



Transmission Incentives: Light at the End of the Tunnel??

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Like the "Big Dig,"
It's a Very Long Tunnel

With Unexpected Twists, Turns –
... And a Few Leaks

Big Dig Trivia

■ Timeline:

- 1970s: Planning began
- 1987: Ronald Reagan vetoed public works bill as too expensive; Congress overrode the veto
- 1991: Ground was broken
- January 13, 2006: The final downtown ramp was opened

■ Scope:

- Projected cost = \$2.5 Billion
- Actual cost = \$14.6 Billion
- 15 million cubic yards of earth excavated
- Enough steel to wrap the earth in a 1" thick bar

Big Dig Trivia (*continued*)

- Still a work in progress:
 - Final implementation will continue for years – including development of extensive above-ground infrastructure (parks, museums, etc.)
 - And it still needs work because *it leaks!*

- A difficult road to travel:
 - Over the years of development, traffic patterns were adjusted routinely
 - The light at the end of the Ted Williams Tunnel was often illusive as the tunnel's entrance and exit locations continued to change

FERC's Big Dig

December 1999 – We enter the tunnel ...
(Hope we have enough gas!)

- FERC issues Order 2000 (to promote RTO development)
 - Established 18 C.F.R. § 35.34(e) re innovative rate proposals
 - Formula ROEs, risk-adjusted ROEs, ROEs decoupled from capital structure
 - Transmission rate moratoria
 - Accelerated depreciation, incremental pricing, levelized rates for new investment, performance-based rates
 - Subject to FPA Section 205 filings, cost-benefit studies, and sunset dates
 - Recognized risks of RTO membership, suggested potential new approaches for ROE measurement, and emphasized that incentives would be available to all RTO structures (*i.e.*, no Transco or other preference)

2000 – 2002 – We meander for awhile ...
(Seems like we're following the right sign markers!)

- TOs/RTOs make RTO compliance filings, some proposing Order 2000 incentives
- Fall '01 – FERC begins 4 regional conferences exploring energy infrastructure needs and establishing that more needs to be done to encourage investment
- Case-by-case (but sparing) application of incentives
 - International Transmission Co. – rate moratorium and make-whole provisions for tax effects of divestiture
 - MISO TOs – 50 pt. RTO membership adder

Jan. 2003 – We seem to reach a turning point ...
(Have the lights in here gotten brighter ?)

- FERC issues *Proposed Transmission Pricing Policy Statement*
- FERC proclaims: “A Clear Policy Is Needed”
- FERC states its intention to “reward” TOs for joining RTOs, forming ITCs, expanding or better operating the grid
- Rewards/incentives are limited to RTO members
 - RTO (+ 50 pts. on all); ITC (+ 100 pts.); Expansion (+ 100 pts. on new facilities)
 - No cost-benefit studies required (unlike Order 2000)

2003-2005 – We hazard past a quick
succession of on- and off-ramps ...
(The pavement becomes bumpy !)

- FERC continues its case-by-case (and sparing) treatment of incentives, with targeted objectives: *e.g.*
 - Expediting Path 15 and other new facilities in California (ROEs up to 13.5%)
 - Promoting ITC investments
 - CWIP in rate base and expensing of pre-operations expenses for American Transmission Co.
 - Deferred cost recovery for Trans-Elect, Inc. to avoid impacts of retail rate moratorium; etc.

2003-2005 – We hazard past a quick
succession of on- and off-ramps ...
(Still pretty bumpy !)

- FERC issues a *Policy Statement on Independent Ownership/Operation of Transmission* (June '05) suggesting that incentives may be linked to independence
- Meanwhile, Traditional TOs struggle to achieve incentives
 - Incentives proposed in Order 2000 compliance filings are either rejected or set for hearing (*e.g.*, PJM and New England TOs)

2003-2005 – More on- and off-ramps ... (AND a couple of sudden U-Turns !)

- The 50 pt. RTO adder is granted for PJM and New England TOs, *but later withheld* in MISO, PJM [and California] following a D.C. Cir. remand (still on appeal for New England)
 - FERC essentially transforms this adder from a “reward” for RTO participation (per 2003 Pricing Policy) to an “incentive” available only to new RTO entrants)
- The 100 pt. investment adder is set for hearing for PJM and New England TOs
 - Focus shifts from all RTO-planned facilities (per 2003 Pricing Policy) to individual benefits in terms of timing, technologies, etc.

August 2005 – Are we there yet ????
(Nice to see a policeman directing traffic past
those long-standing road repairs !)

- Congress enacts the *Energy Policy Act of 2005*, giving FERC one year to issue rules establishing incentive-based rate treatments under new FPA § 219
 - FERC must encourage “Advanced Transmission Technologies” (*i.e.*, anything that increases capacity, efficiency or reliability of an existing or new transmission facility)
 - FERC must provide incentive-based (including performance-based) rate treatments for transmission that ensures reliability and reduces congestion

August 2005 – Are we there yet ????

(The Capitol Police are insistent!)

- FERC's rules, among other things, must:
 - Promote investment in transmission facilities regardless of ownership
 - Allow ROEs that attract investment
 - Allow recovery of prudently incurred costs
 - Provide incentive to each utility that joins a Transmission Organization

Nov. 2005 – We encounter an area
of major new construction ...
(Which way do we turn ??????)

- Three months after EPAct, FERC issues a new *NOPR – “Promoting Transmission Investment through Pricing Reform”*
- Cites DOE: Grid investment will only occur when regulatory policy provides:
 - Reasonably certain cost recovery
 - Regulatory certainty
 - A return that makes transmission investment a reasonable option, considering other available investment options
- Rule would remove 18 C.F.R. § 35.34(e) and establish new § 35.35

(Which way do we turn ?????) (*continued*)

- *Controlling standard/mantra*: All rates must be just, reasonable and not unduly discriminatory or preferential
- Incentive proposals must be filed under FPA § 205 with an explanation of the proposed accounting for the incentives
- Proposals for ROE-based incentives on new investments must explain:
 - How the facilities will improve reliability or reduce congestion
 - If the facilities are part of an independent RTEP process
 - How the proposed ROE was derived and how it will encourage new investment
- New Form X for all TOs to report annually on their current and projected transmission investment activity

(Which way do we turn ?????) (*continued*)

- Proposed Incentives for All TOs:
 - ROE sufficient to attract new investment (Anything new???)
 - 100% transmission CWIP in rate base
 - Expensing rather than capitalizing pre-commercial operation costs
 - Hypothetical capital structure
 - Accelerated depreciation (15 years)
 - Recovery of prudently-incurred costs of abandoned projects
 - Deferred cost recovery (to avoid retail rate caps)
 - Any other incentives approved by FERC

(Which way do we turn ?????) (*continued*)

- Additional Incentives *only for Transcos*:
 - Higher ROE (still within zone of reasonableness)
 - Book value adjustment for transferred assets to remove disincentives related to capitals gains taxes

- Additional Incentives for *joining* an RTO:
 - Higher ROE (still within zone of reasonableness)
 - Recovery of prudently incurred costs of joining

(Which way do we turn ?????) (*continued*)

■ *Some Encouraging Signs:*

- No cost-benefit study as under Order 2000 rules
- Petitions for Declaratory Orders may precede § 205 filings
- FERC may consider alternatives to DCF
- FERC acknowledges changing risk profile for transmission business
- FERC acknowledges that a sufficient return “is fundamental to a public utility’s decision to invest in new capacity”
- FERC may consider hypothetical, project-specific capital structures
- Transcos needn’t be independent

(Which way do we turn ?????) (*continued*)

■ *Some Discouraging Realities:*

- Nothing is final yet – Rules may be in flux until the summer
- Certainty is lacking – nearly everything is left open for future case-by-case filings and litigation
- Time to decision can be unduly long and impede timely investments
 - *E.g.*, New England TO case (filed: November 2003; ID issued May 2005; still awaiting Commission action)
- Filings may re-open *all* rate components – doesn't resolve "harmonization" of new investment treatment with embedded cost treatment

(Which way do we turn ?????) (*continued*)

■ *More Discouraging Realities:*

- It is very difficult to prove that a certain investment will not be made without a certain incentive, but would be made with that incentive (*i.e.*, a “But For” test)
- ROE “Zone of Reasonableness” needs to be awfully wide to accommodate all the individual, additive incentives for different objectives
- Seems like repackaging of 2003 Policy Statement proposals

Jan. 31, 2006 – One party leads the traffic
to find the light at the end of the tunnel
(Is daylight within reach ???)

- AEP seeks Declaratory Order per FERC's Incentives NOPR
 - 765 kV line, 550 miles from West Virginia to New Jersey
 - Owned by "AEP Transco" (wholly-owned by AEP)

- Requests three incentives (and perhaps others after Final Rule)
 - Alternative 1: ROE set at high end of zone of reasonableness
(determined in a later § 205 filing)
 - Alternative 2: 200 pt. ROE adder
 - CWIP in rate base
 - Expense currently pre-construction/pre-operating period costs
(and defer recovery of any costs not yet recovered)

Is FERC ready to show AEP the light at the end of the tunnel ?

■ Questions:

- Is AEP's filing adequately supported?
- Will FERC be willing to act while the NOPR is still pending?
- Will FERC be willing to act without a detailed § 205 rate filing?
- Will FERC prefer to wait until this project has been integrated into PJM's RTEP process?
- Will this project be viewed as the "poster child" for (1) major infrastructure investment and (2) Transco formation, such that the foregoing questions become irrelevant?