

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

Arkansas Electric Cooperative Corporation
Mississippi Delta Energy Agency
Clarksdale Public Utilities Commission
Public Service Commission of Yazoo City
Hoosier Energy Rural Electric Cooperative, Inc.

Docket No. EL15-45-000

v.

ALLETE, Inc.
Ameren Illinois Company
Ameren Missouri
Ameren Transmission Company of Illinois
American Transmission Company LLC
Cleco Power LLC
Duke Energy Business Services, LLC
Entergy Arkansas, Inc.
Entergy Gulf States Louisiana, LLC
Entergy Louisiana, LLC
Entergy Mississippi, Inc.
Entergy New Orleans, Inc.
Entergy Texas, Inc.
Indianapolis Power & Light Company
International Transmission Company
ITC Midwest LLC
Michigan Electric Transmission Company, LLC
MidAmerican Energy Company
Montana-Dakota Utilities Co.
Northern Indiana Public Service Company
Northern States Power Company-Minnesota
Northern States Power Company-Wisconsin
Otter Tail Power Company
Southern Indiana Gas & Electric Company

**REPLY PAPER HEARING BRIEF OF
THE MISO COMPLAINANT-ALIGNED PARTIES**

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Exhibit No.	Sponsoring Party	Description
ICG-208	Michael P. Gorman	Reply Affidavit of Michael P. Gorman on behalf of Industrial Consumer Groups
ICG-209	Michael P. Gorman	Midcontinent Independent System Operator: Short Term Growth Accuracy
ICG-210	Michael P. Gorman	Midcontinent Independent System Operator: Accuracy of Interest Rate Forecasts (Long-Term Treasury Bond Yields - Projected vs. Actual)
ICG-211	Michael P. Gorman	Workpapers of Michael P. Gorman
JCI-207	J. Bertram Solomon	Rebuttal Affidavit of J. Bertram Solomon on Behalf of Arkansas Electric Cooperative Corporation, Hoosier Energy Rural Electric Cooperative, Inc., and Cooperative Energy
JCI-208	J. Bertram Solomon	Restatement of E/B ROEs to E/NPE Earnings to Common Equity Related Portion of Net Plant
OMS-208	Dr. S. Keith Berry	Reply Affidavit of Dr. S. Keith Berry on Behalf of The Organization of MISO States, Inc.
OMS-209	Dr. S. Keith Berry	McKenzie Results with Median; Briefing Order's Method with Median
OMS-210	Dr. S. Keith Berry	Modification of McKenzie Attachment 2, page 1 of 4, For Different Weights
OMS-211	Dr. S. Keith Berry	McKenzie Results With Alternate Sequence of Calculations

OMS-212	Dr. S. Keith Berry	Scenario A: ROE Results Excluding Expected Earnings With Standard Deviation Outliers
OMS-213	Dr. S. Keith Berry	Scenario B: ROE Results Including Business Cycle Expected Earnings With Briefing Order's High Outliers
OMS-214	Dr. S. Keith Berry	Scenario A: ROE Results Excluding Expected Earnings with Outliers Excluded at End of Calculations
OMS-215	Dr. S. Keith Berry	Scenario B: ROE Results Including Business Cycle Expected Earnings with Outliers Excluded at End of Calculations

GLOSSARY

Briefing Order	<i>Ass'n of Businesses Advocating Tariff Equity, et al., v. Midcontinent Indep. Sys. Operator, Inc.</i> , Order Directing Briefs, 165 FERC ¶ 61,118 (2018)
CAPM	Capital Asset Pricing Model
<i>Coakley</i> Briefing Order	<i>Coakley v. Bangor Hydro-Elect. Co.</i> , 165 FERC ¶ 61,030 (2018)
Commission/FERC	Federal Energy Regulatory Commission
DCF	Discounted Cash Flow
DPS	Dividends per share
E/B	Earnings/book
EPS	Earnings per share
FPA	Federal Power Act
GDP	Gross Domestic Product
IBES	Institutional Brokers' Estimate System
ICG	Industrial Consumer Groups
JCA	Joint Consumer Advocates
JCI	Joint Customer Complainants and Intervenor
M/B	Market/book
McKenzie EL11-66 Reply Affidavit	<i>Coakley v. Bangor Hydro-Elec. Co., et al.</i> , Reply Paper Hearing Brief of the New England Transmission Owners at Attachment A, Reply Affidavit of Adrien M. McKenzie, CFA, Docket Nos. EL11-66-001, EL11-66-004, EL11-66-005, EL13-33-000, EL13-33-002, EL14-86-000, EL16-64-000, EL16-64-002 (filed Mar. 8, 2019) (eLibrary Accession Number: 20190308-5262).
MISO	Midcontinent Independent System Operator, Inc.

MISO CAPs	MISO Complainant-Aligned Parties
MISO TOs	MISO Transmission Owners
MLP	Master Limited Partnership
MOMs	Missouri-Mississippi Parties
OMS	Organization of MISO States, Inc.
P/E	Price-to-earnings
ROE	Return on Equity
S&P	Standard & Poor's
Tr.	Hearing transcript
Value Line	The Value Line Investment Survey
Virginia Commission	Virginia State Corporation Commission

I. INTRODUCTION

Pursuant to Rule 706 of the Rules of Practice and Procedure¹ of the Federal Energy Regulatory Commission (“FERC” or “Commission”), the Commission’s November 15, 2018 Order Directing Briefs,² and the Commission’s December 12, 2018, Notice of Extension of Time, the MISO Complainant-Aligned Parties (“MISO CAPs”)³ respectfully submit this Reply Paper Hearing Brief (“Reply Paper Hearing Brief”) in the above-captioned proceeding, which concerns the base rate of return on equity (“ROE”) collected by the Midcontinent Independent System Operator, Inc. (“MISO”) for the MISO Transmission Owners (“MISO TOs”).

¹ 18 C.F.R. § 385.706 (2018).

² *Ass’n of Businesses Advocating Tariff Equity, et al., v. Midcontinent Indep. Sys. Operator, Inc.*, Order Directing Briefs, 165 FERC ¶ 61,118 (2018) (“Briefing Order”).

³ For purposes of this Reply Paper Hearing Brief, the MISO CAPs include: Industrial Consumer Groups (“ICG”), comprising Association of Businesses Advocating Tariff Equity (“ABATE”), Coalition of MISO Transmission Customers (“CMTC”), Illinois Industrial Energy Consumers (“IECC”), Indiana Industrial Energy Consumers, Inc. (“INDIEC”), Minnesota Large Industrial Group (“MLIG”), and Wisconsin Industrial Group (“WIEC”); Joint Consumer Advocates (“JCA”), comprising Illinois Citizens Utility Board, Indiana Office of Utility Consumer Counselor, Iowa Office of Consumer Advocate, Michigan Citizens Against Rate Excess, Minnesota Department of Commerce, and Citizens Utility Board of Wisconsin; Joint Complainants and Intervenor (“JCI”), comprising Arkansas Electric Cooperative Corporation (“AECC”), Cooperative Energy, and Hoosier Energy Rural Electric Cooperative, Inc. (“Hoosier”); Organization of MISO States, Inc. (“OMS”); Mississippi Public Service Commission (“MS PSC”), Missouri Public Service Commission (“MO PSC”) and Missouri Joint Municipal Electric Utility Commission (“MJMEUC”) (collectively, “Missouri-Mississippi Parties” or “MOMs”); and Southwest Electric Cooperative, Inc. (“SWEC”).

OMS participates in this joint Reply Paper Hearing Brief where it is consistent with the policy positions approved by a majority of its Board of Directors. The Manitoba Public Utilities Board and the Council of the City of New Orleans abstained. Nothing in OMS’s participation in this Reply Paper Hearing Brief should be read as assertions or arguments by state commission members of OMS applicable to state return on equity proceedings. Individual state commissions have their own proceedings and applicable precedent guiding state return on equity determinations. Where OMS has no position or its position differs from positions stated in this Reply Paper Hearing Brief, exceptions have been footnoted.

II. SUMMARY OF ARGUMENT

MISO CAPs' Initial Paper Hearing Brief⁴ and accompanying affidavits/testimony demonstrated that for the applicable study period (July-December 2015) all reasonably-implemented methods for inferring the MISO TOs' cost of equity from financial market prices produce similar results, consistently below 10%. The stand-alone Discounted Cash Flow ("DCF") median is 8.81% (and the DCF midpoint is 8.72%);⁵ the stand-alone Capital Asset Pricing Model ("CAPM") median is 8.12%;⁶ and the stand-alone Risk Premium result centers at 9.43%.⁷ When these methods are combined appropriately, they indicate an equity cost of 8.73%.⁸ For all the MISO TOs' past elaborate pleading about undefined "anomalous market conditions" somehow distorting DCF results, the statistically reasonable distillation of the study period's DCF results is very close to the combined indication of multiple empirical methods.

The MISO TOs present significantly higher results, which combined in their fashion would indicate a 10.24% allowed base ROE.⁹ Even that inflated result is far below (214 basis

⁴ "Initial Paper Hearing Brief of the MISO Complainant-Aligned Parties," filed in Docket No. EL15-45-000 (Feb. 13, 2019) ("MISO CAPs Initial Paper Hearing Brief").

⁵ Exhibit No. JCI-200 at 20; Exhibit No. JCI-202.

⁶ Exhibit No. ICG-200 at 26; Exhibit No. ICG-203.

⁷ See Exhibit No. ICG-200 at 37 (estimating a Risk Premium range of 9.09%–9.76%, which averages to 9.425%); Exhibit No. OMS-202 (showing rounded Risk Premium of "9.43%").

⁸ See Exhibit No. OMS-200 at 14 and 18 (Scenario A); Exhibit No. OMS-202.

⁹ "Corrected "Supplemental Initial Brief of MISO Transmission Owners," filed in Docket No. EL15-45-000 (Feb. 14, 2019) ("MISO TOs Supplemental Initial Brief"), Appendix 2, Affidavit of Adrien McKenzie ("McKenzie EL15-45 Affidavit"), Attachment 2, at 1 (10.09% average of three methods' six range ends); *id.* Attachment 7, Pages 1-2 ("historical" and "projected" risk premium results of 10.45% and 10.94%). The simple average of these eight results is 10.24%.

points below) the 12.38% base ROE that was in effect when this complaint was filed.¹⁰ The MISO TOs charged their customers that 12.38% base ROE throughout the MISO II Complaint’s refund effective period, and that base ROE remained (and absent relief here, will remain) the effective-rate ROE for that 15-month refund period, notwithstanding the relief effected as to other periods pursuant to the MISO I Complaint.¹¹ Consequently, the 214-basis point difference between the charged ROE and the per-MISO-TOs allowable ROE suffices to show the unjustness of MISO TOs’ fourth request to dismiss this complaint.

Section III, *infra*, further rebuts that rehashed and previously-rejected dismissal request. We show that under the plain language of Federal Power Act (“FPA”) section 206,¹² ratepayers’ rights to refunds and prospective remedies that align the rates charged with the applicable study-period cost of equity are not extinguished just because an earlier complaint proceeding remains pending. We also show that the statutory just-and-reasonable standard requires a comparison between the rate charged and the record-based best estimate of the equity’s cost, not a comparison to an arbitrarily higher level.

The record-based best estimate of equity’s cost in this case is well below the MISO TOs’ 10.24%. The Commission’s longstanding and still-trustworthy empirical method, DCF, points much lower—to the 8.81% DCF median, in MISO CAPs’ well-supported and statistically sound

¹⁰ *Arkansas Electric Cooperative Corporation, et al., v. ALLETE, Inc., et al.*, Complaint Requesting Fast Track Processing and Motion to Consolidate of Arkansas Electric Cooperative Corporation, *et al.*, Docket No. EL15-45-000, at 3 (Feb. 12, 2015) (“MISO II Complaint”).

¹¹ *Ass’n of Businesses Advocating Tariff Equity, et al., v. Midcontinent Indep. Sys. Operator, Inc., et al.*, Complaint of the Association of Businesses Advocating Tariff Equity, *et al.*, at 1-2, Docket No. EL14-12-000 (Nov. 12, 2013) (“MISO I Complaint”).

¹² 16 U.S.C. § 824e.

estimation (and, as noted above, the DCF midpoint is 8.72%). MISO TOs' proposed upward alterations of the DCF method are wrong, as we show in Section IV.A. Even with those alterations, however, the MISO TOs' DCF studies produce retained-value medians of 8.92% to 9.27%.¹³

The difference between the MISO TOs' 10.24% and our principal results (8.81% for DCF alone, or 8.73% for multiple methods) is not due to any flaw in the DCF method. Rather, it arises mainly from four key errors in the MISO TOs' approach.

First,¹⁴ the MISO TOs reach a CAPM result exceeding 10%, mainly by projecting that a fully diversified equity portfolio will forever enjoy earnings growth of 8.5%. As Section IV.B explains, and as Mr. Gorman demonstrates,¹⁵ such growth cannot be sustained in an economy growing at around 4.35%. Using a more realistic earnings growth rate, Mr. Gorman calculates a more appropriate and better supported CAPM median of 8.12%.¹⁶

Second, the MISO TOs reach inflated risk premium results that average 10.70%, mainly by including a so-called "projected" method that identifies a risk premium by (purportedly) comparing base ROE case outcomes to the contemporaneous actual utility bond yield, and then adding the inferred risk premium difference to projected utility bond yields. Section IV.C

¹³ See McKenzie EL15-45 Affidavit, Attachment 3 at 1, lines 14-15 (Avista and Pinnacle West, producing a median of 8.82%); *id.* at 2, line 13 (PG&E Corp., producing a median of 8.92%); *id.*, Attachment 4 at 1, lines 15-16 (The Value Line Investment Survey ("Value Line") DCF, producing a median of 9.01%, based on averaging the results for WEC Energy Group and Portland General); *id.* at 2, lines 13-14 (Value Line DCF, producing a median of 9.27%, based on averaging the results for Alliant Energy and Westar Energy).

¹⁴ This summary and the organization of our Reply Paper Hearing Brief is sequenced to track the Briefing Order and thereby facilitate side-by-side comparisons of the various participants' briefs; it does not indicate the relative significance of each issue.

¹⁵ See Exhibit No. ICG-208 at 10-32.

¹⁶ See Exhibit No. ICG-200 at 26.

addresses this mismatch and the other errors in MISO TOs' risk premium studies. Correcting those errors, Mr. Gorman finds a risk-premium-indicated equity cost of 9.43%.¹⁷

Third, MISO TOs rely heavily on the proxy holding companies' forecast earnings/book ("E/B") ratios, even though:

- The Commission has previously found, correctly, that when a company's market/book ("M/B") ratio exceeds 1.0, its "E/B ratio [will] ... overstate the market required rate of return;"¹⁸
- The proxy group market/book ratios greatly exceed 1.0, and the 15.25% E/B ratio for Vectren Corp., which drives MISO TOs' results, reflects the fact that Vectren's M/B ratio exceeds 2.0, as well as the fact that Vectren derives much of its earnings from non-regulated lines of business;¹⁹
- MISO TOs' witness Mr. McKenzie has elsewhere admitted that his "Expected Earnings" method does not "attempt[] to estimate the cost of equity" at all;²⁰ and
- The textbook that the Briefing Order treats as authoritative warns that E/B ratios do not indicate investors' opportunity costs, and cautions that if E/B ratios are to be used, they should reflect a full business cycle rather than a one-year snapshot.²¹

Section IV.E addresses the Expected Earnings (or E/B) method, supported by the reply affidavits of Mr. Solomon and Dr. Berry. While the E/B method is inherently disconnected from the MISO TOs' cost of equity, revisions that mitigate the disconnect point to a base ROE of 9.82%.²²

¹⁷ See *supra* n.7.

¹⁸ *Generic Determination of Rate of Return on Common Equity for Public Utilities*, Order No. 461, FERC Stats & Regs. ¶ 30,722 at 30,492 (1986), *reh'g denied*, Order No. 461-A, 38 FERC ¶ 61,160 (1987).

¹⁹ See Exhibit No. OMS-200 at 14-15; Exhibit No. JCI-200 at 31:3-35:10, 45:15-49:6; Exhibit No. JCI-204 at 4-9; Exhibit No. JCI-205 at 1-2; see also Roger A. Morin, *New Regulatory Finance* (Public Utilities Reports, Inc. 2006) ("Morin") at 393.

²⁰ *Belmont Municipal Light Dep't. et al. v. Central Maine Power Co., et al.*, Docket No. EL16-64 Tr. at 786:6-7.

²¹ Morin at 383.

²² See Exhibit No. JCI-204 at 1.

Fourth, after generating inflated proxy company distributions and risk premium values, the MISO TOs apply unsound methods to infer from that data the study-period cost of equity. They focus solely on the six *least* representative data points from their finalized distributions—the single highest and single lowest DCF, CAPM, and Expected Earnings (E/B) proxy results. They thereby discard the information provided by the distributions of proxy results. Inconsistently with the “model risk” premise for using multiple models, they also ignore the fact that when multiple models are applied to identify *each proxy company’s* equity cost, the resulting composite distribution of proxy results provides a narrower and more accurate cost indicator. And they weight their six extreme results and two²³ risk premium results equally, rather than applying weights that emphasize the proven soundness of the DCF method and at least de-emphasize the inherently unsound E/B method. Additionally, the MISO TOs inappropriately rely upon the midpoint, rather than the medial, in calculating the composite zone bounds and the replacement ROE. Sections IV.E-G, supported by the reply affidavit of Dr. Berry, explain these points.

After addressing these four errors, we rebut MISO TOs’ proposals to exacerbate them. Section IV.H rebuts the MISO TOs’ proposal to discard additional low results. Section IV.I rebuts the MISO TOs’ proposal to retain all high results. Section IV.J responds to the MISO TOs’ misguided proposal addressing the Commission’s proposed “natural break” test. And Section IV.K rebuts the MISO TOs’ proposal to effectively eliminate any ceiling on ROE incentive adders.

²³ As noted above (*see supra* n.9), MISO TOs generate and equally weight two risk premium results: one using actual bond yields, and one using an internally inconsistent hybrid of actual and projected bond yields.

For these reasons—and the additional points developed below, in the accompanying reply affidavits, and in MISO CAPs’ Initial Paper Hearing Brief and affidavits/testimony—the MISO TOs’ study-period indicated cost of equity is substantially below 10%. Relief should be granted to effect the cost-based base ROE.

III. THE MISO TOS’ REQUEST THAT THE COMMISSION DISMISS THE COMPLAINT IS WITHOUT MERIT.

A. Background

For the fourth time, the MISO TOs argue that the Commission should dismiss this complaint. Once again, the Commission should reject the MISO TOs’ arguments.

First, in their March 11, 2015 Answers to the Complaint,²⁴ the MISO TOs urged that the MISO II Complaint should be dismissed because, among other things, the complaint was statutorily infirm because the effect would be to create refund periods totaling more than fifteen months.²⁵ The Commission rejected the MISO TOs’ (and Xcel’s) arguments:

[T]he fact that the record in the ABATE Complaint proceeding is still open is irrelevant. Complainants were free to file a complaint requesting a rate decrease based on later common equity cost data without regard to the status of the ABATE Complaint proceeding. We likewise find unpersuasive MISO TOs’ assertion that the Commission should dismiss the Complaint because the base ROE falls within the zone of reasonableness. The Commission has previously rejected the contention that every ROE within the zone

²⁴ “Answer to Complaint of the MISO Transmission Owners” (March 11, 2015) (eLibrary accession no. 20150311-5277) (“Answer”). On the same day, Xcel Energy Services, Inc. (“Xcel”), filed a separate Answer on behalf of two of the MISO TOs, also urging dismissal of the complaint on many of the same grounds. “Answer of Xcel Energy Services Inc. on Behalf of Respondents Northern States Power Company, a Minnesota Corporation, and Northern States Power Company, a Wisconsin Corporation” (March 11, 2015) (eLibrary accession no. 20150311-5320).

²⁵ Answer at 45.

of reasonableness is necessarily just and reasonable, and we do so again here.^[26]

In accordance with its precedent, the Commission proceeded to set the complaint for hearing and to establish the date of filing of the complaint as the refund effective date.²⁷

The MISO TOs then sought rehearing, arguing again, among other things, that the FPA does not permit filing of a complaint challenging the ROE of the MISO TOs while another complaint challenging the ROE of those same transmission owners is still pending.²⁸ On the same day, Xcel filed a separate request for rehearing regarding, *inter alia*, “whether the complaint in Docket No. EL15-45-000 constitutes an impermissible ‘successive’ complaint that contravenes Section 206 of the Federal Power Act....”²⁹ On July 21, 2016, the Commission again rejected these arguments.³⁰

Undaunted by these rejections, the MISO TOs argued for a third time that the MISO II Complaint should be dismissed as statutorily insufficient.³¹ This time, the MISO TOs argued that dismissal was required because the issuance of Opinion No. 551³² had reduced their

²⁶ *Arkansas Elec. Coop. Corp. v. ALLETE, Inc.*, 151 FERC ¶ 61,219 at P 49 (2015) (citation omitted) (“Hearing Order”).

²⁷ *Id.* at PP 45-46.

²⁸ “Request for Rehearing of the MISO Transmission Owners” (July 20, 2015) (eLibrary accession no. 20150720-5198).

²⁹ “Request for Rehearing of Xcel Energy Services Inc. on Behalf of Respondents Northern States Power Company, a Minnesota Corporation and Northern States Power Company, a Wisconsin Corporation,” at 2 (July 20, 2015) (eLibrary accession no. 20150720-5262).

³⁰ *Arkansas Elec. Coop. Corp. v. ALLETE, Inc.*, 156 FERC ¶ 61,061 (2016) (“Rehearing Order”).

³¹ “Motion of MISO Transmission Owners To Dismiss Complaint” (Oct. 2, 2017) (corrected copy) (eLibrary accession no. 20171002-5066) (“Motion To Dismiss”).

³² *Ass’n of Bus. Advocating Tariff Equity, et al. v. Midcontinent Indep. Sys. Operator, Inc.*, Opinion No. 551, 156 FERC ¶ 61,234 (2016), *reh’g pending* (“Opinion No. 551”).

effective ROE from 12.38%,³³ which had been in effect when the complaint in this docket was filed, to 10.32%, and that the MISO II Complaint, which had been pending for 19 months by the time Opinion No. 551 was issued, had failed to predict the future and challenge 10.32% as no longer just and reasonable.³⁴

Now, after having been rejected twice, and with their Motion To Dismiss still pending, the MISO TOs appear to have returned for a fourth bite at the apple. We say “appear to” because the MISO TOs Supplemental Initial Brief is not consistent as to whether it is requesting that the Commission dismiss the complaint as legally insufficient³⁵ or deny the complaint based on the MISO TOs’ view of the evidence.³⁶ In any event, MISO CAPs will show in this section of the Reply Brief that, as the Commission has already determined twice, the complaint is legally sufficient and dismissal would be unwarranted. We will also show that, based on the evidence of record, denial of the complaint would be equally inappropriate.

B. The Second Complaint Asks Whether the 12.38% ROE that Customers Paid, and Will Still Have Paid Notwithstanding the First Complaint Outcome, Remained Just and Reasonable in Light of New Evidence.

The MISO TOs’ case for dismissal begins with the Commission’s statement in the Briefing Order that “the issue to be addressed in the Second Complaint is whether the ROE

³³ The 12.38% ROE applied to all of the MISO TOs except ATC, which had an authorized ROE of 12.20%. In this Reply Paper Hearing Brief, references to the pre-existing 12.38% ROE should be deemed to include ATC’s slightly lower ROE, unless otherwise specified.

³⁴ The MISO TOs’ Motion To Dismiss also argued (at 7-10) that the MISO II Complaint was insufficient as a matter of law because, according to the MISO TOs, it relied entirely on a single DCF analysis. This argument, based on a misreading of *Emera Maine v. FERC*, 854 F.3d 9 (D.C. Cir. 2017) (“*Emera Maine*”) and a mischaracterization of the MISO II Complaint, has been mooted by MISO CAPs’ submission of additional ROE analyses in response to the Briefing Order.

³⁵ MISO TOs Supplemental Initial Brief at 1, 11, 13, 14, 40.

³⁶ *Id.* at 4, 13, 15.

established on remand in the First Complaint remained just and reasonable based on financial data for the six-month period July to December 2015 addressed by the evidence presented by the participants in the Second Complaint.”³⁷ Based on the MISO TOs’ view that the evidence, as they present it, shows the answer to that question to be “yes,” they argue that the Commission must “correct its legal error,” and dismiss the complaint *nunc pro tunc*.³⁸ Further, they argue, such dismissal “as a matter of law, renders the refund condition imposed in the Commission’s order setting the complaint for hearing a legal nullity.”³⁹ Neither the MISO TOs’ arguments on dismissal of the MISO II Complaint nor their arguments concerning the refund date have any merit.

1. **The MISO TOs’ arguments seeking to eliminate their refund obligations under this complaint proceeding should be rejected.**

The MISO TOs’ presentation simply ignores the controlling statute. With regard to refunds, FPA section 206(a)⁴⁰ states, in relevant part, “[a]t the conclusion of any proceeding under this section, the Commission may order refunds of any amounts paid, for the period subsequent to the refund effective date through a date fifteen months after such refund effective date, in excess of those which would have been paid under the just and reasonable rate, ... which the Commission orders to be thereafter observed and in force.” Throughout those fifteen months, the “amounts paid” by transmission customers pursuant to the MISO TOs’ filed Attachment O formula rates incorporated a 12.38% base ROE—a fact that was not altered by the

³⁷ Briefing Order at P 61.

³⁸ MISO TOs Supplemental Initial Brief at 13-14. The MISO TOs do not specify as of what earlier date they believe the dismissal should be effective.

³⁹ *Id.* at 14.

⁴⁰ 16 U.S.C. § 824e(a).

MISO TOs' compliance with Opinion No. 551. Thus, even assuming, for the sake of argument, that the Commission confirms its preliminary calculations in the Briefing Order and finds, based on the record in MISO I Complaint, that the just and reasonable ROE for the MISO TOs is 10.28%,⁴¹ and then finds, on review of the record in this docket, that 10.28% continues to be just and reasonable, MISO transmission customers would continue to be entitled, pursuant to the refund provision of the Hearing Order, to refunds (with interest) of the difference between the 12.38% rate they actually paid for the refund period (February 2015 to May 2016) and the 10.28% determined, in this hypothetical, to be the just and reasonable rate "to be thereafter observed and in force."

Contradicting themselves, the MISO TOs implicitly recognize that 12.38% is the relevant existing ROE for refund purposes in this MISO II Complaint docket. In their Answer, in the course of unsuccessfully urging the Commission to dismiss this complaint, the MISO TOs argued that the effect of hearing this complaint would be to extend the refund period of the first complaint.⁴² The refund period for MISO I Complaint, however, was unquestionably related to refunds from the pre-existing 12.38% ROE. If the effect of the MISO II Complaint was, as the MISO TOs claimed, to extend the MISO I Complaint refund period, that can only mean that the MISO II Complaint refund period must also be measured against that same 12.38% ROE. Furthermore, the issue of whether the Commission's decision to set the refund period right after the MISO I Complaint's refund period was lawful is currently pending in abeyance at the United

⁴¹ Briefing Order at P 60.

⁴² Answer at 45.

States Court of Appeals for the D.C. Circuit (“D.C. Circuit”).⁴³ The Commission lacks the authority to rule on an issue that is currently before the D.C. Circuit.

Interrelated with the MISO TOs’ request for dismissal is their claim that, because the MISO I Complaint will most likely lead to setting an ROE that is different from the ROE in effect when the MISO II Complaint was filed, this docket cannot lead to any refund obligation on their part.⁴⁴ As noted earlier, this ignores the plain language of FPA section 206. It also flouts the central tenet of the FPA that “[a]ll rates and charges made, demanded, or received by any public utility for or in connection with the transmission or sale of electric energy subject to the jurisdiction of the Commission ... shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.”⁴⁵ According to the MISO TOs, they should be allowed to keep revenues from the MISO II Complaint period, with no refund obligation, notwithstanding that those revenues reflect rates that incorporated a 12.38% ROE that was found to be unjust and unreasonable in Opinion No. 551, and that even the MISO TOs themselves concede is no longer just and reasonable.⁴⁶ Based on the MISO TOs’ total net transmission investment of \$23,278,691,191 as of November 1, 2015 (approximately the

⁴³ See *MISO Transmission Owners v. FERC*, U.S.C.A. Case # 16-1325, Unopposed Motion of the MISO TOs to Hold Proceeding in Abeyance (October 11, 2016) (seeking abeyance in order to allow issues pending in rehearing to be heard at the same time as those in this case once a final order is issued), and MISO TOs’ Non-Binding Statement of Issues (October 20, 2016) (listing the refund issue among the issues on appeal).

⁴⁴ *Id.* at 13-15.

⁴⁵ FPA section 205(a), 16 U.S.C. § 824d(a).

⁴⁶ The MISO TOs support a finding that the 10.50% ROE calculated by Mr. McKenzie for the MISO I Complaint remains just and reasonable based on the record in this docket. MISO TOs Supplemental Initial Brief at 3-4.

midpoint of the refund period in this docket),⁴⁷ an extra 188 basis points over fifteen months would produce excess revenues of approximately \$274,000,000. And the use of 188 basis points assumes the Commission accepts the MISO TOs' recommendation to authorize a base ROE of 10.50%. If the Commission affirms its tentative Briefing Order calculation of 10.28% or, in accordance with CAPs' showing in this supplemental briefing, awards a base ROE under 10%, the amount at issue would only grow. Permitting regulated public utilities to keep that much ratepayer money in excess of the MISO TOs' own calculation of their cost of providing service would make a mockery of the principles that the FPA "is meant to "afford consumers a complete, permanent and effective bond of protection from excessive rates and charges,"⁴⁸ and permits "not even a little unlawfulness."⁴⁹

2. **The MISO TOs' arguments seeking dismissal of this complaint proceeding are equally meritless.**

In lieu of the language of FPA section 206, the MISO TOs focus on the single sentence in the Briefing Order quoted above.⁵⁰ While, as explained in MISO CAPs Initial Paper Hearing Brief, MISO CAPs do not agree that the Commission's statement accurately reflects the question to be determined in this docket,⁵¹ the quoted statement would not support dismissal of the complaint in any event, because it addresses the Commission's decisional calculus at the conclusion of the case, not the sufficiency of the complaint to warrant being set for hearing.

⁴⁷ Available from MISO at <https://www.misoenergy.org/markets-and-operations/settlements/ts-pricing/#nt=%2Ftspricingtype%3AAttachment%20%20Data&t=10&p=2&s=effectivedate&sd=desc>.

⁴⁸ *Atl. Refining Co. v. Pub. Serv. Comm'n*, 360 U.S. 378, 388 (1959).

⁴⁹ *Consumers Fed'n of America v. FPC.*, 515 F.2d 347, 358 n.64 (D.C. Cir. 1975) (quoting *FPC v. Texaco*, 417 U.S. 380, 399 (1974)).

⁵⁰ See *supra* n.37 (Briefing Order at P 61).

⁵¹ MISO CAPs Initial Paper Hearing Brief at 85.

Because, as the Commission found in the Hearing Order, and affirmed in the Rehearing Order, the complaint presented evidence substantive enough to merit examination through hearing procedures,⁵² in accordance with the statute and the Commission’s rules, dismissal would have been, and continues to be, inappropriate.

The MISO TOs also claim that dismissal is required for the Commission “to correct its legal error.”⁵³ However, as pointed out in the MISO CAPs’ Initial Paper Hearing Brief, the referenced legal error—namely, the Commission’s “prong one” failure to make an explicit finding that the existing rate was unjust and unreasonable, constituting the first of the two legal errors which led the D.C. Circuit to vacate and remand Opinion No. 531⁵⁴—was *not* duplicated in the two MISO complaints. Both Opinion No. 551 and the Initial Decision in the MISO II Complaint⁵⁵ explicitly determined that the existing ROE was unjust and unreasonable because it exceeded the top of the zone of reasonableness. Moreover, the MISO TOs did not challenge that finding on rehearing in the MISO I Complaint or on exceptions in the MISO II Complaint. Thus, only the second legal error identified by the *Emera Maine* Court—namely, the arbitrary placement of the ROE at the DCF upper midpoint—was duplicated in Opinion No. 551. Correcting that error clearly does not require dismissal of the MISO II Complaint. To the contrary, it can and should be resolved by reviewing the evidence and selecting a base ROE that

⁵² Hearing Order at P 45; Rehearing Order at P 24.

⁵³ MISO TOs Supplemental Initial Brief at 13.

⁵⁴ *Coakley v. Bangor Hydro-Elec Co.*, Opinion No. 531, 147 FERC ¶ 61,234 (2014) (“Opinion No. 531”), order on paper hearing, Opinion No. 531-A, 149 FERC ¶ 61,032 (2014), *order on reh’g*, Opinion No. 531-B, 150 FERC ¶ 61,165 (2015) (“Opinion No. 531-B”).

⁵⁵ *Arkansas Electric Cooperative Corp., et al., v. ALLETE, Inc., et al.*, 155 FERC ¶ 63,030 (2016), 155 FERC ¶ 63,030 (2016) (Errata), 156 FERC ¶ 63,004 (Second Errata), 165 FERC ¶ 63,021 (Third Errata) (“MISO II Initial Decision”).

appropriately reflects the DCF central tendency, or if necessary, the composite central tendency indicated by a reasonable application of the DCF and other reliable, market-based empirical methods.

C. The Proposed Zone of Immunity Cannot Justify Dismissal.

The Briefing Order’s proposal to presume that an existing ROE remains just and reasonable unless it exceeds the top of an applicable “quartile” of proxy company results is just that: a proposal.⁵⁶ The MISO TOs, however, treat it as black-letter law, and claim that, because their affiant places the top of the shielding quartile from the MISO II Complaint above the indicated ROE from MISO I Complaint’s study period, the MISO II Complaint must be dismissed.⁵⁷

The MISO TOs celebrate the proposed zone of presumptive immunity, which is not surprising, considering that the result of that proposal would be to permit them to overcharge their customers by hundreds of millions of dollars and prevent those customers from challenging excessive rates. They claim that such a zone “will give all market participants a useful tool for evaluating potential success before filing or responding to a future ROE complaint, and also should reduce and simplify the Commission’s already significant administrative caseload.”⁵⁸

The Commission should not be misled by this self-serving sophistry. First, if the Commission were to move from one ROE-estimating method to four, and emphasize erratic ranges rather than stable medians, that approach would make the outcome of complaints *more*

⁵⁶ As MISO CAPs demonstrated, it is a proposal that should not be adopted. MISO CAPs Initial Paper Hearing Brief at 66-83.

⁵⁷ MISO TOs Supplemental Initial Brief at 8-13 (citing McKenzie EL15-45 Affidavit).

⁵⁸ *Id.* at 7.

difficult to predict, not less. Second, ROE complaints are already only a miniscule portion of the Commission's administrative caseload. For example, Mr. McKenzie's risk premium study compiles what are ostensibly 87 FERC dockets that resulted in allowed ROEs.⁵⁹ As can be seen by reviewing the Commission's notices in the small subset of those dockets that have EL prefixes, only 2 of those 87 dockets⁶⁰ were initiated by complaints. Third, the effect of such a rule would be to permit only three types of changes to allowed base ROEs: large increases, small increases, and rare large decreases. Base ROEs would ratchet upwards, until that ratcheting and financial market changes brought them so far above the cost of equity as to permit a rare large decrease. That pattern would promote neither stability of allowed ROEs nor consumer welfare. In its appellate brief in *Emera Maine*, the Commission expressed concern that a too large all-at-once decrease in an allowed base ROE "could be of a sufficient magnitude to undermine Transmission Owners' ability to attract capital."⁶¹ If adopted, a zone of immunity approach would have the perverse effect of allowing *only* large-magnitude decreases. The proposed zone of presumptive immunity, like other aspects of the proposed new ROE method, would make the successful prosecution of ROE complaints more difficult without increasing regulatory certainty. On the contrary, it would make ROE swings larger and more unpredictable, while allowing unjust and unreasonable rates to remain in place.

The prospect that adoption of the zone of presumptive immunity will lead to the perpetuation of excessive rates is not simply a "worst case" scenario. The Commission estimates

⁵⁹ See McKenzie EL15-45 Affidavit, Attachment 7 (at 4-5).

⁶⁰ Specifically, Dockets Nos. EL05-19 and EL12-101.

⁶¹ Brief of Respondent in *Emera Maine v. FERC*, D.C. Cir. Case Nos. 15-1118, *et al.* at 66 (Apr. 26, 2016).

the likely outcome of MISO I Complaint is an allowed ROE of 10.28%.⁶² The MISO II Initial Decision found a just and reasonable ROE for the MISO TOs to be 9.70%.⁶³ Under the Commission's zone of immunity proposal, if the Commission confirmed that finding, this complaint would still result in no change in the allowed ROE, even with a Commission finding that the cost of equity had declined by 58 basis points. The MISO TOs express their support for this proposal, but they fail to explain how it comports with the Commission's obligation to ensure that all rates are just and reasonable. Additionally, 58 basis points would constitute nearly 25% of the total decrease from the pre-existing 12.38% ROE, which would make an ROE of 10.28% "substantially excessive" under the longstanding *West Texas* test.⁶⁴

The MISO TOs also fail to grapple with the arbitrariness of the proposed zone. For instance, the Briefing Order's preliminary analysis of the MISO I Complaint study period estimates a zone of presumptive immunity for a group of utilities of average risk of 9.55% to 10.95%. Thus, if the pre-existing ROE were 10.95%, and the Commission's analysis as the result of a filed complaint pointed toward a middle quartile of 9.55% to 10.95%, the Commission would determine that 10.95% remained just and reasonable and would apparently dismiss the complaint, notwithstanding the Commission's own analysis indicating the cost of capital to be 70 basis points lower.⁶⁵ On the other hand, if the pre-existing ROE were 10.96%, the Commission would order a reduction of 71 basis points, to the 10.25% midpoint of the average quartile. This

⁶² Briefing Order at P 61.

⁶³ MISO II Initial Decision at P 2.

⁶⁴ *W. Texas Utils. Co.*, 18 FERC ¶ 61,189, at 61,375 (1982) (rates are "substantially excessive," calling for maximum suspension, where it appears that at least 10 percent of the proposed increase is excessive).

⁶⁵ For the MISO TOs in the aggregate, this would permit collection of excess revenues in the amount of approximately \$105 million annually, based on Attachment O information available on the MISO website.

is the very definition of arbitrary and capricious, and contradicts the MISO TOs' claim that it is an "objective" mechanism.⁶⁶

While the proposed zone of immunity is an unlawful concept that leads to protection of unjust and unreasonable rates,⁶⁷ the MISO TOs propose to make it even worse by adding a corollary whereby an ROE completely outside the relevant quartile of the zone of reasonableness would only be rebuttably presumed to be unjust and unreasonable, subject to the utility's "showing unique facts or demonstrating the range of ROEs for similar-risk utilities has not been calculated correctly."⁶⁸ Granting this proposal would simply expand the already unacceptable amount of unlawfulness the zone of immunity would accept. Moreover, given that no two utilities are exactly alike, the ability to produce "unique" facts will be limited only by counsel's creativity.

Even if it could be concluded that the Commission's presumptive immunity zones are lawful and that the existing base ROE for purposes of the section 206 complaint here was 10.32% (rather than 12.38%),⁶⁹ Dr. Berry shows that protecting the current 10.32% from further reduction is not justified if any of several necessary changes to the methodology for determining the immunity quartiles are adopted. For example, simply recognizing the superiority of the DCF method and the flaws of the Expected Earnings method in the weighting of financial methods would lower the "Shield Level" (*i.e.*, the top of the presumptive immunity zone quartile) to

⁶⁶ MISO TOs Supplemental Initial Brief at 7.

⁶⁷ MISO CAPs Initial Paper Hearing Brief at 66-76.

⁶⁸ MISO TOs Supplemental Initial Brief at 8.

⁶⁹ MISO CAPs Initial Paper Hearing Brief at 85-87.

10.19%.⁷⁰ Similarly, a single methodological change that recognizes the need for a single zone of reasonableness and adopts the MISO CAPs' sequence of computational calculations would lower the Shield Level to 10.29%.⁷¹ And, a single methodology change to recognize that the median better represents the required ROE level for average risk utilities would lower the Shield Level to 10.05%.⁷² Both the 12.38% ROE and the 10.32% exceed these Shield Levels.

D. The Commission Should Again Reject the MISO TOs' Demand that They Be Immunized Against the Possibility of Successive ROE Complaints Regardless of How Long the First Complaint Remains Pending.

Notwithstanding the Commission's unequivocal rejection of the MISO TOs' repeated attempts to insulate their existing ROEs for however many years it takes to finally resolve an initial complaint,⁷³ the MISO TOs yet again urge the Commission either to dismiss any ROE complaint when one is already pending, or to deny refunds in such circumstances.⁷⁴ The fact that the MISO TOs focus on ROE complaints⁷⁵ demonstrates the self-serving nature of their proposal, as there is no statutory basis for treating ROE complaints differently from other complaints that concern temporally-varying elements of the cost of service. Nor, for that matter, was the treatment of successive ROE complaints, or successive complaints generally, among the issues

⁷⁰ Exhibit No. OMS-208 at P 18, and Exhibit No. OMS-210.

⁷¹ Exhibit No. OMS-208 at P 26, and Exhibit No. OMS-211.

⁷² Exhibit No. OMS-208 at P 11, and Exhibit No. OMS-209.

⁷³ See *supra* nn.26, 30 and accompanying text; Hearing Order at P 49.

⁷⁴ MISO TOs Supplemental Initial Brief at 15-23.

⁷⁵ "As a matter of sound regulatory policy, the Commission should revisit its permissive approach to ROE complaints." *Id.* at 20.

on which the Commission invited briefing.⁷⁶ For that reason alone, the Commission should reject the MISO TOs' demands in this regard.

In defending their proposals, the MISO TOs point to the MISO I Complaint, which, they note, “was filed over five years ago and, per *Emera Maine*, is still unresolved.”⁷⁷ That, however, counsels *against* adoption of their one-sided proposals, because it simply emphasizes the fact that, with refunds for any single complaint limited to fifteen months, the MISO TOs' proposal would leave customers at significant risk of paying unjust and unreasonable rates for years until complaints are ultimately resolved—even in the face of evidence that the ROE has declined even more than in an earlier-filed complaint. Moreover, while the MISO TOs complain that pending complaints challenge their ability to earn stable and predictable returns,⁷⁸ the effect of the immunity zone, as noted above, would be to substitute rare large decreases in allowed ROEs for more frequent smaller decreases. More fundamentally, the FPA does not guarantee that returns to investors will be stable or predictable, but only that the return be commensurate with returns on investments in other enterprises having corresponding risks, and sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.⁷⁹ As the Supreme Court made clear, “[a] rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money

⁷⁶ On the other hand, issues related to treatment of successive complaints have been raised by the Commission in its Notice of Inquiry in Docket No. PL19-4-000, and that is where the MISO TOs should direct these arguments. *Inquiry Regarding the Commission's Policy for Determining Return on Equity*, 166 FERC ¶ 61,207 at P 37 (2019).

⁷⁷ MISO TOs Supplemental Initial Brief at 21.

⁷⁸ *Id.*

⁷⁹ *Fed. Power Comm'n v. Hope Nat'l Gas Co.*, 320 U.S. 591, 603 (1944) (“*Hope*”).

market and business conditions generally.”⁸⁰ There is thus no right to continue earning a return that has become too high by virtue of changed circumstances, however much the MISO TOs might like to continue earning such returns. Accordingly, the Commission’s ROE determination policies should be designed to produce allowed ROEs that vary from time to time with changes the cost of equity capital—a target that is not entirely stable or predictable.

IV. ARGUMENT

A. The Two-Step DCF Remains the Appropriate Methodology for Measuring the Cost of Equity.

The Commission’s two-step DCF is a well-established method for estimating the cost of equity for regulated utilities. As explained by the MISO CAPs witnesses in their initial affidavits and underscored in their Reply Affidavits, the DCF remains the most robust and instructive market-based method to use in the determination of just and reasonable ROEs.⁸¹ Therefore, reliance on the median of the two-step DCF method is MISO CAPs’ recommended approach for determining the MISO TOs’ cost of equity. For the study period in this proceeding, the DCF method points to a base ROE of 8.81% for the MISO TOs.⁸²

The Briefing Order seeks to depart from the tried-and-true DCF method based on the false premise, vigorously endorsed by the MISO TOs, that this approach now underestimates the level of return on common equity required to satisfy the FPA’s just and reasonable standard.⁸³

⁸⁰ *Bluefield Waterworks & Improvement Co. v. Public. Serv. Comm’n of West Virginia*, 262 U.S. 679, 693 (1923) (“*Bluefield*”).

⁸¹ See MISO CAPs Initial Paper Hearing Brief at 11-25. See also Exhibit No. JCI-200 at 50-51; Exhibit No. OMS-200 at PP 12-13, 19; Exhibit No. ICG-208 at 3-4.

⁸² See MISO CAPs Initial Paper Hearing Brief at 25-27. See also Exhibit No. JCI-200 at 20; Exhibit No. JCI-202 at 1.

⁸³ See, e.g., Briefing Order at PP 42-49; MISO TOs Supplemental Initial Brief at 3-4.

As demonstrated in MISO CAPs' Initial⁸⁴ and Reply Paper Hearing Briefs⁸⁵ and supporting testimony/affidavits, this premise flies in the face of established Commission precedent as well as economic theory and market evidence. This premise is also fatally flawed because it fails to address why the other market-based financial models on which the Commission proposes to rely—the CAPM and Risk Premium models—are not similarly compromised.⁸⁶ The DCF is an input into the CAPM⁸⁷ and shares inputs with the Risk Premium method.⁸⁸ To the extent that the integrity of the DCF method has somehow become compromised, then logic dictates that the other market-based methodologies, if properly implemented, would be compromised, too.

The MISO TOs' attacks on the reliability of the DCF are coupled with efforts to manipulate the non-DCF analyses to produce higher results than the DCF.⁸⁹ The MISO TOs then compare these manipulated results to the DCF results as a basis for arguing that the DCF has not worked properly.⁹⁰ MISO CAPs urge the Commission to reject the false premise that the DCF method has become unreliable and recognize that the MISO TOs' tactics are designed to

⁸⁴ See MISO CAPs Initial Paper Hearing Brief at 11-25.

⁸⁵ See Section IV.A.1, *infra*; see also Exhibit No. ICG-208 at 10-32.

⁸⁶ See MISO CAPs Initial Paper Hearing Brief at 16-17.

⁸⁷ Exhibit No. ICG-200 at 8-11.

⁸⁸ *Id.* at 33-34.

⁸⁹ *Id.* at 20 (demonstrating the inflated nature of the MISO TOs' CAPM results); see also *id.* at 26-27, 36-37 (demonstrating the inflated nature of the MISO TOs' Risk Premium results).

⁹⁰ MISO TOs Supplemental Initial Brief at 5 (asserting that the higher results produced by their particular application of other methods prove that the DCF model is "an unreliable indicator of investor expectations").

skew the ROE methodology in favor of investors' interests to the detriment of consumers' interests. Failure to do so would frustrate the FPA's consumer protection mandate.⁹¹

To realize its aim of protecting consumers from "exorbitant rates"⁹² the FPA contemplates a rate-making process that "involves a balancing of the investor and consumer interests."⁹³ In the ROE context, this means the Commission is obligated to balance the protection of consumers from excessive rates⁹⁴ with a public utility's interest in capital attraction.⁹⁵ Nothing in *Bluefield* and *Hope* suggests that investors in public utilities are to be insulated from changes in the cost of capital over time. In fact, the capital attraction standards set forth in *Hope* and *Bluefield* contemplate that ROE results will vary over time as the cost of capital changes: "A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions

⁹¹ See *Municipal Light Bds. of Reading and Wakefield v. Fed. Power Comm'n*, 450 F.2d 1341, 1348 (D.C. Cir. 1971) ("the "primary aim [of the FPA] is the protection of consumers from excessive rates and charges.") (citations omitted).

⁹² *American Pub. Power Assoc. v. FPC*, 522 F.2d 142, 147 (D.C. Cir. 1975) (Bazelon, J. concurring); *Washington Gas Light Co. v. Baker*, 188 F. 2d 11, 15 (D.C. Cir. 1950) (referring to U.S. Supreme Court cases dating back to 1890). See also *Municipal Light Bds. of Reading and Wakefield*, 450 F. 2d at 1348.

⁹³ *Hope*, 320 U.S. at 603 ("[t]he rate-making process under the Act, i.e., the fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests.").

⁹⁴ See supra n.91.

⁹⁵ *Bluefield*, 262 U.S. at 679 ("The 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."); *Hope*, 320 U.S. at 603 (A just and reasonable return is "commensurate with returns on investments in other enterprises having corresponding risks" and "should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain [a utility's] credit and to attract capital."); see also *Tenn. Gas Pipeline Co. v. FERC*, 926 F.2d 1206, 1208 (D.C. Cir. 1991) ("The cost of capital is the *minimum* rate of return necessary to attract capital to an investment.") (emphasis added) (quoting A. Lawrence Kolbe, et al., *The Cost of Capital: Estimating the Rate of Return for Public Utilities* at 13 (1984)).

generally.”⁹⁶ Thus, if the market cost of capital has declined in recent years, it logically follows that the ROE produced by any market-based measure of equity would be lower. Efforts to inflate the MISO TOs’ ROE by overhauling the ROE methodology, despite evidence of market data indicating reductions in the cost of capital, are inconsistent with the capital attraction standards and undermine the FPA’s consumer protection aim.

In sum, the market-based DCF approach remains the most appropriate way to determine allowable rates of return that meet the standards set out in *Bluefield* and *Hope*. Only the DCF method has direct, current utility stock investor input through the use of recent, competitive market-determined stock prices. Thus, the DCF remains a sound approach that reliably and accurately measures the cost of capital.

1. **The Commission should reject the MISO TOs’ conditional argument for a DCF model that assumes dividends grow perpetually at analysts’ forecast rate of near-term earnings growth.**

The MISO TOs argue that if the Commission filters DCF results for high-end outliers, “it should employ a single-stage, constant growth DCF, rather than a two-stage DCF,”⁹⁷ using as the “constant” growth rate analysts’ forecasts of earnings-per-share growth over the next three to five years.⁹⁸ The MISO TOs’ attempt to link the growth rate to the high-end outlier test is puzzling: at both ends of the DCF range and throughout the DCF distribution, it is important to use an accurate representation of the long-term dividend stream investors expect, regardless of the tests used to filter outliers. Moreover, given that MISO TOs are not proposing to filter out

⁹⁶ *Bluefield*, 262 U.S. at 693; see also *Hope*, 320 U.S. at 615 (“This is not an order for all time. The Act contains machinery for obtaining rate adjustments.”).

⁹⁷ MISO TOs Supplemental Initial Brief at 35.

⁹⁸ See McKenzie EL15-45 Affidavit, Attachment 8 at 2.

any DCF high results from the study-period results in this proceeding, the MISO TOs' position amounts to a concession that, in this case, the DCF model should apply a two-stage composite growth rate. In any event, the MISO TOs provide no good reason to base the DCF model's dividend growth rate solely on analysts' projections of near-term earnings per share ("EPS") growth. Below, we paraphrase (in italics), and refute, each of the MISO TOs' arguments for this novel approach.

- *MISO TOs' argument: The DCF model requires a growth estimate that matches investors' expectations.*⁹⁹

It is true that the DCF model requires an inference as to investors' expected rate of dividend growth. But that requirement is a reason to factor in, not ignore, the long-term macroeconomic (*i.e.*, Gross Domestic Product or "GDP") constraints on analysts' projected rate of near-term growth in earnings per share. Rational investors know what Dr. Morin explains in the textbook cited throughout the Briefing Order: utility holding companies seek to keep dividend growth on a path they can sustain over the long term, in order to avoid having to cut dividends with every downturn in earnings.¹⁰⁰ The Commission recognized this reality even before Opinion No. 531 extended to electric utilities the Institutional Brokers' Estimate System ("IBES")/GDP composite version of the constant-growth DCF model. The prior approach utilized in combination both IBES growth rates and "br + sv" sustainable growth, and the latter

⁹⁹ See MISO TOs Supplemental Initial Brief at 35-36 & n.111; McKenzie EL15-45 Affidavit at 39:16-18 (claimed "shortcoming" number 1).

¹⁰⁰ See Morin at 284 ("Under normal circumstances, dividend growth rates are not nearly as affected by year-to-year inconsistencies in accounting procedures as are earnings growth rates, and they are not as likely to be distorted by an unusually poor or bad year. Dividend growth is more stable than earnings growth because dividends reflect normalized long-term earnings rather than transitory earnings, because investors value stable dividends, and because companies are reluctant to cut dividends because of the information effect of dividend payments.").

“contain[ed] some elements of a long-term growth projection.”¹⁰¹ The MISO TOs are proposing to entirely eliminate consideration of whether the growth projected by analysts for the next three to five years is sustainable over the long term. But the constant-growth DCF model “requires an estimate of dividend growth extending into the indefinite future,”¹⁰² which is not reliably predicted by “projections by investment advisory services of growth for relatively short periods of years;”¹⁰³ in the long term, “it is reasonable to expect that public utilities, which transmit electricity to supply energy to the national economy, will sustain growth consistent with the growth of the economy as whole.”¹⁰⁴ These quoted factual determinations have been established: they were found applicable to the MISO TOs in the MISO I Initial Decision,¹⁰⁵ were not excepted to by MISO TOs, and were affirmed in Opinion No. 551.¹⁰⁶

- *MISO TOs’ argument: Investors do not reference or rely on estimates of GDP growth in evaluating growth expectations for utility common stocks.*¹⁰⁷

Although Mr. McKenzie asserts this as a fact, he provides no documentary evidence for this startling claim. In reality, Warren Buffet—who owns much of Berkshire Hathaway and thus indirectly owns large shares of MidAmerican Energy Co. (one of the MISO TOs), NV Energy, and PacifiCorp., and as such may well be both the largest and most-followed individual investor

¹⁰¹ Opinion No. 531-B at P 77.

¹⁰² Opinion No. 531 at P 37.

¹⁰³ *Id.* at P 33 (quoting *Consol. Gas Supply Corp.*, 24 FERC ¶ 61,046, at 61,105 (1983)).

¹⁰⁴ Opinion No. 531 at P 40.

¹⁰⁵ MISO I Initial Decision at PP 31-37.

¹⁰⁶ Opinion No. 551 at P 18.

¹⁰⁷ See MISO TOs Supplemental Initial Brief at 35 & n.111; McKenzie EL15-45 Affidavit at 39:19-21 (claimed “shortcoming” number 2).

in U.S. electric utilities—has made clear that he does expect stocks’ long-term earnings growth to be constrained by GDP growth:

You know, someone once told me that New York has more lawyers than people. I think that’s the same fellow who thinks profits will become larger than GDP. When you begin to expect the growth of a component factor to forever outpace that of the aggregate, you get into certain mathematical problems.¹⁰⁸

- *MISO TOs’ argument: For certain utilities, actual or expected growth rates have sometimes exceeded GDP growth.*¹⁰⁹

Mr. McKenzie points out that, as of the study period in this case, the 10-year achieved EPS growth rates of ALLETE, Eversource Energy, OGE Energy, and IDACORP, were, respectively, 7.0%, 8.0%, 8.5%, and 9.0%,¹¹⁰ *i.e.*, had a simple average of 8.1%. Using that same data, the same four companies’ average achieved rate of growth in *dividends* per share (over the same past 10 years, substituting Value Line’s dividends per share (“DPS”) growth rate over the past 5 years where Value Line did not provide the 10-year rate) averaged 4.9%.¹¹¹ Because the DCF model ultimately turns on investors’ expected stream of dividend receipts, the latter is more meaningful. Moreover, Mr. McKenzie’s focus on these four proxies’ rates of past EPS growth is simply an exercise in cherry-picking. Within the same set of Value Line reports, just within the top of the alphabet, one could equally point to the 10-year past EPS growth rates

¹⁰⁸ “Mr. Buffet on the Stock Market,” *Fortune*, November 22, 1999.
https://money.cnn.com/magazines/fortune/fortune_archive/1999/11/22/269071/.

¹⁰⁹ See MISO TOs Supplemental Initial Brief at 36 (“estimated growth rates for utilities ... can and do exceed GDP growth”); McKenzie EL15-45 Affidavit at 43 (“Actual historical growth rates for individual firms refute the notion that long-term growth for electric utilities is constrained by GDP.”).

¹¹⁰ See McKenzie EL15-45 Affidavit at 43 (citing Exhibit No. JCI-9 at 58, 72, 75, & 77).

¹¹¹ See Exhibit No. JCI-9 at 58, 72, 75, & 77 (in Value Line’s “Annual Rates” box, longest-available rates of past growth in dividends per share for these four companies were, respectively, 2.0%, 9.5%, 5.5%, and 2.5%, thus averaging 4.875%).

of American Electric Power (1.5%) Ameren (-2.0%), Centerpoint Energy (2.0%), and Consolidated Edison (3.5%).¹¹²

Mr. McKenzie's cherry-picking continues with his selective recitation of passages in which various authors anticipated rate base growth over the next several years, which he presents as if it contradicted a longer-term macroeconomic constraint on utilities' dividends per share. For example, his first such citation is to Andrew Barry, *Time to Give Utility Stocks Another Look*, Barron's, May 9, 2015, S-3 at 1-3 ("Barron's 2015"), which he claims supports an expectation of "high-single-digit growth in earnings per share."¹¹³ Actually, that article refers to macroeconomic constraints and projects earnings growth of about 4%:

Many view utilities as a no-growth business given little change in U.S. electricity consumption in recent years. However, earnings growth has averaged 4% annually in the past decade and profits could grow at a similar rate in coming years as utilities upgrade or replace aging transmission lines and power plants.¹¹⁴

- *MISO TOs' argument: Capital expenditures forecast in 2018 for 2018 imply higher long-term growth.*¹¹⁵

Citing an April 2018 RRA report, Mr. McKenzie purports to see evidence that capital investment can generate profit expansions that will long exceed GDP growth.¹¹⁶ The relevance of this report in ascertaining the study period cost of equity is far from clear, as it long post-dates

¹¹² See Exhibit No. JCI-9 at 60, 61, 63, & 65.

¹¹³ See McKenzie EL15-45 Affidavit at 44 & n.86.

¹¹⁴ Barron's 2015, S-3 at 2.

¹¹⁵ McKenzie EL15-45 Affidavit at 44-45.

¹¹⁶ See McKenzie EL15-45 Affidavit at 45:9-18 & n.89 (citing Standard & Poor's ("S&P") Global Market Intelligence, *RRA Financial Focus – Utility Capital Expenditures Update*, Regulatory Research Associations (Apr. 20, 2018)), *id.* at 48:6-7, 48:13-14.

the study period and close of record referenced in the Briefing Order, and thus should not be considered at all.¹¹⁷ If it is considered, Table 1 of the referenced report indicates that capital expenditures by the covered electric-industry holding companies will shrink from 2018 to 2020, to a level below that of 2016.¹¹⁸ And that was in the context wherein “[a] rising interest rate environment and sweeping corporate tax cuts enacted in 2018 were major factors encouraging utilities to pull forward large capital projects to secure financing ahead of higher expected interest rates and take advantage of interest deductibility,”¹¹⁹ suggesting that even that level of capital expenditures would not be maintained over a longer period. In any case, by weighting near-term earnings growth rates at 2/3 in projecting the constant rate of dividend growth, the Commission’s composite-growth method already assumes that this near-term growth will continue for decades.¹²⁰ Nothing in the RRA report, or in the record, undercuts the further expectation that earnings growth will eventually align with GDP growth.

Moreover, when it comes to the expected rate of growth in *dividends* per share, which is the real focus of the DCF model (and for which projections of composite multi-stage growth in earnings are only a proxy), even the near-term growth rate is better projected by factoring in long-term GDP growth. Again, companies seek to avoid having to cut dividends, and therefore

¹¹⁷ See Briefing Order at P 62 (“to the extent that participants submit additional financial data or evidence concerning economic conditions in any proceeding it must relate to periods before the conclusion of the hearings in the relevant complaint proceeding”).

¹¹⁸ See April 2018 RRA Report, Table 1 (“Total Electric” Cap Ex of \$93.6 M in 2016A, \$106.6 M in 2018E, and \$86.2 M in 2020E, its most distant prediction).

¹¹⁹ *Id.* at 2.

¹²⁰ See generally *Williston Basin Interstate Pipeline Co.*, 104 FERC ¶ 61,036, P 29 (2003) (this method “is equivalent to averaging 33 years of the short-term growth projection with 17 years of the lower long-term GDP growth rate”).

seek to keep dividend growth on a path they can sustain over the long term.¹²¹ The resulting moderation of earnings growth in realized dividend growth can be seen by comparing past EPS growth projections to actual DPS growth. For example, almost four years have now passed since analysts made the mid-2015 projections of three-to-five-year EPS growth that provided the first-stage basis for the composite growth rate used in Opinion 551. In Exhibit No. ICG-209 hereto, Mr. Gorman compares those projections to the same companies’¹²² realized DPS growth rate between then and now, a comparable period. He shows that these companies’ projected EPS growth rate averaged 5.98%, whereas their realized DPS growth rate averaged 3.81%.¹²³

- *MISO TOs’ argument: A 1974 publication expressed skepticism about the use of a two-stage DCF model.*¹²⁴

The referenced publication dates to the infancy of the DCF model, predating its widespread adoption and refinement over decades of application. Now, there is a widespread consensus, shared by the textbook cited throughout the Briefing Order, favoring “[a] multiple-stage DCF model that better mirrors the pattern of future dividend growth,” and recognizing that “[a] transition must occur between the first stage of growth forecast by analysts for the first five years and the company’s long-term sustainable growth rate.”¹²⁵

- *MISO TOs’ argument: A two-stage DCF for electric utilities would have been appropriate in the 1990s, when investors thought the electric utility was*

¹²¹ See *supra* n.100 and accompanying text.

¹²² Of necessity, the comparison is limited to companies that remain in business and publicly-traded. Thus, it excludes UIL Holdings, ITC Holdings, Empire District Electric, and TECO Energy.

¹²³ Exhibit No. ICG-209 at 2.

¹²⁴ See McKenzie EL15-45 Affidavit at 46.

¹²⁵ See Exhibit No. ICG-208 at 23 (quoting Morin at 308).

*transitioning to non-regulated markets, but expectations of widespread deregulation are a relic from the past.*¹²⁶

As Mr. Gorman explains in Exhibit No. ICG-208, Mr. McKenzie’s argument gets Commission precedent precisely backwards. From Opinion No. 445¹²⁷ until Opinion No. 531, the Commission applied a one-stage version of the constant growth DCF model in electricity ROE cases because it found in *SCE* that as of the turn of the millennium, “[u]nlike the gas pipeline industry, which was nearly through with major restructuring at the time we issued Opinion 396-B, . . . the electric industry [was] just beginning a significant new phase of its restructuring.”¹²⁸ Citing the then-ongoing widespread transition from a regulated, vertically-integrated industry structure to a deregulated, vertical disaggregated model with “retail choice,” the Commission concluded that a one-stage DCF model was appropriate for electric utilities while they were restructuring.¹²⁹ In Opinion No. 531, the Commission found that this temporary, restructuring basis for assuming that utility stocks’ near-term growth rates would continue indefinitely was no longer applicable.¹³⁰ By conceding that “expectations of widespread deregulation are a relic from the past,”¹³¹ Mr. McKenzie concedes that Opinion No. 531 was correct in this regard.

¹²⁶ See McKenzie EL15-45 Affidavit at 41.

¹²⁷ *S. Cal. Edison Co.*, Opinion No. 445, 92 FERC ¶ 61,070 at 61,266 (2000) (“Opinion No. 445”).

¹²⁸ Exhibit No. ICG-2018 at 27.

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ McKenzie EL15-45 Affidavit at 41.

- *MISO TOs' argument: Testimony before a different regulator, by a witness who did not appear here, but who was sponsored in a third proceeding by a party with a name similar to the MISO CAPs, applied a constant growth DCF model.*¹³²

Citing testimony by Dr. J. Randall Woolridge before the Virginia State Corporation Commission (“Virginia Commission”), Mr. McKenzie claims that “a witness for the [New England] Complainant-Aligned Parties in Docket No. EL11-66 has concluded that the constant growth DCF model is ‘[t]he appropriate DCF valuation procedure’ for electric utilities.” Dr. Woolridge’s testimony in the referenced case *opposes*, not supports, basing the DCF growth rate solely on analysts’ projections of near-term EPS growth. In the testimony that Mr. McKenzie mischaracterizes, Dr. Woolridge applied a composite growth rate in which historical EPS growth rates and historical and projected growth in per-share dividends and book value were applied to temper analysts’ near-term optimism.¹³³ He explained why:

[I]t is well known that the long-term EPS growth rate forecasts of Wall Street securities analysts are overly optimistic and upwardly biased. This has been demonstrated in a number of academic studies over the years. Hence, using these growth rates as a DCF growth rate will provide an overstated equity cost rate. On this issue, a study by Easton and Sommers (2007) found that optimism in analysts’ growth rate forecasts leads to an upward bias in estimates of the cost of equity capital of almost 3.0 percentage points. ... [T]he DCF growth rate needs to be adjusted downward from the projected EPS growth rate to reflect the upward bias.

* * *

[T]o best estimate the cost of common equity capital using the conventional DCF model, one must look to long-term growth rate expectations. Internally generated growth is a function of the percentage of earnings retained within the firm (the earnings

¹³² See McKenzie EL15-45 Affidavit at 48-49 & n.99.

¹³³ See Dr. Woolridge’s August 2, 2016 testimony cited by Mr. McKenzie, which is available through a search of the referenced docket at <http://www.scc.virginia.gov/docketsearch#caseDocs/135765>.

retention rate) and the rate of return earned on those earnings (the return on equity). The internal growth rate is computed as the retention rate times the return on equity. Internal growth is significant in determining long-term earnings and, therefore, dividends.¹³⁴

Thus, Dr. Woolridge’s application in that case of a “constant growth” model did not imply sole reliance on analysts’ near-term EPS forecasts. The “constant growth” model can and should use a dividend growth rate that reflects a composite of near-term and long-term (GDP-constrained) earnings growth, as was applied in both Opinion No. 551 and the Briefing Order.

Even if Dr. Woolridge had testified before the Virginia Commission as Mr. McKenzie claims he did, why would that matter? Dr. Woolridge did not appear in this proceeding. Mr. McKenzie’s apparent basis for referring to the Virginia testimony is that a coalition with a name similar to that of the MISO CAPs sponsored Dr. Woolridge in an unrelated proceeding. And that is no basis at all.

More appropriate to raise in this proceeding are the arguments of Mr. McKenzie himself in the parallel ROE Paper Hearing ongoing in New England. In that proceeding, Mr. McKenzie recently presented on reply several erroneous arguments that need to be addressed because we anticipate that he will present similar reply testimony here for the MISO TOs.

- *Mr. McKenzie’s argument: Three related academic papers applied a one-stage DCF in constructing their CAPMs.*¹³⁵

¹³⁴ Dr. Woolridge Testimony, *supra* n.133 at 51-52; *id.* at 48.

¹³⁵ See *Coakley v. Bangor Hydro-Elec. Co., et al.*, Reply Paper Hearing Brief of the New England Transmission Owners at Attachment A, Reply Affidavit of Adrien M. McKenzie, CFA, Docket Nos. EL11-66-001, EL11-66-004, EL11-66-005, EL13-33-000, EL13-33-002, EL14-86-000, EL16-64-000, EL16-64-002 (filed Mar. 8, 2019) (eLibrary Accession Number: 20190308-5262) (“McKenzie EL11-66 Reply Affidavit”) at 27-28.

Mr. McKenzie contends that single-stage DCFs were used to develop the equity market return for CAPM models used in three 1986-1993 articles with a common author, namely Robert S. Harris, *Using Analysts' Growth Forecasts to Estimate Shareholder Required Rates of Return*, Fin. Mgmt. (Spring 1986) ("Harris 1986"); Robert S. Harris and Felicia C. Marston, *Estimating Shareholder Risk Premia Using Analysts' Growth Forecasts*, Fin. Mgmt. (Summer 1992) ("Harris 1992"), and Felicia Marston and Robert S. Harris, *Risk and Return: A Revisit Using Expected Returns*, Fin. Review (Feb. 1993) ("Harris 1993"). The most relevant aspect of these studies was their consistent estimation that the risk premium of a diversified equity portfolio over long-term U.S. bonds averaged well under 7%,¹³⁶ less than the 7.4% and 7.1% that Mr. Gorman applied in his CAPMs for the MISO I and MISO II study periods, respectively, and further below the 8.6% and 8.2% used by Mr. McKenzie for those same periods. As to these studies' use of a one-stage DCF to derive those equity risk premiums, it must be remembered that they aimed to test whether the resulting indicated costs of equity varied over time and across company risks in directionally appropriate ways, not to estimate the absolute value of the cost of equity. Accordingly, the refinement of factoring in a long-term, second-stage growth constraint, which varies little over time and factors the same constraint into all companies' results, was tangential to what they sought to measure. They did not seek to test, and provide no basis to reject, the approach that Dr. Harris attributes to Dr. Malkiel and describes as estimating risk premiums

¹³⁶ See Harris 1986 at 62 (estimating 1982-1984 average annual *ex ante* risk premiums of 6.16%); Harris 1992 at 66 (estimating 1982-1991 average annual *ex ante* risk premiums of 6.47%); Harris 1993 at 132 (estimating monthly average *ex ante* risk premiums from 1982-1987 of 16.35%-10.69%=5.66%).

“using a nonconstant growth version of the DCF model,” in which growth after five years was assumed to “approach[] a long-run real national growth rate of 4%.”¹³⁷

- *Mr. McKenzie’s argument: Investors can realistically expect long-term dividend growth that exceeds the growth rate of the U.S. economy, because the composition of the S&P 500 Index is not static; firms with high growth potential replace firms with low growth potential.*¹³⁸

The CAPM analyses presented in these proceedings that look to DCF analysis of dividend-paying members of the S&P 500 do so *as a proxy* for the entire equity market. Regardless of index composition, the equity market as a whole cannot sustainably grow faster than the economy. Moreover, while sometimes labelled as DCF analyses of the S&P 500, these DCF analyses do not concern the growth of the index; rather, they are based on a DCF analysis of approximately 400 specific large-cap stocks. Finally, the S&P 500 index does *not* grow through this substitution effect; rather, when (in Mr. McKenzie’s factually inaccurate example) Amazon replaces Sears, the index value is held constant, as if the indexed portfolio traded a large number of shares representing a cross-section of the portfolio for a small number of high-priced Amazon shares. When Amazon joined the S&P 500 (replacing AT&T, not Sears), the Wall Street Journal noted that “[w]henver S&P adds a company, it recalculates its divisor -- the figure used to calculate the value of the index -- to account for the difference in market capitalization between the company being added and the one deleted.”¹³⁹ Consequently, there is

¹³⁷ Harris 1986 at 60 & n.12.

¹³⁸ See McKenzie EL11-66 Reply Affidavit at 27-28.

¹³⁹ David A. Gaffen, *Amazon Joins Few Web Names In S&P 500*, Wall St. J. (Nov. 16, 2005) (available at <https://www.wsj.com/articles/SB113207902652797811>).

no basis to assume that such substitution results in a net increase in the earnings that will flow through to a portfolio investor.

- *Mr. McKenzie's argument: The portfolio return must exceed the 9.29% that Opinion No. 551 found insufficient for electric utilities.*¹⁴⁰

This bootstrapped argument should be rejected because it relies on Opinion No. 551, which is under reconsideration herein. The decision therein to place the base ROE above the DCF midpoint relied on the fact that CAPM results, if premised on an unsustainable equity portfolio return, pointed above the DCF midpoint. Relying on that decision to require an equity portfolio return above the DCF midpoint would be untenably circular. Moreover, a comparison between the DCF midpoint and the average portfolio return is arbitrary, because the DCF midpoint (a) includes dividend yields and (b) is not representative, as discussed in Section IV.E. The appropriate comparison would be between the average (or median) composite earnings growth rate used in the utility DCF and the composite earnings growth rate used in the CAPM's portfolio DCF. In the utility-proxies DCF adopted in Opinion No. 551, the average composite earnings growth rate was 5.11% (and the median was 5.00%).¹⁴¹ In Mr. Gorman's recommended modification of the DCF-based CAPM portfolio return, the average composite earnings growth

¹⁴⁰ See McKenzie EL11-66 Reply Affidavit at 31:1-11.

¹⁴¹ See *Ass'n of Businesses Advocating Tariff Equity, et al., v. Midcontinent Indep. Sys. Operator, Inc., et al.*, Initial Decision, 153 FERC ¶ 63,027, Appendix B (2015) ("MISO I Initial Decision"). Subsequently, a Corrected MSO I Initial Decision was issued on December 29, 2015. Errata to the Corrected MISO I Initial Decision were issued on December 31, 2015, and January 7, 2016. Cites to the MISO I Initial Decision refer to the Corrected MISO I Initial Decision. The 37 proxies' 5.11% and 5.00% average and median composite growth rate can be readily found through simple mathematics applied to the values shown there; the composite growth rate of the proxy with the median DCF result (Vectren Corp., positioned at number 18 of 37 in that sorted list) is directly visible, at a similar 5.13%.

rate was 7.1%.¹⁴² Thus, the earnings growth rate for the CAPM equity portfolio is substantially higher than that of the utility proxies, as expected given the utility proxies' low risk. This difference belies Mr. McKenzie's claim that the growth rate obtained by applying a second-stage growth constraint to portfolio earnings is too low when compared to financial data associated with utility stocks.

- *Mr. McKenzie's argument: Other regulators rely on a one-stage DCF to find the CAPM portfolio return.*¹⁴³

Mr. McKenzie's representation of what "other regulators" do relies entirely on testimony filed 18 years ago in a state commission proceeding by a party that is not participating in this proceeding.¹⁴⁴ It is telling that Mr. McKenzie searched so far afield for a regulator applying his approach and came up so empty. The reality is that regulators who apply the CAPM method consistently apply market-wide equity returns far lower than the 11.3% and 11.2% assumed in Mr. McKenzie's MISO I and MISO II CAPM models. Documents referred to in reply testimony in the New England ROE paper hearing surveyed electric transmission ROE regulation in Australia, Canada, the United Kingdom, and Europe. Those documents demonstrate that insofar as other regulators apply CAPM models, they use equity market returns that are typically about 4.75%-6.0% above the risk-free governmental security yield, and that Mr. McKenzie's equity market return is off-the-charts excessive.¹⁴⁵

¹⁴² See Exhibit No. JC-203, pages 1 and 2, "Proj. Growth" component of Market Return.

¹⁴³ See McKenzie EL11-66 Reply Affidavit at 28-29.

¹⁴⁴ See *id.* at 28-29 & n.53.

¹⁴⁵ See Docket No. EL11-66, Exhibit No. CAP-600 at 37-46; *Rate of Return Instrument Explanatory Statement*, Australian Energy Regulator (Dec. 2018), <https://www.aer.gov.au/system/files/Rate%20of%20Return%20Instrument%20-%20Explanatory%20Statement.pdf>;

In short, MISO TOs have provided no good reason to adopt the novel approach of basing the DCF model's dividend growth rate solely on analysts' projections of near-term EPS growth, whether or not high-end DCF outliers are filtered out.

2. IBES is the appropriate source for growth rates in this proceeding.

Although the Briefing Order proposes a modified ROE methodology, it does not place into controversy the appropriate source for growth rates to be used in performing the DCF analysis. As the MISO TOs readily acknowledge, the "Commission has relied solely on the IBES growth rate estimates already in the record of this proceeding."¹⁴⁶ While the MISO TOs "do not advocate reliance on non-IBES short-term growth rate data in this case," they request the Commission to clarify that it would consider "sources of short-term earnings growth rate estimates other than IBES" in the future.¹⁴⁷ Notwithstanding the foregoing, the MISO TOs proceed to perform a one-stage DCF analysis using only Value Line growth rates.¹⁴⁸

As a threshold matter, MISO CAPs support reliance on IBES as the source of growth rates for use in performing a DCF analysis, irrespective of whether it is the well-established two-step DCF or the MISO TOs' alternative single-stage DCF. As the Commission has found, "IBES projections...remain[] the best and most reliable source of growth information available," because "they are widely available and generally reflect the input of a number of financial

Elroy Dimson, Paul Marsh, and Mike Staunton, *Global Investment Returns Yearbook 2017*, Credit Suisse (Feb. 2017), <https://www.creditsuisse.com/media/assets/corporate/docs/about-us/research/publications/credit-suisse-globalinvestment-returns-yearbook-2017-en.pdf>. Pablo Fernandez, *WACC and CAPM according to Utilities Regulators: Confusions, Errors, and Inconsistencies*, Working Paper, SSRN (Feb. 1, 2019) https://papers.ssrn.com/sol3/Data_Integrity_Notice.cfm?abid=3327206.

¹⁴⁶ MISO TOs Supplemental Initial Brief at 38.

¹⁴⁷ *Id.* at 39.

¹⁴⁸ *Id.* at 49; *see also* McKenzie EL15-45 Affidavit, Attachment 8 at 2.

analysis.”¹⁴⁹ In Opinion No. 551, the Commission also considered and rejected the use of Value Line short-term growth rates in lieu of, or as a means of supplementing, the IBES growth rates as a short-term growth rate stage in the two-stage DCF.¹⁵⁰ Thus, the IBES consensus growth rates in this proceeding’s record provide the best available evidence of the growth rates expected by the investment community.

Moreover, the record supports the following conclusions:

- IBES growth represents a consensus sampling of the information that informed study-period investors.¹⁵¹
- Value Line growth captures a substantially retrospective growth period.¹⁵²
- Value Line growth is distorted by spotty normalization of non-recurring earnings.¹⁵³
- IBES growth is more frequently updated.¹⁵⁴
- IBES growth produces less disparate, more statistically coherent spread of results.¹⁵⁵
- IBES growth is a standardized rather than tactically selected source.¹⁵⁶

¹⁴⁹ *Composition of Proxy Grps. For Determining Gas & Oil Pipeline ROE*, 123 FERC ¶ 61,048 at P 75 (2008) (subsequent history omitted) (“*Proxy Group Policy Statement*”).

¹⁵⁰ See Exhibit No. ICG-208 at 7; see also Opinion No. 551 at P 62.

¹⁵¹ *Ark. Elec. Coop. Corp. v. ALLETE, Inc.*, Initial Brief of the Complainant-Aligned Parties at 19-23, Docket No. EL15-45-000 (filed Mar. 26, 2016) (“2016 MISO CAPs IB”). See also *Ark. Elec. Coop. Corp. v. ALLETE, Inc.*, Reply Brief of Complainant-Aligned Parties at 9-12, Docket No. EL15-45-000 (filed Apr. 18, 2016) (“2016 MISO CAPs RB”).

¹⁵² 2016 MISO CAPs IB at 23; see also 2016 MISO CAPs RB at 12-14; Exhibit No. ICG-208 at 8-9.

¹⁵³ 2016 MISO CAPs IB at 23-29; see also 2016 MISO CAPs RB at 14-15; Exhibit No. ICG-208 at 8-9.

¹⁵⁴ 2016 MISO CAPs IB at 29-34; see also 2016 MISO CAPs RB at 15-17; Exhibit No. ICG-208 at 8-9.

¹⁵⁵ 2016 MISO CAPs IB at 34; see also 2016 MISO CAPs RB at 17-18; Exhibit No. ICG-208 at 8-9.

¹⁵⁶ 2016 MISO CAPs IB at 34-38. See also 2016 MISO CAPs RB at 18-20; Exhibit No. ICG-208 at 8-9.

For the foregoing reasons, Value Line growth rates are not comparable to IBES growth estimates.¹⁵⁷ Accordingly, reliance on IBES as the source of short-term growth rate estimates is appropriate.

Although IBES serves as the Commission's go-to source for sampling the near-term growth projections reviewed by study-period investors, and was the sole source used by numerous witnesses in this case, MISO CAPs acknowledge that it is not the only source used by investors. However, the record in this proceeding provides no basis to rely on any non-IBES growth rates. Furthermore, this proceeding is not the appropriate forum in which to address the MISO TOs' request for clarification as to use of non-IBES growth rate sources in future proceedings. In its recently published Notice of Inquiry, the Commission has already invited all concerned to present their arguments for (or against) reference to Value Line or any other non-IBES short term growth rate data.¹⁵⁸ That is the appropriate forum in which to entertain requests to clarify the rules for future proceedings.

3. The MISO TOs' application of the two-step DCF includes an inappropriate dividend yield adjustment.

Consistent with Opinion No. 551, the MISO II Initial Decision in this proceeding correctly applied the well-established $1+g/2$ adjustment to raw dividends.¹⁵⁹ The MISO TOs, however, propose to adjust the two-step DCF's dividend yield component by using the IBES

¹⁵⁷ See 2016 MISO CAPs RB at 6-8; Exhibit No. ICG-208 at 8-9.

¹⁵⁸ *Inquiry Regarding the Commission's Policy for Determining Return on Equity*, 166 FERC ¶ 61,207 at P 38 (2019) (seeking comments on "general issues that affect multiple models, such as the underlying data that the models rely on..."); see also *id.* (asking "Are IBES data a good proxy for 'investor consensus?'" and "Should growth rates be based on Value Line, IBES, or alternative estimates?").

¹⁵⁹ MISO II Initial Decision at PP 27-28 (adopting the CAPs' IBES-based DCF results, including dividend yields that were developed with the $1+g/2$ adjustment).

short-term growth rate, rather than a sustainable growth composite of short-term and long-term growth rates, as the “g” in this adjustment.¹⁶⁰ The net effect is that the initial dividend yield is adjusted to a level above the composite long-term growth rate, but the composite growth rate is not adjusted to reflect the increase in the initial dividend yield.¹⁶¹ Consistent with established precedent, the Commission should reject the MISO TOs’ proposed dividend yield adjustment. Rather, the Commission should adopt the two-step DCF calculation as presented by the MISO CAPs.¹⁶²

As support for the proposed modification to the dividend yield adjustment, Mr. McKenzie cites to *Seaway Crude Pipeline Co.*¹⁶³ According to Mr. McKenzie, in *Seaway* the Commission “determined that the projected GDP growth rate should not be considered in adjusting the dividend yield,”¹⁶⁴ thereby suggesting a departure from the Commission’s long-standing methodology for calculating dividend yields for purposes of the two-step DCF methodology.¹⁶⁵ Contrary to the MISO TOs’ position, however, *Seaway* did not announce a new methodology for calculating dividend yields in electric utility cases, because it makes no finding that short-term earnings growth is the best measure of the near-term dividend growth expected by electric utility investors. In *Seaway*, which concerned an oil pipeline Master Limited Partnership (“MLP”) and applied a DCF proxy group consisting entirely of oil pipeline MLPs,

¹⁶⁰ McKenzie EL15-45 Affidavit at 18.

¹⁶¹ Exhibit No. ICG-208 at 6.

¹⁶² *Id.* at 4-9.

¹⁶³ McKenzie EL15-45 Affidavit at n.43 (citing *Seaway Crude Pipeline Co.*, 154 FERC ¶ 61,070 (2016) (“*Seaway*”).

¹⁶⁴ *Id.* at 18.

¹⁶⁵ *Id.*

the Commission made a case-specific determination that it was inappropriate to disregard the pipeline's DCF study on the basis of the relatively minor difference associated with the choice of the yield-adjustment growth rate.¹⁶⁶ That particular determination does not apply to electric utilities, and there is nothing in *Seaway* that suggests a rule of general applicability to electric utilities.

The Commission's long-standing practice has been to use the composite growth rate, not the first-stage growth rate, as the "g" in the $1+g/2$ adjustment factor.¹⁶⁷ This practice is appropriate because the purpose of the $1+g/2$ adjustment is to account for the quarterly (rather than continuous or annual) payment of dividends, and the adjustment therefore requires a projection of growth in dividends, not growth in earnings.¹⁶⁸ By contrast, the first stage component of the composite growth rate represents a projection of near-term growth in earnings per share, not a projection of near-term growth in dividends. Because (a) long-term earnings growth funds long-term dividend growth, but (b) companies moderate their near-term dividend growth in order to avoid the risk of future dividends cuts, projected long-term earnings growth is the best available predictor of near-term dividend growth.¹⁶⁹ Thus, the composite growth rate is a better predictor of near-term dividend yield increases than in the first stage growth rate.

¹⁶⁶ *Seaway* at P 194.

¹⁶⁷ MISO CAPs Initial Paper Hearing Brief at 15-18.

¹⁶⁸ See Opinion No. 531 at PP 15, 17, 39.

¹⁶⁹ See, e.g., Morin at 284.

Moreover, as explained in Exhibit No. ICG-208 by Mr. Gorman, the MISO TOs' proposal distorts the mathematical construct of the DCF model.¹⁷⁰ The Commission's two-step DCF analysis maintains the mathematical construct of a constant growth DCF model; the growth rate in the FERC model is based on a composite rate which is derived by applying two-thirds weight to a short-term growth rate and one-third weight to the long-term growth rate.¹⁷¹ The composite growth rate ("g") is then used as the long-term constant growth rate in the DCF model.¹⁷² The "g" used in the yield adjustment is the same growth rate that is used to define the long-term growth of dividends.¹⁷³ Under Mr. McKenzie's proposal, however, the modified DCF model would incorporate two different growth rates to derive the DCF.¹⁷⁴ As a result, the modified DCF would distort the projection of future dividends and the cash flows under which the DCF model estimates an investor-required return.¹⁷⁵ The net effect of the MISO TOs' DCF adjustment is that the initial dividend yield is adjusted to a level above the composite long-term growth rate, but the composite growth rate is not adjusted to reflect the increase in the initial dividend yield.¹⁷⁶ Thus, the mismatched growth rates distort the DCF model and fail to track growth based on the composite growth rate.¹⁷⁷

¹⁷⁰ Exhibit No. ICG-208 at 5-6.

¹⁷¹ *Id.* at 5.

¹⁷² *Id.*

¹⁷³ *Id.* at 6.

¹⁷⁴ *Id.*

¹⁷⁵ *Id.*

¹⁷⁶ *Id.* at 7.

¹⁷⁷ *Id.*

In short, *Seaway* did not announce a broadly applicable revision to the Commission's dividend yield methodology. If the Commission had intended to announce a new dividend yield methodology in *Seaway*, it would have stated its intention explicitly. The dividend yield methodology adopted in the MISO II Initial Decision, consistent with Opinion No. 551, accords with the Commission's generally applicable policy and rationale for adoption of the two-step DCF analysis for electric utilities as well as the mathematical constructs underlying the model. Therefore, the two-step DCF model's dividend yield adjustment should continue to be implemented without the modification proposed by the MISO TOs.

B. When Implemented Reasonably, The Market-Based Capital Asset Pricing Model Estimates Equity Costs Aligned With DCF Results.

The principal basis on which the MISO TOs challenge whether the DCF results are truly cost-indicative is that they report significantly higher results using alternative methodologies, such as the CAPM. The MISO TOs endorse the use of the CAPM, as implemented in Order No. 551, as part of the Commission's newly proposed ROE approach.¹⁷⁸ Opinion No. 551 adopted the flawed CAPM methodology advanced by the MISO TOs' witness in that proceeding.¹⁷⁹ Mr. Gorman's Affidavit and accompanying exhibits, however, show that a reasonable application of the CAPM method actually produces results that are aligned with DCF results.¹⁸⁰

¹⁷⁸ MISO TOs Supplemental Initial Brief at 4-5; *see also* McKenzie EL15-45 Affidavit at 19-20.

¹⁷⁹ Opinion No. 551 at P 165; *see also* Exhibit No. ICG-200 at 7-11.

¹⁸⁰ *See* Exhibit No. ICG-200 at 8-26 (discussing CAPM). *Compare* Exhibit No. ICG-203 (CAPM median of 8.12%) *with* Exhibit No. JCI-202 (DCF median of 8.81%).

In his initial Affidavit, Mr. Gorman demonstrated that the flawed approach advocated by the MISO TOs produces CAPM results that are unreliable cost of equity indicators.¹⁸¹ The MISO TOs produce significantly higher results only by applying an unreasonable method—principally, by assuming that a portfolio meant to represent fully diversified investment in the entire equity market will permanently sustain earnings growth much faster than the economy, at 8.5%,¹⁸² so as to produce market-wide equity returns of 11.2%¹⁸³ and equity risk premiums of 8.2%.¹⁸⁴ In his initial Affidavit, Mr. Gorman provided proof that these assumptions are highly unrealistic.¹⁸⁵ Mr. Gorman also corrected errors contained in the MISO TOs' CAPM analysis and described the proper application of the CAPM methodology.¹⁸⁶

Thus, as demonstrated by MISO CAPs' witness Mr. Gorman, a reasonably implemented market-based CAPM produces estimates that are aligned with the numbers produced by the DCF.¹⁸⁷

C. The MISO TOs' Misapplication of the Risk Premium Method Produces Inflated Results.

The Risk Premium method seeks to extrapolate a present cost of equity from past regulatory decisions by identifying a linear relationship between the cost of equity and cost of debt implicit in those decisions, and then adding the implied current difference to the present cost

¹⁸¹ Exhibit No. ICG-200 at 10-25.

¹⁸² See McKenzie EL15-45 Affidavit, Attachment 5.

¹⁸³ See *id.*

¹⁸⁴ See *id.*

¹⁸⁵ Exhibit No. ICG-200 at 10-25; see also Exhibit No. ICG-203.

¹⁸⁶ Exhibit No. ICG-200 at 25-26.

¹⁸⁷ Compare Exhibit No. ICG-203 (CAPM median of 8.12%) with Exhibit No. JCI-202 (DCF median of 8.81%).

of debt to estimate the current cost of equity.¹⁸⁸ This method is inherently less accurate than a well-constructed DCF or CAPM method, as it relies on echoes of the market-based methods applied in past cases, whereas the DCF and CAPM methods apply a market-based method to primary data. Moreover, a Risk Premium-based finding will tend to replicate the regulatory lag and inertial continuation of past returns that affected past regulatory decisions. Consequently, in this period of declining equity costs, the Risk Premium method will tend to produce an excessive estimate of the current cost of equity.¹⁸⁹ Nonetheless, when reasonably applied, the Risk Premium method, like the DCF and CAPM methods, also points to study-period costs of equity well below 10%.¹⁹⁰

The MISO TOs' application of the Risk Premium method points much higher, for two reasons. First, it relies on projected rather than actual bond yields. Second, it relies on imputed base ROEs from cases that did not actually concern base ROEs or find a then-current cost of equity.

1. **The MISO TOs' application of the Risk Premium method relies on bond yield projections the Commission has rightly rejected as speculative.**

The MISO TOs present as their Risk Premium result the average of: (a) a risk premium above *actual* bond yields and (b) a risk premium above *projected* bond yields.¹⁹¹ The MISO TOs present no reason to use projected bond yields for this purpose, other than a statement that

¹⁸⁸ See Briefing Order at 36.

¹⁸⁹ Exhibit No. ICG-200 at 36-37.

¹⁹⁰ Compare Exhibit No. ICG-200 at 37 (recommending a Risk Premium estimate of 9.09%), with Exhibit No. JCI-202 (recommending a DCF median of 8.81%) and Exhibit No. ICG-203 (recommending a CAPM median of 8.12%).

¹⁹¹ See McKenzie EL15-45 Affidavit at 23.

this approach is “[c]onsistent with the approach adopted in the *Coakley* Briefing Order.”¹⁹² It is curious that MISO TOs and their affiant rely on the *Coakley* Briefing Order, when the Briefing Order in the instant proceeding also illustratively used a risk premium result based on actual bond yield, which they acknowledged.¹⁹³ The Briefing Order refers to “the 10.36 percent result of the Risk Premium analysis.”¹⁹⁴ While the Briefing Order provides no citation, the evident source was the 10.36% risk premium result at page 1 of Exhibit No. MTO-29, as cited in the MISO I Initial Decision.¹⁹⁵ The MISO I Initial Decision relied on Dr. Avera’s historical risk premium analysis, and rejected reliance on projected bond yields as “speculative”:

Dr. Avera also produces a risk premium analysis using bond yields projected for 2016-20. This Initial Decision rejects those studies. Projected yields are speculative, and, therefore, a less reliable basis for a study than historical yields.¹⁹⁶

On exceptions, the Commission affirmed this determination:

The Presiding Judge held that projected yields used in risk premium analyses are speculative and less reliable than historical yields, and rejected Dr. Avera’s use of *projected* Baa-rated bond yields. ... [W]e agree with the Presiding Judge. ...¹⁹⁷

¹⁹² *Id.* (citing *Coakley v. Bangor Hydro-Elect. Co.*, 165 FERC ¶ 61,030 (2018) (“*Coakley* Briefing Order”).

¹⁹³ McKenzie EL15-45 Affidavit at n.46 (“The 10.36% Risk Premium value corresponds to Dr. Avera’s application of this method using a six-month historical bond yield average for November 2014-April 2015, as shown on page 1 of Exhibit No. MTO-29 in Docket No. EL14-12-002”).

¹⁹⁴ Briefing Order at P 60.

¹⁹⁵ MISO I Initial Decision at P 235; *see also id.* at P 258; McKenzie EL15-45 Affidavit at n.46.

¹⁹⁶ MISO I Initial Decision at P 257.

¹⁹⁷ Opinion No. 551 at P 194 (emphasis added). The ellipses in our quotation address an issue, concerning which yield projection to use, that was mooted by the wholesale rejection of reliance on projected bond yields.

Thus, the Commission rejected the use of projected bond yields in the Risk Premium analysis.¹⁹⁸ This conclusion was consistent with a prior Commission ruling,¹⁹⁹ and is fully applicable to these proceedings.²⁰⁰

It is true that the *Coakley* Briefing Order referred to a number that was an average of risk premium results reached through both actual (a.k.a. historic) and projected bond yields. There is no reason to believe, however, that the Commission intended to use the latter. By way of background, in their Docket No. EL11-66 Brief on Exceptions, the New England Transmission Owners (“NETOs”) stated, “Dr. Avera’s analysis using the risk premium model suggests a current cost of equity on the order of 10.7% to 10.9% for the [May-October 2012 study period]... and 10.7% to 10.8% for the [October 2012-March 2013 study period].”²⁰¹ The quoted “10.8%” did, indeed, derive from NET-704, but the NETOs did not clearly identify their reliance on projected bond yields, as they neither used the word “projected” in the cited passage nor provided a pinpoint citation to page two of NET-704. Without explanation, Opinion No. 531 then recited the NETOs’ reference to “10.7% to 10.8%” as the risk premium result for the adopted October 2012-March 2013 study period.²⁰² In doing so, it provided no discussion of the question whether to use projected bond yields rather than actual bond yields in applying the Risk

¹⁹⁸ *Id.*

¹⁹⁹ See *Potomac-Appalachian Transmission Highline, L.L.C.*, 122 FERC ¶ 61,188, P 102 (2008), *on reh’g*, 133 FERC ¶ 61,152 (2010) (rejecting Dr. Avera’s “speculative forecasting of th[e] . . . indexed cost of debt” as a basis to raise the low-end test used to filter proxies’ DCF results).

²⁰⁰ See Exhibit No. JCA-1 at 16-18 (CAPs’ witness Mr. Stephen Hill explaining why the use of projected bond yields in determining the current cost of equity capital produces unreliable results).

²⁰¹ *Coakley v. Bangor Hydro-Elec. Co.*, Brief on Exceptions of the New England Transmission Owners at 44-45, Docket No. EL11-66-001 (filed Sept. 20, 2013) (eLibrary No. 20130920-5115) (“NETOs Brief on Exceptions”) (citing Exhibit Nos. NET-300 at 53-54; NET-306; NET-700 at 15; NET-704).

²⁰² Opinion No. 531 at P 147.

Premium method. In short, after the NETOs led the Commission into an unacknowledged, apparently unintended, and subsequently-vacated reliance on projected bond yields, the MISO TOs now are attempting to turn repetition of that error into a cornerstone of equity cost determinations in this and future proceedings.

On the merits, as Mr. Gorman explains, it would not be rational to derive a risk premium based on actual past utility bond yields, and then add that risk premium to current forecasts of future utility bond yields.²⁰³ The MISO TOs have not presented an internally consistent study in which projected bond yields are used to derive the risk premium as well as the yield to which it is added.²⁰⁴ Even if they had done so, such a study would not be useful, because projected bond yields do not represent the known and measurable cost of capital.²⁰⁵ Projected bond yields are also highly unreliable.²⁰⁶ Economists' projections of changes in current yields almost always reflect increases in those yields, which usually prove to be incorrect.²⁰⁷ Through a comparison of actual observable yields and projections of future changes in yields over the period December 2000 through December 2014, Exhibit No. ICG-210 demonstrates that using analysts' projected changes in yield does not produce a reliable estimate of what the actual cost of capital will be at some point in the future.²⁰⁸ Thus, projected bond yields do not accurately reflect investor return requirements, are not an actual depiction of changes in return requirements for future periods,

²⁰³ *See generally* Exhibit No. ICG-208 at 36-41.

²⁰⁴ *Id.* at 39.

²⁰⁵ *Id.* at 40-41.

²⁰⁶ *Id.* at 40.

²⁰⁷ *Id.*

²⁰⁸ *Id.* at 40-41; *see also* Exhibit No. ICG-210.

and are not a known and measureable estimate of what the investor-required return on a bond or stock will be.²⁰⁹ Therefore, using projected bond yields in a Risk Premium analysis to measure the current market cost of equity is not reasonable.

2. **The MISO TOs' application of the Risk Premium method relies on erroneously imputing base ROE determinations to cases that the subject transmission owners recently admitted are not base ROE cases.**

The MISO TOs developed risk premiums for the period between 2006-2015 based on an analysis of FERC-allowed ROEs during that time period, minus a contemporary average utility bond yield at the rate case order date.²¹⁰ The MISO TOs' analysis, however, relies upon a number of decisions that did not concern the cost-based ROE for a new study period, and therefore do not provide the basis for a valid comparison between the date's cost of equity and cost of debt.²¹¹ The MISO TOs' reliance on non-base ROE decisions in the development of risk premiums fatally undermines their application of the Risk Premium model.

Two of those non-base ROE decisions involved the NETOs, who have recently admitted those cases did not involve base ROEs.²¹² In the recent Initial Briefs filed in response to the *Coakley* Briefing Order, the NETOs presented the following as examples of cases that were "not . . . base ROE cases:"

In some cases, the Commission has only set an ROE Incentive, and not a base ROE. *See, e.g., Ne. Utils. Serv. Co.*, 125 FERC ¶ 61,183 (2008), *reh'g denied*, 135 FERC ¶ 61,270 (2011); *The United*

²⁰⁹ Exhibit No. ICG-208 at 41.

²¹⁰ McKenzie EL15-45 Affidavit at Attachment 7; *see also* MISO II Initial Decision at P 349.

²¹¹ *See* McKenzie EL15-45 Affidavit, Attachment 7 at 4.

²¹² *See Coakley v. Bangor Hydro-Elec. Co.*, Initial Paper Hearing Brief of the New England Transmission Owners at 60, n.222, Docket Nos. EL11-66-001, *et al.* (filed Jan. 11, 2019) ("NETOs Initial Paper Hearing Brief").

Illuminating Co., Docket No. ER11-3977-000 (Letter Order, Aug. 25, 2011); *Cent. Me. Power Co.*, 125 FERC ¶ 61,079 (2008), *reh'g denied*, 135 FERC ¶ 61,136 (2011).²¹³

These examples come down to two primary orders: the November 17, 2008 Order in Docket No. ER08-1548, reported at 125 FERC ¶ 61,183, and the October 20, 2008 Order in Docket No. EL08-74, reported at 125 FERC ¶ 61,079.²¹⁴ Both of those orders were included in MTOs' risk premium analysis.²¹⁵ The first appears as "Nov-08 ER08-1548 Northeast Utils Service Co. 11.14%," and the second as "Oct-08 EL08-74 Central Maine Power Co. 11.14%" in Attachment 7 of the McKenzie Affidavit.²¹⁶ The NETOs, the New England utilities that were the subject of the referenced orders, have admitted that neither of these cases concerned a base ROE. Therefore, in light of this information, the Commission's adoption of the MISO TOs' risk premium studies would constitute reversible error.

D. The Expected Earnings Method Should Not Be Relied Upon To Determine ROEs.

The MISO TOs have not provided adequate justification for reliance on the Expected Earnings method, which is based entirely on expected accounting returns, without any consideration of actual market prices of utility stocks. As the MISO CAPs have previously demonstrated, the Expected Earnings method is a fundamentally inappropriate method to determine a just and reasonable ROE for public electric utilities, such as the MISO TOs, for three

²¹³ *Id.*

²¹⁴ The other three citations included in MISO TOs' string cite consist of two orders denying rehearing of these primary orders, and the Docket No. ER11-3977-000 letter order, which merely transferred to a new owner an incentive previously granted to its predecessor in interest.

²¹⁵ McKenzie EL15-45 Affidavit, Attachment 7 at 4.

²¹⁶ *Id.*

primary reasons. First, because the method is not market-based and does not provide the market cost of common equity capital, the Expected Earnings methodology produces erroneously inflated measures of investors' required level of return. Second, there is no evidence that investors rely on the Expected Earnings method. Finally, the Expected Earnings approach is a fatally flawed in that it is circular and self-fulfilling.

1. **The Expected Earnings methodology produces flawed results because it does not provide a reasonable estimate of investors' required return.**

A fatal flaw of the Expected Earnings methodology is that it lacks capital market input and does not measure the rate of return investors require to invest in the market-priced common equity capital of a utility; rather, it measures expectations of what publicly-traded utility holding companies will earn on the book value of their common equity.²¹⁷ The Briefing Order, by way of describing the Expected Earnings methodology, incorrectly states that “[t]he returns on book equity that investors expect to receive from a group of companies with risks comparable to those of a particular utility are relevant to determining that utility’s cost of equity, because those returns on book equity help investors determine the opportunity cost of investing in that particular utility instead of other companies of comparable risk.”²¹⁸ In fact, a proxy’s expected earned return on book value indicates neither what an investor can expect to earn on an investment in that company’s common stock, nor what return an investor requires to invest in that stock, except in the unusual circumstance where the proxy’s stock happens to be trading in

²¹⁷ Exhibit No. JCI-200 at 26; Exhibit No. JCI-207 at 45.

²¹⁸ Briefing Order at Appendix. p. 37.

the market at a price at or very near that company's book value per share.²¹⁹ As MISO CAPs' witness Mr. Solomon has explained, this is because an investor cannot purchase a company's common stock at its book value, but must instead pay the prevailing market price for common equity.²²⁰

Indeed, even MISO TOs' witness Mr. McKenzie has acknowledged that the results of the Expected Earnings method "do not represent a market-based estimate of investors' required return."²²¹ Notwithstanding this acknowledgment, Mr. McKenzie, in an attempt to salvage the usefulness of the Expected Earnings method, has claimed in related proceedings that the method "provides a direct guide to ensure that the allowed ROE is similar to what other utilities of comparable risk will earn on invested capital" and that "[b]ecause these returns on book value equity are analogous to the allowed return on a utility's rate base, this measure of opportunity costs results in a direct, 'apples to apples' comparison."²²² Additionally, Mr. McKenzie has asserted that the "Expected Earnings approach relies on the straight-forward concept that when evaluating two investments of comparable risk, investors will choose the alternative with the higher expected return."²²³ Mr. McKenzie's position on these matters is erroneous for three principal reasons.

First, as the Commission has long recognized, its obligations under the Federal Power Act and *Hope* and *Bluefield* dictate that regulated returns must reflect the market cost of equity

²¹⁹ Exhibit No. JCI-207 at 45.

²²⁰ Exhibit No. JCI-200 at 27; Exhibit No. JCI-207 at 53.

²²¹ McKenzie EL11-66 Reply Affidavit at 81, Attach. A.

²²² Exhibit No. MTO-1 at 48.

²²³ McKenzie EL11-66 Reply Affidavit at 83, Attach. A.

capital (and thus, the return that investors require), not what comparable-risk publiclytraded companies will earn on their book common equity capital.²²⁴ In fact, the Commission has explicitly stated that “there is compelling economic justification for relying on the market cost of capital as the standard for rate of return decisions. Furthermore, a market cost of capital approach addresses both the comparable earnings and capital attraction standards of the *Hope* decision.”²²⁵ As such, the lack of any market input into the proposed Expected Earnings method is in direct contrast with the Commission’s obligations and precedent and it should therefore be given no weight in the determination of a just and reasonable ROE.

Second, Mr. McKenzie’s contention that an investor will choose the higher expected return when evaluating two utilities of comparable risk is fundamentally incomplete, and dangerously misleading, given that no rational investor would ignore the prevailing market price of the stock which he/she must pay in order to acquire the right to that accounting return. When an investor must pay more than book value to gain the right to the future expected earnings on book value, that investor must be expecting to earn something less than the forecast earnings per book value on his or her higher amount of investment in the company.²²⁶ From the investor’s perspective, as a leading treatise explains, “[t]he investor’s ‘book’ value is the purchase [market] price,” and the investor’s expected return, given an expected E/B ratio of 20 percent and a

²²⁴ *Generic Determination of Rate of Return on Common Equity for Pub. Utilities*, Order No. 461, FERC Stats. & Regs. ¶ 30,722, *reh’g denied*, Order No. 461-A, 38 FERC ¶ 61,160 (1987); *Generic Determination of Rate of Return on Common Equity for Pub. Utilities*, Order No. 489, FERC Stats. & Regs. ¶ 30,795 (1988) (“Order No. 489”); *Orange & Rockland Utils., Inc.*, Opinion No. 314, 44 FERC ¶ 61,253 at 61,952 (“Opinion No. 314”), *on reh’g*, Opinion No. 314-A, 45 FERC ¶ 61,252 (1988); Exhibit No. JCI-200 at 27.

²²⁵ Order No. 489 at 30,993.

²²⁶ Morin at 359.

Market-to-Book (“M/B”) ratio of two, “would be 10 percent.”²²⁷ Additionally, investors’ required return for the MISO TOs is significantly less than the expected accounting return on the book value of equity, as evidenced by the M/B ratios for the MISO II proxy group being greater than 1.0.²²⁸

Third, contrary to Mr. McKenzie’s claim, the returns on book value equity are not directly analogous to the allowed return on a utility’s rate base. On the contrary, the expected earnings/book value misrepresent an investor’s required level of return.²²⁹ As JCI witness Solomon demonstrates, the Expected Earnings methodology result for the proxy group is significantly higher than the return investors require to invest in the common equity of comparable-risk electric utilities such as the MISO TOs.²³⁰ Additionally, many of the proxy group companies’ high earnings and expected levels of earnings/book value are not the result of rate-regulated electric utility operations; rather, many are holding companies and some have diversified merchant generation or other unregulated utility and nonutility businesses that give them high earnings relative to their net book value. Reference to the earnings/book ratios of such proxy companies distorts the Expected Earnings analysis results, rendering such results unreliable as a guide to the MISO TOs’ cost of equity.²³¹ Accordingly, the Expected Earnings analysis should be disregarded.

²²⁷ James C. Bonbright, Albert L. Danielsen, & David R. Kamerschen, *Principles of Public Utility Rates* 330 (2d ed. 1988).

²²⁸ See Exhibit No. JCI-205 at 1.

²²⁹ Exhibit No. JCI-200 at 34.

²³⁰ *Id.*

²³¹ Exhibit No. JCI-200 at 35; Exhibit No. JCI-207 at 57.

2. Investors do not rely on the Expected Earnings method.

The Briefing Order and the MISO TOs erroneously assert that investors rely on the Expected Earnings method.²³² However, there is no evidence for the conclusory assertion that investors rely on this methodology. As Mr. Solomon demonstrates in his Reply Testimony, two stock research reports presented by Mr. McKenzie's colleague Mr. Quackenbush demonstrate just the opposite.²³³ In fact, the financial data that the two reports prominently display, and that are considered important to utility stock investors, are the DCF model and other stock valuation indicators, including market price, dividend yield, expected dividend growth rates, expected earnings growth rates, price-to-earnings ("P/E") ratios, and M/B ratios.²³⁴ Thus, the two stock research reports demonstrate the importance of market-oriented valuation information and completely omit expected earnings to book (E/B) value.

While Value Line provides projected earnings/book value ratios (labelled as "Return on Com. Equity"), there is no evidence that investors use that information in the way that Mr. McKenzie proposes (*i.e.*, to indicate the "opportunity" cost of capital). On the contrary, the projected earned ROEs are neither an "opportunity" cost nor an investor's required rate of return.²³⁵ In *New Regulatory Finance*, a text cited multiple times in the Briefing Order, Dr. Roger Morin explains that:

²³² "Investors appear to base their decisions on numerous data points and models, including the DCF, CAPM, Risk Premium, and Expected Earnings methodologies." Briefing Order at P 42; *see also* MISO TOs Supplemental Initial Brief at 6.

²³³ Exhibit No. JCI-207 at 55 (citing Mar. 8, 2019 Reply Affidavit of John D. Quackenbush, CFA in FERC Docket No. EL11-66-001 at 19:15-27 – 20:5-6).

²³⁴ Exhibit No. JCI-207 at 55-56.

²³⁵ *Id.* at 63.

Accounting rates of return are not opportunity costs in the economic sense. . . . Only stock market price is sensitive to a change in investor requirements. Investors can only purchase new shares of common stock at current market prices and not at book value.²³⁶

As such, it would be illogical and irrational for investors to rely on Mr. McKenzie's proposed methodology, because it is applied without any knowledge of or consideration for the current market price the investor would have to pay in order to invest in the company's common stock. There would, therefore, be no way for an investor to know what return he/she might be able to expect on an investment in the company's common equity.²³⁷

3. The Expected Earnings approach is a fatally flawed, circular and self-fulfilling methodology.

The Commission should not rely on the Expected Earnings method in determining a just and reasonable ROE because the method is inappropriately circular and potentially self-fulfilling. At the outset, it should be noted that the Commission has previously found that dividing expected earnings by the book value (rather than market price) of common equity is inappropriately circular.²³⁸ Dr. Morin has also cautioned that the results of the Expected Earnings approach would be circular, stating:

It would be circular to set a fair return based on the past returns of other regulators... The rates of return earned by other regulated utilities may very well have been reasonable under historical conditions, but they are still subject to tests of reasonableness under current and prospective conditions.²³⁹

²³⁶ Morin at 393.

²³⁷ Exhibit No. JCI-207 at 63-64.

²³⁸ See Opinion No. 314 at 61,952.

²³⁹ Morin at 383.

As JCI witness Mr. Solomon explains in his Reply Affidavit, placing reliance on Value Line's projected, or forward-looking, accounting returns on book value does not avoid the undeniable issue of circularity. Value Line's projections for regulated utilities are grounded in existing ROEs awarded by the Commission and state commissions, as applicable. Value Line reports, therefore, do not provide projections of future authorized ROEs; instead, the past allowed ROEs provide the basis for future earnings.²⁴⁰

Additionally, using the Value Line projected ROEs would also provide the utilities the opportunity to earn those ROEs and would virtually guarantee it when the utility's rates, specifically FERC-style formula rates, are based on forward projections of investment and costs with true-ups to provide for the recovery of actual costs, including the authorized ROE.²⁴¹ Moreover, Value Line would have significant undue influence over the direction of this self-fulfilling approach as the Commission would be placing sole reliance on its forecasts.²⁴² Accordingly, relying on the fatally flawed, circular, and potentially self-fulfilling Expected Earnings methodology would result in inappropriate Commission policy.

4. **Even if the Commission were to adopt an Expected Earnings methodology, it should modify the proposed method to mitigate its many deficiencies.**

The Expected Earnings method should not be relied upon at all to determine ROEs. If, however, the Commission decides to place any reliance on the Expected Earnings methodology, it should be modified to minimize its significant flaws. As previously explained by Mr. Solomon,

²⁴⁰ Exhibit No. JCI-207 at 59-60.

²⁴¹ *Id.* at 61.

²⁴² *Id.*

the Commission should implement, at a minimum, three adjustments to the proposed Expected Earnings method.²⁴³

First, the Expected Earnings method should only be used in combination with an analysis of the proxy companies' M/B ratios to evaluate whether investors' required rate of return for investing in utilities' common equity is less than, more than, or approximately equal to the forecasted ROEs for the proxy companies, and thus to evaluate the reasonableness of the ROEs estimated using the market-oriented methods.²⁴⁴

Second, Mr. McKenzie's method included only the Value Line projection for the 2018-20 period, but did not include the projections Value Line provided for 2015 and 2016, resulting in an incomplete prospective view. The Commission has previously found it appropriate to use all three forward projections provided by Value Line and should do so in this proceeding in order to better reflect long-term expectations of investors.²⁴⁵

Third, even if the full scope of the Value Line projections is used, those projections still cover only an average of five years (*i.e.*, 2015-2020), which is too short a period to reflect the ups and downs of market and economic conditions covering a full business cycle, as Dr. Roger Morin instructs is needed. Dr. Morin warns that selecting a short-term period may not be reflective of the firm's expected long-run earnings, and recommends that in order "to dampen cyclical aberrations and remove the effects of cyclical peaks and troughs in profitability, an

²⁴³ Exhibit No. JCI-200 at 37-46.

²⁴⁴ Exhibit No. JCI-207 at 49.

²⁴⁵ See Opinion No. 531 at P 25 (citing Opinion No. 445 at 61,263).

average over several time periods should be employed.”²⁴⁶ As such, the Expected Earnings method should be adjusted to incorporate the full panoply of historic and forecasted ROE data provided by Value Line.

Additionally, if the Commission uses the Expected Earnings method, it should be given little if any weight as compared to the other three methods, because it has many methodological flaws, as discussed above and in Mr. Solomon’s testimony, and because it does not calculate the market-based cost of equity.²⁴⁷

E. The Commission Should Reject the MISO TOs’ Reliance on the Midpoint.

Mr. McKenzie uses the midpoint, instead of the median, for his calculations. This includes his use of the midpoint to establish the level at which the allowed ROE would be immunized against alignment with the updated cost of equity (*i.e.*, the “Shield Level”),²⁴⁸ and his calculation of the replacement ROE.²⁴⁹ The Commission should reject Mr. McKenzie’s calculations and should use the median instead of the midpoint in calculating the composite zone bounds and the replacement ROE.

As Dr. Berry discussed in his Initial Affidavit, the midpoint is inherently inferior to the median as a measure of central tendency because it depends upon only the two most extreme, unrepresentative observations—the highest point and the lowest point in the proxy group results—and ignores the distribution of proxy group results, making it more susceptible to being

²⁴⁶ Morin at 383.

²⁴⁷ Exhibit No. JCI-207 at 53-54.

²⁴⁸ *See supra* n.70.

²⁴⁹ McKenzie EL15-45 Affidavit, Attachments 2 and 9.

skewed by outlier values.²⁵⁰ This characteristic of the midpoint compromises the Commission's attempts to address model risk because the most extreme results of each model (those most affected by model risk and least likely to represent the MISO TOs' actual cost of equity) become the determinants of what customers pay.²⁵¹ Furthermore, using the midpoint artificially broadens the proposed Shield Level that would limit customers' ability to challenge unjust and unreasonable ROEs. The Shield Level calculated adopting the Commission's proposed ROE framework, but using the median rather than the midpoint, is 10.05%,²⁵² which is more than 100 basis points below the 11.13% Shield Level endorsed by the MISO TOs.²⁵³ Most importantly, the replacement ROE using the Commission's proposed ROE framework, but using the median rather than the midpoint, is 9.81%.²⁵⁴

Dr. Berry explains that the circumstances under which the Commission has defended the use of the midpoint for a group of utilities of diverse risk have changed.²⁵⁵ One of these changes is that the Commission now characterizes the MISO TOs as a group of utilities facing "average risk"²⁵⁶ rather than as a group of utilities facing diverse risks.²⁵⁷ Another change is that the

²⁵⁰ Exhibit No. OMS-208 at P 4.

²⁵¹ Exhibit No. OMS-200 at P 24.

²⁵² Exhibit No. OMS-208 at P 11.

²⁵³ McKenzie EL15-45 Affidavit, Attachment 2 at 4.

²⁵⁴ Exhibit No. OMS-208 at P 11.

²⁵⁵ Exhibit No. OMS-208 at PP 5-6.

²⁵⁶ Briefing Order at P 58.

²⁵⁷ Exhibit No. OMS-208 at PP 7-8.

Commission now uses large, national proxy groups, with dozens of members, rather than a smaller group consisting of the nine companies²⁵⁸ owning the MISO TOs themselves.

Notably, the MISO TOs' witness, in recent testimony sponsored by one of the largest MISO TOs, has conceded that there is no basis to vary the measure of central tendency as between regional and single-utility cases. He testifies that using midpoints in one and medians in the other is unreasonable, because "differentiating between a proceeding involving a single transmission utility and a joint filing of multiple RTO members ignores the requirements of investors, which are based on comparable-risk opportunities available in the capital markets."²⁵⁹ Given the Commission's correct and judicially-affirmed finding that the median best represents investor requirements in single-utility cases,²⁶⁰ it follows that the median should be applied in all cases.

The midpoint is not the central or typical value of a given distribution of data. As Dr. Berry explains, this fact is illustrated by observing the distributions of results from Mr. McKenzie's DCF and Expected Earnings analyses. Mr. McKenzie's midpoint exceeds 16 of the 25 proxy company estimates produced by his IBES DCF analysis,²⁶¹ and 22 of the 31 proxy company estimates produced by his Expected Earnings analysis.²⁶² In other words, the proxy company estimates cluster predominantly at the central or lower end of the range. These data

²⁵⁸ See *Midwest Indep. Transmission Sys. Op., Inc.*, 99 FERC ¶ 63,011, Appendix B (2002).

²⁵⁹ Answering Testimony of Adrien M. McKenzie, Exhibit No. SER-0001 in Docket Nos. EL17-41, *et al.*, at 20-21 (March 20, 2019) (eLibrary No. 20190320-5185).

²⁶⁰ See *S. Cal. Edison Co. v. FERC*, 717 F.3d 177, 181-87 (D.C. Cir. 2013).

²⁶¹ McKenzie EL15-45 Affidavit, Attachment 3 at 2 (IBES DCF – Modified Low-End Test).

²⁶² *Id.*, Attachment 6 at 1; Exhibit No. OMS-208 at P 9.

points show that while the median value is “central” and “typical” of the distribution, the midpoint is not. Thus, the record in this proceeding echoes the concern expressed by the *Emera Maine* Court, which found it arbitrary and capricious to adopt a base ROE that “was higher than 35 of the 38 data points”²⁶³ on which the Commission relied. The Commission should reject Mr. McKenzie’s reliance on the midpoint and use the median for calculations under the proposed base ROE framework.

F. The MISO TOs’ Reliance on Three Separate Zones of Reasonableness Instead of a Single Composite Zone Is Inappropriate.

Mr. McKenzie supports the Commission’s proposed sequence of calculations for the composite zone of reasonableness, which involves separately calculating three zones of reasonableness for the DCF, CAPM, and Expected Earnings methods and which (after applying high-end and low-end outlier tests) defines the bounds of the composite zone.²⁶⁴ The presumptive immunity zones are defined in quartiles within the composite zone bounds based on the risk profile of the target utility(ies).²⁶⁵ But the replacement base ROE is determined using the median or midpoint of three separate zones of reasonableness without regard to placement within the composite zone.²⁶⁶

Consistent with the Commission’s practice of relying on a single zone of reasonableness,²⁶⁷ MISO CAPs proposed an alternative sequence of calculations that would

²⁶³ *Emera Maine* at 28.

²⁶⁴ McKenzie EL15-45 Affidavit at 9, and Attachments 2 and 9.

²⁶⁵ McKenzie EL15-45 Affidavit, Attachment 9; Briefing Order at P 29.

²⁶⁶ Briefing Order at P 18.

²⁶⁷ See, e.g., *Emera Maine* at 21 (describing the Commission’s practice of assembling a zone of reasonable ROEs on which to base a utility’s ROE.)

establish a single composite zone with composite results for each of the proxy companies within the zone of reasonableness.²⁶⁸ The MISO CAPs' proposal is the appropriate approach because, ultimately, there is only *one* just and reasonable ROE for each proxy company,²⁶⁹ just as there is only *one* just and reasonable base ROE for the target utility.²⁷⁰ Neither Mr. McKenzie nor the Commission has explained why it is appropriate to rely on three separate cost of equity estimates for each proxy company, instead of calculating each proxy's just and reasonable return.

The MISO CAPs propose a composite zone established by first calculating *for each proxy company* the weighted average of the DCF and the CAPM results (and the Expected Earnings results, if used) to determine a company-specific cost of equity for each company in the proxy group.²⁷¹ If the results under one method for a particular proxy company are eliminated due to separate application of the high-end or low-end outlier tests to the results of each model, Dr. Berry recommends averaging the proxy results that are not eliminated.²⁷² While it may be argued that this approach affects the weighting of models in estimating the results of a given proxy company for which other methods lack results, the same issue would arise under the Commission's proposed methodology that Mr. McKenzie endorses when the high and low proxies do not have return estimates under the three financial models.²⁷³

²⁶⁸ Exhibit No. OMS-200 at PP 19-24.

²⁶⁹ *Id.* at P 22.

²⁷⁰ *See, e.g., Emera Maine* at 26 (recognizing that the Commission eventually reduces the zone of reasonableness to a single just and reasonable ROE).

²⁷¹ Exhibit No. OMS-200 at PP 19-24.

²⁷² Exhibit No. OMS-208 at PP 22, 23.

²⁷³ *Id.*

Combining the results of the three models for each proxy company will also help address the Commission's concerns regarding model risk. As Dr. Berry explains, using three separate ranges for the DCF, CAPM, and Expected Earnings methods, as Mr. McKenzie does, makes the three methods' high-points, low-points, and midpoints especially susceptible to the Commission's asserted "model risk," which the Commission describes as a potential source of errors or inaccuracies.²⁷⁴ Mr. McKenzie's method results in an unwarranted expansion of the composite zone of reasonableness.

The zone of reasonableness is intended to balance the interests of investors and consumers.²⁷⁵ While the MISO TOs may complain that the proposed single composite zone could narrow the zone of reasonableness, this potential result will only reflect the improved accuracy of the calculations by preventing unrepresentative extreme values (both high and low) from being used to set the bounds of that composite zone.²⁷⁶ Dr. Berry calculated a single composite zone using Mr. McKenzie's data, the Commission's proposed framework, and his proposed sequence of calculations to illustrate how this approach changes the results endorsed by Mr. McKenzie.²⁷⁷ The results reduce: (1) the upper bound of the overall composite range by 86 basis points from 12.71%²⁷⁸ to 11.85%, (2) the replacement ROE by 35 basis points from 10.18% to 9.83%; and (3) the Shield Level by 45 basis points from 10.74% to 10.29%.²⁷⁹

²⁷⁴ Exhibit No. OMS-200 at P 24; Exhibit No. OMS-208 at P 19.

²⁷⁵ *Emera Maine* at 21 (citing *Pac. Gas & Elec. Co. v. FERC*, 306 F.3d 1112,1116 (D.C. Cir. 2002)).

²⁷⁶ Exhibit OMS-208 at P 21.

²⁷⁷ Exhibit No. OMS-211.

²⁷⁸ McKenzie EL15-45 Affidavit, Attachment 2 at 1.

²⁷⁹ Exhibit OMS-208 at P 26.

Finally, establishing a composite zone using MISO CAPs' alternative sequence of calculations does not affect the efficacy of each financial model because the predetermined weighting of each model ensures that due consideration of individual model inputs is given at a level set by the Commission.²⁸⁰ The Commission implicitly recognized this fact by proposing to average the highest and lowest proxy company results from the DCF, CAPM and Expected Earnings models to define the bounds of the composite zone.²⁸¹

G. The Expected Earnings Method Should Receive Little, if Any, Weight, and the Commission's Long-Standing DCF Method Should Receive More Weight than the Other Proposed Models.

MISO CAPs believe there is insufficient support for MISO TOs' witness Mr. McKenzie's arguments in favor of the Commission's proposal to give equal weights to the results of the cost of equity models, *i.e.*, a one-third weighting to the results of each of the DCF, CAPM, and Expected Earnings models in the first prong of the section 206 decisional process.²⁸² Too little weight is given to the proven DCF method, and too much weight is given to the Expected Earnings method, which, as discussed above in Section IV.D, is riddled with flaws.²⁸³

The DCF method should be given more weight because it has been used by the Commission for many years as the primary equity-cost estimation method for both gas pipelines and electric utilities, with proven success. As Dr. Berry explains, unlike the other proposed models, the DCF method has been honed through decades of Commission rulemakings and rate

²⁸⁰ *Id.* at P 20.

²⁸¹ Briefing Order at P 32.

²⁸² *See* McKenzie EL15-45 Affidavit at 9:1-19, and Attachments 2 and 9. Mr. McKenzie does not complete the second prong of FERC proposed methodology.

²⁸³ *See* Exhibit No. OMS-208 at P 15; Exhibit No. OMS-200 at PP 12-18.

cases. This history also means that investors are familiar with that method and more likely to utilize it in the same manner prescribed by the Commission.²⁸⁴ Furthermore, the DCF model is the only financial model that incorporates direct input from investors pertaining to the market value of electric utilities' common equity capital (through the "P" term in the DCF equation), which makes it a superior tool for assessing investors' expectations and their required returns.²⁸⁵

By contrast, the record shows that the Expected Earnings method deserves zero weight, or at most, significantly less weight than the other three methods. It does not calculate the market-based cost of equity, as the other three methods do; it has many methodological flaws; and there is no evidence that investors would give it weight in informing their investment decisions.²⁸⁶ As Dr. Berry explains, although investors consider forecast *earnings* in gauging utilities' future profitability and financial health, there is no indication that investors consider earnings/book equity *ratios*—the focus of the "Expected Earnings" method—to be any kind of measure of the return that investors expect, or require, from their investments in market-priced utility stocks.²⁸⁷ Although the expected per-book returns that are input to and indicated by the Expected Earnings model may help investors predict the stock-issuing company's own rate of return per *its* book equity, it cannot predict the investor's own rate of return on his or her investment unless it is adjusted for the market/book ratio.

²⁸⁴ Exhibit No. OMS-208 at PP 13-14.

²⁸⁵ *Id.* at P 13.

²⁸⁶ See Exhibit No. JCI-200 at 26-37; Exhibit No. OMS-200 at PP 12-18.

²⁸⁷ Exhibit No. OMS-208 at P 15.

To be sure, current investors' expectations of utility stocks' earnings per book equity are generally high. But that is because utility stocks' market/book ratios are generally well above unity, which signifies that the earnings/book that investors expect utilities' parent companies to realize significantly exceeds the returns that investors require on their own investments. As the Commission is well aware, the *Hope and Bluefield* standards do not guarantee investors any particular level of expected profits, only the level of return required to attract investment and maintain the financial health of the utility. That level is tied to what investors require on their own investment, not their expectations as to utility holding companies' earnings/book ratios.²⁸⁸

Dr. Berry outlines the results of all of the methodologies as calculated by Mr. McKenzie—ignoring for the purposes of this simplified presentation the various shortcomings and flaws in the implementation of these methodologies as proposed by the MISO TOs²⁸⁹—but with a more appropriate weighting of the methods.

MISO CAPs propose the following weighting of financial models (if Expected Earnings is included) to better account for the superiority of the DCF method and the concerns raised by the Expected Earnings method:²⁹⁰

²⁸⁸ *See id.*

²⁸⁹ Dr. Berry explains that while he does not endorse the modified results of Mr. McKenzie's analysis for application in this docket, he nonetheless includes these results to demonstrate that a simple and reasonable modification, which recognizes the importance of the DCF method and reduces the influence of the severely flawed Expected Earnings method, makes a significant difference in Mr. McKenzie's results. Exhibit No. OMS-208 at P 16.

²⁹⁰ *Id.* at P 17.

	Composite Zone	Replacement ROE
DCF	50%	37.5%
CAPM	33.3%	25%
Expected Earnings	16.7%	12.5%
Risk Premium	N/A	25%

Modification of Mr. McKenzie’s primary results (shown in his Attachment 2, page 1), by applying these weights with no other changes,

- (1) Reduces the upper boundary of the overall composite range by 75 basis points, from 12.71% to 11.96%;
- (2) Reduces the replacement ROE by 37 basis points, from 10.18% to 9.81%; and
- (3) Reduces the top of the average-risk quartile (the “Shield Level”) by 55 basis points, from 10.74% to 10.19%—less than the 12.38% base ROE that was charged during the MISO refund effective period, and indeed, less than the 10.28% that the Briefing Order proposes as the outcome of the MISO I complaint.²⁹¹

Thus, a simple change in the Briefing Order’s proposed approach, which is necessary to better account for the superiority of the DCF method over the Expected Earnings method, significantly reduces the indicated cost of equity, and refutes Mr. McKenzie’s recommendation to dismiss the MISO II complaint, even if one accepts the MISO TOs’ legal theory supporting that recommendation.

²⁹¹ *Id.* at P 18; Exhibit No. OMS-210.

H. The Commission Should Reject the MISO TOs' Proposal To Depart from the Commission's Long-Standing Low-End Outlier Test.

The MISO TOs object strenuously to the Commission's proposed high-end outlier screen,²⁹² but simultaneously ask that the Commission "reconsider its proposal to use a fixed risk premium of 100 basis points to establish the threshold for excluding low-end results" from the results of the models, other than the risk premium model which produces only a single result.²⁹³ The MISO TOs recognize that "[t]he Commission historically has relied on a 100 basis point spread over such bond yields as a test of whether an estimate is low enough that investors would consider the corresponding utility stock to yield essentially the same return as debt[,]"²⁹⁴ but argue that "a fixed premium of 100 basis points over Baa public utility bond yields significantly understates investors' low-end threshold for returns on equity investments in utilities."²⁹⁵

The Commission did not propose to change or otherwise seek comment on changing its low-end outlier test, and the MISO TOs' arguments that the Commission should actually do so should be rejected out of hand. As explained in the Briefing Order:

Under the low-end outlier test, the Commission excludes from the proxy group companies whose ROE fails to exceed the average 10-year bond yield by approximately 100 basis points, taking into account any natural break between the cost of equity estimates of the companies excluded from the proxy group and the lowest cost of equity estimate of the companies included in the proxy group. The Commission excludes these low-end outliers on the ground that investors generally cannot be expected to purchase a common stock if debt, which has less risk than a common stock, yields essentially the same expected return. The Commission will

²⁹² MISO TOs Supplemental Initial Brief at 29-38.

²⁹³ *Id.* at 24 and n. 67.

²⁹⁴ *Id.* at 24.

²⁹⁵ *Id.* at 25.

continue to use this test for purposes of the CAPM and Expected Earnings analyses as well as the DCF analysis.^[296]

The MISO TOs and their witness Mr. McKenzie now argue that the 100 basis-point threshold is too low because bond yields have declined significantly since the Commission initially adopted its 100 basis point risk premium threshold for low-end outliers in *So. Cal. Edison* and several other decisions.²⁹⁷ The MISO TOs inaccurately claim that this means “the equity risk premium now is substantially larger.”²⁹⁸ Mr. McKenzie argues that the margin by which the low-end threshold exceeds the utility bond yield should expand by 72 basis points for every 100 basis-point drop in the Baa public utility bond yield²⁹⁹—a very specific, albeit unsupported, recommendation—which would result in the low-end threshold being held nearly static. In Attachment 3 (at p. 2), Mr. McKenzie applies this concept to his DCF distribution for the MISO II Complaint, and now, for the first time, proposes to exclude three results (7.21% for IDACORP; 7.20% for CenterPoint; and 6.81% for OGE Energy Corp.) that the MISO II Initial Decision included,³⁰⁰ even though all three of these exceeded the study-period average yield on

²⁹⁶ Briefing Order at P 52 (citing Opinion No. 531 at P 123, and Opinion No. 445 at 61,266).

²⁹⁷ MISO TOs Supplemental Initial Brief at 25, n.71 (citing *Atlantic Path 15, LLC*, 122 FERC ¶ 61,135 (2008) (“*Atlantic Path 15*”); *Startrans IO, L.L.C.*, 122 FERC ¶ 61,306 (2008) (“*Startrans*”); *Pioneer Transmission, LLC*, 126 FERC ¶ 61,281 (2009) (“*Pioneer*”); *S. Cal. Edison Co.*, 131 FERC ¶ 61,020 at P 55 (2010) (“*So. Cal. Edison Paper Hearing Order*”)); McKenzie EL15-45 Affidavit at 25-26.

²⁹⁸ MISO TOs Supplemental Initial Brief at 25 (citing McKenzie EL15-45 Affidavit at 26).

²⁹⁹ McKenzie EL15-45 Affidavit at 26.

³⁰⁰ MISO II Docket No. EL15-45 Initial Decision at P 54 (adopting proxy group developed by CAPs in Appendix I). *See* Initial Brief of the Complainant-Aligned Parties (Mar. 30, 2016) (“CAPs Initial Brief”) at 45 (“CAPs witnesses used a Moody’s Baa utility bond yield of 5.42% for the six-month DCF study period, because” the average bond yield is used as a proxy for the tested utility’s cost of debt and “each of the low-end ROE estimates being tested are for companies with ratings in the BBB/Baa categories. That bond yield (5.42%), plus a 100 basis-point spread, indicated a low-end outlier DCF return threshold of 6.42%. Applying the Commission’s low-end outlier screen, CAPs witnesses eliminated four companies from their respective proxy groups: Edison International, FirstEnergy Corp., Public Service Enterprise Group, and Entergy Corp.”). Notably, as pointed out in the CAPs Initial Brief, the

Baa-rated utility bonds (5.41%)³⁰¹ by well over 100 basis points. As a result, the bottom of Mr. McKenzie's new DCF range would be 7.55%,³⁰² *i.e.*, 214 basis points above the contemporaneous average bond yield.

The MISO TOs' arguments and Mr. McKenzie's proposed upward revisions of the low-end threshold are baseless for several reasons, as discussed below.

1. **The MISO TOs mischaracterize the *SoCal Edison* decision as requiring a margin that expands when bond yields drop.**

The MISO TOs and their witness mischaracterize the *So. Cal. Edison* decision in which the Commission adopted the 100 basis-point margin by incorrectly treating *So. Cal. Edison* as requiring a margin that expands when bond yields drop, such that the low-end threshold stays nearly unchanged.³⁰³ That is not what the Commission held in *So. Cal. Edison*, and nothing in the Briefing Order even hints that this is the case. The fact that the average yield on Baa public utility bonds over the two six-month periods ending November 2007, and September 2008, respectively, is higher than the 5.41% average yield on Baa public utility bonds for the six-month period ending December 2015,³⁰⁴ is irrelevant to, and does not change the purpose behind or the implementation of, the Commission's low-end outlier test.

Since *So. Cal. Edison*, the Commission has consistently found that a roughly 100 basis-point margin between bond yields and equity cost is the proper measure to determine if investors

exclusion of these four utilities was not disputed (*id.* at 44), and was incorporated into the CAPs Appendix I, adopted by the MISO II Initial Decision.

³⁰¹ MISO II Initial Decision at n. 175 (holding that during the study period, the average Baa Bond yield was 5.41 percent).

³⁰² McKenzie EL15-45 Affidavit at 27.

³⁰³ MISO TOs Supplemental Initial Brief at 25; McKenzie EL15-45 Affidavit at 25-26.

³⁰⁴ McKenzie EL15-45 Affidavit at 26, n. 57.

would consider a stock to yield “essentially the same return” as the company’s debt. The 100 basis-point margin is simply a test for whether the proxy group utility’s DCF result and the average bond yield as a measure of that utility’s debt cost are essentially identical; it is not a variable risk premium. After deciding to use the roughly 100 basis-point margin in 2010, the Commission did not alter it for the subsequent reduction in interest rates when it decided Opinion No. 531 in 2014, Opinion No. 551 in 2016, or Opinion No. 554 in 2017.³⁰⁵ In fact, the Commission did not adjust that margin for interest rate changes in any decisions between 2010 and 2017. Similarly, the MISO II Initial Decision in the instant proceeding did not alter it either (and the MISO TOs did not challenge the MISO II Initial Decision in this respect). Expanding the margin in this case would be contrary to all this precedent.

The low-end threshold in Opinion No. 551, which the MISO TOs also did not challenge on exception or on rehearing, was 5.65%, exactly 100 basis points above the 4.65% study-period yield on Baa-rated utility bonds.³⁰⁶ And, as noted above, the (unchallenged) low-end threshold in the MISO II Initial Decision was 6.42%, 101 basis points above the 5.41% study-period yield on Baa-rated utility bonds.³⁰⁷ By the MISO TOs’ logic, since bond yields were *higher* in the MISO II study period, the “equity risk premium” would be “substantially” *smaller*, and “the inverse relationship between equity risk premiums and bond yields” should call for a “considerable” *downward* adjustment “to the Commission’s risk premium threshold for low-end

³⁰⁵ *Potomac-Appalachian Transmission Highline, LLC, PJM Interconnection, L.L.C.*, Opinion No. 554, 158 FERC ¶ 61,050 (2017).

³⁰⁶ See Opinion No. 551 at P 20 (applying 5.65% low threshold); see *id.* at PP 10, 22 (affirming this threshold, to which no participant took exception).

³⁰⁷ See *supra* n.300.

outliers.”³⁰⁸ Yet—not surprisingly—this is not what Mr. McKenzie recommended. Rather, he arbitrarily declares that because the average yield on Baa public utility bonds over two six-month periods ending 2007-2008 was 6.69%, and 6.69% is higher than 5.41%, “this evidence supports an upward adjustment to the 100 basis point risk premium” in the instant proceeding.³⁰⁹ Other than playing “fast and loose” with the time periods, the MISO TOs’ proposal fails for other reasons, as discussed below.

2. **The MISO TOs’ proposal to adjust the Commission’s low-end outlier test neither accurately reflects risk premiums inherent in the market nor meets the Commission’s purpose in implementing the low-end threshold test.**

As Mr. Gorman explains, changes in risk premiums for utility stocks over bond yields are affected by changes in perceived levels of investment risk, not only by changes in interest rates. Accordingly, calibrating the low-end bond spread for changes in interest rates does not accurately reflect risk premiums inherent in the marketplace, and it does not address the Commission’s stated intent in implementing the low-end threshold test.³¹⁰ The Commission has explained that “[t]he purpose of the low-end outlier test is to exclude from the proxy group those companies whose ROE estimates are below the average bond yield or are above the average bond yield but are sufficiently low that an investor would consider the stock to yield essentially the same return as debt.”³¹¹ In other words, the purpose of the low-end outlier test is to establish

³⁰⁸ See MISO TOs Supplemental Initial Brief at 25 (“Bond yields during the 2015 study period for this case were substantially lower, indicating that the equity risk premium is now substantially larger.”) (citing McKenzie EL15-45 Affidavit at 26 n.58).

³⁰⁹ McKenzie EL15-45 Affidavit at 25-26.

³¹⁰ Exhibit No. ICG-208 at 33.

³¹¹ Opinion No. 531 at P 122; *see also* Briefing Order at P 52.

a minimum risk premium that satisfies the tests of economic logic.³¹² The MISO TOs' proposed upward adjustment to the 100 basis points risk premium will not accomplish this objective.

The 100-basis point spread over prevailing utility bond yields is a reasonable risk premium that will distinguish a minimum risk premium for a utility stock return over a utility bond return. While risk premiums are impacted by changes in investment risk, market data show that a primary component of the required return on utility stock remains relatively stable over time compared to the utility bond yield. As Mr. Gorman explains, yield spreads for utility stock dividends over utility bond yields are relatively stable during most markets. The only notable exception would be during distressed markets where the market demands abnormal risk premiums to invest in securities of greater risk.³¹³ In most market conditions, a Baa bond³¹⁴/stock yield spreads generally hover around 100 basis points, or equal to the Commission's minimum risk premium for utility stock versus utility bonds.³¹⁵

The stable yield spread indicates that the stock risk premium is driven by changes in the stock return expected growth rate. The low-end outlier test assumption of 100-basis point minimum stock return spread over Baa bonds implies a minimum growth outlook of no less than two percentage points which is in line with the Fed's long-term inflation outlook.³¹⁶ This minimum spread is economically logical in describing a minimum risk premium between a

³¹² Exhibit No. JC-208 at 33.

³¹³ Exhibit ICG-208 at 35.

³¹⁴ The Baa bond yield is used as an example here; as discussed in Section IV.H.3, below, the Commission's precedent does not require use of a Baa bond yield measure for all companies, however.

³¹⁵ Exhibit ICG-208 at 35 (Figure 1).

³¹⁶ *Id.* at 36.

utility stock and Baa bond yield and reasonably defines a return spread that will distinguish an expected return for a higher risk utility stock return from that of a Baa utility bond return.³¹⁷

Mr. McKenzie's proposed regression analysis does not accurately measure risk premium changes for utility stocks. Risk premiums for equity versus bond investments are driven by the market's perceived investment risk changes for an equity investment versus a bond investment. Because these relationships are affected not only by changes in interest rates, but also by other market factors, such as inflation outlooks, economic turbulence, the distress of the financial market, and the market's willingness to accept securities of greater investment risk, Mr. McKenzie's regression analysis is neither accurate nor reliable because it only tracks changes in interest rates and equity risk premiums without considering other factors that change equity risk premiums. Accordingly, this methodology should simply not be relied on in establishing an appropriate low-end test threshold.

3. **The MISO TOs mischaracterize the Commission's 100 basis-point low-end outlier test as being exclusively based on the BAA-bond yield index.**

As explained by Mr. Solomon, MISO TOs witness Mr. McKenzie mischaracterizes the Commission's precedent with his assertion that it has been the Commission's practice to rely exclusively on Baa-rated utility bond yields in applying its low-end outlier test.³¹⁸ The purpose of referring to the bond yield in testing low-end ROE results is to ensure that an investor would not consider a proxy company's equity return to be essentially the same as its cost of debt. However, it has not been the Commission's regular practice to rely solely on Baa-rated utility

³¹⁷ *Id.* at 36-37.

³¹⁸ *See* McKenzie EL15-45 Affidavit at 16.

bond yields in applying its low-end test of reasonableness.³¹⁹ Credit ratings consider both financial and business risks of utilities and differentiate between the overall risks associated with individual utilities. Investors require lower capital cost rates for utilities with lower risks and higher capital costs for those with higher risks. This fact is evidenced by the differences in the Moody's Baa utility bond index yields and its A utility bond index yields. Indeed, the Commission has previously relied upon bond yields based on the Moody's public utility bond index for the same rating category as the utility whose low-end ROE is being tested.³²⁰

In Opinion No. 489, the Commission affirmed "that in eliminating unreliable low-end ROEs, it is appropriate to consider the company's own cost of debt, not the composite debt rate of the proxy group . . . [A] company whose ROE is lower than its own debt cost should not be included in the proxy group. What may be an economically logical ROE for one company with low risk and low debt costs may be illogical for another company with higher risk and higher debt costs."³²¹ The analysis that the Commission relied on in that case was based on a utility's bond rating of A+ and the latest yield data in the record for Moody's A-rated public utility bonds.³²² The Commission thus recognized that the yield for a single credit rating category cannot be reliably used as a substitute for the debt cost of every utility irrespective of the utility's own credit rating and risk level. For example, the Moody's Baa utility bond index yield is not a

³¹⁹ Exhibit No. JCI-207 at 7-8.

³²⁰ See Exhibit No. JCI-200 at 11; Exhibit No. JCI-207 at 9.

³²¹ *Bangor Hydro-Electric Company*, Opinion No. 489, 117 FERC ¶ 61,129 at P 53 (2006) (citation omitted).

³²² *Id.* at PP 56-57.

reasonable or appropriate substitute for the debt cost of an A+ rated utility and would not be an appropriate test of the reasonableness of its ROE.³²³

In reviewing its precedent regarding testing low-end returns, the Commission subsequently stated that in Opinion No. 489, it had eliminated companies whose ROEs “were below the bond yield *for that particular rating*.”³²⁴ The use of the phrase “that particular rating” referred to the use of debt cost for the particular rating of the proxy company whose low-end ROE was being tested in Opinion No. 489, whereas, for example, in Opinion No. 445, “that particular rating” referred to the Commission’s use of the average Moody’s A public utility bond index yield to test the reasonableness of the low-end ROE calculated for PG&E.³²⁵ In *Atlantic Path 15* and *Startrans*, all of the proxy companies had credit ratings in the BBB- to BBB+ range,³²⁶ and the average Moody’s Baa utility bond index yield was, therefore, the appropriate testing basis for *that particular rating* in those cases.³²⁷

³²³ Exhibit No. JCI-207 at 9.

³²⁴ *So. Cal. Edison* Paper Hearing Order at P 54 (footnotes omitted, and emphasis added) (referring to Opinion No. 489). Similarly, explained that in Opinion No. 445, it had eliminated companies whose ROEs “were less than 36 basis points above the average Moody’s bond yield *for that particular rating*” and that in *Atlantic Path 15* and *Startrans*, the Commission had eliminated companies “whose ROEs were less than 100 basis points above Moody’s bond yield *for that particular rating*.” *Id.* (footnotes omitted; emphasis added).

³²⁵ Opinion No. 445 at 61,266 (finding that PG&E’s low-end ROE was 8.42% or just 36 basis points higher than the average Moody’s “A” grade public utility bond yield of 8.06% and that “[b]ecause investors generally cannot be expected to purchase stock if debt, which has less risk than stock, yields essentially the same return, this low end-return cannot be considered reliable in this case.”).

³²⁶ *See Startrans IO, L.L.C.*, 122 FERC ¶ 61,306 at P 26 (2008) explaining that one of the proxy group selection criteria in both *Startrans* and *Atlantic Path 15* was “using utilities that have similar senior bond and/or corporate credit ratings of BBB- to BBB+.” Note that Moody’s uses the Baa rating category designation and encompasses Baa1, Baa2, and Baa3 ratings and are equivalent to S&P’s BBB rating category which encompasses BBB-, BBB, and BBB+.

³²⁷ *See* Exhibit No. JCI-207 at 10-11.

Mr. McKenzie gets it partially right when he states that in the *So. Cal. Ed. Paper Hearing Order*, the Commission “determined that the Moody’s six-month average yield on Baa public utility bonds ending November 2007 is 6.44 percent” and that “[t]here are five companies whose low-end ROEs are less than the 6.44 percent bond yield plus 100 basis points, or 7.44 percent.”³²⁸ However, Mr. McKenzie fails to mention that the five companies that the Commission referred to all had ratings of BBB or BBB+, falling within the Baa/BBB category.³²⁹ As Mr. Solomon explains, in that case, the proxy group the Commission relied on had only one utility with an A category credit rating, and when the witness that had presented this proxy group used the Moody’s A public utility bond index yield to test that utility’s low-end ROE, its ROE was not low enough to be in controversy. As a result, all five of the companies that were eliminated because their ROEs were less than the average Moody’s Baa utility bond index yield plus 100 basis points, and the one additional utility that was eliminated as a result of a natural break at the low end, had credit ratings in the Baa/BBB category, which included BBB-, BBB, and BBB+ ratings.³³⁰

Mr. McKenzie’s reliance on a quotation from Opinion No. 396-C (that the “Baa bond rate is the lowest yield on an equity investment an investor would accept”)³³¹ is not instructive because the quotation is taken completely out of context. As Mr. Solomon explains, the

³²⁸ McKenzie EL15-45 Affidavit at 16, n.36 (quoting *So. Cal. Edison Paper Order* at P 56).

³²⁹ Exhibit No. JCI-207 at 12 (citing Exhibit No. SCE-13 of *So. Cal. Ed. witness Hunt*, eLibrary accession no. 20080506-5010).

³³⁰ Exhibit No. JCI-207 at 12 (citing Exhibit SCE-13 of *So. Cal. Ed. witness Hunt*, *supra* n.329; and *So. Cal. Edison Paper Hearing Order* at PP 29, 53 and 56).

³³¹ McKenzie EL15-45 Affidavit at 16, n.36 (quoting *Nw. Pipeline Co.*, Opinion No. 396-C, 81 FERC ¶ 61,036 at 61,197 (1997)).

Commission did not use the Baa bond rate to test low-end DCF ROE estimates nor did it suggest that such use of Baa bond rates would be appropriate. Instead, the Commission used the 8.56% Baa bond rate to support the reasonableness of its 12.59% authorized ROE for Northwest, noting that “[t]he 12.59% rate of return on equity accorded to Northwest, a pipeline of average risk, is over 400 basis points greater than the 8.56% interest rate on an investment grade Baa bond.”³³²

Notwithstanding Mr. McKenzie’s citation to Opinion No. 551 as having affirmed the Presiding Judge’s exclusion of three companies “because their ROEs were less than 5.65 percent, which is 100 basis points above the average yield for public utility bonds rated Baa by Moody’s,”³³³ as shown by Mr. Solomon, each of these companies had S&P and/or Moody’s ratings in the BBB/Baa category.³³⁴

As Mr. Solomon demonstrates, it is appropriate to continue to use the low-end outlier test that is based on the Moody’s Public Utility Bond index yield for the same rating category as the utility whose low-end ROE is being tested because it is the economic logic of the calculated ROE for the specific proxy company that is being tested. Using the Baa bond index yield to test the ROE for an A-rated utility, as Mr. McKenzie suggests in his affidavit, would be mixing apples and oranges and would not be appropriate.³³⁵ Exclusively using Baa-rated utility bond yields in the low-end outlier test, irrespective of the company’s underlying credit rating and risk profile, is illogical, is an inappropriate way to determine whether a proxy company’s ROE

³³² Exhibit No. 207 at 13-14 (quoting Opinion No. 396-C at 61,197).

³³³ McKenzie EL15-45 Affidavit at 16, n.36 (quoting Opinion No. 551 at PP 20, 65).

³³⁴ See Exhibit No. JCI-207 at 14 (citing Exhibit No. JCI-102). Note that Edison International had S&P and Moody’s ratings, respectively, of BBB+ and A3, Entergy Corp.’s ratings were BBB and Baa3, and FirstEnergy Corp.’s ratings were BBB- and Baa3. Exhibit No. JCI-102 at 1.

³³⁵ Exhibit No. JCI-207 at 15; *see also* Exhibit No. JCI-200, at 11, lines 9-18.

produced by an ROE analytical method is an unreliable low-end outlier, and is contrary to Commission standards and practice.³³⁶

I. The Commission Should Reject the MISO TOs' Proposal to Eliminate the High-End Outlier Test.

The Briefing Order proposes to exclude distorted high-end and low-end results produced by the financial models.³³⁷ The MISO TOs, however, encourage the Commission to eliminate low-end outliers, but to keep all high-end outliers produced by the DCF model. Their main arguments are that (1) the median of the DCF is an unreliable reference point because it does not reflect investors' expectations, and (2) the proposed test does not provide a uniform market threshold applicable to all financial models. The MISO TOs' arguments against elimination of high-end outliers lack merit and should be rejected by the Commission.

The MISO TOs propose an alternative high-end outlier test. This test would exclude proxy company results that are above 150% from the highest median produced by each of three financial models. The MISO TOs' own witness admits that this test "lack[s] any link to objective evidence regarding the range of returns required by investors"³³⁸ The proposal has no basis in economic logic. Its only purpose is to ensure that distorted high-end outcomes are not excluded from the proxy group to artificially inflate the base ROE. Rather than adopting the MISO TOs' proposed modifications to the high-end outlier test, the Commission should adopt the MISO CAPs' two standard deviation proposal,³³⁹ or the Grubbs test.³⁴⁰

³³⁶ Exhibit No. JCI-207 at 16.

³³⁷ Briefing Order at P 50.

³³⁸ McKenzie's EL15-45 Affidavit at 33:16-17,

³³⁹ Exhibit No. JCI-200, Direct Testimony of J. Bertram Solomon, at 13.

1. **The DCF median represents the ROE of a typical proxy company of average risk, and it is the best reference point to be used in high-end outlier screening.**

The Commission's proposed high-end test is based on the premise that the median presents the most meaningful and unbiased guide to the central clustering of the ROE estimates produced by each financial modeling method, and is therefore an appropriate starting point for testing the degree of dispersion and for judging the reasonableness of proxy company ROE estimates.³⁴¹ Mr. McKenzie, however, argues that the Commission's premise is unfounded because there is no logical basis for finding the median value to be characteristic of a "typical" member of the relevant population.³⁴²

Commission precedent supports using the median value to represent the return required by a typical utility of average risk,³⁴³ and Mr. McKenzie has endorsed the Commission's characterization of the MISO TOs as utilities of average risk.³⁴⁴ Thus, there is a firmly established logical basis for using the median as a reference point reflecting the return required by a "typical" utility of average risk.

As Mr. Solomon explains, outliers by definition are determined by their relationship to or degree of dispersion from the other estimates in the array.³⁴⁵ It is, therefore, important that the

³⁴⁰ MISO CAPs Initial Paper Hearing Brief at 62, n 285.

³⁴¹ Exhibit No. JCI-207 at 23.

³⁴² McKenzie EL15-45 Affidavit at 30.

³⁴³ *So. Cal. Edison* Paper Hearing Order at P 85.

³⁴⁴ McKenzie EL15-45 Affidavit at 9:15-17; Briefing Order at P 58.

³⁴⁵ Exhibit No. JCI-207 at 25.

high-end outlier test not be unduly influenced by the extreme values it is intended to test.³⁴⁶ Dr. Berry further explains that the median is recognized as the most statistically accurate measure of central tendency because it is less sensitive to outlier results and accounts better for the degree of dispersion of the ROE estimates within the output.³⁴⁷ The Commission’s proposed use of the median as a reference point in the high-end outlier test is, therefore, more appropriate than using a midpoint reference.

Mr. McKenzie also claims that there is no record support for the Briefing Order’s suggestion that an estimate greater than 1.5 times the median of a model’s range of estimates must be the result of “atypical circumstances” unlike those “of a more normal utility.”³⁴⁸ According to Mr. McKenzie, the “magnitude” of the difference between the median and any higher value in a range of estimates is not probative, in itself, of any of the Commission’s inferences.³⁴⁹ By disregarding the difference between the median and *any* high-end value, it appears that Mr. McKenzie is arguing that no high-end ROE can be found to be “atypical.” There is no logic to that argument, and it should be rejected.

The magnitude of the difference between the median and a high-end proxy company ROE is relevant to assessing risk comparability between the proxy company and the MISO TO operating companies. As the Commission has recognized and the Courts have affirmed, it is crucial that the risk associated with companies in the proxy group be comparable to the risk

³⁴⁶ *Id.* at 22.

³⁴⁷ Exhibit No. OMS-200 at PP 6-7; Exhibit OMS-208 at P 5; Exhibit No. JCI-207 at 21.

³⁴⁸ MISO TOs Supplemental Initial Brief at 31.

³⁴⁹ *Id.*

associated with the regulated utility whose rate is being determined.³⁵⁰ The median represents the ROE that an average risk utility requires.³⁵¹ The margin of upward deviation from this reference point must exclude riskier companies requiring ROEs “so far above the cost of equity of a typical proxy company as to suggest that it is the result of atypical circumstances not representative of the risk profile of a more normal utility.”³⁵² A 150% of the median threshold provides an overly generous margin above the ROE required by an investor in a typical average risk utility.

The generosity of the Commission’s proposed high-end outlier threshold can be clearly observed by looking at the underlying Value Line data driving the growth rate of high-end proxy companies, and by looking at alternative investments. For example, Mr. McKenzie’s Expected Earnings analysis³⁵³ includes a 15% return expected from Vectren Corp. (“Vectren”). The underlying Value Line data for Vectren, however, reveals that Vectren’s high returns are driven by unregulated infrastructure services that Vectren provides in maintaining and constructing other entities’ shale gas and oil pipelines.³⁵⁴ There is no evidence that the MISO TOs’ transmission divisions have market-to-book ratios resembling those of Vectren. Nevertheless, the 150% of the median high-end threshold allows for inclusion of Vectren’s 15% Expected Earnings result in the proxy group representing the risk profile of the MISO TOs under that

³⁵⁰ See generally *Proxy Group Policy Statement* at P 48 (quoting *Petal Gas Storage, L.L.C. v. F.E.R.C.*, 496 F.3d 695, 699 (D.C. Cir. 2007)).

³⁵¹ See, e.g., *So. Cal. Edison Paper Hearing Order* at PP 85-86.

³⁵² Briefing Order at P 54.

³⁵³ McKenzie EL15-45 Affidavit at Attachment 6.

³⁵⁴ Exhibit No. JCI-207 at 22.

model.³⁵⁵ In addition, the Expected Earnings 15.42% high-end outlier threshold calculated according to the Commission's proposed methodology³⁵⁶ would include proxy companies with a return almost 500 basis points above the already inflated market risk premium Mr. McKenzie calculated,³⁵⁷ and well over 800 basis points above Mr. McKenzie's projected future Baa Utility Bond yields.³⁵⁸ In other words, the assumption embedded in the EE proxies selected using the high-end outlier screen is that investors in average risk utility stock require equity returns that are vastly higher than utility bond yields. There is no basis to assume that utility stock investors require such high equity returns. In fact, such an assumption runs counter to MISO TOs' witness Lapson's testimony in this proceeding that under current market conditions investors see utility stocks as a substitute for bonds.³⁵⁹

Finally, Mr. McKenzie states that the median of the DCF is an inappropriate data point because it is 63 basis points below the 9.26% threshold that the Commission has already determined is unjust and unreasonable.³⁶⁰ The median, however, is within the DCF zone of reasonableness. And, even assuming that the Commission, following this supplemental briefing, continues to find that 9.29% is lower than the just and reasonable base ROE for the MISO TOs, that would not demonstrate that a base ROE more than two standard deviations about that level was reasonable. Furthermore, there is no basis for comparing the median of the DCF or the

³⁵⁵ McKenzie EL15-45 Affidavit at Attachment 6.

³⁵⁶ *Id.*

³⁵⁷ *Id.*, Attachment 7.

³⁵⁸ *Id.* at 2.

³⁵⁹ Exhibit No. MTO-16, Lapson Answering Testimony at 32:8-10.

³⁶⁰ *Id.* at 31.

high-end outlier threshold with the Commission's proposed presumptive immunity zones. If such comparisons were germane, then it should also be noted that the DCF 12.99% high-end outlier threshold is over 200 basis points above the top of McKenzie's IBES-DCF zone of reasonableness,³⁶¹ and 28 basis points above the top of his composite zone of reasonableness.³⁶²

2. **The Commission properly recognized that the two-step DCF method can produce unreasonably high results.**

Mr. McKenzie uses the Commission's proposed high-end outlier test to collaterally attack the validity of the two-step DCF methodology. First, he argues that the proposed high-end outlier test will not achieve the Commission's desired objective when applied to the two-step DCF method because any DCF application can differ substantially from investors' expectations and is subject to substantial distortion.³⁶³ Second, he states that the two-step DCF method addresses concerns over the sustainability of securities analysts' growth projections, and thus makes a high-end outlier test unnecessary.³⁶⁴ Finally, the MISO TOs conclude that if the Commission nonetheless insists on applying a high-end outlier test to the DCF portion of its new four-model approach to determining base ROE, it should employ a single-stage, constant growth DCF, rather than a two-stage DCF.³⁶⁵

None of these attacks on the two-step DCF methodology justify elimination of the high-end outlier test. As Mr. Solomon explains, the Commission's discussion of high-end outliers in

³⁶¹ *Id.*, Attachment 3 at 1.

³⁶² *Id.*, Attachment 2 at 1.

³⁶³ *Id.*, at 30.

³⁶⁴ *Id.* at 29.

³⁶⁵ MISO TOs Supplemental Initial Brief at 35.

Opinion No. 531 was based upon the specific record in that proceeding.³⁶⁶ It was not a generic pronouncement that all future high-end outlier issues would not be addressed. In fact, the Commission specifically addressed high-end outlier issues in Opinion No. 531³⁶⁷ and concluded only that “the high-end outlier issue *in this proceeding* is moot.”³⁶⁸

In Opinion No. 531, the Commission stated that under the two-step DCF method it is unnecessary to screen the proxy group for unsustainable growth rates because the method assumes that the long-term growth rate of all proxy companies is equal to the GDP growth rate, and therefore sustainable.³⁶⁹ However, GDP growth accounts only for one-third of the DCF composite growth weighting. Unsustainable short-term growth projections may prevail under this weighting and illogical outliers may still need to be excluded to avoid skewed results. High-end outlier screening is especially necessary if the Commission determines the ROE using the midpoint because, as Dr. Berry explains, the midpoint relies only on the two extremes of the proxy group and is too susceptible to being skewed by outliers.³⁷⁰

The Commission correctly acknowledged the need for screening high-end outliers in the Briefing Order.³⁷¹ This acknowledgement is consistent with the Commission’s long standing practice in pipeline proceedings, which use the same two-step DCF methodology adopted in

³⁶⁶ Exhibit No. JCI-207 at 19.

³⁶⁷ Opinion No. 531 at P 118.

³⁶⁸ *Id.* (emphasis added).

³⁶⁹ *Id.*

³⁷⁰ Exhibit No. OMS 200 at P 7; Exhibit No. OMS-208 at P 4.

³⁷¹ Briefing Order at P 53.

Opinion No. 531,³⁷² to exclude proxies with growth projections that are illogical or anomalous.³⁷³ In conclusion, Mr. McKenzie's claim that high-end outlier screening is unnecessary under the two-step DCF methodology has no merit and is inconsistent with long-standing Commission precedent.

3. There is no need to apply the same outlier threshold across all three financial models.

Mr. McKenzie argues that, from the point of view of investors' expectations, it would be illogical to find that a value of 15.4% is acceptable in framing the zone of reasonableness estimates under the Expected Earnings approach, while simultaneously holding that a DCF cost of equity of 13.0% is excessive.³⁷⁴ According to Mr. McKenzie, there should be a single test applied uniformly across financial methods.³⁷⁵

Mr. Solomon explains how Mr. McKenzie's argument fails.³⁷⁶ Whether a proxy company's ROE estimate is illogical can only be determined through reference to the full array of ROE outputs produced by that same model, based on the same assumptions as applied to each of the companies in the proxy group. As Dr. Roger Morin has explained, "[e]ach methodology possesses its own way of examining investor behavior, its own premises, and its own set of simplifications of reality."³⁷⁷ The assumptions and results of any one particular ROE model

³⁷² Opinion No. 531 at P13.

³⁷³ *Composition of Proxy Groups for Determining Gas and Oil Pipeline Return on Equity*, 123 FERC ¶ 61,048 at P 79 (2008).

³⁷⁴ McKenzie EL15-45 Affidavit at 32.

³⁷⁵ *Id.* at 31-32.

³⁷⁶ Exhibit No. JCI-207 at 20.

³⁷⁷ Morin at 429 and referenced by the Commission in the Briefing Order at P 36.

should not be used to control the outcome of other ROE models. Such an approach would override the information each ROE model seeks to provide³⁷⁸ and compromise the Commission’s ability to address its concerns regarding model risk.³⁷⁹ It would be particularly inappropriate for the median value produced by the Expected Earnings method (an accounting-based method) to be used to define the outlier threshold applicable to the results produced by the DCF and CAPM methods (each a market-oriented method).

Given the Commission’s concern with the risk inherent in each method, it is imperative that the extreme values produced by each method be tested against the other estimates produced by that method.³⁸⁰ The Commission should reject McKenzie’s unfounded concern over uniformity. Both the high-end and the low-end outlier tests should continue to apply individually to each financial model.³⁸¹

4. None of the outlier screens have an “observable foundation” in the capital markets.

The MISO TOs’ state that, unlike the low-end outlier test, a high-end outlier test lacks an “*observable foundation in the capital markets.*”³⁸² This statement has no merit because neither outlier test has a foundation in capital markets.

The basis for excluding low-end proxy results is a comparison to alternative investments based on a non-market sensitive threshold. In essence, the Commission assumes an equity return

³⁷⁸ Exhibit No. JCI-207 at 20.

³⁷⁹ *Id.* at 20, 25.

³⁸⁰ *Id.* at 25.

³⁸¹ *Id.* at 20.

³⁸² McKenzie EL15-45 Affidavit at 32:4-7 (emphasis added).

must be at least 100 basis points above bond yields and excludes proxy companies with returns below that threshold.³⁸³ The risk premium method (unlike the 100-basis point threshold) estimates the *market* premium required by utility stock investors above bond yields.³⁸⁴ Neither the Commission's low-end and high-end outlier tests, nor Mr. McKenzie's proposed alternative high-end outlier test, has an observable foundation in the capital markets. While there has to be some basis for the outlier threshold, there is no need for a market foundation to identify outliers. Mr. Solomon's proposed high-end outlier alternative has a foundation in well recognized statistical principles and should be adopted by the Commission.

5. The Commission should reject the MISO TOs' proposed revisions to the high-end outlier test.

The MISO TOs propose that if the Commission were to apply its median-based test, it should apply a uniform test of high-end estimates based on 150% of the *highest* overall median value produced by the DCF, CAPM, and Expected Earnings methodologies. Following Mr. McKenzie's proposal, the high-end outlier threshold in this case would be 15.42% (10.28% Expected Earnings median * 1.5 = 15.42%).³⁸⁵

The MISO TOs do not provide a valid reason for comparing each method's high-end outliers to 150% of the *highest* of the three methods' medians. If the only justification is to apply the same uniform threshold, then they could have proposed the use of the *lowest* median of the three methods rather than the highest. The self-serving upward bias of the MISO TOs' high-end

³⁸³ See, e.g. Briefing Order at P 52.

³⁸⁴ Briefing Order, Appendix, at 37.

³⁸⁵ McKenzie EL15-45 Affidavit, Attachment 6.

outlier proposal is evident.³⁸⁶ Notably, Mr. McKenzie's proposed 15.42% outlier threshold is almost 500 basis points above his already inflated 10.45% historic risk premium, and 448 basis points above his 10.94% projected risk premium. The purpose of the high-end outlier test is to identify unsustainably high model results and to identify those companies whose cost of equity under the model in question is so far above the cost of equity of a typical proxy company as to suggest that it is the result of atypical circumstances not representative of the risk profile of a more normal utility. McKenzie's high-end outlier fails to achieve this goal. Ultimately, the proxy group is supposed to reflect the required returns of investors supplying equity capital to the target utility. However, including proxy companies just below Mr. McKenzie's proposed high-end ROE threshold implies that companies whose investors require returns: (1) well over 400 basis points above the market risk premium; (2) more than 1,000 basis points above historical utility bond yields of 5.41%;³⁸⁷ and (3) more than 800 basis points above projected utility bond yields of 7.14%, are comparable in risk to the MISO TOs.³⁸⁸ Such high returns are not in line with the returns typically required by investors in companies of average risk. Mr. McKenzie's high-end threshold not only defies economic logic, it also runs counter to MISO TOs' witness Ms. Lapson's testimony characterizing utility stocks as "bond substitutes."³⁸⁹

³⁸⁶ Exhibit No. JCI-207 at 28.

³⁸⁷ McKenzie EL15-45 Affidavit, Attachment 7 at 1.

³⁸⁸ *Id.* at 2.

³⁸⁹ *See, e.g.*, Exhibit No. MTO-16, Lapson Answering Testimony at 32:8-10.

6. The two standard deviation approach proposed by MISO CAPs best eliminates illogical high outliers.

MISO CAPs recommend replacing the Commission's 150% multiplier with a common statistical method that eliminates results that are more than two standard deviations from the median of each model's ROE array (prior to testing for low-end and high-end outliers).³⁹⁰ This statistical method has been used in other ROE proceedings to eliminate high-end outliers.³⁹¹ The standard deviation is a statistical tool that measures the dispersion evident in the dataset and appropriately considers information inherent in the underlying array of ROEs produced by each model. As such, the two standard deviation test does not suffer from the deficiencies Mr. Solomon identified in Mr. McKenzie's alternative high-end test recommendation.³⁹²

Mr. McKenzie's opinion is that the dispersion between a particular cost of equity result and the next lowest value provides no relevant information in evaluating the reasonableness of estimates at the upper end of the range.³⁹³ He claims that using statistical concepts in proxy group formation is inappropriate because statistical analysis involves sampling, while the proxy

³⁹⁰ See MISO CAPs Initial Paper Hearing Brief at 4; *see also* Exhibit No. JCI-200 at 13:3-6.

³⁹¹ See, e.g., *I/M/O the Application of Delmarva Power & Light Company for Approval of a Change in Electric Distribution Rates and Miscellaneous Tariff Changes*, Delaware Public Service Commission Order No. 8589, Docket No. 13-115, at PP 222,269,271 (April 2, 2014) (accepting the utility's DCF calculation using a two-standard deviation from the mean method to screen outliers in constant growth DCF analysis); *I/M/O the Application of Potomac Electric Power Company for Authority to Increase its Rates and Charges for Electric Distribution Service*, Maryland Public Service Commission Order No. 85028, Case No. 9286, at n.396 (July 20, 2012) (finding that Staff's DCF analysis using two standard deviation from mean in proxy group formation was supported); *I/M/O the Application of Northern States Power Company for Authority to Increase its Electric and Natural Gas Rates with Respect to 1988 Test Year*, Order of the Wisconsin Public Utility Commission, Docket No. 4220-UR-101, at 348 (Dec. 22, 1987) (using the two standard deviations in DCF proxy group formation).

³⁹² Exhibit No. JCI-207 at 28-29.

³⁹³ McKenzie EL15-45 Affidavit at 34.

group represents a population rather than a sample. In other words, Mr. McKenzie believes that through application of proxy group criteria, the Commission has identified *all* of the utilities deemed to be of comparable risk to the MISO TOs.³⁹⁴

As Mr. Solomon explains, Mr. McKenzie's logic fails at the outset because it is not possible to identify a full and complete population of utilities with risk comparable to the MISO TOs due to limitations on the available data. Therefore, representative (or sample) data must be relied upon in evaluating the characteristics of the population.³⁹⁵ Mr. McKenzie's argument is also inconsistent with positions he advanced in other affidavits submitted to this Commission. These include his claim that companies outside of those identified by Value Line should be included in the proxy group³⁹⁶ and his concerns that statistical issues may arise from having a proxy group that he deemed to be too small.³⁹⁷ A proxy group does not define the totality of proxy companies potentially representative of the MISO TOs' risk profile. Furthermore, the magnitude of dispersion relative to other proxy companies can be used to infer conclusions regarding whether outlier proxy company results represent the risk profile and required returns properly associated with the MISO TOs.

J. The Commission Should Reject the MISO TOs' Arguments Regarding the Natural Break Test and Instead Should Adopt Clear, Objective and Symmetrical Standards.

The MISO TOs argue against using the Commission's "natural break" test for high-end outliers because, they claim, it is "based on a false premise that evaluating cost-of-equity

³⁹⁴ *Id.* at 35.

³⁹⁵ Exhibit No. JCI-207 at 32.

³⁹⁶ *Id.* at 36-37.

³⁹⁷ *Id.* at 38-39.

estimates for the relevant proxy group is akin to sampling.”³⁹⁸ They rely on the analysis in Mr. McKenzie’s Affidavit to support the erroneous conclusion that “as a statistical matter, the breadth of separation between individual estimates within the proxy group range is not a valid test of whether a particular estimate is credible.”³⁹⁹

The Commission’s statutory obligation is to determine a just and reasonable return on equity for the MISO TOs’ transmission service. Because an investor’s required ROE is not directly observable, the Commission must rely on a set of analytical tools, albeit imperfect ones, to reach this determination. The Commission’s reliance on a proxy—or representative—group of utilities that are deemed to be of comparable risk to the subject utilities (here, the MISO TOs) enables the Commission to meet the core tenets of the *Hope* and *Bluefield* standards. These standards recognize that ratemaking involves a balancing of investor and consumer interests and that the equity investor’s interest is served if the return is comparable to the returns on investments in other enterprises having similar risks.⁴⁰⁰ In addition to this screening for risk comparability, the Commission also screens for, among other things, whether ROE values produced by an analytical model are economically sound and logical. The “natural break” analysis forms a critical part of this screen.⁴⁰¹

³⁹⁸ MISO TOs Supplemental Initial Brief at 27.

³⁹⁹ *Id.* (citing McKenzie EL15-45 Affidavit at 36).

⁴⁰⁰ Exhibit No. JCI-207 at 34-35 (citing *Hope*, 320 U.S. at 603).

⁴⁰¹ Exhibit No. JCI-207 at 35.

As Mr. Solomon explains, the MISO TOs are not exchange-listed, publicly-traded companies that can themselves be used to apply the empirical ROE models;⁴⁰² therefore, the Commission must rely on a market-based dataset, or a proxy group consisting of utility holding companies.⁴⁰³ Mr. McKenzie’s theory that the resulting comparable risk utility group represents the full and only population of companies reflecting the risk of the MISO TOs is belied by the fact that the Commission’s proxy group selection criteria have changed over time, evolving, for example, from regional to national groups. Thus, according to Mr. McKenzie’s theory, under the Commission’s previous regional proxy group criteria, the total “population” would be a different group than the total “population” selected from the national data set; his theory is thus inconsistent with the Commission’s goal of identifying a sample of stocks that are representative of the rate-regulated utility whose return is at issue.⁴⁰⁴

The empirical models are used to estimate the cost of equity of the proxy companies precisely because it is impossible to have the “population” of the actual cost of equity even for the proxy companies themselves; thus, the empirical models are exposed to potential “model risk,” and each model’s estimates must be tested for reasonableness. One way to do that is to test for outliers, which by definition are determined by their relationship to other estimates—or the degree of dispersion. Thus, relative dispersion can and should be used to make inferences about the reasonableness of the estimates especially at the extremes as the Commission proposed.⁴⁰⁵

⁴⁰² *Id.* at 36 (citing Exhibit No. MTO-32).

⁴⁰³ Exhibit No. JCI-207 at 36.

⁴⁰⁴ *Id.* at 37.

⁴⁰⁵ *Id.* at 40-41.

Mr. McKenzie's argument is also inconsistent with positions he advanced in other affidavits submitted to the Commission. These include his claim that companies outside of those identified by Value Line should be included in the proxy group⁴⁰⁶ and his concerns that statistical issues may arise from having a proxy group that he deemed to be too small since "proxy group size is analogous to the use of sampling in statistical analyses."⁴⁰⁷ Moreover, the hypothetical example Mr. McKenzie presents to support his position⁴⁰⁸ is unavailing and suffers from key flaws, including that the proxies (in his case, students) are not chosen based on any expectation of comparability of family incomes and that the reported returns (in this case, incomes) are not estimates but actuals.

K. The Commission Should Retain the DCF Incentive Ceiling and Reject the MISO TOs' Incentive Ceiling Proposal.

It is critical that the Commission continue to cap the total ROE (*i.e.*, base ROE plus incentives) at the top of the zone of reasonableness to appropriately balance the interests of industry and consumers. The Commission's proposed ROE framework, adopted by the MISO TOs, places the incentives ceiling at the top of the composite zone.⁴⁰⁹ The proposed composite zone of reasonableness departs from longstanding Commission precedent relying on the DCF zone of reasonableness to determine the total ROE cap.⁴¹⁰ Moreover, the composite zone

⁴⁰⁶ *Id.* at 37-38.

⁴⁰⁷ *Id.* at 40 (citing McKenzie Prepared Direct Testimony and Exhibits, Docket No. EL18-58-000, Exhibit No. OGE-001, page 49).

⁴⁰⁸ *See* McKenzie EL15-45 Affidavit at 36-38.

⁴⁰⁹ Briefing Order at P 57; McKenzie EL15-45 Affidavit, Attachment 2.

⁴¹⁰ MISO CAPs Initial Paper Hearing Brief at 83.

artificially raises the incentives ceiling because the top of the range will be defined by unrepresentative Expected Earnings results that do not reflect the market cost of equity.⁴¹¹

As MISO CAPs explained in their Initial Paper Hearing Brief, the DCF continues to be the best method to define the zone of reasonableness and the applicable incentive ceiling.⁴¹² The DCF incentive ceiling in this case is 10.68%.⁴¹³ If the Commission, nevertheless, adopts the composite zone ceiling, it should calculate the composite zone using the alternative sequence proposed by MISO CAPs.⁴¹⁴ Adopting the MISO CAPs' alternative sequence of calculations and all other proposed changes to the Briefing Order's ROE framework would result in a 9.93% incentive ceiling.⁴¹⁵ If, however, the Commission adopted some, but not all, of the MISO CAPs' proposed changes, the incentive ceiling would vary from 10.04% to 11.42%.⁴¹⁶ For example, if the Commission does not adopt any of the MISO CAPs' proposed changes to the ROE framework except for the alternative sequence, the incentive ceiling would be 11.40%.⁴¹⁷

In contrast to these numbers, the MISO TOs propose an incentive ceiling of a far higher 13.17%, which results from applying the Commission's proposed base ROE framework and Mr. McKenzie's proposed changes to the DCF method and outlier tests.⁴¹⁸ As explained in this brief,

⁴¹¹ *Id.* at 40-46.

⁴¹² *Id.* at 83-84.

⁴¹³ Exhibit No. JCI-202. Mr. McKenzie's DCF ceiling is 10.76% (*see* McKenzie EL15-45 Affidavit, Attachment 3 at 1).

⁴¹⁴ Exhibit No. OMS-200 at PP 19-24.

⁴¹⁵ *Id.* at P 42 (Scenario A).

⁴¹⁶ *Id.*

⁴¹⁷ *Id.* (Scenario C).

⁴¹⁸ McKenzie EL15-45 Affidavit, Attachment 2 at 4.

none of the changes to the ROE framework advanced by the MISO TOs have any merit. Their 13.17%, incentive ceiling should, therefore, be rejected. If the Commission rejects the MISO TOs' baseless changes to the ROE framework and does not adopt any of the MISO CAPs' proposals, the incentive ceiling would be 12.71%.⁴¹⁹

V. CONCLUSION

As discussed in this Reply Paper Hearing Brief and in the MISO CAPs' Initial Paper Hearing Brief, there appears to be no dispute, and longstanding Commission precedent demands, that the replacement base ROE should be set at the best estimate of the study-period cost of equity. That estimate for purposes of Docket No. EL15-45 is the DCF median, 8.81%.⁴²⁰ In any event, once addressing the substantial flaws in the MISO TOs' arguments, there is clearly substantial evidence that the record supports an ROE significantly lower than 10 percent. Whatever ROE the Commission determines is the just and reasonable one, the MISO TOs have an obligation to provide refunds consistent with the plain language of FPA section 206 for the 15-month refund period established in this proceeding.

⁴¹⁹ *Id.* at 9-10, and Attachment 2 at 1.

⁴²⁰ *See supra* n.5; *see also* MISO CAPs Initial Paper Hearing Brief at 91-92 presenting alternative analyses should the Commission disagree with any of the MISO CAPs' recommendations. The OMS supports the conclusions of this Reply Paper Hearing Brief, but does not endorse any specific base ROE for the MISO TOs.

Respectfully submitted,

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Dated: April 10, 2019

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of the foregoing pleading *via* electronic transmission, hand-delivery or ordinary U.S. mail, postage prepaid, upon each person designated on the official service list compiled by the Secretary in this proceeding.

Dated at Washington, D.C., this 10th day of April, 2019

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