JONES DAY

COMMENTARY

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D.C. Circuit Tells FERC to Try Again on Utility Rates of Return

IN SHORT

The Decision: The D.C. Circuit vacated a landmark FERC order, requiring the Commission to provide a rational explanation of its policy for setting the rate of return on equity for electric utilities.

The Impact: In the short term, the decision will cause uncertainty regarding the rates of return electric utilities are allowed to earn through FERC-approved rates.

Looking Ahead: It's unclear whether the litigants will appeal to the Supreme Court, but either way, FERC could have years of work on its hands.

On April 14, 2017, the U.S. Court of Appeals for the D.C. Circuit issued a decision that could cause short-term uncertainty for electric utilities, whose rates for transmission service, including the allowed rate of return, are set by the Federal Energy Regulatory Commission ("FERC"). In *Emera Maine v. FERC*, No. 15-1118 (D.C. Cir. Apr. 14, 2017), the court vacated and remanded FERC's 2014 landmark Opinion No. 531 (and successor orders), through which FERC had updated its methodology for setting the rate of return on equity ("ROE") a utility is permitted to recover through its transmission service rates. On remand, FERC will have the opportunity to revisit and reformulate its policy, a process that could take several years.

In Opinion No. 531, FERC addressed a complaint brought by states and consumer-side stakeholders ("Customers") alleging excessiveness in the ROE levels reflected in transmission rates for utility members of the regional independent system operator ISO-New England ("Transmission Owners"). In doing so, FERC announced that it was adopting the two-step discounted cash flow methodology ("DCF") long applied to natural gas and oil pipelines for use in determining ROE for electric utilities to set an ROE zone of reasonableness—a range of ROEs that investors would expect to receive on capital invested in electric utilities. FERC also altered the way it selects a specific just and reasonable ROE level within that zone of reasonableness.

Historically, FERC set the ROE for utilities at the midpoint value within the zone. In Opinion No. 531, however, FERC determined that anomalous capital market conditions could produce unduly low ROEs, and it decided that the ROE instead should be set at the midpoint of the zone's upper half. Thus, while in Opinion No. 531 FERC *lowered* the Transmission Owners' ROE, it did so by less than the Customers had requested. Parties on both sides of the dispute pursued rehearing and ultimately petitioned the D.C. Circuit for review.

The court's decision faulted FERC's reasoning in two principal ways. First, the court explained that FPA section 206 requires FERC to find that an existing rate is unjust and unreasonable as a "condition precedent" to acting to change that rate. In Opinion No. 531, however, FERC had performed a single DCF analysis and used the results of that analysis to set a new just and reasonable ROE *and* to find the existing ROE to be unjust and unreasonable.

The court did not find fault with FERC's reliance on a DCF analysis, including the use of alternative benchmarks. Rather, it found that FERC had failed to adequately explain how it relied on this methodology to

In rejecting FERC's approach, the court explained that FERC's showing that a new rate was just and reasonable did not, by itself, show that all other rates, including the preexisting rate, were *per se* unlawful. (The court also rejected arguments that all rates within the DCF zone of reasonableness were just and reasonable and that only rates that fell outside of the zone could be found to be unlawful under Section 206.) FERC's failure, in the court's view, was that it never explained how the existing rate was unjust and unreasonable, other than by showing that the rate was higher than the new rate FERC deemed to be just and

reasonable.

Second, the court found that FERC failed to explain adequately its decision to set the new ROE at the midpoint of the DCF zone's upper half. Having expressed a lack of confidence in the historical ROE methodology, FERC looked to alternative methods for selecting a just and reasonable ROE from within the zone of reasonableness. The D.C. Circuit held, however, that FERC "did not set forth a rational connection between the record evidence and its placement of the base ROE."

reach the specific determinations at issue.

Although evidence supported the selection of an ROE above the median, FERC inadequately explained how these analyses justified the ROE ultimately selected as just and reasonable. Notably, the court required only that FERC make "a principled and reasoned decision supported by the evidentiary record."

A key takeaway is that the court did not find fault with FERC's reliance on a DCF analysis, including the use of alternative benchmarks. Rather, the court found that FERC had failed to adequately explain how it relied on this methodology to reach the specific determinations at issue here, *i.e.*, whether an existing rate is unlawful and what a new just and reasonable rate should be.

The long-term impact of *Emera Maine* is unclear. FERC's Opinion No. 531 methodology led to numerous challenges to utility ROEs, and in the short term, the court's decision likely will cause uncertainty and additional litigation. But while FERC now must revisit its ROE policy, *Emera Maine* provides little basis to question the new methodology's substance or its effect of raising ROEs above levels produced by the historical model. Moreover, *Emera Maine* clarifies the way FERC must exercise its power under section 206 but does not appear to constrain FERC's flexibility in doing so.

THREE KEY TAKEAWAYS

1. The D.C. Circuit vacated and remanded FERC's landmark 2014 order on utility rates of return on equity, Opinion No. 531, but did not fault FERC's reliance on discounted cash flow analysis or alternative benchmarks.
2. Electric utilities could experience significant short-term rate uncertainty given the importance of Opinion No. 531 to setting ROE.
3. FERC will have the opportunity to revisit and reformulate its policy, but that process could take several years.

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