UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Promoting Transmission Investment through Pricing Reform	Docket No. RM06-4-000

REQUEST FOR REHEARING OF THE
TRANSMISSION ACCESS POLICY STUDY GROUP

On July 20, 2006, the Commission issued Order 679,[1] thereby completing a rulemaking that was instituted pursuant to the new Section 219 of the Federal Power Act. The new rule, codified at 18 C.F.R. § 35.35, adopts a long list of available incentives and removes the explicit cost-benefit test for above-cost rates that had been included in the predecessor regulation. Pursuant to 16 U.S.C. § 825*l* and 18 C.F.R. § 385.713, the Transmission Access Policy Study Group ("TAPS") requests rehearing or, in the alternative, clarification of the Commission's new regulation.

I. STATEMENT OF ISSUES

Pursuant to Rule 713(c)(2), 18 C.F.R. § 385.713(c)(2), TAPS provides the following statement of issues:

1. Should the Commission have tied cost-increasing incentives (*e.g.*, return) to major reforms that will really enhance the ability to get transmission built: (1) inclusive or independent transmission companies; (2) joint ownership arrangements; or (3) the regionally-spread portion of regional rates? Whether Order 679 missed the opportunity to focus incentives on the structural reforms that have been shown to be capable of delivering consumer benefits through robust transmission development: Inclusive planning, inclusive ownership, and inclusive regional rates. FPA § 219.

2. Whether two of the rebuttable presumptions adopted by Order 679 – that incentives are appropriate for all owner-initiated development that receives approvals from regional

[1] *Promoting Transmission Investment Through Pricing Reform*, 71 Fed. Reg. 43,294 (July 31, 2006), 116 F.E.R.C. ¶ 61,057 (2006) (to be codified at 18 C.F.R. §§ 35.34-35.35).

planning processes or state authorities – are so over-inclusive that they should be narrowed or withdrawn. FPA § 219.

3. Whether the Order's "nexus" requirement is unduly vague, in that it fails to clearly require a causal connection between the incentive and the statute's purposes, *i.e.*, that the incentive is reasonably expected to cause consumer benefits. FPA §§ 205, 206, 219; *City of Detroit v. FPC,* 230 F.2d 810, 817 (D.C. Cir. 1955); *Farmers Union Cent. Exch., Inc. v. FERC,* 734 F.2d 1486, 1503 (D.C. Cir.), *cert. denied sub nom., Ass'n of Oil Pipelines v. Farmers Union Cent. Exch., Inc.*, 469 U.S. 1034 (1984); *Pub. Utils. Comm'n of Cal. v. FERC,* 367 F.3d 925, 929 (D.C. Cir. 2004); *Pub. Serv. Comm'n of the State of N.Y. v. FERC,* 589 F.2d 542, 552-54 (D.C. Cir. 1978); *Colonial Pipeline Co.*, 116 F.E.R.C. ¶ 61,078, P 63 (2006).

4. Whether the Commission should explicitly provide that in the specific cases to come, the Commission will modify requested incentives when doing so will result in an incentive program that is better-designed to yield net consumer benefits. FPA §§ 205, 206, 219; *Permian Basin Area Rate Cases,* 390 U.S. 747 (1968); *FPC v. Hope Natural Gas Co.,* 320 U.S. 591, 602-03 (1944); *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.,* 463 U.S. 29, 43 (1983); *City of Detroit v. FPC,* 230 F.2d at 810, 817; *Farmers Union Cent. Exch., Inc. v. FERC,* 734 F.2d at 1502-03; *Public Utils. Comm'n of Cal. v. FERC,* at 929; *Pub. Serv. Comm'n of Ky. v. FERC,* 397 F.3d 1004, 1006-07 (D.C. Cir. 2005); *Missouri Pub. Serv. Comm'n v. FERC*, 337 F.3d 1066, 1071 (D.C. Cir. 2003); *Maine Pub. Utils. Comm'n v. FERC,* 454 F.3d 278 (D.C. Cir. 2006); *City of Charlottesville v. FERC,* 661 F.2d 945, 955 (D.C. Cir. 1981) (Wald, J, concurring).

5. Whether the Commission should provide for transparency as to who will pay requested incentives, and evaluation of whether they will fall discriminatorily on unbundled transmission customers, creating the potential for anti-competitive price squeezes. Whether cost allocation should be considered as part of the incentive program. FPA §§ 205, 206, 219; *Midwest Indep. Transmission Sys. Operator, Inc. and Ameren Servs. Co.,* 109 F.E.R.C. ¶ 61,167, P 14 (2004); *New England Power Pool and ISO New England, Inc.*, 103 F.E.R.C ¶ 61,304, P 34, *clarified [on denial of reh'g],* 105 F.E.R.C. ¶ 61,211 (2003); *New England Power Pool and ISO New England, Inc.,* 109 F.E.R.C. ¶ 61,252, P 29 (2004), *clarified,* 110 F.E.R.C. ¶ 61,003 (2005).

6. Whether the Order erroneously suggests that the Commission may place returns high in the range of proxy results without a valid reason for such placement, and fails to take appropriate steps to ensure that that range is so bounded as to be reasonably used for its new incentive-related purpose. FPA §§ 205, 206, 219; *High Island Offshore Sys., L.L.C.*, 110 F.E.R.C. ¶ 61,043, P 148, *reh'g denied*, 112 F.E.R.C. ¶ 61,050 (2005).

7. Whether the Order fails to ensure that public power will be treated comparably, and that incentive-seekers who turn down public power investment without good cause will be disfavored. FPA §§ 205, 206, 216, 217, 219; *Allegheny Energy, Inc., Monongahela Power Co., The Potomac Edison Co., and West Penn Power Co.*, 116 F.E.R.C. ¶ 61,058, P 151 (2006).

8. Whether the Order misconstrues FPA § 219 as not allowing incentive programs to include below-cost rates for poor performers. FPA §§ 205, 206, 219; Order No. 2000, 65 Fed. Reg. at 921, [1996-2000 Regs. Preambles] F.E.R.C. Stats & Regs. at 31,185;[2] *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968); *Viking Gas Transmission Co.*, 57 F.E.R.C. ¶ 61,417, at 62,356 (1991); *Incentive Ratemaking for Interstate Natural Gas Pipelines, Oil Pipelines, and Elec. Utils.*, 61 F.E.R.C. ¶ 61,168 at 61,590 (1992).

9. Whether the Order provides for sufficient transparency regarding who is paying how much as incentives, and what facilities they are getting in return. FPA § 219.

II. IDENTIFICATION OF ERRORS

Pursuant to Rule 713(c)(1), 18 C.F.R. § 385.713(c)(1), TAPS identifies the following errors:

1. Order 679 missed the opportunity to focus incentives on the structural reforms that have been shown to be capable of delivering consumer benefits through robust transmission development: Inclusive planning, inclusive ownership, and inclusive regional rates. The Commission erred by failing to tie cost-increasing incentives (*e.g.*, return) to major reforms that will really enhance the ability to get transmission built: (1) inclusive or independent transmission companies; (2) joint ownership arrangements; or (3) the regionally-spread portion of regional rates. See Part III.A, below.

2. The Order adopts rebuttable presumptions that incentives are appropriate for all owner-initiated development that receives approvals from regional planning processes or state authorities. These presumptions are so over-inclusive that they should be narrowed or withdrawn. See Part III.B.

3. The Order's "nexus" requirement is unduly vague, in that it fails to clearly require a causal connection between the incentive and the statute's purposes, *i.e.*, that the incentive is reasonably expected to cause consumer benefits. See Part III.C.

4. The Order fails to explicitly provide that in the specific cases to come, the Commission will modify requested incentives when doing so will result in an incentive program that is better-designed to yield net consumer benefits. See Part III.D.

5. The Order fails to provide for transparency as to who will pay requested incentives, for evaluation as to whether they will fall discriminatorily on unbundled transmission customers, and for consideration of cost allocation as part of the incentive program. See Part III.E.

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[2] *Regional Transmission Organizations*, Order No. 2000, 65 Fed. Reg. 809, 921 (Jan. 6, 2000), [1995-2000 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 31,039, at 31,185, *Order on reh'g*, Order No. 2000-A, 65 Fed. Reg. 12,088 (Mar. 8, 2000), [1996-2000 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 31,092, *appeal dismissed for want of standing sub nom. Pub. Util. Dist. No. 1 v. FERC*, 272 F.3d 607 (D.C. Cir. 2001).

6. The Order erroneously suggests that the Commission may place returns high in the range of proxy results without a valid reason for such placement, and fails to take appropriate steps to ensure that that range is so bounded as to be reasonably used for its new incentive-related purpose. See Part III.F.

7. The Order fails to ensure that public power will be treated comparably, and that incentive-seekers who turn down public power investment without good cause will be disfavored. See Part III.G.

8. The Order appears to misconstrue FPA Section 219 as not allowing incentive programs to include below-cost rates for poor performers. See Part III.H.

9. The Order fails to provide for sufficient transparency regarding who is paying how much as incentives, and what facilities they are getting in return. See Part III.I.

III. ARGUMENT

A. Scope of Argument

The Final Rule's decision to state broad principles and leave the details to case-by-case development is disappointing. The rule muffs an opportunity to use incentives the way an effective charitable trust would: strategically, as a "challenge grant" that conditions above-cost rates on the structural reforms that have already been proven to work. Inclusive planning, inclusive ownership, and inclusive regional rates are what works.[3] Facility-by-facility incentives generally won't. Where vertically integrated utilities control the decision whether to build transmission that will open their markets to competition, an incentive will induce action only if it exceeds the monopoly rents that are available to generation sales in walled-off markets. Granting so large an incentive would exceed the bounds of what is just, reasonable, and non-discriminatory, would violate FPA Section 219, and would amount to abdication of the regulatory duty to keep delivered power prices in a range that simulates competitive results.

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[3] *See* January 11, 2006 Comments of the Transmission Access Policy Study Group in Docket No. RM06-4 ("TAPS NOPR Comments") at 9-16.

The *AEP*[4] and *Allegheny*[5] companion orders to Order 679 prove the rule. Who is proposing to build new lines connecting coal-belt generation to eastern seaboard loads? Not the vertically integrated systems that serve eastern seaboard loads. Their role in those cases was to seek delay. The promoters of stronger west-to-east ties are the owners of western generation, who seek wider outlets for their generation sales.

We recognize that the Commission generally has discretion to defer what could have been rulemaking decisions to case-by-case decision. *SEC v. Chenery Corp.*, 318 U.S. 80, 86 (1943). And while we retain the hope that the Commission's case-by-case decisions will ultimately come to focus incentives on the kinds of structural reforms that work, we urge the Commission to act now, by rule, when the action will produce the maximum benefit for the industry and the country. Thus, we reiterate our request that the Commission tie cost-increasing incentives (*e.g.*, return) to major reforms that will really enhance the ability to get transmission built: (1) inclusive or independent transmission companies; (2) joint ownership arrangements; or (3) the regionally-spread portion of regional rates.[6] Nonetheless, we focus the rehearing requests that follow on the Final Rule's errors of commission, not omission — the areas where the regulatory text, as adopted, might be construed to pledge incentives that will not serve the stated, consumer-benefiting purposes of Section 219.

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[4] *American Elec. Power Serv. Corp.*, 116 F.E.R.C. ¶ 61,059 (2006) ("*AEP*").

[5] *Allegheny Energy, Inc., Monongahela Power Co., The Potomac Edison Co., and West Penn Power Co.*, 116 F.E.R.C. ¶ 61,058, P 151 ("*Allegheny*").

[6] *See* TAPS NOPR Comments at 31-39.

B. The "Rebuttable Presumptions" Presume too Much

The rule as adopted is not faithful to FPA Section 219, or even to the rule's own preamble. A central example is the exceedingly broad "rebuttable presumption" that has been adopted as Section 35.35(i)(2). Under this provision, the Commission will presume that "an applicant has met the requirements of section 219" (perhaps meaning that whatever incentive such an applicant has requested will be presumed to be appropriate) for any project that "has received construction approval from an appropriate state commission or state siting authority." This presumption was not included in the NOPR. It is a late addition for which Order 679 provides no real explanation, and is not consistent with FPA Section 219.

State laws and regulations requiring construction approval vary widely, but they are generally oriented to environmental at least as much as to consumer protection, and many of them require some form of construction approval for a very broad class of facilities. For example, in connection with the state certification that is required for all generating plants larger than 75 MW, Florida requires state commission certification for all "associated transmission lines to be owned by the applicant which connect the electrical power plant to an existing transmission network or rights-of-way." Florida Electrical Power Plant Siting Act, Fla. Stat. §§ 403.503.13 and 403.506. Iowa has essentially the same requirement, but with a lower (25 MW) generator-size trigger. Iowa Code § 476A.1.5. Other states require certification for all lines above a certain voltage or length. In one Midwestern state, the trigger is a voltage level exceeding 700 volts (0.7 kV).[7] These criteria capture projects that merely extend the grid to

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[7] *See* National Regulatory Research Institute, Survey of Transmission Siting Practices in the Midwest, Appendix A at 25 (summarizing Nebraska's siting process), available at http://misostates.org/WG7TransPlanWIPLIST.htm (prepared by the Brattle Group for NRRI on behalf of the Edison Electric Institute and the Organization of MISO States).

reach a new generation site or load center, and which would be built with or without incentives because such extension is both obligatory and intrinsically profitable to a transmission owner, especially one who is vertically integrated. Indeed, some (as in Florida and Iowa) even capture what are generally thought of as generation tie lines, which may or may not otherwise even be considered a part of the grid. On the other hand, upgrades that will re-use an existing right-of-way often do not require a certificate. For both reasons, the fact that a project is one of the legions that require state construction approval provides no meaningful assurance that incenting the project will advance the statutory purpose of FPA Section 219: "benefiting consumers by ensuring reliability and reducing the cost of delivered power by reducing transmission congestion."

The new Section 35.35(i)(*i*) presumption based on regional planning is likewise overbroad. Although regional planning is a relevant criterion, it should come into play as a threshold requirement: no incentive should be available for projects that are to be sited in regions that plan regionally[8] but which bypass the regional planning process. But where regional planning exists, it commonly examines every electrically significant facility proposed for interconnection to the regional grid, if only to ensure that the interconnection will not degrade reliability below an acceptable level. It cannot reasonably be presumed that every facility that is subject to regional scrutiny will "benefit[] consumers by ensuring reliability and reducing the cost of delivered power by reducing transmission congestion."[9] FPA § 219(a).

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[8] If the Final Rule in Docket Nos. RM05-25 follows the NOPR, all regions should be planning regionally. *See Preventing Undue Discrimination and Preferences in Transmission Service*, Notice of Proposed Rulemaking, 71 Fed. Reg. 32,636 (proposed June 6, 2006), IV F.E.R.C. Stat. & Regs. ¶ 32,603, P 214.7, *corrected*, 71 Fed. Reg. 37,109 (June 29, 2006) ("Order 888 Reform NOPR").

[9] The third ground that creates a rebuttable presumption is location "in a National Interest Electric Transmission Corridor pursuant to section 216 of the Federal Power Act." 18 C.F.R. § 35.35(i)(*3*). This ground is less worrisome, because the criteria for NIETC designation are aligned with the statutory purposes of Section 219,

Indeed, both of these presumptions appear to be at odds with intended limitations on the receipt of certain of the proposed incentives. With respect to an "incentive-based ROE," the Final Rule states:

> For example, routine investments made to comply with existing reliability standards may not always qualify for an incentive-based ROE. These are the types of investments that have, as a general matter, been adequately addressed through traditional ratemaking because there is an obligation to construct them and high assurance of recovery of related costs. For these and other reasons, traditional ROE determinations may continue to be appropriate for these investments.

Order 679 at P 94. The rebuttable presumptions contained in the regulation conflict with the apparent intention that "routine investments" (which may well be included in a regional plan and require receive state siting approval prior to construction) "may not always qualify" for an incentive-based ROE.

C. The "Nexus" Requirement Is Unduly Vague

FPA Section 219 calls for a rule designed to "benefit[] consumers by ensuring reliability and reducing the cost of delivered power by reducing transmission congestion," *id.*, and which promotes "reliable <u>and economically efficient transmission</u> and generation of electricity." FPA § 219(b)(1) (emphasis added). Accordingly, the "nexus" test ought to ask whether a requested incentive is reasonably expected to have those effects. And because the incentives' direct cost will ultimately be financed by consumers, this question must include consideration of whether the incentive's drawbacks — the direct increase of delivered power costs, and the risk of a backlash effect whereby state siting authorities and their constituents oppose transmission development out of opposition to paying incentives — will be outweighed by countervailing

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making it not unreasonable to infer that NIETC-designated projects will likely serve the purposes of Section 219. Such alignment is what Sections 35.35(<u>i</u>)(*i*)-(*ii*) are missing.

benefits, such that there is an adequate basis to predict that the net effect on consumers will be beneficial. For such a finding to be rational, the incentive must be reasonably expected to cause either a net decrease in delivered power costs even after considering incentive-increased transmission costs, or, where the expected net effect on delivered power costs is an increase, reliability gains that make that increase worthwhile.

To insist on a rationally-supported causal connection to net consumer benefits of the kind specified in Section 219 is simply to reiterate the nexus test that the courts have long demanded, as part of the "just and reasonable" test that Section 219 retains. Before the Federal Power Act was amended to identify the specific consumer-benefiting purposes of Section 219, the D.C. Circuit made clear that when the Commission chose to consider non-cost factors in setting rates, "it must also, and always, relate its action to the primary aim of the Act to guard the consumer against excessive rates." *City of Detroit v. FPC*, 230 F.2d at 817 (emphasis added); *see also Farmers Union Cent. Exch.*, 734 F.2d at 1503. Accordingly, the Commission's authority to award above-cost incentives has always turned on whether the incentive's cost is "outweighed by the benefits customers will receive," *Pub. Utils. Comm'n of Cal. v. FERC*, 367 F.3d at 929 (finding that the Commission-approved incentive was necessary given the urgent need for transmission upgrades in California and the fact that no party had "stepped forward to construct upgrades" until the incentive was offered); *Pub. Serv. Comm'n of the State of N.Y. v. FERC*, 589 F.2d at 552-54 (requiring "symmetry" between oil exploration incentives and the production increases expected to result).

Section 219 identifies congestion reduction and reliability as two specific consumer benefits that can justify incentives. However, by invoking these purposes and by continuing to require that the overall result be just and reasonable, it continues to require a rationally-found causal connection between those purposes and the incentives. That is, Section 219 requires a reasonable basis to predict that the granting of such incentives will result in those consumer benefits — that ultimately, consumers will be better off with the incentive and its expected effect on investors than they would be without the incentive and its effect.

As written, the Final Rule's "nexus" requirement is overly vague in two respects. First, it fails to clearly require a connection between the incentive and the statute's purposes, as distinguished from a connection merely between the facility and the statute's purposes. Second, it fails to clearly require that the connection must be causal, *i.e.*, that the incentive is reasonably expected to cause consumer benefits. The rule's preamble does state that "an applicant will be required to show how the granting of the incentive will promote reliable and economically efficient transmission and generation of electricity, attract new investment, or increase capacity and efficiency of existing transmission facilities or improve their operation." Order 679 at P 82. Apart from the "attract new investment" clause (which suggests inappropriately that spending on transmission is an end in itself whether or not it yields useful facilities), this an important and appropriate statement of a causation requirement. But the regulatory text does not track this causation requirement.

Suppose that on the facts of a specific case, the record is clear that a particular new facility will reduce congestion, but also that it will be built, on the same schedule, with or without a proposed incentive. *E.g.*, the entity requesting the incentive has a longstanding contractual obligation to build the facility, as agreed reciprocation for prior lines built by others under an investment equalization arrangement, or it has let its system go to the point that it must perform deferred maintenance in order to stop violating minimal NERC reliability standards. Nonetheless, it requests an incentive award of two additional dollars for every dollar it spends to meet its prior obligation. Because the amount of the resulting award would have an arithmetic relationship to the amount of new investment, there arguably would exist a connection that would satisfy the nexus test as written in the Final Rule, even though there is no causal connection. (Again, by hypothesis, the same development would happen on the same timetable with or without the incentive.) No doubt the Commission does not intend that result. Again, it would be inconsistent with the explanation set forth in Order 679 at P 82.[10] However, the Commission should pause to reflect on whether there is anything in the actual language of the 18 C.F.R. § 35.35 regulatory text that precludes it.

Linguistically, the problem is that a "connection between A and B" does not specify that A must cause B. A connection of sorts would exist if B caused A, or if C caused both A and B, or if the connection was other than causal. But such a connection would not suffice to meet the purpose of Section 219. Accordingly, the nexus clause of 18 C.F.R. § 35.35(d) should be revised as shown below:

> The applicant must demonstrate that the facilities for which it seeks incentives either ensure reliability or reduce the cost of delivered power by reducing transmission congestion consistent with the requirements of section 219, that ~~there is a nexus between~~ the incentive sought is designed to result in ~~and the investment~~ those facilities being invested in, completed, and placed into service, ~~made,~~ and that resulting rates are just and reasonable.

[10] The Commission's recent decision in *Colonial Pipeline Co.*, 116 FERC ¶ 61,078, P 63 required a causal nexus when it held that an oil pipeline seeking accelerated depreciation (*i.e.*, a depreciation term set intentionally shorter than the facility's expected economic life) must "explain[] why this proposal is necessary to foster the proposed investment."

D. The Rule Should Explicitly Provide for Consideration of Better-Targeted Alternative Incentives

Although it does so implicitly,[11] the Final Rule fails to explicitly provide that applicants' proposed incentives will be modified when doing so will advance the customer-benefiting objectives of Section 219. For example, in order to magnify the investment to which incentives will apply, an applicant considering an incentive-worthy, congestion-reducing, new line may present it to the Commission packaged with mundane existing facility replacements that have already been committed to and do not advance Section 219 objectives.[12] If the incentive was targeted more precisely to the new line alone, it could be reformulated either as a larger bonus for each dollar invested in the new line, or as the same per-investment bonus applied only to the incentive-worthy investment. Either way (or in combination), when the costs of the incentive are factored in, the likelihood of timely and effective reduction of delivered power costs would be higher with the modified, better-targeted incentive than with the broadcast one. In such a case, the modified alternative will better advance the purpose of Section 219. Accordingly, the rule should provide that the Commission will consider such alternatives, and will adopt such modifications when they more effectively and efficiently advance the purposes of Section 219.

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[11] At P 20, Order 679 states that "[b]efore adopting any incentive-based rate treatments for a particular company, the Commission will need to determine that the applicant has justified its specific incentive request." Similarly, at P 55, Order 679 states that "[i]f an interested party believes that a particular incentive is not warranted, it may raise its concerns when an applicant proposes that incentive in a declaratory order [sic; petition] or in a section 205 rate application." We trust that means that the Commission would evaluate those concerns and be prepared to modify requested incentives when appropriate. More generally, by requiring that all approved incentives be just and reasonable, the Final Rule implicitly provides for modifying requested incentives that do not meet that standard.

[12] The distinction between new facilities and replacement investment is a real one, and is recognized in PJM. *See*, *PJM Interconnection, L.L.C.*, 116 F.E.R.C. ¶ 63,007, P 10, *corrected*, 116 F.E.R.C. ¶ 63,013 (2006) ("[C]urrent, ongoing and future transmission owner initiated investment in the refurbishment, enhancement, maintenance and operation of existing transmission facilities in PJM are not subject to the mechanism adopted for new facilities.").

The principle here is simple. When the incentives requested by an applicant exceed what would suffice to cause the desired consumer benefit, there is always an alternative way to spend that excess that will help reduce congestion or ensure reliability, and which is thus more likely to advance the purposes of Section 219 than will result from throwing that excess to shareholders.[13] The same point holds whether the excess involves an applicant placing on its wish list too many of the 18 C.F.R. § 35.35(d)(1)(i)-(viii) options, or selecting options that are poorly tailored to its factual situation, or fleshing them out with overly remunerative amounts, or applying them to too many facilities. Faced with an incentive request, the Commission should recognize that it may be inflated,[14] and should always ask whether every dollar they will collect represents the most congestion-reducing or reliability-ensuring way to spend the next dollars of society's investment in transmission facilities and technologies.[15] For example, if a utility with no demonstrated cash flow constraint requests accelerated depreciation, the Commission should ask why the utility is seeking to trade its future rate base for present profit, whether the utility is really counting on gulling a future Commission into allowing it to write up its rate base or collect a post-depreciation "management fee," and whether CWIP would provide a better way to

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[13] If nothing else, the Commission could always donate the excess to EPRI for research on new transmission technologies. We advance that suggestion only to show that alternatives are ubiquitous, not because we expect the Commission to actually pursue that particular alternative.

[14] A utility formulating an incentive request will know that it is unlikely to receive more than it requests, and that it if requests too much, it is unlikely to experience any downside beyond seeing its request scaled back to the Commission's tolerance level. Accordingly, all of the incentives (as it were) point towards bold and multifaceted incentive requests.

[15] Relatedly, if an applicant requests incentives that are purely additive, with no potential for returns in the low end of the zone of reasonableness in the event of shoddy transmission development performance, the Commission should ask whether an incentive program that bracketed the cost-based result with performance based potential rate increases and decreases would better advance the purposes of Section 219. See Part III.D. An incentive regime that can only result in rate increases is not the most "efficient," Section 219(b)(1), way to incent the consumer-benefitting performance sought by Section 219. Most successful incentive programs reward competent management and penalize incompetent management.

provide early financing. If it fails to ask these questions, the Commission will not be honoring the explicit consumer-benefiting purpose of Section 219 and its requirement that any approved incentives be just and reasonable.

The Commission' obligation to ensure that any intentionally non-cost component of approved rates serves authorized statutory purposes is well-recognized. In *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), on which Order 679 relies (at P 65 & n.50), the Supreme Court held that any pricing approach must be "reasonably calculated to achieve appropriate regulatory purposes." *Id*. at 800. Putting a finer point on this reasonable calculation requirement, the D.C. Circuit has held that "[i]f the Commission contemplates increasing rates for the purpose of encouraging exploration and development … it must see to it that the increase is in fact needed, and is no more than is needed, for the purpose." *City of Detroit v. FPC*, 230 F.2d at 817. The court affirmed this determination in *Farmers Union*, criticizing the Commission for failing to "even attempt to calibrate the relationship between increased rates and the attraction of new capital." *Farmers Union*, 734 F.3d at 1503. In so doing, it applied to this Commission a prior holding that an Interstate Commerce Commission rate adder was arbitrary and capricious because it lacked "adequate justification for the choice of a particular increment above fully allocated costs."[16] In *Public Utilities Commission of California v. FERC*, 367 F.3d at 929, the majority and dissenting opinions diverged on the factual question of whether the incentive awarded had adequately been shown to have been necessary, but they agreed that only a necessary incentive should be awarded.[17]

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[16] *Id*. at 1503, citing *San Antonio v. United States*, 631 F.2d 831, 851-52 (D.C. Cir. 1980), *rev'd on other grounds sub nom. Burlington Northern, Inc. v. United States*, 459 U.S. 1229 (1983).

[17] *Compare id*. at 929 (finding that the incentives and proposed project were presented to FERC together as a take-it-or-leave-it package) *with id.* at 932 (Rogers, C.J., dissenting) (questioning whether the ROE component of the

In short, the rule should make clear that the Commission will be free to choose the incentive(s) that in a particular case are rationally suited to advancing the purposes of Section 219, and that the orders in such cases will articulate an explicit "rational connection between the facts found and the choice made." *Motor Vehicle Mfrs. Assn' v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. at 43 (quoting *Burlington Truck Lines v. United States*, 371 U.S. 156, 168 (1962)).

Order 679's explicit rule that any awarded incentive must leave the overall rate still within the "zone of reasonableness" does not amount to the same thing. Even when moving within the zone, FERC's exercise of its discretion must be reasoned. Despite keeping rates inside a zone of reasonableness, the Commission may still be reversed for failing to adhere to reasoned decisionmaking in placing the rate within that range. *See, e.g., Pub. Serv. Comm'n of Ky. v. FERC*, 397 F.3d at 1006-07 (reversing an incentive award that did not "play fair"). The Commission may not, for example, flip a coin in a non-incentive case to determine whether to award a rate at the top of the zone or the bottom of the zone. Rather, the Commission must give a "reasoned explanation" for relying on any non-cost factor, *see Missouri Pub. Serv. Comm'n v. FERC*, 337 F.3d at 1071, including "a reasoned explanation of how the factor justifies the resulting rates," *Farmers Union*, 734 F.3d at 1502.

To be sure, when the "reasonabl[e] calculat[ion]" (*Permian Basin Area Rate Cases*, 390 U.S. at 800) involves predicting—especially when it involves predicting the consumer value of a structural reform, such as RTO formation—it may not be possible to calculate precisely. The calculation need only meet the deferential standards of reasoned decision under the Administrative Procedures Act. Accordingly, it would "demand[] too much" to require a showing that a proposed incentive is set at exactly the optimum point, where the net consumer

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offer was in fact take-it-or-leave-it).

benefit (after weighing both what the incentives yield and what they cost) is at its zenith. *See Maine Pub. Utils. Comm'n v. FERC*, 454 F.3d at 288. In some cases, especially before experience is gained, the calculation may have to be more qualitative than quantitative. If that is all that the Commission meant to establish by replacing the cost-benefit requirement of 18 C.F.R. § 35.34(e)(ii), then that replacement would not violate its statutory obligations. But to say that the calculus involves judgment and deserves deference is very different from saying that it can be ignored. Even *Maine Public,* which goes as far as any case towards deferring to the Commission's incentive-related judgment, states that FERC is bound to "an end-result test." *Id.* at 289. In other words, when the Commission is considering incentive rates, it is the "total effect" — the net impact on customers — "which counts."[18]

While some incentives appear more likely to be counterproductive than others,[19] as it gains experience administering FPA Section 219 the Commission will gather further insights as to which incentives return net consumer benefit, and which don't, and will become able to "verify the accuracy of its prediction[s] that granting … [rate] incentives will spur increased investment." *City of Charlottesville v. FERC,* 661 F.2d at 955 (Wald, J, concurring). The rule should be amended to explicitly retain a "reasonable calculation" test, so that this experience will be taken into account.

E. Incentive Applications Should Have to Explain What Customer Classes and Geographic Zones Will Pay the Incentive-Increased Rate

The Order defers "rate design" issues, including issues concerning regional versus zonal rates versus participant funding, to "associated section 205 filings in which applicants are

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[18] *FPC v. Hope Natural Gas Co.*, 320 U.S. at 602-03. This *Hope* "end result" test is cited both in Order 679 (at n.20) and in *Pub. Serv. Comm'n of Ky. v. FERC*, 397 F.3d at 1009, which *Maine Public* cites in turn.

[19] *See* TAPS NOPR comments at 9-22, 42-43.

seeking rate recovery of transmission incentives." Order 679 at PP 383, 388. Although this approach is superficially consistent with the Order's general approach of deferring many specific issues to future proceedings, it raises two specific concerns.

First, before the Commission gives an incentive even a general, declaratory approval, it should ascertain what ratepayer classes will be subject to paying it. Assuring that incentive rates are non-discriminatory is expressly required under FPA § 219(d), and that requirement has, properly, been carried forward into 18 C.F.R. § 35.35(d)&(e). But a reasoned determination that an incentive will be non-discriminatory cannot be reached without knowing to what transmission user classes it will apply. Most importantly, if an incentive rate will apply only to unbundled transmission customers while bundled retail customers of the incented TO continue to pay cost-based rates, the incentive will be function as an anti-competitive pricing differential. *See generally Midwest Indep. Transmission Sys. Operator, Inc. and Ameren Servs. Co.*, 109 F.E.R.C. ¶ 61,167, P 14. And because the non-owners who would pay the higher price would represent a relatively small share of the transmission users, the discriminatory revenues probably would not even amount to enough, in system-wide terms, to make a difference in getting transmission built, although it could subject TDUs to an anticompetitive price squeeze.

Second, issues of geographic cost allocation must not get lost in the shuffle between declaratory petitions and formal Section 205 rate filings. TAPS showed in its NOPR comments (at 13-14) that broader cost allocation is one of the keys to getting transmission built, and the Commission has so found. *See New England Power Pool and ISO New England, Inc.*, 103 F.E.R.C ¶ 61,304, P 34), *clarified on denial of reh'g*, 105 F.E.R.C. ¶ 61,211 (2003); *New England Power Pool and ISO New England, Inc.*, 109 F.E.R.C. ¶ 61,252, P 29 (2004), *clarified*, 110 F.E.R.C. ¶ 61,003 (2005). Furthermore, the prospect that incentive-heightened costs will be spread should not become a reason for the perpetuation of construction-inhibiting license-plate rates (or participant funding, which makes grid expansion that accomplish Section 219 purposes even less likely and the incentives more burdensome and less necessary). As part of considering whether requested incentives can be better formulated to advance the consumer benefits envisioned by Section 219, it therefore is important to consider at the appropriate time whether an incentive request should be conditioned on geographically broadened cost spreading.

Order 679 at P 388 can be read to suggest that cost allocation issues should be deferred all the way to Section 205 proceedings, but they should also be considered in connection with the facility-specific declaratory petitions that may precede Section 205 applications to avoid a Catch 22. The *Allegheny* and *AEP* companion orders deferred, naturally enough, to the ongoing PJM geographic cost allocation proceedings in Docket No. EL05-121. However, future petitions involving other regions may arise without such allocation proceedings having already been instituted. The Commission should state its readiness to consider in the course of declaratory proceedings how cost allocation is being handled for the subject facilities, and whether altering that treatment should be part of the incentive program.

F. Guidance Is Needed Regarding How the Top End of the "Zone of Reasonableness" Will Be Set

As Order 679 and conventional Commission practice now stand, the most important issue in transmission ratemaking will be the selection of proxy companies. As exemplified by the *AEP* and *Allegheny* companion orders to Order 679, many transmission owners will request rates set at the high end of the "zone of reasonableness." So long as the Commission retains the Final Rule's overly broad presumptions and vague nexus standard, see Parts III.B and C above, too many of those requests will be presumptively granted. The main restraint on transmission rates therefore will be the ceiling that is set by the placement of the top of the zone of reasonableness.

When that zone is computed according to recent conventions for electric utilities, that zone may be very broad, and the top of the zone may be correspondingly high. Order 679 (at P 92) illustratively refers to a hypothetical zone of reasonableness that extends from 9% to 13%. In actual recent practice, however, the zone has been defined by taking a sample group that includes a large number of proxy companies and calculating two data points per proxy. Each pair of points represents the extreme values for each company, because they reflect diverse growth forecasts and atypical dividend yields at the highest and lowest and transient share prices of the study period. Even more important, the large number of proxies (a high "*n*") means that the array of 2*n* data points is very widely dispersed. The "zone of reasonableness" is often characterized as reaching up to the higher data point for the most extreme company in the proxy set — that is, the most extreme of the extremes.

This approach was less of a problem when transmission returns were set at the center of the resulting broad range, whether it be the midpoint that is used in Regional Transmission Organization cases[20] or the median that is used in single-company cases.[21] But when the top of the range becomes the return, defining the top by reference to the extreme among extremes is a recipe for indefensible results that will fail to yield net consumer benefits — as Section 219 requires, see Parts III.C and D above.

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[20] *Midwest Indep. Transmission Sys. Operator, Inc.*, 100 F.E.R.C. ¶ 61,292 (2002), *aff'd in relevant part sub nom. Pub. Serv. Comm'n of Ky. v. FERC*, 397 F.3d 1004 (2005); *ISO New England, Inc.*, 109 FERC ¶ 61,147, P 205 (2004), *aff'd*, *Maine Pub. Utils. Comm'n v. FERC*, 454 F.3d 278 (D.C. Cir. 2006).

[21] *See Golden Spread Electric Coop., Inc. v. Southwestern Pub. Serv. Co.*, 115 F.E.R.C. P 63,043, P 106, *corrected*, 115 F.E.R.C. ¶ 63,054 (2006) ("Commission precedent clearly establishes the median as the more appropriate point to be used for establishing the ROE. SPS' arguments to the contrary are not persuasive; clearly in *MISO Remand* the Commission stated that the setting of the midpoint was due to the unusual circumstance of setting an ROE for an entire group of electric utilities."). *See also Bluegrass Generation Co., LLC*, 115 FERC ¶ 63,015, P 107 (2006) (reciting Staff position adopting the median, in a reactive case that ultimately applied the surrounding TO's return as a proxy).

Consider the spreads in the proxy results data points from the two most prominent recent electric transmission return cases to have proceeded through an evidentiary hearing, based on proxy data compiled this century. In the Midwest ISO final order,[22] the lowest proxy data point was 8.79%, and the highest was 15.96%, *i.e.*, 717 basis points higher. In the RTO New England Initial Decision,[23] the lowest proxy data point was 7.35%, and the highest was 14.09%, *i.e.*, 674 basis points higher. With such wide spreads, the spread from the lowest to the highest data point may extend far beyond a "zone of reasonableness" whose purpose now includes identifying the highest reasonable rate.

This risk of error is especially large if the proxies are selected principally for geographical proximity, as they were in the MISO and New England cases, rather than on the basis of having company-wide capital requirements that fairly indicate the costs and risks of capital invested in transmission.[24] It may be that "risk assessment is part of the traditional DCF analysis," Order 679 at P 92, but only in the sense that traditional DCF analysis is aimed at identifying both high and low returns in order to bracket a reasonable return at the <u>center</u> of the range. Traditional DCF analysis does <u>not</u> hold that the indicated experienced return of the utility in the proxy group that has the highest implicit highest-days cost of capital is "reasonable" for the utility in the proxy group that has the lowest cost of capital. When the indicated returns will be used only as a step to identifying a central value, it may not be unreasonable to apply imprecise but neutral criteria, such as regional co-location, to identify the proxies that will be

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[22] *Midwest Indep. Transmission Sys. Operator, Inc.*, 100 F.E.R.C. ¶ 61,292 (2002).

[23] *Bangor Hydro-Electric Co.*, 111 FERC ¶ 63,048, P 73 (2005), *exceptions pending.*

[24] Indeed, there is a real question as to whether a company-wide cost of capital for companies with widely divergent activities, fairly reflect the cost of capital for transmission lines. If the company in question has significant investments in South America or China, for example, cross subsidization issues clearly come into play, and the company-wide cost of capital may well be far in excess of the cost of capital needed for transmission alone.

studies to generate the range. But when the top of the range sets the return, it becomes critical to ensure that every company included in the proxy group very closely resembles the utility whose return is being capped, in every relevant regard — its capital structure, business risk, financial risk, and associated capital costs. Thus, if the Commission continues to declare in favor of rates set at the top of a range that has not yet been established, it will have to be prepared to apply much stricter scrutiny to the composition of the proxy group that will determine that range. On rehearing, the Commission should make clear that it will do so.

The Commission should also make the array of proxy results more meaningful as a way to establish a high and low reasonable rate by adopting a simple methodological change. Rather than bringing two results per proxy company into the array of results, the Commission should first average those two results with each other so as to generate one, averaged result per proxy company.[25] It is clearly not unreasonable to average two initial results per proxy so as to bring forward one combined result per proxy. The Commission already does that in a standard-methodology gas case.[26] Taking a similar approach to the number of proxy results considered in

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[25] For example, consider the proxy results that were submitted by New England transmission owners in Docket No. ER04-157 and considered by the Commission in *ISO New England, Inc.*, 109 F.E.R.C. ¶ 61,147, P 205. The Commission discarded one of the two results for proxy group member PPL: the 17.7% result, which was found to assume an unsustainable growth rate. In that same study, PPL also had an 8.9% result (based on the lower dividend yields associated with higher-stock-price days and a more moderate growth projection). Under the methodology suggested in the text, PPL would have been given a single result, of (8.9%+17.7%)/2 = 13.3%, which presumably would have been retained. If it had been retained and the top of the zone of reasonableness was set by reference to the highest retained data point, PPL would have furnished that point, and the zone therefore would have extended up to that 13.3%. In contrast, if the Order 679 approach had applied to those proxy results, in a manner that set the top of zone at the highest result remaining among the two-per-proxy results after discarding the PPL 17.7%, the zone would have extended up to 15.5% (the high-side result for Public Service Enterprise Group). *See* Exh. NETOs-3, filed in Docket No. ER04-157 on November 4, 2003.

[26] *See, e.g.*, *High Island Offshore System, L.L.C.*, 110 F.E.R.C. ¶ 61,043, P 148 (reciting the standard gas-case version of the DCF methodology; it involves <u>one</u> implied cost of equity per proxy company, derived by averaging two growth rates (IBES short-term growth rates and multi-source economy-wide long-term growth rates) and combining that with <u>one</u> measure of dividend yields, one that reflects both upswing and downswing stock market days).

electric cases would yield a narrower zone of reasonableness, higher at the low end and lower at the high end, and thereby provide a more defensible basis for the conclusion that returns set anywhere within that narrowed range can be just and reasonable.

Finally, the Commission must ensure that returns set at the top of the range do not become a self-escalating spiral. If the highest proxy result sets the top of the zone of reasonableness and that result already reflects an investor expectation that the proxy itself will garner above-cost incentive profits, the outcome may be a feedback loop in which high profits for one company raise those of others, *ad infinitum*. In the individual cases that will follow the Final Rule, the Commission will have to take care to prevent that cycle, and on rehearing, it should express its readiness to do so.

G. Public Power Should Be Treated Comparably, and Projects that Exclude Ready, Willing, and Able Co-Investors Should Face Stricter Incentives Scrutiny

Order 679's treatment of public power participation fails to honor the directive of FPA § 219(b)(1) that the rule should "promot[e] capital investment in the enlargement, improvement, maintenance, and operation of all facilities for the transmission of electric energy in interstate commerce, regardless of the ownership of the facilities." (Emphasis added.) The congressional desire to expand the "TO club" is also evident in Section 216(b)(1)(B).[27] On rehearing, the Commission should make clear that any approved incentive will be equally available to all owners of the facilities that are found to merit incentives, regardless of their entity form or business model. It should also make clear that if vertically integrated utilities have excluded

[27] This provision makes available backstop federal siting authority for designated corridors where the applicant is not eligible to receive a state permit because it does not serve retail load in the state.

other utilities from co-owing a facility located in their common footprint, the Commission will view with disfavor a request to incent that facility.

The Final Rule's failure to honor Section 219(b)(1) is especially disappointing in light of the rulemaking record. The "Participation by Public Power" panel at the April 22, 2005 Transmission Investment Technical Conference left no doubt that public power and coops are ready and willing to invest in the grid if permitted to do with comparable cost recovery.[28] Also significant, the "Role of the Independent Transmission Companies" panel at the same conference produced a virtual chorus stating that public power and coop investment was not only welcome but was an important factor in getting transmission built.[29] PJM also pointed to its "consortium" approach as a means to include public power transmission investment.[30] Thus, technical conference testimony provided strong support for making public power investment part of the solution to the nation's transmission needs. In line with this consensus, the NOPR (at PP 59-61) found it "important that the Commission encourage needed transmission expansion from all sectors of the industry, including public power," and recited numerous examples of public

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[28] *Transmission Independence and Investment*, Docket Nos. AD05-5-000 and PL03-1-000, April 22, 2005 ("Transmission Investment Technical Conference"), Sue Kelly, APPA (Tr. 256-58); Roy Thilly, WPPI/TAPS (Tr. 275). *See also* Written Statement of Anne Kimber on behalf of MMTG and TAPS for the December 7 Technical Conference, Docket No. RM04-7, at 11 (Dec. 7, 2004); APPA, *Restructuring at the Crossroads* (Dec. 2004) (available at: http://www.appanet.org/files/PDFs/APPAWhitePaperRestructuringatCrossroads1204.pdf).

[29] Commissioner Brownell's question ("would you welcome partners as in coops and public power?") at the Transmission Investment Technical Conference (Tr. 241) was answered resoundingly in the affirmative by Nick Winser, National Grid (Tr. 242); Paul McCoy, Trans-Elect [erroneously referenced as Mr. Boyko] (Tr. 242-43); Dale Landgren, ATCLLC (Tr. 243); Eric Lammers, ArcLight Capital Partners (Tr. 244); and Jose Rotger, TransEnergie ("no question, public power is a part of this. They're very much a driver of investment," Tr. 244).

[30] Audrey Zibelman, PJM (Tr. 75-76). *See also* testimony at the May 13, 2005 technical conference held in Charleston, West Virginia, *Promoting Regional Transmission Planning and Expansion to Facilitate Fuel Diversity Including Expanded Uses of Coal-Fired Resources*, Docket No. AD05-3-000 of PJM's Karl Pfirrmann (Tr. at 68) (through the consortium concept, "public power entities who have long expressed interest in ownership of transmission facilities, can now be partners in such a project").

power's demonstrated ability to "provide capital and build transmission capacity in some of the most critical transmission projects."[31]

Despite this record and despite Section 219(b)(1), the Order stops short of stating clearly that any ownership-tilted incentive will be disapproved or at least disfavored. Instead, the Order states merely that "a public power entity should have the same opportunity afforded to jurisdictional entities to recover <u>costs</u> related to new transmission investment." Order 679 at 356, emphasis added. Cost recovery is the constitutional minimum; rate orders that fail to provide it are reversible as confiscatory.[32] But the gist of Order 679 is that certain transmission rates will be intentionally set <u>above</u> costs. If that is taken as a given, there is no sufficient reason to limit the applicability of incentives such that they are available only to those potential transmission developers who happen to be FERC-jurisdictional. As FPA § 219(b)(1) reflects, the Commission's mission is to serve the interests of the entire nation and its electricity-consuming public, not those of a certain ownership sector. In capital markets as in other markets, narrowing the sources of supply while holding demand constant will raise the price. Consequently, as between offering a modest incentive to any ready, willing, and able investor, and offering a larger incentive while restricting its applicability to only certain investors, the statute clearly requires the former.

The FPA § 219(b)(1) directive to promote transmission investment "regardless of the ownership of the facilities," coupled with the Commission's obligation under FPA § 217(b)(4) to facilitate the planning and expansion of the grid to meet the needs of all load serving entities,

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[31] *Promoting Transmission Investment through Pricing Reform*, Notice of Proposed Rulemaking, 70 Fed. Reg. 71,409 (proposed Nov. 29, 2005), IV F.E.R.C. Stat & Regs. ¶ 32,593, PP 59-61.

[32] *See, e.g.*, *FPC v. Natural Gas Pipeline Co*., 315 U.S. 575, 585 (1942); *FPC v. Texaco Inc*., 417 U.S. 380, 391 - 392 (1974).

also calls for the Commission to target transmission incentive spending so as to promote inclusive joint ownership arrangements, in order to be non-discriminatory and in order to get the job done. That may be the Commission's intent; in the *AEP* and *Allegheny* orders that accompanied Order 679, the Commission stated that "[c]onsistent with the Final Rule, we look favorably upon applications by joint public and investor-owned consortia." *Allegheny*, 116 F.E.R.C. ¶ 61,058 at P 151. On rehearing, however, the Commission should make clear that the converse is also true — that it looks with disfavor upon an application from which public power investment has been unreasonably excluded.

This is not a request "to mandate a particular joint-structure be used in all cases," Order 679 at P 356. For some projects there may be no public power system wanting to participate, and we do not mean to suggest that such a project be disqualified from incentives on that basis alone. We also recognize that a transmission development group that seeks to qualify for "transco" incentives might reasonably want to exclude participation by both public power and private power generation market participants, and that there could conceivably be a reasonable explanation for a narrow-based transmission ownership group in some other unusual specific case. However, in general, a project sponsor or sponsorship group that is serious about getting transmission built will welcome participation from all responsible potential investors, and especially from public power entities, who often have governmental relationships with siting authorities and distribution relationships with the environmentally-minded public. And as the record in Wisconsin and elsewhere shows, such broad participation is the key to effective transmission planning and development. See TAPS NOPR Comments at 9-22 (summarizing "What Works" and "What Doesn't Work," and demonstrating that inclusive planning, inclusive ownership, and inclusive regional rates are the key to successful grid development programs).

Conversely, when a transmission owner comes to the Commission seeking authorization to collect above-cost dollars from ratepayers despite turning down dollars offered by would-be co-owners, the Commission should recognize the inconsistency and look askance at the request. Accordingly, when a ready, willing, and able public power investor has sought participation and has been rebuffed, the Commission should be strongly disinclined to reward the excluding sponsor(s) with the privilege of incentive rates.

Furthermore, if an incentive will have the effect of raising rates only for those transmission loads that pay unbundled transmission prices, while leaving rates cost-based for those loads that take the transmission owners' bundled retail service, it will be inherently discriminatory. Such discrimination should be presumed to be undue, and thus presumptively barred by FPA §§ 219(d), 205 and 206, if no genuine opportunity to participate in the upgrades was made widely available to all TDUs in the project's footprint. The opportunity to participate in the upgrade and its associated incentive (with recovery through credits or otherwise) mitigates incentives' competitive sting for the TDU. Without that opportunity, however, TDUs would be required to subsidize, through incentive returns, their vertically integrated competitor's generation sales, making the resulting incentives discriminatory. At bottom, this is another version of the recently recognized discrimination problem with the former OATT Section 30.9. *See* Order 888 Reform NOPR at P 257 (proposing revisions to eliminate this "disincentive to coordinated planning and investment in the transmission grid"). Just as it is unduly discriminatory to allow large utilities to veto transmission investment credits by refusing to engage in joint planning, it is unduly discriminatory to allow such utilities to veto transmission investment incentives by refusing to participate in inclusive ownership arrangements.

In sum, the Commission should tie receipt of return incentives to a demonstration that the vertically integrated transmission owner has offered TDUs in its footprint opportunities to participate as owners in the upgrade on reasonable terms, *i.e.*, on a basis that will allow TDUs to achieve ownership rights in the combined transmission system up to their load ratio share through investment equalization on a net book basis, with the TDUs' revenue requirement offsetting (and once it achieves parity, eliminating) the TDUs' obligation to pay to use combined facilities, and included (with incentives) on a comparable basis in the transmission provider's rates to third parties.[33]

H. *The Commission Should Retract Its Statement that Section 219 Would Not Allow Incentive Programs to Be Performance-Based, and thus to Yield Below-Cost Results for Poor Performance*

Section 219 expressly provides that incentive programs may be "performance based." It is well-established that performance-based rates may bracket the cost-based revenue requirement, such that relatively good performers earn more than that amount, and relatively poor performers earn less. A form of such "symmetry" was used in *Permian Basin Area Rate Cases*, 390 U.S. at 760, 796-98; old or oil-well gas was priced "relatively low … since price could not serve as an incentive, and since any price above average historical costs, plus an appropriate return, would merely confer windfalls." The requirement that "PBR should encompass both rewards and penalties" is included in Order 2000's principles for FPA-compliant

[33] In an RTO, recognition of TDU investment could be achieved by creating a multiple transmission owner zone, with shared revenue distribution on a shared basis. *See, e.g.*, SPP Tariff, Attachment, accepted in *Southwest Power Pool, Inc.*, 112 F.E.R.C. ¶ 61,355 (2005), *clarified*, 114 F.E.R.C. ¶ 61,242 (2006). In the absence of an RTO, such recognition can be achieved through crediting under OATT § 30.9, as may be reformed by the Final Rule to be used in Docket No. RM05-25.

performance- based rates,[34] and has long been a foundation for Commission incentive rate policy.[35] Indeed, the Commission used to reject incentive proposals if they failed to provide that sub-par performance would yield sub-par rates. *See, e.g., Viking Gas Transmission Co.,* 57 F.E.R.C. ¶ 61,417, at 62,356 (1991). Even if the rule does not require that all asymmetrical approaches will be rejected, the Commission is not statutorily free to rule out such symmetrical approaches, whether they are sponsored by incentive applicants or recommended with appropriate support by intervenors who suggest alternatives to a request.

Unfortunately, Order 679 can be read to have done so. It summarizes a TAPS suggestion as recommending that "transmission providers should have their returns reduced to the low end of the zone of reasonableness if they fail to achieve and maintain a robust transmission infrastructure." Order 679 at P 275. In response, it states that "to the extent these proposals consist of penalties (which would not provide incentives to expand transmission infrastructure and would likely limit the investment in infrastructure by reducing the return – and therefore funds for capital expansions), they do not implement the requirements of section 219." Order 679 at P 277.

But while Section 219 may not <u>require</u> that poor performers earn returns at the low end of the reasonable zone rather than the center, it surely <u>permits</u> that result. Requiring utilities to have

[34] Order No. 2000, 65 Fed. Reg. at 921, [1996-2000 Regs. Preambles] F.E.R.C. Stats. & Regs. at 31,185. The Commission reasoned: "Although some PBR designs employ either rewards or penalties, but not both, most commenters suggest, and the Commission agrees, that the most effective and most fair designs will likely encompass both. One rationale for this is that it is not always clear what incentives an RTO will respond to, and therefore the prospect of higher revenues as well as the threat of lower revenues may induce an RTO to provide the best possible performance. An additional rationale is that under the FPA, the Commission is required to set rates for transmission service at just and reasonable levels. To the extent that rates may vary within a range—both up and down— as a function of RTO performance, this statutory requirement may be better satisfied."

[35] *See Incentive Ratemaking for Interstate Natural Gas Pipelines, Oil Pipelines, and Elec. Utils.*, 61 F.E.R.C. ¶ 61,168 at 61,590 (1992) ("incentive regulation should be designed to penalize utilities that fail to achieve these efficiencies—opportunities for reward should be offset by a symmetric downside risk").

better-than-poor performance in order to earn a return above the bottom of the zone of reasonableness would be a performance-based incentive and thus fall within the scope of Section 219. Logically, the Commission cannot claim broad discretion to set rates at the high end of the zone of reasonableness while denying that it has authority to set rates at the low end of the zone.

I. Form 730 Should Be Revised to Provide More-Transparent Reporting of Incentives' Cost and Results

> Evaluate what you want — because
> what gets measured, gets produced.
>
> James Belasco

The reporting requirements proceed from a fundamental misconception as to the purpose of Section 219 and of its implementing rule. At P 367, the Order states that "[t]he rule's purpose is to both provide new investment as well as ensure that customers benefit." But that is not correct. The purpose is explicitly stated in Section 219: "the purpose of benefiting consumers by ensuring reliability and reducing the cost of delivered power by reducing transmission congestion." FPA § 219(a). Transmission investment is not legitimately an end in itself; it is statutorily a <u>means</u> to the end of benefiting consumers. A gold-plated transmission line to nowhere would provide "new investment," but it would not serve the purpose of Section 219. What ultimately matters is not how much transmission spending occurs, but how much transmission gets completed and energized, whether that transmission is well-designed to benefit consumers, and whether the amounts that consumers pay above transmission cost prove worthwhile by reducing delivered power cost and/or improving reliability. Order 679 elsewhere recognizes as much, stating (at P 372) that "the goal of the rule is not to ensure the achievement of annual capital spending targets but rather to ensure the overall project is completed."

Accordingly, the Form FERC-730 Table 1 tracking of capital spending increases is misdirected. Table 2 calls for project status information, and is therefore closer to providing a useful measure of whether incentives are benefiting consumers, but it too will fail to identify how much consumers are spending as incentive rate treatments and what they are getting in return. Order 679 (at P 372) rejected TAPS' suggestions for reporting requirements that would elicit that information on the ground that such information "is beyond the scope of our requirements," but that is a conclusion, not a reason. We urge the Commission to expand the Form 730 reporting requirements, effective with the next reporting cycle after the Commission acts on rehearing, to include at least the following additional information.

- A budgeted or as-built cost column (preferably, both) should be added to Table 2, preferably with supporting detail or division by year, such that each annual total investment amount in Table 1 can be mapped to the individual projects in Table 2. This detail would help to prevent utilities from gaming the reports by breaking delayed projects into segments smaller than the $20 million cost below which project detail is not required, and reporting only their successes. It would also help customers predict their future transmission rates, especially rates paid to transmission owners that use the AFUDC method.
- The information in Table 2 should be broken out by USoA account. At minimum, facilities that are booked to transmission under traditional Uniform System of Accounts ratemaking, but which are now functionalized to generation or distribution under established Commission policy (*e.g.,* costs of generator step-up transformers) should be removed or segregated from the reported totals. Consider, *e.g.*, a report for a utility with many on-schedule generator transformers and one, delayed, transmission line addition. Without this information, Form 730 will present a misleading picture.

- A column should be added to Table 2 summarizing, for each project, which network service customers are predominantly paying for that project's costs — *i.e.*, whether they are being rolled in to a regional rate, collected on a rolled-in basis from customers in a particular transmission owner's area, or directly assigned. This will help customers predict their exposure to future transmission rates and provide the data for empirical evaluation of how cost allocation affects transmission development.
- Most important, Form 730 should reveal the expected differential cost to consumers (annually or over the subject facilities' expected life, and preferably both) of each project's approved above-cost incentives. In order to determine, at least in retrospect, whether above-cost incentive payments are turning out to be worthwhile, it is essential to keep track of the price tag.

CONCLUSION

For the reasons discussed above and in TAPS NOPR Comments, TAPS urges the Commission to grant our rehearing requests and revise the Final Rule so that it puts in place policies and rates that will work together to get needed transmission built in a way that reduces overall costs to consumers, as Congress intended.

Respectfully submitted,

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