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Blog Post

FERC Establishes New ROE Policies for Jurisdictional Electric Utilities and Natural Gas and Oil Pipelines

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On May 21, 2020, the Federal Energy Regulatory Commission (“FERC”) issued two key orders establishing new policies for determining the return on equity (“ROE”) component of the cost-of-service rates charged by FERC-jurisdictional electric utilities, natural gas pipelines and oil pipelines. First, on the electric side, FERC issued an order setting the ROE component of the rates charged by electric transmission owners in the Midcontinent Independent System Operator (“MISO”) region (“[MISO Order](#)”). The policy adopted in that order is expected to apply nationwide, not just in the MISO region. Second, FERC issued a Policy Statement on determining the ROE for natural gas and oil pipelines (“[Pipeline ROE Policy Statement](#)”). Both orders signal a departure from the ROE methodologies previously used by the FERC for the respective industries and could significantly impact the earnings of FERC-jurisdictional entities, and the returns ultimately realized by their investors.

Background

In general, to establish public utilities’ electric transmission rates and natural gas and oil pipelines’ transportation rates, FERC utilizes cost-of-service ratemaking principles under which a jurisdictional entity’s rates are designed based on its cost of providing service, including an opportunity to earn a reasonable rate of return on the entity’s investments. In setting the ROE component of a jurisdictional entity’s rates, FERC must comply with Supreme Court precedent holding that “the return to the equity owner should be commensurate with the return on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to

attract capital.”¹ Since the 1980s, FERC has relied almost exclusively upon the discounted cash flow (“DCF”) methodology to determine ROE for jurisdictional entities.

However, in an October 2018 order addressing a complaint against the transmission owners in New England, FERC proposed abandoning its exclusive reliance on the DCF methodology for public utilities, by taking into consideration the cost of equity results of three additional methodologies: (1) Capital Asset Pricing Model (“CAPM”), (2) Risk Premium and (3) Expected Earnings.²

Subsequently, in a March 2019 notice of inquiry³ and a November 2019 order concerning the MISO transmission owners’ ROE,⁴ FERC adopted an ROE policy for public utilities that would give equal weight to the results of the DCF and CAPM models, by averaging them, but would reject the use of the Risk Premium and Expected Earnings models.⁵ FERC did not adopt or propose those reforms for natural gas or oil pipeline ROEs; instead, FERC requested comment in its March 2019 notice of inquiry regarding whether ROE policy changes would be appropriate for natural gas or oil pipelines.

FERC’s recent MISO Order and Pipeline ROE Policy Statement adopt new ROE policies for electric transmission and natural gas and oil pipeline rates, and those policies differ between the electric sector and the pipeline sector.

MISO Order

In the MISO Order, FERC granted rehearing with respect to various aspects of Opinion No. 569, establishing a new policy for determining public utilities’ ROE by averaging the results of three methodologies: (1) DCF, (2) CAPM, and (3) Risk Premium. FERC found that utilizing three different methodologies would increase the reliability of ROE results. Although FERC previously rejected the Risk Premium methodology, it decided to change course and include it in its ROE analysis because averaging it with the other models would reduce ROE volatility.

FERC has historically utilized high-end and low-end outlier tests when setting public utility ROEs to eliminate potentially unrepresentative ROE results. In Opinion No. 569, FERC modified its high-end outlier test to treat companies as high-end outliers if their ROE results are more than 200% of the median result of all potential proxy group members in that model, subject to a natural break analysis.⁶ FERC did not change its low-end outlier test, so it will continue eliminating proxy group results that are less than the yields of generic corporate Baa bonds plus 20% of the CAPM risk premium.

FERC also changed the analysis it will use under the threshold statutory standard in reviewing future ROE complaints. Under FPA section 206, FERC must conduct a two-prong analysis. The first prong requires FERC to determine whether the public utility's existing ROE remains just and reasonable. If FERC finds that the previously approved ROE is no longer just and reasonable, it must proceed to the second prong, which requires FERC to set a new just and reasonable ROE. To determine whether an existing ROE is just and reasonable, FERC historically would analyze the range of cost of equity estimates for the companies in its DCF proxy group. FERC refers to that range as the "zone of reasonableness."

For the purpose of conducting its analysis under the first prong, FERC will now divide the zone of reasonableness into thirds. Each of those tertiles will establish presumptively just and reasonable ROEs for below-average risk, average risk and above-average risk utilities, respectively. FERC previously had excluded the Risk Premium methodology from its analysis under the first prong, because it provides a single ROE estimate rather than a range. However, FERC now will utilize the Risk Premium methodology under prong one by imputing the average width of the zones of reasonableness from the CAPM and DCF models onto the ROE produced by the Risk Premium model, with the ROE serving as the measure of central tendency.

Historically, FERC has used either the median (for a single utility) or the midpoint (for a group of utilities) of proxy group results to set the ROE for medium-risk utilities, and increased or decreased the ROE relative to the median or midpoint for high- or low-risk utilities. FERC will continue using the median as the measure of central tendency when setting the ROE for a single utility, and the midpoint when establishing ROEs for groups of utilities.

The Pipeline ROE Policy Statement

In the Pipeline ROE Policy Statement, FERC outlined its new policy for determining ROEs for natural gas and oil pipelines, which partly follows the policy outlined in the MISO Order with some key changes to address differences in the respective industries.

The biggest divergence in the policies pertains to the methodologies FERC will use to calculate ROEs for natural gas and oil pipelines. Specifically, FERC adopted the DCF and the CAPM methodologies, but rejected the Risk Premium methodology for gas and oil pipelines. FERC justified this disparate treatment by noting there are very few FERC decisions or settlements providing a stated ROE for natural gas and oil pipelines.

Rather, most pipeline rate proceedings result in “black box” settlements that do not enumerate specific ROEs. Accordingly, FERC rejected the Risk Premium methodology for natural gas and oil pipelines, because FERC and interested parties simply do not have the requisite data needed to apply the methodology to gas and oil pipelines.

Another key distinction between FERC’s policies for the respective industries is the weighting given to short-term and long-term growth projections in FERC’s two-step DCF methodology. Rather than adopting the same weighting of short-term and long-term growth projections as it did for public utilities in the MISO Order, FERC will continue to calculate the growth rate for natural gas and oil pipeline DCF analyses by giving two-thirds weight to the short-term growth projections and one-third weight to the long-term growth projections.

In support of this distinction, FERC found that the reasoning for revising the policy for public utilities was not as applicable to natural gas and oil pipelines, because natural gas and oil pipelines’ short-term growth projections have not decreased to the same degree as the short-term growth projections of public utilities. FERC also reaffirmed its finding that investors do not expect Master Limited Partnership pipelines (“MLPs”) to grow at the same rate in the long-term as their C-Corporation counterparts. Accordingly, FERC retained its policy to reduce the long-term growth projection by 50% for gas and oil pipelines organized as MLPs.

Because most pipeline companies are wholly owned subsidiaries and their common stock is not publicly traded, FERC utilizes a proxy group of publicly traded entities with similar risk to set pipeline ROEs. It has become increasingly difficult to develop representative proxy groups in recent years for a variety of reasons, including significant consolidation in the industry. Accordingly, FERC addressed this difficulty by clarifying various issues with respect to proxy groups.

FERC retained its existing proxy group criteria, to include in its proxy groups for pipeline ROE analyses only companies that meet the following criteria: (1) the company’s stock must be publicly traded; (2) the company must be recognized as a natural gas or oil pipeline company and its stock must be recognized and tracked by an investment service; and (3) pipeline operations must constitute a high proportion of the company’s business. FERC has historically found that a company meets the “high proportion” standard if the pipeline business accounts for 50% of its assets or operating income over the most recent three-year period. In the Pipeline ROE Policy Statement, FERC explained that it will continue to apply the high-proportion criterion flexibly on a case-by-case basis, including relaxing the 50% requirement discussed above in rate proceedings where there are less than five companies eligible for the

proxy group. As an additional way to address the ongoing decline in companies eligible for pipeline proxy groups, FERC stated that it will now consider the inclusion of Canadian companies that otherwise meet the criteria.

Additionally, unlike for public utility ROEs, FERC declined to establish rigid outlier tests for proxy group results in natural gas and oil pipeline ROE analyses. FERC explained that the adoption of rigid outlier tests could make it difficult to develop a proxy group with four or five members due to the diminishing number of potentially eligible proxy group companies for gas and oil pipeline rate proceedings. Thus, FERC noted that rather than adopt strict outlier tests, it will continue applying the general principle that anomalous or illogical data should be excluded from the DCF proxy group in such cases. FERC also will continue setting ROEs at the median of proxy group results in gas and oil pipeline rate cases. FERC reasoned that this policy also reduces the effect of any outliers in the proxy group results.

Looking Ahead

Although FERC's application of the new ROE policies in individual proceedings will depend upon specific circumstances and market conditions at the time such proceedings arise, the new policies contain some potentially beneficial revisions for both public utilities and oil and natural gas pipeline companies that could result in higher ROE determinations than if FERC relied exclusively upon its traditional DCF methodology. Despite this, questions remain regarding whether the ROE policies will produce returns on investments in electric, oil and natural gas infrastructure sufficient to support federal and state energy policy goals.

There is also some uncertainty how the recently adopted ROE policies will fare in the face of legal challenges. Various parties, including the MISO transmission owners have filed petitions for review of the MISO Order in the U.S. Court of Appeals for the D.C. Circuit, and parties have also requested rehearing of the Pipeline ROE Policy Statement. Accordingly, there is likely to be uncertainty until these proceedings reach a final resolution, which could take 18–24 months.

In the meantime, investors and energy market participants should closely monitor FERC's actions in pending and future rate proceedings to ascertain how FERC intends to apply its new ROE policies in individual adjudicatory proceedings, and whether it makes further refinements.

1. *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 605 (1944).↔

2. *Coakley v. Bangor Hydro-Elec. Co.*, 165 FERC ¶ 61,030 (2018).↔

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

4. *Ass'n of Bus. Advocating Tariff Equity v. Midcontinent Indep. Sys. Operator, Inc.*, Opinion No. 569, 169 FERC ¶ 61,129 (2019) ("Opinion No. 569").↔

5. *Id.* at P 1. ↔

6. A natural break analysis typically involves comparing the distance between the potentially anomalous proxy group member and the next closest proxy group member and to the dispersion of other proxy group companies.↔

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