return annually. Second, NEP and EEI argue that the ratemaking rate concept implicitly makes a distinction between jurisdictional and nonjurisdictional operations, despite the Commission's finding in Order No. 442 that no such distinction is warranted.[9]

2. Commission's Analysis

The new DCF model adopted in Order No. 442 ("442 Effective Rate Model") estimated the investors' "effective" required rate of return. At footnote 13, Order No. 442 explained that the effective rate of return includes the return that the investor expects from the company's reinvestment of retained earnings and the reinvestment of intra-year dividends by the investor. The order further explained that, unlike the rate determined by the prior Order No. 420 model, which was designed to yield a rate which could be used as the allowed rate of return, the effective required rate of return is only a conceptual starting point for determining a rate of return which could be used as the allowed, or benchmark, rate of return. This approach was based upon the belief that the effective rate of return expected to be received by the investor is greater than the rate of return the Commission need allow the company an opportunity to earn on its rate base. To arrive at an appropriate allowed rate of return, the investor's required effective rate of return, as determined by the Order No. 442 Effective Rate Model[10] was adjusted for purposes of achieving three objectives:

(1) To eliminate that portion which relates to the reinvestment of quarterly dividends,

(2) To *eliminate* that portion which relates to the reinvestment by the utility of intra-year retained earnings, and

(3) To make the definition of the allowed rate of return consistent with the Commission's method of computing rate base.

The result was referred to as the ratemaking rate of return.

The effective required rate of return can be viewed from another perspective as being composed of two components:

(1) The dividends and growth that investors expect from their investment in the firm, and

(2) The return that investors expect from their reinvestment of the dividends. In other words, what investors require from their investment in the firm is simply the effective rate less the return from reinvestment of dividends. The return that investors expect from the firm does not include the income that they expect to receive from the reinvestment of dividends; investors have the opportunity to produce this income by their own actions in reinvesting the dividend portion of their return. Thus, it was concluded in Order No. 442 that, in developing the benchmark rate of return, the investors' effective required rate of return should be reduced by these dividend reinvestment earnings.[11] The applicants do not object, in principle, to adjusting the required effective rate of return to account for the effect of the investor's reinvestment of quarterly dividends (Objective No. 1 above). This objective had been previously established in Order No. 420.[12]

Neither Order No. 420 nor Order No. 442, however, specifically discussed the issue of why one would also want to exclude the return associated with reinvestment of retained earnings from the effective required rate of return. (Objective No. 2).[13] Most of the discussion of the ratemaking rate of return concept in Order No. 442 focused on the adjustment for rate base considerations (Objective No. 3). Understandably then, applicants likewise focused their objections to the ratemaking rate of return concept *only* on the rate base considerations.

The Commission is sensitive to the contentions that there was perhaps too little opportunity to address the ratemaking rate of return concept and that the explanation given in Order No. 442 may have been deficient insofar as it focused primarily on only one of the three purposes for the concept. The rehearing requests and further staff analysis[14] have persuaded the Commission that there are a number of unresolved questions with regard to some of the stated purposes of the ratemaking rate of return. For example: (a) Is there really any need to be concerned about consistency between rate base and allowed rate of return for the purposes of this rulemaking; (b) can such concerns be better addressed through cost of service adjustments as opposed to rate of return adjustments; (c) what reasonable assumptions can the Commission adopt regarding "typical" utility reinvestment patterns and rates? Because of such unresolved questions and the absence of a sufficient record upon which to postulate reasoned answers, the Commission has determined not to adopt the ratemaking rate to return concept, as developed in Order No. 442, in this proceeding. Instead, the Commission will retain the model adopted in Order No. 420, pending further considertion.[15] As discussed above, the Order No. 420 Model recognizes that any return investors expect to receive from dividend reinvestment is not part of the return required from investment in the firm. Since the use of this model was proposed in the NOPR, no party will be prejudiced by this result.

III. Conclusions

The Commission is unpersuaded that any basis has been presented to warrant modification of Order No. 422 regarding the treatment of the growth rate, flotation cost, indexing, and equity accretion. Rehearing, in that regard, will therefore be denied. The Commission is persuaded, however, that questions raised on rehearing and in further staff analysis regarding the ratemaking rate of return concept warrant modification of the earlier order as discussed above. Rehearing, in that regard, will therefore be granted.

The Commissions orders—

(A) The Petitioners' request for rehearing regarding growth rate, floatation costs, indexing, and equity accretion are hereby denied.

(B) The Petitioner's requests for rehearing regarding the ratemaking rate of return adjustment are granted and Chapter I, Title 18 of the *Code of Federal Regulations* is amended accordingly, as set forth below, effective July 21, 1986.

[9] Order No. 442, 51 FR 343 at 366 (1986).

[10] *Id.* at 348.

[11] Separating the return associated with reinvestment of dividends from the effective required rate determined by the Order No. 442 *Effective Rate Model*, 51 FR 343 at 348 (1986), results in the Order No. 420 Model. The attached Office of Regulatory Analysis staff study paper demonstrates this relationship.

[12] Order No. 420, 50 FR 21,802 at 21,811 (1985); Order No. 420–A, 50 FR 34,086 at 34,087 (1985).

[13] The rationale for an adjustment to reflect the effect of dividend reinvestment would be different from the rationale for adjusting for the reinvestment of retained earnings. As noted, the former adjustment is intended to reflect the investor's recognition of the additional earnings associated with his own reinvestment of dividend payments. In contrast, the return from periodic utility reinvestment of retained earnings is, in effect, reflected in the return that the investor expects/requires from investment in the utility.

[14] *See* the attached report prepared by the staff of the Commission's Office of Regulatory Analysis which discusses the effect of reinvestment of retained earnings on the revenue requirements' analysis.

[15] The original language in the regulatory text adopted in Order No. 420 has been revised slightly for purposes of clarification only; no substantive changes to the Order No. 420 model are intended. The table of quarterly benchmark rates of return in § 37.9 has been revised in accordance with our decision to return to the use of the Order No. 420 model.

GLEASON-000773