

By the Commission.
Kenneth F. Plumb,
Secretary.

PART 37—[AMENDED]

1. The authority citation for Part 37 continues to read as follows:

Authority: Federal Power Act, 16 U.S.C. 791a-825r (1982); Department of Energy Organization Act 42 U.S.C. 7101-7352 (1982).

2. Section 37.3 is revised to read as follows:

§ 37.3 Definitions.

For purposes of this Part:

(a) "Benchmark rate of return" means the rate of return on common equity that is determined each quarter based on the findings made in the annual proceeding regarding the indexing procedure and the average cost of common equity for the jurisdictional operations of public utilities.

(b) "Cost of common equity" means the minimum rate of return that investors require to buy common stock adjusted for the flotation costs incurred by a company when selling such stock.

(c) "Indexing procedure" means the method by which the average cost of common equity under this Part is updated quarterly between annual proceedings to determine benchmark rates of return.

3. Section 37.4 is revised to read as follows:

§ 37.4 Annual proceedings.

An estimate of the average cost of common equity for the jurisdictional operations of public utilities and a quarterly indexing procedure to establish the initial benchmark rate of return and update it quarterly will be determined annually through informal rulemaking proceedings under 5 U.S.C. 553.

4. Section 37.9 is amended by revising paragraph (a)(1), removing paragraphs (a)(2) and (a)(3), redesignating paragraphs (a)(4), (a)(5) and (a)(6) as paragraphs (a)(2), (a)(3) and (a)(4), revising redesignated paragraphs (a)(2), (a)(3), and (d), to read as follows. The introductory text of (a) is republished for the convenience of the reader.

§ 37.9 Quarterly indexing procedure.

(a) *Procedure for Determining Quarterly Benchmark Rates of Return.* In accordance with § 37.4 of this part, the Commission will use the following indexing procedure to update quarterly the benchmark rate of return on common equity.

(1) For purposes of establishing the benchmark rate of return on common equity for period t , the average cost of common equity for the jurisdictional operations of public utilities shall be calculated as follows:

$$k_t = a(y_t) + b$$

where:

k_t = average cost of common equity for the jurisdictional operations of public utilities for period t ;
 a = adjustment factor to account for the timing of dividend increases (determined in annual proceeding);
 y_t = average current dividend yield applicable to period t determined under paragraph (b) of this section;
 b = adjustment factor to account for expected growth, new common stock flotation costs and jurisdictional risk difference (determined in annual proceeding); and
 t = successive three month time periods: February 1 through April 30, May 1 through July 31, August 1 through October 31, and November 1 through January 31.

(2) The benchmark rate of return on common equity for the first quarter to which an annual proceeding is applicable will be set equal to the average cost of common equity for the jurisdictional operations of public utilities as determined by the formula of paragraph (a)(1) of this section.

(3) The benchmark rate of return on common equity for subsequent quarters prior to the conclusion of the next annual proceeding will be set equal to the average cost of common equity for the jurisdictional operations of public utilities as determined by the formula of paragraph (a)(1) of this section, except where an increase or decrease of more than 50 basis points from the previous quarter's benchmark would occur.

(d) *Table of Quarterly Benchmark Rates of Return.*¹ The following table presents the quarterly benchmark rates of return on common equity:

Benchmark applicability period (t)	Dividend increase adjustment factor (a)	Expected growth adjustment factor (b)	Current dividend yield (Y _t)	Cost of common equity (P ₀)	Benchmark rate of return
Feb. 1, 1986-Apr. 30, 1986	1.02	4.54	9.03	13.75	13.75
May 1, 1986-Aug. 31, 1986	1.02	4.54	8.37	13.08	13.25
Aug. 1, 1986-Oct. 31, 1986	1.02	4.54			
Nov. 1, 1986-Jan. 1, 1987	1.02	4.54			

Appendix—Staff Report on Rate-making Rate of Return by Office of Regulatory Analysis, Federal Energy Regulatory Commission

Note.—The following appendix will not appear in the Code of Federal Regulations.

A. Introduction

Order No. 442 introduced a new concept called the "rate-making rate of return" based on the idea that allowing a rate of return equal to the cost of capital can lead to a higher earned rate of return. This concept was the major issue raised in the rehearing petitions. Petitioners raised some questions on both its concept and application which have caused the Commission to reevaluate and modify its decision.

In Order No. 389, the Commission set up a rule for determining benchmark rates of return on common equity and applying them in individual electric utility cases. 49 FR 29946 (July 25, 1984). That rule provides that the Commission would have annual proceedings to determine the industry average cost of common equity and a procedure for updating the cost on a quarterly basis for purposes of establishing the benchmark rates of return for individual rate cases.

The first annual proceeding (Docket No. RM84-15) culminated in Order No. 420. 50 FR

21802 (May 29, 1985). In that order, the Commission adopted a relatively simple constant growth discounted cash flow (DCF) model for purposes of supporting a base year cost of common equity estimate and as the basis for the quarterly indexing procedure. In this report, that model shall be referred to as the 420 Model.²

Order No. 442 is the final rule in the second annual generic rate of return proceeding. Docket No. RM85-19. 51 FR 343 (January 8, 1986). In this proceeding, the Commission adopted a different form of DCF model, which we will refer to as the 442 Effective Rate Model.

The 442 Effective Rate Model is as follows:

¹ Because of the time lag between the issuance of the quarterly updates to the benchmark rate of return and the publication of the Code of Federal Regulations, the currently effective benchmark rate of return can be found, in the FEDERAL REGISTER.

² The 420 Model is as follows:

$$k = \frac{D_0}{P_0} (1 + 5g) + g$$

Where:

k = market required rate of return (420 nominal rate)

D_0 = current (indicated) annual dividend rate

P_0 = current market price of stock

g = dividend growth rate (annual rate).