

RETAIL AND WHOLESALE TRANSMISSION PRICING: A TROUBLESOME DIVERGENCE

By Ashley Brown and Susan Kaplan
Harvard Electricity Policy Group
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The difference between the pricing of transmission services for retail customers and the pricing for wholesale customers could hardly be more striking. Retail customers still pay for transmission in exactly the same way that they have done for generations, namely through bundled retail rates. There are no unbundled retail transmission tariffs as such. Rates are based on the classic, time-honored methodology of cost of service regulation, namely capital investment minus depreciation times rate of return, plus expenses. The rate is then adjusted to account for customer class differences.

With one or two possible exceptions related to future transmission services, wholesale customers generally pay, or at least have the option to choose to pay, an unbundled, transmission-specific rate and then choose their supplier from the marketplace. The transmission price will at least reflect the discrete costs of providing transmission-specific services or, depending on the pricing system employed in the locality the service is being rendered, may well be reflective of all costs actually being incurred on the system, including congestion costs. In short, transmission-specific price signals are, with a few possible exceptions, given solely to wholesale customers. They are not conveyed to retail customers either directly or indirectly.

The divergence in pricing is even more stark in the context of the residual revenue responsibility borne by retail customers. Utilities planning and building transmission lines did so in contemplation of serving their native load customers. In exchange, those same customers were expected to bear the full responsibility of paying for the facilities. In an era of insular electrical systems, such an arrangement seemed eminently sensible. As interconnections developed for reliability purposes, the mere fact that neighboring systems relied on one another did not move the industry to reconsider the arrangement for revenue responsibility.

As utilities began using the interconnections for trading as well as reliability purposes, concerns about pricing transmission use by entities who were not native load customers led to the development of wholesale transmission tariffs. Prior to 1992, such arrangements were largely voluntary, but with passage of the Energy Policy Act of that year, the FERC acquired the authority to mandate the opening of transmission facilities for all players in the wholesale market. The number of wholesale transactions has grown enormously, and with such growth has come increased use of the grid by non-native load customers. Not surprisingly, enormous controversy has arisen over how that use ought to be priced.

Remarkably, however, despite the changes in the market and the dramatic change in the

use of the grid, the basic revenue source for transmission has remained unchanged. Native load customers—almost exclusively retail customers since the advent of open transmission access—bear the full revenue responsibility for transmission facilities. That obligation may be offset by payments for use by non-native load users of the grid, but it remains the same financial centerpiece of the grid that it has been for the past century.

The residual revenue responsibility emerges from the fact that the owners of almost all of the transmission facilities in the United States are utilities with franchise obligations to serve all consumers within a specified geographic area. These companies are obligated to build physical plants, including transmission lines, to serve their native territories. The customers they are obliged to serve become obligated for all of the costs that were prudently incurred to serve them. To make sure that obligation is met, transmission lines, like other capital assets, are put into rate base and paid for out of rates. If all costs were prudently incurred, then native load customers are required to pay 100 percent of the investment that was made.

The fact that transmission lines may well be used by customers who are neither native load nor the intended beneficiaries of the asset at the time it was built does nothing to relieve the native load customers of their ultimate responsibility to pay. Revenues derived for use of the grid by non-native load customers may well offset the actual revenue requirement imposed on native customers, but this does not alter the fact that they bear the residual responsibility for the grid.

This circumstance turns transmission pricing arrangements into zero sum games for utilities. Subject to regulatory lag considerations, they cannot profit from efficient access and pricing of transmission services, and cannot lose from inefficient access and pricing. The revenue requirement set by the retail regulator constitutes a ceiling. If non-native load use produces large revenues, the actual revenue responsibility shouldered by native load customers is substantially reduced. If those revenues are small, then the actual dollars paid by native load consumers are closer to the full revenue requirement.

Prior to passage of the 1992 Act, this state of affairs, coupled with substantial liabilities associated with reliability problems and competitive threats, created huge incentives for denying third party access to the grid. The open access requirements of the Act and subsequent FERC implementation actions created a legal barrier to following these incentives, but they did not alter the fact that revenues derived for transmission services had little or nothing to do with efficient access and pricing.

The opening of the wholesale market to competition and FERC's increased attention to the terms, conditions, and pricing of unbundled transmission services has, to date, brought little or no action from state regulators responsible for regulating retail markets. Despite a resolution passed by the National Association of Regulatory Utility Commissioners in the

early 1990s suggesting that the states begin contemplating the removal of transmission from retail rate base, little activity has taken place.

There are a variety of reasons for this inactivity. One is simple lethargy. Another is that, because state regulators have historically thought in terms of bundled rates rather than discrete functions, transmission costs have been overlooked because they constitute such a small part of the costs of a vertically integrated utility. A third reason is the daunting nature of the challenge of sorting out and allocating costs, undoing cross-collateralization of assets, deciding a host of equity and fairness matters, such as native load priority, thinking through the reliability issues, and a myriad of other difficult tasks that need to be done in order to effectively unbundle.

Additionally, and not inconsequentially, there are legal reasons for the states' lack of activity. They fall into three basic categories. The first is the fear that state jurisdiction over transmission applies only to bundled retail service. Thus, any unbundling, it is feared, will lead to the state losing retail transmission jurisdiction altogether. Whether that argument has merit or not has not been determined by the Courts, but it has certainly been advanced by enough parties to make it impossible for state regulators to overlook the possibility of their jurisdiction shrinking should they choose to unbundle.

The second legal issue is that a number of state certification and siting laws require that the benefits of a proposed transmission facility be primarily designed to serve consumers within a state's boundaries. That requirement, coupled with the fact that the planning and pre-approval of such facilities in the certification process approximates a finding of prudence assuring, absent construction mishaps, full cost recovery for the utility building the line, makes it difficult to remove the "fig leaf" of planning to meet native load requirements as the chief motivator for siting a new line. In fact, in some cases the "fig leaf" may be intentionally removed by incumbents in order to provide a barrier to market entry in a transmission constrained market.

The third legal problem is the possibility of a "taking" argument if the transmission pricing and grid use patterns are such that a utility lost the opportunity for full cost recovery for investments that had never been found to be imprudent. Finally, there is the simple equity question for state regulators, namely priority of service for native load customers, the traditional bearers of the residual revenue responsibilities for the grid. Many state regulators are deeply concerned about this issue; it is a priority to which they attach great importance.

Regardless of the reasons for inaction, however, the simple fact is that there is no evidence of retail unbundling on the scale required to send transmission price signals to end users. That being the case, whatever price signals are created on the grid, the likelihood that the price signals will be passed on to the retail customer, while not precluded, is not great.

For the FERC, which has made "comparability" the standard for utility compliance with open access requirements, the resounding inactivity in the states on transmission renders the

standard, at a minimum, very difficult to put into effect. If all customers are held to similarly constructed, or comparable rates, "comparability" makes eminent sense. Where one set of customers, however—the retail customers—are asked to bear all of the residual revenue requirements of the grid, and wholesale customers pay only for their share of the use of the grid, equity and fairness suggest that "comparability" is less than fair. Arguably, it mandates that one set of customers gets use of the grid on exactly the same terms and conditions as another set of consumers who bear substantially greater risks.

This is not to suggest that FERC is wrong to employ "comparability" as a standard. It is not entirely clear what alternative there is for the agency. Similarly, state regulators would not be wrong to argue that retail customers are entitled to higher priority of service because they are at greater risk in meeting the grid's revenue requirements. While states could perhaps solve that problem by removing transmission from rate base and either acquiesce to FERC's assuming retail transmission jurisdiction or, if legally permissible, set unbundled retail rates, there is still the question of deriving the full value from the assets for which they have been paying for many years. Thus, even were states to agree to unbundle and/or acquiesce to FERC jurisdiction over retail transmission service, the transitional issues are not without their own complexity. The disputes concerning firm transmission rights being waged in some regions is an example of the complexity of the transition issues.

The lack of retail transmission pricing also serves to limit the options available for regional transmission organizations (RTOs). While ISOs are obviously capable of operating within the existing regime and so, perhaps, are not-for-profit transcos, it is hard to comprehend how a for-profit transco can operate as an RTO, unless it is nothing more than the unbundling of an existing utility. Even then, however, because, as noted earlier, transmission revenues are a zero sum game for utilities, price signals and profit opportunities may not be sufficient to provide any incentive other than those that exist at present. For there to be a meaningful environment in which for-profit transcos can operate effectively, the states would have to either unbundle or be preempted.

It might be argued that the "solution" to the problem would be for the FERC or Congress to preempt the states on retail transmission services. It seems politically unlikely that Congress will move to do so. If FERC were to attempt to do so, a court challenge seems likely. The outcome of such a challenge is uncertain. While many have argued that FERC acquires jurisdiction when the states unbundle retail transmission, as noted earlier, the Courts have not yet spoken on the issue. Regardless of what a court might hold, however, the preemption "solution" for the problem at hand is not who has jurisdiction over unbundled retail transmission, but whether FERC can assert jurisdiction in order to compel retail unbundling. The outcome of a legal battle on that issue is even less certain. Moreover, even if FERC were to successfully assert jurisdiction in order to force retail unbundling, and it were to get the pricing right in order to provide adequate incentives for transmission owners to invest, it would still encounter further problems in the jurisdictional thicket.

These problems stem from the fact that states have exclusive jurisdiction over the siting of transmission lines, thereby putting the states in the position of placing institutional and legal barriers in the way of following the economic incentives. Indeed, given the difficulties associated with siting new lines for the purpose of serving domestic load within a state, the idea of building a line whose primary benefits might accrue to out-of-state interests seems even more likely to attract serious, and perhaps fatal, opposition. Once again, Congress could preempt the siting issue, but the politics of doing so make that seem even more politically improbable than preempting retail transmission service.

The simple reality is that there appears to be no easy way to harmonize the pricing of retail and wholesale transmission service. There appear to be only two realistic choices in the near term. The first is to simply continue to ignore the differences and improvise around them where they become particularly problematic. Some argue that the PJM and California license plate approach is a way of harmonizing retail and wholesale transmission service. Others might contend, however, that it is as good an improvisation as can be made. The second choice, which, in the short run, may not look too different than the first, is to put the issue on the table for FERC-State dialogue, along with the issue of RTOs.

Over the longer term, two facts appear inevitable. The growth of competition and demands for efficiency in electricity markets, both wholesale and retail, will make the dual pricing regime less sustainable and less manageable over time, and cause the FERC a great deal of frustration. That will lead to the second inevitable development: Increased calls for Congressional preemption of all transmission issues. The inevitability of these two developments ought to provide both state and federal regulators, as well as many of the constituencies of electricity regulation, ample incentive to try to resolve matters in a sensible manner.