

UNITED STATES OF AMERICA 117 FERC 61,129
FEDERAL ENERGY REGULATORY COMMISSION

OPINION NO. 489

Bangor Hydro-Electric Company
Central Maine Power Company
NSTAR Electric & Gas Corporation
New England Power Company
Northeast Utilities Service Company
The United Illuminating Company
Vermont Electric Power Company
Central Vermont Public Service Corp.
Green Mountain Power Corporation

Docket No. ER04-157-004

Florida Power & Light Company –
New England Division

Docket No. ER04-714-001

OPINION AND ORDER ON INITIAL DECISION

Issued: October 31, 2006

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APPEARANCES

Wendy N. Reed, Esq. and Amanda Riggs, Esq. on behalf of Bangor Hydro-Electric Company.

David B. Raskin, Esq. and Monique Rotham-Kennedy, Esq. on behalf of Northeast Utilities Service Company.

G. Phillip Nowak, Esq. on behalf of The United Illuminating Company.

Elias G. Farrah, Esq. on behalf of Central Maine Power Company.

Randall L. Speck, Esq. and Holly Hawkins, Esq., on behalf of the Connecticut Department of Public Utility Control.

Alexander J. Cochis, Esq. on behalf of the Massachusetts Attorney General.

Sean A. Atkins, Esq., Kenneth G. Jaffee, Esq., and Robert Ivanauskas, Esq., on behalf of National Grid.

Sonia C. Mendonca, Esq., on behalf of Unitil Energy Systems and Fitchburg Gas & Electric Light Company.

OPINION NO. 489

APPEARANCES

Mary A. Murphy, Esq., on behalf of Florida Power & Light.

Jay Matson, Esq., Richard Lorenzo, Esq., Thomas Weis, Esq., and Arthur Adelberg, Esq., on behalf of the Vermont Electric Power Company.

David E. Pomper, Esq., on behalf of the New England Consumer-Owned Entities.

Phillip Sussler, Esq., and Scott Strauss, Esq. on behalf of the Connecticut Municipal Electric Energy Cooperative.

Ben Ficklestein, Esq., on behalf of the Vermont Public Supply Authority.

Scott Strauss on behalf of the Massachusetts Municipal Wholesale Electric Company.

John P. Coyle, Esq. and Paul M. Breakman, Esq. on behalf of the New England Consumer-Owned Entities, Braintree Electric Light Department, Reading Municipal Light Department, and Taunton Municipal Lighting Plant.

Denyse Zosa, Esq., Harvey Reiter, Esq., and John McCaffery, Esq. on behalf of the Maine Public Utilities Commission and Vermont Department of Public Service & NECPNC.

Warren C. Wood, Esq., and Gopal Swaminathan, Esq. on behalf of the Federal Energy Regulatory Commission.

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Before Commissioners: Joseph T. Kelliher, Chairman;
Sudeen G. Kelly, Marc Spitzer,
Philip D. Moeller, and Jon Wellinghoff.

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ORDER ON INITIAL DECISION

(Issued October 31, 2006)

1. This case is before the Commission on exceptions to an *Initial Decision* issued May 27, 2005.¹ The *Initial Decision* addressed two issues: (i) the base-level return on equity (ROE) applicable to the regional transmission organization (RTO) proposed in this proceeding by ISO New England, Inc. (ISO New England) and the New England transmission owners² (collectively, the RTO Filing Parties); and (ii) whether, in addition

¹ *Bangor Hydro-Electric Company*, 111 FERC ¶ 63,048 (2005) (*Initial Decision*).

² The transmission owners are: Bangor Hydro Electric Company; Central Maine Power Company; NSTAR Electric & Gas Corporation; New England Power Company; Northeast Utilities Service Company; The United Illuminating Company; and Vermont Electric Power Company.

to the base-level ROE, a 100 basis point incentive should be approved for the purpose of encouraging transmission expansion.³

2. For the reasons discussed below, the *Initial Decision* is affirmed, in part, and reversed, in part. Specifically, we will adopt a base-level ROE of 10.2 percent, *i.e.*, the midpoint ROE indicated by the range of reasonable returns for a proxy group made up of 10 northeast utility companies. In addition, we also find that three ROE adjustments are warranted as follows: (i) a 50 basis point incentive for RTO participation (as previously granted by the Commission in the *RTO Order*); (ii) a 100 basis point incentive for new transmission investment; and (iii) a 74 basis point adjustment reflecting updated bond data, as applicable to the period commencing with the date of this order. The resulting ROEs for existing transmission, *i.e.*, without the 100 basis point adjustment which applies only to new transmission, are 10.7 percent for the locked-in period (*i.e.*, from the rate effective date through the date of this order) and 11.4 percent for the going-forward period. The ROEs that will apply to new transmission include the 100 basis point adjustment and are 11.7 percent for the locked-in period and 12.4 percent for the going-forward period.

3. With respect to the various base-level ROE issues addressed in the *Initial Decision*, we agree with the Presiding Judge that among the 10 companies included in the proxy group, it was appropriate to include PPL Corporation (PPL), Consolidated Edison, Inc. (Con Ed), Northeast Utilities, Public Service Enterprise Group (PSEG), and Exelon Corporation (Exelon). We also find that the Presiding Judge appropriately excluded from the proxy group UGI Corporation (UGI) and UIL Holdings Corporation (UIL). In addition, we find that the Presiding Judge appropriately rejected the use of a benchmark ROE (12.9 percent), as established by the Commission for the participating transmission owners in the Midwest Independent Transmission System Operator, Inc. (Midwest ISO).⁴ We also find that the *Initial Decision* appropriately rejected the inclusion of a flotation

³ The Commission authorized the establishment of ISO New England as an RTO in a series of orders issued in this proceeding. *See ISO New England, Inc.*, 106 FERC ¶ 61,280 (*RTO Order*), *order on reh'g and compliance*, 109 FERC ¶ 61,147 (2004) (*RTO Rehearing Order*), *order on reh'g and compliance*, 110 FERC ¶ 61,111 (*February 10, 2005 Order*), *order on reh'g and compliance*, 110 FERC ¶ 61,335 (2005) (*March 24, 2005 Order*), *order on reh'g*, 111 FERC ¶ 61,344 (2005) (*June 2, 2005 Order*).

⁴ *See Midwest Independent Transmission System Operator, Inc.*, 100 FERC ¶ 61,292 (2002) (*Midwest ISO ROE Order*), *order on reh'g*, 102 FERC ¶ 61,143 (2003), *order on remand*, 106 FERC ¶ 61,302 (2004) (*Midwest ISO Remand Order*), *aff'd*, *Public Service Comm'n of Kentucky v. FERC*, 397 F.3d 1004, 1010 (D.C. Cir. 2005).

cost adjustment attributable to new construction costs. However, we will modify the *Initial Decision's* findings by including the latest available financial information in calculating the allowed ROE, *i.e.*, by utilizing certain updated data inputs, as discussed more fully below.

4. With respect to the proposed incentive to encourage new transmission, we find that the proposed ROE adjustment will provide an important impetus to transmission owners to advocate on behalf of their projects, will assist transmission owners in obtaining favorable project financing, and will include valuable rate payer benefits. We also find that this ROE incentive should be applied to all projects approved as necessary by ISO New England, pursuant to its regional planning process.

I. Background

A. The Proposal to Establish the ISO New England RTO

5. On October 31, 2003, the RTO Filing Parties submitted for approval, pursuant to section 205 of the Federal Power Act (FPA),⁵ a proposal to establish ISO New England as an RTO for the six-state New England region previously overseen by ISO New England and the New England Power Pool. In conjunction with that proposal, the Transmission Owners, joined by Green Mountain Power Corporation and Central Vermont Public Service Corporation (collectively, the ROE Filing Parties), submitted, on November 4, 2003, a related section 205 filing seeking approval for the ROE component recoverable under the regional and local transmission rates charged by ISO New England.⁶ In their submittal, the ROE Filing Parties proposed a single ROE of 12.8 percent, an incentive of 50 basis points to incent RTO participation, and an incentive of 100 basis point to encourage future transmission expansions.⁷

⁵ 16 U.S.C. § 824d (2000).

⁶ As referred to herein, the ROE Filing Parties also include the entities that subsequently joined this group, namely: Florida Power & Light Company – New England Division (FPL); Unil Energy Systems; and Fitchburg Gas and Electric Light Company.

⁷ The ROE Filing Parties' proposed incentives were based on a proposed policy statement. *See Proposed Pricing Policy for Efficient Operation and Expansion of Transmission Grid*, 18 C.F.R. Pt. 35, 102 FERC ¶ 61,032 (2003) (*Proposed Pricing Policy Statement*).

6. In the *RTO Order*, we found, subject to conditions and refund, that the RTO Filing Parties' proposal to establish ISO New England as an RTO complied with the minimum characteristics and functions applicable to RTO operations, as set forth by the Commission in Order No. 2000.⁸ We also addressed the ROE Filing Parties' proposals. First, we accepted the ROE Filing Parties' proposed 50 basis point ROE incentive, as applicable to Regional Network Service under ISO New England's OATT, *i.e.*, applicable to ISO New England's pooled transmission facilities. However we rejected this same incentive as it would have applied to the Transmission Owners' Local Service Schedules, *i.e.*, to *non*-pooled transmission facilities. We also rejected the ROE Filing Parties' proposed 100 basis point incentive as it would have applied to the ROE Filing Parties' Local Service Schedules. However, we set for hearing, subject to suspension, hearing, and the application of the Commission's *Proposed Pricing Policy Statement*, the ROE Filing Parties' proposed 100 basis point incentive as it would apply to Regional Network Service.⁹ Finally, we set for hearing, subject to suspension and refund, the ROE Filing Parties' proposed base-level ROE.¹⁰

7. In the *RTO Rehearing Order*, we granted, in part, the ROE Filing Parties' request for clarification regarding the appropriate methodology to be used to calculate their proposed base-level ROE. Specifically, we granted the ROE Filing Parties' request for clarification regarding the use of a "midpoint" return to calculate their proposed ROE.¹¹ We found that the use of a midpoint return is an appropriate measure for determining a

⁸ See Regional Transmission Organizations, Order No. 2000, 65 Fed. Reg. 809 (2000), FERC Stats. & Regs. ¶ 31,089 (1999), *order on reh'g*, Order No. 2000-A, 65 Fed. Reg. 12,088 (2000), FERC Stats. & Regs. ¶ 31,092 (2000), *aff'd*, Public Utility District No. 1 of Snohomish County, Washington v. FERC, 272 F.3d 607 (D.C. Cir. 2001).

⁹ As noted below, the *Proposed Pricing Policy Statement* has been superseded by the Energy Policy Act of 2005 (EPA 2005), Pub. L. No. 109-58, 119 Stat. 594, 961 (2005). See *supra* note 102.

¹⁰ In a related order issued by the Commission on May 26, 2004, we consolidated, in the instant proceeding, the ROE issues presented by the rate filing submitted by FPL in connection with FPL's acquisition of the Seabrook Nuclear Generating Facility. See *Florida Power & Light Company – New England Division*, 107 FERC ¶ 61,186 (2004).

¹¹ *RTO Rehearing Order*, 109 FERC ¶ 61,147 at P 203. The midpoint ROE is the average of the highest and the lowest ROEs indicated by the proxy group.

single, region-wide ROE in this proceeding, consistent with our findings in the *Midwest ISO Remand Order*.¹²

8. We also found that a proxy group comprised of Northeast utility companies, including transmission-owning companies doing business in the markets operated by ISO New England, the New York Independent System Operator (New York ISO) and PJM Interconnection, L.L.C. (PJM), would provide a sufficiently representative universe of companies for calculating an ROE in this case and that, in identifying these companies, it would be generally acceptable, as proposed by the ROE Filing Parties, to exclude firms that do not pay common dividends, or for which no growth rate data are currently available, as reported by I/B/E/S International, Inc. (I/B/E/S) or Value Line. However, we also noted that we would not preclude the Presiding Judge from finding candidates for inclusion in the proxy group for which comparable data can be reasonably substituted for the growth rate data reported by I/B/E/S or Value Line. We also found it appropriate, as proposed by the ROE Filing Parties, to exclude from consideration in the proxy group, companies whose low-end ROE was lower than these companies' reported debt cost. In addition, we found that the inclusion of PPL in this proxy group was inappropriate because its 17.7 percent ROE was an outlier.

9. We also provided guidance regarding the types of investment that might qualify for an ROE incentive attributable to new transmission investment. We found that the relevant issues, in this regard, would include, among others, whether the investments were: (i) approved through the Regional System Planning Process (*see* ISO New England OATT at section 48); (ii) capable of being installed relatively quickly; (iii) include the use of improved materials that allow significant increases in transfer capacity using existing rights-of-way and structures; (iv) utilize equipment that allows greater control of energy flows, enabling greater use of existing facilities; (v) has sophisticated monitoring and communication equipment that allows real-time rating of transmission facilities, facilitating greater use of existing transmission facilities; or (vi) is a new technology and/or innovation that will increase regional transfer capability.

B. The Hearing Held before the Presiding Judge

10. The hearing in this proceeding was held from January 25 through February 1, 2005. Initial briefs were filed on March 2, 2005 by Commission Trial Staff (Staff), the ROE Filing Parties, the New England Consumer Owned-Entities (NECOE),¹³ the

¹² 106 FERC ¶ 61,302 at P 8-10.

¹³ Connecticut Municipal Electric Energy Cooperative, Massachusetts Municipal Wholesale Electric Company, Vermont Public Power Supply Authority, New Hampshire
(continued)

Attorney General of Massachusetts, the Attorney General of Rhode Island, and jointly by the Connecticut Department of Public Utility Control and Connecticut Office of Consumer Counsel (collectively, Connecticut Commission, *et al.*). On March 25, 2005, reply briefs were filed by the Maine Public Utilities Commission (Maine Commission), the Vermont Department of Public Service (VDPS), and the New England Conference of Public Utilities Commissioners (NECPUC).

11. In the *Initial Decision*, the Presiding Judge found that the appropriate proxy group to be used to establish ISO New England's ROE in this case includes the following companies: Con Ed, Northeast Utilities, Constellation Energy (Constellation), First Energy Corp. (First Energy), Pepco Holdings, Inc. (Pepco), PSEG, Exelon, Energy East, NSTAR, and PPL. The Presiding Judge also determined that UGI, a company included in the proxy group proposed by the ROE Filing Parties, should not be included in the proxy group.

12. The Presiding Judge also found that utilizing the above-identified proxy group, the low-end ROE was 7.4 percent (as represented by Con Ed) and that the high-end ROE was 14.1 percent (as represented by PPL). The Presiding Judge found that using the Commission's constant-growth, Discounted Cash Flow (DCF) methodology, the midpoint ROE was 10.7 percent.¹⁴ Finally, the Presiding Judge found that the ROE Filing Parties were not entitled to receive a 100 basis point incentive attributable to new transmission investment.¹⁵

13. The Connecticut Commission, *et al.* (joined by NECPUC, the Maine Commission, VDPS, and the Vermont Board), the ROE Filing Parties, and NECOE filed briefs on exceptions. The ROE Filing Parties, NECOE, Connecticut Commission, *et al.*, and Staff filed briefs opposing exceptions.

Electric Cooperative, Inc., Braintree Electric Light Department, Reading Municipal Light Department, and Taunton Municipal Lighting Plant.

¹⁴ The DCF methodology determines the ROE by summing the dividend yield and expected growth rate. The formula is applied as follows: $D/P(1 + g) + g = k$, where D = Dividend, P = Price, D/P = Dividend Yield, g = the growth rate of dividends per share, and k = the resulting ROE. The sustainable growth is calculated by the following formula: $g = br + sv$, where b is the expected retention ratio, r is the expected earned rate of return on common equity, s is the percent of common equity expected to be issued annually as new common stock, and v is the equity accretion rate.

¹⁵ The Presiding Judge's reasoning is discussed *supra* at PP 87-91.

II. Discussion

A. Base-Level ROE and Authorized Incentives

14. For the reasons discussed below, we affirm the *Initial Decision*'s finding that a 10-member proxy group comprised of northeast utilities is appropriate for calculating an ROE in this case.¹⁶ Based on this proxy group and the updated ROE values, as noted below, the low-end ROE is 7.3 percent (as represented by Con Ed) and the high-end ROE is 13.1 percent (as represented by PPL). Based on this zone of reasonable returns and the use of a midpoint return, as required by our findings in the *RTO Rehearing Order*,¹⁷ we will approve a base-level ROE of 10.2 percent.

15. In addition to this base-level ROE, we also find that an ROE in excess of the midpoint ROE is appropriate based on the application of: (i) the 50 basis point incentive as approved by the Commission in the *RTO Order*;¹⁸ (ii) a 100 basis point incentive to encourage new transmission investment; and (iii) a 74 basis point adjustment reflecting updated bond data, as applicable to the period commencing with the issuance of this order. The resulting ROEs are 10.7 percent for the locked-in period (*i.e.*, from the rate effective date through the date of this order) and 11.4 percent for the going-forward period. The application of the 100 basis point adjustment to new transmission results in ROEs of 11.7 percent for the locked-in period and 12.4 percent for the going-forward period.

B. Whether the Presiding Judge Erred in Including PPL in the Proxy Group

1. Initial Decision

16. The Presiding Judge noted that in the *RTO Rehearing Order*, the Commission found that it was appropriate, as proposed by the ROE Filing Parties, to exclude PPL

¹⁶ As noted above, the 10 companies are PSEG, Exelon, PPL, Con Ed, Northeast Utilities, Constellation Energy, Energy East, FirstEnergy, NSTAR, and Pepco Holdings.

¹⁷ See *RTO Rehearing Order*, 109 FERC ¶ 61,147 at P 203 (finding that the use of the midpoint ROE is an appropriate measure for determining a single, region-wide ROE in this proceeding). By contrast, the *Initial Decision* adopts a base-level ROE of 10.7 percent. The ROE Filing Parties propose 12.4 percent.

¹⁸ See *RTO Order*, 106 FERC ¶ 61,280 at P 245.

from the proxy group because its 17.7 percent ROE was an outlier.¹⁹ However, the Presiding Judge agreed with Staff and the ROE Filing Parties that evidence submitted for the record following the issuance of the *RTO Rehearing Order* supported the inclusion of PPL in the proxy group. Specifically, the Presiding Judge found that PPL's growth rates have decreased to sustainable levels and that, as such, it is no longer an outlier.²⁰ The *Initial Decision* also rejected arguments raised by NECOE that the Presiding Judge was precluded from including PPL in the proxy group by operation of the *RTO Rehearing Order*. The *Initial Decision* found that, in fact, had PPL's financial indicators been different at the time that the *RTO Rehearing Order* was issued, the Commission most likely would have approved the inclusion of PPL in the proxy group.²¹

2. Exceptions

17. The Connecticut Commission, *et al.* and NECOE argue that PPL should have been excluded from the proxy group because the Commission's findings on this issue were intended to be final. The Connecticut Commission, *et al.* argue that PPL was appropriately excluded from the proxy group given the volatility in its growth rates. Specifically, the Connecticut Commission, *et al.* point out that PPL's high-end ROE decline represents a substantial change in a short span that signals its unreliability. The Connecticut Commission, *et al.* also argue that PPL should be excluded from the proxy group given the risk factors associated with its unregulated, non-utility business operations. The Connecticut Commission, *et al.* note, for example, that the majority of PPL's business operations involve unregulated, high risk components of the electric industry outside of New England, that only five percent of its 2003 net income came from its domestic utility operations, and that more than three-quarters of its work force is devoted to high-risk, non-utility business components.

18. NECOE adds that PPL's growth rate is unsustainable because it exceeds the Social Security Administration's long-term Gross Domestic Product (GDP) forecast. In addition, NECOE argues that PPL's high-end ROE of 14.1 percent, as relied upon by the Presiding Judge, was tainted by a timing error and should have been reduced to 13.1 percent. Specifically, NECOE argues that PPL's July 30, 2004 common share count

¹⁹ See *RTO Rehearing Order*, 109 FERC ¶ 61,147 at P 204. See also *February 10, 2005 Order*, 110 FERC ¶ 61,111 at P 23 & n.19; *June 2, 2005 Order*, 111 FERC ¶ 61,344 at P 8.

²⁰ *Initial Decision*, 111 FERC ¶ 61,048 at P 62.

²¹ *Id.* at P 63.

(not the share count reflected as of December 31, 2003) should have been utilized to calculate the “sv” component of its growth rate.²²

3. Briefs Opposing Exceptions

19. Staff and the ROE Filing Parties oppose the exceptions raised by the Connecticut Commission, *et al.* and NECOE. Staff submits that the Presiding Judge properly included PPL in the proxy group, given the fact that PPL’s business activities include significant operations within PJM. Staff notes, for example, that PPL distributes electricity to approximately 1.3 million customers in a 10,000-square mile service territory in eastern and central Pennsylvania and is classified by Standard & Poor’s (S&P) as a “U.S. Utility and Power Company.” In addition, Staff point out that, as of the time that it submitted its direct testimony in this case, PPL’s projected growth rate was only one hundred basis points higher than that of Exelon, while its dividend yield was among the lowest in the proxy group.

20. The ROE Filing Parties argue that the Presiding Judge properly included PPL in the proxy group, given its falling growth rate and high-end ROE at the time that the evidence in this case was submitted. The ROE Filing Parties further note that while the Commission excluded PPL from the proxy group in the *RTO Rehearing Order*, that finding did not purport to be dispositive with respect to updated data raising new facts and circumstances.

21. Staff and the ROE Filing Parties also take issue with NECOE’s assertion that because PPL’s calculated growth rate exceeds long-term GDP forecasts it is for that reason unsustainable. Staff argues that were the Commission to exclude from a proxy group, any company whose growth rate exceeds that of the overall economy, the resulting ROE would be artificially low. Staff argues that this is so because the exclusion would likely affect only the top of the range, leaving in place only companies whose low-end ROEs are below that of the overall economy.

22. The ROE Filing Parties further assert that the Commission has rejected the contention that the growth rate used in a DCF analysis for an electric utility should be based on the long-term growth of the economy, as measured by the GDP, and has never suggested that the GDP growth rate should serve as a cap on the DCF growth rate for an

²² See *supra* note 14 for an explanation of the components used to calculate the sustainable growth rate.

electric utility.²³ The ROE Filing Parties further point out that the present PPL growth rate is now below the growth accepted by the Commission for the Midwest ISO.

23. Staff adds that while, theoretically, a company cannot be expected to grow indefinitely at a rate in excess of the overall economy, it may do so for a considerable period of time. Staff concludes that supportable projections of such a growth trajectory are therefore a valid part of a DCF analysis and balance out the lower growth projections of less successful firms.

4. Commission Finding

24. We agree with the Presiding Judge that it was appropriate to include PPL in the proxy group, based on the updated record evidence presented. In the *RTO Rehearing Order*, the Commission, without the benefit of this updated evidence, found that PPL should be excluded from the proxy group, based on its then-prevailing growth rate (13.3 percent) and its resulting ROE (17.7 percent). However, we agree with the Presiding Judge that at the time that the updated testimony in this case was filed, PPL no longer set the high-end ROE value in the proxy group initially proposed by the ROE Filing Parties.

25. In fact, at that time, PPL's growth rate had fallen to 10 percent while its high-end ROE had fallen to 13.7 percent. Under these changed circumstances, as the Presiding Judge correctly noted, PPL's growth rate was only one percentage point higher than Exelon's growth rate. Accordingly, while PPL's financial indicators failed to meet the threshold test of economic logic at the time of our prior orders in this case, PPL's financial indicators now reflect a growth rate and implied cost of equity that can no longer be considered outliers. Based on these changed circumstances, we affirm the Presiding Judge's inclusion of PPL in the proxy group.

26. We reject the argument made by the Connecticut Commission, *et al.* and NECOE that the change in PPL's ROE demonstrates a volatility that warrants its exclusion from the proxy group. Our initial determination to exclude PPL from the proxy group, in the *RTO Rehearing Order*, was based on a finding that PPL's growth rate was not sustainable. However, we did not exclude PPL from the proxy group on the basis that PPL was otherwise atypical of a northeast utility company, or that it was not part of a sufficiently representative universe of companies for calculating an ROE applicable to

²³ See ROE Filing Parties brief opposing exceptions at 11, *citing System Energy Resources, Inc.*, 92 FERC ¶ 61,119 at 61,446 (2000) (finding that the growth rate calculations that result from using the traditional electric, constant growth DCF approach are sustainable in the long term).

the ROE Filing Parties. Nor do we agree that the change in PPL's cost of capital signifies its unreliability for purposes of calculating a DCF in this case; rather, it indicates that PPL's financial indicators, at the time of hearing, had decreased to levels considered sustainable and thus met the Commission's threshold test for inclusion in the proxy group.

27. We also reject NECOE's contention that PPL's growth rate is unsustainable because it exceeds the Social Security Administration's long-term GDP forecast. Staff correctly point out, in its brief opposing exceptions, that excluding companies whose growth rates exceed that of the overall economy, produces an artificially low ROE. Specifically, the exclusion would affect only the top of the range and leave only companies whose low-end ROEs are below the overall economy. In *SoCal Edison*, moreover, we rejected the argument that the growth rate used in a DCF analysis for an electric utility should be based on the long-term growth of the economy, as measured by GDP.²⁴

28. Finally, we reject NECOE's argument that the Commission should use PPL's July 30, 2004 common share count (as opposed to its share count for December 31, 2003). While the Commission has generally required the use of the latest financial information in making its DCF calculations, it has also been our policy that the data inputs reflect a uniform time period.²⁵ Here, the latest available data for determining the common share count for the proxy group is December 31, 2003, not July 30, 2004. In this instance, NECOE's suggested use of non-contemporaneous data introduces the potential for distorted results and must be rejected.

C. Whether the Presiding Judge Erred in Excluding UGI from the Proxy Group

1. Initial Decision

29. The Presiding Judge rejected the ROE Filing Parties' proposal to include UGI in the proxy group. The Presiding Judge determined that UGI should be excluded from the

²⁴ See 92 FERC ¶ 61,070 at 61,261-62 (2000) (*SoCal Edison*) (declining to incorporate GDP data in the growth rate estimate applicable to an electric utility company).

²⁵ See, e.g., *Consumer Advocate v. Allegheny Generating Co.*, Opinion No. 281, 40 FERC ¶ 61,117 at 61,316 (1987) (requiring updated values to reflect both dividend yield and growth rate data).

proxy group, as recommended by the Connecticut Commission, *et al.*, Staff, and NECOE, because it was primarily a natural gas company with a different risk profile than the other companies included in the proxy group. The Presiding Judge noted, for example, that UGI's electric transmission operations represented only an insignificant percentage of its overall operations.²⁶ In excluding UGI from the proxy group, the Presiding Judge relied on both *SoCal Edison* and the *Midwest ISO ROE Initial Decision* for the proposition that natural gas companies should not be included in a proxy group used to determine an ROE for an electric utility company.²⁷

30. In making this determination, the Presiding Judge also rejected the ROE Filing Parties' argument regarding the purported comparability of UGI's financial risk factors. The Presiding Judge determined that similar risk ratings based on selected financial risk indicators, including ratings by S&P and Value Line, cannot be considered the sole appropriate standard for inclusion in the proxy group, because these same factors could be relied upon to support the use of any number of companies in businesses entirely unrelated to the electric utility industry.²⁸

2. Exceptions

31. The ROE Filing Parties assert that the Presiding Judge erred in excluding UGI from the proxy group. First, the ROE Filing Parties argue that the Presiding Judge was precluded from making this revision to the group of companies proposed by the ROE Filing Parties, because, they claim, the Commission approved the use of this proxy group in the *RTO Rehearing Order* with the exclusion of only PPL. The ROE Filing Parties argue that while the Commission's orders permitted the Presiding Judge to consider *additions* to the proxy group (subject to the availability of substitute data for the DCF inputs that were missing for some of the companies otherwise eligible for the proxy group) and *deletions* (for companies whose financial data is unsustainable), neither allowance covers the Presiding Judge's exclusion of UGI on the basis of its business characteristics (primarily relating to natural gas) and its associated business risk profile.

32. In addition, the ROE Filing Parties assert that inclusion of UGI in the proxy group is appropriate because evidence presented at hearing failed to demonstrate that the growth

²⁶ *Initial Decision*, 111 FERC ¶ 63,048 at P 58.

²⁷ *Id.* at P 59, citing *SoCal Edison*, 92 FERC ¶ 61,070 at 61,262 and *Midwest ISO ROE Initial Decision*, 99 FERC ¶ 63,011 at P 20-21.

²⁸ *Id.* at 60.

rate for UGI is too high to be sustainable.²⁹ The ROE Filing Parties add that, even assuming that business risk issues should have been considered by the Presiding Judge, UGI should be included in the proxy group, because it is a transmission owner in PJM and does not have a risk profile that is significantly different from any of the other transmission owners in the proxy group.

33. The ROE Filing Parties also challenge the Presiding Judge's assumption that UGI is primarily a natural gas company. The ROE Filing Parties argue that, in fact, UGI is engaged in both electric and gas operations and that the Commission has never excluded from a proxy group a company engaged in a mix of businesses of this sort. In addition, the ROE Filing Parties claim that rating agencies, including Fitch and S&P, do not view UGI differently than the other companies included in the proxy group from a "line of business" perspective.

3. Briefs Opposing Exceptions

34. Staff and the Connecticut Commission, *et al.* oppose the ROE Filing Parties' exceptions. Staff argues that the Presiding Judge properly excluded UGI from the proxy group because UGI is not regarded by investors as an electric utility company. Staff notes, for example, that while UGI owns electric transmission facilities located within PJM, these assets comprise only one quarter of one percent of PJM's system and that the revenues generated by these assets represent only a *de minimis* (and shrinking) share of UGI's overall revenues (only 2.4 percent in 2004). The Connecticut Commission, *et al.* add that in 2004, UGI acquired one of the largest propane distributors in France, raising the required capital by issuing 7.8 million shares of new stock and, thereby, producing a gross distortion of its imputed earnings.

35. The Connecticut Commission, *et al.* also assert that as result of the dilution of earnings caused by UGI's acquisition, the sustainable growth ratio for UGI is 150 basis point higher than any other company proposed for inclusion in the ROE Filing Parties' proxy group. The Connecticut Commission, *et al.* add that UGI's growth in common shares outstanding (4.8 percent) is two-thirds higher than the growth for any other proxy group member and more than ten times the projected growth of any transmission owner operating in the markets overseen by ISO New England.

²⁹ The ROE Filing Parties note that by including UGI in the proxy group (and assuming the rest of the *Initial Decision* is adopted by the Commission), Con Ed would set the low-end ROE and UGI would set the high-end ROE, producing a range of reasonableness of 7.3 percent to 15.3 percent, with a midpoint return of 11.3 percent.

36. Staff and the Connecticut Commission, *et al.* further submit that while the *RTO Rehearing Order* allowed for the inclusion of UGI in the proxy group, the Commission, in that order, did not specifically consider UGI's status as a gas company. The Connecticut Commission, *et al.* add that the Commission, in the *RTO Rehearing Order*, expressly allowed the Presiding Judge to exclude companies that have financial indicators that are not sustainable. Staff and the Connecticut Commission, *et al.* submit that the Commission should therefore reject its prior finding and instead follow its ruling in the *Midwest ISO ROE Order*.³⁰

4. Commission Finding

37. We agree with the Presiding Judge that it was proper to exclude UGI from the proxy group, given its primary status as a natural gas company. We agree that given this status, UGI has a risk profile significantly different than the risk profile of an electric utility company and the other companies included in the proxy group. As such, UGI's DCF is an outlier and may not reasonably be used to project ISO New England's future earnings requirements in this case.

38. In *SoCal Edison*, we found that the differences between the electric utility industry and the natural gas pipeline industry warranted the continued use of different growth rates in the DCF models for each. Accordingly, we rejected the Presiding Judge's recommended ROE in that case and the natural gas pipeline company methodology on which it relied.³¹ Similarly, in the *Midwest ISO ROE Order*, we affirmed the Presiding Judge's findings that the appropriate proxy group for the transmission owners that comprise the Midwest ISO consisted of companies that are currently in the Midwest ISO, and included comparable risk companies that are similar in profile and size.³² We agreed that the Presiding Judge in that case appropriately rejected DCF analyses using other proxy groups, including (i) natural gas pipeline transmission operators; (ii) Moody's electric utilities; (iii) S&P's electric utilities; and (iv) generation-divested electric utilities.³³ Applying these precedents here, we find that UGI is primarily a gas company and is therefore appropriately excluded from the proxy group.

³⁰ 100 FERC ¶ 61,292 at P 9-11 (affirming the Presiding Judge's rejection of a proxy group comprised of natural gas pipeline companies).

³¹ See *SoCal Edison*, 92 FERC ¶ 61,070 at 61,261.

³² See *Midwest ISO ROE Order*, 100 FERC ¶ 61,292 at P 12.

³³ *Id.*

D. Whether the Presiding Judge Appropriately Applied the Commission's Requirement Regarding Certain Low-End ROE Results

1. Initial Decision

39. The Presiding Judge noted that in the *RTO Rehearing Order*, the Commission found that it was appropriate to exclude from consideration in the proxy group companies whose low-end ROEs were lower than their reported debt costs.³⁴ The Presiding Judge also noted, however, that the parties in this case took differing positions regarding their interpretation of this requirement. Specifically, the Presiding Judge noted that while Staff, NECOE, and the Connecticut Commission, *et al.* supported a comparison based on each company's low-end ROE and that company's *own* cost of debt, the ROE Filing Parties, by contrast, advocated a comparison utilizing the *composite* debt rate of the proxy group. The Presiding Judge found in favor of Staff, NECOE, and the Connecticut Commission, *et al.*, based on the Presiding Judge's interpretation of the *RTO Rehearing Order*. Specifically, the Presiding Judge interpreted the *RTO Rehearing Order* to require a comparison between each company's low-end ROE and that individual company's cost of debt, as provided in Staff's exhibits.³⁵

40. Applying this standard, then, the Presiding Judge found, in concurrence with Staff, that UIL's low-end ROE should not be used to establish the low-end ROE in this case. The Presiding Judge, however, rejected Staff's recommendation to use UIL's high-end ROE as its low-end value. Instead, the Presiding Judge agreed with the ROE Filing Parties that UIL's unrepresentative low-end ROE value tainted its use in the DCF calculation for *any* purpose and that UIL, accordingly, was properly excluded from the proxy group.³⁶ The Presiding Judge also agreed with Staff, however, that Con Ed's low-end ROE was substantially above its cost of debt, with a risk differential of at least 153 basis point. The Presiding Judge found that in these circumstances, and a similar

³⁴ *RTO Rehearing Order*, 109 FERC ¶ 61,147 at P 205.

³⁵ *Initial Decision*, 111 FERC ¶ 63,048 at P 55. In addition, Staff's analysis, on which the Presiding Judge relied, was also based on a single bond yield reported closest to the date of the DCF analysis. As noted below, the ROE Filing Parties support the use of an average bond yield over the same time period that the dividend yield calculation is made in the DCF analysis.

³⁶ *Id.* at P 56.

differential accepted by the Commission in *SoCal Edison*,³⁷ it was appropriate to include Con Ed in the proxy group.³⁸

2. Exceptions

41. Exceptions to the Presiding Judge's findings are raised by the Connecticut Commission, *et al.*, NECOE, and the ROE Filing Parties. The Connecticut Commission, *et al.* assert as error the Presiding Judge's determination to exclude UIL's high-end ROE from consideration in the DCF calculation. The Connecticut Commission, *et al.* argue that while the Presiding Judge correctly excluded UIL's low-end ROE from the proxy group comparison (because it was below the cost of UIL's lower risk of debt), UIL should not have been excluded from the proxy group for *all* purposes. Specifically, the Connecticut Commission, *et al.* submit that UIL's high-end ROE should have been considered because it was 85 basis point above UIL's cost of debt and consistent with the Commission's ruling in *SoCal Edison*.³⁹

42. NECOE agrees, regarding the use of UIL's high-end ROE, but argues that UIL's low-end ROE should also have been used in this case. NECOE argues that in the *RTO Rehearing Order*, the Commission held that an implied cost of equity may be excluded in this case as unrepresentative where the financial indicators of the company at issue are not sustainable, but allowed for no other challenges. NECOE adds that the *RTO Rehearing Order* further clarified that the question of whether a proxy candidate's low-end ROE is lower than its reported debt cost would not be considered in determining whether to retain a low-end ROE drawn from the 12-company proxy group proposed by the ROE Filing Parties, but would be considered only with respect to a proposal to add additional companies. NECOE argues that this approach supports the inclusion of UIL in the proxy group. NECOE argues that UIL is a New England transmission-owning utility that has already been found to belong in the proxy group (absent a finding that its financial indicators are unsustainable).

43. NECOE further asserts that UIL has been found to have risk comparable to the Commission's benchmark and that a midpoint ROE cannot be found representative of the full range of publicly-traded New England transmission owners unless UIL is included.

³⁷ *SoCal Edison*, 92 FERC ¶ 61,070 at 61,266.

³⁸ *Initial Decision*, 111 FERC ¶ 63,048 at P 57.

³⁹ 92 FERC ¶ 61,070 at 61,266 (rejecting PG&E's low-end ROE but including PG&E's high-end ROE).

NECOE concludes that a Commission may not calculate an ROE by excluding low-end ROE outliers, while retaining high-end ROE outliers.⁴⁰

44. The ROE Filing Parties assert as error the Presiding Judge's rejection of their proposed methodology for excluding low-end ROEs, namely, the use of an average bond yield over the same time period that the dividend yield calculation is made in the DCF analysis. The ROE Filing Parties argue that under this methodology, the comparison of a company's debt and equity can be made based on consistent data, with the comparison based on the difference between a company's ROE result and the average debt cost of the proxy group.⁴¹ The ROE Filing Parties argue that comparing the individual ROE to an average is appropriate because the purpose of the comparison is to develop a range of reasonableness for a group. They argue that the importance of using an average is heightened when interest rates are volatile. The ROE Filing Parties note that making these adjustments would have produced a range of reasonableness of 7.8 percent to 15.3 percent, with a midpoint ROE of 11.6 percent.

45. The ROE Filing Parties also assert as error the Presiding Judge's determination to include Con Ed and Northeast Utilities in the low-end ROE value in this case. The ROE Filing Parties argue that the low-end ROEs for these companies should not have been utilized in the DCF calculations because the low-end ROEs for these companies were only a few basis point higher than the expected return on debt going forward (with Con Ed's low-end ROE of 7.3 percent only 75 basis point above debt cost and Northeast Utilities 7.4 percent ROE only 85 basis point above debt cost). The ROE Filing Parties submit that such companies should be eliminated from the proxy group calculation where their low-end ROE values are sufficiently close to the cost of debt that no rational investor would invest in these equities.

46. The ROE Filing Parties also assert that Con Ed's low-end ROE cannot be considered economically rational due to investors' expectations that interest rates will be

⁴⁰ NECOE brief on exceptions at 17, citing *Missouri Pub. Serv. Comm'n v. FERC*, 215 F.3d 1, 5 (D.C. Cir. 2000) (finding that the Commission had given "no explanation as to why any outlier should be removed . . . much less why a low outlier should be removed and a high one retained").

⁴¹ By contrast, Staff's analysis, on which the Presiding Judge relied, was based on the single bond yield reported closest to the date of the DCF analysis, with the appropriate comparison based on the difference between a company's ROE result and that same company's debt cost.

increasing in the near future, thereby possibly causing Con Ed's low-end ROE to be only a few basis points higher than the expected return on debt going forward.

3. Briefs Opposing Exceptions

47. The ROE Filing Parties oppose the exceptions raised by the Connecticut Commission, *et al.* and NECOE regarding the exclusion of UIL from the proxy group. The ROE Filing Parties assert that the Presiding Judge properly excluded UIL from the proxy group for all purposes, given the ROE results indicated for this company. With respect to the Connecticut Commission, *et al.*'s assertion that UIL's high-end ROE result should have been included in the DCF calculations used to establish ISO New England's ROE in this case, the ROE Filing Parties argue that the Connecticut Commission, *et al.* has failed to cite any precedent in which the Commission included a high-end ROE after having excluded a low-end ROE result. In addition, the ROE Filing Parties argue that the Commission's precedent in this area is based on economic logic, which supports the exclusion of both high and low-end ROE results where the calculation of a company's imputed ROE produces an irrational result. The ROE Filing Parties also challenge the Connecticut Commission, *et al.*'s claim that UIL's high-end ROE is sufficiently high to be included in the proxy group. The ROE Filing Parties argue that, in fact, the most recent data for UIL indicates a high-end ROE of 7.0 percent, only 45 basis points above an average debt cost, or only 85 basis points above UIL's own cost of debt.

48. The ROE Filing Parties also rebut NECOE's contention that there was no record evidence from which the Presiding Judge could have determined that UIL's low-end ROE was economically irrational. The ROE Filing Parties assert that, in fact, every estimate of UIL's debt cost submitted in this case was above 5.0 percent, *i.e.*, above UIL's low-end ROE, with NECOE at no time claiming, in its submitted testimony, a lower debt cost.

49. Staff and the Connecticut Commission, *et al.* oppose the exceptions raised by the ROE Filing Parties regarding the use of a composite debt cost to make the debt/equity comparison required by the Commission in the *RTO Rehearing Order*. Staff argues that the Presiding Judge correctly relied on a debt/equity comparison using each company's *own* debt cost and not a composite debt cost. Staff argues that this is the appropriate methodology because a company's level of risk will affect both its debt and equity costs. Staff notes, therefore, that 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. The Connecticut Commission, *et al.* add that a DCF result that is calculated based on the particular projected ROE can only be considered illogical if it is lower than that same company's cost of debt.

50. Staff and the Connecticut Commission, *et al.* also oppose the exceptions raised by the ROE Filing Parties, regarding the Presiding Judge's reliance on the low-end ROEs for

Con Ed and Northeast Utilities. The Connecticut Commission, *et al.* note that the ROE Filing Parties, in their brief on exceptions, argue in favor of excluding the low-end ROEs of Con Ed and Northeast Utilities, based on the claim that these companies' low-end ROEs are too close to their cost of debt to be considered economically reasonable. The Connecticut Commission, *et al.* argue, however, that in the *RTO Rehearing Order*, the Commission held that to be considered economically illogical, the DCF result for a given company must be lower than its debt cost. In addition, the Connecticut Commission, *et al.* point out that while in *SoCal Edison*, the Commission accepted the removal of a low-end ROE value that was 36 basis point above the bond yield, that determination cannot be applied to either Con Ed or Northeast Utilities where the basis point differential is 75 and 85 basis point above the bond yield, respectively.

51. Staff also takes issue with the ROE Filing Parties' reliance on a debt/equity comparison that uses debt cost information averaged out over the same period used to make the dividend yield calculation. Staff submits that the Presiding Judge correctly adopted Staff's recommendation using the latest available debt cost information, consistent with the approach accepted by the Commission in *SoCal Edison*. Staff argues that this approach should be followed here, consistent with the Commission's general policy of using the latest available financial information in establishing a company's ROE, and because there is no conceptual linkage between the period for calculating the average dividend yield in the DCF analysis and the comparison of a company's debt and equity levels.

52. The Connecticut Commission, *et al.* also challenge the ROE Filing Parties' claim that Con Ed's low-end ROE cannot be considered economically rational due to investors' interest rate expectations. The Connecticut Commission, *et al.* argue that this contention is speculative and that the ROE Filing Parties' own data demonstrates a steady decline in utility bond yields that continues through the close of the record in this case.

4. Commission Finding

53. We affirm the Presiding Judge's determination 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. On this basis, the Presiding Judge properly excluded UIL from the proxy group because UIL's low-end ROE falls below its cost of debt. The ROE Filing Parties argue, to the contrary, that the comparison should be based on an average bond yield over the time period for which the dividend yield calculation is made and that this comparison must be based on the composite debt rate of the proxy group. However, the Presiding Judge properly followed the *February 10, 2005 Order* which found that a company whose ROE is lower than its own debt cost should not be

included in the proxy group.⁴² 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. Moreover, the ROE Filing Parties' argument that use of an average figure is more appropriate, especially when interest rates are volatile, is speculative. The record in this case does not support the finding of increased interest rates.

54. In rejecting UIL's low-end ROE as unreliable, the Presiding Judge also excluded UIL's high-end ROE. The Connecticut Commission, *et al.* argue that UIL should not have been excluded from the proxy group for all purposes, asserting that UIL's high-end ROE should have been used to establish the low-end of the proxy group. We agree with the Presiding Judge that having excluded UIL's low-end ROE, it would have been improper to then use UIL's high-end ROE to establish the low-end ROE for the proxy group. The Connecticut Commission, *et al.*'s argument is inconsistent with the Commission's method for computing the DCF analysis which compares the low dividend yield and growth rate of each company to that company's high dividend yield and growth rate. The use of only one component of the UIL data would skew the Commission's DCF method and is rejected.

55. With the exclusion of UIL, Con Ed establishes the low-end ROE of the proxy group. The ROE Filing Parties oppose this result, arguing that both Con Ed and Northeast Utilities should have also been excluded. Specifically, the ROE Filing Parties argue that the low-end ROE values for these companies were so close to their debt rate that no rational investor would invest in these equities. The ROE Filing Parties also note that in *SoCal Edison* the Commission rejected a low-end ROE that was 36 basis point above an average public utility bond yield.

56. The Presiding Judge rejected this argument, relying on Staff's analysis which showed that based on the most recent data available, the ROE for both Con Ed and Northeast Utilities is above the bond yield. Staff's analysis was based on Con Ed's bond rating (A+) and the latest yield data in the record for Moody's A-rated public utility bonds (5.8 percent). The Presiding Judge agreed that, based on these measures, there is a sufficient return difference for investors to differentiate between Con Ed's debt and equity capital in making economic decisions.

57. Moreover, we agree with Staff that this return difference is sufficiently above the line relied upon by the Commission in *SoCal Edison*. We also agree with the Connecticut Commission, *et al.* that even using the ROE Filing Parties' proposed methodology, *i.e.*, a comparison utilizing the average bond yields of the proxy group,

⁴² 110 FERC ¶ 61,111 at P 25.

does not justify the exclusion of Con Ed and Northeast Utilities. In fact, the Connecticut Commission, *et al.*, demonstrated that even utilizing the ROE Filing Parties' own data (as supplied by witness Avera), a steady decline in utility bond yields can be evidenced.⁴³ As such, the bond yields of Con Ed and Northeast Utilities are well above the average utility bond yield.

58. The ROE Filing Parties note that the Commission, in *SoCal Edison*, excluded PG&E from the proxy group based on a comparison of PG&E's ROE to an average A bond and rejected the company's ROE because it was only 36 basis points above an average public utility bond yield. However, the Commission's analysis in *SoCal Edison* was based on the record in that case. The Commission did not have before it evidence of PG&E's own bond yields, and therefore relied on an average yield.

59. Moreover, the Commission's analysis, in *SoCal Edison*, did not establish a bright line regarding how much of a rate differential would support the inclusion or exclusion of a company from the proxy group. In this proceeding, the Commission's orders have focused on the relationship between the debt and equity costs of each company. In this context, the ROE Filing Parties have failed to support their claim that the low-end ROEs for Con Ed and Northeast Utilities were so near their debt costs that no rational investor would invest in equity with such a small differential. Based on the facts presented here, we find that it was reasonable for the Presiding Judge to conclude that Con Ed and Northeast Utilities were properly included in the proxy group.

60. We also affirm the Presiding Judge's utilization of the latest available debt cost information. This issue was addressed in *SoCal Edison* where the Commission used the latest bond yield contained in the record, in keeping with its general policy of using the latest available financial information in the record.

E. Whether the Presiding Judge Erred in Including PSEG and Exelon in the Proxy Group, Given the Proposed Merger of these Companies

1. Initial Decision

61. The Presiding Judge rejected NECOE's argument that the planned merger of PSEG and Exelon (and the effect that this merger could be expected to have on these companies' stock prices) warranted the exclusion of these companies from the proxy group. The Presiding Judge acknowledged that where there is evidence that a merger or acquisition has affected a company's stock price, the company should be excluded from

⁴³ See Exh. Nos. CT-24 at 2 and CT-25 at 2.

the proxy group.⁴⁴ However, the Presiding Judge determined that in this case, the ROE Filing Parties had submitted credible evidence supporting the conclusion that the stock prices of these companies had not been distorted over the relevant period.

62. In addition, the Presiding Judge also rejected NECOE's argument that these companies' anticipated involvement in the nuclear energy industry, following their merger, also supported their exclusion from the proxy group. The Presiding Judge agreed with the ROE Filing Parties that this anticipated involvement had had no impact on the DCF calculations relied upon in this case.⁴⁵ The Presiding Judge also found that both companies have substantial commitments to the regulated electric utility business.

2. Exceptions

63. Exceptions are raised by the Connecticut Commission, *et al.* and NECOE. The Connecticut Commission, *et al.* argue that PSEG and Exelon should have been excluded from the proxy group, consistent with Commission precedent,⁴⁶ because, during the relevant study period in this case, the stock prices for these companies would have been distorted by investors who were expecting these companies to merge.

64. In addition, the Connecticut Commission, *et al.* argue that neither company has a risk profile that could be considered representative. The Connecticut Commission, *et al.* point out that both Exelon and PSEG are involved in the nuclear energy industry and the generation and trading components of the electric energy industry. They claim that these operations have higher risks than those associated with the electric energy transmission business. Finally, NECOE challenges the inclusion of Exelon in the proxy group based on Exelon's prior plans to acquire the Illinois Power Company (Illinois Power).

⁴⁴ *Initial Decision*, 111 FERC ¶ 63,048 at P 65-66, citing *SoCal Edison*, 92 FERC ¶ 61,070 at 61,264-66 and *Midwest ISO ROE Initial Decision*, 99 FERC ¶ 63,011 at P12, n.10.

⁴⁵ *Id.* at P 68.

⁴⁶ Connecticut Commission, *et al.* brief on exceptions at 14, citing *Transcontinental Gas Pipe Line*, 90 FERC ¶ 61,279 at 61,932-33 (2000) (*Transco*) (removing Pan Energy and Duke Power Company (Duke) from the proxy group due to their post-test period merger, given the affect of the merger of the companies' growth projections); *Stingray Pipeline Company*, 98 FERC ¶ 63,004 at 65,039 (2002).

3. Briefs Opposing Exceptions

65. The ROE Filing Parties oppose the objections raised by the Connecticut Commission, *et al.* and NECOE. The ROE Filing Parties assert that the Presiding Judge properly included PSEG and Exelon in the proxy group because they are both transmission owners in PJM. The ROE Filing Parties further assert that the proposed merger of these entities, as announced on December 20, 2004, *post-dated* the publication of the Value Line used by the parties in their final DCF updates in this case, and thus could not have distorted the ROE results indicated for these entities, as the Presiding Judge correctly found.⁴⁷

66. The ROE Filing Parties conclude that, under these circumstances, the Commission has no basis for applying, here, its holding in *Transco* to exclude a utility engaged in a merger, because in that case, the merger at issue had already had an effect on the growth projections for the companies at issue.⁴⁸ Finally, the ROE Filing Parties argue that NECOE's argument regarding Exelon's prior plans to acquire Illinois Power should be rejected. The ROE Filing Parties argue that there was no evidence presented in this case suggesting that this planned acquisition (which was later cancelled) had any material effect on the values included in the parties' DCF calculations.

4. Commission Finding

67. We agree with the Presiding Judge that PSEG and Exelon were properly included in the proxy group, despite the planned merger of these entities. The assertions to the contrary of the Connecticut Commission, *et al.* and NECOE are unsupported by evidence demonstrating that the planned merger of PSEG and Exelon distorted these entities' stock prices or had any effect on the DCF analysis relied on to establish the allowed ROE in this case. Specifically, the merger of PSEG and Exelon was announced on December 20, 2004, *after* the publication of the Value Line used in the final DCF updates. Moreover, evidence presented by the ROE Filing Parties confirms that the merger's pending announcement had no impact on the financial data of either Exelon or PSEG.⁴⁹

⁴⁷ *Initial Decision*, 111 FERC ¶ 61,048 at P 67.

⁴⁸ 90 FERC ¶ 61,279 at 61,933.

⁴⁹ *See* Tr. at 124 and 295 (cross examination testimony of witness Avera).

68. We also reject NECOE's and the Connecticut Commission, *et al*'s argument that Commission precedent supports, in every instance, the exclusion from a proxy group of any utility engaged in merger activity. In *Transco*, Pan Energy was removed from the proxy group because its merger with Duke had been announced *before* the close of the test period and because the evidence presented in that case showed that the acquisition had already had an effect on the growth projections for that company. Here, by contrast, the record demonstrates that the merger at issue did not affect the DCF calculation.

69. We also reject NECOE's argument that Exelon's plan to acquire the Illinois Power Company (which it later abandoned) renders unreliable its inclusion in the proxy group. NECOE failed to present any record evidence to show that this cancelled acquisition might have had a material effect on the input values reflected in the DCF calculations for Exelon.

70. We also reject the argument raised by NECOE and the Connecticut Commission, *et al.* that Exelon and PSEG should have been excluded from the proxy group, due to their involvement in the nuclear energy industry. In the *RTO Rehearing Order*, we found that the ROE Filing Parties' proposed proxy group, comprised of northeast transmission-owning utilities including both Exelon and PSEG, reflected a "sufficiently representative universe of companies for calculating an ROE applicable to the New England Transmission Owners in this proceeding."⁵⁰ Although the companies in this proxy group comprise varying levels of risk, collectively these risk levels are representative of risks faced by transmission owning companies in ISO NE. Moreover, in the *Midwest ISO ROE Order*, the Commission rejected the need for a "transmission only" proxy group, based on its finding that transmission investments are not inherently less risky than other investments.⁵¹ Finally, as Staff has observed, neither PSEG nor Exelon lie at either the low-end or the high-end of the ROEs calculated in this case. As such, their individual ROE values are not relevant here with respect to the ROE Filing Parties' allowed midpoint ROE.⁵²

⁵⁰ *RTO Rehearing Order*, 109 FERC ¶ 61,147 at P 204.

⁵¹ 100 FERC ¶ 61,292 at P 12.

⁵² The midpoint ROE is calculated as the average of the highest and the lowest ROEs, *i.e.*, the 10.2 percent base-level ROE approved in this case is at the "midpoint" between high-end ROE of 13.1 percent and the low-end ROE of 7.3 percent.

F. Whether the ROE Established in the *Midwest ISO ROE Order* Should Be Used as a Benchmark ROE for ISO New England

1. Initial Decision

71. The Presiding Judge rejected the argument advanced by the ROE Filing Parties that, in order to further the Commission's policies of encouraging investment in the transmission sector, ISO New England's ROE should be set in this case at a level comparable to the 12.4 percent ROE accepted by the Commission in the *Midwest ISO ROE Order*.⁵³ The Presiding Judge found to the contrary, that ISO New England's ROE should be established without regard to the inputs reflected in the Midwest ISO's ROE.

2. Exceptions

72. The ROE Filing Parties assert as error the Presiding Judge's failure to use the base-level ROE accepted by the Commission in the *Midwest ISO ROE Order* (12.4 percent) as a benchmark for considering the reasonableness of the base-level ROE in this proceeding. The ROE Filing Parties argue that if the ROE for ISO New England is significantly lower than the ROE approved for the Midwest ISO, equity investors interested in the transmission business will logically want to put their investment dollars where they can earn the higher ROE. Accordingly, the ROE Filing Parties assert that the Presiding Judge's adoption of a base-level ROE of 10.7 percent cannot be justified. Instead, the ROE Filing Parties request a base-level ROE no more than 50 basis point below the Midwest ISO base-level ROE.⁵⁴

3. Briefs Opposing Exceptions

73. Staff and the Connecticut Commission, *et al.* oppose the ROE Filing Parties' assertion that the Presiding Judge should have taken into consideration the 12.4 percent base-level ROE accepted by the Commission in the *Midwest ISO ROE Order*. Staff argues that the ROE Filing Parties' request, if granted, would be tantamount to a rejection of the Commission's DCF methodology. The Connecticut Commission, *et al.* add that regardless, the ROE accepted in the *Midwest ISO ROE Order* was established based on a

⁵³ 100 FERC ¶ 61,292 at P 1. As noted above, the ROE Filing Parties' initial filing in this case proposed an ROE of 12.8 percent. *See supra* P 5.

⁵⁴ The ROE Filing Parties concede that a base-level ROE that is somewhat lower than the Midwest ISO base-level ROE may be appropriate in this case, given the changing financial conditions presented here.

different time period and under different economic circumstances. The Connecticut Commission, *et al.* assert that the transmission owners participating in the markets overseen by the Midwest ISO are entirely different than the transmission owners participating in ISO New England's markets.

4. Commission Finding

74. We agree with the Presiding Judge that a base-level ROE should be determined in this case using the Commission's long-established DCF methodology, without specific reference to an ROE result established for another public utility RTO in a proceeding in which a different proxy group, separate input values, and other data for a prior, distinguishable period were relied upon by the Commission.⁵⁵ Using the Midwest ISO as the sole proxy would, in this instance, be inappropriate and must be rejected.

G. Use of Updated Data

1. Initial Decision

75. The *Initial Decision* found that the calculation of ISO New England's ROE should be made using updated ROE values, as supplied by Staff (Exh. No. S-5), representing a six-month study period ending November 4, 2004.⁵⁶ The *Initial Decision* did not address whether there were more current data that could have been utilized.

2. Exceptions

76. The Connecticut Commission, *et al.* and NECOE assert as error the Presiding Judge's reliance on Staff's ROE values. The Connecticut Commission, *et al.* argue that these ROE values did not constitute the most current data that could have been utilized, given the data sponsored by witness Parcell (Exh. No. CT-16), which reflected updates for a six-month period ending December 4, 2004 (as opposed to Staff's exhibit which reflected a six-month period ending November 2004). The Connecticut Commission, *et al.* point out that the Presiding Judge was bound by Commission precedent to use this updated data and that had she done so, the resulting ROE would have been lower

⁵⁵ See *Bluefield Water Works & Improvement Co. v. Public Serv. Commission of W. Va.*, 262 U.S. 679, 693 (1923) (whether an ROE justly compensates the public utility "depends upon circumstances, locality and risk, [such that] no proper rate can be established for all cases").

⁵⁶ *Initial Decision*, 111 FERC ¶ 63,048 at P 73.

(10.4 percent compared to 10.7 percent).⁵⁷ Alternatively, the Connecticut Commission, *et al.*, NECOE, and Staff argue that the updated data supplied by the ROE Filing Parties should be used (Exh. No. NETO-15), because it also includes data for December 2004.

3. Briefs Opposing Exceptions

77. The ROE Filing Parties oppose the exceptions made by the Connecticut Commission, *et al.* and NECOE. The ROE Filing Parties assert that the Presiding Judge's reliance on Staff's updated data is inappropriate because the Presiding Judge incorrectly eliminated UGI from the proxy group. Accordingly, the ROE Filing Parties argue that their own data, as supplied in Exh. No. NETO-17, should be utilized because it includes the updated values for UGI. The ROE Filing Parties note, however, that in the event that UGI is not included in the proxy group, there is no valid reason not to use Staff's data. In addition, the ROE Filing Parties counsel against reliance on their own exhibit (Exh. No. NETO-15), based on their contention that this exhibit contained a methodological error, which was subsequently corrected by the ROE Filing Parties in Exh. No. NETO-17.⁵⁸

78. Staff opposes, in part, the assertions made by the Connecticut Commission, *et al.* and NECOE. Staff argues that while the updated data identified by the Connecticut Commission, *et al.* and NECOE were for a six-month period ending one month later than the data supplied by Staff (and accepted by the Presiding Judge), the methodology

⁵⁷ Connecticut Commission, *et al.* brief on exceptions at 16, citing *SoCal Edison*, 92 FERC ¶ 61,070 at 61,267 (“Because capital market conditions may change significantly between the time the record closes and the date the Commission issues a final decision, we have consistently required the use of updated data in setting a company’s ROE.”).

⁵⁸ The ROE Filing Parties state that this error consisted of the improper use of a year-end number from Value Line in calculating the “r” factor in the $br + sv$ growth component, rather than an average number over the course of the year, as reflected in *SoCal Edison*, 92 FERC ¶ 61,070 at 61,263. See *supra* note 14 (explaining the formula used to calculate the expected growth rate). The ROE Filing Parties further point out that Staff’s testimony and exhibits also reflected the use of the average rather than year-end figures.

underlying those calculations was faulty and thus was properly rejected.⁵⁹ However, as noted above, Staff concurs with NECOE that the Commission's stated preference is to use the latest available financial information and that application of this policy, here, supports use of Dr. Avera's updated data and calculations (Exh. No. NETO-15), as applied to Con Ed and PPL.⁶⁰

4. Commission Finding

79. For the reasons discussed below, we will adopt two separate updates to the midpoint ROE approved by the *Initial Decision*, *i.e.*, an update based on Exh. No. NETO-15 (lowering the high-end ROE from 14.1 percent to 13.1 percent) and a second update based on the use of the most recent bond data (increasing the midpoint return by 74 basis point, effective as of the date of this order).

80. First, we agree that the use of the latest available financial information is the Commission's stated preference and should be used here. Accordingly, we will adopt the updated data, as submitted by Dr. Avera in his supplemental testimony (Exh. No. NETO-15), *i.e.*, the six-month average dividend yield for the period July through December 2004. Utilizing these inputs as they relate to the proxy group identified above produces a zone of reasonable returns with a low-end ROE of 7.3 percent (as represented by Con Ed), a high-end ROE of 13.1 percent (as represented by PPL) and a midpoint ROE of 10.2 percent. This midpoint ROE will constitute the base-level ROE for a locked-in period, *i.e.*, from the rate effective date (March 1, 2004) through the date of this order.

81. Because capital market conditions may change significantly between the time the record closes and the date on which the Commission issues a final decision, we have consistently required the use of updated data in setting a company's ROE for the period subsequent to the date of our Opinion. The monthly yields on ten-year constant maturity U.S. Treasury Bonds provide a good indicator of these trends and have previously been endorsed by the Commission.⁶¹ For the six-month period reflected in Staff's updated

⁵⁹ Specifically, Staff notes that this updated data eliminated Value Line's calendar year 2004 growth projection and thus relied on only two of Value Line's three growth projections. Staff asserts that this approach is inconsistent with the approach adopted by the Commission in the *Midwest ISO ROE Order*.

⁶⁰ Staff notes that the implied range for these two entities would be 7.3 percent to 13.1 percent, with a midpoint ROE of 10.2 percent.

⁶¹ See, *e.g.*, *Union Electric Company*, Opinion No. 279, 40 FERC ¶ 61,046 (1987), *order on rehearing*, Opinion No. 279-A, 41 FERC ¶ 61,343 (1987).

values (Exh. No. S-5), *i.e.*, for the period July 2004 through December 2004, the average monthly yield on these bonds was 4.2 percent, while the most recent bond data (for the period March 2006 through August 2006), produces an average monthly yield of 5.0 percent (a difference of 74 basis point).⁶² Adjusting the ROE for the going-forward period by this amount (inclusive of the base-level ROE and the other incentives noted above) raises the ROE from 11.7 percent to 12.4 percent, an ROE that falls within the zone of reasonableness.

H. Whether an Adjustment to the DCF Results Was Required to Account for Certain Flotation Costs

1. Initial Decision

82. The Presiding Judge rejected the flotation cost proposal made by the ROE Filing Parties, *i.e.*, the proposal to adjust their allowed ROE by 20 to 40 basis point covering the ROE Filing Parties' anticipated incurrence of certain costs relating to their acquisition of capital to finance the construction of new transmission. The Presiding Judge noted that in support of that adjustment, the ROE Filing Parties had asserted that these projected costs were not otherwise reflected by the input values used to calculate their ROE in this case. The Presiding Judge noted that, as claimed by the ROE Filing Parties, the costs to issue new equity securities would be approximately five to ten percent of their allowed ROE.

83. The Presiding Judge found that while, under the Commission's precedent, a flotation cost adjustment may be considered appropriate in a given case, the Commission requires the public utility applicant seeking the adjustment to quantify the specific costs for which the adjustment will apply and show a nexus between these costs and the planned issuance, by the company, of public stock.⁶³ The Presiding Judge further found that in supplying this quantification, it is appropriate to utilize the formula supplied in *Boston Edison Co.*,⁶⁴ for calculating the flotation cost

⁶² The Federal Reserve Board, *Statistics: Releases and Historical Data* (2006). See www.federalreserve.gov/RELEASES.

⁶³ *Initial Decision*, 111 FERC ¶ 63,048 at P 89-91, citing *Allegheny Generating Company*, 65 FERC ¶ 63,026, 65,179 (1993) (*Allegheny*).

⁶⁴ 66 FERC ¶ 63,013, 65,084 (1994), *aff'd*, Opinion No. 411, 77 FERC ¶ 61,272, 62,172 (1996).

adjustment.⁶⁵ Applying this formula, the Presiding Judge determined that the ROE Filing Parties had failed to provide any values for either “k” or “s.”

2. Exceptions

84. Exceptions are raised by the ROE Filing Parties. The ROE Filing Parties claim that because their existing and projected transmission expansion obligations may exceed \$2 billion and will need to be financed, they will be required to enter the equity capital markets in the near future and that when they do so, a significant amount of equity financing costs will be incurred that are not reflected in the DCF analyses performed in this case. The ROE Filing Parties argue that, under these circumstances, *Boston Edison Co.* supports the allowance of a flotation cost adjustment. Specifically, the ROE Filing Parties assert that a flotation cost adjustment of 20 to 40 basis points would be appropriate, based on their projected financing costs in the range of five to ten percent of their ROE.

3. Briefs Opposing Exceptions

85. Staff and the Connecticut Commission, *et al.* oppose the ROE Filing Parties’ asserted need for a flotation cost adjustment. Staff argues that the ROE Filing Parties failed to substantiate the existence of the planned expansions underlying their proposal, or whether, in conjunction with these claimed expansions, new equity would be issued. Staff further argues that no explanation was provided as to why these claimed expansions could not be financed either internally, out of retained earnings, or externally, through the issuance of debt.

86. The Connecticut Commission, *et al.* assert that at the time the record in this case closed, there was no evidence available of specific equity issuances contemplated by the ROE Filing Parties. The Connecticut Commission, *et al.* further argue that the ROE Filing Parties’ own five-year growth projection in common shares outstanding (as reflected in their “sv” analysis), shows only a negligible expected new stock growth (less than 0.5 percent over the five-year period at issue, or less than 0.1 percent per year).

⁶⁵ That formula provides that $k = fs / (1+s)$, where “k” equals the flotation cost adjustment to the allowed ROE; “f” equals the industry average flotation cost as a percentage of the offering price; and “s” equals the proportion of new common equity expected to be issued annually to total common equity.

4. Commission Finding

87. We agree with the Presiding Judge that the ROE Filing Parties have failed to demonstrate a need for a flotation cost adjustment covering their projected costs for financing new construction. In the past, the Commission has approved flotation cost adjustments only when the utility demonstrates that a new stock issuance is imminent. In *Williston Basin Interstate Pipeline Co.*,⁶⁶ for example, we found that flotation costs would not be permitted unless it could be demonstrated, among other things, that there is actual test period evidence that such costs can be expected to be incurred. In addition to this requirement, it was also determined in *Allegheny*,⁶⁷ that a flotation cost adjustment would not be appropriate absent sufficient evidence to show that common stock will be issued in the near term. Applying these standards, here, we find that the Presiding Judge properly excluded the ROE Filing Parties' request for a flotation cost adjustment.

I. Whether ISO New England's ROE Should Be Increased By 100 Basis Points To Encourage Investment in New Transmission

1. Initial Decision

88. The *Initial Decision* rejected the ROE Filing Parties' request for a 100 basis point incentive for new transmission investments. In reaching this determination, the *Initial Decision* found that the issues set for hearing in this case did not include the level of the appropriate ROE adjustment. The issue, rather, focused on the appropriateness of granting any incentive, assuming that the incentive, if approved, would be established at the amount specified by the Commission in the *RTO Order*, *i.e.*, at a 100 basis point level.⁶⁸

89. Next, the *Initial Decision* found that the applicable standard to be applied in addressing the ROE Filing Parties' requested incentive would be the standard specified by the Commission in the *RTO Order*, namely, whether the incentive is needed to incent investment in new transmission facilities.⁶⁹ The *Initial Decision* further found that this standard required proof of some link between the cost of the incentive and the benefits to

⁶⁶ 104 FERC ¶ 61,036 at P 51 (2003).

⁶⁷ 65 FERC ¶ 63,026 at 65,179.

⁶⁸ *Initial Decision*, 111 FERC ¶ 63,048 at P 145.

⁶⁹ *Id.* at P 147, *citing RTO Order*, 106 FERC ¶ 61,280 at P 249.

be derived from it.⁷⁰ The *Initial Decision* also found that the burden of proof, on this issue, as in all section 205 filings, was on the public utility applicant, and that the evidentiary requirements applicable to incentive rates, as set forth in *Farmers Union Cent. Exch. Inc. v. FERC*,⁷¹ should also be followed, namely, the causation requirement set forth in the *RTO Order*, as noted above.

90. In applying this standard, the *Initial Decision* found that the proposed incentive was not required to assist the ROE Filing Parties in obtaining financing for their expansions because the challenges associated with the construction of these projects was not primarily related to the acquisition of capital.⁷² The *Initial Decision* also found that there is no evidence in this record that paying an incentive would lead to the timelier implementation of transmission projects.

91. The Presiding Judge next considered the ROE Filing Parties' cost-benefit analysis, finding that this analysis also failed to justify the requested incentive. Specifically, the *Initial Decision* found that this analysis demonstrated only that the incentive's present value "cost" (\$148.2 million) would be outweighed, under the assumptions relied upon by the ROE Filing Parties, by the resulting "benefit" of \$152 million in two years (\$76 million per year of avoided costs). The *Initial Decision* found that while this analysis may support a finding that the timely construction of ISO New England's planned transmission expansions may be worthwhile, the analysis fails to address the issue of whether the incentive, if allowed, will cause these projects to be built. In addition, the *Initial Decision* found that while the evidence presented by the ROE Filing Parties may have demonstrated the *need* for new transmission, this showing, alone, does not demonstrate why the incentive would be necessary to *effectuate* these expansions.⁷³

92. Finally, the *Initial Decision* found that while the requested incentive might encourage a given transmission owner to push hard for the approval of its project at the state level, the availability of the incentive alone could not affect that transmission owner's *ability* to overcome the problems inherent in siting new transmission. The *Initial Decision* noted that, in fact, local resistance to a given project might even be strengthened by the knowledge that, if built, the project would result in a higher ROE payable by the

⁷⁰ *Id.* at P 158.

⁷¹ 734 F.2d 1486, 1503 (D.C. Cir. 1984) (*Farmers Union*).

⁷² *Initial Decision*, 111 FERC ¶ 63,048 at P 158.

⁷³ *Id.* at P 166.

state's residents. The *Initial Decision* found that, regardless, state regulatory approvals were unlikely to be affected in any significant positive way by the allowance of the ROE Filing Parties' requested incentive.⁷⁴

2. Exceptions

93. The ROE Filing Parties assert that the *Initial Decision* applied a wrong (and far too stringent) standard in this case in determining whether a 100 basis point incentive is appropriate, namely, whether the transmission projects at issue would have been built in the absence of the incentive, taking into consideration all issues (and obstacles) affecting this approval process. The ROE Filing Parties suggest that this standard, if applied by the Commission in this case, would impose a virtually impossible burden on *any* public utility applicant seeking the incentive, with the illogical result being the rejection of an incentive in *every* case in which it is sought. The ROE Filing Parties argue that the implications of the *Initial Decision's* ruling cannot be squared with the Commission's recognition in its proposed policy statement that an incentive can serve a useful role in promoting efficient, necessary expansions of the nation's transmission grids.

94. Accordingly, the ROE Filing Parties propose a more narrowly-focused standard that would take into consideration the conduct of the transmission owner *alone, i.e.*, whether the availability of the incentive will provide critical encouragement to the transmission owner to advocate on behalf of its project. The ROE Filing Parties assert that this interpretation of the Commission's proposed standard would be more consistent with the Commission's recognition in the *RTO Rehearing Order* that the proposed incentive is an appropriate first step in promoting needed transmission investment.

95. The ROE Filing Parties further assert that, applying this standard, here, the findings set forth in the *Initial Decision* would have supported the grant of their requested incentive. Specifically, the ROE Filing Parties point out that the *Initial Decision* found that "the potential application of the 100 basis point incentive to new transmission projects would provide an incentive to [the transmission owners] to use their available resources to get the new transmission built."⁷⁵

⁷⁴ *Id.* at P 167, 233.

⁷⁵ ROE Filing Parties brief on exceptions at p. 45, *citing Initial Decision*, 111 FERC ¶ 63,048 at P 233.

96. The ROE Filing Parties also argue that the *Initial Decision* erred in concluding that the availability of the incentive could not affect the ROE Filing Parties' ability to address the local opposition to their proposed transmission projects. The ROE Filing Parties argue that, in fact, even where an independent entity like ISO New England has confirmed the need for a transmission project, these projects are often highly unpopular and can require the sponsoring transmission owner to expend political capital to move the project forward. The ROE Filing Parties argue, moreover, that this political capital constitutes a limited, finite resource that requires the transmission owner to decide, in a given case, whether to "spend" this capital on local officials and local communities in support of a given transmission project, or whether instead, to allocate this capital to an unrelated project. The ROE Filing Parties conclude that an incentive, if granted in this case, would both motivate and induce the transmission owner to spend its political capital on an eligible transmission project and thus not on a competing, unrelated commodity.

97. The ROE Filing Parties also challenge the *Initial Decision's* finding that a transmission owner, even were it motivated by the allowance of an incentive to push for its project at the local level, could not or would not have the ability to get its project approved. The ROE Filing Parties assert that this finding must be disregarded, given the *Initial Decision's* conflicting finding that an incentive applied to all transmission projects "would arguably provide an incentive to over-build."⁷⁶

98. Finally, the ROE Filing Parties challenge the *Initial Decision's* determination that an incentive, if allowed, would not affect the ability of a transmission owner to acquire capital in support of its project. The ROE Filing Parties argue that the Presiding Judge, in so holding, overlooked the critical issue of how the allowed returns for new transmission projects affect the terms under which capital is available. The ROE Filing Parties note that, theoretically, capital is always available at some price. They submit, however, that investor perceptions will affect the terms under which such capital is available to utilities seeking to construct new transmission, and that currently, investors do not believe that existing returns are sufficient to compensate them for the risks of investing in the transmission business.

⁷⁶ *Id.* at p. 50, citing *Initial Decision*, 111 FERC ¶ 63,048 at P 198.

3. Briefs Opposing Exceptions

99. Staff, the Connecticut Commission, *et al.*, and NECOE oppose the ROE Filing Parties' exceptions regarding the appropriateness of applying a 100 basis point incentive to ISO New England's ROE in this case to incent investment in new transmission. Staff argues that the *Initial Decision* appropriately rejected the ROE Filing Parties' proposed incentive, given the absence of evidence indicating that the proposed incentive would, in fact, yield *any* beneficial system upgrades or *any* new transmission additions in *any* form. Staff and NECOE also assert that the Presiding Judge's causation analysis is consistent with the requirements of the *RTO Order*, which required that applicants seeking the 100 basis point incentive demonstrate why the incentive is required to incent investment in new transmission.⁷⁷ NECOE point out that the ROE Filing Parties could not make this showing.

100. The Connecticut Commission, *et al.* argue that the ROE Filing Parties' proposed incentive is subject to the requirements of *Farmers Union*, where the court held that any deviations from cost-based pricing must be reasonable and consistent with the Commission's statutory responsibility.⁷⁸ The Connecticut Commission, *et al.* submit that to satisfy this burden here, the ROE Filing Parties would have been required to reasonably calibrate the relationship between the increased rates resulting from the incentive and the attraction of new capital. The Connecticut Commission, *et al.* add that only incentives that can reasonably show how the increased rates will attract new capital may be included as an addition to an already just and reasonable base-level ROE.

101. The Connecticut Commission, *et al.* argue that contrary to the proof required by this standard, the ROE Filing Parties offered no evidence in this case attempting to estimate or quantify the effect the requested incentive would have on investment in transmission infrastructure. The Connecticut Commission, *et al.* further assert that there is no evidence in this record demonstrating (or even speculating on) how the incentive, if allowed, would overcome the existing obstacles to constructing new transmission. The Connecticut Commission, *et al.* also challenge the standard proposed by the ROE Filing Parties, which is based on the transmission owner's conduct alone and on whether the transmission owner would be incented to support its own project. The Connecticut Commission, *et al.* suggest that such a test would grant an incentive with *no* showing that

⁷⁷ See also Connecticut Commission, *et al.* brief opposing exceptions at p. 18 (arguing that the ROE Filing Parties failed to show the link between payment of the incentive and any benefits to be derived from it.).

⁷⁸ 734 F.2d at 1503.

the incentive contributed *anything* to eliminating obstacles or completing transmission projects.

102. The Connecticut Commission, *et al.* also assert that an incentive should not be approved in this case based solely on the approval of a transmission project as part of ISO New England's Regional Transmission Expansion plan. The Connecticut Commission, *et al.* note that there is no assurance that projects approved through this process will, in fact, be built.

4. Commission Finding

103. For the reasons discussed below, we will reverse the *Initial Decision*. As an initial matter, the Commission's authority to encourage investment in infrastructure through the application of incentive pricing is not new. The Commission, exercising its existing authority under section 205, has done so for the purpose of encouraging new investment to meet demonstrated needs.⁷⁹ Indeed, the courts have recognized that a primary purpose of the FPA and the Natural Gas Act is to encourage plentiful supplies of energy at reasonable prices, through, among other means, the development of needed infrastructure.⁸⁰ As recently as June of this year, the Court of Appeals for the D.C. Circuit affirmed that the Commission has significant discretion within its ratemaking authority to consider both cost-related factors and policy-related factors (*e.g.*, the need for new transmission investment). In *Maine Public Utilities Commission v. FERC*, the court reviewed the Commission's authority to approve incentive rates, holding that the Commission's determinations "involve matters of rate design . . . [and] policy judgments [that go to] the core of [the Commission's] regulatory responsibilities."⁸¹ The court further stated that, "the court's review of whether a particular rate design is just and

⁷⁹ See, *e.g.*, *Western Area Power Administration*, 99 FERC ¶ 61,306, reh'g denied, 100 FERC ¶ 61,331 (2002), *aff'd sub nom. Public Utilities Commission of the State of California v. FERC*, 367 F.3d 925 (D.C. Cir. 2004); *Michigan Electric Transmission Co., LLC*, 105 FERC ¶ 61,214 (2003); *American Transmission Company, L.L.C.*, 105 FERC ¶ 61,388 (2003), *order approving settlement*, 107 FERC ¶ 61,117 (2004); *ITC Holdings Corp.*, 102 FERC ¶ 61,182, *reh'g denied*, 104 FERC ¶ 61,033 (2003); *Trans-Bay Cable LLC*, 112 FERC ¶ 61,095 (2005), *order granting clarification*, 114 FERC ¶ 61,104 (2006).

⁸⁰ See, *e.g.*, *Pub. Utilities Comm'n of the State of California v. FERC*, 367 F.3d 925, 929 (D.C. Cir. 2004), *citing NAACP v. FPC*, 425 U.S. 662, 670 (1976).

⁸¹ 454 F.3d 278, 288 (D.C. Cir. 2006) (*Maine Public Utilities Commission*). See also *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968).

reasonable is highly deferential.”⁸² The court also rejected the argument that the Commission was required to calibrate the level of benefits that an incentive is designed to produce beyond a finding that the incentive at issue is within the zone of reasonableness.⁸³

104. In considering the ROE Filing Parties’ proposed incentive and the record established in the hearing, we will apply the standard of review established by the Commission in the *RTO Order*, *i.e.*, whether the incentive is needed to encourage investment in new transmission. As we stated in the *RTO Order*, “[a]pplicants seeking this incentive adder [are] required to demonstrate why the adder is needed to incent investment in new transmission facilities”⁸⁴ The *Initial Decision*, however, applied a very different standard of review than the one we established in the *RTO Order*. In response to evidence presented supporting why the incentive was needed for new investment, the *Initial Decision* stated that the evidence, “does not show that the adder will result in building of transmission that would otherwise not be built at all or that the [transmission] projects would be built in a ‘timely’ manner.”⁸⁵ While we agree with the Presiding Judge that the ROE Filing Parties shoulder the burden of proof on this issue, we disagree that this evidentiary burden requires a showing that “but for” the incentive, the projects at issue will not be built.

105. In stating that applicants are required to demonstrate why the adder is needed to incent investment in new transmission facilities in the *RTO Order*, we did not establish an insurmountable burden of proof or require an impossible evidentiary showing. Nonetheless, the *Initial Decision*, by requiring that Applicants meet a “but for” test, did just that. As Staff notes, the hurdles facing new transmission projects include: (i) regulatory approvals; (ii) prudence reviews; (iii) regulatory disallowances; (iv) expenditure of political capital; (v) siting delays; (vi) zoning regulations; (vii) land use requirements; and (viii) public opposition.⁸⁶ Staff further recognized that these risks are “too amorphous to quantify” and that it is “very difficult to measure” the affect to which an incentive can help overcome such obstacles.⁸⁷ We agree and, in fact, we can not conceive of a case in which an applicant could ever make a showing with certainty

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *RTO Order*, 106 FERC ¶ 61,280 at P 249.

⁸⁵ *Initial Decision*, 111 FERC ¶ 63,048 at P 163.

⁸⁶ *Id.* at P 120.

⁸⁷ *Id.*

that absent a 100 basis point incentive (or a one percent increase in the ROE contribution to a project) a transmission project would not be built. Thus, we reject the *Initial Decision's* use of the “but for” test for evaluating whether the proposed 100 basis point incentive is needed for new transmission investment. Rather, consistent with the *RTO Order*, the applicable standard is whether (i) the proposed incentive falls within the zone of reasonable returns; and (ii) there is some link or nexus between the incentives being requested and the investment being made, *i.e.*, to demonstrate that the incentives are rationally related to the investments being proposed.⁸⁸

106. The evidence presented in the hearing satisfies this standard. First, the proposed incentive falls within the zone of reasonable returns for the reasons cited above.⁸⁹ Second, the evidence reviewed below demonstrates a sufficient link between the cost of the ROE incentive and the benefits to be derived from it.

107. We begin with the observation that there is an undisputed need for the projects to which the proposed adjustment will apply, as evidenced by ISO New England's regional planning process and the analyses made pursuant to this process. Under ISO New England's OATT, ISO New England is responsible for independently assessing system reliability and market efficiency needs, providing information about regional system needs to market participants, and identifying regulated transmission solutions in the event a market solution is not forthcoming in response to ISO New England's identified needs.⁹⁰ ISO New England is also required to initiate system enhancement and expansion

⁸⁸ The *Initial Decision* even purports to apply a very similar standard to the facts presented during the hearing. The Presiding Judge stated that, “I read the March 24 Order [*RTO Order*] to require a showing of some link between the cost of the adder and the benefits to be derived from it.” *Id.* at P 158. However, as noted above, the *Initial Decision* ultimately evaluates the proposed adder under a much stricter and practically insurmountable standard.

⁸⁹ Specifically, the proposed 100 basis point incentive would result in an overall ROE of 11.7 percent for the locked-in period ($10.2 + 0.5 + 1.0 = 11.7$) and 12.4 percent for the going-forward period ($10.2 + 0.5 + 1.0 + 0.74 = 12.4$).

⁹⁰ See, *e.g.*, ISO New England OATT at section 48.1:

The Regional System Plan (the “RSP”), including the related system enhancement and expansion studies, shall be completed by [ISO New England]. The purpose of the RSP is to identify system reliability and market efficiency needs and types of resources that may satisfy such needs so that Market Participants may provide efficient market solutions (*e.g.*,

(continued)

studies at least once every three years and to incorporate the results of these studies into ISO New England's Regional System Plan.⁹¹ The criteria for determining which market efficiency needs are included in the completed needs assessment is developed by ISO New England with input from a Planning Advisory Committee.⁹²

108. The 2004 Regional Transmission Expansion Plan (RTEP-04) approved by ISO New England has identified specific projects necessary to satisfy the needs of the region. Based on this independent analysis and the process pursuant to which it was conducted, we can conclude here that the proposed incentive will apply only to projects that are: (i) constructed and brought on line; and (ii) meet a demonstrated need.⁹³

109. We also find that the proposed incentive will assist ISO New England in bringing these projects on line in a timely fashion. Specifically, we agree with the ROE Filing Parties that the proposed incentive will give project owners a significant impetus to push hard for their projects at all phases of the approval process.⁹⁴ As witnesses Scott, Avera,

demand-side projects, distributed generation and/or merchant transmission) to identified needs.

⁹¹ *Id.* at section 48.3(a). In the most recent RSP, ISO New England "identified 272 transmission projects required throughout New England to meet planning criteria. These upgrades are required to reliably serve load and to reduce the need to commit generating units for operating reserves, voltage support, and relief of other transmission constraints. These 272 projects are estimated to cost about \$3.0 billion." Exh. NETOs-25 at p. 10.

⁹² *Id.* at section 48.2. The Planning Advisory Committee provides input to ISO New England concerning the development of the Regional System Plans including input regarding study assumptions, needs assessments, and project options.

⁹³ This need is also borne out by additional evidence in this case. *See, e.g.*, Exh. No. NETO-20 at 2 (U.S. Department of Energy's National Transmission Grid Study); and Exh. No. NETO-21 at 4-5 (prepared testimony of Gordon Van Welie, President and Chief Executive Officer of ISO New England before the House Committee on Energy and Commerce).

⁹⁴ The Presiding Judge made findings that support this conclusion. The Presiding Judge acknowledged, for example, that the requested ROE adjustment will provide an incentive to the transmission owners to use their available resources to ensure that the new transmission is built. *See Initial Decision*, 111 FERC ¶ 63,048 at P 233.

and Schnitzer each testified in this case, utilities can be expected to respond to financial motivations and, in so doing, to expend the time and effort necessary to sell the importance of their projects at the local level.⁹⁵ As witness Schnitzer further testified, an incentive of 100 basis point is sufficient in size to trigger this needed response.⁹⁶ Accordingly, we reject the *Initial Decision's* finding that the availability of the ROE incentive cannot affect a transmission owner's ability to address local opposition to transmission facilities or otherwise affect the process of obtaining regulatory approvals.

110. We also find that the proposed ROE incentive will assist the ROE Filing Parties in obtaining favorable financing terms for their projects. The Presiding Judge agreed that the proposed incentive would, in theory, encourage investment, but then went on to find that the impediments to bringing this new transmission on line are not "primarily" attributable to a lack of capital.⁹⁷ However, we agree with the ROE Filing Parties that the relevant issue, here, is not whether the proposed incentive will allow the ROE Filing Parties to obtain capital irrespective of the financing cost, but whether there is some link between the incentive requested and the investment being made. On this issue, we agree with the ROE Filing Parties that the proposed incentive will have a favorable impact on the terms under which capital can be obtained, which will support the timely construction of the needed transmission infrastructure in ISO New England.⁹⁸ This showing meets our requirement that the applicants demonstrate that the incentives requested are rationally related to the investments proposed.

111. We also find that there will be ratepayer benefits attributable to the proposed incentive. As witness Schnitzer testified, ISO New England's customers are currently burdened with costs attributable to an insufficiently robust grid, including costs attributable to reliability agreements, reliability-must-run arrangements, involuntary load shedding, congestion costs, marginal losses, and stopgap transmission expenditures.⁹⁹ By

⁹⁵ See Tr. 217; 220; 725-727; 955-959; Exh. Nos. NETO-19 at 24-25 and NETO-23 at 31.

⁹⁶ Tr. 988-89.

⁹⁷ *Initial Decision*, 111 FERC ¶ 63,048 at P 158.

⁹⁸ See, e.g., Tr. 67 (witness Scott: It's unlikely that National Grid will not be able to fund its obligations; the question is at what price will we be able to raise the capital to do that and what the share price would be as a result of the effect.').

⁹⁹ See Exh. No. NETO-23 at 15-16.

contrast, the timely, successful completion of the projects identified by ISO New England in its regional transmission plan should assist in minimizing these costs and thus benefiting ratepayers.¹⁰⁰

112. We reject the *Initial Decision*'s finding that an allowance of an ROE incentive could lead to the construction of unnecessary projects. As noted above, the incentive will apply only to projects approved through ISO New England's regional planning process.

113. Finally, we note that the ROE incentive approved here, and the standard used to evaluate the incentive, is consistent with our prior decisions with respect to analogous incentive rate requests¹⁰¹ and is consistent with EAct 2005 and our final rule issued pursuant to EAct 2005.¹⁰² Section 1241 of EAct 2005 is entitled, "Transmission Infrastructure Investment," and requires the Commission to issue a rule that *inter alia* promotes capital investment in the enlargement, improvement, maintenance and operation of transmission facilities. There can be no doubt that Congress, in enacting this provision, desired the Commission to encourage new transmission investment. As we stated in the *Pricing Reform Final Rule*, "the fundamental issue raised by commenters – whether transmission incentives are *necessary* to encourage new infrastructure – was put

¹⁰⁰ Mr. Schnitzer goes on to quantify specific costs and benefits attributable to the ROE incentive, asserting that the total cost of the incentive, on a pre-tax basis, is \$148.2 million, while the *annual* benefits will be at least \$76 million. See Exh. No. NETO-23 at 28-29. However, we need not parse these numbers here or consider the various other less quantifiable benefits attributable to the proposed incentive. See, e.g., Tr. 630-633 and Exh. No. NETO-22 at 9 (discussing the impact of congestion). It is sufficient to note that, on balance, and based on the specific record evidence presented here, the timely, successful completion of ISO New England's requested additions to its transmission grid *will* inure to the benefit of ratepayers.

¹⁰¹ See, e.g., *PJM Interconnection LLC*, 104 FERC ¶ 61,124, at P75 (2003) (requiring a showing of why an incentive adder is needed to promote investment in transmission facilities); *Allegheny Energy, Inc.*, 116 FERC ¶ 61,058 (2006). See also *American Electric Power Service Corp.*, 116 FERC ¶ 61,059 (2006).

¹⁰² See EAct 2005 at section 1241 and *Promoting Transmission Investment through Pricing Reform*, Docket No. RM06-4-000, Final Rule, 116 FERC ¶ 61,057 (2006) (*Pricing Reform Final Rule*), *reh'g pending*. Although both EAct 2005 and the *Pricing Reform Final Rule* followed the close of the record in this case and, therefore, cannot govern the outcome of this proceeding, they do represent current law as well as Congress's and the Commission's most recent policy on transmission pricing and incentives.

to rest by the plain language of [new FPA] section 219(a), which requires the Commission to issue a rule that adopts ‘incentive-based . . . rate treatments.’”¹⁰³ Moreover, in the *Pricing Reform Final Rule* we addressed whether an applicant must show that, but for the incentive, the investment would not be made. Consistent with our decision based on the record in this proceeding, we rejected arguments to impose such a “but for” test for transmission incentives and instead required applicants to demonstrate “some nexus between the requested incentive and the proposed investment being made, *i.e.*, to demonstrate that the incentives are rationally related to the investment being proposed.”¹⁰⁴

J. Whether an ROE Incentive Adjustment for New Transmission, if Allowed, Should Apply to all Transmission

1. Initial Decision

114. The *Initial Decision* found that among the issues set for hearing, was the issue of whether an ROE incentive adjustment for new transmission, if allowed, should apply to all types of transmission expansion or be narrowly focused on transmission expansions that utilize innovative, less expensive technologies.¹⁰⁵ The *Initial Decision* found that if an ROE incentive were found by the Commission to be appropriate in this case, it should *not* be applied to all transmission expansions. Instead, the *Initial Decision* found that this ROE incentive should be applied, if at all, to transmission expansions that can be installed relatively quickly¹⁰⁶ and that utilize innovative, lower cost technologies.¹⁰⁷

2. Exceptions

115. The ROE Filing Parties assert as error the *Initial Decision’s* findings regarding the limited application of any ROE adjustment that may be approved in this case. The ROE

¹⁰³ *Pricing Reform Final Rule*, FERC Stats. & Regs. ¶ 31,222 at P19 (emphasis added).

¹⁰⁴ *Id.* at P 48.

¹⁰⁵ *Initial Decision*, 111 FERC ¶ 63,048 at P 147, *citing RTO Order*, 106 FERC ¶ 61,280 at P 249.

¹⁰⁶ *Id.* at P 211.

¹⁰⁷ *Id.* at P 232.

Filing Parties assert that consistent with the Commission's objectives for promoting all needed transmission upgrades, the 100 basis point incentive should, as requested, apply to all new transmission facilities that are approved by ISO New England through its regional planning office. The ROE Filing Parties add that restricting the ROE incentive adjustment to a more narrow category of transmission upgrades would deny the greatest net benefit to customers that will result from the cost-effective mix of innovative and traditional technologies developed through ISO New England's regional planning process. The ROE Filing Parties add that a determination of what constitutes a transmission technology that is both "innovative" and "less expensive," as proposed by the *Initial Decision*, would be contentious and fact-specific, leading to substantial uncertainty and litigation on the question of whether any given project will qualify for the ROE incentive adjustment.

116. The Connecticut Commission, *et al.* assert as error the *Initial Decision's* findings regarding the appropriate scope for any ROE incentive that may be authorized by the Commission in this case. The Connecticut Commission, *et al.* argue that an ROE incentive would not be appropriate for projects that can be installed relatively quickly, because there is no reasonable benchmark for determining how these projects would qualify under this standard, or whether there would be any system benefit attributable to this allowance. The Connecticut Commission, *et al.* note that projects that can be installed relatively quickly typically involve the replacement of limited existing facilities and thus could provide an incentive to "cherry pick" these projects over competing, more difficult projects that could provide greater system benefits at a comparable price.

117. The Connecticut Commission, *et al.* further argue that the Commission should not approve an ROE incentive for facilities that use so-called innovative, lower cost technologies because such an allowance could produce unjustified windfalls. Specifically, the Connecticut Commission, *et al.* argue that many of these projects may already be subsidized through existing industry and government-funded research and development activities.

3. Brief's Opposing Exceptions

118. Staff and the ROE Filing Parties oppose the Connecticut Commission, *et al.'s* objections regarding the *Initial Decision's* alternative findings. Staff argues that if the Commission does permit an ROE incentive, it would be appropriate, as the *Initial Decision* found, to limit the incentive to transmission projects that can be installed relatively quickly. Staff asserts that ISO New England's regional planning process provides a useful basis for developing benchmarks to measure "relatively quick" installation time. In addition, Staff submits that the Commission is in the best position to determine the types of technologies to which the ROE incentive, if allowed, should apply.

119. Staff also takes issue with the ROE Filing Parties' assertion that their requested ROE incentive, if allowed, should apply to all transmission expansions approved by ISO New England. Staff asserts that the *Initial Decision* correctly found that requiring transmission investments to qualify for the proposed incentive by meeting certain broad and flexible criteria would help ensure that the incentive, if allowed, would function as a true incentive and provide system benefits.

120. Staff claims that an incentive, for facilities that use innovative, lower cost technologies, could produce unjustified windfalls. The ROE Filing Parties argue, in response, that the projects included in ISO New England's regional planning process will produce substantial benefits that will more than offset the cost of the incentive. The ROE Filing Parties further assert that they will not be permitted to cherry pick projects included in the regional planning process, given their obligation to construct *all* projects included in that plan.

121. The ROE Filing Parties also oppose the Connecticut Commission, *et al.*'s exceptions challenging the *Initial Decision*'s alternative finding that the Commission, assuming it approves an incentive, should limit the incentive to transmission expansions that can be installed relatively quickly and utilize innovative, lower cost technologies. The ROE Filing Parties assert that the Presiding Judge correctly concluded that the Commission is capable and in the best position to determine the types of technologies to which the incentive could apply. As such, the ROE Filing Parties reject the conclusion advanced by the Connecticut Commission, *et al.* that would deny the incentive for any upgrade, including those that could be installed relatively quickly.

4. Commission Finding

122. For the reasons discussed below, we will reverse the *Initial Decision*'s finding that the ROE incentive for new transmission, if allowed, should be applied only to new transmission expansions that can be installed relatively quickly and that utilize innovative, less expensive technologies. Instead, we will accept the proposed ROE incentive, as applicable to *all* projects identified as necessary by ISO New England in its regional planning process.

123. Our policy, as it relates to transmission investment, is to promote the development and maintenance of a healthy transmission infrastructure, including the promotion of all transmission projects designed to provide efficient, reliable, and non-discriminatory transmission service.¹⁰⁸ This policy, as set forth in Order No. 2000, has also served as a

¹⁰⁸ See Order No. 2000, FERC Stats. & Regs ¶ 31,089 at 31,003; *RTO Rehearing Order*, 109 FERC ¶ 61,147 at P 206. See also 18 C.F.R. § 35.34(k)(7) (2006):

(continued)

founding principle underlying the establishment of ISO New England's regional planning process, *i.e.*, a process designed to independently assess system reliability and market efficiency needs.¹⁰⁹ This policy will be appropriately served, here, by applying the incentive for new transmission to *all* projects approved as necessary by ISO New England's regional planning process. Granting the incentive to all projects approved through this process will ensure that all decisions relating to technology options, including the cost-effectiveness of these options, will be made fairly and independently by ISO New England.¹¹⁰ We also find that this allowance will not lead to over-building, given the approval process itself and its focus on "necessary" additions.¹¹¹

124. We also agree with the ROE Filing Parties that, as a practical matter, any effort to narrow the scope of the allowed incentive is unworkable and unnecessary. For example, attempting to identify a transmission technology that is "innovative" *and* "less expensive" *and* that can be installed "relatively quickly" may exclude projects that should be encouraged and may be unfair if the measure of these values fails to give sufficient weight to siting considerations, in-service dates, long-term needs, or other important intangibles. A failure to consider each of these factors, or to give sufficient weight to the factors that are considered, could lead to arbitrary results and could provide perverse incentives as it relates to the proposal and selection of new transmission projects.

[An authorized RTO must be] responsible for planning, and for directing or arranging, necessary transmission expansions, additions, and upgrades that will enable it to provide efficient, reliable and non-discriminatory transmission service and coordinate such efforts with the appropriate state authorities. [In addition, the RTO must] encourage market-driven operating and investment actions for preventing and relieving congestion [and] accommodate efforts by state regulatory commissions to create multi-state agreements to review and approve new transmission facilities. [This process must also] be coordinated with programs of existing Regional Transmission Groups . . . where appropriate.

¹⁰⁹ See, *e.g.*, ISO New England OATT at 48.1.

¹¹⁰ See Exh. Nos. NETO-19 at 22 and NETO-29 at 8.

¹¹¹ See Exh. Nos. NETO-19 at 22 and NETO-25 at 5. See also Exh. No. S-7 at 8-9 (noting that ISO New England will have a stronger incentive to select the least-cost solution to a particular problem than would a transmission owner that has financial interest in its own project).

125. In addition, it could be difficult, if not impossible, to “calculate” any qualitative differences between these approved projects, either as a generic matter or in a given case and could lead to an overly litigious process that could operate as a drain on the Commission’s resources.¹¹² This process, moreover, would ultimately defeat the objective of timely, efficient expansions and thus would be counter-productive relative to the Commission’s planning policies.¹¹³ For all these reasons, we will accept the application of the incentive to all projects approved as necessary by ISO New England.

The Commission orders:

The *Initial Decision* is hereby affirmed, in part, and reversed, in part, as discussed in the body of this order.

By the Commission. Commissioner Kelly dissenting in part with a separate statement attached.
Commissioner Wellinghoff dissenting in part with a separate statement attached.

(S E A L)

Magalie R. Salas,
Secretary.

¹¹² As the ROE Filing Parties point out, the Commission would be required to examine each individual transmission project included in each annual update of the regional plan.

¹¹³ The *Initial Decision* acknowledges, for example, that if the ROE incentive is tailored to apply only to innovative, less expensive technologies, additional proceedings would need to be initiated to determine which projects included in ISO New England’s regional plan will qualify. See *Initial Decision*, 111 FERC ¶ 63,048 at P 237.

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Docket No. ER04-157-004

Florida Power & Light Company-
New England Division

Docket No. ER04-714-001

(Issued October 31, 2006)

KELLY, Commissioner, *dissenting in part*:

The discussion in this order regarding the 100 basis point incentive adder troubles me greatly, on both legal and policy grounds. Accordingly, for the reasons set forth below, I respectfully dissent on this issue.

When the Commission sent to hearing the ROE Filing Parties' request to increase their Commission-authorized return on equity (ROE) by 100 basis points for investments in new transmission, it ordered them to "demonstrate why the adder is needed to incent investment in new transmission facilities" and to address "whether the adder should apply to all types of transmission expansion or be more narrowly focused on transmission expansions that utilize innovative, less expensive technology."¹¹⁴ The Presiding Judge required the ROE Filing Parties to provide "a showing of some link between the cost of the adder and the benefits to be derived from [the adder]."¹¹⁵

The majority asserts that the Presiding Judge incorrectly applied an impossible-to-meet "but for" standard in proving why the adder is needed to incent investment in new transmission facilities. The majority also states that the Presiding Judge's test is "a very different standard of review than the one we

¹¹⁴*ISO New England, Inc.*, 106 FERC ¶ 61,280 at P 249 (RTO Order).

¹¹⁵*Initial Decision*, 111 FERC ¶ 63,048 at P 158.

established in the RTO Order.” Assuming, *arguendo*, that the Presiding Judge applied a “but for” standard,¹¹⁶ and assuming even further that this standard is incorrect, the majority nevertheless incorrectly substitutes a standard that is “a very different standard of review than the one we established in the RTO Order,” one that is astonishingly low. In effect, the majority holds that so long as the transmission is needed and is built, and the requested ROE premium does not raise the utility’s ROE above the highest ROE earned by a utility within a proxy group, then it is a justifiable “incentive.” Moreover, the majority approves the adder without requiring the ROE Filing Parties to: 1) provide any specific record evidence of the adder’s need or utility; 2) make the most beneficial transmission investments in return for receiving the adder, or 3) adhere to any benchmarks or performance standards to demonstrate the adder’s efficacy. Just as the majority asserts it cannot conceive of a case in which an applicant could ever meet the Presiding Judge’s “but for” standard, I cannot conceive of a case in which an applicant would ever be denied an incentive under the majority’s new standard. This is not reasoned decisionmaking.

Under FPA section 205(e), as a threshold issue that must be satisfied before a rate case can move forward, the ROE Filing Parties must make a *prima facie* showing that a 100 basis point adder will result in new transmission investment in order to receive the requested adder.¹¹⁷ Because the ROE Filing Parties did not meet their burden of demonstrating that the 100 basis point adder is justified, or

¹¹⁶ I agree with Trial Staff that the Presiding Judge did not necessarily determine that the adder is *only* available for transmission projects that would not be built in the absence of the adder. Rather, as part of her analysis of the standard, the Presiding Judge described the meaning of the “need to incent investment in new transmission” by describing the standard as “how the 100 basis point adder will produce these results,” and “to show why the adder is necessary to provide an incentive to invest in such transmission.” In other words, as Trial Staff asserts, where is the nexus between the adder and the likelihood that it will lead to new transmission? *See Initial Decision* at PP 164-166.

¹¹⁷ The U.S. Court of Appeals for the D.C. Circuit has underscored the importance of specific record evidence to justify the need for incentive adders, noting that in allowing an adder, the Commission’s record evidence must contain “evidence on the need for-- or appropriate size of--such a premium.” *Public Service Comm’n. of Kentucky v. FERC*, 397 F.3d 1004, at 1012 (D.C.Cir. 2005) (rejecting Commission’s proposal to award an RTO participation adder of 50 basis points for failure to place parties on proper notice).

that the adder is needed to attract new capital, I believe the majority is acting arbitrarily and capriciously, and without a reasonable factual foundation, in approving the ROE Filing Parties' proposed adder.

The ROE Filing Parties have failed to provide substantial evidence to justify receiving a 100 basis point adder above the base ROE for investment in new transmission facilities. They offer no evidence that an increased ROE would help in any tangible way to alleviate any external factors that would hamper their efforts to build transmission. They provide no evidence showing how the increased rates will attract new capital for transmission investments,¹¹⁸ nor do they attempt to estimate or quantify the effect the requested adder will have on such investments.¹¹⁹

There is no question that the ROE Filing Parties provided abundant evidence concerning the desirability and benefits of expanding transmission in New England. However, as Trial Staff noted, general statements regarding the overall desirability and benefits of new transmission investments cannot be the sole justification for awarding the 100 basis point *incentive* adder. The whole point of an incentive adder is to overcome some barrier to transmission investment, and it is absurd to pay an incentive in the absence of an adequate showing of whether that incentive can have an effect on any of the critical barriers to transmission investment, such as zoning laws, environmental regulations, or public opposition.

Regardless of what standard the Commission applies in determining whether the 100 basis point adder is needed to incent transmission investments, FPA section 205 requires us to ensure that the rates are just and reasonable. By eliminating a

¹¹⁸ In fact, the Presiding Judge found that in this case, financing would be available to finance new transmission, noting that “the problem is not primarily a lack of capital” and that “the record shows that capital is available.” Indeed, the ROE Filing Parties' own witness conceded that the RTEP projects would be built regardless of whether the adder was granted. *See Initial Decision* at P 158.

¹¹⁹ The ROE Filing Parties' primary argument is that the adder will incent them to spend the “political” capital needed to overcome the obstacles to building new transmission, such as siting, environmental and local concerns. I agree with the Presiding Judge's findings that there is no evidence that any “monetary” capital amassed by a 1% increase in ROE will induce the ROE Filing Parties to spend “political” capital to overcome resistance to building projects, and that local resistance to a given project may be *increased* by the knowledge that, if built, the transmission project would result in a higher ROE for the transmission owner (and, I would add, higher costs to the consumers). *See Initial Decision* at P 167.

showing of need, particularly where, as here, it appears the applicant has adequate access to capital, the Commission is awarding an inflated ROE with no justification. The determination of a “base” ROE is not an arbitrary process; it is based on a careful consideration of the applicant’s risk relative to the companies that make up the proxy group. It relies on a well-tested Discounted Cash Flow (DCF) methodology, which has been upheld as reasonable and reliable by the courts. Only with a proper showing of need can we depart from that reasoned analysis and reset a utility’s ROE.

The adder will apply, without limitation, to all new transmission projects, including those that would have been built without an incentive. Thus, the adder doubly rewards the ROE Filing Parties, at the expense of their consumers, for risks already accounted for in the base ROE and the 50 basis point participation adder already approved by the Commission.

There is simply nothing on the record in this case to demonstrate that consumers will derive any benefit from paying the 100 basis point adder. Moreover, an inflated ROE--above the levels calculated in accordance with existing Commission policy, which are already sufficient to attract capital--will not provide an added incentive to do what the ROE Filing Parties are already legally obligated to do, and, in fact, are already doing.¹²⁰

The majority makes much of the recent *Maine Public Utilities Commission v. FERC* decision, which affirms the Commission’s significant discretion within its ratemaking authority to consider both cost-related factors and policy-related factors, such as the need for new transmission investment. I agree with the court’s findings. However, *Maine Public Utilities Commission* does not reverse or amend Commission precedent, as reiterated in the RTO Order, that an applicant must provide record evidence of why an adder is needed to incent investment in new transmission facilities, nor does it override the Commission’s statutory duty to ensure that rates are just and reasonable.¹²¹

For all these reasons, I disagree with the majority’s finding that the 100 basis point adder is justifiable as an incentive to get more transmission built in New England. Even though I conclude that the ROE Filing Parties failed to justify their 100 basis point adder

¹²⁰ Note that New England transmission owners are contractually obligated to construct a transmission solution that has been identified by ISO-NE as appropriate to address the identified need. *See Initial Decision* at P 116.

¹²¹ Further, the majority’s citation to *Maine Public Utilities Commission* for the proposition that Commission determinations involving matters of rate design are subject to high deference by the courts is inapposite here, where the issue is one of rates, not rate design.

request, I would not have dismissed their application. Rather, I would have remanded the Initial Decision, and allowed the ROE Filing Parties the opportunity to refile a new incentive proposal under the newly enacted section 219(a) of the Federal Power Act and our new *Pricing Reform Final Rule*, consistent with the findings in the pending order on rehearing.¹²² This would have allowed the ROE Filing Parties the opportunity to take advantage of the panoply of incentive options now available in certain circumstances under the Final Rule. This would also have allowed the ROE Filing Parties to propose incentives better tailored to address their needs, including incentives designed to provide better benefits to consumers than an ROE adder, and at a lesser cost.¹²³ Although I cannot prejudge the outcome of such a filing, offering the option would have, at the very least, been fair and appropriate for all parties concerned.

Finally, under the right circumstances, I believe that properly focused incentives, including basis point adders to ROE, may very well be used to overcome either financial or non-financial impediments to transmission expansion. However, in the particular facts of this case, it is the failure of the ROE Filing Parties to provide credible record evidence of *any* link between the proposed incentive adder and alleged barriers to transmission expansion that leads me to conclude that approving the 100 basis point adder is not only arbitrary and capricious, but also sets a precedent such that the Commission will never reject a proposed adder. This turns the concept of “incentive” on its ear, and at the expense of the very customers that the FPA is intended to protect.

¹²² I also believe that this order inappropriately prejudices the outcome of the *Pricing Reform Final Rule*, for which, as noted above, rehearing is pending before the Commission. Several parties have raised concerns on rehearing over the Final Rule’s “nexus” requirement, that is, that it fails to clearly require a causal connection between an incentive and transmission investments. This goes to the very heart of the matter at issue here, yet, in spite of the pending rehearing, the majority notes in this order that its findings on the 100 basis point adder are “consistent with” the final rule, and that the final rule represents “current law...” For example, see the Connecticut Department of Public Utility Control, *et al.*, rehearing request of *Promoting Transmission Investment Through Pricing*, Docket No. RM06-4-000 (asserting, *inter alia*, that the “Commission’s decision to dispense with any showing of need before awarding ROE incentives is contrary to the requirement in Section 219(d) that any rates approved...be just and reasonable”).

¹²³ For example, an ROE adder is a much more expensive way to raise capital than Construction Work in Progress (CWIP) regulatory treatment of new transmission projects.

Docket No. ER04-157-004, *et al.*

6

For these reasons, I dissent in part.

Sudeen G. Kelly

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Docket No. ER04-714-001

(Issued October 31, 2006)

WELLINGHOFF, Commissioner, dissenting in part:

The Commission in this order approves the ROE Filing Parties' request for a 100 basis point incentive adder to their ROE for all new transmission investment. In reaching that conclusion, the Commission reverses the Presiding Judge's finding that the ROE Filing Parties did not satisfy their evidentiary burden. I dissent with respect to that issue because I agree with the Presiding Judge's finding and because I believe that an incentive adder should be more narrowly targeted to promote types of transmission investment that provide incremental benefits, such as increased energy efficiency.

When the Commission established a hearing in this proceeding on the request for a 100 basis point incentive adder, we directed the ROE Filing Parties to "demonstrate why the adder is needed to incent investment in new transmission facilities ..."¹²⁴ In this order, the Commission characterizes the Presiding Judge's approach to that required demonstration as setting an impossible-to-meet "but for" standard. Instead, the Commission relies in part on assertions made by witnesses for the ROE Filing Parties that their companies will respond to the incentive adder by "expending the time and effort necessary to sell the importance of their projects at the local level."

¹²⁴ *ISO New England, Inc.*, 106 FERC ¶ 61,280 at P 249 (2004) (March 2004 Order).

Setting aside the question of whether the Presiding Judge applied too stringent a standard on this issue, there is insufficient evidence to conclude that the ROE Filing Parties have satisfied their burden to demonstrate why the requested adder is needed to incent investment in new transmission facilities. The ROE Filing Parties have already committed to build the projects approved by ISO New England,¹²⁵ and their own witness conceded that the projects would be built without the adder.¹²⁶ In addition, the ROE Filing Parties are already obligated to use every effort to push transmission projects forward,¹²⁷ and the Presiding Judge found that there was “no evidence” that the adder would induce the ROE Filing Parties “to spend ‘political capital’ to overcome resistance to building projects.”¹²⁸ The Presiding Judge further observed that, even if the adder would motivate the ROE Filing Parties to spend such “political capital,” it could also strengthen local resistance to a given project.¹²⁹ Giving due weight to the testimony of the ROE Filing Parties’ witnesses, these considerations lead me to believe that any positive effect that the adder may have on transmission investment would be, at best, highly attenuated. For this reason, I would uphold the Presiding Judge’s finding on this issue.

The Commission also states in this order that we have broad discretion within our ratemaking authority to approve incentive adders.¹³⁰ I do not disagree with that statement. Therefore, the key issue is not whether the Commission has the authority to approve incentive adders, but how we exercise our discretion to do so. To that end, when the Commission established the hearing in this proceeding, it directed the ROE Filing Parties to “demonstrate ... whether the adder should apply to all types of transmission expansion or be more narrowly focused on transmission expansions that utilize innovative, less expensive technologies.”¹³¹ I believe that this question goes to the heart of determining when it is appropriate for the Commission to approve an incentive adder.

¹²⁵ Initial Brief of Commission Trial Staff at 27 (Trial Staff); Initial Brief of Intervenors Connecticut Department of Public Utility Control and Connecticut Office of Consumer Counsel at 44 (Connecticut Commission).

¹²⁶ *Bangor-Hydro Electric Co.*, 111 FERC ¶ 63,048 at P 158 (2005) (Initial Decision).

¹²⁷ Trial Staff at 27; Connecticut Commission at 44.

¹²⁸ Initial Decision at P 167.

¹²⁹ *Id.*

¹³⁰ In support of this statement, the Commission cites *Maine Public Utilities Commission v. FERC*, 454 F.3d 278 (D.C. Cir. 2006).

¹³¹ March 2004 Order at P 249.

The starting point for considering an incentive adder request is the purpose of the base ROE. In setting the base ROE, the Commission balances the interests of shareholders and consumers, recognizing that the base ROE must be sufficiently high to attract capital¹³² and compensate the utility for its risks, including regulatory risk. I fully support the base ROE that we set in this order. I believe that the base ROE provides each utility with an opportunity to earn a reasonable return on its investment, including overcoming the regulatory barriers to transmission investment.

In contrast to the base ROE, an incentive adder should focus on encouraging investment decisions beyond the upgrades required by a utility's service obligations or good utility practice. An incentive adder should be more narrowly targeted to types of investment that provide incremental benefits, such as increased energy efficiency. The Commission in this proceeding previously indicated its interest in specific types of energy efficiency investments, including: (1) improved materials that allow significant increases in transfer capacity using existing rights-of-way and structures; (2) equipment that allows greater control of energy flows, enabling greater use of existing facilities; (3) sophisticated monitoring and communication equipment that allows real-time rating of existing transmission facilities, facilitating greater use of existing facilities; and (4) new or innovative technologies that will increase regional transfer capacity.¹³³ The Commission further stated that these technologies are "fully tested and commercially available," but are not "widely diffused and of sufficient size and scale to have an immediate and meaningful impact on the grid."¹³⁴ Despite these statements, the ROE Filing Parties "provided little evidence" on these issues and, "[d]ue to a general lack of consensus by the parties on the meaning of the terms, the little evidence that was presented was contradictory."¹³⁵ Thus, the record unfortunately includes little evidence that such energy efficiency investments actually will be made.

The Commission's previous statements in this proceeding on energy efficiency investments identified circumstances where the use of an incentive adder is particularly appropriate. Rather than requiring a showing of such an appropriate use, this order makes an incentive adder applicable to virtually all new transmission projects, including those that the record indicates would be built even without that incentive.

¹³² The Presiding Judge found that the availability of capital was not an issue in this case. Initial Decision at P 158.

¹³³ *ISO New England, Inc.*, 109 FERC ¶ 61,147 at P 206 (2004).

¹³⁴ *Id.* at n. 107.

¹³⁵ Initial Decision at P 235.

Docket No. ER04-157-004, *et al.*

4

For these reasons, I respectfully dissent in part.

Jon Wellinghoff
Commissioner