

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

Promoting Transmission Investment
Through Pricing Reform

Docket No. RM06-4-000

**Comments of the Electricity Consumers Resource Council (ELCON),
the American Iron & Steel Institute (AISI), the American Chemistry Council
(ACC), the Coalition of Midwest Transmission Customers (CMTC),
Industrial Energy Consumers of America, NEPOOL Industrial Customer
Coalition (NICC), the PJM Industrial Customer Coalition (PJMICC), and the
Southeast Electricity Consumers Association (SeECA)**

The Electricity Consumers Resource Council (ELCON), the American Iron & Steel Institute (AISI), the American Chemistry Council (ACC), the Coalition of Midwest Transmission Customers (CMTC), Industrial Energy Consumers of America, NEPOOL Industrial Customer Coalition (NICC), the PJM Industrial Customer Coalition (PJMICC), and the Southeast Electricity Consumers Association (SeECA) (collectively “Industrial Consumers”) appreciates the opportunity to comment on the Commission’s proposed implementation of the Congressional mandate under the Energy Policy Act of 2005 (EPAAct 2005) section 1241 that FERC create incentives to encourage the development of transmission facilities.

Industrial Consumers would advise the Commission to proceed with this latest task with caution. Constraints on transmission are a major obstacle to efficient grid operations. However, insufficient investment in transmission has not been caused by deficiency in FERC pricing policy. Rather, it is the result of long neglect coupled with a climate of regulatory uncertainty that has created, in many instances, an unwillingness to invest. Nonetheless, Congress has

determined that incentives are warranted to spur the investment necessary to upgrade the transmission grid for the benefit of consumers. The Commission's task is to construct incentives that will achieve the goal of transmission expansion, but avoid incentives that are disproportionate and thus do not provide net benefits to consumers. FERC must specify criteria to ensure that incentives are applied on a just and reasonable basis. FERC should, among other safeguards, appropriately measure risk against performance, adopt guidelines for ensuring net benefits to customers exceed costs including any incentive premium, and establish a screening process to prevent windfall profits to free-riders.

I. SUMMARY OF COMMENTS

For decades, investment in the transmission system has been neglected. Faced with urgent need to improve the transmission system, the NOPR offers investors a menu of rich incentives. Any rule adopted by the Commission should offer the minimum incentives necessary to get the job done. All possible steps should be taken to avoid "creamy" incentives disproportionate to the resulting benefit to consumers. FERC should insist on a *quid pro quo* for each incentive, *e.g.*, (1) prudence review, (2) independent regional stakeholder planning process, (3) applicant's willingness to accept third-party ownership, (4) a requirement to seek third party funding that would reduce the amount of investment exposed to the incentive, (5) a requirement that long-term capacity rights in a new facility be offered in an open-season bidding process, or (6) ensuring that the transmission expansion accommodates economic needs and not just the more narrow need for reliability.

Section 219 requires that transmission investment benefit customers. We believe that a cost-benefit analysis is crucial to allowing the Commission to reach this conclusion especially in any circumstances where prudence is not reviewed.

FERC proposes prudence reviews with respect to five categories of investment:

(i) investments to meet reliability standards under Section 215 of EPAct; (ii) investments related to transmission infrastructure development in transmission national interest corridors under Section 216; (iii) investments in prudently-incurred development costs where facilities are abandoned as a result of factors beyond the utility's control; (iv) recovery of prudently-incurred transmission-related CWIP in rate base; and (v) recovery of prudently-incurred pre-commercial operation costs. ELCON endorses these categories and suggests that prudence reviews be conducted on all transmission investments as a *quid pro quo* for incentive treatment.

PBR carries many downside risks to consumers. PBR provides as much opportunity for utility gamesmanship as cost of service ratemaking. At a minimum, PBR requires both downward and upward adjustments to punish as well as reward performance and known benchmarks specified in advance. Application of PBR to a non-profit is a non-sequitur.

II. COMMENTS

A. Incentives Should Be No Higher Than Needed To Achieve Desired Investment

FERC must exercise caution when allowing inclusion of incentives in rate formulas so as to avoid the risk of returns that are excessively “creamy,” a concern voiced by the D.C. Circuit in *Farmers Union Central Exchange Inc. v. FERC*.¹ The case law requires demonstration that the incentives are carefully calibrated and will not result in a windfall. In *Farmers Union*, the D.C. Circuit held that unsupported predictions of increased investment in oil pipelines were not sufficient to justify the challenged incentive rates. There must be an attempt to “verify the accuracy of [the Commission’s] prediction that granting ... incentives will spur increased

¹ 734 F.2d 1486, 1503 (D.C. Cir. 1984), *cert. denied* 469 U.S. 1034 (1984).

investment.”² The increase should not be inflated beyond what is needed to incent the regulated utility.³ Incentives could be subject to refund in the event of a showing that they are unsupported or excessive; FERC has long noted that it has the authority under FPA Section 206 to order the refund of imprudently incurred costs.⁴ Finally, if any incentives are offered with respect to new construction, utilities should not be allowed to “double dip” and claim stranded costs for such facilities. If incentives are justified on the basis of putative risk, utilities – and not consumers – should bear the risk that the facilities might become stranded.

A specific concern is that transmission has not been built because of utility reluctance to expose their generation to new competition. For example, a transmission owner with combined assets in organized markets with LMP risks losing money if congestion is reduced. The challenge facing FERC is to tailor incentives so that they are sufficient to motivate a utility to forego congestion revenues but will not harm consumers.

B. Cost Benefit Analyses

FERC states in the NOPR that it does not propose to require applicants to provide cost-benefit analyses. Rather, review will occur under Sections 205, 206 and 219, all of which require that rates meet the just and reasonable standard. As Congress dictated in Section 219(a), FERC is to establish incentive-based rate treatments “for the purpose of benefiting consumers by ensuring reliability and reducing the cost of delivered power by reducing transmission congestion.” Industrial Consumers believe that inclusion of cost benefit analysis is essential to meet the Congressionally-mandated goal to assure that transmission incentives provide net benefits to consumers and to assure compliance with the just and reasonable standard.

² *Id.* (quoting *City of Charlottesville*, 661 F.2d at 955 (D.C. Cir. 1981) (Wald, J., concurring)).

³ *See City of Charlottesville*, 661 F.2d at 950.

⁴ *Maine Public Advocate v. Maine Yankee Atomic Power Co.*, 83 F.E.R.C. ¶61,122 (1998); *Wisconsin Public Service Corporation*, 60 F.E.R.C. ¶61,279 (1992).

The most explicit guidance that FERC has provided with respect to transmission investment was in the context of investments by RTOs in Order No. 2000.⁵ The Commission stated that applicants for innovative transmission rate treatments must demonstrate how “investment in the transmission supplier and reliability benefits consumers,” and provide a cost-benefit analysis including rate impacts. § 305.54(e) provides:

(e) Innovative transmission rate treatments for Regional Transmission Organizations.

(1) The Commission will consider authorizing any innovative transmission rate treatment, as discussed in this paragraph (e), for an approved Regional Transmission Organization. An applicant's request must include:

- (i) A detailed explanation of how any proposed rate treatment would help achieve the goals of Regional Transmission Organizations, including efficient use of and investment in the transmission system and reliability benefits to consumers;
- (ii) A cost-benefit analysis, including rate impacts; and
- (iii) A detailed explanation of why the proposed rate treatment is appropriate for the Regional Transmission Organization.

An applicant under this paragraph (e) must support any rate proposal as just, reasonable, and not unduly discriminatory or preferential.

In its 1992 Policy Statement on Incentive Regulation,⁶ the Commission focused on requiring quantification of benefits to consumers:

The Commission remains convinced that benefits to consumers must be quantifiable even though the task is admittedly a difficult one. All proposals must include a quantifiable estimate of the consumer benefits... and a realistic estimate of the program's prospects for success and risks of failure.⁷

⁵ 65 Fed. Reg. 809 (Jan. 6, 2000).

⁶ *Id.*, at 61, 587.

⁷ *Id.*, at 61,590.

The 1992 Policy Statement determined that there should be an “absolute upper limit in the risk to consumers that the incentive rates would be higher than rates they would have paid under traditional regulation.”⁸

Industrial Consumers believe that FERC should continue its policy of requiring a cost-benefit analysis for incentive-based rate treatments.

C. Regional Stakeholder Planning Process

The Commission should specify ground rules for a regional stakeholder process as a prerequisite for incentive treatment. Only if consumers and other interested parties are involved in the process can FERC assure that the mandate of Section 219 is fulfilled and that transmission incentives will benefit consumers. This is especially important given the historically piecemeal fashion in which transmission infrastructure takes place. Transmission planning, siting, and construction outside of RTOs has not been coordinated. Each infra-state segment of a multi-state transmission line must meet applicable state criteria. A roadblock encountered at any one segment may obstruct the whole project.

D. Recovery Of Prudent Development Costs

FERC proposes to conduct prudence review in connection with five categories of investments, including investments to meet reliability standards under Section 215 of EPAct, investment in transmission national interest corridors,⁹ recovery of prudently-incurred

⁸ *Incentive Ratemaking for Interstate Natural Gas Pipelines, Oil Pipelines, and Electric Utilities*, 61 FERC ¶61,168 (1992).

⁹ EPAct adds a new Section 216 to the FPA, which describes a national interest electric transmission corridor as any geographic area designated by the Secretary of Energy which is “experiencing electric energy transmission capacity constraints or congestion that adversely affects consumers.” Factors the Secretary will consider in making this determination will include whether:

(A) the economic vitality and development of the corridor, or the end markets served by the corridor, may be constrained by lack of adequate or reasonably priced electricity;

(B)(i) economic growth in the corridor, or the end markets served by the corridor, may be jeopardized by reliance on limited sources of energy; (ii) a diversification of supply is warranted;

transmission-related CWIP in rate base, recovery of prudently-incurred pre-commercial operation costs, and recovery of development costs in cases where construction of facilities is subsequently abandoned due to factors beyond the control of the public utility. Industrial Consumers commend the Commission for its decision to conduct prudence reviews in these particular instances, but suggest that it would be appropriate to subject all incentives to prudence review.

Review of the prudence of incurred costs has long been included in the Commission's regulatory toolbox. As FERC has previously stated:

The Supreme Court of the United States early recognized that the determination of what is just compensation for a public utility involves consideration of the utility's conduct in incurring its costs. ...

...[W]e reiterate that managers of a utility have broad discretion in conducting their business affairs and in incurring costs necessary to provide services to their customers. In performing our duty to determine the prudence of specific costs, the appropriate test to be used is whether they are costs which a reasonable utility management (or that of another jurisdictional entity) would have made, in good faith, under the same circumstances, and at the relevant point in time. We note that while in hindsight it may be clear that a management decision was wrong, our task is to review the prudence of the utility's actions and the costs resulting therefrom based on the particular circumstances existing either at the time the challenged costs were actually incurred, or at the time the utility became committed to incur those expenses.

New England Power Company, Opinion 231, 31 FERC ¶61,047, at 61,081-61,084 (1985).

As for abandoned facilities, the Commission's policy has traditionally been to limit recovery from ratepayers of only 50% of the utility's prudently incurred investment in the case of facilities that are not completed or placed into operation. The reason for this has been to ensure that transmission owner's management weighed the risk of abandonment or cancellation

(C) the energy independence of the United States would be served by the designation;

(D) the designation would be in the interest of national energy policy; and

(E) the designation would enhance national defense and homeland security.

before embarking on a project. *See New England Power Company*, Opinion No. 295, 42 FERC ¶61,016 at 61,068, *order on reh'g*, 43 FERC ¶61,285 (1988). The Commission has, at times, deviated from this policy and allowed 100% recovery only where the applicant has shown that the particular circumstances warranted they not shoulder the risk of the project. *Southern California Edison Co.*, 112 FERC ¶61,014 (2005). Industrial Consumers recommend that FERC maintain its 50% policy and that it permit additional recovery only upon a showing that the decision to develop or abandon a project does not lie with utility management and that shareholders do not share in earning from the project.

E. CWIP And ROE Adders

Industrial Consumers endorse, in principle, the Commission's proposals to allow CWIP costs to be expensed subject to prudence review. In November 2003, ELCON supported ATC's proposal to include transmission-related CWIP in ATC's rate base (in lieu of capitalizing the "Allowance For Funds Used During Construction" (AFUDC)) because this proposal was more beneficial to consumers in the long run.¹⁰ *American Transmission Co., (ATC)*, 105 FERC ¶ 61,388 (2003).

The CWIP cost recovery mechanism eliminated obvious disincentives to invest in new transmission and otherwise held customers harmless. At the same time it provided ATC much needed cash flow during the construction period, allowing the company to maintain financial health and ensure access to reasonably priced capital and minimizing rate impacts on its customers. The mechanism directly promoted transmission grid investment because revenues cannot be collected by the utility unless it is engaged in the construction of a new facility.

¹⁰ ELCON's comments, November 20, 2003, FERC Docket No. ER04-108-000.

ATC did not seek both CWIP and an ROE adder -- ATC agreed to forego the ROE 50 basis point adder for RTO participation and the 100 basis point adder for construction of new facilities. Industrial Consumers recommend that applicants for CWIP not be allowed also to obtain an ROE adder. Only one or the other should be available. Additionally, Industrial Consumers reiterate that CWIP recovery should be conditioned on approval through an RTO, reducing risk that consumers will foot the bill for a project that is ill advised or that does not go into service.

F. Performance-Based Regulation

The establishment of an accurate baseline revenue requirement is absolutely critical to the success of PBR. Because of the difficulty in establishing an accurate baseline, Industrial Consumers have in the past expressed its opposition to PBR.¹¹ Unfortunately, the adjudicatory process under PBR would face the same challenges as those the regulator faces with respect to traditional cost-of-service regulation: gamesmanship, incomplete information and cost revelation. From a consumer (ratepayer) perspective, the problem with any baseline revenue requirement determination is the high probability that the baseline will be overestimated. A new baseline estimate typically reflects the utility's inflated historical costs rather than starting from a "clean" set of books from which cross-class subsidies and other, often arbitrary, past accommodations and adjustments are removed.

Decades of experience by industrial intervenors in state and federal rate-setting proceedings has demonstrated that it is very difficult to prove that the failure to undertake a cost-saving action - such as a decision to make, or not to make, a new investment - is responsible for creating unreasonable costs. PBR is even less transparent than conventional ratemaking.

¹¹ Entergy, Docket RT01-75, June 18, 2001.

Additionally, PBR is appropriate only for profit-making entities whose favorable economic behavior is motivated by the profit incentives in real market environments. PBR is a non-sequitur for the non-profit business model because these entities are not driven by the need to increase shareholder revenues. ELCON has previously suggested that this problem could be resolved by requiring RTOs/ISOs to restructure their business models and shift business functions to an Independent System Administrator that serves under an incentive-driven contract. It may be possible to adapt PBRs to this business model where the Administrator and its staff are induced to operator efficiently and to innovate, and are held accountable for their performance.¹² Certainly PBR should not be applied to non-profits unless and until a successful model is up and running for for-profit entities.

IV. CONCLUSION

Any rules the Commission adopts should be appropriately tailored to accomplish the goal of transmission expansion that accommodates economic needs as well as reliability, without offering a promise of excessive returns. Incentives should be approved quid pro quo, including, e.g., prudence review, independent regional planning process, or a willingness to accept third party ownership.

¹² See ELCON's Nov. 4, 2004, Comments in FERC Docket RM04-12-000.

VI. NOTICES AND COMMUNICATIONS

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Dated: January 11, 2006