UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Proposed Pricing Policy for Efficient Operation And Expansion of Transmission Grid	)	Docket No. PL03-1-000

COMMENTS OF NEW ENGLAND CONFERENCE OF PUBLIC UTILITIES COMMISSIONERS

The New England Conference of Public Utilities Commissioners ("NECPUC") hereby submits its comments on the Proposed Policy Statement ("Policy Statement") issued in the above-captioned proceeding on January 15, 2003, *Proposed Pricing Policy for Efficient Operation and Expansion of Transmission Grid*, 103 FERC ¶ 61,032 (2003).[1]

In the Policy Statement, the Federal Energy Regulatory Commission (the "Commission") proposed a new pricing policy that would provide additive rate incentives for transmission owners ("TOs") that: (1) transfer operational control of their transmission facilities to a Regional Transmission Organization ("RTO"); (2) form independent transmission companies ("ITCs") within RTOs, or (3) construct facilities that would expand the transmission grid.

The two stated purposes of the Commission's proposed policy statement are: (1) to increase the independence of the transmission grid from market participants (¶ 21) and (2) to reduce transmission congestion (¶ 22) which may increase opportunities to

[1] The comments herein are submitted on behalf of the utility regulatory bodies of Connecticut, Maine, New Hampshire, Rhode Island, and Vermont. The Massachusetts Department of Telecommunications and Energy did not participate in these comments and will file separate comments in this proceeding.

exercise market power in load pockets. NECPUC supports these goals and is not opposed to incentive ratemaking, tied to performance, that may be necessary to advance these objectives, particularly if such incentives are necessary to overcome conflicts of interest and other disincentives that work against the proper and efficient design, expansion and operation of the transmission grid. As discussed below, however, the Commission's proposal is not properly designed to achieve its stated objectives: Its proposal would provide rewards for actions already taken and grant incentives for all transmission expansions, even when such incentives may not be necessary and may unfairly elevate transmission solutions over transmission alternatives that might accomplish the same purpose. Nor, finally, is the Commission's proposed Policy Statement consistent with its existing incentive rate policy requiring that incentive mechanisms be symmetrical – i.e., that they reward enhanced performance but penalize poor performance.

I. The Commission Has Neither Explained Why An Increased Return Allowance Should Be Offered to Entities That Previously Joined an RTO or an ISO Nor Has It Attempted to Tailor the Incentive to The Objective to be Achieved.

A. The Incentives Proposed.

The Commission proposes incentives for TOs that join RTOs or transfer their assets to ITCs. Specifically, TOs that transfer operational control of their transmission facilities to RTOs would qualify for an incentive of 50 basis points on their return on equity ("ROE") for each facility whose control is transferred, while ITCs that meet the independent ownership requirement (i.e., those that have been entirely spun off from vertically-integrated utilities who retain no passive ownership interests) and participate in

RTOs would qualify for the equivalent of 150 basis points to be applied to the book value of their facilities at the time of the divestiture. In addition, the Commission proposes awarding a 100 basis point incentive to TOs (including merchant transmission companies), who build new transmission facilities. The 50 basis point incentive for joining an RTO would apply to all public utilities, *including those that have already turned over operational control of their facilities to an RTO*. On the other hand, the lump sum incentive for independent ownership and the incentive for new transmission construction would only apply prospectively.

B. The Incentives Offered for Joining an RTO or Transferring Assets to an ITC Have Not Been Justified.

The Commission states, and NECPUC agrees, that wholesale power markets benefit from the existence of grid operators who are independent of market participants. However, the sum and substance of the Commission's rationale for the generous incentives it proposes to offer to TOs either joining an RTO or transferring their assets to an ITC is that these benefits accrue to end users and generators and that TOs should get some benefit too:

> While significant benefits from competition are expected to result from RTOs and ITCs, these benefits will be shared among end-use customers and generators, among others. To assure that transmission owners receive benefits from RTO formation, we believe that it is reasonable to allow an adjustment to be applied to the rates of transmission owners participating in an RTO, or in an ITC within an RTO, as discussed further below.

Proposed Policy Statement at ¶ 21.

This rationale is inconsistent with the statutory scheme, and departs without explanation from the Commission's existing policies on incentive rates. These points are discussed below.

1. The Statute Requires that Incentive Adders to Cost-Based Rates Be Tailored to the Objective of the Incentive.

Transmission, because of its natural monopoly characteristics, remains a cost-based service. The rule in such a case is clear: FERC must point to substantial evidence in the record to support the conclusion that the incentive it has chosen is rationally related to the stated purpose and, indeed, no more than necessary to achieve it. *Farmers Union Central Exchange, Inc. v. FERC*, 734 F.2d 1486, 1503 (D.C. Cir. 1984). The stated purpose for the new policy, however -- that TOs deserve to get some of the benefits of a more competitive market -- describes a *reward*, not an incentive. There is no basis for such a reward. Under a cost-based rate regime, TOs are already granted a reasonable return allowance. And, even as an incentive measure, the Commission has made no finding that higher return allowances would actually encourage new RTO participation or asset transfers to ITCs. Nor, as importantly, has the Commission offered any explanation for the size of the incentive chosen.

2. Statutory Requirements Aside, the Commission's Proposed Policy Constitutes an Unexplained Departure from Its Existing Policies.

More than a decade ago, the Commission issued its *Policy Statement for Incentive Regulation*, 61 FERC ¶ 61,168, at p. 61,589 (1992), a carefully crafted statement of principles that would govern the eligibility of regulated entities for ratemaking incentives. Those principles remain as sound today as they were then. A key component of the Commission's policy was that any decision to allow an incentive based return must be prospective.[2] "Additional rewards for past performance," it stated, "would raise customers' cost without providing corresponding benefit."[3] A second critical component of the Commission's 1992 policy statement was that consumer benefit had to be demonstrated and quantified[4] and that the incentive policy, therefore, had to be a symmetrical balance of rewards *and* penalties:

> Incentive mechanisms should be designed to reward utilities that succeed in reducing costs, expanding services, and streamlining operations. At the same time, incentive regulation should be designed to penalize utilities that fail to achieve these efficiencies--opportunities for reward should be offset by a symmetric downside risk.[5]

Consistent with the policies it identified in 1992, Order No. 2000 made clear that allowing an increased ROE was not to enhance the revenues of transmission owners at the expense of transmission customers.[6] Nor was innovative transmission pricing to take the place of traditional cost-based ratemaking.[7] In fact, the Commission stated that transmission prices must reflect the costs of providing the service.[8] Moreover, even if an increased ROE was necessary as an incentive to construct new transmission, it is the Commission's obligation to "see to it that the increase is in fact needed, and is no more than is needed for the purpose. Further than this . . . the Commission cannot go without

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[2] *Policy Statement for Incentive Regulation*, 61 FERC ¶ 61,168, at p. 61,589 (1992).

[3] *Policy Statement for Incentive Regulation*, 61 FERC at 61,599.
[4] Id. at 61,590.
[5] *Id*. at 61,590.
[6] *Regional Transmission Orgs.*, Order No. 2000, 1996-2000 FERC Stats. & Regs., Regs. Preambles ¶ 31,089, at 31,173 (1999), *order on reh'g*, Order No. 2000-A, 1996-2000 FERC Stats. & Regs., Regs. Preambles ¶ 31,092 (2000), *petition for review dismissed*, *Public Util. District No. 1 of Snohomish County v. FERC*, 272 F.3d 607 (2001). ("Order No. 2000").

[7] *Id.*

[8] *Id.*

additional authority from Congress."[9] (emphasis added). Consistent with that requirement, Order No. 2000 states that applicants for innovative transmission rate treatment must provide a detailed explanation of how any proposed rate treatment would help achieve the goals of Regional Transmission Organizations, including efficient use of and investment in the transmission system and reliability benefits to consumers.[10] Rewarding a transmission owner for something it is already required to do,[11] or would have done anyway,[12] is not permitted under Order No. 2000.

Identifying no specific goals to be achieved by the generous upward adjustments it has proposed, the proposed Policy Statement, in contrast to Order No. 2000 and FERC's 1992 Policy statement, also offers no explanation as to why FERC believes that those adjustments -- a substantial 50 basis points for joining an RTO and an additional 150 basis points for divesting transmission assets to an ITC -- are "no more than is needed for the [still inadequately defined] purpose." While the Commission is free to change its incentive rate policies, it must acknowledge that it is doing so and then provide a reasoned explanation for its change in course.[13] The proposed Policy Statement fails this test.

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[9] *Farmers Union Central Exchange Inc.*, 734 F.2d 1486, 1503 (quoting *City of Detroit*, 230 F.2d at 817.)

[10] 18 CFR § 35.34 (e)(1)(i) (2001).

[11] *See, e.g., New England Power Pool*, 97 FERC ¶61,093 at 61,477 (2001).("This decision is in the public's interest as it does not unjustly reward NEP for doing what it is supposed to do, *i.e.*, to adequately maintain its facilities in a prudent, cost-effective manner.")

[12] Id. (a "proposal can not provide an incentive to encourage procedures that have already been completed.")

[13] *Greater Boston Television Corp. v. FCC*, 444 F.2d 841, 852 (D.C. Cir. 1970), cert. denied, 403 U.S. 923 (1971).

3. A Properly Tailored Incentive Policy to Encourage RTO Participation and ITC Formation Would Provide Differentiated Incentives Depending on the Status of the Would-Be Beneficiaries of the Incentives.

Most of the utilities in New England have divested themselves of their generating assets and *all* of them have turned control of their transmission assets over to ISO New England, Inc., an entity that FERC has found to meet the Order No. 888 independence criteria governing Independent System Operators. These facts do not make New England unique, but they do differentiate New England utilities from those operating in other regions of the country where most generation is still owned by vertically-integrated utilities and where transmission is not under the control of an ISO. These differences are significant and they should be factored into any incentive scheme designed to encourage either RTO participation or ITC formation.

(a) There are, at best, only limited benefits to New England consumers from RTO formation where TOs have already divested most of their generation, have already transferred control of their transmission assets to an ISO, and where the ISO has already implemented key components of the Commission's Standard Market Design Rulemaking.

Consider first the return adder offered to TOs willing to join RTOs. When a TO turns control of its transmission assets over to an RTO the principle benefit to consumer welfare is that the control of the transmission assets is taken out of the hands of market participants who, left to their own devices, would tend to favor themselves or their affiliates over other transmission users. This is also the principle benefit of an ISO. As the Commission has noted however, a "proposal can not provide an incentive to encourage procedures that have already been completed." *See, e.g., New England Power Pool*, 97 FERC ¶61,093 (2001). Since TOs in New England have already turned control of their transmission assets over to an ISO, and since most have divested themselves of generating assets as well, it is not at all clear that they need an increased return allowance to encourage them to join an RTO. The benefit to New England consumers is even less clear where the established ISO has implemented a form of Standard Market Design (SMD) that adheres closely to the Commission's SMD rulemaking proposal in RM01-12. In Order No. 2000, the Commission made clear that allowing an innovative ROE was not to enhance the revenues of transmission owners at the expense of transmission customers.[14] Even assuming that formation of an RTO in the circumstances extant in New England is still a material benefit, it is plainly less of a benefit than where no ISO exists at all. If the Commission ultimately adopts a return adder for TOs agreeing to join an RTO, it should tie the size of the adder to the degree of change from the status quo that would be accomplished by TO participation in an RTO. As the D.C. Circuit has noted, it is not reasonable to adopt an "industry-wide solution for a problem that exists only in isolated pockets." *AGD, supra*, 824 F.2d at 1019 (D.C. Cir. 1987). *See also*, *Williams Natural Gas Co. v. FERC*, 943 F.2d 1320, 1322 (D. C. Cir. 1991).

Finally, whether or not the Commission ultimately defines a rationale for granting incentives to encourage public utilities to join RTOs, or justifies the size of any incentive it ultimately adopts, no bonus return allowance should be given to those TOs that already have turned control of their transmission assets over to an RTO or ISO. Such entities did not need an inducement to join an RTO or ISO and providing them with a reward after the fact cannot, by definition, provide them with any incentive. *See, e.g.*, *ISO New England, Inc.*, 96 FERC ¶ 61,359 at 62,355 (2001*), aff'd, Sithe New England Holdings LLC*

[14] *Regional Transmission Orgs.*, Order No. 2000, 1996-2000 FERC Stats. & Regs., Regs. Preambles ¶ 31,089, at 31,173 (1999), *order on reh'g*, Order No. 2000-A, 1996-2000 FERC Stats. & Regs., Regs. Preambles ¶ 31,092 (2000), *petition for review dismissed, Public Util. District No. 1 of Snohomish County v. FERC*, 272 F.3d 607 (2001). ("Order No. 2000").

v. FERC, No. 01-1933 (1st Cir. October 4, 2002) ("applying [deficiency charge] retroactively would not provide an incentive, since LSEs and others would have already made their decisions.")

(b) The Policy Statement Has Not Made the Case for Awarding Additional Return Adders to TOs that Transfer Their Assets to ITCs.

Although it does not fully explain its rationale, the Commission proposes a higher return adder for TOs that turn their transmission assets over to an ITC than to those who only relinquish control, but not ownership, to an RTO. Indeed, the adder is additive, i.e., a TO that joins and RTO and transfers its transmission assets to an ITC gets *both* return adders. There may well be an added consumer benefit from the formation of ITCs and, if so, such a benefit may justify its own incentive.[15] But the Commission's proposed Policy Statement does not make the case either for the added consumer benefit or, assuming its existence, for the size of the adder it proposes. For purposes of these comments, and with the intent of being constructive, NECPUC focuses only on the latter shortcoming.

As with the generic return adder for TOs agreeing to join RTOs, the ITC return adder is equally available to all TOs even though their circumstances differ greatly from one another. These differing circumstances greatly affect both the need for a return adder and the size of the adder needed. Again, the circumstances in New England are a case in point.

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[15] Truly independent transmission companies will have the incentive, because they make their money solely on transmission service, to relieve transmission bottlenecks rather than to create or perpetuate them. Market participants without transmission assets generally benefit from policies that increase the independence of transmission owners from market participants, and it may be that ITCs will provide them an even greater benefit. As the Commission defines ITCs, the return adder it offers will only be available to those ITCs with no passive ownership interests. Assuming the Commission adopts the proposed policy, NECPUC strongly urges the Commission to retain its limitation on the ITCs that qualify for a return adder.

With the exception of Vermont, utilities in every New England state have divested themselves of generation, though some utilities have affiliates with generation. In Maine, utility affiliates' ability to participate as power marketers is restricted. Shorn of generating assets and having already turned control of their transmission assets over to ISO New England, New England TOs already have less ability to disadvantage other market participants than TOs operating in other regions of the country. Indeed, one of the largest of these TOs, National Grid, touts its expertise and its mission as a transmission company able to maximize the use of its assets by transmission customers. And in Vermont, even though there has been no vertical divestiture, the benefits of a transmission-only company were recognized *forty years ago*, when the state's utilities – public and private - formed VELCO to provide backbone transmission service to all of them on a non-discriminatory basis. Given Vermont's heavy dependence on power imported from outside the state (and from outside New England), moreover, its utilities have a greater stake as transmission customers than they do as transmission providers.

In these circumstances, while NECPUC is not opposed to the formation of ITCs, it sees only limited consumer benefit to their formation in New England, insufficient to warrant the increase in transmission costs that would result under the Policy Statement.

II. The Commission's Return Adder for Transmission Upgrades Fails to Distinguish Between Relief of Congestion or Reliability Problems and Mere System Expansion.

In addition to its proposal to provide TOs with return adders for joining RTOs and for divesting their transmission assets to ITPs, the Commission also proposes a separate transmission adder for expanding transmission. The Commission explains its policy as follows:

> Similarly, significant benefits from increased competition and improved reliability will occur from the construction of *needed* grid expansions and from *other measures* that make additional transmission capacity available to market participants. Therefore, it is reasonable to encourage investments in grid capacity expansion by adjusting the rates of transmission owners for investment in certain new transmission facilities that will be under operational control of RTOs and for other actions that result in additional transmission capacity under RTO management being made available to market participants.

Policy Statement at ¶ 22. (emphasis added)

If incentives are needed to provide congestion relief, performance-based ratemaking is one tool that can be considered. However, the Commission has not demonstrated that such incentives are necessary. Further, the Commission's Policy Statement would reward any transmission expansion, regardless of the need or appropriateness of incentives for any particular expansion. And, while the proposed Policy Statement recognizes that "other measures" might also enhance transmission availability or system reliability, it offers the return adder to transmission providers even when such an adder may disadvantage non-transmission solutions. While NECPUC states no position on whether, and under what circumstances, a *regional* transmission revenue requirement should be used to fund transmission expansions, this proposal fails to explain why an incentive for every transmission expansion would not disadvantage competing solutions some of the time. For all the reasons stated above, NECPUC cannot support the Commission's proposed policy.

Respectfully submitted,

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