the precedents applicable under Natural Gas Act are equally applicable to a case decided under the Federal Power Act.[27] Rather than adopting this approach, however, we believe that significant differences exist in the electric utility industry and the natural gas pipeline industry which warrant the continued use of different growth rates in the DCF models for each. Accordingly, we will not adopt the Initial Decision's ROE of 9.68 percent and the natural gas pipeline company methodology on which it relies. Instead, we will approve an ROE for SoCal Edison of 11.60 percent, based on the Commission's standard constant growth DCF model, as applied below. Should circumstances in the industry change, in the future, we will reevaluate our methodology, as necessary.

In Opinion No. 396-B, we gave four reasons why the long-term growth of the United States economy as a whole is a reasonable proxy for the long-term growth rate of all firms, including regulated firms in the gas business.[28] First, the record in that case showed that as companies reach maturity over the long-term, their growth slows, and their growth rate will approach that of the economy as a whole. Second, it is reasonable to expect that, over the long-run, a regulated firm will grow at the rate of the average firm in the economy. Third, the purpose of using the DCF model approved in Opinion No. 396-B was to approximate the rate of return an investor would reasonably expect from a pipeline company, and no evidence in that record indicated that investors relied upon any of the alternative long-term growth approaches suggested by the parties in that proceeding. Fourth, each of the witnesses in Opinion No. 396-B used the long-term growth of the economy as a whole as confirmation or support for their analyses.

We find that our rationale in Opinion No. 396-B does not support the use of GDP data in developing a growth rate estimate in this proceeding. Unlike the gas pipeline industry, which was nearly through with major restructuring at the time we issued Opinion No. 396-B, on June 11, 1997, the electric industry is just beginning a significant new phase of its restructuring. In particular, SoCal Edison had just begun to restructure from a vertically integrated utility when it made its filing in the instant proceeding.[29] In addition, in contrast to the growth estimates that underlay the two-step approach for gas pipelines, the current growth rate estimates for SoCal Edison are not two to three times

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[27]Initial Decison, 86 FERC at 65,141.

[28]Opinion No. 396-B, 79 FERC at 62,382-83.

[29]SoCal Edison notes, moreover, that the transmission assets which are the subject of this proceeding, were state-regulated assets, until only recently, earning an 11.6 percent ROE. See SoCal Edison's Brief Opposing Exceptions, at p.4.

greater than GDP. [30] Moreover, the use of a two-step approach in natural gas pipeline company cases is supported by the fact that two large investment firms, Merrill Lynch and Prudential Securities, use the long-term growth of the economy as a whole in their analyses of gas pipeline companies. However, Prudential Securities indicates that it treats electric utilities differently from all of the other industrial companies when estimating growth rates. [31]

Trial staff also notes a number of significant differences between the electric and gas industries.[32] Specifically, trial staff notes that gas pipeline companies are similar to other industrial companies in that they have low dividend payout ratios (i.e., low dividend yields) and that they reinvest a high proportion of their earnings into their businesses to promote future growth.[33] By comparison, electric utilities typically have much higher dividend payout ratios (i.e., high dividend yields) as compared to most other industrial companies, including most gas pipeline companies. As a result, electric utilities reinvest less than a third of their earnings. [34]

This distinction between the two industries is critical, because retained earnings are a key source of dividend growth. The higher payout ratios attributable to electric

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[30]See, e.g., Ozark Gas Transmission System, 68 FERC ¶ 61,032 at 61,104-05 (1994) (Ozark) (growth estimates ranging from 8.81 percent to 15.2 percent and GDP estimates of 5.4 percent); Williston Basin Interstate Pipeline Company, 72 FERC ¶ 61,074 at 61,387 (1995) (growth estimates ranging from 8 to 15 percent and GDP estimates of 5.37 percent and 6.33 percent); and Opinion No. 414-A, 84 FERC at 61,427-7 (growth estimates ranging from 8 percent to 15 percent and GDP estimates of 5.45 percent). By comparison, the IBES growth estimate for SoCal Edison is 5.87 percent. See trial staff's Reply Comments, Att. D-1, at p. 1. GDP estimates range from 4.41 percent to 5.2 percent. See Exh. SCE-97, at pp. 5-7.

[31]See Exh. S-2, Schedule 14, at pp. 1-4.

[32]Trial staff's Brief on Exceptions, at pp. 19-21.

[33]Trial staff also points out that industrial companies, on average, had a payout ratio of 29 percent for the period 1994-97 and a forecasted payout ratio of 24 percent for 2002. Exh. S-2, Schedule No. 15, at p. 2. Gas pipelines had a payout ratio of 45 percent for the period 1993-97 and a forecasted payout ratio of 30 percent for 2002. Id., Schedule No. 13.

[34]Electric utilities had an average payout ratio of 71 percent for the period 1993-97, and a forecasted payout ratio of 68 percent for 2002. Id.

utilities cause these companies to have significantly lower expected dividend growth rates than most other industrial companies (including most gas pipeline companies). For example, the record in this case indicates that while the internal growth rate of gas pipelines averaged 6.05 percent from 1993 to 1997, and is projected to be 9.16 percent in 2002, the internal growth rate of electric utilities averaged only 2.51 percent over the same period, and is projected to be 3.86 percent in 2002.[35] While retention ratios for the electric utility industry, as a whole, are projected to increase slightly, in the future, as noted above, the rate of retention is still significantly lower than the average gas pipeline company. For all these reasons, we find that it would be premature, at this time, to incorporate GDP in the DCF model applicable to an electric utility company.

Nor are we convinced that trial staff's proposed use of DRI data is a reliable source for projecting growth, in this case, for SoCal Edison. Trial staff argues that because the DRI data on which it relies is closely related to total return on common equity, it is both more appropriate than GDP for projecting dividend growth for electric utilities and more likely to be used by investors. However, as the Presiding Judge found, DRI's estimate of return on total capital may be depressed by its anticipated write-offs of stranded costs that are incorporated into its forecasts.[36] Moreover, trial staff has not demonstrated that its DRI projection of growth in total capital equates to the measure of "g" on which the DCF model relies, i.e., growth in dividends per share, as we discuss below.

In the past, we have consistently applied a one-step, constant growth DCF model for calculating ROEs for electric utilities. The DCF methodology determines the ROE by summing the dividend yield (with an adjustment for the quarterly payment of dividends) and expected growth rate. The resulting formula is $D/P(1+.5g) + g = k$, where "D/P" is the dividend yield, "g" is the sustainable growth rate of dividends per share, and "k" is the resulting ROE. The sustainable growth rate 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.[37]

Based on the evidence submitted by trial staff in its Initial Comments, we can calculate an ROE for SoCal Edison using this one-step, constant growth DCF

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[35]See id., Schedule Nos. 10 and 13. A company's internal growth rate is computed as the product of its retention rate and its earned return on equity.

[36]Initial Decision, 86 FERC at 65,142; See also Exh. SCE-55, at p. 9.

[37]Connecticut Light & Power Co., 45 FERC ¶ 61,370 at 62,161, n. 15. (1988).

methodology. We turn first to the growth rate, of "g." From Value Line's growth projections for SoCal Edison's parent company, Edison International, a payout ratio can be calculated by dividing forecasted dividends per share by forecasted earnings per share. The payout ratio, for 1999, is 55.38 percent (based on Value Line's forecasts of dividends per share of $1.08, and earnings per share of $1.95); 52.68 percent for 2000 (based on Value Line's forecasts of dividends per share of $1.08, and earnings per share of $2.05), and 52.73 percent for 2003 (based on Value Line's forecasts of dividends per share of $1.16, and earnings per share of $2.20). The average forecasted payout ratio is 53.6 percent. Consequently, the retention ratio, "b," which is 1 minus the payout ratio, is 46.40 percent.

Value Line also forecasts a return on book value for Edison International, the "r" in the "br+sv" equation. For both 1999 and 2000, that return is expected to be 12.5 percent. It is expected to be 11.5 percent for 2003. The average forecasted "r" is 12.17 percent. However, these are forecasted year-end returns which must be adjusted by the growth in common equity for the period to derive an average yearly return. The average yearly return ("r") is thus 12.52 percent.[38]

Because Edison International is not issuing any new common stock, the external growth rate "sv," in the br+sv model, in this case, is zero.

Consequently, "g" may be calculated as "b" (.4640) times "r" (.1252), for a forecasted growth rate of 5.81 percent. By comparison, the IBES growth forecast for Edison International is 5.87 percent.[39] Using both projections, we will frame the zone of reasonableness in this case by combining the average low dividend yield for the six-month period ending August 1999 (3.96 percent), with the low growth rate (5.81 percent) and the average high dividend yield for this period (4.51 percent) with the high growth rate (5.87 percent).[40] The resulting zone of reasonable returns, as adjusted for the quarterly payments of dividends, is 9.89 percent to 10.51 percent.

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[38] In 1998, SoCal Edison's common equity ratio was 37.4 percent, with total capital of $13.6 billion (the equity component was $5.1 billion). For 2003, Value Line forecasts an equity ratio of 46 percent, with total capital of $14.8 billion (the equity component is $6.8 billion). Therefore, the growth in common equity ("G") is 5.9 percent. The adjustment factor -- $2(1+G)/(2+G)$ is 1.0287, which is applied to the year-end "r".

[39] Trial staff's Initial Comments, Att. D, at p. 1.

[40] Appalachian, 83 FERC at 62,350.

The Supreme Court has provided guidance in two often cited decisions regarding the range of allowed returns that may be permitted in a particular case. In Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia, [41] the Court stated that the approved return should be "reasonably sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit, and enable it to raise the money necessary for the proper discharge of its public duties." [42] In a subsequent case, FPC v. Hope Natural Gas Co., [43] the Court provided additional guidance on this issue:

> From the investor or company point of view, it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock.... By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. The return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital.[[44]]

Applying these guidelines, we will measure the zone of reasonable returns indicated by the above analysis against a group of proxy companies having corresponding risks. A number of alternative proxy groups were proposed in this case by SoCal Edison, trial staff, SMUD, and PG&E. In the original proceeding and its Initial Comments, SoCal Edison relied on a proxy group of 13 companies with operating revenues of over $1 billion, and a bond rating of "A" or "A+." In its Initial Comments, SoCal Edison also developed an alternative proxy group, based on two criteria: companies located in states in which electric restructuring is at a comparable level to SoCal Edison's own restructuring, and companies having comparable bond ratings. [45] Trial staff, by contrast, chose its four-company proxy group based on the following criteria: (1) bond ratings of "AA-" to "A+"; (2) nuclear generation equal to at least 17 percent of total generation; (3)

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[41] 262 U.S. 679 (1923) (Bluefield).

[42] Id. at 693.

[43] 320 U.S. 591 (1944) (Hope).

[44] Id. at 603.

[45] SoCal Edison's alternative proxy group consists of Allegheny Energy Inc., MDU Resources Group, New England Electric System, PG&E, Pacificorp, and Sempra Energy.

a Standard & Poors (S&P) business profile of average or above; (4) $3 billion or more in total revenues, for 1996; and (5) an exclusion of any utility involved in any merger activity.

SMUD also calculated a zone of reasonableness based on a six company proxy group and the following seven criteria: (1) common stock actively traded on the open market and reported in the Wall Street Journal: (2) 80 percent of 1998 operating revenues derived from electric utility operations; (3) consistent financial history lasting for at least the last five years; (4) the exclusion of any utility involved in any merger activity or other significant structural change; (5) nuclear energy operations comprising less than 20 percent of generation fuel base; (6) companies paying dividends for the last ten years; and (7) companies whose non-utility revenues are equal to 15 percent, or less, of total operating revenues. PG&E calculated its proposed ROE utilizing a group of natural gas local distribution companies as a proxy group.

The Presiding Judge adopted trial staff's proxy group and we will do the same for the purpose of confirming our DCF analysis for SoCal Edison. As such, we will reject the proxy groups proposed by SoCal Edison, SMUD, and PG&E. As noted by the Presiding Judge, SoCal Edison's 13 company proxy group is based on overly-broad selection criteria without any emphasis on finding companies that are comparable in risk to SoCal Edison. SoCal Edison's alternative proxy group is a closer fit, however, it too lacks the detailed risk analysis of trial staff's comparable group. Several of the companies included by SMUD in its proxy group are insufficient in size relative to SoCal Edison. In addition, unlike SoCal Edison, five of the companies in SMUD's proxy group have no nuclear facilities. Finally, we will reject PG&E's proposed proxy group, given the significant differences between the gas industry and the electric utility industry, as discussed above.

Trial staff's proxy group, by contrast, includes comparable risk companies that are similar to SoCal Edison in size, business profile, and level of nuclear generation. Moreover, two of the four companies in trial staff's proxy group are currently in a Commission-approved ISO -- PG&E and the Constellation Energy Group (the parent company of Baltimore Gas & Electric Company). Thus trial staff's comparable group is the best proxy group to apply the standards enunciated in Bluefield and Hope.

In calculating our comparison group ROE, we will use the same "br + sv" formula, applied above, and the same Value Line source material relied upon above to calculate

SoCal Edison's individual zone of reasonableness.[46] In addition, we will corroborate the calculated growth rate with the forecasted IBES growth rate to set the high and low end of the zone of reasonableness. The results are summarized in the table below:

	avg. low dividend	avg. high dividend	growth rate (br + sv)[47]	growth rate (IBES)	zone of reasonableness
PG&E	3.63	3.88	4.70	6.153[48]	8.42 - 10.15
Constel-lation	5.63	6.16	4.10	3.85	9.59 - 10.39
Duke	3.74	4.14	7.60	8.13	11.48 - 12.44
Southern	4.81	5.35	5.28	5.85	10.22 - 11.36

An adjustment to this data is appropriate in the case of PG&E's low-end return of 8.42 percent, which is comparable to the average Moody's "A" grade public utility bond yield of 8.06 percent, for October 1999.[49] Because investors generally cannot be expected to purchase stock if debt, which has less risk than stock, yields essentially the same return, this low end-return cannot be considered reliable in this case. Therefore, excluding this single outlier, the resulting zone of reasonableness for the comparable companies is 9.59 percent to 12.44 percent. The midpoint return is 11.02 percent.

We will next consider where, within this zone of reasonable returns, SoCal Edison's ROE should be set. In making this determination, it is necessary to measure the business and financial risks faced by SoCal Edison relative to the overall risks attributable to the appropriate proxy group of companies. As noted above, a substantial body of evidence has been presented in this case arguing for and against the relative riskiness of a utility transferring its transmission assets to an ISO. In addition, SoCal Edison, trial staff, and SMUD attempted to quantify the potential risks associated with SoCal Edison's

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[46]See trial staff's Initial Comments, Att. D-1, at pp. 12-15.

[47]Both Constellation and Duke are forecasted to issue stock.

[48]Exh. SCE-104, at p. 14 (containing a corrected forecasted growth rate of eight percent rather than 39 percent for the one analyst that was excluded from trial staff's calculation).

[49]Exh. SCE-104, at p. 31.

transfer of assets to the California ISO. However, much of this evidence was disputed by one party or another, or was speculative. In addition, much of the evidence submitted by the parties in their Initial Comments and Reply Comments was tied only tangentially to SoCal Edison.

The revised and updated DCF analyses submitted by SoCal Edison, trial staff and SMUD reflect updated investor expectations for SoCal Edison, which are based on more than a year's worth of operating practice by the California ISO. Given the conflicting evidence in this case on the issue of risk, we find that the updated financial data relied upon above is the best quantifiable measure of the investment communities' current risk assessment for SoCal Edison.

SoCal Edison argues that its risks exceed those of the proxy group based, among other things, on the rating of the comparable group's senior secured debt. Except for two of the five Southern Company subsidiaries, which have the same S&P bond rating as SoCal Edison, the rest of the companies in this proxy group are rated "AA-".[50] SoCal Edison's zone of reasonableness (9.89 - 10.51 percent) places SoCal Edison at the lower end of the zone of reasonableness of the comparable companies. This would be a reasonable result, if SoCal Edison was less risky than the comparable companies. However, based on the higher bond ratings of the comparable companies, we find that SoCal Edison is more risky than the comparison group. Therefore, the appropriate ROE for SoCal Edison should be above the midpoint of returns indicated for the comparison group. Therefore, we will establish SoCal Edison's ROE at the midpoint of the upper half of the zone of reasonableness.[51] That zone is 11.02 - 12.44 percent with a midpoint of 11.73. However, because this return exceeds SoCal Edison's own request, we will adjust the indicated return downward to 11.60 percent.

Use of Updated Data

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.[52] Here, however, the re-opened record authorized by the September 17 Order has permitted us to use current data,

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[50] Exh. SCE-102, at p. 18.

[51] See Consumers Energy Company, 85 FERC ¶ 61,100 at 61,364 (1998).

[52] See Appalachian Power Company, 55 FERC ¶ 61,509, order on reh'g, 57 FERC ¶ 61,100 (1991), order on reh'g, 58 FERC ¶ 61,193 (1992).

making any additional updates unnecessary. Consequently, SoCal Edison's ROE will be set at 11.6 percent for the period the rates went into effect and prospectively from the date of this order until SoCal Edison files for a change in its transmission rates.

F. Whether the Presiding Judge Properly Determined the Allocation of Administrative and General Expense and General and Intangible Plant to ISO Transmission

Initial Decision

The Initial Decision found that trial staff's proposed use of labor cost ratios to allocate administrative and general (A&G) and general and intangible plant (G&I) expenses was consistent with the Commission's long-standing policy set forth in Minnesota Power and Light Company, [53] and rejected SoCal Edison's alternative proposal, which relied on a multi-factor allocator. The Initial Decision noted that under SoCal Edison's proposal, A&G and G&I costs would be assigned to generation, ISO transmission, and non-ISO business segments by grouping these costs into one of three cost attribution pools: direct, joint, or common. These costs would then be assigned to the appropriate business segment based on the attribution technique specific to that pool, with the stated objective of limiting the amounts to which general allocation formulas are applied.

The Presiding Judge rejected this approach based, in part, on the Commission's recent reaffirmation of its long-standing use of labor ratios to allocate A&G and G&I expenses. [54] The Presiding Judge also found that while the alternative allocation proposal advanced by SoCal Edison and trial staff lead to different allocations, this difference alone does not prove that one method is superior to the other, nor did it satisfy SoCal Edison's burden of showing that the Commission's existing policy is unjust and unreasonable and that its own proposal was just and reasonable. The Presiding Judge also found that SoCal Edison failed to support its own allocation of its costs, and that the timing of rate cases before this Commission and the California Commission and the restructuring of SoCal Edison's facilities and services did not support the rejection of labor ratios as the preferred allocation methodology.

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[53] 4 FERC ¶ 61,268 (1978).

[54] Initial Decision, 86 FERC at 65,145, citing Portland General Electric Company, 84 FERC ¶ 61,216, at p. 62,004 (1998) and Montana Power Company, 83 FERC ¶ 61,211, at p. 61,935 (1998).

Exceptions

Exceptions were filed by SoCal Edison, in which SoCal Edison renews the arguments presented at hearing concerning the reasonableness of its proposed A&G and G&I allocation methodology. In addition, SoCal Edison states that the Presiding Judge's determination would result in significant under-recovery of its reasonably incurred transmission costs. SoCal Edison contends that the California Commission assumed that these costs would be recovered in transmission rates when the California Commission designed SoCal Edison's state jurisdictional retail rates. SoCal Edison concludes that these costs would be unrecovered due solely to the transfer of jurisdiction over retail transmission from the California Commission to this Commission resulting in an unfair denial of its legitimately-incurred costs.

Trial staff opposes SoCal Edison's exceptions, reiterating its arguments presented at hearing. The California Commission submitted comments stating that SoCal Edison's allegation that the unrecovered costs at issue would "fall through the jurisdictional cracks" is misleading. The California Commission states that Socal Edison filed for and received a resolution action from the California Commission giving SoCal Edison the opportunity to present evidence to the California Commission in order to recover these costs.

Discussions

We will affirm the Initial Decision. The majority of the arguments raised by SoCal Edison on exceptions were presented at hearing and were properly disposed of in the Initial Decision. We also find that the Presiding Judge properly applied the Commission's existing policy for allocating A&G and G&I costs. In addition, the California Commission has made clear in its comments that SoCal Edison has the opportunity, if it so chooses, to seek state jurisdictional review and potential recovery of any non-transmission costs subject to the California Commission's jurisdiction. Given this opportunity, we find that SoCal Edison's claimed inability to recover its legitimately incurred costs, due to changes in jurisdiction, is unfounded.

G. Whether the Presiding Judge Properly Determined that SoCal Edison's Projected 1998 A&G Expenses Should be Rejected in favor of the 1997 Recorded A&G Amounts, as Adjusted

Initial Decision

The Initial Decision rejected SoCal Edison's 1998, Period II test year forecasts to calculate its A&G expenses, adopting instead the California Commission's

recommendation, which was based on SoCal Edison's 1997 Form No. 1 A&G data, with an adjustment to account for its divested oil and gas plants. In support of his holding, the Presiding Judge cited Commission precedent for the proposition that Period II adjustments may be based on more recent actual data.[55] The Presiding Judge also found that the use of this data was appropriate in this case given SoCal Edison's restructuring. and because SoCal Edison's Period II projections were poorly founded.

Exceptions

SoCal Edison and trial staff filed exceptions. SoCal Edison cites Commission policy for the proposition that a utility's test year projections must be accepted if found to be reasonable when made, and there is no evidence that it will produce unreasonable results.[56] SoCal Edison argues that the single fact that its 1998 Period II estimate and its 1997 data vary does not demonstrate that its test period estimate was unreasonable when made. Moreover, SoCal Edison points out that its projected 1998 A&G expense level was based on a significant reduction in its 1995 A&G expenses and was a reasonable projection of the cost reductions it anticipated.

Trial staff argues that no showing was made in this case that use of SoCal Edison's 1997 actual costs are representative of the costs that will be incurred by SoCal Edison during the rate-effective period and that these costs, in any event, would have to be adjusted to reflect future operations. Trial staff also objects to the mixing of data from different years for use of Period II data.

The California Commission opposes these exceptions, citing record evidence showing that SoCal Edison knew when they filed their 1998 Period II estimate that (1) staffing reductions decreased their A&G costs by $70 million as recorded in 1997 Form No. 1 data; (2) that the costs of certain terminated programs should be removed from the A&G projection; and (3) that use of inflation-related escalators was not accurate given the multi-year Performance Based Rate (PBR) cost-cutting measures SoCal Edison had committed to hold constant. Because SoCal Edison failed to incorporate these known changes into their projection, the California Commission supports the Presiding Judge's

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[55]Initial Decision, 86 FERC at 65,176, citing Cleveland Electric Illuminating Company, 28 FERC ¶ 63,089 (1984) (Cleveland Electric), aff'd in relevant part, 32 FERC ¶ 61,381 at 61,858 (1985); Southern California Edison Company, 56 FERC ¶ 61,003, at 61,021-24 (1991).

[56]SoCal Edison's Brief on Exceptions, at p. 58, citing Delmarva Power & Light Company, 24 FERC ¶ 61,199 at 61,453 (1983).

finding that the estimates were not reasonable when made. In addition, the California Commission refutes SoCal Edison's interpretation of the case law, stating that in Cleveland Electric adjustments were made to the historic data because that was the only data available at the time, as opposed to this case where 1997 Form No. 1 data is available.

Discussion

None of the exceptions warrant reversing the Presiding Judge's determination in this proceeding that SoCal Edison's Period II estimate is unjust and unreasonable. The Presiding Judge's reasoning that the use of 1997 adjusted Form No. 1 data is more likely to yield just and reasonable results than SoCal Edison's poorly supported Period II estimates is well-supported by the record evidence. The approach adopted by the Presiding Judge is acceptable in this situation because of the unique facts of this case. As noted by the Presiding Judge, SoCal Edison drastically restructured and downsized its previous utility operations, divested substantial generation assets and turned over its transmission facilities to the ISO. Their escalation of 1995 A&G data in this proceeding was unwarranted given the cost cutting incentives under the PBR when SoCal Edison made its test year projections. As noted by the Presiding Judge, So Cal Edison has the burden of showing that its projections were reasonable when made, but it has not done so. Given the unique facts of this case we will affirm the Initial Decision.

H. Whether the Presiding Judge Properly Determined the Level of SoCal Edison's Cost-Based Ancillary Services Rates for the Locked-In Period, April 1, 1998 - November 2, 1998

Initial Decision

The Initial Decision found that SoCal Edison's proposed cost-based bid caps for four ancillary services for the locked-in period April 1, 1998 through November 2, 1998 [57] should not be based on the cost of SoCal Edison's oil and gas generation facilities, as proposed by SoCal Edison, but rather on SoCal Edison's hydro resources, as proposed by trial staff. The Presiding Judge further found that SoCal Edison's proposed bid caps

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[57] The locked-in period was the result of the Commission's ruling in AES, 85 FERC at 61,459-65, in which the Commission granted market-based rate authority to all entities providing ancillary services in the State of California, based on our determination that cost-based bid caps in the ancillary services market were restricting supplies to these markets .

should be based on a trial staff study of 1997 FERC Form 1 data for its Hoover and Big Creek costs.

The bid caps established the maximum amount SoCal Edison could bid in the ISO's ancillary service markets during the period that the cost-based rates were in effect. SoCal Edison's filing states that these proposed rates were an interim measure to continue their existing ancillary services rates until the company completed the market study required for filing for market-based ancillary service rates.[58]

In support of its ruling, the Initial Decision noted trial staff's contention that because these facilities were divested during the period that the proposed ancillary service bid caps were in effect, the rate should be based on SoCal Edison's remaining hydro units. Even though SoCal Edison owned oil and gas-fired generation facilities through part of June 1998, trial staff maintained that SoCal Edison did not use these units for ancillary services during any part of the locked-in period. Only trial staff objected to the continued use of SoCal Edison's rates, maintaining that SoCal Edison's bid caps were in excess of the actual costs of the units that provided the services during the locked-in period.

Exceptions

On exceptions, SoCal Edison argues that its proposed ancillary services bid caps are significantly below the levels that the Commission found to be just and reasonable in AES, and are otherwise fully cost-justified. In particular, SoCal Edison notes that some of the ancillary services it provided during the relevant time period did in fact rely on SoCal Edison's oil- and gas-fired units. Moreover, SoCal Edison argues that its ancillary services sales are subject to the Commission's policy regarding off-system sales, as enunciated in Illinois Power Company,[59] which permits pricing flexibility not necessarily tied to the actual generating resource used to provide the service at issue.

In addition, SoCal Edison takes exception to various methods and calculations of cost used by trial staff to determine alternative ancillary service rates based exclusively on SoCal Edison's individual hydro units. SoCal Edison maintains that its proposed ancillary services bid caps are below costs that it experiences in providing ancillary services from its hydro resources.

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[58] SoCal Edison's Transmittal Letter at 18, n. 5.

[59] 57 FERC ¶ 61,213 at 61,699 (1991) (Illinois Power).

Discussion

We find that the Presiding Judge's rejection of SoCal Edison's cost-based ancillary services bid caps, for the locked-in period, is in error. First, we agree with SoCal Edison that its proposed bid caps are cost-justified and consistent with our ruling in Illinois Power. The reasonableness of these rates, moreover, is confirmed by trial staff's own analysis, which would support a maximum rate well above SoCal Edison's proposed bid caps.[60]

We reject trial staff's contention that ancillary service bid caps must reflect the actual costs of the individual unit supplying the ancillary service at the time of sale. The ISO's ancillary services market is based on an auction mechanism in which suppliers submit hourly bids that are put in merit order, with the market clearing price paid to all bidders who are selected. As a result, during the locked-in period, all units which provide ancillary services for that hour receive the market clearing price capped at their respective cost-based bid caps. This market clearing mechanism does not comport with the theory trial staff espouses for tracking the exact costs of the actual generating unit used to supply a particular service.

Given the circumstances of this case and the state of the ISO ancillary services markets during the locked-in period, we reject the Presiding Judge's finding that trial staff's ancillary service bid caps are representative of the ceiling costs of these services during the locked-in period. For the reasons discussed above, we approve SoCal Edison's proposed ancillary service bid caps, as filed.

The Commission orders:

(A) The Initial Decision is hereby vacated in part, affirmed in part, and reversed in part, as discussed in the body of this order.

(B) The motions to intervene filed by EEI, ELCON, AISI, and the ISO Participants are hereby granted, as discussed in the body of this order.

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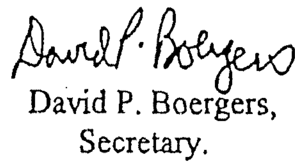
[60] Trial staff calculated the unit-by-unit costs for SoCal Edison's hydro generation resources, resulting in a maximum capacity charge of $26.02/MW/hr. See Exhibit S-4, at 16-18 and Exh. S8). In contrast, SoCal Edison's proposed ancillary services bid caps ranged from $4.47/MW/hr to $9.55/MW/hr. See TO Tariff and DA Tariff at Original, Sheet Nos. 74 through 78.

(C) SoCal Edison is hereby directed to file, within 45 days of the date of this order, a compliance filing addressing those matters discussed herein. However, if a request for rehearing is pending at the end of the 45 day period, the compliance filing shall be made within 15 days of the date such rehearing is disposed of by the Commission.

By the Commission.

(S E A L)



David P. Boergers,
Secretary.

98 FERC ¶ 61,333

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Consumers Energy Company

Docket No. OA96-77-000
Docket No. ER97-1502-000
Docket No. ER98-1247-000

OPINION NO. 456

OPINION AND ORDER AFFIRMING IN PART AND REVERSING IN PART INITIAL DECISION

Issued: March 27, 2002

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UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Consumers Energy Company

Docket No. OA96-77-000
Docket No. ER97-1502-000
Docket No. ER98-1247-000

OPINION NO. 456

APPEARANCES

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Cheryl M. Feik, Esq., Gary D. Bachman, Esq., and Jay T. Ryan, Esq. on behalf of Edison Sault Electric Company

Mark S. Hegedus, Esq., Thomas C. Trauger, Esq., Robert A. Jablon, Esq., Thomas J. Byrne, Esq., and Sara C. Weinberg, Esq., on behalf of Michigan Public Power Agency, Michigan South Central Power Agency, Wolverine Power Supply Cooperative, and Michigan Public Power Rate Payers Association

David D'Alessandro, Esq., on behalf of Michigan Public Service Commission

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UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Pat Wood, III, Chairman;
William L. Massey, Linda Breathitt,
and Nora Mead Brownell.

Consumers Energy Company

Docket No. OA96-77-000
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OPINION AND ORDER AFFIRMING IN PART AND
REVERSING IN PART INITIAL DECISION

(Issued March 27, 2002)

I. Introduction

This proceeding, which involves certain rate filings by Consumers Energy Company (Consumers), is before the Commission on exceptions to an Initial Decision.[1] While the Commission for the most part affirms the judge's decision, we must reverse certain aspects of his resolution of Consumers' appropriate rate of return on equity, in order to ensure consistency with our precedent and fairness to customers.

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[1]Consumers Energy Co., 86 FERC ¶ 63,004 (Initial Decision), corrected, 86 FERC ¶ 63,005 (1999).

II. Background

To comply with the Commission's Order No. 888,[2] Consumers filed its open access transmission tariff in Docket No. OA96-77-000 on July 9, 1996. The Commission subsequently set Consumers' rates for hearing, along with those of other, similarly-situated utilities.[3] In Docket No. ER97-1502-000, Consumers filed an unexecuted transmission service agreement (TSA) and a network operating agreement for service to the Municipal Cooperative Coordinated Pool (MCCP)[4] under Consumers' open access transmission tariff. On April 1, 1997, the Commission accepted the agreements for filing, suspended and made them effective subject to refund, and established hearing procedures.[5] The proceedings were later consolidated.

On December 30, 1997, Consumers filed in Docket No. ER98-1247-000, an unexecuted TSA for service to the MCCP from January 1, 1998, to December 31, 1998, to replace the TSA filed in Docket No. ER97-1502-000. In all material respects, this TSA had the same terms and conditions as the prior one. On February 27, 1998, the Commission issued an order accepting the TSA for filing, suspending and making it effective subject to refund, establishing hearing procedures, and consolidating this docket with the ongoing proceedings.[6]

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[2]Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities and Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, Order No. 888, 61 Fed. Reg. 21,540 (May 10, 1996), FERC Stats. & Regs. ¶ 31,036 (1996), Order No. 888-A, 62 Fed. Reg. 12,274 (March 14, 1997), FERC Stats. & Regs. ¶ 31,048 (1997), order on reh'g, Order No. 888-B, 81 FERC ¶ 61,248 (1997), order on reh'g, Order No. 888-C, 82 FERC ¶ 61,046 (1998), aff'd in relevant part, Transmission Access Policy Study Group, et al. v. FERC, 225 F.3d 667 (D.C. Cir. 2000), aff'd, New York v. FERC, 122 S.Ct. 1012 (2002).

[3]American Electric Power Service Corp., et al., 78 FERC ¶ 61,070 at 61,269 (1997). The non-rate terms and conditions of the tariff had previously been accepted for filing. Allegheny Power System, Inc., et al., 80 FERC ¶ 61,143 (1997).

[4]MCCP is comprised of the Michigan Public Power Agency (MPPA) and the Wolverine Power Supply Cooperative, Inc.

[5]Consumers Power Co., 79 FERC ¶ 61,001 (1997).

[6]Consumers Energy Co., 82 FERC ¶ 61,206 (1998).

A hearing was conducted in the consolidated proceedings in which Consumers, the Michigan Systems (Michigan Systems,[7] the Association of Businesses Advocating Tariff Equity (ABATE), the Board of Public Works of the City of Holland, Michigan (Holland), The Michigan Public Service Commission (MPSC), Edison Sault Electric Company (Edison Sault), and Commission Trial Staff (Staff) all participated. The Initial Decision was issued on January 14, 1999.

Briefs on exceptions to various issues resolved by the Initial Decision were filed by Consumers, Michigan Systems, and Staff. Briefs opposing exceptions were filed by Consumers, Michigan Systems, Holland, ABATE and Staff.

Of the issues resolved by the Initial Decision, we address only certain aspects of Initial Decision's setting of Consumers' rate of return on equity.

As to the remaining issues, the Commission finds, having reviewed the Initial Decision, the record and the parties' briefs, that they were properly resolved by the Initial Decision. We therefore deny the exceptions and summarily affirm and adopt the Initial Decision as our own decision on the following issues: (1) Consumers' facilities deemed part of rate base; (2) credits for customer-owned facilities; (3) voltage-differentiated rate structure; (4) rate treatment of generator step-up transformers; (5) rate treatment of dedicated lines and substation investments; (5) materials and supplies and prepayment components of working capital; (6) taxes; (7) revenue credits; (8) plant held for future use; (9) all issues with respect to the proper rate divisors of Consumers' annual revenue requirement; (10) treatment of real power loss factors; (11) treatment of ancillary service rates; (11) all issues with respect to energy imbalance service; (12) supplemental reserve service issues; and (13) rate treatment of general advertising expense.

III. Discussion

There are several areas of disagreement concerning the parties' approach to calculating the proper rate of return for the locked-in period of January 1, 1997 to December 31, 1999: the appropriate proxy group to use in making this determination; the appropriate growth rate to be used in the Discounted Cash Flow (DCF) formula; the appropriate dividend yields to use in the DCF formula; and where the rate should be set within the zone of reasonableness. We discuss these issues seriatim.

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[7]Michigan Systems consist of the MPPA, Michigan South Central Power Agency, Wolverine, and Michigan Public Power Rate Payers Association.

A. Proxy Group

Initial Decision

The Initial Decision employed Consumers' proxy group. As the judge explained, Consumers' witness on this issue included in the proxy group companies whose business was primarily electrical operations, and were comparable to Consumers' vis-a-vis their bond ratings, equity ratios, net plant size, and geographical location.[8] The proxy group in question consisted of five companies: Atlantic Energy, Inc., Delmarva Power & Light Company, Illinova Corporation, Minnesota Power & Light Company, and PP&L Resources, Inc.

The judge rejected Staff's proposed proxy group because he deemed several of the companies included not to be comparable to Consumers. Specifically, he was concerned that one of the group, CMS Energy, carried "baggage" of significant non-electric business, while another, Rochester Gas & Electric, not only had significant non-electric revenues but also an equity ratio unlike Consumers. The judge also disagreed with the Staff's choice of Eastern Utilities Associates (EUA), with a plant significantly smaller than Consumers', and which operates in New England, "where climate and meteorological conditions are different from the Midwest where [Consumers] operates."[9]

Exceptions

On exceptions, Staff maintains that the presiding judge should have used its proposed proxy group, which was based on companies substantially similar to Consumers in terms of business and financial risk factors. Indeed, Staff observes, the Commission had approved the use of this proxy group in setting Consumers' rate of return in an earlier proceeding.[10] Staff also takes issue with the judge's finding that EUA was not a suitable proxy choice because it was located in a different region and climate than Consumers.[11]

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[8] 86 FERC at 65,023, citing Exh. No. CE-25 at 45.

[9] Id. at 65,024 (footnote omitted).

[10] Staff Brief on Exceptions at 6, citing Consumers Energy Company, 64 FERC ¶ 63,029 at 65,133 (1993), aff'd, Opinion 429, 85 FERC ¶ 61,100 at 61,361 (1998).

[11] Michigan Systems supports Staff's arguments on the proxy group. Michigan Systems Brief on Exceptions at 55.

Consumers asserts in reply that the presiding judge correctly concluded that Consumers' proposed proxy group provided a better comparison than that proposed by Staff. Consumers also argues that Staff's group was based on inappropriate criteria in various particulars.

Finally, Consumers argues that Opinion No. 429 is irrelevant, because on the record presented here, it has proposed the more representative proxy group.[12] In any event, Consumers asserts, if the same criteria employed in the prior proceeding were applied to the instant case, it would not support the use of Staff's proxy group.

Commission Decision

The Commission affirms the Initial Decision on the use of Consumers' proxy group. Staff has not demonstrated that the group was unrepresentative of Consumers or an unreasonable choice in any other particular.

While our conclusion that the judge's choice was reasonable is sufficient to decide this issue, two further points deserve mention. First, we agree with Consumers that the decision on this issue should be based on the record of this proceeding, and not extrapolated from the determination made in a prior case. Second, we agree with Staff that the judge should not have eliminated EUA as a proxy choice solely because of geographical or climatic differences. However, this error does not undermine his analysis in support of choosing Consumers' group.

B. Dividend Yields

Initial Decision

On dividend yield, the Initial Decision noted that Consumers had calculated the current dividend yield of its proxy group by determining the closing stock price for each day over six months and calculating an average closing price over the six months. As the judge explained:

> The quarterly dividend used to complete the calculation was the latest recorded dividend from the Value Line Survey at the time of the study. . . . This quarterly amount was annualized by multiplying by four. Monthly yield calculations were then

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[12]Consumers' Brief on Exceptions at 39.

> performed for each company by dividing the annualized dividend by the average stock price for each month.[13]

However, the judge agreed with Staff that the company's proposal was not representative of recent trends, and more current dividend yield information in the record should be used to determine the appropriate dividend yield for Consumers' proxy group to be used in the DCF formula.[14] Thus, he developed "composite" dividend yield figures by averaging the yields proposed by Consumers and those proposed by Staff.[15]

Exceptions

Staff contends that the presiding judge's fusion of a current growth rate with outdated dividend yield results in a distorted growth picture, "since both growth and dividend yields were changing over this period."[16] Staff further observes that the exhibit on which the Initial Decision relies on this point, Exh. No. S-58, "was accepted only for the limited purpose of supporting the growth rate in Exh. [No.] S-56, and cannot be used for other purposes."[17] According to Staff, the dividend yield of its witness Mr. Green, using data from the most recent six-month period, is in accord with Commission precedent and should be employed here.[18] Staff also criticizes the data on which Consumers relies to derive its dividend yield as being outdated.[19]

Consumers agrees that the judge improperly relied on Exh. No. S-58, and should have used its proposed dividend yield, using six-month dividend yields for each of its

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[13]86 FERC at 65,026 (citation omitted). The dividend yields, adjusted to reflect that dividends are paid quarterly, are depicted in Exh. No. CE-54, which is Appendix A to this order.

[14]86 FERC at 65,056, citing Exh. No. S-58.

[15]Id.

[16]Staff Brief on Exceptions at 16, citing Exh. Nos. S-49, S-50, and S-56.

[17]Id., citing Tr. 723.

[18]Id., citing Panhandle Eastern Pipeline Company, Opinion No. 404, 74 FERC ¶ 61,109 at 61,362-63 (1996).

[19]Staff Brief Opposing Exceptions at 16.

proxy companies.[20] Consumers asserts that Staff misconstrues Opinion No. 404, which it views as expressing a preference for using the most recent six months of data for an already-established proxy group.[21]

Commission Decision

The Commission agrees with Staff and Consumers that the judge's reliance on Exh. No. S-58 was improper. Thus, we must reverse the Initial Decision on this issue.

The question then becomes what data should be used to calculate dividend yield. As the Commission prefers to use the most recent dividend yield data available, we will use Exh. No. CE-54, which contains the most recent dividend yield in the record for the proxy group.

C. Growth Rates

Initial Decision

On the issue of growth rates to be used in the DCF formula, the judge believed that the Commission precedent in natural gas pipeline cases indicated that a two-stage model for determining growth was appropriate.[22] Under this approach, he indicated, the Commission had used "growth rate projections for a five-year [] averaged with longer term growth rate projections."[23] He further observed that the Commission had most recently given two-thirds weight to the short term growth rate and one-third weight to the longer term growth rate.[24]

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[20]Consumers Brief on Exceptions at 23, 28-29, citing Exh. No. CE-54

[21]Consumers observes that in Williston Basin Interstate Pipeline Company, 84 FERC ¶ 61,081 at 61,382 (1998), the Commission rejected the approach taken by Staff here. Consumers Brief on Exceptions at 26-27.

[22]86 FERC at 65,024, citing Northwest Pipeline Corp., 79 FERC ¶ 61,309(1997); Williston Basin Interstate Pipeline Co., 79 FERC ¶ 61,311 (1997).

[23]Id.

[24]Id., citing Opinion No. 414-A, Transcontinental Gas Pipe Line Corp., 84 FERC ¶ 61,084 (1998); Williams Natural Gas Co., 84 FERC ¶ 61,080 (1998).

The judge denied Staff's proposal to employ DRI/McGraw-Hill, Inc.'s World Energy Service U.S. Outlook (DRI) return on capital projections, rather than the GDP forecast preferred by the Commission for the long term growth component of the two-stage return analysis. In this context, the judge also rejected Michigan Systems' argument that the return should be set as if the Company was a transmission only entity as "not developed sufficiently on the record."[25]

Thus, the judge employed gross domestic product (GDP) projections, which had been used to measure long term growth for natural gas pipelines, for the long term growth component of a two-stage growth rate calculation. For the short term growth rate component, he accepted Staff's proposed use of the short term (5-year) growth rate published by Institutional Brokers Estimate Service (IBES) as in accord with Commission precedent.

Exceptions

Staff argues that the Initial Decision erred in rejecting its use of DRI return on capital as a proxy for long-term growth rates. In this context, Staff criticizes the judge's reliance on precedent in natural gas pipeline cases because of significant dissimilarities between the natural gas and electric industries. Consumers argues that the judge properly relied on the natural gas pipeline precedent. We need not address the parties' contentions in any detail, however, because of later developments in this area, discussed below.

Commission Decision

Subsequent to the close of briefing in the instant case, the Commission issued two decisions discussing the appropriate manner in which to set the return on equity in electric rate cases, Opinion No. 445[26] and Opinion No. 446.[27]

In the proceeding reviewed in Opinion No. 445, the presiding judge had applied the two-step DCF model employed in natural gas pipeline cases in determining the rate of return for Southern California Edison Company (SoCal Edison). The Commission

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[25] Id.

[26] Southern California Edison Company, Opinion No. 445, 92 FERC ¶ 61,070 (2000), reh'g pending.

[27] System Energy Resources, Inc., Opinion No. 446, 92 FERC ¶ 61,119 (2000), reh'g denied, Opinion No. 446-A, 96 FERC ¶ 61,165 (2002).

reversed the Initial Decision on this point, explaining that "significant differences exist in the electric utility industry and natural gas pipeline industry which warrant the continued use of different growth rates in the DCF models for each."[28]

The Commission relied on several factors in reaching this conclusion. First, the Commission stated that while the natural gas pipeline cases using GDP data to develop a growth rate estimate involved an industry's restructuring that was "nearly through," the electric industry's restructuring was just entering into a "significant new phase."[29] Second, "in contrast to the growth estimates that underlay the two-step approach for gas pipelines," the growth rate estimates for SoCal Edison were not two to three times greater than GDP.[30] Third, at least one large investment firm had indicated that it treated electric utilities differently from other companies when estimating growth rates.[31] Finally, the Commission found that electric utilities have a much higher dividend payout ratio than most natural gas pipeline companies (and most other industrial companies), so that they have a much lower level of retained earnings, which are a key source of dividend growth.[32] Opinion No. 445 also rejected Staff's proposed use of DRI data as a reliable source for projecting growth.[33]

Thus, the Commission in Opinion No. 445 concluded that there was no reason to deviate from its "consistently applied . . . one-step, constant growth DCF model for calculating ROEs for electric utilities."[34]

Similarly, in Opinion No. 446, setting rate of return on equity for System Energy Resources, Inc., the Commission once again determined that, unlike natural gas pipeline proceedings where the record demonstrated that short-term growth rate was not representative of the long-term growth rate, the record "did not support using industry or

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[28]Opinion No. 445, 92 FERC at 61,261.

[29]Id.

[30]Id.

[31]Id. at 61,262.

[32]Id.

[33]Id.

[34]Id. at 61,263.

general economic data to develop a long-term growth rate for electric public utilities."[35] In addition to the factors relied upon in Opinion No. 445, the Commission observed that the changing environment for electric utilities rendered long-term forecasts unreliable.[36]

While the parties and the judge did not have the benefit of our decisions in Opinion No. 445 and Opinion No. 446, they are the appropriate precedent to apply in this proceeding. The Commission therefore reverses the Initial Decision's use of a two-step growth rate methodology. Instead, Consumers' rate of return on equity should be calculated using the one-step, constant growth methodology.

In Opinion No. 445, the Commission considered both IBES estimates and growth projections derived under the br+sv model. However, since the record in this proceeding does not contain br+sv numbers for the proxy group at issue, we will rely on IBES estimates; they are shown on Appendix A to this opinion.

D. Setting the Rate of Return Within the Zone of Reasonableness

Initial Decision

The judge established that a zone of reasonableness for the locked-in period of 10.27 to 12.09 percent had been justified on this record. He determined that the return within that range most appropriate for Consumers was 11.09 percent, the median of the range of reasonableness, "because no special circumstances have been demonstrated on this record that would justify selection of the low or high end of the indicated range."[37]

Exceptions

Consumers contends that in natural gas pipeline cases, the Commission has taken into consideration the pipeline's risk as compared to that of the proxy companies, particularly by measuring their relative equity ratios, in setting the rate of return.[38] Thus,

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[35]Opinion No. 446, 92 FERC at 61,144.

[36]Id. at 61,445 (footnotes omitted).

[37]86 FERC at 65,056, citing Opinion No. 414-A.

[38]Consumers Brief on Exceptions at 32-33, citing Opinion No. 414, Transcontinental Gas Pipe Line Corp., 80 FERC ¶ 61,157 at 61,669, 61,673 (1997):

(continued...)

Consumers argues, because the record here demonstrates that "[t]he proxy group, as a whole, reflects less risk and more stability than [Consumers]," the return on equity should be set at the upper end of the range of reasonableness.[39]

Michigan Systems, on the other hand, argues that the record supports setting the rate of return at the low end of the range of reasonableness, because the rate at issue is for transmission service only, "which represents a lower risk profile than that faced by the proxy companies used in the DCF calculations."[40]

Staff agrees that the judge's use of the median of the zone was in keeping with Commission precedent,[41] and that the record does not support the contention that Consumers faces risks greater than its proxy group.[42]

Commission Decision

Our analysis of the record indicates that to the extent that there is any merit to Consumers' and Michigan Systems' assertions, they essentially cancel each other out. We agree with the Initial Decision, and with Staff, that the rate of return should not be set at the high or low end of the range. However, the Commission reverses the judge's use of the median of the zone, rather than the midpoint. The precedent on which the judge and Staff rely in this instance was developed in the context of setting the rate of return for gas pipelines. In this case, there has been no reason provided to depart from our precedent in Opinion Nos. 445 and 446, setting the return at the midpoint of the zone of reasonableness.

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[38](...continued)
Northwest Pipeline Corp., Opinion No. 396-B. 79 FERC ¶ 61,309 at 62,385 (1997); TransColorado Gas Transmission Company, 67 FERC ¶ 61,301 at 62,026 (1994).

[39]Id. at 35, citing Exh. Nos. CE-59 at 27; CE-112 at 9.

[40]Michigan Systems Brief on Exceptions at 60. In this regard, Michigan Systems relies on Exh. No. MS-41 at 11; Exh. No. CE-59 at 27-28; Tr. 623-33.

[41]Staff's Brief Opposing Exceptions at 19, citing Michigan Gas Storage, 87 FERC ¶ 61,038 (1999) and Opinion No. 414-A, 84 FERC at 61,427-4.

[42]Id. at 21-22. Staff particularly refers to the testimony of Consumers' witness Mr. Ernst, who conceded that the company did not face more risk than other companies due to electric industry restructuring or Clean Air Act regulation. Id. citing Tr. 626-27.

E. Conclusion

Consistent with Opinion No. 445, the Commission begins the calculation of an appropriate return on equity for Consumers by determining a zone of reasonableness based on our proxy group. The first step in the process is to determine the high and low monthly average dividend yields from the most recent six months of data in the record. As we have explained above, Exh. No. CE-54 contains that data. The first two columns in the chart based on that data (Appendix A to this opinion) indicate the associated low and high dividend yields.

The next step is to adjust these dividend yields to reflect the quarterly payment of dividends.[43] The results of this adjustment are shown in the third and fourth columns of Appendix A. The IBES estimates of growth rates are shown in column five. Column six provides the results of combining the growth rate with the high and low adjusted dividend yields. Thus, based on Exh. No. CE-54, the zone of reasonableness is 10.56 percent to 12.98 percent for the locked-in period at issue.

Consumers' appropriate rate of return in this case is therefore 11.77 percent, the midpoint of the zone of reasonableness established above.

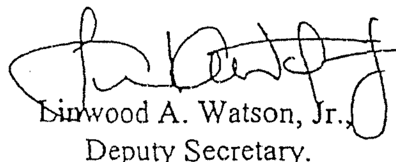
The Commission orders:

(A) The Initial Decision in this proceeding is hereby affirmed in part and reversed in part, as discussed in the body of this order.

(B) Within 45 days from the date of the issuance of this order, Consumers should make a compliance filing with the Commission reflecting the requirements of this order. However, if a request for rehearing is filed, Consumers must make its compliance filing within 45 days of the date the Commission disposes of the request for rehearing.

By the Commission.

(S E A L)



Linwood A. Watson, Jr.,
Deputy Secretary.

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[43]This is done using the formula: Adjusted DY=DY*(1+(0.5*G)), where DY stands for dividend yield and G is the growth rate.

APPENDIX A

	Yld Low	High	Adjusted Yld Low	High	(IBES)	Zone of Reasonableness
Atlantic	8.84	9.43	8.93	9.52	2.00	10.93 - 11.52
Delmarva	8.09	8.96	8.21	9.09	3.00	11.21 - 12.09
Illinova	5.18	5.85	5.34	6.03	6.10	11.44 - 12.13
Minnesota	6.13	7.38	6.30	7.58	5.40	11.70 - 12.98
PP&L	7.86	8.57	7.96	8.68	2.60	10.56 - 11.28

source: Exhibit CE-54

KENTUCKY POWER COMPANY
American Electric Power
SECOND DATA REQUESTS OF COMMISSION STAFF
Case No. 2005-00341

Item No. 49

Refer to the Moul Testimony, Exhibit No. PRM-1, Schedule 9, page 2 of 4. Since financial theory assumes that current stock prices already reflect and embody all current knowledge available to the market, explain why a 6-month-old monthly high and low stock price would have any relevance to an investor.

Response

One goal in the public utility ratesetting process is an attempt to establish costs that will be representative of those that will be incurred by the utility for the rate effective period. Achievement of this goal is particularly challenging in the measurement of the cost of equity due to the vagaries of the stock market. So while a spot price of stock may reflect all current knowledge available to the market (at least in the weak or semi-strong form of the EMH), such prices can change abruptly for reasons unrelated to the fundamentals of a utility. Hence, the ratesetting process usually considers some average of historical prices in an attempt to smooth market vagaries. A common historical average of six-months is used in this regard.

Witness: Paul R. Moul

KENTUCKY POWER COMPANY
American Electric Power
SECOND DATA REQUESTS OF COMMISSION STAFF
Case No. 2005-00341

Item No. 50

Refer to the Moul Testimony, Exhibit No. PRM-1, Schedule 9, page 3 of 4.

a. In the "b times r" Growth Rate table, explain the derivation of the Growth column under Common Equity, and of the "b times r" Growth Rate column.

b. Explain why it is valid to use both average return on equity estimates and *Value Line* Return on Common Equity in the "b times r" Growth Rate table.

c. Explain the derivation of the Sixth-Month Average Stock Price column and the Growth of Common Shares Outstanding column, in the "s times v" Growth Rate table.

Response

a. The "b times r" growth rates were determined as the "Average Yearly Return" shown on page 3 times the complement of the "Dividend Payout" shown on page 4.

b. The "Average Yearly Return" is calculated from the *Value Line* Return on Common Equity as adjusted in the manner shown in the top panel of data on page 3 of Schedule 9. It is necessary to make this adjustment because *Value Line* uses end of period, rather than average book values.

c. The "Six-Month Average Stock Price" is calculated from the monthly high and monthly low stock prices shown on page 2 of Schedule 9. The "Growth of Common Shares Outstanding" is the compound growth rate in shares outstanding from 2004 to 2008-10 shown on page 3 of Schedule 9.

Witness: Paul R. Moul