

**Some thoughts on
State/federal Jurisdictional Issues in Transmission
and the Transition to a
Competitive Electricity Market**

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Some Thoughts on State/federal Jurisdictional Issues in Transmission and the Transition to a Competitive Electricity Market

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The debate on the issue of pricing transmission services, indeed transmission policy in general, is characterized by a massive cognitive dissonance. FERC issues a lengthy series of significant questions about just about everything a federal regulator would ever want to know about transmission, except for how they relate to the other set of regulators who have so much to say about the grid. Other than a passing reference, that question did not get asked at all. Thus we are involved in a debate where most of the discussion takes place in a forum that is responsible for significantly less than half the revenue that's derived from transmission. Moreover, the regulators that *are* responsible for the bulk of transmission revenues set them as part of bundled retail rates and rarely, if ever, think about transmission in discrete terms. Accordingly, we not only have cognitive dissonance as to the forum and the substance, but we have decision-makers making critical decisions who simply do not think about what their peers may be doing, except to the extent that state regulators worry about FERC preemption of their authority, and FERC fears that state regulators are actually monopolists who intend to impede all competition. Beyond that, there is not much dialogue. Given this state of affairs, it seems unlikely that coherent transmission policies will emerge in the absence of a more formal system of cooperation.

The goal of this paper is to examine the jurisdictional conflicts that exist between federal and state regulation of electricity transmission and explore some possible means of reconciling them.¹

¹ There are a number of other areas of jurisdictional conflicts besides transmission which merit examination, but they lie beyond the scope of this paper.

Conflicts:

There are four fundamental regulatory issues regarding transmission: planning, siting, pricing, and access. Each of these aspects of transmission regulation is critical, and, taken together, they form a jurisdictional maze of complex dimensions.

Planning and siting are fairly simple jurisdictionally. They are plenary state jurisdictional issues. With a few exceptions in siting where various federal agencies have something to say, such as the Corps of Engineers when lines cross navigable streams, for the most part there is no federal siting jurisdiction and there is a minimal federal role in transmission planning.

In pricing, it is not as clear where jurisdiction lies. Conventional wisdom sees pricing as a FERC issue. Certainly all transactions between utilities are FERC jurisdictional, and the Federal Power Act says that FERC has the authority to price transmission services. But the fact is that retail transmission rates, as little as state regulators may ever think about them in discrete terms, are set by state regulators. While there is not a state in the union that sets discrete transmission prices, every single transmission line owned by a state-regulated utility in the United States is in the retail rate base of that utility, and thus embedded in the bundled price that electricity consumers pay. Research on the issue turned up only one case, in California, where there had been a disallowance for transmission investment, and on rehearing the California Commission reversed itself and put that line into rate base. The effect of transmission being in rate base is that retail ratepayers are in the position of being the guarantors of the utility revenue requirements for transmission investment.

While state regulators have put retail ratepayers in the position of bearing the residual revenue responsibility for transmission, there is some question about retail jurisdiction because of

the implications of the *Colton*² case, a 1964 Supreme Court case which held that, since the movement of electrons on the interconnected AC grid was essentially one seamless web, all wholesale transactions affect interstate commerce and are therefore subject to federal regulation, whether they are intrastate or interstate. That logic could arguably be extended to all transmission matters, although the court has never so stated. The implications of that for retail wheeling are unclear, however, because Congress, in the 1992 Energy Policy Act, prohibited the FERC from mandating retail wheeling and implied, although it did not explicitly state it, that it was a matter left to the states.

Wholesale access under the Energy Policy Act of 1992 is of course FERC jurisdictional. The Act gives the FERC the ability to mandate wholesale transmission access on a case by case basis when someone requests it. If the utility from whom the service is requested is able to demonstrate to the FERC's satisfaction that because of congestion or other factors it cannot provide the service requested without building new transmission facilities, the utility incurs a good faith obligation to obtain the authority to site and actually build a new facility in order to carry out the mandate of FERC's access order.

There lies the black hole of the 1992 Act. To fulfill its "good faith" obligation, the utility has to seek approval to build the new facility from the state commission or the state siting authority, depending on who has that authority in the state.³ When the utility goes to the state for siting approval for a FERC mandated or wholesale market driven facility, the state faces a real policy

² FPC vs. Southern California Edison Co. 376 U.S. 205(1964)

³ According to a 1987 report of the National Governor's Association, Moving Power, only 28 states even exercise siting authority in a formal way - in 22 states there is no siting law. That may mean a variety of things, ranging from the absence of any problem siting a line to the need to obtain the approval of every township and municipal zoning agency.

dilemma. Historically, lines have been planned and sited at the state level based on the notion that the beneficiaries of the new transmission line are the native load customers - most of them retail. Consequently, when regulators approve a new facility they have really been making two decisions. The first is to certify the need for the line, and the second (assuming prudence in the construction of the facility) is to require the retail ratepayer to bear the residual revenue responsibility for that line. If there are revenues that are derived from other sources (e.g. wholesale users), they serve to offset the financial obligations of the native load customer. If, however, there are no additional revenues, or the utility chooses to forego them for whatever reason, the transmission line owner will still be made whole by those who bear the residual revenue responsibility, namely the native load rate-payers. State regulators have never looked at these two questions in a decoupled fashion.

Decoupling the question of who pays from that of whether the line should be certified gives an interesting dichotomy in perspective. On the one hand, in siting a line for which the FERC has already determined the need, should the state expend a great deal of effort inquiring anew into the need for the facility? FERC has issued an access order; surely the need exists. On the other hand, the need is not necessarily the need of the local ratepayers. If two companies in neighboring states to the east and west of a state enter into a transaction which requires a new line through the state in the middle, why should the regulators in that middle state site that line? In terms of simply siting the line, good public policy would suggest that the state siting authority ought not to be parochial. On the second question, however, of who should pay for it, is the state being unduly parochial when it says that, given a lack of need for the facility to serve the rate-payers of that state, the state's ratepayers need not pick up the tab for the line, or even bear the residual revenue responsibility for the new facility. If the middle state's ratepayers have no foreseeable need for the facility, why should they bear the residual revenue responsibility for it? In the absence of the state's "guarantee" of the full revenue requirements, investors in the line would have to seek full recovery

from FERC set wholesale rates, a prospect neither the utility nor the FERC has ever faced before. Is the state being parochial for refusing to bear full residual revenue responsibility for a facility not required to serve its own load? On the recovery issue one might expect state regulators to be parochial, because their job is to protect the captive retail ratepayer.

On the other hand, it is difficult to justify parochialism as to the physical siting of the line. An excellent example of unwarranted parochialism was a 1974 Mississippi Supreme Court decision which held that the majority of the rate-payers who would benefit from a proposed line were located in Louisiana, and therefore Mississippi eminent domain statutes could not be used to condemn property in order to build the line. As a result of that decision, although the need for the line was never disputed, construction took place at a substantially higher cost. While the Court's myopic view of the public interest in siting was unjustifiable, it is fair to say that if the Mississippi Commission had ordered Mississippi rate-payers to bear the residual revenue responsibility for the line without knowing what contribution, if any, was to be forthcoming from the Louisiana rate-payers who were the real beneficiaries, the Commission could fairly be criticized for failing to protect the state's consumers.

The next question, of course, is, how will the FERC price service on that line? Historically, the FERC has had a nice regime in terms of pricing because there were no bottom line consequences to FERC's transmission pricing. Regardless of what the FERC did, utilities would be made whole by the native load, primarily retail rate-payers. If the FERC underpriced transmission assets, it did not affect the utility's bottom line. If the utility was very efficient and conscientious in providing transmission services for all transactions, including those for which it possessed capacity not needed to serve its native load customers - given that native load customers bore residual revenue responsibility, state regulators were likely to offset that burden by crediting

those revenues directly to the utility's overall revenue requirement.

In terms of price signals, the utility gains nothing by being efficient and loses nothing by being inefficient in its use of transmission assets. This arrangement has enabled the industry and regulators to largely ignore the question of compensation for parallel flows (other than when a company was compelled to back down its own generation), as well as remain indifferent to a host of other economic issues related to transmission.⁴ No state commission has yet moved to reduce the burden carried by native load beyond the attribution of revenue actually received. If a state were to disallow transmission assets in retail rate base because most of the use of a facility was non-retail, the FERC's pricing policy is unclear. The advantage of the current pricing system to the FERC is clear, in terms of avoiding pricing intricacies involved in parallel flows and other issues, but if states decide to end the practice of imposing residual revenue responsibility on native load ratepayers, transmission owners run the very real risk of getting whipsawed between FERC and state jurisdiction and finding themselves with significant revenue shortfalls as well as a powerful disincentive to build transmission.

Options for state regulators in dealing with these conflicts:

The critical transmission question before state regulators at present is whether to continue the practice of bundling rates or to treat transmission in very discrete terms. Should cost allocations or pricing of transmission be altered so as to do away with the residual revenue responsibility? How far can states go in this area without running the risk of preemption?

The options available to state regulators are interesting.

⁴ The Ohio Commission once asked a rhetorical question: Why did American Electric Power have a 765 KV system in its native load rate base, when it was very clear that the capacity was substantially beyond what was needed for native load purposes, and others were essentially deriving free service in the form of parallel flows?

A. They could continue to combine economic distributions in transmission pricing, an option which is fraught with risks of preemption by the FERC and inequitable treatment of retail customers.

B. They could set discrete rates for transmission. The danger of this option is that under the *Colton* decision and under the provisions of the Federal Power Act, the FERC has the jurisdiction to set rates for transmission services. It is not clear whether that power applies to retail transmission services, but the FERC has never chosen to try to assert any authority in regard to retail transmission services. If states do choose to unbundle and set discrete rates for retail transmission (an independent question from whether or not states permit retail wheeling), do they run the risk, having discretely identified transmission cost, of having their rate-making authority preempted altogether by the FERC? While pursuing this option is attractive from the standpoint of rate-payer equity and economic precision, one negative aspect is that it may invite a move by FERC to preempt state regulators on retail transmission rates. One could argue that it should not really matter to state regulators whether or not they can set retail transmission rates, because what they really care about is regulating distribution companies, but Congress (largely at the urging of most of the registered holding companies), has refused to legislate the *Pike County*⁵ doctrine, which would allow states to review the prudence of wholesale purchases by retail utilities subject to their jurisdiction. Lacking clear authority to review prudence in wholesale purchases, states are obviously going to be very nervous about losing retail transmission jurisdiction. There is nothing in federal law that prevents states from setting discrete rates under federal law, but the possibility that the FERC might try to preempt the state on retail transmission is a mighty deterrent to regulators who

⁵*Pike County, Ltd. Power Company vs. Pennsylvania PUC*, 77 PA Commw. 268, 465 A.2nd 735. (1983).

FERC might try to preempt the state on retail transmission is a mighty deterrent to regulators who might otherwise try to get transmission pricing right. Additionally, there is some question under some state laws as to whether or not state commissions can set direct transmission rates. While there may be good policy reasons for unbundling retail transmission rates, an effort to do so is likely to become embroiled in legal controversy, although acting in collaboration with the FERC might avoid some of these jurisdictional uncertainties, something which FERC has been loath to do.

C. Another option for state regulators is to simply accede to the FERC preemption of all transmission rate making, an option they are not likely to pursue or even accept without a battle, unless it was sweetened by codification of *Pike County*, a joint board on transmission, or some other institutional arrangement or combination of arrangements.

D. State regulators could produce the effective equivalent of setting discrete rates by carefully scrutinizing what transmission assets go into rate base. In the absence of unbundled retail rates, it is harder to argue that the FERC has preemptive authority over deciding what portion of transmission is in fact legitimately being used for, and therefore should be paid for by, retail ratepayers, and can preclude a state commission from simply removing that portion of transmission assets not used for retail service from ratebase for purposes of setting retail rates. Utilities facing this issue may argue that the transmission facility was built with the purpose of serving retail customers, and therefore the costs were prudently incurred, but state regulators can counter that the benefits of this line are not accruing to the intended set of ratepayers, and the prudence of construction for serving the entirety of the market goes to the larger question of whether there should be recovery in general and not which number of ratepayers should pay. Retail rates are not

required to include charges for assets being used for other customers. Indeed, cost of service ratemaking principles lead inexorably to the opposite conclusion.

If states do more in the direction of identifying direct retail transmission rates, then utilities face the question of whether the FERC's rates provide ample opportunity for cost recovery. If they do not, is the utility likely to get whipsawed between the two jurisdictions? It might also be possible that the utility could run into a windfall by the same process, but that seems a less likely outcome. The policy question, however, is simply whether, in the absence of any collaborative mechanism, the operation of two completely independent regulatory rate-making systems can ever produce coherent price signals that allow for investors to make appropriate decisions.

E. A logical option, which the states have proposed through NARUC, is to institute some sort of collaborative exercise of jurisdiction with the FERC. The native load issue looks very different to state regulators than it does to FERC regulators. For the FERC regulator, as former Chair Martin Alday noted, "Everybody is somebody's native load". While that may be true, it does not answer the question of whether everybody is bearing their fair share of the burden for moving the electrons on the grid. Coherent public policy regarding transmission cannot be made by the FERC alone because it lacks any authority over issues like planning and siting, and has, at best, doubtful authority in retail transmission rate-making and services. Similarly, states lack authority in wholesale access and pricing issues and even state authority over transmission pricing for retail service is less than clear. Thus, even though collectively utility regulators do have enough authority and enough jurisdiction to set transmission policy, neither federal or state regulators alone has enough to produce coherent public policy on their own, although each probably has enough authority to block the other level of regulation from establishing a particular policy direction. For the utility, that means good news and bad news. The good news is they can sometimes go shopping

and try to find the most attractive forum. The bad news is that they will have uncertainty and may well get whipsawed and lose money -- perhaps a great deal of money -- in the process. In terms of public policy, however, the pursuit of a go-it-alone course seems likely to produce little but confusion and litigation.

There are various models for cooperative mechanisms between the FERC and the state commissions, ranging from informal discussions to formal joint boards and various options in between, but the pursuit of any meaningful cooperation will require leadership from the FERC.

Options for the FERC in dealing with these conflicts:

What can and should the FERC do?

A. One is continue to do what it has been doing, which is to treat state regulators simply as party to its proceedings rather than as the federal courts relate to the state courts, in comity with them. Continuing this type of relationship destroys the opportunity for producing policy coherence unless, of course, Congress clarifies the jurisdiction balance between the states and federal government.

B. FERC could and should explore the previously described "black hole" problem in the Energy Policy Act, the gap between a FERC access order and the actual siting of a new line. Why not have some sort of understanding between the FERC and state commissions, whereby, for example, an access order from the FERC affectively preempts state siting determinations in regard to the need for a facility? The states would still have to do the siting reviews for environmental, public health, aesthetic and other matters, but states do not have to conduct a *de novo* inquiry into the question of whether or not a facility is needed. Such exploration by the FERC, of course, necessitates some form of collaboration with the states.

C. Another area ripe for FERC inquiry is the question of what happens when a state has an open and comprehensive planning processes for transmission where everybody with any conceivable need to access the system has input into the actual planning decisions that precede building transmission facilities. What happens when such a state issues a comprehensive planning order and a party which wants access decides the state process is too expensive, cumbersome, or otherwise

undesirable, and simply chooses to go to the FERC and obtain an access order, thereby bypassing the state's planning process? Should there not be some sort of system where the FERC recognizes the state process, and indeed, within some reasonable time constraints, adopts a policy of denying access orders when a party bypasses a broadly inclusive planning process that could have provided the relief sought?

D. Joint boards could be quite useful in two different areas where state and federal jurisdictions intersect or are both involved. One is on regional issues - such issues as pooling arrangements, mergers and acquisitions and registered holding companies, that are specific to a region and involve only a subset of the states. The second area for joint board activity is on generic issues like transmission pricing that affect both states and federal jurisdictions. Joint decision-making is more likely to produce a coherent pricing system than anything the FERC could accomplish on its own, because it could produce a unified pricing scheme for both retail and wholesale customers, and reduce controversy both legally and politically because joint decision-making simultaneously can be structured is so that it invokes both state and federal jurisdiction. It could also allow consensus to emerge on such key issues as priority of access in areas of constraint and acquisition of capacity rights.

E. Of course the final option for FERC is to go it alone. That option may make it easier to make decisions, but it is also the route most likely to be challenged in the courts, thereby creating less certainty than is desirable. It is the easiest option for FERC to pursue, but is also the one most likely to produce heat rather than light.