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FERC's U-Turn on Transmission Rate Incentives

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The Federal Energy Regulatory Commission's (FERC or "Commission") Order No. 679,[1] issued in July 2006, set the stage for the approval of over two dozen rate incentive mechanisms for transmission infrastructure investment. Order No. 679 was in response to a Congressional mandate under the Energy Policy Act of 2005,[2] which added a new Section 219 to the Federal Power Act.[3] Under Section 219, transmission incentives were to be provided when they benefitted consumers "by ensuring reliability and reducing the cost of delivered power by reducing transmission congestion."[4]

FERC's initial interpretation of the mandate under Section 219 was fairly broad. As a result, the Commission granted incentives for a wide range of stated reasons, including, among other things, encouraging membership in Regional Transmission Organizations, compensating for the increased risk of using new technologies, supporting the inherent risk associated with single-asset entities, and promoting construction in critical transmission corridors. Table 1 below summarizes recent rate approvals, including incentive adders.

Table 1. **Recent Rate Approvals**

Case	Allowed ROE	Description of Adders	Total ROE
Bangor Hydro-Electric Co., 111 FERC ¶ 63,048 (2005)	10.2	100 basis point incentive return on equity (ROE) adder for transmission projects approved through ISO New England, Inc.'s (ISO-NE) Regional Transmission Expansion Planning (RTEP) process	11.2
Northern Pass Transmission LLC, 134 FERC ¶ 61,095 (2011)	10.4	166 basis point incentive ROE adder based on the unique nature of Northern Pass Transmission LLC's project and the unique commercial arrangements facilitating its construction 50 basis point incentive ROE adder to reflect its participation in ISO-NE	12.56
Pepco Holdings, Inc., 124 FERC ¶ 61,176 (2008)	11.3	150 basis point ROE adder for the PHI Projects	12.8
RITELine Illinois, LLC, 137 FERC ¶ 61,039 (2011)	9.93	100 basis point adder for the risks and challenges of the project 50 basis point Regional Transmission Organization (RTO) adder	11.43
Desert Southwest Power, LLC, 135 FERC ¶ 61,143 (2011)	NA	100 basis point ROE adder for its structure as an independent transmission company ("Transco") 50-basis point ROE adder for overall Project risk and the use of advanced technologies	NA
Central Maine Power Co., 135 FERC ¶ 61,136 (2011)	NA	25 basis point ROE adder because the project is not routine and faces significant siting, construction, regulatory, environmental, and financial risks and challenges	NA
New England Conference of Public Utilities Commissioners, Inc. v. Bangor Hydro-Electric Co., 135 FERC ¶ 61,140 (2011)	NA	100 basis point ROE adder for all present and future projects in ISO-NE's RTEP process	NA
Green Power Express LP, 135 FERC ¶ 61,141 (2011)	10.78	10 basis point incentive adder in recognition of the size, scope, benefits, risks and challenges of the project; 50 basis point ROE adder for Green Power Express LP's ("Green Power") participation in an RTO; 100 basis point adder in recognition of Green Power's status as an independent transmission-only company.	12.38
Ameren Services Co., 135 FERC ¶ 61,142 (2011)	12.38	None	12.38
Atlantic Grid Operations A LLC, 135 FERC ¶ 61,144 (2011)	10.09	100 basis point adder for the risks and relative complexity of the project, 50 basis point adder for use of advanced technologies 50 basis point adder for Transco status 50 basis point RTO adder	12.59
Central Transmission, LLC, 135 FERC ¶ 61,145 (2011)	NA	50 basis point RTO adder	NA
Virginia Electric & Power Co., 124 FERC ¶ 61,207 (2008)	11.4	150 basis point ROE adder for the risks and challenges of 4 new projects 125 basis point ROE adder for the risks and challenges of 7 other new projects	12.9 12.65
Average	**10.81**		**12.32**

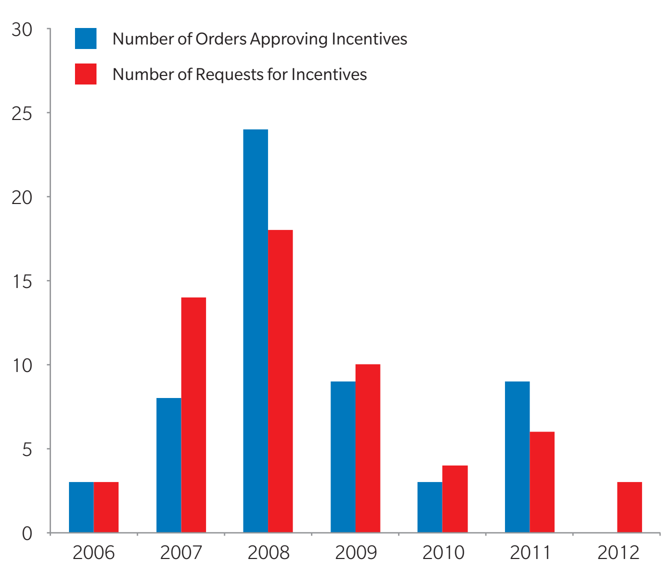
The Commission's recent Policy Statement[5] on transmission incentives, however, retreats from the prior approach broadly applying the incentive returns on equity (ROE) across the transmission sector. In the Policy Statement, the Commission revised its incentive policies by concluding that risk-reducing regulatory provisions, such as recovery of 100% of construction work in progress (CWIP) and abandoned plant costs, may lessen the need for incentive ROE adders. In addition, FERC stated that it expects applicants for an incentive ROE to commit to limiting the application of that ROE to a certain estimated cost. Expenditures on the project exceeding that cost would not receive the incentive ROE. The Commission stated that it is open to differing approaches regarding this commitment, although it seems to favor the estimated cost used for the project in the regional planning process. Such a policy change has sweeping implications for investors in the midstream electric utilities business.

FERC has indicated that it intends to be less generous granting ROE adders in the future than it was in the wake of Order No. 679. For example, in two recent decisions denying rehearing of orders granting transmission incentives issued in 2008, the Commission stated that it might not grant the same incentives if the requests were filed today.[6] In PEPCO, the Commission stated that:

> We recognize that the requests for rehearing raise significant issues about the incentives granted in the August 22 Order. Indeed, it can be argued that if a similar request for incentives were submitted to the Commission at this time, the result might be different in light of the Commission's evolving policy with respect to the application of the Order No. 679 nexus test.[[7]]

During the past three years FERC has issued relatively few orders granting transmission ROE incentives, in part because the fewer requests have been made, as shown on Figure 1, below. Indeed, there appears to be a close correlation between the number of orders issued by the Commission approving incentives and the number of requests that are made. It is possible that fewer incentives mean fewer projects will be proposed.

Figure 1. **Incentive Orders and Requests by Year**



In its most recent order, setting the ROE for the RITELine project in the PJM Interconnection, L.L.C. ("PJM") region, the Commission denied the applicants' request for a 13.2% incentive ROE, which included a base ROE of 10.7%, plus 50 basis points for membership in PJM, 50 basis points for the use of advanced transmission technology, and 150 basis points to compensate for risks associated with the project.[8] The Commission found that the proxy group used by the applicants to calculate the base ROE improperly included PPL Corporation, which was a high-end outlier in terms of cost of equity. Therefore, the Commission concluded that the proper base ROE for the project was 9.93%. The Commission granted the requested adder for participation in PJM, denied the adder for the use of advanced technology, and granted a risk incentive adder of 100 basis points, rather than the requested 150 basis points. The Commission reduced the incentive adder by 50 basis points based, in part, on the other incentives granted to the applicants, including 100% CWIP recovery, recovery of abandoned plant costs, and the establishment of a regulatory asset for pre-construction costs.[9] The applicants also committed to apply the risk adder only to the project cost estimate at the time the project is approved by PJM, unless the cost of the RITELine Project is increased due to changes required as a result of the siting process and/or changes specifically directed by PJM.[10] The final authorized ROE for the RITELine project, including adders, totaled 11.43%. The Commission also approved an ROE of 11.49% (which included a base ROE of 10.99% plus an RTO adder of 50 basis points) for American Electric Power's transmission subsidiaries in PJM;[11] however, this rate was established through a settlement, and is therefore of no precedential value.

The Commission is currently hearing a hotly contested ROE proceeding involving the ISO New England Inc. ("ISO-NE").[12] At issue is the appropriate base ROE for the ISO-NE transmission owners. The complainants, which include various state attorneys general, regulatory commissions, and ratepayer advocates, contend that the current base ROE (which in some cases is supplemented with adders for specific transmission owners or projects) should be reduced by at least 194 basis points, to no more than 9.2%.[13] The complainants' argue in their direct case for an ROE of 9.0%.[14] The respondent ISO-NE transmission owners argue that the ROE should remain at 11.14%, consisting of "10.4 percent with an upward adjustment of 74 basis points to account for changes in capital market conditions."[15] The Commission Trial Staff's witness disagreed with the calculations of both the complainants and respondents and offered her own recommendation of a 9.66% return on equity for the ISO-NE transmission owners.[16] Although a recommendation from FERC staff is not binding on the Commission, it is a first glimpse of thinking inside FERC on this issue. The *Coakley* proceeding is unusual in that the ROE was established to reflect particular market conditions, which have subsequently changed. However, this proceeding bears close watching, as it is likely to provide strong insight into where the Commission believes the zone of reasonableness for ROE lies in today's capital market conditions.[17]

Notes

[1] *Promoting Transmission Inv. through Pricing Reform*, Order No. 679, 116 FERC ¶ 61,057 (2006) ("Order No. 679"), *order on reh'g*, Order No. 679-A, 117 FERC ¶ 61,345 (2006), *order on reh'g*, 119 FERC ¶ 61,062 (2007).

[2] Energy Policy Act of 2005, Pub. L. No. 109-058.

[3] 16 U.S.C. § 824s (2006) ("Section 219").

[4] *Id*. § 824s(a).

[5] *Promoting Transmission Inv. Through Pricing Reform*, 141 FERC ¶ 61,129 (2012) ("Policy Statement").

[6] *Va. Elec. & Power Co.,* 139 FERC ¶ 61,143 at P 11 (2012) (upholding ROEs of 12.65% and 12.9% inclusive of incentive adders) (*"VEPCO"*); *Pepco Holdings, Inc.*, 139 FERC ¶ 61,144 at P 12 (2012) (upholding an ROE of 12.8%, including a base ROE of 11.3% and a 150 basis point incentive ROE adder) (*"PEPCO"*).

[7] *PEPCO* at P 12; *see also VEPCO* at P 11.

[8] *RITELine Ill., LLC*, 137 FERC ¶ 61,039 (2011) ("RITELine").

[9] *RITELine* anticipates the Commission's more conservative approach to ROEs, reflected in its recently issued Policy Statement. With regard to its decision to grant a smaller-than-requested incentive adder, the Commission stated that "[w]e find that granting 100 basis points is just and reasonable in light of the other incentives that the Commission is conditionally granting the RITELine Companies herein, some of which reduce certain financial and regulatory risks that the RITELine Companies cite as support for a 150-basis-point incentive ROE adder." *Id*. at P 63.

[10] *Id*. at PP 5, 64.

[11] *AEP Appalachian Transmission Co., Inc.*, 135 FERC ¶ 61,066 (2011).

[12] *See Coakley v. Bangor Hydro-Electric Co*., 139 FERC ¶ 61,090 (2012) ("Coakley").

[13] *Id*. at P 1.

[14] *Coakley v. Bangor Hydro-Electric Co*., Complainants' Direct Case at 3, filed Oct. 1, 2012, Docket Nos. EL11-66-000, *et al*.

[15] *Coakley* at P 2; *Coakley v. Bangor Hydro-Electric Co*, Respondents' Answering Case at 1, filed Nov. 20, 2012, Docket Nos. EL11-66-000, *et al*.

[16] *Coakley v. Bangor Hydro-Electric Co*., Direct and Answering Testimony of Trial Staff Witness Sabina U. Joe, filed Jan. 18, 2013, Docket Nos. EL11-66-000, *et al*.

[17] In the midst of the ongoing proceeding initiated *Coakley,* Environment Northeast, the Greater Boston Real Estate Board, the National Consumer Law Center, and the NEPOOL Industrial Customer Coalition initiated their own complaint against the ISO-NE transmission owners, seeking an order to reduce their base ROE to an even lower value of 8.7%. In addition, the complainants moved to consolidate their complaint with Docket No. EL11-66. *ENE v. Bangor Hydro-Electric Co*., Complaint of ENE, *et al*. Challenging Base Return on Equity and Motion for Consolidation, filed Dec. 27, 2012, Docket No. EL13-33-000. In their response, the ISO-NE transmission owners moved to summarily dismiss the new complaint because (i) granting the complaint would be contrary to the fifteen-month refund limitation of section 206 of the Federal Power Act and (ii) the complainants failed to show that the ROE is unjust or unreasonable. Moreover, the respondents requested that, if the complaint is not dismissed, then the Commission should analyze the two complaints separately based on the different market conditions that may occur in the relevant time periods. *ENE v. Bangor Hydro-Electric Co*., Answer of Respondent New England Transmission Owners to Complaint Regarding Level of Base Return on Equity, filed Jan. 16, 2013, Docket No. EL13-33-000.

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