8.6%
13	Integrys Energy Grp	5.3%	5.8%	5.4%	6.0%	1.8%	7.9%	7.1%	--	13.9%	--
14	ITC Holdings Corp.	2.2%	2.4%	2.3%	2.6%	10.0%	16.5%	12.3%	--	19.1%	--
15	Pepco Holdings	5.9%	6.4%	5.9%	6.6%	0.7%	7.0%	6.5%	--	13.6%	--
16	PG&E Corp.	3.9%	4.2%	4.0%	4.4%	6.0%	6.5%	9.9%	--	10.9%	10.4%
17	Pinnacle West Capital	5.1%	5.5%	5.2%	5.7%	3.5%	6.5%	8.7%	--	12.2%	10.5%
18	Portland General Elec.	5.1%	5.4%	5.1%	5.5%	3.4%	5.4%	8.5%	--	10.9%	9.7%
19	PPL Corp.	5.1%	5.5%	5.2%	5.8%	10.6%	3.6%	8.8%	--	16.4%	12.6%
20	Progress Energy	5.7%	6.1%	5.7%	6.2%	2.0%	3.7%	7.7%	--	9.9%	8.8%
21	TECO Energy	4.7%	5.1%	4.8%	5.3%	4.9%	6.8%	9.7%	--	12.1%	10.9%
22	UIL Holdings	6.1%	6.6%	6.2%	6.8%	5.7%	3.7%	9.9%	--	12.5%	11.2%
23	Westar Energy	5.0%	5.4%	5.1%	5.6%	2.8%	7.8%	7.9%	--	13.4%	10.7%
24	Wisconsin Energy	2.8%	3.0%	2.9%	3.1%	7.0%	10.1%	9.9%	--	13.2%	11.6%
	Range of Reasonableness							**1.5%**	--	**19.1%**	
	Adjusted Range of Reasonableness (e)							**7.7%**	--	**16.4%**	
	Midpoint								**12.1%**		
	Median (f)										**10.4%**

(a) Six-month average dividend yield for June - November 2010.
(b) Six-month dividend yield adjusted for one-half years' growth.
(c) See Exhibit No. NPT-604.
(d) *Thompson Reuters Company in Context Report* (Dec. 7, 2010).
(e) Excludes highlighted values.
(f) Based on the average of the low and high DCF estimates for all companies with two valid observations.