

## energy lawflash

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## FERC Changes Electric Utility Return-on-Equity Calculation

*The Commission's order applies the same methodology used for natural gas and oil pipeline return on equity and discards the former one-step calculation in favor of a two-step calculation that uses short- and long-term growth projections.*

On June 19, the Federal Energy Regulatory Commission (the Commission) issued Opinion No. 531,<sup>1</sup> which affirmed in part and denied in part an initial decision<sup>2</sup> on the return on equity (ROE) for the public utility transmission-owning members of ISO New England (ISO-NE). In addition, the Commission announced a modification to its policies regarding ROE calculation for electric utilities.

Opinion No. 531 tentatively determined that the “just and reasonable base ROE” for the ISO-NE transmission owners would be 10.57%, which is halfway between the midpoint and the maximum point of a “zone of reasonableness” based on a range of cost-of-equity estimates. The Commission determined that the base ROE should be set above the midpoint because of the unusual capital market conditions and other indicators, including a review of state-approved ROEs, which demonstrate that simply setting the base ROE at the midpoint of the zone of reasonableness would be insufficient to attract capital for new investment in transmission.

The Commission announced a change in its ROE policy for public utilities, moving from a single-step discounted cash flow (DCF) methodology to the two-step DCF methodology used in calculating natural gas and oil pipeline ROEs. In contrast to the single-step DCF methodology, the two-step DCF methodology incorporates both short- and long-term growth rates. The two-step methodology approximates long-term growth rates with gross domestic product (GDP) growth,<sup>3</sup> but the Commission commenced a paper hearing to determine whether GDP is an appropriate long-term growth rate. The base ROE for the ISO-NE transmission owners is tentative until the paper hearing's conclusion.

The Commission also announced in Opinion No. 531 that it will no longer use changes in U.S. Treasury bond yields to update an ROE after the record closes. Because capital market conditions may change between the date the utility files its case-in-chief and the date the Commission issues a final decision, the Commission's practice has been to update the ROE within the zone of reasonableness at the time of the final decision to reflect those capital market changes. The Commission's long-standing practice has been to base this post-hearing adjustment on the change in Treasury bond yields during the same time period. However, the Commission concluded in Opinion No. 531 that there is no direct correlation between changes in Treasury bond yields and changes in ROE. Instead of relying on changes in Treasury bond yields, the Commission announced that it will allow the participants in a rate case to present the most recent financial data available at the time of the hearing, including available post-test period financial data.

### Contacts

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact any of the following Morgan Lewis lawyers:

1. *Coakley v. Bangor Hydro-Elec. Co.*, Docket No. EL11-66-001, 147 FERC ¶ 61,234 (2014) [hereinafter Opinion No. 531].

2. Initial Decision, 144 FERC ¶ 63,012 (2013).

3. See *id.* at P 8 (“We also make a tentative finding that the required long-term growth projection should be based on projected long-term growth in gross domestic product”).

# Morgan Lewis

## Washington, D.C.

Glen S. Bernstein  
Joseph W. Lowell  
Christopher M. Drake

202.739.5994  
202.739.5384  
202.739.5845

[gbernstein@morganlewis.com](mailto:gbernstein@morganlewis.com)  
[jlowell@morganlewis.com](mailto:jlowell@morganlewis.com)  
[cdrake@morganlewis.com](mailto:cdrake@morganlewis.com)

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