

ORGANIZATION OF MISO STATES, INC.
Special Board of Directors Meeting
Conference Call Notes
January 10, 2006

Steve Gaw, President of the Organization of MISO States, Inc. (OMS), called the January 10, 2006 Special Meeting of the OMS Board of Directors to order via conference call at approximately 2:00 p.m. (CST). The following board members or their proxies participated in the meeting:

Randy Rismiller, proxy for Kevin Wright, Illinois
David Hadley, Indiana
John Norris, Iowa
Jeff Johnson, proxy for Mark David Goss, Kentucky
Laura Chappelle, Michigan
Ken Nickolai, Minnesota
Steve Gaw, Missouri
Greg Jergeson, Montana
Tim Texel, proxy for Louis Lamberty, Nebraska
Susan Wefald, North Dakota
Judy Jones, Ohio
Kim Pizzingrilli, Pennsylvania

Absent

Manitoba, South Dakota, Wisconsin

State Agency members participating

Bill VanderLaan – Illinois
Chancy Bittner, Amy Christensen – Iowa
Jack Dwyer – Iowa Office of Consumer Advocate
Mike Proctor – Missouri
Burl Haar, Nancy Campbell – Minnesota
Jorge Valladares, AW Turner – Kentucky
Jerry Lein – North Dakota
Jan Karlak, Kevin Holtsberry, Andy Tebbs – Ohio
Kim Joyce, John Levin – Pennsylvania

OMS Staff participating - Bill Smith, Julie Mitchell

The directors and proxies listed above established the necessary quorum for the meeting of at least eight directors being present.

Business Items

1. OMS Consideration of Comments of FERC on Incentive Pricing NOPR.

- The deadline on comments is January 11, 2006.
- Dave Hadley has problems with the document, he cited several passages he felt were too negative and stated he felt it should be a more positive statement. AW Turner agreed. He felt the overall thrust of the document was too negative. Judy Jones and Susan Wefald also had issues with the document.

- Kim Pizzingrilli stated that Pennsylvania would file its own comments and will abstain from voting on the OMS document. Missouri will also file its own comments, but intends to go along with the OMS comments. Nebraska stated it intends to abstain.
- Randy Rismiller provided the Commissioners with a brief overview of the issue and the Commissioners then went through the draft document page by page to offer corrections and wording changes.

Susan Wefald moved that the document be adopted with the changes as discussed. Laura Chappelle seconded. The motion passed 8 to 0 with 4 abstentions and 3 states not present. States voting aye were: Illinois, Indiana, Iowa, Michigan, Minnesota, Missouri, Montana, and North Dakota. States abstaining were: Kentucky, Nebraska, Ohio, and Pennsylvania. States not present were: Manitoba, South Dakota, and Wisconsin.

2. Status of Joint Board on Economic Dispatch.

- Discussion on whether OMS should fund travel to Joint Board on February 12, 2006.

3. Participation in Electricity Delivery Forum, February 15-16.

- Should OMS fund travel to Nat'l Delivery Forum?

Upcoming Meetings.

FTR WG – Jan 11 – 9:00 am CST

LTDG WG – call on MISO Strategic Plan – Jan 12 at 1:00 pm CST

- Burl Haar spoke, he wants to submit comments “characterized” as of the work group to MISO.

MISO A/C Agenda Review Conference Call – Jan 12 at 2:00 pm CST

MISO Advisory Committee Meeting – Jan 18

OMS Work Group Chairs meeting – Jan 20 – 9:30 am CST

FERC Demand Response Technical Conference – Jan 25

OMS Executive Committee meeting – Jan 26 at 2:00 pm CST

Next OMS BOD meeting: Feb 9 at 2:00 pm CST

Meeting adjourned at 4:30 pm CST

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

**Promoting Transmission Investment
through Pricing Reform**

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Docket No. RM06-4-000

COMMENTS OF THE ORGANIZATION OF MISO STATES

I. Introduction

On November 18, 2005, the Federal Energy Regulatory Commission (“Commission”) issued a Notice of Proposed Rulemaking (“NOPR”) on “Promoting Transmission Investment Through Pricing Reform.” The NOPR states that Section 1241 of the Energy Policy Act of 2005 added a new section to the Federal Power Act that requires the Commission to establish rules for incentive-based (including performance-based) rate treatments “for the purpose of benefiting consumers by ensuring reliability and reducing the cost of delivered power by reducing transmission congestion.”¹ The Commission states that its purpose in issuing the NOPR is to “promote capital investment in new transmission capacity.”² The NOPR further states that the Commission “seeks to provide incentives and regulatory certainty sufficient to support expanded and improved transmission infrastructure (including advanced technologies) while at the same time ensuring that transmission rates remain just, reasonable, and not unduly discriminatory or preferential.”³

¹ NOPR at 1.

² NOPR at 3.

³ NOPR at 5.

The Commission set January 11, 2006 as the due date for Comments on the NOPR. The Organization of MISO States (“OMS”) hereby respectfully submits its Comments on the Commission’s November 18 transmission incentives NOPR.

II. Major Points in the Comments and Statement of Issues

1. The Commission should clarify that its proposal for ROE adders would apply only to investment in new transmission facilities and not to existing transmission investment;
2. Commission approval of an incentive application should be contingent on a demonstration of consumer benefits;
3. Care should be taken to ensure that ROE adders do not result in counter-productive perpetuation of transmission constraints rather than their elimination;
4. The Commission’s deferred cost recovery proposal should be re-examined so as not to conflict with legitimate goals of state regulatory authorities;
5. The Commission’s proposed ROE incentive for Transco formation requires greater clarity and should reflect Transco participation in an RTO or in an independent regional planning process;
6. The Commission’s proposed incentive for utilities that join a “Transmission Organization” requires further definition of “Transmission Organization”;
7. The addition of standards to the Commission’s incentive proposals would provide additional regulatory certainty and rate recovery certainty;
8. The Commission’s proposed rule would be strengthened if it tied each proposed incentive solution to a presumed underlying cause of transmission under-investment;
9. Attention to industry structural issues and promotion of rate certainty and regulatory certainty may be more productive approaches to increasing transmission investment than granting ROE adders; and
10. Participation in an independent regional transmission planning process is an important factor to take into account in considering applications for transmission incentives.

III. Discussion of the NOPR’s Proposed Transmission Incentives

As stated above, the Energy Policy Act of 2005 directs the Commission to establish rules for incentive-based (including performance-based) rate treatments. In response, the Commission issued the November 18 NOPR and proposes to add Section 35.35 to its rules. The NOPR states that for all jurisdictional public utilities, including Transcos, the Commission will encourage incentive-based rate proposals, including proposals to:

- (1) provide a rate of return on equity that is sufficient to attract new investment in transmission facilities;

- (2) recover all prudently incurred transmission related construction work in progress (CWIP) and recover prudently incurred pre-commercial operations costs by expensing these costs instead of capitalizing them;
- (3) adopt a hypothetical capital structure;
- (4) accelerate the recovery of depreciation expense;
- (5) recover all prudently incurred development costs in cases where construction of facilities may subsequently be abandoned as a result of factors beyond the public utility's control;
- (6) provide deferred cost recovery; and
- (7) provide any other incentives approved by the Commission that are determined to be just and reasonable and not unduly discriminatory or preferential.⁴

In addition to the above list of options, the Commission proposes to also provide

Transcos with the following options:

- (1) a higher return on equity which is sufficient to encourage Transco formation; and
- (2) an adjustment to the book value of transmission assets being sold to a Transco to remove the disincentive associated with the impact of accelerated depreciation on federal capital gains tax liabilities.⁵

Finally, for public utilities that join a Transmission Organization, the Commission will consider authorizing a return on equity that is higher than the Commission might otherwise allow if the public utility did not join a Transmission Organization.⁶

A. Providing an ROE that Attracts New Investment in Transmission Facilities

The NOPR states that the Commission will consider granting an incentive-based ROE to all jurisdictional public utilities “that build new transmission facilities that benefit consumers by ensuring reliability and reducing the cost of delivered power by reducing transmission congestion” and that “the Commission will continue to consider and approve ROE levels that attract investment for new transmission projects, thereby fulfilling a requirement of section 219.⁷

⁴ NOPR at 8.

⁵ NOPR at 9.

⁶ NOPR at 9.

⁷ NOPR at 12 - 13.

In the “Single Issue Ratemaking” section of the NOPR the Commission proposes to “consider incentive filings that propose rates applicable only to the new transmission project.”⁸

The intent of this portion of the NOPR is clearly on attracting investment for building new transmission facilities. However, the proposed language is not clear that the increased ROE incentives are limited to only new transmission facilities. In particular, the language of the NOPR text and of the proposed rule could be interpreted to mean that the Commission intends to provide a higher rate of return for all of the utility’s transmission assets. For example, paragraph 22 on page 13 of the NOPR states that “the Commission will consider granting an incentive-based ROE to all public utilities . . . that build new transmission facilities.” It does not state that the Commission will consider granting an incentive-based ROE on the investment that public utilities make in new transmission facilities. Similarly the language in Section 35.35(d)(1)(i) of the Commission’s proposed rule states that the Commission will consider applications for an increased return on equity “sufficient to attract new investment in transmission facilities” It does not state that the Commission will consider applications for an increased return on equity on the investment in new facilities.

The Commission should consider clarifying its NOPR text and its proposed rule language in this regard, i.e., that proposed rate of return incentives are on investments in new transmission , as contrasted with all of a public utility’s transmission investment. By making such a differentiation, the Commission would be giving incentives to promote growth of actual transmission facilities, instead of just accounts and rates.

The NOPR also proposes that, in order to earn an incentive return on equity, an applicant must demonstrate how the new facilities will improve regional reliability and reduce

⁸ NOPR at 33.

transmission congestion.⁹ The applicant would have to explain why the proposed incentive return on equity is appropriate to encourage new investment (which, presumably, would require an explanation of why the project would not be pursued absent the incentive) and if the facilities were planned as part of an independent regional planning process, such as that administered by an RTO or ISO. The OMS finds these requirements to be reasonable and appropriate. In addition, to assure that the right investment is being done, the demonstration should show that the transmission investment is warranted over competing generation and demand-side management projects and that the transmission investment actually benefits consumers.

In the RTO regional planning process proposed by the Midwest ISO as part of the cost allocation proposals that have recently been developed for new investment in transmission needed for reliability, it became clear that in order for new investment to qualify for regional cost allocation it must meet the scrutiny of the RTO with respect to both 1) the need for reliability;¹⁰ and 2) the lowest cost transmission upgrades for meeting that need.¹¹ The Midwest ISO is in the process of developing planning processes that will insure that these objectives will be met.

Given that MISO is making a determination of transmission upgrades needed to meet reliability, it would not be reasonable to expect that the inclusion of an “incentive” that increases the cost to ultimate ratepayers (“incentive adders”) would significantly increase the amount of investment in transmission for this purpose. Moreover, such an incentive adder could possibly result in the substitution of provisions like alternative modes of operating existing facilities

⁹ NOPR at 13.

¹⁰ Since the cost allocation plans only relate to investment in new transmission needed for reliability, it is clearly important for the RTO planning process to make an independent determination of such a need.

¹¹ While vertically integrated transmission owners can recommend upgrade options to correct a reliability problem, the RTO has an obligation as an independent regional planner to ensure that these recommended options are not designed to regionally allocate costs beyond what are needed to fix the reliability problem.

rather than capital investment in new transmission facilities and thereby decrease the amount of capital investment to improve the reliability of the transmission system.

Investment in transmission to reduce congestion is a matter of costs incurred compared to benefits received. The NOPR has no discussion of this fundamental principle, yet Section 219 of EAct 2005 is very clear on this issue where it states,

[t]he Commission should establish, by rule, incentive-based (including performance-based) rate treatments for the transmission of electric energy in interstate commerce by public utilities for the purpose of **benefiting consumers** by ensuring reliability and **reducing the cost of delivered power** by reducing transmission congestion.¹²

Moreover, the wording of Section 219 recognizes that the objective is not to eliminate all, or even most, transmission congestion. Rather, the purpose is to eliminate the congestion where the cost of the new transmission is less than the generation costs saved by the reduction in congestion resulting from the transmission expansion. It is the sum of these two components - an increase in transmission costs plus a decrease in generation costs - that determines the cost of delivered power to the ultimate consumers. However, by placing incentive adders onto the transmission costs, the cost of transmission would actually be increased relative to the potential savings in generation costs, resulting in fewer transmission expansion projects being cost justified; i.e., there will be transmission upgrades that are cost-beneficial prior to the incentive adder, but subsequent to increasing the transmission cost component would no longer be worth the investment.

Because new transmission to reduce congestion is ultimately the choice of the load-serving entities (either individually or through some form of RTO stakeholder process), adding to the cost of transmission would be a disincentive to getting new transmission built. At a minimum, the Commission should recognize this distinction and provide incentives for this

¹² Section 219(a) of the FPA, underlining added.

category of new transmission investment that do not result in higher transmission costs and thereby result in a disincentive for new investment in transmission intended for reducing congestion.

The Commission also sought comment on whether ROE adders are an appropriate mechanism for an acceptable ROE.¹³ To the extent that the Commission wants to give a higher ROE as an incentive, then adders are a transparent way of quantifying that decision. While recognizing that more return may entice some investors to willingly assume more risk, the OMS believes that the statute's dual promotion of "increased investment" and "just and reasonable rates" is more likely to be realized if the Commission can reduce risk and uncertainty than by increasing returns. The Commission should consider that perhaps the solution to promoting transmission investment is not so much in higher ROEs but in encouraging a better industry structure and promoting regulatory certainty and shared vision among the states and the Commission.¹⁴ This may be particularly true with respect to regulatory uncertainty about which market structures and regulation would prevail. The Commission should attempt to articulate a vision that Congress, the states, and major stakeholders can accept. There is need for more work on this front. Nevertheless, if a mechanism to enhance ROE allowances is required to provide an incentive over and above real capital costs, then the transparency of an ROE adder has some appeal.

1. DCF Analysis and Incentives

¹³ NOPR, at 21

¹⁴Electric Utility Week, Oct 31, 2005, pp. 1, 23. American Transmission Corp. (ATC) and ITC Holdings Corp. both were reported to say they do not need additional incentives to attract investment and finance system expansions. However, ATC would support incentives for utility divestiture of transmission lines. ITC suggests putting transmission systems on formula tariffs and separating those incomes from generation and distribution incomes.

In its discussion of an incentive ROE, the Commission asked for comment on whether it should consider alternatives to the DCF analysis as a way to incent investment in new transmission capacity.¹⁵ While the OMS recognizes that the Commission is seeking various ways to incent new transmission, the Commission should not diminish the integrity of its cost of capital determination. If the Commission believes its current methodology no longer accurately estimates the cost of equity, then the Commission should focus on improving the methodology. However, the Commission should not adopt different, less robust methodologies just to get higher results. In other words, the Commission should use the best methodology available to determine the cost of equity and then use adders for additional incentives if such are adequately justified based upon demonstrated positive effects upon reliability and/or reduction in congestion.

While the central tendency of proxy groups should be retained in its DCF analysis for ROE determination, the zone of reasonableness as predicated upon the range of proxy outcomes is less useful. In fact, to blindly accept a mechanistically-generated, high outlier from DCF analysis as the top of a zone of reasonableness is questionable and encourages the proposal of, and perhaps adoption of, inappropriate proxies. To grant significance to the upper end of the range (for determining the amount of ROE adders possible to consider) produces the ironic situation where a wider variance around the mean may be allowed a higher ROE adder than a more statistically robust DCF estimate with lesser variance.

One alternative to this distortion would be for the Commission to just ignore the DCF range of reasonableness in determining what level of ROE adders to adopt. In other words, make the best estimate of cost of equity and then make the separate, discrete step of attaching an incentive ROE adder on top, irrespective of the range given by the proxy group's DCF outcomes.

¹⁵ NOPR, at 20

With such an approach, the Commission would not have to resort to a hypothetical capital structure or other incentive mechanisms to accomplish the same purpose.

B. Construction Work in Progress, Expensing of Pre-Commercial Operations Costs and Accelerated Depreciation

It seems reasonable for the Commission to consider applications for practical ratemaking options in certain cases where cash flow is a barrier to investment as described in the NOPR. However, the Commission should require an applicant to prove its case. The NOPR asks whether the Commission should adopt a presumption that the investments of applicants for these options meet the reliability and reduced cost standards of FPA section 219.¹⁶ The OMS recommends that applicants for these options be required to make a sufficient case for them. The OMS also points out that there are some states that are not legally allowed to include ratemaking options such as CWIP in the rate base of a utility. As such, the practicality of the Commission considering these options may be somewhat limited.

C. Hypothetical Capital Structure

The NOPR proposes that applicants be permitted to propose an overall rate of return based on a hypothetical capital structure, and have the flexibility to refinance or employ different capitalizations as may be needed to maintain the viability of new capacity additions. This proposal appears to allow a transmission builder to finance its operations with lower debt costs (plus associated tax savings) while receiving an overall return based upon hypothetically higher equity ratio and costs.

Both this mechanism and the proposed ROE adders increase the overall rate of return allowed on rate base. The Commission may be proposing both so that they could be applied in combination. For example, if the DCF range of reasonableness based upon proxy companies did

¹⁶ NOPR at 16.

not provide enough latitude to support the various ROE adders proposed, then the hypothetical capital structure could be used as a functional equivalency to adopting a cost of equity well in excess of the DCF range of reasonableness. While the Commission might like the extra freedom of using both incentives, this hardly seems an adequate reason to adopt an across-the-board proposal that allows the capital structure for rate determination to differ from the actual capital structures used. This would be particularly egregious if the incentive were applied to the company's entire rate base, instead of just its new transmission because that would result in a windfall to the applicant.

Furthermore, while the Commission expects to evaluate proposals for this incentive on a case-by-case basis, the NOPR fails to specify what specific standards must be met to justify the incentive. Moreover, even though the emphasis ostensibly is "to maintain the viability of new capacity additions," it is not obvious that the incentive would be restricted just to new capacity additions.¹⁷ This should be avoided. Again, the Commission should consider focusing rate of return incentives on new transmission investment only and not existing transmission.

D. Recovery of Costs of Abandoned Facilities

The NOPR describes this option as a way to provide a public utility with added certainty regarding the cost recovery for projects that may be later cancelled or abandoned due to factors beyond the public utility's control. This appears to be a reasonable option in certain cases where the utility's perception of rate recovery risk constitutes a barrier to transmission investment that is needed by other parties. The Commission's proposed condition that the project cancellation factors be out of the utility's control is a very important one. However, a demonstration on that condition alone should not be considered sufficient for the Commission to approve the recovery of cancelled project costs. For example, a turn in the economy that was unexpected by the utility

¹⁷ NOPR at 29.

would certainly be outside the utility's control. But that should not be a reason to permit automatic recovery for costs of cancelled projects that result for example, from a utility's forecasting of economic conditions that turns out after the fact not to have hit the mark. The Commission should also take into account the distribution and location of risks for corporate interests of the public utility's holding company, if any. For example, in cases where the public utility's affiliates are engaged in lines of business, such as generation, that rely upon complementary public utility investments, the Commission should not permit shifting of risk to ratepayers that properly belongs with utility holding company shareholders. Finally, in reviewing applications for recovery of costs for abandoned facilities, the Commission should take into consideration whether or not the facilities were originally undertaken as a result of an independent regional planning process.

E. Deferred Cost Recovery

In instances involving retail access programs where the Commission has jurisdiction over transmission rates for retail customers, the Commission should reconsider its proposal to permit deferred cost recovery for public utilities under retail rate freezes or rate moratoriums. In cases where a state has gone to retail access and set rate caps in place, it would appear that the relevance of the NOPR proposal would be to investment in transmission during the period of the rate cap where the benefits and cost recovery from others during that rate freeze period do not cover the costs normally allocated to that same period.

While allowing a different timing for the recovery mechanism would most likely be in agreement with the principle that "beneficiaries should pay", such an option also runs the risk of undermining state-level reasons for adopting a retail rate freeze or moratorium. Typically, retail rate freezes or moratoriums are part of larger negotiated package of legislation or regulatory

action and utilities often receive benefits in exchange for agreement to a retail rate freeze or moratorium. Accordingly, Commission authorization for deferred cost recovery could upset the state-level negotiated package. For these reasons, the Commission should give great thought as to the circumstances surrounding a rate freeze or price cap prior to granting deferred cost recovery for public utilities under retail rate freezes or rate moratoriums as one of its incentive transmission rate options where the calculation of the costs to be deferred do not include the current benefits to the utility (e.g., production cost savings or increased profits from sales of generation), or the costs that are recovered from other transmission customers.

The NOPR also expresses interest in mechanisms that could improve certainty of transmission cost recovery at both the wholesale and the retail level.¹⁸ While this is a laudable goal, rather than adopting policy unilaterally, the Commission would do better to work with state authorities on retail rate recovery issues. Commission statements and accusations like those in the NOPR that state-statutory retail rate reviews “undermine incentive ratemaking at the federal level” are unwarranted.¹⁹ It would be analogous to saying that Commission policies like approving deferred rate recovery where a state legislative or regulatory authority has adopted a retail rate freeze or moratorium could undermine policy decisions made at the state level. The OMS believes that this issue is a two-way street and accordingly recommends a cooperative federalism approach in these circumstances.

If the Commission chooses to retain a proposed deferred cost recovery option in its rules, the Commission should consider granting deference to objections from state-level officials.

F. ROE Incentives for Transco Formation

¹⁸ NOPR at 21.

¹⁹ NOPR at 24.

The NOPR states that Transcos are an important part of the Commission’s mandate to support transmission capacity investments.²⁰ In particular, that the positive record for Transco investment is related to their stand-alone nature and that Transcos eliminate the competition for capital between the generation and transmission functions within corporations. The NOPR states that, because of their sole focus on the business of transmission, Transcos (as contrasted with vertically-integrated utilities) may be in a better position to respond to market signals about when and where transmission investment is needed. Finally, the NOPR states that, unlike some traditional public utilities, Transcos “do not face a potential decrease in value to their generation assets as a result of additional transmission.”²¹

As described previously, the last issue in this list of Commission observations is important. Specifically, when transmission is integrated with generation, either within the utility, or between the utility and generating affiliates, and if transmission planning occurs absent an independent regional transmission planning process, the resulting structure can set up disincentive conditions for certain transmission expansions.

The NOPR proposes to allow an ROE-based incentive for Transco formation. The NOPR notes that current Transcos exhibit a range of independence from market participant interests and asks whether the Commission should take into account a Transco’s degree of independence when considering an applicant’s ROE incentive request. In our view, the level of Transco independence is an important consideration. Accordingly, the Commission could apply a graduated ROE incentive depending upon the degree of independence between the Transco and market participants, affiliates or generation business.

²⁰ NOPR at 22.

²¹ NOPR at 23.

The OMS notes that the NOPR does not include a complete and consistent definition of the term “Transco”. While proposed Section 35.35(b) defines “Transco” as “a stand-alone transmission company that has been approved by the Commission and that sells transmission services at wholesale and/or on an unbundled retail basis, regardless of whether it is affiliated with another public utility”, “stand-alone transmission company” is not defined in the proposed rule itself. The text of the NOPR defines “stand-alone transmission company” as “a company engaged solely in selling transmission at wholesale or on an unbundled retail basis.”²² This combination of definitions means that, while a “stand-alone transmission company”, and consequently a Transco, can itself engage solely in the business of transmission, its affiliation with generation interests will not be taken into account.

The implication of this is that any utility could spin off its transmission assets to an affiliate, and that affiliate would qualify as a “stand-alone transmission company” and would also qualify as a Transco if it obtains approval from the Commission. This would give the Commission jurisdiction over all transmission costs paid by the retail customers of the utility from which it is either corporately or functionally separated. But this separation would also require state approval. The Commission should consider why a state would be willing to approve this separation if the immediate result is an increase in transmission costs because of an incentive adder to the ROE being applied in the determination of rates to be paid by retail customers. A possible reason for state approval is where states find that generation costs are likely to decrease and offset the higher transmission costs. In this regard, a Transco should not receive the incentive benefits proposed in the NOPR “regardless of whether it is affiliated with another public utility.” Continued affiliation of transmission with generation is less likely to provide the generation benefits needed to offset the higher transmission costs associated with an

²² NOPR, at 7.

incentive adder; particularly in instances where the Transco is not part of an independent regional transmission process. The Commission's Transco incentive policy should reflect this key structural aspect.

Electric industry structure is a continuum. In addition to Transcos, the Commission should consider the positive attributes of other structural alternatives to vertical integration. For example, a utility that divests all of its generation interests to non-affiliates to focus on a distribution and retail sales business would exhibit many of the positive features the NOPR lists with respect to Transcos: (1) eliminating competition for capital between a generation and transmission function within a corporation; (2) stronger focus on the business of transmission resulting in better response to market signals about when and where transmission investment is needed; and (3) eliminating the possibility of diminishing their generation asset value as a result of additional transmission. Such a company focusing on transmission, distribution, and retail sales functions would be a "market participant" according to the Commission's definition of that term in the NOPR.²³ Furthermore, such a company would not qualify to be a Transco because it would fail the requirement that a "stand-alone transmission company" have a sole focus on transmission.. Nevertheless, this type of company would experience less effect on transmission expansion disincentives than would a Transco that, as defined in the Commission's NOPR, could have unlimited affiliation with generation. For these reasons, the Commission should consider how the creation of such alternative business structures might improve conditions for transmission investment, thereby meriting incentives.

Finally, in setting the level of a Transco's incentive ROE, the NOPR proposes to not take into account whether or not the Transco is a member of an RTO.²⁴ In our view, the Commission

²³ NOPR at 26, footnote 37.

²⁴ NOPR at 26.

would be making a mistake by disregarding the independent regional transmission planning factor. Because the Commission's Transco Independence Policy Statement recognizes Transcos with a range of market participant involvement, including passive participation of generation owners, and, as described above, the NOPR goes beyond that and proposes to define a Transco regardless of its level of affiliation with generation, the extra level of independence that Transco participation in an RTO would bring should be an important consideration in setting a Transco's incentive ROE. An independent RTO also brings the additional benefits of a broader geographic scope of transmission planning that is critical to any decisions made regarding transmission plans. For these reasons, the Commission should reverse its proposed policy and recognize the positive benefits of Transco membership in RTOs.

G. Transco Recovery of Amounts to Offset Payment of Accumulated Deferred Income Taxes

The NOPR recognizes that utilities may be reluctant to sell their transmission facilities to a Transco if they cannot obtain in the sale price an amount sufficient to cover at least the book value plus an amount to cover the deferred income taxes that the seller will have to pay to the government.²⁵ On the other hand, the transmission facilities buyer may well be unlikely to pay that amount absent assurance that the adjustment to pay the seller's deferred income tax will be recoverable in the buyer's transmission rates. The NOPR proposes to consider Transco buyer proposals for cost recovery of the accumulated deferred income tax amount.²⁶

This issue of adjustments to book value to account for the seller's deferred income taxes is related to the issue of Transco acquisition premiums.²⁷ However, the Commission's proposal to consider allowing the ADIT cost recovery adjustment appears more reasonable than simply

²⁵ NOPR at 27.

²⁶ NOPR at 27.

²⁷ NOPR, at 33

authorizing filings to recover acquisition premiums. The ADIT adjustment premium would be specifically quantifiable and tied to a specified purpose. These features would make it more likely that the applicant could demonstrate ratepayer benefits from the transaction. The Commission should not grant blanket authorization for unspecified acquisition premiums not tied directly to ratepayer benefits.

H. ROE Incentive for Joining a Transmission Organization

The NOPR proposes to consider incentive ROE requests from utilities that join a Transmission Organization. The NOPR proposes to consider allowing an ROE that is higher than that which the Commission would otherwise allow a utility not in a Transmission Organization, but still within the zone of reasonableness. A problem with this proposal lies in the Commission's proposed definition of "Transmission Organization." The Commission proposes to define "Transmission Organization" as "a Regional Transmission Organization, Independent System Operator, independent transmission provider, or other transmission organization finally approved by the Commission for the operation of transmission facilities."²⁸

While the standards and requirements for RTOs and ISOs are fairly well specified, the Commission currently has inadequately specified standards and requirements for "independent transmission providers" and no established standards or requirements for "other transmission organizations." Until these entities are more clearly defined, the Commission should not enact the part of its proposal that would grant ROE incentives to utilities joining such entities.

While Section 219 of the FPA requires the Commission to adopt a rule providing incentives to public utilities that join a "Transmission Organization", nothing in the statute requires the Commission to offer the same incentive regardless of the type of Transmission Organization that the public utility joins. The Commission should consider adopting a graduated

²⁸ See proposed Subpart G, Section 35.35(b)(2). Underlining added.

incentive tied to important features of the Transmission Organization like degree of independence, range of functions, transparency of operations, openness of stakeholder forums, and geographic scope of the transmission planning area.

Giving ROE incentives to companies that are already participating in a Transmission Organization would run the risk of unnecessarily raising consumer rates. Giving ROE incentives to companies that join an existing Transmission Organization while not giving ROE incentives to companies that are already participating in that Transmission Organization would open the Commission to allegations of discrimination. Consequently, the Commission should consider giving ROE incentives only to companies joining a newly forming Transmission Organization, rather than existing ones.

In this section of the NOPR, the Commission also asks whether it should consider granting ROE-incentives to utilities that are not in an RTO but that join a “Commission-approved regional planning organization.” As with “independent transmission providers” and “other transmission organizations”, the standards and requirements for a “regional planning organization” are currently unspecified. Until the nature of such organizations is better defined, the Commission should not consider granting an ROE incentive to a utility that joins such an organization. Factors that could be considered in assessing whether transmission built as a result of a regional planning organization process merits incentives might include degree of independence, range of functions, transparency of operations, openness of stakeholder forums, and geographic scope of the transmission planning area of the regional planning organization.

IV. The Proposed Rule Could be Modified to Provide Additional Regulatory Certainty and Rate Recovery Certainty

The Commission’s NOPR seems to reflect a belief that regulatory certainty and cost recovery certainty, are important factors affecting transmission investment. The OMS is in

agreement with this position. However, the NOPR could do more to provide additional certainty for transmission investment in this regard. For example, the NOPR only provides that the Commission is willing to consider incentive applications for enhanced rates of return and other incentives. A Commission offer merely to consider an application would not seem to provide an applicant with a great deal of certainty about how the Commission would react to a particular application or the likely results of the Commission's consideration.²⁹

The Commission's NOPR would be strengthened if it provided specific objective standards that an applicant's filing would need to satisfy in order to receive affirmative treatment from the Commission. For example, the Commission's Merger Rule establishes standards for merger applicants and the Commission's review of merger filings centers on whether the applicant met those standards. Similarly, the Commission's *Edgar* series of cases established standards under which wholesale power sales from a Commission-jurisdictional entity to an affiliated public utility with captive retail customers would be found to be just and reasonable.³⁰ The standards in those Commission rules provide the type of predictable certainty for applicants that is lacking in the Commission's proposed transmission incentives NOPR.

V. The Proposed Rule Would be Strengthened if it Tied Each Proposed Incentive Solution to a Presumed Underlying Cause of Transmission Under-Investment

While the NOPR makes an argument that transmission investment has not kept up with national needs, the NOPR does not thoroughly analyze why there is under-investment.³¹ Rather than providing conclusions about what is causing transmission under-investment, the NOPR proceeds directly to propose remedies, in the form of transmission incentives, for the under-

²⁹ Similarly, by including the "any other incentives" catch-all in proposed Section 35.35(d)(1)(viii), the NOPR does not provide prospective applicants added certainty about options that are not likely to find favor with the Commission.

³⁰ See *Boston Edison Company Re: Edgar Electric Energy Company*, 55 FERC ¶ 61,382 (1991) (*Edgar*); *Allegheny Energy Supply Company, LLC*, 108 FERC ¶ 61,082 (2004) (*Allegheny*).

³¹ For example, that NOPR states at 2 that, since 1975, there has been a significant decrease in transmission capacity relative to load in every region.

investment. If the NOPR identified specific causes of inadequate investment in transmission infrastructure and addressed each of those with a tie to a recommended incentive proposal, the NOPR would be strengthened. We recognize that Section 1241 of the Energy Policy Act directs the Commission to adopt an incentive ratemaking rule and we would like to see the Commission develop the best rule possible.

Based on an examination of the specific incentive options that the NOPR proposes to provide to address transmission infrastructure adequacy, it may be possible to deduce some barriers the Commission had in mind. For example: (1) inadequate rate of return-on-investment; (2) timing of corporate cash flow considerations; and (3) rate recovery risk. The Commission appears to aim incentive returns at the return-on-investment issue, construction work in-progress (“CWIP”) and accelerated depreciation at the cash flow issue, and the deferred cost recovery and recovery for discontinued projects incentives at the rate recovery risk issue. While the above list of factors may indeed be significant contributors to the current state of transmission under-investment and the proposed transmission policy incentive options that the NOPR associates with each of these factors may be well-targeted to mitigate each factor, the NOPR does not make these connections to the extent that it could.

VI. Greater Emphasis Should be Given to Industry Structural Issues and Their Relationship to Transmission Investment

A. Structural Issues Related to Disincentives for Transmission Investment

The NOPR briefly touches on three structural issues that are related to disincentives for transmission expansion. First, the Transco section of the NOPR states that, unlike some traditional public utilities, Transcos “do not face a potential decrease in value to their generation

assets as a result of additional transmission.”³² When transmission is integrated with generation, either within the utility or at the holding company level, the organizational structure can set up disincentives for certain transmission expansions due to the impact of transmission expansion on a company’s existing generation line of business. This issue may be of greater concern in states that have undergone certain forms of retail restructuring than in states with traditional retail regulation.

Second, in its discussion of an ROE incentive to attract new investment in transmission, after requiring the applicant for such an incentive to explain how the facilities being proposed for the incentive adder are “part of an independent regional planning process,” the Commission notes that it seeks comment on whether the final rule should establish a definition of “independent regional planning process.”³³ When a vertically integrated utility is not a part of an independent planning process, that utility would be less likely to invest in transmission upgrades that could potentially conflict with its generation business interests. However, when that same utility is a part of an independent regional transmission organization, which is implementing an independent transmission planning process, subject to the review of stakeholders and independent Board of Directors, these processes can help to override the structural disincentive where the vertically integrated utility is required to exercise best efforts to build the transmission specified in the independent regional plan.

Third, in its discussion of the recovery of costs of abandoned facilities, the Commission discussed the risks related to the recovery of the costs of abandoned projects.³⁴ Also, in its discussion of deferred cost recovery, the Commission discussed the disincentive to build transmission due to “concerns about cost recovery “ when the utility building the facilities is

³² NOPR at 23.

³³ NOPR at ¶ 21, p.13.

³⁴ NOPR at ¶5, p.p. 18-19.

under a rate moratorium.³⁵ Moreover, these references are only a small part of a larger issue of transmission owners' concerns about recovery of the costs of new transmission facilities. Where an independent regional planning process that is reviewed by stakeholders and an independent board determines that new transmission facilities are needed and beneficial, the concern regarding decisional prudence with respect to making these investments would likely be significantly diminished. In addition, if the utility is required to build these facilities, having both state and federal approval, there should be less concern regarding the recovery risks for the costs of new transmission facilities.

Thus having an independent regional planning process is a critical key in addressing transmission infrastructure under-investment. The Commission would do well to focus on these structural factors of the industry when developing its transmission incentive policy. If the Commission does not thoroughly evaluate the implications of the structural issue and continues to address transmission under-investment through providing transmission incentives to vertically-integrated utilities as proposed in the NOPR, then the incentives would most likely need to be generous enough to overcome this inherent structural disincentive (i.e., the negative impact on vertically integrated utility generating revenues from transmission expansion) and transmission incentives at that level are unlikely to be just and reasonable. Thus, the incentive approach for increasing transmission investment, absent consideration of structural reform, could result in an inefficient allocation of resources.

B. Defining an Independent Regional Transmission Planning Process

The definition of an "independent regional transmission planning process" has two major components: 1) independence; and 2) regional planning. First, with respect to independence, the transmission planning process must be entirely separate from any direct or affiliated generation

³⁵ NOPR at ¶6, p. 21.

interests. For example, a Transco that is part of a holding company structure in which there are affiliated generation companies, either Exempt Wholesale Generators or Regulated Generators, would not qualify as being independent. In addition, it is critical for independence that there be a stakeholder review of the transmission plans by those that will be paying the costs of the transmission upgrades. While an “independent” body may have made the decision, such bodies should not have the unilateral right to impose costs on transmission customers without a review of the need and benefits from such investments. Thus, independence should not give the transmission planner the right to impose costs on ratepayers, absent a showing of need and benefit.

Second, with respect to regional planning, almost all transmission upgrades have some impact on a region that is larger than the one encompassed by any single transmission planning entity. For example, most existing Transcos are limited in geographic scope, and while being independent, their decisions to build new transmission have an impact on neighboring transmission systems. In addition, RTOs that have a larger geographic scope than Transcos should coordinate their transmission plans with neighboring transmission systems. The geographic extent of the independent regional plan is an important factor.

The OMS supports well-designed incentive mechanisms to promote transmission investment that, when viewed in concert with other aspects of market development and consultation with state commissions, creates a comprehensive and coherent transmission pricing policy. One driver for the formation of the Organization of MISO States was to facilitate the development of interstate transmission that would be a critical part of the wholesale markets being developed by the Midwest ISO. The OMS has endorsed broad, reliable, and economically efficient regional wholesale markets. The OMS agrees with a goal of the FERC’s NOPR that

continuing efforts must be made, especially in regions not served by Regional Transmission Organizations (“RTOs”), to eliminate the discriminatory practices that exist today in the use of the nation’s electric transmission systems. The OMS believes that the existence of the Midwest ISO’s planning process, because it is comprehensive (considering transmission, generation, and demand response), open to states and all stakeholders, is independent of vested financial interests, is well-designed. In the near-term, as a result of all these regional considerations, incentive programs to encourage new transmission investment may not be as critical in much of the Midwest as they may be in other regions.

VII. The Commission Should Retain the Option for RTOs to Propose Incremental Pricing for New Transmission Facilities in Association with an Embedded-Cost Access Fee for Existing Transmission Facilities

In the NOPR, the Commission proposes to remove the existing section of its rules (18 CFR 35.34(e)) that permits RTOs to apply for innovative rate treatments.³⁶ The Commission’s rationale for this action is that retention of the provisions in Section 35.34(e) could cause confusion and potential conflicts given the incentives the Commission now proposes to adopt in the NOPR. For most of the elements of existing Section 35.34(e), the Commission’s rationale appears sound. However, Section 35.34(e) appears to contain a provision that permits RTOs to apply for incremental pricing for new transmission facilities in association with an embedded-cost access fee for existing transmission facilities. Such a provision does not appear to be encompassed in the language of the Commission’s proposed new Section 35.35 rule. The OMS believes that such a provision could prove useful in certain circumstances and urges the Commission not to drop this provision in the transition process of deleting the elements in Section 35.34(e) and replacing them with the new elements in Section 35.35.

VIII. Proposed Commission Reporting Requirement

³⁶ NOPR at 31.

The NOPR proposes to require jurisdictional utilities to provide an annual report on their current and projected transmission investment activity.³⁷ The Commission would use these reports as the basis for determining the effectiveness of the incentives proposed in the NOPR. OMS recommends that the Commission establish sufficient reporting requirements to measure the program's success or failure in achieving the goal of creating consumer benefits. For transmission owning utilities that are members of RTOs, it may streamline the reporting requirement and be more efficient for the Commission to obtain an aggregate report from the RTO.

IX. Advanced Technologies

At pages 39-40 of the NOPR, the Commission provides a long list of items that could, under certain circumstances, be considered advanced transmission technologies. While standard technologies frequently provide low-risk/low-reward results, advanced technologies often offer high-risk/high-reward results. The NOPR does not propose to adopt any special incentives for advanced technologies. Rather, the NOPR takes the position that advanced technologies will be promoted as a matter of course, given the regular incentives proposed in the NOPR.

The Commission's position on this issue may be overly conservative. As academic research in the field of finance has demonstrated, a portfolio approach that combines low-risk/low reward instruments with high-risk/high reward instruments often generates an overall higher risk-weighted portfolio return. These findings might also be transferable to a utility's portfolio of transmission projects. Also, the Commission should take customer interests into account. For example, the Commission should be willing to consider utility applications for risk-

³⁷ NOPR at 30.

sharing in the context of advanced technology projects when such risk-sharing is supported by the utility's customers.

X. Conclusion

The OMS respectfully requests that the Commission consider the above Comments.