

## Commissioner Warns of FERC Retreat on Transmission Rate Incentives

On the very last business day of 2011, the Federal Energy Regulatory Commission (FERC) used its authority under Section 219 of the Federal Power Act to grant New Jersey's Public Service Electric & Gas Company (PSE&G) rate incentives for construction of a large transmission project (the "NGR Project"), including a 25 basis-point adder to PSE&G's return on equity (ROE) for project expenditures. Two years earlier to the day, FERC had issued a similar order granting Section 219 rate incentives for a predecessor project to NGR (the "BRH Project"). In the BRH case, however, the incentives had differed in one major respect—instead of a 25 basis-point ROE adder, FERC had awarded fully 125 basis points. This difference did not pass without comment. In fact, FERC's Commissioner Moeller himself said, in his NGR dissent: "This Commission may again be retreating from its incentive policy on needed transmission lines." Is this in fact the case? If not, why such different outcomes—authorized returns on equity that, all else being equal, differ by a full percentage point—for such very similar projects?

### Background

The Energy Policy Act of 2005 ("EPAct 2005") made numerous adjustments to federal energy policy, among them changes intended to remedy perceived under-investments in electric transmission infrastructure. As FERC stated in its Order No. 679 (*Promoting Transmission Investment Through Pricing Reform*, FERC Stats. & Regs. ¶ 31,222 (2006)):

[I]nvestment in transmission facilities in real dollar terms declined significantly between 1975 and 1998 . . . [and] data for . . . 2003 [] shows investment levels still below the 1975 level in real dollars. This decline in transmission investment in real dollars has occurred while the electric load using the nation's grid more than doubled. Further, the record shows that the growth rate in transmission mileage since 1999 is not sufficient to meet the expected 50 percent growth in consumer demand for electricity over the next two decades.

To address this problem, Congress enacted Section 219 of the Federal Power Act, which provides in part that "the Commission shall establish, by rule, incentive-based . . . rate treatments . . . for the purpose of benefiting consumers by ensuring reliability and reducing the cost of delivered power by reducing transmission congestion."

FERC's July 2006 Order No. 679 issued regulations implementing Section 219. Order No. 679 provides a two-part analysis to apply to utility requests for rate incentives. As the BRH Order discusses, the first part establishes a rebuttable presumption that rate incentives are appropriate "if the transmission project results from a fair and open regional planning process that considers and evaluates projects for reliability and/or congestion and is found to be acceptable to the Commission, or a project has received construction approval from an appropriate state commission or state siting authority." (In some cases, FERC will grant incentives even if this first factor is not present. See, e.g., *RITELine Illinois, LLC*, 137 FERC ¶ 61,039 (2011).)

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The second part of the analysis “requires an applicant to demonstrate a nexus between the incentives being sought and the investment being made,” that is, “whether the incentives requested are tailored to address the demonstrable risks or challenges faced by the applicant.” FERC “has found the question of whether a project is ‘routine’ to be particularly probative” in answering the “nexus” question. The question of “routineness” in turn depends on:

(1) the scope of the project (e.g., dollar investment, increase in transfer capability, involvement of multiple entities or jurisdictions, size, effect on region); (2) the effect of the project (e.g., improving reliability or reducing congestion costs); and (3) the challenges or risks faced by the project (e.g., siting, long lead times, regulatory and political risks, specific financing challenges, other impediments).

If Order No. 679’s two-part analysis indicates that incentives are appropriate, FERC has several at its disposal. It can grant “an incentive ROE adder” for the project investment, allow the utility to place 100 percent of project-related Construction Work In Progress (CWIP) expenditures in rate base, and allow for recovery of 100 percent of prudently-incurred project expenditures if the project is cancelled due to causes beyond the utility’s control.

### The PSE&G Cases

FERC applied its Order No. 679 analysis straightforwardly in both the BRH and NGR cases. *Public Service Electric and Gas Co.*, 129 FERC ¶ 61,300 (2009) (“BRH Order”); *PJM Interconnection, L.L.C.*, 137 FERC ¶ 61,253 (2011) (“NGR Order”). Initially, FERC found in both cases that the rebuttable presumption part of the analysis was satisfied because both projects were approved under the PJM Interconnection’s regional transmission planning process (RTEP). In fact, NGR was the project PJM substituted for BRH when its 2010 RTEP identified “fewer and less severe” reliability violations in northern New Jersey than in 2008.

As to the “nexus” factors, FERC found in both cases that the proposed project addressed regional transmission issues, including relief of flows on existing transmission lines, and that both projects would enhance reliability. In both cases, it found that the project would traverse environmentally sensitive and densely populated areas, and would be subject to siting proceedings in multiple jurisdictions. Implicit in FERC’s review of these cases was that both projects were to be built by the same utility, assuring an identity of financial conditions.

In addition to these identical facts in the two cases, FERC also made a series of findings that seem very similar. The cost estimate for BRH was \$1.1 billion, while that for NGR is \$0.9 billion. BRH’s schedule was estimated at four years, NGR’s at three and a half years. BRH would require expenditures of about \$270 million per year, while NGR would require about \$257 million per year. BRH would have approximately doubled PSE&G’s transmission plant in service, while NGR will represent 64 percent of PSE&G’s net transmission plant.

Very few aspects of the two cases exhibit a greater level of dissimilarity. FERC found in the BRH case that the project would address 20 PJM-identified reliability violations; in the NGR case, it found that 10 such reliability violations would be addressed. However, other than the general statement that NGR was substituted for BRH because reliability violations had become “fewer and less severe,” neither the magnitude nor importance of any of these violations is discussed in detail, and FERC does not mention this difference in its holding in the NGR case. Also, FERC found in BRH that the expenditure of \$270 million per year would be four times PSE&G’s historic annual transmission expenditures, while in NGR it found that the expenditure of

\$257 million per year would be only 1.4 times PSE&G's annual transmission expenditures "over the past five years"; however, this difference appears to be mainly a result of the different metrics used in the two cases ("historic" versus "over the past five years").

Aside from the difference in the ROE incentive adder, the other relief granted in the case is likewise virtually identical: in both cases, PSE&G was granted 100 percent CWIP in rate base, 100 percent recovery of prudently incurred costs in the event the project had to be abandoned because of factors outside its control, and the right to assign the package of incentives to a PSE&G affiliate if such affiliate was tasked with the construction of the project.

In making its NGR holding, FERC said:

[I]n consideration of the scope, effects and risks and challenges of the NGR Project and the total package of incentives granted in this order, we are reducing PSE&G's requested 100 basis point adder to 25 basis points. We find that granting 25 basis points is just and reasonable in light of the other incentives that the Commission is granting to PSE&G as discussed below; the CWIP in rate base and abandonment incentives reduce certain financial and regulatory risks that PSE&G cites as support for a 100 basis point incentive ROE adder.

But given that all these "other incentives" were also present in the BRH case, what is the justification for a whole one percent difference in the rate of return adder on two projects both costing approximately a billion dollars? (Note that the final ROE approved for BRH, including the incentive adder, was 12.93 percent, versus 11.93 percent for NGR.) The NGR Order never addresses this question directly, but it does remind the reader that the "nexus test is fact-specific and requires the Commission to review each application on a case-by-case basis," examining "the entirety of the project and the requested incentives" to determine what incentives are just and reasonable.

Perhaps predictably, this explanation did not satisfy everyone. FERC's Commissioner Moeller, in his NGR Order dissent, says bluntly:

This Commission may again be retreating from its incentive policy on needed transmission lines. . . . Although this order finds that the NGR Project demonstrated the nexus between the investment made and the incentives sought, it reduces the requested return on equity incentive adder by seventy-five basis points, without sufficient explanation.

Indeed, a less formal analysis of the differences between the BRH and NGR Orders may not be completely devoid of support. It is no secret that Order No. 679's incentive regime has not been uniformly popular. The title of a recent National Association of Regulatory Utility Commissioners (NARUC) presentation—"FERC and the Recent ROE Giveaway"—gives some idea of the attitude of some state utility commissions. See <http://www.narucmeetings.org/Presentations/ROE%20slides.pdf>. The presentation criticizes several FERC incentive orders under Order No. 679 resulting in total ROEs near or above 13 percent, compared to a list of apparently non-incentivized utility ROEs ranging mostly between 10 and 12 percent. It may be coincidence that while the total ROE resulting from FERC's BRH Order is near 13 percent, the equivalent NGR Order total ROE is just shy of 12 percent.

## Implications

In summary, it is possible that the one percent difference in incentive ROE granted in the BRH and NGR cases can be considered a result of factual differences between the two projects—NGR is slightly cheaper and addresses fewer reliability violations (though their magnitude compared to those addressed in the BRH case is unknown).

On the other hand, there is some support also for the idea that other factors may have played into FERC's NGR Order. As Commissioner Moeller's dissent implies, the NGR Order may reflect an evolution in FERC's incentive policy taking place outside of, and parallel to, the pending Notice of Inquiry. See *Promoting Transmission Investment Through Pricing Reform*, Notice of Inquiry, 76 Fed. Reg. 30,869 (May 27, 2011), FERC Stats. & Regs. ¶ 35,572 (2011). This reading of the NGR Order is also supported by FERC's citation in the NGR Order of earlier cases, in which it had adjusted requested ROE incentive adders based on the allowance of other incentives that were deemed to reduce the riskiness of the project. In those cases, however, FERC typically made a significantly smaller adjustment to the requested ROE incentive. If FERC is indeed signaling that it will now give greater weight to other requested incentives when it decides how large an ROE incentive to award, utilities and transmission developers will have to take this policy direction into account in structuring their incentive applications.

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