

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

Promoting Transmission Investment Through Pricing Reform *
* **Docket No. RM11-26-000**
*

**COMMENTS OF THE PUBLIC
SERVICE COMMISSION OF MARYLAND**

Pursuant to the Notice of Inquiry issued by the Federal Energy Regulatory Commission (“Commission”) on May 19, 2011 seeking comment on the scope and implementation of the Commission’s transmission incentive regulations and policies under Order No. 679,¹ the Maryland Public Service Commission (“Maryland PSC”) respectfully makes the following comments in support of reform of certain transmission incentive policies and regulations. Specifically, the Maryland PSC comments that (i) An incentive return on equity (“ROE”) should only be awarded in highly unusual circumstances where risk cannot be effectively mitigated or the proposed project presents extraordinary benefits to ratepayers; (ii) The ROE should be reduced when the Commission grants transmission incentives that mitigate risk; (iii) Routine projects should not be granted transmission incentives; (iv) The Commission should deemphasize proxy groups and place more weight on traditional ratemaking principles when determining reasonable returns; and (v) The Commission should remove or reduce the incentive for transmission providers to join regional transmission organizations. In support of those comments, the Maryland PSC states as follows:

¹ *Promoting Transmission Investment Through Pricing Reform*, 116 FERC ¶ 61,057 (Order No. 679), 177 FERC ¶ 61,345 (2006), order on reh’g (Order No. 679-A).

I. Communication

The Maryland PSC requests that communications regarding these proceedings be directed to the following representatives:

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II. IDENTITY AND INTERESTS OF THE MARYLAND PUBLIC SERVICE COMMISSION

The Maryland PSC is an agency of the State of Maryland, established pursuant to Maryland Public Utilities Article §§ 1-101 et seq. (2010). Public Utilities Article § 2-113 vests in the Maryland PSC supervisory and regulatory authority over Maryland public service companies (including electric companies), and empowers the Maryland PSC to ensure that Maryland public service companies operate in the interest of the public and deliver adequate, economical and efficient utility services in the State.

Maryland ratepayers are directly impacted by the Commission's regulations and policies regarding transmission incentives. The State of Maryland is contained entirely within PJM Interconnection, L.L.C. ("PJM"), a Regional Transmission Organization ("RTO") that contains regions with high levels of congestion that appropriate investment in transmission infrastructure could help resolve. However, the Maryland PSC is also concerned that FERC's implementation of § 219 of the Federal Power Act ("FPA") through its panoply of transmission incentives offered through Order 679 has placed too great a burden on Maryland's ratepayers and disrupted the balance that previously existed between customers and investors. The Maryland PSC therefore has a vital interest in

promoting beneficial transmission investment that does not impose unreasonable cost burdens on the State.

III. COMMENTS

Since the issuance of Order No. 679 and the promulgation of incentive regulations thereunder, the Maryland PSC has commented on (and often protested) numerous incentive requests by transmission developers and owners as unnecessary or overly generous. Yet, despite these protests, the Maryland PSC has also consistently noted, as it does here, the importance of investment in new transmission facilities, particularly facilities that by design would relieve congestion and improve regional electric reliability. In addition to those benefits, transmission expansion can help diminish the exercise of generation market power by opening isolated load pockets to additional competition. Moreover, for states with renewable portfolio standards (“RPS”) such as Maryland, new transmission infrastructure can facilitate the linking of renewable generation resources in isolated locations to load.

Nevertheless, the benefits new transmission resources provide do not justify the excessive level of incentives that transmission developers have been successful in extracting pursuant to the Commission’s policies and regulations enacted through Rule No. 679. Instead, transmission incentives should be carefully tailored to meet the risks and challenges presented by a project.² Additionally, to the extent transmission developers obtain incentives that mitigate their financial and regulatory risks, their return on equity (“ROE”) should be reduced to reflect the decreased risk of the project. That outcome is especially equitable given that incentives such as granting 100 percent

² Order No. 679 at P 26.

construction work in progress (“CWIP”) and recovery of the costs of abandoned plant do not actually reduce risk – rather, these incentives shift the risk to ratepayers. In other words, granting transmission developers abandonment costs does not reduce the risk of the transmission project being abandoned, it simply places the financial consequences of abandonment squarely on the shoulders of ratepayers. Therefore, transmission developers should not be entitled to obtain an incentive ROE on top of these risk-shifting incentives.

A. Incentive Return on Equity Should be Awarded Only in Highly Unusual Circumstances Where Risk Cannot be Mitigated or the Proposed Transmission Upgrade Presents Extraordinary Benefits to Ratepayers

The Maryland PSC opposes the routine granting of incentive ROEs as an inducement to the construction of transmission infrastructure. As described later in these comments, the ROE should be based on a thorough analysis of variables such as the risk presented to a transmission developer that cannot be mitigated, the comparable return available to unregulated entities facing similar levels of risk, and the demand for money, as measured by applicable interest and inflation rates. An incentive ROE represents nothing more than a bonus above and beyond what traditional ratemaking principals dictate is a just and reasonable return. It should only be considered in highly unusual circumstances such as when a transmission developer faces high levels of risk that cannot be effectively mitigated, where the project is particularly innovative, or where the transmission developer is able to demonstrate that the project will provide extraordinary benefits to ratepayers in the form of congestion reduction or regional reliability. Unfortunately, during the last several years, transmission developers have been successful in obtaining incentive rates for projects that do not utilize particularly

innovative technology or provide extraordinary benefits, and despite the fact that they have largely mitigated risk by shifting it to ratepayers.

No doubt, some parties will point to the lack of substantial construction of new transmission and comment that incentive rates are not high enough. That assertion, however, falsely implies that there is but one obstacle to building transmission – finding the right incentive rate. In fact, transmission construction is dependent on many variables, including need.

B. Return on Equity Should Be Reduced When the Commission Grants Transmission Incentives that Mitigate Risk

1. *Transmission Incentives such as Construction Work in Progress and Abandonment Costs Dramatically Reduce Risk to Transmission Developers*

A fundamental rule of finance is that an investor's or developer's return on equity should be directly proportional to risk, a rule that the Commission attempts to or should attempt to replicate. Granted the construction of large-scale transmission lines presents unique risks to developers including a significant outlay of financial capital that under traditional ratemaking principles was not recovered for months or even years, until the transmission line became commercially operational. The prospect of writing off development costs if the new transmission project was abandoned presented an additional threat to transmission developers; for reasons beyond its control, such as a generation developer's decision to terminate construction of new resources or a sudden and unexpected economic slowdown, a transmission developer could be forced to abandon a transmission project and lose the ability to recover planning and development costs. Such risks understandably chilled investor enthusiasm.

By providing in Order No. 679 for the recovery of 100 percent of prudently incurred costs of transmission facilities that are cancelled or abandoned through no fault of the developers, the Commission convincingly removed this risk.³ The action reduced regulatory uncertainty and eliminated a major stumbling block for investors.

Additionally, the Commission's approval of 100 percent of CWIP as a transmission incentive available to applicants significantly reduced risk to transmission developers. CWIP enables transmission developers to include construction costs in rate base and to expense rather than capitalize pre-commercial operation costs associated with new transmission investment, thereby facilitating an immediate and substantial cash flow. This incentive ameliorates the risk of regulatory delay, reduces the risk of a credit downgrade, and decreases borrowing costs. The introduction of formula rates complemented CWIP by mitigating the risk of regulatory lag, reducing the possibility of cost non-recovery and bolstering the confidence of investors. As the Commission stated in Order 679, formula rates provide "certainty of recovery that is conducive to large transmission expansion programs."⁴

Unfortunately, however, after routinely granting applicants all three of these transmission incentives, the Commission has not acted to reduce their ROE. The transmission developer's return should be directly proportional to the risk of the project. By reducing the risk of project delay, creating a cash stream in advance of commercial operation, and firmly placing on ratepayers the risk of project abandonment, the Commission has eviscerated the once high level of risk of transmission development. To be sure, the project could still be delayed or cancelled, but ratepayers, not investors, will

³ *Id.* at P 163.

⁴ *Id.* at P 386.

pay the bill. The ROE should therefore be materially reduced to acknowledge the pronounced decrease in investor risk. Instead, inexplicably, transmission investors have been rewarded with higher, incentive ROEs, in contravention of sound ratemaking principles.

2. *The Award of Incentive ROEs in Addition to Other Transmission Incentives Disturbs the Historic Balance the Commission Has Maintained Between Investors and Consumers*

The Commission has long acknowledged the historic balance it has acted to maintain between consumer and investor interests.⁵ Indeed, in its recent Notice of Inquiry, the Commission pledged “by issuing this Notice of Inquiry, the Commission is not departing from its longstanding recognition of the need to balance consumer and investor interests.”⁶ Nevertheless, the Commission’s routine approval of CWIP, abandonment costs and formula rates has significantly reduced risks on transmission developers by reallocating the risks to ratepayers. The balance between investors and consumers can be reestablished, but only if the Commission acts to lower the investors’ ROE to account for the shift in risk.

Interestingly, Order No. 679 alludes to the historic balance of consumer and investor interests in the context of CWIP. That Order states “our policies regarding the recovery of Construction Work in Progress (CWIP) seek to balance investor and consumer interests by allowing, in the typical case, 50 percent of CWIP in rate base.”⁷

The Order explains that the balance was maintained by permitting investors to recover

⁵ *Id.* at P 26.

⁶ Notice of Inquiry, *Promoting Transmission Investment Through Pricing Reform*, 135 FERC ¶ 61,146 at P 12 (2011). *See also*, *Promoting Transmission Investment through Pricing Reform*, Order No. 679-A, 119 FERC ¶ 61,062 at P 21 (2007), providing: “The longstanding rule is that utility rate regulation must adequately balance both consumer and investor interests.”

⁷ Order No. 679 at P 22.

some construction costs on a current basis “while also protecting consumers against full rate recovery before a particular facility is placed into service.”⁸ By approving 100 percent CWIP, however, the Commission changed that arrangement to require ratepayers to pay for all project costs related to construction before enjoying any of the benefits of the project.

The history of abandonment costs is similar. Before Order No. 679 and the Commission’s decision in *Southern California Edison*,⁹ the Commission addressed abandonment costs through a careful balancing of risks and interests between consumers and investors. Order No. 679 provides:

Prior to *SCE*,¹⁰ the Commission’s policy with respect to recovery of cancelled plant costs provided that 50 percent of the prudently incurred costs of a cancelled generating plant should be amortized as an expense over a period reflecting the life of the plant if it had been completed and that the remaining 50 percent of the prudently incurred costs of the cancelled plant should be written off as a loss.¹¹

The consumer and investor shared equally the risk that changed circumstances, such as reduced load forecasts resulting from an economic slowdown, would obviate the project before it could be completed. In order to quell investor fears that they could be responsible for a percentage of the abandonment costs, however, the Commission firmly placed all of the risk on ratepayers.¹² The probability that a project will be abandoned

⁸ *Id.*

⁹ 112 FERC ¶ 61,014, reh’g denied, 113 FERC ¶ 61,143 (2005).

¹⁰ In *Southern California Edison Company*, the Commission approved the transmission developer’s request to recover all prudently incurred costs related to proposed transmission facilities if those facilities were later cancelled or abandoned. 112 FERC ¶ 61,014 at P 58-61. In Order No. 679, the Commission made that incentive widely available to all applicants for new transmission projects.

¹¹ Order No. 679 at P 156 n. 105.

¹² The Maryland PSC notes an additional disadvantage to relieving developers of the obligation to pay for any abandonment costs. Transmission developers are in the best position to gauge the likelihood that external factors, such as load forecast changes or regulatory delay, will cause the abandonment of a project. Certainly, they are in a better position than ratepayers. By placing all abandonment costs on ratepayers, the

because of new forecasts, intervenor opposition or any other factor did not change, but consumers have now absorbed the entire risk – at the Commission’s direction.

In order to restore the balance between consumers and investors, the Commission should require a reduction in the ROE for transmission projects that take advantage of incentives such as 100 percent CWIP and the award of 100 percent abandonment costs. Indeed, the Commission alluded to the possibility that it might do so in Order No. 679-A, which provides: “If some of the incentives in the package reduce the risks of the project, that fact will be taken into account in any request for an enhanced ROE.”¹³

Unfortunately, based on the routine granting by the Commission of incentive ROEs on top of incentives that reduce investor risk at the expense of ratepayers, it is evident that the Commission has failed to take into account reduced risk when examining ROEs.

Going forward, the Commission should act to restore the historic balance between consumers and investors by requiring a reduction in return when risk-reducing incentives are granted.

C. Routine Projects Should Not be Granted Incentive Adders

The Maryland PSC reemphasizes its longstanding position that incentives should not be granted as a matter of course at the level requested by transmission owners and developers, as has often been done in the past. As described above, the Maryland PSC

Commission may have inadvertently realigned incentives in such a way as to remove the responsibility of making sound planning decisions from those in the best position to make them. While the Maryland PSC acknowledges the benefits to investors of awarding 100 percent abandonment costs, we submit that under no circumstances should a transmission developer receive an incentive ROE for a project that has been abandoned. The incentive ROE, if granted at all, should only be authorized for transmission projects that are successfully placed in service.

¹³ Order No. 679-A at P 6. *See also*, Order No. 679 at P 143, providing “a utility that receives approval to recover abandoned plant in rate base would likely face lower risk and thus may warrant a lower ROE than would otherwise be the case without this assurance.” The Maryland PSC submits that this principle should be the norm and not an outlying exception.

submits that incentive ROEs should only be awarded in highly unusual circumstances where risk cannot be mitigated, where the project is particularly innovative, or the proposed transmission upgrade presents extraordinary benefits to ratepayers. Other transmission incentives should be closely scrutinized, but in any event must not be approved routinely. The Commission has articulated that rate incentives do not constitute bonuses that will be routinely doled out to transmission developers merely for good behavior under incentive pricing regulations.¹⁴ Instead, the transmission project developer must establish a nexus between the project and the requested incentives. Specifically, the Commission has held that “the incentive(s) sought must be tailored to address the demonstrable risks and challenges faced by the applicant in undertaking the project.”¹⁵ Recently, the Commission confirmed that RTO approval of a project does not automatically entitle the transmission developer to incentives under the nexus test.¹⁶

In Order Nos. 679 and 679-A, the Commission affirmed the principle that “the most compelling case for incentive ROEs are new projects that present special risks or challenges, not routine investments made in the ordinary course.”¹⁷ Nonetheless, the Commission has persistently awarded overly generous incentives for projects that in some case are routine in nature and that provide little or no regional benefit.

¹⁴ See, Order No. 679, at P 26 (“[O]ur reforms adopted in the Final Rule provide ‘incentives’ to construct new transmission, but they do not constitute an ‘incentive’ in the sense of a ‘bonus’ for good behavior. Rather, as we explain below, each will be applied in a manner that is rationally tailored to the risks and challenges faced in constructing new transmission. Not every incentive will be available for every new investment. Rather, each applicant must demonstrate that there is a nexus between the incentive sought and the investment being made. Our reforms therefore continue to meet the just and reasonable standard by achieving the proper balance between consumer and investor interests on the facts of a particular case and considering the fact that our traditional policies have not adequately encouraged the construction of new transmission.”)

¹⁵ Order No. 679-A at P 21.

¹⁶ See, *Commonwealth Edison Company*, 125 FERC ¶ 61,250 at PP 36-37 (2008), *rehearing denied*, 127 FERC ¶ 61,301 (2009); *Trans-Allegheny Interstate Line Company*, 126 FERC ¶ 61,286 at P 31 (2009).

¹⁷ Order No. 679-A at P 60.

The Maryland PSC consistently has maintained that the Commission should adopt standards to guide its determination of whether a project is “routine” and whether there is a sufficient “nexus” between the project and the incentive. In particular, the Maryland PSC supports the nexus test articulated by former Commissioner Suedeen Kelly, as set forth in her dissent in *American Electric Power Service Corporation*.¹⁸ This test involves consideration of six factors: 1) public interest benefits, 2) project cost, 3) project cost compared to current transmission rate base, 4) project difficulty owing to the number of jurisdictions traversed and the applicant’s familiarity therewith, 5) difficulty relying upon normal recovery methods owing to the length of time for project completion, and 6) whether the applicant otherwise would be required to build the project without the incentive.¹⁹ Additionally, the Maryland PSC continues to support Chairman Wellinghoff’s position in his prior dissents from various Commission incentive orders that the Commission should focus upon the use of advanced technology as well.

The Maryland PSC is especially concerned that local utilities are obtaining incentives for routine transmission upgrades that the utilities are required by state law to make. The Commission addressed this issue in Order No. 679, finding that these types of projects may not merit incentive adders because the regulatory obligation to build them creates a high assurance of recovery. Specifically, the Commission held:

[R]outine investments made to comply with existing reliability standards may not always qualify for an incentive-based ROE. These are the types of investments that have, as a general matter, been adequately addressed through traditional ratemaking because there is an obligation to construct them and high assurance of recovery of the related costs. For these and

¹⁸ 118 FERC ¶ 61,041 (2007).

¹⁹ *Id.* at 1

other reasons, traditional ROE determinations may continue to be appropriate for these investments.²⁰

Unfortunately, routine projects that provide no regional reliability benefits have often been awarded incentive rate treatment, such as in *Baltimore Gas & Electric Co.*²¹ and *Pepco Holdings, Inc.*²² The Maryland PSC strongly agrees with the dissenting opinion of former Commissioner Kelly who asserted in *Pepco Holdings, Inc.* that the Commission's decision to bestow ROE adders for all of PHI's projects "runs contrary to Order No. 679-A, which states that 'the most compelling case for incentive ROEs are new projects that present special risks or challenges, not routine investments made in the ordinary course.'"²³

D. The Commission Should Place Less Reliance on Proxy Groups as a Justification for Elevated Returns

The review of proxy groups should not be the primary driver of the ROE a transmission developer is ultimately awarded. For example, the fact that an applicant is able to show that a group of past transmission projects (or companies with development projects similar to transmission) received a spectrum of ROEs with a low of 8 percent, a median of 11 percent and a high of 14 percent is not analytically related to the question of what return a transmission developer needs to compensate for risk and earn a just and reasonable return. Instead, the proxy group process merely perpetuates a tautology by empowering one transmission developer to claim that it should receive a high rate of return because the previous transmission developer obtained an equally high rate.

²⁰ Order No. 679 at P 94.

²¹ 120 FERC ¶ 61,084 (2007).

²² 124 FERC ¶ 61,176 (2008).

²³ Kelly Opinion at 2 (citing Order No. 679-A at P 60).

The misplaced focus on proxy groups also leads to transmission developers shopping for the highest rate proxies available, often by referring to entities that do not share comparable risk. For example, applicants engaged solely in transmission often cite proxies engaged in much more risky business ventures, such as generation, despite the fact that generation development contains substantially more risks and variables such as the price of fuel, regional market conditions, and changing environmental regulations. When the transmission applicant is granted incentives that ensure recovery of costs regardless of the outcome of the project, such as CWIP and abandonment costs, the comparison to entities such as generation owners for purposes of determining an appropriate return is misplaced and illogical.

In any event, changing economic parameters can quickly make any comparison to proxies irrelevant, as happened when the U.S. economy plunged into recession and interest rates plummeted. An analytical approach to determining the appropriate return would have adjusted the ROE downward to reflect the decreased demand for money as well as the diminished risk of inflation. However, applicants for incentive ROEs still routinely use proxies that were granted high ROEs prior to the recession in 2008 in order to inflate their requested returns.

While proxy groups may have some value in verifying that an analytically derived ROE fits within the “range of reasonableness” of similar projects approved in the recent past, applicants have often abused the concept. In addition to stacking the deck with proxies facing significantly higher risk than transmission development, developers have also argued that analytical tools such as medians should be ignored as long as proposed

ROEs fit within the “high end of the range of reasonableness.”²⁴ The process of locating the highest ROE approved by the Commission as the starting and ending point of discussion demeans rigorous ratemaking principles and analysis. The Commission should therefore reexamine the value of proxy groups during this inquiry and refocus ROE determinations on traditional ratemaking analysis. In so doing, the Maryland PSC recommends that the Commission develop procedures that disregard or devalue proxies that face higher risks than transmission projects. Specifically, the Commission may want to consider developing a proxy group that corrects for the risks associated with the inclusion of unregulated business activities by focusing on companies that are in the primary business of providing electric delivery service.

E. The Commission Should Remove or Reduce the Incentive for Transmission Providers to Join Regional Transmission Organizations

In Order No. 679, the Commission determined that it would approve requests for incentives for public utilities that join and/or continue to be a member of an RTO.²⁵ While the Commission decided to issue such incentives on a case by case basis, in practice, it has routinely granted transmission developers a significant adder (50 basis points) for joining or remaining a member of an RTO.²⁶ The Maryland PSC submits that this adder has become nothing more than a discriminatory tax on ratepayers who happen to reside within RTOs, such as PJM. It is unclear that the incentive encouraged any utilities to join RTOs that would not have otherwise done so. At this point, however, five

²⁴ See, *Pioneer Transmission, L.L.C.*, Docket No. ERO9-75-000, Exhibit PNR-700 at 58-59.

²⁵ Order No. 679 at P 326.

²⁶ The Commission clarified that an applicant “will be presumed to be eligible for the incentive if it can demonstrate that it has joined an RTO, ISO, or other Commission-approved Transmission Organization, and that its membership is on-going.” Order No. 679 at P 327.

years after issuance of Order 679, the incentive appears to have no positive value and it should be discarded. If the Commission believes that it is compelled by FPA § 219 to retain some level of incentive for RTO membership, the incentive should be significantly reduced.

CONCLUSION

The Maryland PSC urges the Commission to reform its transmission incentive regulations and policies in accordance with the recommendations presented in these comments.

Respectfully submitted,

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