UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Proposed Policy For Efficient Operation And Expansion of Transmission Grid	: :	Docket No. PL03-1-000

NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES' COMMENTS ON PROPOSED POLICY STATEMENT

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EXECUTIVE SUMMARY

The National Association of State Utility Consumer Advocates (NASUCA) is a national association of consumer advocate offices with members in 42 states and the District of Columbia. NASUCA's members are charged by their respective state laws with the responsibility to represent consumers in utility proceedings before state and federal regulatory commissions and courts. The Proposed Policy Statement to establish new pricing for the rates of transmission owners by providing return on equity (ROE) incentive adders to the cost-of-service for certain actions taken by transmission owners is opposed by ***all*** NASUCA members. The Proposed Policy Statement represents a multi-billion dollar giveaway of consumer money that will likely offset any benefits anticipated from the goals that the Commission seeks to achieve. As conservatively calculated by NASUCA, the cost of this proposal for consumers is over $13 billion, or approximately $711 million per year for the 19 year time horizon of the Proposed Policy Statement. See Affidavit of Matthew I. Kahal attached to Comments. When compared to the Commission's own estimate of the benefits of RTO formation, which found approximately $725 million per year in efficiencies ("Transmission

Case Only"), it is evident that the potential costs of this Proposed Policy Statement virtually offset the potential benefits of RTO formation that the Commission seeks to encourage.

Through this Proposed Policy Statement, the Commission seeks to encourage transmission owning utilities to join RTOs, divest transmission assets to Independent Transmission Companies (ITCs) and invest in new transmission infrastructure. While NASUCA members support transmission infrastructure investment to relieve congestion and provide reliable, economically efficient transmission service at just and reasonable rates, NASUCA members do not support the Commission's proposal as a means of achieving these goals. For those states where consumer advocates and state commissions have argued forcefully that this Commission's RTO and Standard Market Design (SMD) policies will harm consumers, giving utilities a few hundred basis point higher return does not make these policies ***better*** for consumers – it just makes them more expensive. For those states that have already implemented many of the Commission's RTO and Standard Market Design principles, the proposal simply provides the transmission owner with "incentives" to do something they already have done. In some cases, it even provides the transmission owner an "incentive" or "reward" for complying with a state statute, state commission order, or this Commission's own prior Orders.

The Proposed Policy Statement is flawed in many respects. The most fundamental flaws that NASUCA brings to the Commission's attention in these Comments are as follows:

- The Proposed Policy Statement is not in keeping with fair rate of return principles that form the basis of just and reasonable rates.
- The Proposed Policy Statement is contrary to sound economic efficiency principles.

- The Proposed Policy Statement is inconsistent with the Commission's own principles for incentive or innovative ratemaking.
- The potential cost of the incentive adders will virtually offset the Commission's own estimate of the net benefit of its policies.
- The potential cost of the incentive adders will discourage RTO or ITC participation, at least prior to December 31, 2004, where state approval is necessary for such action.
- The potential cost of the incentive adders could discourage further unbundling at the state level.
- The Proposed Policy Statement seeks to support an ITC business model that has not been demonstrated to be a superior business model for transmission service.
- The Proposed Policy Statement is inconsistent with the Commission's Standard Market Design proposal and several of its Orders on RTO formation.
- The incentive adders are inconsistent with reliance on a regional transmission planning process conducted by an independent RTO.
- The implementation process is vague and could result in impermissible single issue ratemaking.

NASUCA urges the Commission to not lose sight of the fact that transmission owners are public utilities that have an affirmative obligation to provide safe, adequate, efficient and reasonable service at just and reasonable rates. The Proposed Policy Statement here simply enriches transmission owners at the expense of ratepayers. NASUCA urges the Commission to withdraw this proposed policy.

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Proposed Policy For Efficient Operation And	:	
Expansion of Transmission Grid	:	Docket No. PL03-1-000

NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES' COMMENTS ON PROPOSED POLICY STATEMENT

I. INTRODUCTION

The National Association of State Utility Consumer Advocates ("NASUCA") is a national association of consumer advocate offices with members in 42 states and the District of Columbia. NASUCA's members are charged by their respective state laws with the responsibility to represent consumers in utility proceedings before state and federal regulatory commissions and courts. Many of the NASUCA members have significant experience with the regulation of transmission rates and the implementation of incentive rate programs. This experience informs these comments.

The following comments are submitted in response to the Notice of Proposed Policy Statement ("NOPPS") issued on January 15, 2003 by the Federal Energy Regulatory Commission ("FERC" or "Commission") in the above-referenced proceeding. In its NOPPS, the Commission proposes:

> [A] new pricing policy for the rates of transmission owners that transfer operational control of their transmission facilities to a Regional Transmission Organization (RTO), form independent

> transmission companies (ITCs) within RTOs, or pursue additional measures that promote efficient operation and expansion of the transmission grid. The proposed policy would create rate incentives that reward RTO and ITC formation and grid investment, because independent regional grid operation and coordination will improve grid performance, reduce wholesale transmission and transaction costs, improve electric reliability, and make electric wholesale competition more effective in ways that benefit all customers.

Proposed Pricing Policy for Efficient Operation and Expansion of the Transmission Grid, 68 Fed. Reg. 3842 at ¶1 (2003), Summary (hereinafter "NOPPS").

NASUCA strenuously opposes the Commission's incentive proposal. The proposal is contrary to the fundamental principles of just and reasonable rates and will likely result in costs to consumers that offset any benefit from RTO development that has been calculated. NASUCA has calculated that the incentives proposed by the Commission, if fully utilized by transmission owners, would cost consumers over $13 billion, or approximately $711 million per year for the 19 year time horizon in the Proposed Policy Statement. See attached Affidavit of Matthew I. Kahal. When compared to the Commission's study of the potential benefits of RTO formation conducted by ICF Consultants, which found approximately $725 million per year in efficiencies ("Transmission Only Case"), it is evident that a conservative estimate of the potential cost of this Proposed Policy Statement virtually offsets the expected benefits of RTO formation found by ICF Consultants. More to the point, however, these incentive dollars serve no useful purpose nor provide any additional benefit since a large portion of the jurisdictional transmission owners already participate in RTOs or organizations presently seeking Commission RTO approval.

Given the potentially high cost to consumers, the Commission's Proposed Policy Statement could result in further delay in achieving the very goals that the Commission seeks to obtain. In those states where RTO formation has not yet been approved, the proposal could result in further delay as states will be reluctant to approve RTO formation proposals that increase costs to consumers by such a substantial and unnecessary amount. Similarly, states may be reluctant to approve divestiture of assets to an ITC if the result is a wholly unjustified increase in costs to consumers. Indeed, it is likely that advancement of the Commission's goals could be delayed until after December 31, 2004, the date the incentive offers expire, as necessary state approvals are delayed or not able to be obtained.

The Proposed Policy Statement also does not constitute a proper form of incentive ratemaking, is inconsistent with the fundamental principles of economic efficiency, is an unwarranted departure from prior Commission practices, and is inconsistent with transmission expansion planning principles of RTOs and the SMD NOPR. The Proposed Policy Statement seems to serve no purpose but to enrich transmission owners and make the supply of electricity more costly for consumers.

The Proposed Policy is opposed by <u>all</u> NASUCA members. Some NASUCA members support the development of RTOs and the general thrust of this Commission's SMD NOPR; other NASUCA members believe that, as presently constituted, some elements of those RTO and SMD policies will be harmful to consumers in their states; while still other NASUCA members believe that all of the Commission's current RTO and SMD policies will be harmful to consumers in their states. All NASUCA members, however, oppose the multi-billion dollar giveaway of consumer money that is reflected in the Proposed Policy Statement. For those states that already have implemented many of the Commission's RTO and SMD policies, this proposal would provide transmission owning utilities with "incentives" to do something they already have done. Indeed, in some cases such as RTO participation, the action has been mandated by state law or as merger conditions by this Commission. Is the Commission now saying that transmission owners must be paid retroactive incentives to obey this Commission's Orders or comply with state laws? As for states where consumer advocates and state Commissions have argued forcefully that this Commission's policies will harm consumers, giving utilities a few hundred basis point higher return does not make these policies ***better*** for consumers; it just makes them much more expensive.

The Commission must not lose sight of the fact that public utilities have an affirmative obligation to serve in an efficient and reasonable manner. The development of Commission policies that are directed toward the creation of reasonable and efficient structures for transmission expansion and planning would serve the public interest. The Commission's proposal to simply throw billions of ratepayer dollars at transmission owners in such an undirected manner in the hope that something will be accomplished is unsound. NASUCA urges the Commission to withdraw this proposed policy.

II. SUMMARY OF THE PROPOSED POLICY STATEMENT

The Order commencing this proceeding proposes a new set of incentives to induce transmission-owning utilities to transfer control of their facilities to FERC-approved Regional Transmission Organizations ("RTOs") and to take other steps. The Commission is proposing a system of automatic return on common equity ("ROE") adders for certain actions by transmission owning utilities. The actions that the Commission seeks to encourage through this proposal include joining an RTO, divesting transmission assets to ITCs, constructing new transmission plant and implementing innovative operating methods. The Commission summarizes its proposal as follows:

> Under this proposed policy: (1) any entity that transfers operational control of transmission facilities to a Commission-approved RTO would qualify for an incentive adder of 50 basis points on its return on equity (ROE) for all such facilities transferred; (2) ITCs that participate in RTOs and meet the independent ownership requirement (discussed below) would qualify for an additional incentive equivalent to 150 basis points applied to the book value of facilities at the time of divestiture; and (3) we also propose a generic ROE-based incentive equal to 100 basis points for investment in new transmission facilities which are found appropriate pursuant to an RTO planning process.

NOPPS, ¶2. Under the proposal, these bonuses are potentially additive resulting in an incentive of up to 200 basis points for existing transmission and up to 300 basis points for new transmission investment.

The proposal does impose certain time limits on the adders. For example, in order to receive an incentive adder for joining an RTO or divesting transmission facilities to an ITC, the action must be completed by December 31, 2004. NOPPS, ¶28. The ROE adder for RTO participation would remain in effect until December 31, 2012 and the ROE adder for transmission asset divestiture to an approved ITC would remain in place until December 31, 2022. NOPPS, ¶28.

The NOPPS does not appear to place any limits on the length of time that the transmission owner may obtain an ROE adder for new transmission. NOPPS, ¶30.

In addition to the ROE adders specifically listed, the NOPPS seeks comments on other areas that might warrant more incentives such as additional levels of independence. NOPPS, ¶29. The Commission also seeks comment on a broad range of other activities that might merit ROE bonuses or other types of financial incentives. The Commission identifies a number of new technologies and innovative operating practices that it might seek to encourage through the use of incentives. NOPPS, ¶¶31, 32. Some of the technologies and operating practices identified by the Commission include improved materials that allow significant increases in transfer capacity on existing rights-of-way and structures; equipment that allows greater control of energy flows; sophisticated monitoring and communications equipment that allows real-time rating of transmission facilities; operation of facilities beyond traditionally accepted limits; distributed generation; demand response; and demand-side management. NOPPS, ¶¶31, 32.

To implement this proposal, the Commission proposes that eligible public utilities submit Section 205 filings. Remarkably, the Commission specifically states that it will not require the public utility to file a cost-benefit analysis to qualify for any of the incentives. NOPPS, ¶36. The Commission notes its intention to cap the bonuses at the upper end of the cost of capital range for a proxy group of companies consisting of investor-owned transmission owners participating in the relevant RTO. NOPPS, ¶37. Although not clearly stated, it appears as if the Section 205 filings may be treated as single issue rate proceedings.

Finally, the Commission summarizes its reasons for this proposal as follows:

> We believe that these incentives will encourage RTO participation and independent ownership in a timely fashion and that customers will benefit from an independent and regional approach to the provision of electric transmission service. The additional incentives proposed for new investment in transmission facilities, in combination with RTO system expansion planning, should encourage long-overdue investment in new transmission, increase the number of generators who can compete in the market place, improve efficiency and reliability, and ultimately lower the costs paid by customers of electricity.

NOPPS, ¶37.

As detailed below, NASUCA submits that the Commission's Proposed Policy Statement is misguided and will result in a potential cost burden for consumers that will offset the potential benefits that could hope to be achieved. Rather than spur efficient transmission expansion and RTO development, the policy will result in inefficient system expansion, delay in RTO and ITC formation, possible delay in transmission expansion, and burdensome costs to consumers.

III. REGULATORY PRINCIPLES

Even in this current environment of promoting competitive wholesale electricity markets throughout the Nation, electric transmission remains a monopoly service regulated under the Federal Power Act, 16 U.S.C. § 824. *New York, et al. v. Federal Energy Regulatory Commission,* 535 U.S. 1 (2002). The primary goal of the Federal Power Act in regulating interstate transmission of electricity is to curb abusive practices by public utilities and to protect customers from excessive rates and charges. *Federal Power Commission v. Hope Natural Gas Co.,* 320 U.S.591, 610, 64 S.Ct. 281, 291 (1944) and *Electrical Dist. No. 1 v. FERC,* 774 F.2d 490, 493 (D.C. Cir. 1985). The Commission has stated that its primary responsibility in administering the Federal Power Act is to ensure adequate and reliable supplies of electric energy at a just and reasonable price. *Remedying Undue Discrimination through Open Access Transmission Service and Standard Electricity Market Design,* Docket No. RM01-12-000, "Notice of Proposed Rulemaking" at ¶1, 100 FERC ¶61,138 (July 31, 2002) (hereinafter "SMD NOPR"). The Commission has an equally important responsibility to ensure that safe, adequate and reliable transmission service can be provided to consumers at a just and reasonable price. 16 U.S.C. §§ 824d, e, and f.

Regulatory principles governing the provision of transmission service at both the state and federal level have developed over many years. The Federal Power Act provides that a utility may charge only rates that are just and reasonable. 16 U.S.C. §824d(a). In interpreting this mandate, the Commission and the Courts have found that rates should be based primarily on the cost of providing service to the utility's customers, plus a just and reasonable return on equity. *Alabama Elec. Coop v. FERC,* 684 F.2d 20, 27 (D.C. Cir. 1982); *Sithe Independent Power v. FERC,* 285 F.3d

1, 5 (D.C. Cir.2002); and *Kootenai Electric Cooperative, Inc. V. FERC,* 192 F.3d 144 (D.C. Cir. 1999).

For both state commissions and this Commission, in determining the level of rates that satisfy the just and reasonable standard, the Courts require a balancing of investor and consumer interests, as well as protection of consumers from exploitation at the hands of regulated utilities. The general rule when establishing just and reasonable rates is that a public utility, whose facilities and assets have been dedicated to public service, is entitled to no more than a reasonable opportunity to earn a fair rate of return on its investment. This general rule was first set forth in 1923. The standard to evaluate what is a fair rate of return was established by the United States Supreme Court in *Bluefield Waterworks & Improvement Company v. Public Service Commission of West Virginia*, 262 U.S. 679, 693 (1923) ("*Bluefield*"):

> The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to raise the money necessary for the proper discharge of public duties.
>
> The Supreme Court held in *Bluefield* that the allowed rate of return should reflect:
>
> [A] return on the value of the [utility's] property which it employs for the convenience of the public equal to that being made at the same time on investments in other business undertakings which are attended by corresponding risks and uncertainties.

262 U.S. at 692. As the Supreme Court set forth in *FPC v. Hope,* 320 U.S. at 610, 64 S.Ct. at 291, the primary responsibility of the Commission is to protect consumers from exploitation at the hands of regulated utilities.

The principles espoused in the myriad of state and federal court opinions on this subject set forth the guidelines for regulation of transmission service. These principles provide the appropriate framework for assessment of the proposed transmission incentive rate policies under consideration in the Proposed Policy Statement at issue here. The Commission's primary goal in the Proposed Policy Statement is the same as that espoused in the SMD NOPR, *i.e.* to "promote competitive wholesale electric markets" and "harness the benefits of competitive markets for the Nation's electric energy customers." NOPPS at ¶1; SMD NOPR at ¶1. The Commission's desire to spark competition, however, should not unseat long-standing regulatory principles that govern monopoly transmission service, or the delicate balance espoused in those principles between shareholder and consumer interests. Tipping the balance in favor of shareholders at the expense of consumers merely sanctions the exploitation the Federal Power Act seeks to avoid, and ultimately will cause harm to consumers that is not outweighed by any benefits of competition.

IV. LEGAL, TECHNICAL AND POLICY FLAWS IN THE COMMISSION'S PROPOSAL

A. Introduction.

NASUCA recognizes the underlying goal of the Commission, to spur participation in RTOs and ITCs and support needed transmission expansion. The Proposed Policy Statement, however, will not contribute to achieving the Commission's goals. In fact, the Commission's proposal will interfere with the Commission's own objectives as well as the progress that has been made to date. NASUCA submits that throwing ratepayer money at the "problem" in such an untargeted manner will only succeed in harming consumers, impairing economic efficiency and creating resistance to, or weakening support for, independent grid management. Simply put, the Commission's proposal will be a step backward not a step forward.

NASUCA discusses below several of the major legal, technical and policy flaws in the Commission's approach.

B. Economic Efficiency And Principles Of Just And Reasonable Rates Require The Setting Of Fair Rate Of Return At The Utility's Cost Of Capital.

1. The Commission's Proposal Is Not In Keeping With Fair Rate Of Return Principles Or Economic Efficiency Principles That Are The Basis Of Setting Just And Reasonable Rates.

As a general rule, a public utility, whose facilities and assets have been dedicated to public service, is entitled to no more than a reasonable opportunity to earn a fair rate of return on its investment. As noted above, the standard to evaluate what is a fair rate of return was established by the United States Supreme Court in *Bluefield Waterworks & Improvement Company v. Public Service Commission of West Virginia*, 262 U.S. 679, 693 (1923) ("*Bluefield*"):

The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to raise the money necessary for the proper discharge of public duties.

The Supreme Court held in *Bluefield* that the allowed rate of return should reflect:

> [A] return on the value of the [utility's] property which it employs for the convenience of the public equal to that being made at the same time on investments in other business undertakings which are attended by corresponding risks and uncertainties.

262 U.S. at 692.

Twenty-one years later, the United States Supreme Court reviewed the issue of fair rate of return in *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944) ("*Hope*"). In *Hope*, the Supreme Court held that a fair rate of return "should be commensurate with returns on investments in other enterprises having corresponding risks" while being sufficient "to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital." *Id.* at 603. The Court also noted, however, that "[t]he rate-making process under the Act, i.e., the fixing of 'just and reasonable' rates, involves a balancing of the investor and consumer interests . . . and does not insure that the business shall produce revenues." *Id.*

The Supreme Court in 1968 set forth the parameters for the Commission's weighing of competing investor and consumer interests. The Court stated:

> The Commission cannot confine its inquiries either to the computation of costs of service or to conjectures about the prospective responses of the capital market; it is instead obliged at each step of its regulatory process to assess the requirements of the broad public interests entrusted to its protection by Congress. Accordingly, the 'end result' of the Commission's orders must be measured as much by the success with which they protect those interests as by the effectiveness with which they 'maintain * * * credit and * * * attract capital.

In Re Permian Basin Area Rate Cases, 390 U.S. 747, 791 (1968). The Court required that this balancing of interests provide "appropriate protection to the relevant public interests, both existing and foreseeable." *Id.* at 792. Quoting from a 1959 Supreme Court decision, the Court stated:

> The consumer is thus obliged to rely upon the Commission to provide 'a complete, permanent and effective bond of protection from excessive rates and charges.'

Id. at 794-795, citing *Atlantic Refining Co. v. Public Service Commission*, 360 U.S. 378, 388 (1959). The Court has made clear that protection of consumer interests from excessive rates and exploitation at the hands of monopolies must be given as great a weighting by the Commission as the interests of the utilities themselves. NASUCA submits that in the Proposed Policy Statement the Commission has inappropriately distorted this balance.

Under this line of cases, it has been this Commission's practice over the years to set the fair rate of return for transmission-owning utilities at a "best estimate" of the cost of common equity. The Commission has relied upon market-based methods, such as the discounted cash flow (DCF) model, for that purpose. The market cost of capital standard is the basis for establishing a transmission owner's authorized return, consistent with the Commission's statutory obligation to set just and reasonable rates. This is a matter of both fairness and economic efficiency.

Although the Commission's objective here is to foster greater competition for the bulk power supply markets, the fact remains that transmission will remain a regulated service for the foreseeable future. The rates of return that are the subject of this Proposed Policy Statement will be used to determine the zonal access charges that the transmission-owning utilities will recover from their captive ratepayers. Customers have no alternative to paying these charges, and utilities are not at any significant risk for recovery of their prudent transmission fixed costs from these customers.

Monopoly utilities must be subject to regulation in order to restrain the exercise of monopoly power. Systematically and intentionally setting a utility's authorized return above its cost of capital (and therefore above its cost of service) is a form of monopoly pricing and is an unwarranted transfer of wealth from consumers to transmission owners.[1] It is inherently unfair and inconsistent with sound regulatory principles, and cannot result in rates that are just and reasonable.

Additionally, return on equity adders, such as those in the Proposed Policy Statement, cannot be justified on the basis of added risk. The Proposed Policy Statement does not assert that joining an RTO, divesting to an ITC, or investing in new facilities will generally and systematically increase a transmission owner's business risk profile. Even if an increase in risk does occur as a result of these decisions, this risk will be reflected in the market-derived cost of capital. Setting the rate of return at the actual market-determined (and now higher) cost of capital would fully compensate the transmission owner. Arbitrarily adding a substantial basis point bonus to the rate of return, however, would be unfair to consumers.

NASUCA would also note that it has long been understood by economists that artificially inflating a utility's authorized rate of return above its market cost of capital is inconsistent with economic efficiency principles. An excessive authorized rate of return will provide incentives to inflate rate base, and will distort the mix of inputs to provide service.[2] While an RTO-supervised planning process will be helpful in mitigating such distortions, it will not eliminate the problem of

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[1] A variation on cost-based ratemaking, performance-based or incentive ratemaking, allows for the opportunity for excess profits by the monopolist based on the utility's actual performance. As discussed herein, the proposed Policy Statement is not a form of performance-based or incentive ratemaking.

[2] The seminal article on this issue is Averch, H. and Johnson, L. 1962. "Behavior of the Firm Under Regulatory Constraint," American Economic Review, 52, 1052-69.

distortions in the planning process resulting from such incentives. An RTO planning process will also not eliminate the transmission owner's incentive to inflate or "gold plate" the costs of approved projects. As such, the added costs to consumers are not merely the effects of higher rates of return, but also the potentially inflated costs of unnecessary or gold-plated transmission projects that could result from this process.

2. The ROE Cap Will Not Protect Against Transmission Rates Being Unjust and Unreasonable.

In implementing this proposal, the Commission proposes to cap the authorized ROE at "the top of the range of reasonable ROEs for a proxy group consisting of the investor-owned transmission owners participating in the relevant RTO whose shares are publicly traded." NOPPS, ¶37. The Proposed Policy Statement observes that for the Midwest ISO ("MISO"), this top end cap would not be binding on a total ROE incentive adder as large as 300 basis points. *Id.* While the Proposed Policy Statement does not explain the purpose of the cap, the Commission may have intended it to be a rate mitigation feature of its proposal to prevent transmission rates from being unjust and unreasonable as a result of the adders.

NASUCA submits that the cap will not provide effective mitigation and cannot prevent the ROE adders from producing transmission rates that are unjust and unreasonable. The Commission concedes that based on its recent experience with MISO, the cap would not have made any difference and would not have been a binding constraint even for an adder as high as 300 basis points. The plain fact is that the cap -- even if it provides some mitigation -- will not prevent transmission rates and costs to consumers from being higher than they otherwise would be. The fair rate of return no longer will be set at this Commission's best estimate of the cost of equity but at an artificially higher figure. The top end of the "reasonable range" for a proxy group is not a fair return but the systematic award of monopoly profits to transmission owners.

There also are a number of practical problems with the cap feature in the proposal. First, the Proposed Policy Statement appears to mandate that a rate of return shall be based upon a "proxy group" of publicly-traded companies comprising the RTO. NOPPS, ¶37. This would unduly restrict the evidence on cost of capital that could be presented regarding a specific company and may not produce a reasonable result. For example, the SeTrans RTO, which received provisional approval on its business model in October 2002 includes only three publicly-traded companies (Southern Company, Entergy Corporation and Cleco Power). *Cleco Power, L.L.C., et al.,* 101 FERC ¶61,008 (Order Granting Petition for Declaratory Order, Docket No. EL02-101-000, October 10, 2002). This would be an overly narrow proxy group.

Second, the upper end of the range may be reasonable for the high risk companies in the proxy group but not the low risk companies. Third, the Commission's cap proposal will merely encourage gaming in rate proceedings. Transmission owners (or parties benefitting from high returns) will be encouraged to litigate not merely the best estimate of the cost of capital but the top end of the range as well. In fact, litigation over the top end (which would encourage widely dispersed proposals) may become more important than the best estimate. Fourth, the cap proposal will greatly burden rate settlements. It will eliminate the possibility of "black box" rate settlements and require that a settlement specify both a "base" and "top end" ROE. Moreover, many existing transmission rate case settlements do not provide the information that would allow the identification of an ROE cap value.

The proposal to cap the award at the high end of the "zone of reasonableness" cannot salvage this Proposed Policy Statement. Rather, the cap proposal creates a myriad of other issues that will further confound the regulatory process.

3. Conclusion.

NASUCA submits that the Commission's Proposed Policy Statement is contrary to sound regulatory principles that the Commission has followed for decades in establishing rates that are just and reasonable. Additionally, the proposed cap on the ROE adder at the high end of a "zone of reasonableness" does not solve the problems with this misguided policy and simply creates additional problems.

C. The Proposed Policy Statement Is Not Consistent With Proper Principles Of Incentive Or Innovative Ratemaking.

1. Introduction.

State and federal laws currently require utilities to provide for adequate and reliable transmission service at just and reasonable rates. Section 207 of the Federal Power Act requires utilities to provide "proper, adequate and sufficient" transmission services. 16 USC §824f. NASUCA submits that there has been no demonstration that special incentives are necessary to ensure that transmission owning utilities meet these statutory obligations. In fact, the Commission has previously rejected the notion that ROE incentives for utility transmission investors are necessary for actions considered to be "best practices" within the industry. *New England Power Pool,* 97 FERC ¶61,093 (2002). Simply put, utilities have a public service obligation to maintain adequate and efficient transmission systems.

No showing has been made here that utilities will not pursue economically efficient alternatives consistent with their public service obligation. Indeed, many utilities are already pursuing measures that they determine will bring efficiencies. For example, under Iowa law, public utilities are required to provide reasonably adequate facilities and service and are required to operate efficiently.[3] Without any special incentives, an Iowa electric utility, MidAmerican Energy Company, has committed to construct a 345 KV transmission line in connection with a planned coal generation facility. Currently, there is no incentive ROE associated with this transmission line. *MidAmerican Energy Co.*, Docket No. GCU-02-1, Final Decision and Order at 4 (Iowa Utils. Bd., Jan. 23, 2003) and *MidAmerican Energy Co.*, IUB Docket Nos. E-21621, E-21622, E-21623, E-21624 and E-21625 (pending 345 kV electric transmission franchise petitions).

In this Proposed Policy Statement, the Commission sets forth a number of incentives for certain actions on the part of transmission owners that the Commission anticipates will result in greater efficiencies. In other words, the Commission is proposing a form of incentive ratemaking for transmission owners. The Commission has recognized that for any form of incentive or innovative ratemaking, certain principles should be followed to ensure that rates are just and reasonable. These principles have been set forth in a number of cases, policy statements, and in Order No. 2000. The Commission's 1992 Policy Statement, Order No. 2000, and its recent Western Order implementing incentive rates provide particular guidance in this area. NASUCA submits that the Commission's principles for incentive rates are key to ensuring that incentive rates meet the just and reasonable standard, if incentive rates are to be permitted at all. The Proposed Policy Statement, however,

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[3] Iowa Code Sections 476.8 and 476.52. Both of these statutory mandates require reasonably adequate transmission facilities at reasonable cost, both old and new, without any incentive.

strays from these important principles, and cannot be considered a form of either performance-based ratemaking or incentive ratemaking.

2. <u>The Commission Has Failed To Follow The Principles Set Forth In The Policy Statement of 1992 and Order 2000</u>.

The Commission issued a Policy Statement in 1992 where it outlined the appropriate use of incentives. *Re Incentive Rate Making for Interstate Natural Gas Pipelines, Oil Pipelines, and Electric Utilities*, 61 F.E.R.C. 61,168 (1992) ("1992 Policy Statement"). In the 1992 Policy Statement, the Commission affirmed four standards and issued a fifth standard designed to assure that incentive ratemaking is fair. The five standards are as follows: a) incentive mechanisms must be prospective; b) participation must be voluntary; c) incentive mechanisms must be understood by all parties; d) benefits to consumers must be quantifiable; and e) quality of service must be maintained. *Id.* at 61,589 - 61,590.

In Order No. 2000, the Commission approved the use of incentive rate mechanisms under conditions that are consistent with these standards. *Regional Transmission Organizations, Order No. 2000,* FERC Stats and Regs [Regulations Preambles July 1996 - December 2000] ¶31,089 (1999), *Order on Reh'g.*, Order 2000-A, FERC Stats and Regs [Regulation Preambles July 1996 - December 2000] ¶31,092 (2000), *petitions for review dismissed, Public Utility District No. 1 of Snowhomish County, Washington v. FERC,* 272 F.3rd 607 (D.C. Cir. 2001) (*Order No. 2000*). Order No. 2000 explicitly discusses new approaches to return on equity as part of incentive ratemaking. The Commission therefore invited RTOs "to submit proposals for ROE-programs" but did not require such a program. *Order No. 2000* at 31,193. The Commission reaffirmed that its pricing and return setting goal is:

> to ensure that customers have access to non-discriminatory service at just and reasonable rates, and that transmission owners have an opportunity to earn a reasonable rate of return on their investment. (Id.)

Although Order No. 2000 provides considerable latitude for the filing of incentive rate proposals, the Commission established certain standards or requirements necessary to support these proposals similar to those previously detailed in the Commission's 1992 Policy Statement.

Specifically, the Commission stated that applications for innovative rate treatments "must explain how the proposed rate treatment would help achieve the goals of RTOs, including efficient use of and investment in the transmission system and reliability benefits to consumers; provide a cost-benefit analysis, including rate impacts; and explain why the proposed rate treatment is appropriate for the RTO proposed by the Applicant." *Order No. 2000* at 31,171. Order No. 2000 also required that the proponent of the incentive ratemaking demonstrate that the proposal is appropriate, just, reasonable and nondiscriminatory. *Id.*

The pending Proposed Policy Statement is inconsistent with the standards of the 1992 Policy Statement and Order No. 2000. The Proposed Policy Statement simply sets aside the important principles established by these orders. Two key standards from the Policy Statement and Order No. 2000 that form the heart of the consumer protection provisions have not been followed by the Commission here. First, the Proposed Policy Statement provides no cost/benefit assessment (and further specifies that none is needed), nor does it require any estimate of rate impacts or demonstration that the proposal will provide just and reasonable rates. Second, the Proposed Policy Statement provides rewards for past actions and requires no demonstration that actions would have been taken but for the incentive.

a. <u>The Commission's Proposed Policy Statement Does Not Require That The Benefits To Consumers Be Quantifiable</u>.

In the 1992 Policy Statement, the Commission stated:

> [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 quantified estimate of the consumer benefits compared to cost-of-service regulation (i.e., a comparison of projected cost-of-service rates to prospective rates under the proposed incentive rate mechanism), and a realistic estimate of the program's prospects for success and the risks of failure. The projected cost-of-service rates will serve as an overall cap on incentive rate increases to limit consumer risk. The cap must be designed to ensure that the incentive rate is no higher than it otherwise would have been under the projected traditional cost-of-service ratemaking.

Id. at 61,590.[4]

The proposed return on equity adders here do not constitute incentive rates in lieu of cost-of-service rates. Rather, they are one-way adders to the cost-of-service. Critically, however, there is absolutely no quantification of the benefits to consumers and no estimate of the consumer benefits compared to cost of service regulation is even required. The Commission either assumes that the increased RTO participation, ITC creation, and transmission investment which it hopes will result from this incentive pricing proposal will offset the associated costs, or they believe that the

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[4] The Commission subsequently eliminated the requirement to quantify benefits for gas pipelines and removed the requirement that incentive regulation rates be no higher than they would have been under traditional cost-of-service regulation. 74 F.E.R.C. at 61,238. Instead, the Commission would allow incentive rates where pipelines shared with their ratepayers the efficiency gains that occurred under incentive rates. *Id.* The Commission's revision of this Policy Statement does not apply to electric markets. The Commission required pipelines to "explicitly specify the performance standards it defines, the mechanism for sharing benefits with customers, and a method for evaluating the proposal." *Id.* These requirements retain the core principle of balancing consumer benefits with investor gains. There are no similar consumer protections of this nature in the current incentive pricing proposal.

added costs will bring about some other benefits not yet determined. At this point, however, the Commission has not produced, and will not require, *any* quantification of the costs and benefits that it anticipates consumers will see. NOPPS at ¶36.

Moreover, the Commission has not made any demonstration or required any demonstration that its proposal will result in just and reasonable rates. The Commission only suggests that it will set a cap on the adders at the upper end of a "zone of reasonableness" for return on equity. NOPPS at ¶37. As discussed above in Section IV.B.2., this aspect of the Proposed Policy Statement does not protect against rates being unjust and unreasonable.

Introducing a pricing policy that adds to the cost-of-service without requiring a showing of quantifiable benefits to consumers or a demonstration that rates will be just and reasonable is an unwarranted departure from prior Commission policy. If billions of ratepayer dollars are to be transferred to transmission owning utilities and their shareholders, NASUCA submits that it is incumbent upon the Commission to make a demonstration of substantial, quantifiable benefits. The Proposed Policy Statement fails in this regard.

b. The Proposed Policy Statement Rewards Past Actions Contrary To The Principles Of Incentive Ratemaking.

The Commission has previously stated that, "Incentive regulation is not designed to reward past efficient, cost-saving behavior. To do so would violate the objective of benefitting customers." *1992 Policy Statement* at 61,589. This principle recognized that incentive rates should benefit consumers by requiring that benchmarks or performance exceed existing levels. An incentive proposal that rewards an entity for past acts violates this most basic tenet of incentive ratemaking– an entity seeking an incentive must actually *do* something beyond existing, or reasonably expected performance. The current pricing proposal fails to meet this basic principle in several ways. First, it allows utilities that have already transferred control of assets to an RTO to receive an incentive. Transmission owners who have taken this step have done so either to pursue their own interests or may have been required to do so by statutory or regulatory directive. Second, for utilities that have not yet joined an RTO or an ITC, there is no requirement for a showing that, but for the incentive, the utility would not otherwise have joined. Without these two key components, the necessary protections for consumers to ensure that incentive rates are just and reasonable do not exist. The Proposed Policy Statement, which violates this basic principle, cannot result in just and reasonable rates.

3. <u>The Commission's Proposed Policy Statement Deviates From Its Recent Western Order Addressing Incentive Adder To Return On Equity</u>.

The Commission recently approved a series of equity return incentives for the construction of new or upgraded transmission capacity in California and Western markets in order to spur development of needed infrastructure to remedy the specific crisis faced by those markets during 2000-2001. *Removing Obstacles to Increased Electric Generation And Natural Gas Supply In The Western United States.* 96 F.E.R.C. 61,155 (2001)("Western Order"). Under the Commission's first incentive proposal, a 200 basis point return on equity adder was given on upgrades at existing constrained facilities if those upgrades were in service by July 1, 2001, and 150 basis points if in service by November 1, 2001. *Id.* at 61,669. The second incentive allowed a 100 basis point premium for new facilities not already in use that would add significant transfer capability and could be in service by November 1, 2002. *Id.* The third incentive allowed a 150 basis point return on equity adder for facilities needed to interconnect new supply to the grid put into service by November 1, 2001, and 100 basis points if in service by November 1, 2002. *Id.*

The Western Order differed from the current incentive pricing proposal in two key respects. First, there was evidence to support the assumption that the costs to consumers due to incentives would be outweighed by the benefit they would receive from increased transmission infrastructure, particularly given the situation in the Western markets of 2000 and 2001. Second, the return on equity adders allowed in that case applied as an incentive for new development that addressed a specific need of consumers. Regarding these two principles, the Western Order was consistent with incentive ratemaking principles as espoused by the Commission in its 1992 Policy Statement and Order No. 2000.

In the Western Order, the Commission allowed the incentives while stating, "we fully considered the impact on ratepayers. . . We also considered that the potential savings on the commodity side due to greater transmission capacity and less congestion far outweigh the costs embodied in these incentives, and will not unduly burden ratepayers. . ." *Id.* at 61,671. The investment being incented in the Western Order was specific and necessary to relieve constraints, improve transfer capability, or attract new supply. The Commission also stated, "We noted that we adopted these incentives due to the extraordinary circumstances surrounding the ongoing imbalances in California's electricity power supply system, as reflected by the severity of the power shortages in the WSCC in general and in California, specifically. Due to the need for immediate relief, the May 16 Order departed from the Commission's normal process for determining the case-by-case return on equity allowances." *Id.* at 61,670.

The incentives were then linked to specific activities that addressed market conditions in order to benefit consumers. In the Western Order, the Commission stated that due to tight generation and transmission resources in the Western markets, "the higher prices that inevitably result from the limited supply affects ratepayers more than the minor effects of the rate incentives." *Id.* at 61,671. As demonstrated below, however, there is no way to conclude that the benefits in the Commission's Proposed Policy Statement will outweigh the costs.

The Western Order also recognized that an important feature of incentives is that they must actually foster development and investment that would, but for the incentive, not occur. The Commission limited the return on equity adder to facilities that were placed in service by specific dates in order to relieve the California energy market crisis as quickly as possible. Incentives provided a reason to increase efforts to bring projects on line. The Commission did not apply incentives to embedded costs or to construction projects that were near completion and undertaken without any knowledge of the ordered incentive. As the Commission stated, "With respect to Cities/—S-R's concern that this option should not be available to projects that are near completion, current projects will be eligible for the incentives if they show that the construction schedule was accelerated in response to the incentive program, and the facilities are placed into service within the prescribed time frames." *Id.* at 61,671.

The Commission's prior principles have established the basis for the consideration of whether incentive rate proposals or performance-based ratemaking proposals can result in just and reasonable rates. Here, the Commission's Proposed Policy Statement deviates so significantly from the Commission's own fundamental principles, that it cannot be considered to result in just and reasonable rates.

4. The Proposed Policy Statement Is Inconsistent With Performance Based Rate Proposals As Envisioned In Order No. 2000.

Order No. 2000 also discussed principles for performance-based ratemaking (PBR). The Proposed Policy Statement also fails to satisfy these principles for several reasons. Most importantly, the Commission's Proposed Policy Statement is asymmetric.

This Commission sanctioned and invited incentive rate and PBR proposals as part of its Order No. 2000. In doing so, the Commission established the following standards for PBR:

(1) PBR should not be piecemeal.

(2) PBR should encompass both rewards and penalties.

(3) PBR should foster efficiency and not impair reliability.

(4) The benefits flowing from PBR should be shared with the RTO and customers.

(5) The PBR system of rewards and penalties should be based on known and measurable benchmarks.

Order No. 2000, at 31,185.

Any reasonable plan which seeks to address performance or provide incentives must include both penalties and rewards, not just rewards. As an example, price cap plans (such as those used for telephone service) establish formulas for rate increases or decreases that are linked to cost control and productivity gains. A plan that allows for excess profits when a performance benchmark is exceeded, but does not reduce utility profits when performance falls short of the benchmark, would be unreasonable and would fail to balance customer and utility investor interests. The Commission's proposal provides incentives that work only in one direction -- to increase utility profits -- with no performance accountability. This is one sided and inherently unfair.

The Commission's Proposed Policy Statement cannot be considered to meet any of the principles of performance based ratemaking. The Proposed Policy Statement should not be further pursed.

5. Conclusion.

The Proposed Policy Statement provides very substantial and costly rate of return adders to transmission-owning utilities as a result of these utilities taking certain actions (or even having taken certain actions in the past). While the Commission argues that these actions will be beneficial, this is not a defensible form of performance or incentive-based regulation that warrants a departure from cost-based ratemaking.

The rate of return adders proposed under the Proposed Policy Statement are not based on the transmission owner achieving some specified level of performance. Rather, it is a reward for shareholders -- paid for by consumers -- for doing little more than "being there." The utility is rewarded merely for transferring control of transmission to an RTO, divesting to an ITC or spending money on transmission upgrades, as directed by the RTO. There is no "performance" requirement. The utility need not provide any demonstration of customer savings, efficiency gains, improved service quality or any other performance measure. The utility is not even required to submit a cost/benefit filing showing that any performance gains are likely. The utility will receive its rate of return bonuses automatically even if its performance in providing service deteriorates.

The Commission must adhere to the incentive ratemaking principles it laid out in its 1992 Policy Statement, Order No. 2000, and applied in the Western Order described above in order to achieve fairness in rates. As the Commission stated, "Incentive ratemaking *must* be fair. Properly done, all can benefit; improperly done, it may hurt parties -- especially those the Commission has historically protected -- as much as it helps. Incentive ratemaking must simultaneously protect customers' interests and offer potential rewards to the utility for good performance." *1992 Policy Statement* at 61,589 (emphasis in original). NASUCA urges the Commission to evaluate its current proposal with these principles in mind. As is quickly seen, the proposal completely fails to meet these principles. As such, this proposal should be tabled immediately.

D. The ROE Bonus Dollars Will Exceed The Commission's Own Estimate Of The Net Benefit For Consumers.

One person's incentives are another person's costs. In this case, the cost of providing an ROE incentive adder will eventually be borne by consumers. As detailed below, NASUCA has conservatively estimated the cost to consumers from applying the specified ROE adders to existing transmission facilities to be $13.5 billion, or $711 million per year for the 19 year period. Kahal Affidavit, p. 6-8. This is just a conservative, preliminary calculation and is likely only the tip of the iceberg. NASUCA submits that if FERC even considers proceeding further in this direction, it should calculate the true costs of its proposal to consumers and factor that into any cost/benefit analysis of RTO formation.

As the attached Affidavit of Matthew I. Kahal demonstrates, the potential cost of these ROE adders, when compared to the expected RTO efficiencies estimated by ICF Consulting on behalf of the Commission, essentially offset the potential benefits to consumers from RTO formation. As explained in more detail in the Affidavit, to estimate the potential cost to consumers from the Commission's proposal, Mr. Kahal applied the specified ROE adders to existing industry net investment in transmission plant and to assumed on-going future transmission expenditures.[5]

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[5] For the on-going future transmission value, Mr. Kahal assumed that the expenditures (continued...)

Mr. Kahal assumed that the ROE adders would have their intended effect, that is that all major investor-owned transmission owners would join an RTO and divest transmission assets to ITCs.[6] Mr. Kahal then applied these ROE adders to the estimate of industry-wide net investment in transmission plant taken from the Financial Statistics of Major U.S. Investor-Owned Electric Utilities, 1996 (DOE/EIA-0437(96)11).[7]

As Table 2 of the Affidavit shows, the potential impact of this proposal on consumers would be enormous. The annual average cost of the 50 basis point adder for RTO participation is $151 million, the annual average cost of the 150 basis point adder for ITC divestiture is $453 million, and the annual average cost of the 100 basis point adder for new transmission is $186 million. Table 2 from the Affidavit is presented below:

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[5](...continued)
for additions would equal the annual depreciation. Kahal Affidavit at ¶11.

[6] As Mr. Kahal explained, however, the adders could discourage states from granting RTO participation or ITC divestiture to avoid these potential rate penalties. Kahal Affidavit at ¶10.

[7] As of 1996, the transmission plant was $65.5 billion for major investor-owned utilities, without including an allocation of general plant, working capital and the like. Mr. Kahal then assumed that net transmission plant was 62% of the total, the same ratio assumed by EIA for overall electric utility plant. This resulted in a 1996 value of industry-wide net transmission plant of $40.2 billion. No change from this 1996 value was assumed for the purpose of the calculation. Kahal Affidavit at ¶11.

Table 2

Transmission Access Charge Impacts for U.S. Investor-Owned Utilities from Proposed ROE Adders (millions $)

		Annual Average	Cumulative
1.	RTO participation	$151	$ 1,359
2.	ITC divestiture	453	8,607
3.	New Transmission	186	3,534
	Total	**$711***	**$13,500**

*Based on $13.5 billion divided by 19 years. Column total is $790 million but the RTO figure is only for first 9 years.

As noted, the estimate of $711 million in potential costs each year, or $13.5 billion over the time period that the incentives are permitted to remain in place, is roughly comparable to the $725 million per year in expected RTO efficiencies estimated by ICF Consulting on behalf of the Commission. Economic Assessment of RTO Policy, (Transmission Only Case) February 26, 2002, Prepared for the Federal Energy Regulatory Commission. As Mr. Kahal points out in his Affidavit, the potential consumer impacts could rise sharply if the ROE adders cause distortion in transmission investment, inflation of costs, or misallocation of cost responsibility due to the ROE allowance exceeding the cost of capital. Kahal Affidavit at ¶9.

NASUCA submits that this preliminary calculation demonstrates that the potential cost to consumers is significant, virtually offsetting the potential efficiencies or benefits to be expected from RTO formation.[8] Equally troubling, however, is that there are no studies that

[8] Regional RTO studies have also estimated modest benefits relative to consumer costs. (continued...)

demonstrate or quantify any savings from an ITC structure for a transmission business as opposed to a vertically integrated utility turning over operation of its transmission assets to an RTO. NASUCA strongly recommends that the Commission withdraw this Proposed Policy Statement. If the Commission seeks to continue with this Policy, it should undertake a full cost/benefit analysis to determine whether such incentives are necessary, warranted, and properly designed to achieve the intended result at the least cost.

E. The Vast Majority Of The Bonus Dollars Will Serve No Useful Purpose.

NASUCA interprets the Proposed Policy Statement's ROE adder for RTO participation as applying to all jurisdictional transmission owners, including those transmission owners that already have transferred control of transmission assets to an RTO. The Commission's rationale for the ROE adder is that the transfer of transmission assets to RTOs is in the public interest, and the ROE adder will provide significant encouragement for additional transfers. This appears to be based on the Commission's assumption that the benefits from fostering RTOs will exceed the costs of the ROE adder, although no such explicit comparison of benefits and costs is provided in the Proposed Policy Statement. As NASUCA has demonstrated through the Affidavit of Matthew I. Kahal, this assumption may not be accurate.

The implied notion that consumer benefits from the increased or accelerated RTO participation exceed the costs of the ROE adder is called into further doubt for several basic reasons.

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[8](...continued)
A study prepared by utilities sponsoring RTO West estimated net savings of $260 million. But, a critique of that study prepared by a stakeholder group estimated annual benefit, before costs, to be only $49 million. Kahal Affidavit, ¶17. When the cost of the incentive adder is considered, the costs may exceed the benefits in some regions.

First and foremost, a large portion of the jurisdictional transmission owners already participate either in RTOs or in organizations presently seeking Commission RTO approval. This is the case for virtually the entire Northeast from Maryland to Maine and the vast majority of the major utilities in the Midwest. Additionally, several other of the largest Midwest utilities have announced plans to join RTOs. The largest transmission-owning utilities in the South and Southeast are currently sponsoring RTO proposals, most prominently GridSouth and SeTrans. Thus, in the Eastern Interconnection, the vast majority of the industry either has joined an approved RTO or has indicated plans to do so. Similar efforts are under way in the Western region of the U.S. It is clear that no consumer benefit would result from a rate of return adder awarded for taking actions that already have occurred or are planned.

The Commission also should note that some transmission owners have joined (or have committed to join) RTOs because they are required to do so. Several states where retail restructuring has taken place require their utilities to join RTOs or ISOs either by statute or as part of restructuring settlements. For example, in Ohio, a state statute requires that transmission owners transfer control of their transmission facilities to a qualifying transmission entity that meets certain specific requirements set forth by the statute. Ohio Rev. Code Ann. §4928.12(A). Those requirements, including an entity approved by FERC, separating control of transmission facilities and generation facilities, an independent governance structure, and others, are similar to those for RTOs and ITCs that have been established by FERC. Ohio Rev. Code Ann. §4928.12(B). An Illinois statute places a similar requirement on electric utilities in Illinois. Section 16-126 of the Illinois Public Utilities Act, 220 ILCS 5/16-126 provides that electric utilities owning transmission systems as of 1997 must submit an application to establish or join an independent system operator to the Illinois Commission for approval.

Mandatory RTO membership also has been used as a market power mitigation tool in merger cases, and may continue to be so used in the future. This Commission required American Electric Power to join an RTO as a condition of merger in *American Electric Power Company and South West Corporation*, Opinion No. 442, 90 FERC ¶61,242 (2000). In *Commonwealth Edison Company and PECO Energy Company*, 91 FERC ¶61,036 (2000), Commonwealth Edison made a commitment to join an RTO as part of its request for merger approval. FERC held that ComEd's decision to join the RTO was a commitment, whether or not the merger moved forward. It would be completely inappropriate, as well as unnecessary, to provide a rate of return adder for a utility to "reward" it for taking an action required by these conditions of merger approval as a means of mitigating market power.

Divestiture of assets to an ITC has also proceeded on a voluntary basis without incentives. By way of example, Iowa's regulated electric utilities have voluntarily requested approval from the Iowa Utilities Board to transfer control and/or ownership of transmission facilities to TRANSLink ITC. *Interstate Power and Light Co.*, IUB Docket No. SPU-02-21 (reorganization application pending) and *MidAmerican Energy Co.*, IUB Docket No. SPU-02-23 (reorganization application pending). TRANSLink proposes to operate as an ITC in conjunction with the MidWest ISO and possibly other RTOs. *TRANSLink Development Co., L.L.C.*, Docket Nos. EC01-156-000, ER01-3154, ER03-83 (Order Authorizing Disposition of Jurisdictional Facilities and Participation in the MidWest ISO Regional Transmission Organization) 99 FERC ¶61,106 (Apr. 25, 2002). Interstate Power Company and IES Utilities Inc. (now known as Interstate Power and Light) have obtained Iowa Utilities Board approval to transfer control of their transmission assets to the MidWest ISO. *IES Utilities Inc. And Interstate Power Co.*, Docket No. SPU-01-8 ,"Order Terminating Docket" (IUB, Nov. 30, 2001). TRANSLink has also reached a settlement with a number of mid-west municipal intervenors that will likely lead to greater participation of Iowa's non-regulated transmission owning utilities.[9] TRANSLink proponents initially requested the state authorized ROE for its members, without special incentives, which FERC approved in Docket Nos. EC01-156 and ER01-3154 on April 25, 2002.[10]

It is true that not all utilities in the U.S. have as of this date joined, or indicated that they plan to join, an RTO or divested their assets to an ITC. Moreover, the transfer of assets to RTOs and the development of new business structures might not be as rapid as this Commission anticipated when Order No. 2000 was issued. However, in those cases where a transmission-owner has not yet decided to join an RTO or divest its transmission assets, it is not clear that the proposed ROE adder would induce the utility to join the RTO or materially accelerate the decision.

On the other hand, the proposed ROE adder will serve as a pure windfall for those utilities that have already joined RTOs, have announced plans to do so, or have divested their transmission assets to an ITC. Their customers will pay the added cost and receive no added benefit

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9 This settlement was filed with FERC in ER03-83 on or about November 25, 2002. It now appears to have been withdrawn and filed in a different docket.

10 FERC subsequently authorized a 12.88 ROE for the MidWest ISO Transmission owners in Docket No. ER02-485 (September 23, 2002). TRANSLink then obtained FERC approval of a 12.88 ROE on existing assets owned by TRANSLink participants in Docket No. ER03-83 (December 19, 2002). The Iowa Office of Consumer Advocate and Iowa Utilities Board intervened in Docket No. ER03-83, protesting the ROE which would exceed the state authorized return previously approved for TRANSLink by both Iowa and FERC. The Iowa Utilities Board requested rehearing in FERC Docket No. ER03-83. The filing seeks to enforce the state authorized ROE that the TRANSLink members originally proposed. The Iowa OCA supports this position.

in return. Such utilities account for the majority of the jurisdictional transmission assets in the United States. Investors in those utilities would receive the ROE incentive as "free riders," meaning they would receive higher profits for no additional expenditure of effort by the utility. There are other utilities that do not yet have definitive RTO plans, but it is not at all clear that the proposed ROE adders would alter their decisions in any way. Hence, the proposal for ROE adders to induce RTO participation or ITC divestiture may be all cost and no benefit.

F. The High Cost To Consumers Will Discourage States From Supporting RTO Or ITC Participation Prior To December 31, 2004 And Will Discourage Further Unbundling At The State Level.

This Commission has recognized that its achievement of its policy goals will be more successful and timely with the support of state regulators. State Commissions typically exercise approval authority over efforts to join RTOs or to divest transmission assets to an ITC. Many states also exercise certification or siting authority for major new transmission projects. The automatic rate of return adders that the Commission would grant transmission owners, however, will be counter-productive and reduce the likelihood of state approvals -- certainly the likelihood of state approval before December 31, 2004.

Some states, even without the ROE incentive adders, are reluctant to allow the transfer of utility assets to RTOs or ITCs. The higher the cost of this transaction, the more reluctant these states may become. Recent studies have identified benefits from RTOs, but in percentage terms, those benefits are relatively thin. The Commission's own RTO study[11] estimates production cost benefits (before considering RTO costs) of 0.6 percent. A study sponsored by the Southeastern

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[11] Economic Assessment of RTO Policy, ICF Consulting, February 26, 2002. Reference here is to the study's "Transmission Only Case."

Association of Regulatory Utility Commissioners (SEARUC) similarly found razor thin benefits with "considerable uncertainty" as to whether RTOs in the Southeast region would provide any net benefits.[12] The Proposed Policy Statement raises the price tag for consumers of RTO participation by their local utilities. For those states not yet committed to RTOs, this artificial and totally unnecessary increase in cost will discourage state support by creating further doubts concerning consumer benefits. Rather than advance the Commission's objectives, the Proposed Policy Statement could result in a delay in these objectives being achieved until after December 31, 2004, when the incentives would expire, as states withhold approval to avoid these cost consequences.

The proposed ROE bonus for divestiture to ITCs will similarly discourage state approvals. In Washington state, for example, asset divestiture must be approved by the state public utility commission and must meet a public interest test to be approved. RCW 80.12.020, WAC 480-143-170. Adding a certain cost increase through the incentive ROE for divestiture will make it more difficult to meet this public interest standard. Thus, the incentive ROE could result in the disapproval of an asset divestiture under Washington law if the test cannot be met which would thwart FERC's intent.

The Proposed Policy Statement could also slow the adoption of retail choice and unbundling of services in some states. The adverse rate impact estimates discussed in Section IV.D, are based on the assumption that retail customers pay rates for transmission, including the transmission owner's rate of return, set by this Commission. This is generally the case for customers in retail access states where the state commission has unbundled rates. However, under present

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12 The Benefits and Costs of Regional Transmission Organizations and Standard Market Design in the Southeast. Charles River Associates, November 6, 2002.

practice, in states that do not unbundle rates, *i.e.*, customers take service from a vertically-integrated utility, the charges for transmission service paid by retail customers is determined by the state regulator. This includes the rate of return on transmission investment.

This suggests that a state may spare its retail electric customers the burden of the ROE adders in the Proposed Policy Statement merely by refraining from unbundling retail rates. Since unbundling is, for all practical purposes, a requirement of retail competition, the ROE adders succeed in raising the price tag for introducing retail competition as well as burdening states that already have adopted retail access. While each state should evaluate electric retail restructuring on its merits, the proposed ROE adders create an artificial incentive for a state not to do so.

NASUCA submits that the expected increased cost of transmission service associated with these adders will discourage states from approving utility transmission divestiture or RTO formation. It will become more difficult for utilities to demonstrate to their state regulators that transmission divestiture or RTO formation is in the public interest. This Proposed Policy Statement is likely to have the unintended consequence of having a state commission reject or delay an RTO formation proposal or ITC proposal that it otherwise would be inclined to approve. Moreover, the Proposed Policy Statement may have the unintended effect of slowing the introduction of rate unbundling and retail choice in many states. The additional cost burden that would accompany such a move might weigh against further development. As such, a significant likelihood exists that the Commission's policy will have the opposite effect than that sought to be achieved.

G. The Proposed Policy Statement Provides No Evidence That ITC's Are A Superior Business Model For Transmission Service.

The Proposed Policy Statement discusses the potential benefits from independent transmission companies (ITCs), although it notes that only one such company currently is in operation. NOPPS, ¶5. The Commission has previously addressed the potential role of ITCs in providing transmission service in both its Order No. 2000 and in the SMD NOPR. Paragraph 16 of the Proposed Policy Statement cites the SMD NOPR concerning the potential benefits of the ITC business model. NOPPS, ¶16. These claimed advantages would include (1) improved asset management, including greater willingness to invest in transmission; (2) greater access to capital markets as compared to vertically-integrated utilities; (3) greater willingness to develop "innovative services;" and (4) additional independence. NOPPS at ¶5, citing SMD NOPR, ¶132.

The Proposed Policy Statement sets forth incentives for utilities to divest their transmission assets, even though no evidence has been presented that the ITC is the most appropriate business model for transmission service on an industry-wide basis. Although the Commission cites to possible advantages of the ITC business form, there have been no studies undertaken demonstrating that ITC transmission service is superior to the transmission service provided by utilities that operate within an RTO structure. The Proposed Policy Statement touts the independence of ITCs, but there is no evidence that ITC independence is superior to RTOs operating the transmission assets of vertically integrated utilities. In fact, the Commission has acknowledged that the opposite may be the case in that the Commission has required that ITCs operate under RTO control. *Alliance Companies*, 100 FERC ¶61,137 (July 31, 2002). *See also*, *TRANSLink Order*, 99 FERC ¶61,106 (April 2002)

The plain fact is that there are no studies demonstrating the relative advantages of the ITC model, merely unsupported assertions. As the Proposed Policy Statement concedes, as of today there is little experience in the U.S. with ITC operation. It therefore is improper to leap to the conclusion that the ITC is the superior business model for transmission in all cases and that strong incentives must be imposed to promote industry-wide divestiture to ITCs. The creation of such incentives, at the expense of consumers, lacks a factual foundation and at best is premature. The Commission, at a minimum, should gain experience with ITCs and conduct cost/benefit evaluations before determining that ratepayer funds should be used to promote this business model through substantial rate of return adders.

H. The ROE Bonus Is Inconsistent With Several Aspects Of FERC's RTO Orders And Its Standard Market Design Proposal.

1. The ROE Bonus Is Inconsistent With The Reliance On A Regional Planning Process Conducted By The Independent RTO.

This Commission has recognized the importance of regional transmission planning to ensure robust bulk power markets. The Commission has required this planning process to be conducted by the RTO rather than by the integrated utilities. This has been emphasized both in RTO orders as well as in the SMD NOPR. *See, e.g., PJM, L.L.C.,* 101 FERC ¶61,137 at ¶¶20-26 (*December 20th PJM Order*)[13] and *SMD NOPR* at ¶¶335-350. Recently, the Commission has recognized the need for the RTO to be proactive in its planning to consider not just reliability projects and generator interconnections but "economic" upgrades as well. *PJM Order*, 101 FERC ¶24. The economic upgrades, while not required for reliability, will help to facilitate the

[13] Order Granting PJM RTO Status, Granting in Part and Denying in Part Requests for Rehearing, Accepting and Directing Compliance Filing and Denying Motion for Stay, 101 FERC ¶61,345 (December 20, 2002).

development of a competitive market by expanding access to suppliers and reducing congestion costs.

The Commission addressed these planning objectives in its July 12, 2001 Order conditionally approving PJM's RTO Plan and more recently in its December 20, 2002 PJM Order providing final RTO approval. *PJM Interconnection, L.L.C.*, 96 FERC ¶61,061 (*July 12th Order*) and *December 20th Order, Id.* The December 20th Order further clarified that the RTO itself has explicit responsibility for preparing a transmission plan that addresses <u>both</u> reliability and economic infrastructure requirements <u>and</u> must have the authority to ensure that the plan is carried out by the Transmission Owners. The Order stated:

> PJM's regional transmission plan must provide authority for PJM to require upgrades both to ensure system reliability and to support competition. Thus, we anticipate that the plan will enable PJM to (a) require the necessary additions to its TOs' systems to ensure reliability, and (b) identify transmission constraints and require new construction to address those constraints. DEMEC, in its protest, recommends that, as PJM, identifies appropriate economic upgrades, it should give priority to proposals for transmission expansion at current interconnections with utilities, in areas where transmission is constrained, and to interconnection applications by generators locating in congested areas. We will require PJM either adopt the priorities suggested by DEMEC, or if it believes that other priorities are superior, to state what they are and why.

101 FERC at ¶24 (*December 20th Order*). The Commission further required that PJM adopt tariff language:

> that explicitly states that any party may propose a new project -- whether a transmission owner, or a third party seeking to build a merchant transmission plant -- and that the party proposing the project will be responsible for its costs of the project.

Id. at ¶26. Some NASUCA members are currently participating in PJM's development of the planning protocols to comply with these directives. These protocols are expected to be filed soon with the Commission.

This Commission's policies on RTO transmission planning make it clear that planning is the responsibility of the RTO (and possibly an ITC meeting the independence requirements), that the planning process <u>must</u> encompass both reliability and economic (*i.e.,* competitive market) needs, and that the RTO has the <u>authority</u> to require the completion of the upgrades. Notwithstanding that responsibility and authority, other parties may <u>propose</u> additional transmission projects, but if not already included in the RTO's approved plan, the party proposing the project is assigned the cost. Presumably, the party proposing the additional project would do so in order to capture for itself the economic benefits.

The Commission's Proposed Policy Statement specifies substantial financial benefits to the transmission owners for investment in new transmission, over and above that utility's cost of capital. NASUCA interprets the Proposed Policy Statement as providing an ROE adder of 100 basis points for investment in new transmission facilities found appropriate through an RTO planning process. When combined with the other incentives, as the Proposed Policy Statement seems to contemplate, new transmission could qualify for an adder of 300 basis points. These proposed adders appear to be motivated by the Commission's belief that investment in transmission infrastructure has been insufficient to support the optimal development of wholesale bulk power markets. NOPPS, ¶19. The Commission observes that this inadequate investment, coupled with industry restructuring, has led to increases in congestion. *Id.*

NASUCA supports transmission infrastructure investment to relieve congestion and provide reliable, economically efficient transmission service at just and reasonable rates. We agree with the Commission and its recent PJM order that ensuring that such cost effective investment takes place should be the responsibility of the RTO where one exists and that the RTO must have the authority to require that such projects are built. The RTO's planning process can be supplemented, but not replaced, by market forces, *i.e.*, merchant transmission, siting generation behind existing constraints, demand response, and the like.

Given this structure and designation of responsibilities for upgrades under current Commission policy, it is unclear as to why there is <u>any</u> need for generic ROE adders for the transmission owners. Accepting the Commission's view that economic upgrades are needed, the RTO is charged with the responsibility to <u>identify</u> such upgrades and <u>require</u> that they be constructed. The RTO is the decision maker in this case (albeit with input from market participants), but the RTO, which does not own the assets, does not receive the ROE adders for new investment. Thus, the incentive adder is received by an entity that is not the decision maker in the planning process.[14] The ROE adders therefore are superfluous and contribute nothing (other than causing higher transmission access rates) to improving transmission service.

In point of fact, the ROE adders are likely to be counter-productive. Presumably, the RTO will authorize or order the construction of economic upgrades subject to a cost effectiveness test as part of its planning process. The ROE adders will place a burden on that test by adding to the

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[14] It is true that the transmission owners (and others) may propose upgrades outside of those comprising the RTO's plan. In that case, the proposing party does so to capture the market benefits, and no special regulatory incentive is needed.

ratepayer cost of the project. In other words, the ROE adders become additions to project cost.[15] Similarly, a transmission owner has an incentive to respond to the ROE adder (since the RTO is the actual decision maker) by inflating its project costs. That is, the more expensive the actual cost of the project, the greater will be the transmission owner's excess profit resulting from the ROE adders. The consumer receives no benefit and pays higher transmission rates due (a) to the ROE adders; and (b) as a result of inflated project costs.

NASUCA submits that reliance on the regional planning process, conducted by an independent RTO, is an appropriate mechanism for ensuring the safety, reliability and economic efficiency of the grid where an RTO exists. Under this approach, incentives would be unnecessary. The Commission's proposal here would simply add to the cost of transmission that a transmission owner was otherwise obligated to construct under an approved RTO transmission expansion plan. There would be no benefit, only costs to consumers.

2. <u>The ROE Bonus Is Inconsistent With The Concept Of Participant Funding Contained In The Standard Market Design NOPR</u>.

The Commission's proposed Standard Market Design (SMD) expresses a preference for using the concept of "Participant Funding" to assign the costs of economic upgrades, including those associated with interconnecting new power plants to the grid. The SMD NOPR states that

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15 The incentives will skew any least cost planning analysis and could impede the functioning of the competitive markets. The "build transmission" option may or may not be the least cost way to proceed, but providing such an incentive could skew the decision process and provide an unfair advantage to transmission investment as opposed to demand response options or generation additions.

Participant Funding, in cases where independent grid management is in place, will facilitate investments in non-reliability grid expansions. The SMD NOPR provides:

> We are eager to see new infrastructure in place as soon as possible and believe that participant funding will be a useful tool to make that happen. Accordingly, we propose that, for proposed transmission facilities that are included in a regional planning process which is conducted by an entity, whether an RTO, ISO, or other independent entity, that is independent, we will consider participant funding for that project. (SMD NOPR,¶199)
>
> Our goal is to remove any cost recovery impediments to transmission expansion so that upgrades get built now. (SMD NOPR, ¶196)

SMD NOPR, ¶¶199 and 196. The SMD NOPR finds that a matching of benefits and cost recovery responsibility is appropriate and "would encourage greater regional cooperation to get needed facilities sited and built." Participant funding is judged to be consistent with this matching. SMD NOPR, ¶197.

NASUCA agrees that a matching of benefits and cost responsibility is appropriate and may help foster cost effective infrastructure development. NASUCA submits, however, that the ROE adders of 150 to 300 basis points do not fit in with the Participant Funding framework advocated in the SMD NOPR. The Participant Funding concept is that the cost of the economic upgrade is assigned to the beneficiary or the party seeking the upgrade (*e.g.*, a new generator seeking to interconnect and receive network resource designation). In such a case, there is no need or justification for the ROE adders as proposed in this Policy Statement. It is notable that the Proposed Policy Statement does not recognize that the Commission has proposed the use of a Participant Funding framework for assigning costs.

The ROE adders not only are incompatible with the Participant Funding framework, but they have the potential to undermine its operation. The adders will provide an incentive for the TOs (or the ITC) to advocate that certain grid upgrade investments be "rolled in" to the TOs' zonal access rates rather than being assigned to the market participant benefitting from the upgrades. Misallocating the upgrade investments to the TO's rate base that more properly should be participant funded (*i.e.*, directly assigned) will enable the transmission owner to capture the ROE adders and maximize excess profits.

The above discussion of Participant Funding has been in reference to economic upgrades that reduce congestion. The SMD NOPR is not proposing Participant Funding for reliability upgrades and assumes that such investments would be recovered through the transmission owner's rolled-in zonal rates. NASUCA's understanding of the Proposed Policy Statement, however, is that the application of the new investment ROE adders does not distinguish between reliability and economic upgrades. The former would be assigned to the TO that needs the upgrade for local reliability, and that TO automatically would receive the ROE adder. There can be no justification for providing an adder for these non-discretionary reliability investments. Such investments are a basic public utility responsibility of the TO and will be approved as part of the RTOs transmission plan. No excess profit award for providing reliability can be justified. Moreover, at no time has the Commission identified transmission reliability of service (as opposed to congestion) as a problem that requires extraordinary ratemaking treatment.

I. <u>FERC's Implementation Proposal Is Vague And Appears To Contemplate Impermissible Single Issue Ratemaking</u>.

The Commission recognizes in the Proposed Policy Statement that "A clear policy is needed" for incenting utilities to join RTOs or form ITCs so that the goals envisioned in Order No. 2000 and the SMD NOPR can be realized. NOPPS, ¶20. However, the Proposed Policy Statement provides insufficient details and substantial lack of clarity as to the process by which utilities will be able to obtain the proposed transmission incentives. While NASUCA recommends against implementation of the Proposed Policy Statement, if the Commission nonetheless pursues this course, clarity in process as well as clarity in substance is needed to achieve the Commission's goals. Different options for process may well have enormous cost implications for consumers. The Commission must more clearly delineate the process that will govern utility requests for the incentives proposed through a second proposed policy statement or a proposed rulemaking process.

The Proposed Policy Statement contains very few, relatively brief statements related to process issues. The Commission proposes that eligible public utilities would make a Section 205 filing to receive authorization to obtain the proposed incentives. NOPPS, ¶36. The Commission further states that it would not require that a cost-benefit analysis be filed as part of that Section 205 case. *Id.* The Commission then states that a cap will be imposed equal to the top of the range of reasonable ROEs for a proxy group consisting of the publicly traded, investor-owned transmission owners participating in the relevant RTO. NOPPS, ¶37. No other information is provided as to process. There are many possibilities for the type of process that could be employed within the cryptic statements paraphrased above. These brief proposals raise many questions as to exactly what process the Commission is proposing. While NASUCA can not anticipate all possible issues, NASUCA will address its concerns regarding a single issue ratemaking process in these comments.

The Commission proposes to allow eligible utilities to avail themselves of the incentives proposed in the Policy Statement through the filing of Section 205 rate proceedings. Three possible courses of action include: a) a traditional Section 205 rate case with full review of all cost and revenue elements in the rate case; b) a limited proceeding leading to certification that the utility is eligible for the incentives, but leaving the actual increase in rates to the utility's next full Section 205 rate case; or c) a limited Section 205 rate filing in which only the issue of the rate of return and the incentive adder is considered. The language in the Proposed Policy Statement seems to contemplate that a full review of all elements of a utility's cost of service will not be conducted. In the event that the Commission is considering a limited form of filing, NASUCA urges that the Commission reject such an approach.

Section 205 of the Federal Power Act allows electric utilities to file for increased rates. 16 U.S.C. § 824d. However, that statute authorizes the Commission to suspend the effectiveness of the proposed increase for a five month period, and further provides that the rate increase may go into effect subject to refund after full investigation and hearing as to the justness and reasonableness of the proposed level of rates. *Id.* The Courts have generally construed this provision to require investigation into the entire range of a utility's costs that underlie the proposed increase. *Cities of Batavia, et al. v. FERC*, 672 F.2d 64 (D.C. Cir. 1982); *See also Colorado Interstate Gas Company v. FERC*, 791 F.2d 803, 807 (10th Cir. 1986).

In *Cities of Batavia,* the Court determined that in Section 205 rate cases, the Commission has the authority to review "... a revised rate completely to assure its parts – old and new – operate in tandem to insure a 'just and reasonable' result..." *Cities of Batavia, et al.*, 672 F.2d at 77. The Court also determined that where a party challenging a utility's rates demonstrates that increased revenues will result in the near future, it would be arbitrary and capricious to adopt a presumption that costs will rise to offset the increased revenues. *Id.* at 75. Thus the Court imposes on the utility the burden of proving both cost and revenue elements in a Section 205 rate case. *Id.*

The Courts have applied similar reasoning in deciding interstate pipeline cases under the Natural Gas Act, whose Section 4 rate requirements track the provisions in Section 205 of the Federal Power Act. In *Colorado Interstate Gas Co.,* the Court found that:

> By filing a rate increase, a ... company assumes the risk of having to justify its entire rate structure, including integral provisions of that structure which the company does not propose to change.

Colorado Interstate Gas Company v. FERC, 791 F.2d 803, 807 (10th Cir. 1986, citations omitted).[16] In a 1999 decision in a Northern Border Pipeline Company docket, the Commission applied this fundamental principle, stating that:

> The Commission has held that these provisions of section 4 govern any pipeline proposal to increase its rates based upon a proposed increase in its overall cost of service. That includes both the individual cost of service components the pipeline proposed to increase and those that it left unchanged. As the Commission explained in Tennessee and Northwest, each component of the pipeline's cost of service is an integral part of the pipeline's proposed overall rate increase. Therefore, the pipeline's burden under NGA section 4 of 'showing that an increased rate or charge is just and reasonable' necessarily includes the burden of supporting each component of the cost of service, the unchanged as well as the changed components. Moreover, to the extent the pipeline fails to

[16] The ratemaking provisions of Section 205 of the Federal Power Act, 16 U.S.C. §824d, and Section 4 of the Natural Gas Act, 15 U.S.C. §717c, contain very similar language relating to Commission authority to regulate the justness and reasonableness of electric utility and interstate natural gas pipeline rates respectively. The precedents under those statutes have been followed interchangeably by the Courts without distinction between natural gas and electricity cases. *FPC v. Sierra Pacific Power Co.*, 350 U.S. 348, 353 (1956).

> sustain that burden, the Commission may order refunds of the overall increase in the cost of service. This result is consistent with the fact that section 4 speaks solely of 'increased rates or charges,' without distinguishing between the cost components that make up those rates and charges.

Northern Border Pipeline Company, 89 FERC ¶61,185 at 61,575 (1999) (footnote citation omitted).

Essentially, the federal courts and the Commission recognize that as one item of cost in a public utility's cost of service increases, it is possible that offsetting cost decreases may have occurred. *Arkansas Power & Light Co. v. Missouri Public Service Commission*, 829 F.2d 1444, 1451-52 (1987). The establishment of just and reasonable rates for consumers would require analysis of not only those items of a utility's cost of service, such as return on equity, that have allegedly increased, but would also require consideration of those items of cost of service that have decreased. Id. Only by considering both sides of the issue can the Commission fulfill its statutory mandates in Section 205 of the FPA and Section 4 of the NGA to protect consumers from the utility's ability to extract monopoly rents and from unjust and unreasonable rates. Consequently, the Courts generally require the Commission to review all elements of cost of service in FPA Section 205 and NGA Section 4 proceedings initiated by the utility.[17]

Most utilities that are likely to avail themselves of the incentives proposed in the Proposed Policy Statement are utilities whose rates were set some time ago. Some of those utilities have transmission rates for native load that were approved by state regulatory commissions and transmission rates for wholesale transactions that were approved by this Commission. Others, in

[17] Waivers of the general rule for full blown rate cases are found only in limited circumstances, for example where the utility is merely an accounting conduit for rate changes made by another utility from whom the first utility purchases services. *Panhandle Eastern Pipe Line Co. v. FERC,* 613 F.2d 1120 at 1127 (D.C. Cir. 1979).

response to Order Nos. 888 and 2000, have already joined ISOs or RTOs and have all transmission rates set by this Commission. At the time the utilities made those Order Nos. 888 and 2000 compliance filings, the Commission allowed the utilities to establish rates based on the same overall level of revenues authorized in the utility's last state or federal rate case. Order No. 888 was issued in 1996 and Order No. 2000 was issued in 1999. This means that the last rate case for most of those utilities occurred some time ago. Consequently, many of those rates were established when the level of transactions, particularly in wholesale markets, may have been lower than today. Even the Commission in Order No. 2000 and in the more recent SMD NOPR has recognized that increased use of the transmission grid nationwide has resulted from the development of more competitive wholesale markets under Order Nos. 888 and 2000. *Order No. 2000* at 30,996 - 30,997; SMD NOPR at ¶¶2, 93-96. As a result, it is possible that many electric utilities today are over-earning their currently authorized returns. Providing increases of up to 300 basis points on these already excessive ROEs would only further exacerbate the current problem.

The primary responsibility of the Commission under the Federal Power Act is to protect consumers from exploitation at the hands of regulated utilities. *Federal Power Commission v. Hope Natural Gas Co.,* 320 U.S. at 610, 64 S.Ct. at 291; *Accord, Phillips Petroleum Co. v. State of Wisconsin,* 347 U.S. 672 at 685, 74 S.Ct. 794 at 800-801 (1954) and *Electric Dist. No. 1 v. FERC,* 774 F.2d 490, 493 (D.C. Cir. 1985). While NASUCA disagrees that the incentives proposed in this Proposed Policy Statement constitute a reasonable approach to providing incentives to utilities to join RTOs or divest to ITCs, especially for those utilities already members of existing RTOs, if the Commission nonetheless decides to pursue this approach, any Section 205 filing to implement such incentives must be fully investigated to assure that the overall level of revenues authorized, even with the incentive adders, remains just and reasonable. The Commission can only accomplish that goal by ensuring full review of all of the utility's cost and revenue components. To provide a 50 to 300 basis point adder to equity returns via a single issue rate case when current rates may already result in excessive returns merely requires consumers to pay even higher unjust and unreasonable rates.

J. The Commission Should Reject Proposals For Even Greater Incentives Than Those Identified In the Proposed Policy Statement.

The Commission adds even greater uncertainty as to what is being proposed by requesting comment on additional levels of independence that could merit incentives above the basic ROE incentive adders set forth in the Proposed Policy Statement. NOPPS, ¶29. The example the Commission provides concerns ITC employment of staff independent of member company staff. *Id.* The Commission further seeks comment on whether a broad range of other activities might merit ROE bonuses or other types of financial incentives. The Commission identifies a number of new technologies and innovative operating practices that it might seek to encourage through the use of incentives. NOPPS, ¶¶31, 32.

NASUCA submits that incentives for certain technologies or practices may not be appropriate. It may not be the role of the Commission to determine desired technologies for all transmission owners. Transmission systems will have different technology requirements and a Commission incentive policy cannot take all of the unique design elements into consideration. Incorrect incentives could lead to inefficient, or even dangerous practices. Moreover, the Commission does not ask for, or appear to contemplate any performance standards associated with these incentives.

To the extent any party submits such a proposal for Commission consideration, other parties will not have had an opportunity to comment on the merits of such a proposal. NASUCA and most parties are unable to anticipate all the possible proposals that may be submitted. If other proposals are made by parties, the Commission should provide opportunity to affected stakeholders, including consumers, to comment on any newly proposed programs.

V. CONCLUSION

All NASUCA members strenuously oppose the Commission's Proposed Policy Statement. The Proposed Policy Statement is fundamentally flawed, contrary to sound regulatory principles, and contrary to sound economic principles. The Proposed Policy Statement will likely result in costs to consumers that virtually offset the expected benefits of the RTO development that the Commission seeks to achieve. NASUCA urges the Commission to withdraw this Proposed Policy Statement.

UNITED STATES OF AMERICA

BEFORE THE

FEDERAL ENERGY REGULATORY COMMISSION

Proposed Pricing Policy for	)	
Efficient Operation and	)	
Expansion of the Transmission	)	**Docket No. PL 03-1-000**
Grid	)	

AFFIDAVIT OF
MATTHEW I. KAHAL

1. My name is Matthew I. Kahal. I am employed as an economist and independent consultant, specializing in energy economics, environmental issues and public utility regulation. My business address is 12510 Prosperity Drive, Suite 350, Silver Spring, Maryland 20904.

2. I have more than 25 years experience in consulting, having undertaken or supervised projects on a wide range of issues including electric utility integrated resource planning, power purchase contracts and competitive solicitations, fair rate of return/utility financial assessments, mergers, industry restructuring, power plant licensing, utility environmental compliance, transmission/RTO issues and other topics. I have testified on more than 250 occasions before approximately two dozen state commissions, the Federal Energy Regulatory Commission, the Federal Communications Commission, the Province of Alberta, Canada, and the U.S. Congress (House Committee on Ways and Means).

My current and recent clients include the U.S. Air Force, the U.S. Department of Energy, the U.S. Department of Justice, the Maryland Department of Natural Resources/Energy Administration, Pennsylvania Office of Consumer Advocate, the New Jersey Rate Counsel, the Rhode Island Division of Public Utilities, the Connecticut Attorney General, the Louisiana Public Service Commission and Arkansas Public Service Commission. Please see Appendix A for a Statement of Qualifications and list of past cases in which I have testified.

3. On January 15, 2003, this Commission issued a Proposed Policy Statement to provide jurisdictional transmission owners (TOs) with certain rate of return incentives if the TOs would join approved Regional Transmission Organizations (RTOs) and/or divest transmission assets to Independent Transmission Companies (ITCs) by a certain date. These rate of return incentives, if approved, could have a significant impact on the transmission access charges paid by consumers. I have been asked by the National Association of State Utility Consumer Advocates (NASUCA) to prepare a quantitative assessment of the potential impact of the proposed financial incentives on transmission rates.

4. Paragraph 2 of the Proposed Policy Statement summarizes the rate of return incentives being proposed at this time. TOs would be eligible for the following "adders" to their Commission-approved return on equity (ROE):

(a) a 50 basis point adder for joining a Commission-approved RTO;

(b) a 150 basis point adder for divesting transmission assets to an ITC (participating in an RTO); and

(c) a 100 basis point adder applicable for new transmission approved as part of the RTO's planning process.

Moreover, the Proposed Policy Statement indicates that these three ROE adders are potentially cumulative, not alternatives. This implies that new transmission could receive an ROE adder as much as 300 basis points, and "existing" transmission as much as 200 basis points. I am interpreting the adders as applying only to the portion of the TOs investment in transmission financed with common equity (which, for present purposes, I assume to be 45 percent of the total).

5. The TO may obtain the ROE adders by making a Section 205 filing, and no supporting cost-benefit analysis would be required. (Paragraph 36) Since there is no indication that cost of service or earnings data need be filed, the Section 205 request would appear to be a single issue rate request. The deadlines for the RTO/ITC adders would be December 31, 2004 for joining the RTO and/or divesting to an ITC. The incentives would apply until year-end 2012 for the RTO and year-end 2022 for the ITC. (Paragraph 28) The Policy Statement does not specify a time limitation for the new

transmission investment adder.

6. Paragraph 25 of the Proposed Policy Statement briefly describes how the ITC adder revenues would be calculated and recovered by the TO. The adder of 150 basis points applies to the existing book value of the transmission facilities at the time of divestiture, calculated as a lump sum dollar amount and amortized to rates over the incentive period (i.e., presumably through 2022). I am assuming that the reference to "book value" is intended to be net of accumulated depreciation. The Proposed Policy Statement provides no further description or sample calculation of this "lump sum" methodology, but I assume that the Commission proposed this method in order to facilitate providing different financial incentives for existing versus new transmission investment.

7. The Proposed Policy Statement seeks comments on (but does not propose at this time) additional financial incentives for TOs, beyond those described above, for innovative technologies and/or operating procedures. (Paragraph 31) Proposals are also solicited for financial incentives for non-transmission alternatives such as demand response programs or distributed generation. (Paragraph 32)

8. The Proposed Policy Statement can impact the transmission rates that customers pay in several ways. First, the TOs will increase their authorized returns on equity and returns on rate base purely as a result of joining an RTO, divesting assets to an ITC and constructing new transmission facilities

pursuant to RTO planning approval. These rate impacts can be readily estimated based on assumptions concerning RTO/ITC participation and new transmission investment. Second, the ROE adders cumulatively are quite large, and will provide an incentive for TOs to inflate costs for new transmission investments, to propose to the RTO investments that may not be meritorious, or to misallocate investments as "rolled in" when they should be "participant funded." Thus, even if it does not inflate its costs, the TO has an incentive to seek to allocate the costs of new investments to captive ratepayers rather than to the market participants causing the costs. Third, the Proposed Policy Statement invites additional financial incentive proposals beyond the ROE adders summarized in Paragraph 2.

9. My affidavit only addresses the first set of costs, i.e., the additional access charge revenue requirements resulting directly from the ROE adders. I do not quantify the effects of artificial increases in the TO rate base due to inflated project costs or improper cost allocations. The magnitude of such added or misallocated costs cannot be readily predicted. My affidavit also does not attempt to quantify the costs of other financial incentives solicited by the Proposed Policy Statement because such incentives have not yet been identified.

10. The approach I have taken is to apply the specified ROE adders to existing industry net investment in transmission plant and to assumed ongoing future transmission expenditures. These should be viewed as "potential" impacts on customers in that I assume that the incentives will achieve

the Commission's objective of inducing all major (investor-owned) transmission owners to join an RTO and to divest transmission assets to ITCs. In point of fact, the adders might not have such an effect at all because it could discourage states from granting RTO participation or ITC divestiture approval to avoid what they perceive as ratemaking penalties. However, in this context it makes most sense to assume that the incentives succeed and to evaluate the potential customer impacts of the assumed "success."

11. I start by obtaining an estimate of industry-wide net investment in transmission plant. According to the Financial Statistics of Major U.S. Investor-Owned Electric Utilities, 1996 (DOE/EIA-0437(96)11, December 1997), transmission plant in 1996 was $65.5 billion for the major investor-owned utilities.[1] This does not include an allocation of general plant, working capital, etc. Unfortunately, this report provides only total transmission plant and not net transmission plant, i.e., transmission plant net of accumulated depreciation. However, the report does provide net plant and total plant balances for all electric functions combined (generation, transmission, distribution and general plant). On a combined basis, net plant is 62 percent of total plant. Applying the 62 percent figure to transmission total plant of $65.5 billion results in industry-wide net transmission plant of $40.2 billion. I assume that by 2004 (the assumed first year the incentives apply) no change in transmission net plant from the estimated 1996 value will occur. That is, increases in the accumulated depreciation reserve and new investment are assumed to offset.

[1] It is my understanding that EIA has ceased publishing this report.

12. In calculating the impacts, I make the following assumptions summarized on Table 1:

Table 1

Assumptions Used to Calculate Impacts
Of FERC-Proposed ROE Adders

1.	Investor-owned TOs Qualifying for Adders	All
2.	Common Equity Ratio	45%
3.	Combined federal/state income tax rate	40%
4.	RTO time period	2004-2012
5.	ITC/new transmission time period	2004-2022
6.	Annual post 2003 transmission investment	$3 billion
7.	New transmission depreciation rate	2.5%
8.	Annual increase in transmission net plant	$0

13. I have used these assumptions to calculate the impacts on transmission rates for each of three adders, and this is shown on Table 2. These calculations assume that all transmission ratemaking, including for bundled retail service, is under FERC jurisdiction.[2] The values on Table 2 further assume no distortion of transmission investment, i.e., no inflating costs or misallocating cost responsibility due to an ROE allowance exceeding the cost of capital. If that assumption is relaxed, the consumer impacts on Table 2 could increase sharply due not only to a higher rate base, but also due to higher depreciation and O&M expense.

[2] If transmission is provided by an ITC, as my analysis assumes, it is difficult to see how ratemaking could be other than FERC jurisdiction.

Table 2

Transmission Access Charge Impacts for U.S. Investor-Owned Utilities from Proposed ROE Adders (millions $)

		Annual Average	Cumulative
1.	RTO participation	$151	$ 1,359
2.	ITC divestiture	453	8,607
3.	New Transmission	186	3,534
	Total	**$711***	**$13,500**

*Based on $13.5 billion divided by 19 years. Column total is $790 million but the RTO figure is only for first 9 years.

14. In accordance with the Proposed Policy Statement, the cumulative impact is nine years for RTO participation (2004-2012) and 19 years for ITC divestiture and new investment (2004-2022). The calculations assume a constant rate base for RTO participation and ITC divestiture and a 100 basis point adder for new transmission. This procedure is followed even though new transmission is actually eligible for up to 300 basis points additional ROE. This was done to avoid a double counting problem when summing the dollar impacts of the three adders. That is, the "constant rate base" assumption captures the effect of new transmission investment in the first two categories.

15. The cumulative impact of the three adders, based on the assumptions used in the analysis, averages $711 million per year and $13.5 billion for the entire 19-year time period. The calculations assume transmission rate base remains constant and industry-wide new investment of $3 billion per year

beginning in 2004. This amount is somewhat higher than Edison Electric Institute (EEI) trend data would suggest for the 1990s (i.e., about $2.5 billion).[3] The $3 billion per year reflects a modest increase to reflect restructuring needs plus the effects of inflation. However, if a lower level of investment is assumed (e.g., only $2 billion per year), the annual impact would decline to about $650 million and $12.3 billion for the full 19 years.

16. The transmission rate impact of about $700 million per year and $12.3 to $13.5 billion over 19 years can be placed in perspective by comparing these added consumer costs to the expected RTO efficiencies estimated by ICF Consulting on behalf of this Commission. The ICF study estimates annual average production cost benefits for the period 2004 to 2020 of about $725 million per year -- roughly comparable to my estimate of the potential cost to consumers of the ROE adders.[4] In other words, the costs to consumers of the proposed ROE incentives would essentially offset the estimated production cost efficiencies from RTOs. It should be noted that the production cost benefits estimated by ICF are before netting out any RTO development and administrative costs.

17. Regional RTO studies also have estimated modest benefits relative to the consumer costs of the RTO adders. A study sponsored by the Southeast Association of Regulatory Utility Commissioners (SEARUC) estimated relatively thin net benefits, with "considerable uncertainty" as to whether RTOs

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[3] Statistical Yearbook of the Electric Utility Industry, 1999, Edison Electric Institute, Table 70.
[4] This is ICF's "Transmission Only Case," Economic Assessment of RTO Policy, February 26, 2002, Prepared for the Federal Energy Regulatory Commission, Table ES-1.

would provide any net benefits for the Southeast.[5] A benefit/cost study prepared for the utilities sponsoring RTO West estimated benefits for the Western Systems Coordinating Council (WSCC) of $410 million per year compared to costs of about $127 to $143 million per year -- a net savings of about $260 million.[6] However, a critique of that study prepared by a stakeholder group estimated the annual benefit (before consideration of costs) to be $49 million.[7]

18. A large portion of the ROE adder burden is associated with divestiture of transmission assets to ITCs. I am aware of no studies that demonstrate or quantify any savings from an industry-wide movement to an ITC structure for transmission service.

19. There can be legitimate differences of opinion regarding the expected consumer benefits from RTOs, ITCs and even increased transmission investment. My affidavit calculates the impacts on transmission access charges from the proposed ROE adders, assuming it motivates full participation in RTOs and transmission divestiture. The consumer costs that can be quantified at this time are about $700 million per year and $12 to $13.5 billion over 19 years. These calculations are based on readily available data and certain assumptions that I have employed. Clearly, the potential dollar amount of these impacts are sufficiently large that this Commission should undertake its own analysis of both the costs of its financial incentive proposals and the expected benefits. A Commission cost analysis should

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[5] The Benefits and Costs of Regional Transmission Organizations and Standard Market Design in the Southeast. Charles River Associates, November 6, 2002.

[6] RTO West Benefit/Cost Study, Final Report Presented to the RTO West Filing Utilities, Tabors Caramanis & Associates, March 11, 2002.

[7] Corrections to the Benefits/Costs Study for RTO West, Linc Wolverton, et al., April 19, 2002.

employ more accurate information on transmission rate base and projected transmission investment than is presently available to me. The Commission's January 15, 2003 Proposed Policy Statement provides no quantitative analysis of either the costs or benefits of proposals that potentially could impose a multi-billion dollar cost on consumers.

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UNITED STATES OF AMERICA

BEFORE THE

FEDERAL ENERGY REGULATORY COMMISSION

Proposed Pricing Policy for	)	
Efficient Operation and	)	
Expansion of the Transmission	)	**Docket No. PL 03-1-000**
Grid	)	

AFFIDAVIT OF
MATTHEW I. KAHAL

Matthew I. Kahal, being first duly sworn, deposes and states that the attached statement was prepared by him and is true and correct to the best of his knowledge and belief.

Matthew I. Kahal

Matthew I. Kahal

SUBSCRIBED and sworn to before me, the undersigned notary public this 10 day of March 2003.

Deborah M. Adams

Notary Public

Commission expires: 2/01/2007

APPENDIX A

QUALIFICATIONS OF

MATTHEW I. KAHAL

[LIST OF CASES
OMITTED]

MATTHEW I. KAHAL

Mr. Kahal is currently an independent consulting economist, specializing in energy economics, public utility regulation and financial analysis. Over the past two decades, his work has encompassed electric utility integrated resource planning (IRP), power plant licensing and a wide range of utility financial issues. In the financial area he has conducted numerous cost of capital studies and addressed other financial issues for electric, gas, telephone and water utilities. Mr. Kahal's work in recent years has shifted to electric utility restructuring, mergers and competition.

Mr. Kahal has provided expert testimony on more than 200 occasions before state and federal regulatory commissions and the U.S. Congress. His testimony has covered need for power, integrated resource planning, cost of capital, purchased power practices and contracts, merger economics, industry restructuring and various other regulatory policy issues.

Education:

B.A. (Economics) - University of Maryland, 1971.

M.A. (Economics) - University of Maryland, 1974.

Ph.D. candidate - University of Maryland, completed all course work and qualifying examinations.

Previous Employment:

1981-2001 - Exeter Associates, Inc. (founding Principal).

1980-1981 - Member of the Economic Evaluation Directorate, The Aerospace Corporation, Washington, D.C. office.

1977-1980 - Economist, Washington, D.C. consulting firm.

1972-1977 - Research/Teaching Assistant and Instructor, Department of Economics, University of Maryland (College Park).

1975-1977 - Lecturer in Business/Economics, Montgomery College.

Professional Work Experience:

Mr. Kahal has more than twenty years experience managing and conducting consulting assignments relating to public utility economics and regulation. In 1981, he and five colleagues founded the firm of Exeter Associates, Inc. and for the next 20 years he served as a Principal and corporate officer in the firm. During that time, he supervised multi-million dollar support contracts with the State of Maryland and directed the technical work conducted both by Exeter professional staff and numerous subcontractors. Additionally, Mr. Kahal took the lead role at Exeter in consulting to the firm's other governmental and private clients in the areas of financial analysis, utility mergers, electric restructuring and utility purchase power contracts.

At the Aerospace Corporation, Mr. Kahal served as an economic consultant to the Strategic Petroleum Reserve (SPR). In that capacity he participated in a detailed financial assessment of the SPR, and developed an econometric forecasting model of U.S. petroleum industry inventories. That study has been used to determine the extent to which private sector petroleum stocks can be expected to protect the U.S. from the impacts of oil import interruptions.

Before entering consulting, Mr. Kahal held faculty positions with the Department of Economics at the University of Maryland and with Montgomery College teaching courses on economic principles, business and economic development.

Publications and Consulting Reports:

Projected Electric Power Demands of the Baltimore Gas and Electric Company, Maryland Power Plant Siting Program, 1979.

Projected Electric Power Demands of the Allegheny Power System, Maryland Power Plant Siting Program, January 1980.

An Econometric Forecast of Electric Energy and Peak Demand on the Delmarva Peninsula, Maryland Power Plant Siting Program, March 1980 (with Ralph E. Miller).

A Benefit/Cost Methodology of the Marginal Cost Pricing of Tennessee Valley Authority Electricity, prepared for the Board of Directors of the Tennessee Valley Authority, April 1980.

An Evaluation of the Delmarva Power and Light Company Generating Capacity Profile and Expansion Plan, (Interim Report), prepared for the Delaware Office of the Public Advocate, July 1980, (with Sharon L. Mason).

Rhode Island-DOE Electric Utilities Demonstration Project, Third Interim Report on Preliminary Analysis of the Experimental Results, prepared for the Economic Regulatory Administration, U.S. Department of Energy, July 1980.