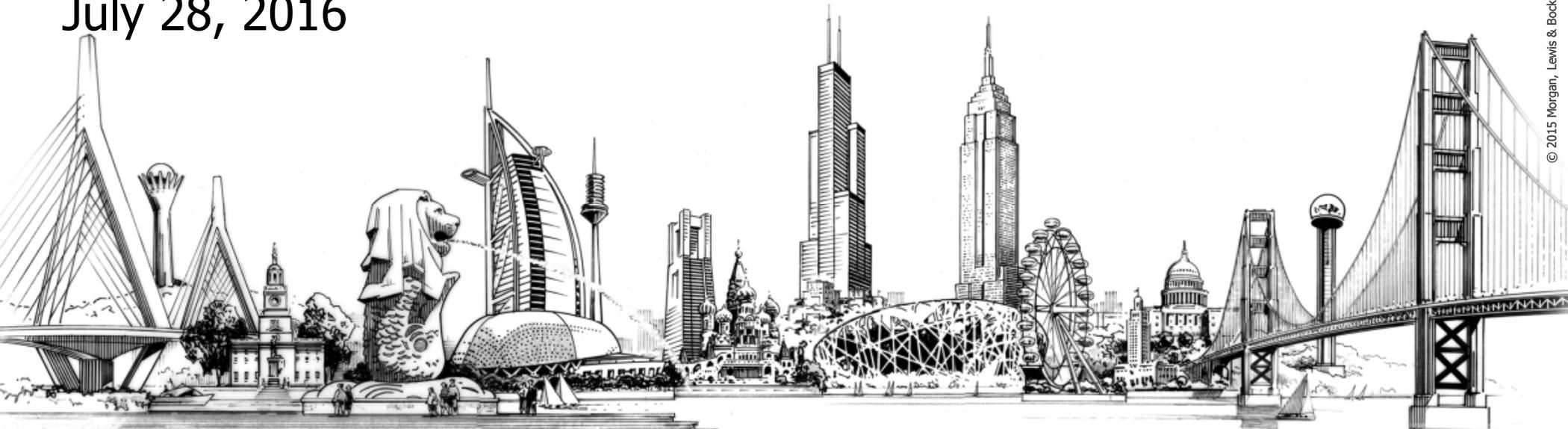


Morgan Lewis **COMPETITIVE TRANSMISSION DEVELOPMENT**

Stephen M. Spina

J. Daniel Skees

July 28, 2016



Agenda

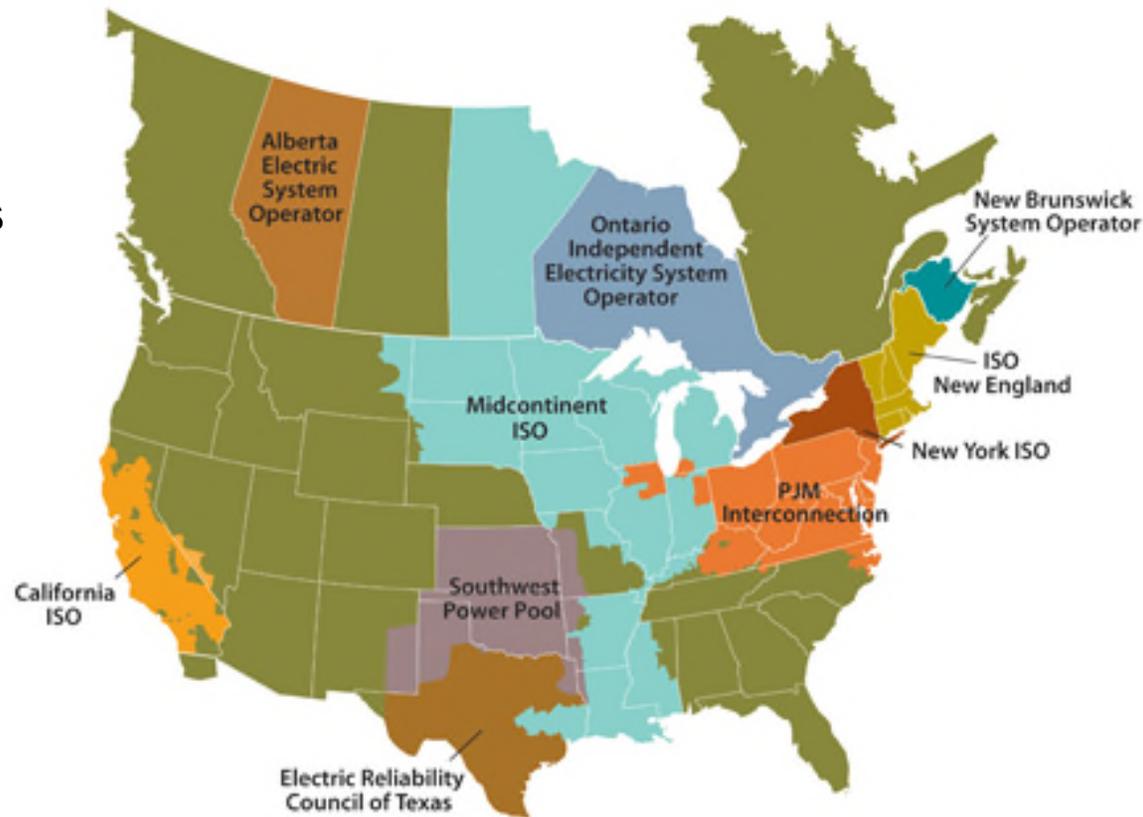
- Why develop transmission?
- Competitive transmission development update
 1. Recent transmission development models and their success
 2. The issues most likely to lead to disputes
 3. The role of developer cost caps in developer selection
 4. The role of rate proceedings following developer selection
 5. The transmission needs that have been overlooked
 6. Potential changes in developer incentives
- Questions

INTRODUCTION: WHY DEVELOP TRANSMISSION?

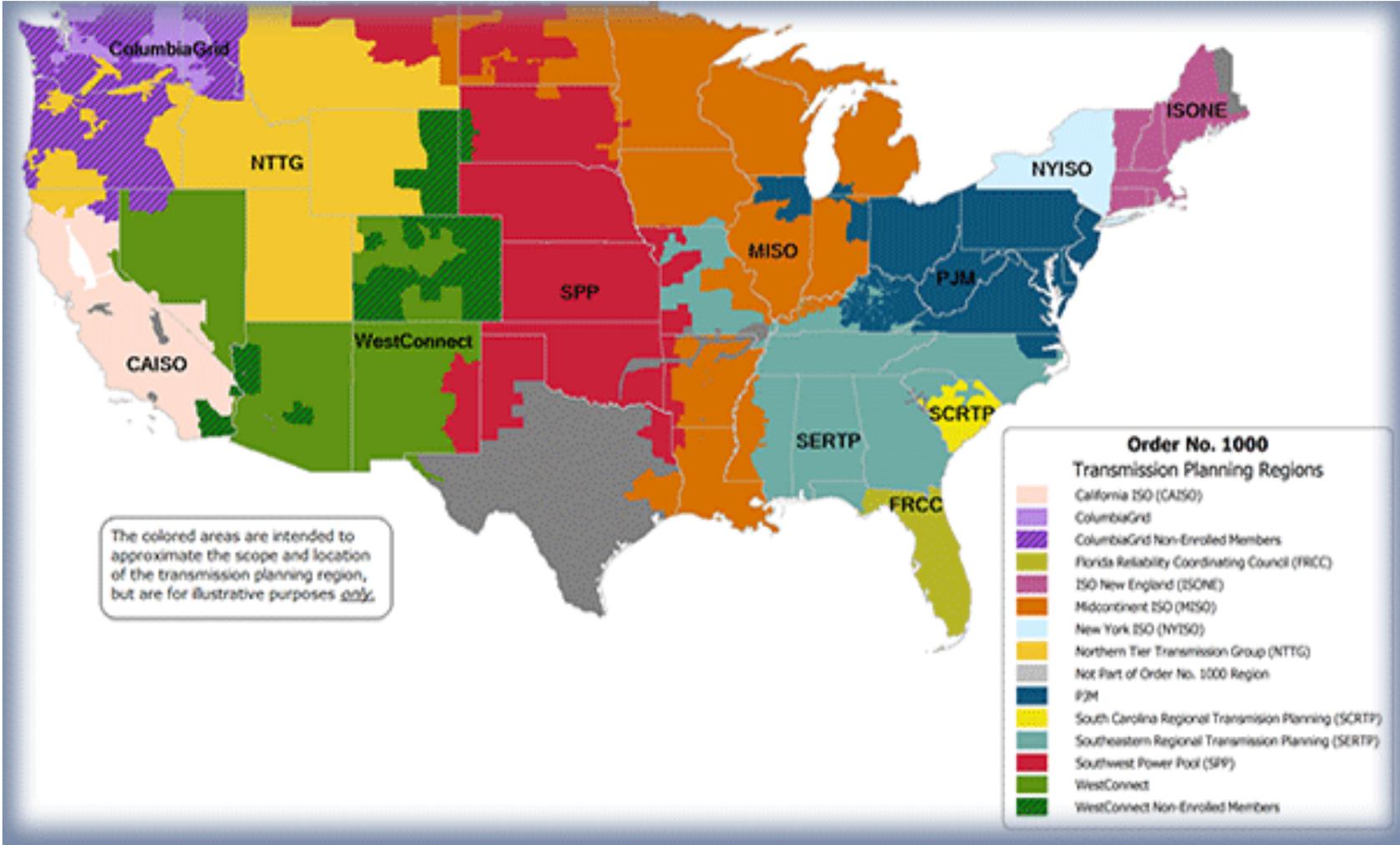
Transmission Development: Why Now?

- Order No. 1000 greatly expanded the areas with mandatory, large-scale transmission planning beyond the RTOs

RTO Regions



Transmission Development: Why Now?



Order No.
1000 Planning
Regions

Transmission Development: Why Now?

- “Rights of First Refusal” removed from FERC-jurisdictional agreements, opening every regional transmission project to competition
- This move was controversial for those regions with a federal right of first refusal (RTOs), but FERC’s decision was upheld by each court that has reviewed it so far:
 - *South Carolina Public Service Authority v. FERC* (DC Cir. 2014)
 - Rulemaking order upheld general directive to remove ROFRs, but did not rule on whether *Mobile-Sierra* provisions in individual agreements would protect ROFR provisions in those agreements
 - *Oklahoma Gas & Electric Co. v. FERC* (DC Cir. 2016)
 - Order confirming that *Mobile-Sierra* did not apply to SPP owners’ agreement
 - *MISO Transmission Owners v. FERC* (7th Cir. 2016)
 - Order confirming that *Mobile-Sierra* did not apply to MISO owners’ agreement
 - *American Transmission Systems Inc. v. FERC* (DC Cir. 2016)
 - Order finding that petitioners had not properly preserved challenges alleging that the ROFR in the PJM owners’ agreement was protected by *Mobile-Sierra*

Transmission Development: Why Now?

- Order No. 1000 cost allocation and cost recovery
 - Binding cost allocation methodologies for multiple project types
 - Reliability projects
 - Economic projects
 - Public policy projects
 - Combined project types
 - Developers are selected for individual projects and provided the opportunity to rely upon the applicable cost allocation methodology if the projects are built
 - Cost-based recovery
- Expanding need for transmission
 - Load changes driving need for transmission that can support it
 - Production savings through access to less expensive generation
 - Access to green power resources

Transmission Development: What Are the Benefits?

- Many projects in many regions need to be developed for each category of need
 - Renewable integration a growing percentage: 46% of projects in 2015 intended to facilitate renewables
- Expertise in transmission development is not widespread compared to other avenues of capital investment, reducing the pool of investors likely to be successful in competitive development
- Cost-based rates for projects identified through regional plans provide a guaranteed revenue stream, which can be attractive to investors
 - For traditional investor-owned utilities, such investments provide increased returns in a time of decreased load-growth
 - For financial investors, these investments can provide guaranteed and significant long-term returns

COMPETITIVE TRANSMISSION DEVELOPMENT UPDATE

Recent Transmission Development Models and Their Success

- Traditional transmission expansion projects continue apace in each RTO
 - Example: ITC Midwest's Multi-Value Projects 3 & 4
 - Example: Minnesota Power's Brookings County to Hampton line
- Cost-based Order No. 1000 regional transmission projects are commencing, although many regional processes are only in the early stages
 - Transource's Nebraska City—Sibley Line and Iatan—Nashua line
- Merchant transmission proposals
 - Chinook Power Transmission, LLC (open season allocation of capacity)
 - Maine Power Express, LLC (open solicitation allocation of capacity)
- Non-competitive transmission projects remain an option—even under Order No. 1000—for local projects
- Partnership for development are becoming more popular: 36% of in-progress projects in 2015
- Overwhelmingly high-voltage projects: 66% of projects in 2015 were 345 kV+

Cost-Based Rates vs. Merchant Transmission

Key Differences

Traditional Projects

- Cost-based rates provide rate of return
- Protection for developer against cost overruns
- Less development risk
- Full regulatory transparency
- Heightened 206 risk

Merchant Projects

- Negotiated rates can provide a higher return
- Negotiated rates provide an opportunity to improve profits through greater efficiency
- Little protection for developer against cost overruns
- Significant risk during development
- Less regulatory transparency
- Less 206 risk

What Is a Cost Cap?

- Cost caps exist in the competitive transmission context and are used to make a project proposal more attractive in the competitive evaluation: to show that they are more cost effective or efficient than the alternatives proposed to fill a given need
 - Cost must be a part of the evaluation in any event, even without a cost cap
- Cost caps are intended to provide ratepayer protection by guaranteeing that the development costs for a transmission project will not surpass a particular level
 - BUT can be subject to exclusions to address certain contingencies
- Cost caps exist at an unusual nexus between (a) transmission expansion a traditional RTO or regional responsibility and (b) transmission ratemaking, the exclusive responsibility of FERC
- Cost caps allocate risk between load responsible for paying for transmission expansion and project investor

The Benefits of Cost Caps

- Transmission is cost-based, with a return on that investment, which undermines the normal incentive to deliver at the lowest cost
 - Cost caps serve as a disincentive for excessive expenditures in constructing and maintaining a project
 - Cost caps are intended to protect ratepayers from the risk of cost overruns and provide a level of long-term assurance on transmission costs
- If the developer cannot deliver for under the cap, the cost overruns are the responsibility of the developer
- Can provide a quantitative measure to distinguish between otherwise similar projects or project developers—a benefit to regional transmission planners

The Risks of Cost Caps

- Could lead to the selection of the project with the lowest promised cost, which may not be the best project
- Forces RTOs to engage in more ratemaking analysis; RTOs traditionally have limited role in ratemaking; rate concerns could drag out the project selection process
- Litigation “down the road” if projects are less reliable or developer fails
- Could overwhelm other aspects of project proposals leading to competitions only on cost
- Cost caps are permanent, but customers could file a section 206 complaint at any time, which could lower the return even more
 - But there is an open question as to whether developers themselves could challenge their own cost caps in certain circumstances
- Exclusions exist, which could undermine the benefit of the cost cap
- Projects could be more likely to fail because a developer faced with significant cost overruns could choose to abandon a project rather than spend significant sums that are unrecoverable
 - Particularly problematic for reliability projects where not completing the projects is rarely an option

Cost Cap Improvements and Alternatives for Cost Containment

- Various parties have suggested the following as improvements to the use and implementation of cost caps in regional transmission processes
 - Greater regional expertise in evaluating the likely cost of delivering the promised projects
 - Limiting the scope of cost caps generically, such as applying cost caps to capital costs and not cost of capital (i.e. remove ROE from the cost cap)
 - Applying cost caps only to competitive bidding model, not sponsorship model, to ensure “apples-to-apples” evaluations
 - Exclusion of developer incentives from consideration in evaluating bids
- Suggested alternatives to cost caps include:
 - Greater specificity in scoping the work for a project
 - Requiring detailed cost estimates in proposing projects

Role of Rate Proceedings Following Developer Selection

- Any recovery of transmission rates requires FERC filing and approval, BUT what will that review entail?
 - What will be reviewed?
 - The regional plan and the needs it identified?
 - The projects selected by the region?
 - The developer selected for a project?
 - The allocation of costs?
 - The proposed rate structure?
 - Will that review be process-oriented (i.e. did the region follow the tariff) or will FERC review the justness and reasonableness of each issue that led to the selection of the project, developer, and allocation of cost?
- What role will competitors take in these proceedings, given that they stand to gain the most if FERC requires a re-bid?
- What role will the region and its utilities take in these proceedings?
- Litigation over project and developer selection may ultimately be the main source of FERC guidance on these issues

Issues Most Likely to Lead to Disputes

- Key issue: FERC's standard of review is unclear.
 - Will FERC simply evaluate whether the region followed its process, or will FERC review the substance of the decision itself?
- Litigation risks in project and developer selection include:
 - Setting the project for hearing puts all of the underlying issues on the table
 - Developer selection through the regional planning process, which is inherently qualitative in many aspects
 - Cost containment proposals in bids, including the weight they are given and how they are evaluated
 - Proposals can have different exclusions, different rate design, which makes evaluation difficult
 - Regions and RTOs are more likely to make errors in these ratemaking issues
 - Will cost containment contracts be subject to renegotiation in certain circumstances?
- The effects of litigation
 - Delayed transmission project delivery
 - Economic and reliability benefits not delivered on time, resulting in greater production costs or less economic short-term fixes
 - Access to "clean" power resources not achieved on time, delaying the retirement of more carbon-intensive generation

Potential Changes in Developer Incentives

- At FERC's recent technical conference on transmission development, entities floated a number of proposals to modify the existing incentives for developing transmission projects, including the following:
 - ROE incentive changes:
 - ROE adder for projects developed under cost caps
 - Standardizing the ROE for transmission development companies
 - Presumption that projects with a cost cap receive an ROE towards the top of the zone of reasonableness
 - In establishing ROE for competitive transmission developers, allow the use of a different proxy group than incumbent utilities
 - Limiting the availability of ROE incentives to existing public utilities
 - ROE added for delivering project under cost cap
 - Removing the RTO adder
 - Allow recovery of prudently incurred cost overruns for cost-capped projects, but reduce the ROE

Potential Changes in Developer Incentives

- Proposed changes in non-ROE incentives
 - Removal of technology adder
 - Introduction of a congestion reduction incentive
 - Automatic grant of CWIP and abandoned cost recovery for projects selected through competitive processes
 - “Certainty incentive” (i.e. automatic *Mobile-Sierra*)

Overlooked Transmission Needs

- Transmission needs have been limited to reliability projects, economic projects, and public policy projects
- “Resiliency” projects are a need utilities have not historically addressed
 - CIP-014 and the identification of the most “critical” substations
 - Traditional protections for these substations enhance their physical protections
 - This significantly reduces the attack vectors for most likely attacks, but has substantial risks due to “eggs in one basket problem”
 - Far beyond an N-1, N-2, or N-3 analysis
- A transmission development option provides greater security, and also an investment opportunity
 - Major, high voltage substations can be split into smaller substations that serve fewer lines
 - The loss of several smaller substations will have significantly lower risk to reliability than the loss of several large substation

Questions?

Competitive Transmission Development

July 28, 2016

Stephen M. Spina
(202) 739-5958
sspina@morganlewis.com

J. Daniel Skees
(202) 739-5834
dskees@morganlewis.com

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Almaty	Dallas	Los Angeles	Philadelphia	Singapore
Astana	Dubai	Miami	Pittsburgh	Tokyo
Beijing	Frankfurt	Moscow	Princeton	Washington, DC
Boston	Hartford	New York	San Francisco	Wilmington
Brussels	Houston	Orange County	Santa Monica	
Chicago	London	Paris	Silicon Valley	



Morgan Lewis

THANK YOU

This material is provided for your convenience and does not constitute legal advice or create an attorney-client relationship. Prior results do not guarantee similar outcomes. Attorney Advertising. Links provided from outside sources are subject to expiration or change.

© 2015 Morgan, Lewis & Bockius LLP

Morgan Lewis