

**COMMENTS OF TROUTMAN SANDERS LLP
ON THE
EUROPEAN REGULATORS GROUP FOR ELECTRICITY AND GAS
DRAFT PROPOSAL ON GUIDELINES ON INTER-TSO COMPENSATION**

In response to the “EREGG Draft Proposal on Guidelines on Inter-TSO Compensation” and the accompanying Cover Note and Explanatory Note, Troutman Sanders LLP (“Troutman Sanders”) is pleased to provide the following comments.

I. IDENTITY OF COMMENTER.

Troutman Sanders is an international law firm with approximately 650 attorneys resident in offices in the United States, the United Kingdom, and Hong Kong. Troutman Sanders has extensive experience with energy regulatory and transactional issues in both Europe and the United States. These comments are offered to inform the debate on the ERGEG Draft Proposal on Guidelines on Inter-TSO Compensation, and are based primarily on Troutman Sanders’ experience in the United States in attempting to resolve the same issue.

II. COMMENTS.

A. Analogy between the United States and European Union.

The electric industry in the United States has undergone significant restructuring since the Federal Energy Regulatory Commission (“FERC”) issued its landmark Order No. 888 a decade ago.¹ While Order No. 888 and later FERC orders touch on many aspects of electric industry restructuring, the rise of regional transmission organizations (“RTOs”) and Independent System Operators (“ISOs”) is particularly relevant to the debate on the ERGEG Draft Proposal on Guidelines on Inter-TSO Compensation. RTOs and ISOs in the United States are the rough

¹ *Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, Order No. 888, FERC Stats. & Regs. [Regs. Preambles 1991-1996] ¶ 31,036 (1996), *on reh’g*, Order No. 888-A, FERC Stats. & Regs. [Regs. Preambles 1996-2000] ¶ 31,048 (1997), *on reh’g*, Order No. 888-B, 81 FERC ¶ 61,248 (1997), *on reh’g*, Order No. 888-C, 82 FERC ¶ 61,046 (1998), *aff’d in part and remanded in part, sub nom., Transmission Access Policy Study Group, et al., v. FERC*, 225 F.3d 667 (D.C. Cir. 2000), *aff’d*, *New York v. FERC*, 535 U.S. 1 (2002).

equivalent to the European Transmission System Operators (“TSOs”): RTOs and ISOs independently operate the bulk transmission system over a particular region.²

In the United States, RTOs or ISOs operate the transmission systems for large portions of the country, while the remainder of the country’s transmission grid is operated by individual entities, including investor-owned, vertically-integrated companies and government-owned utilities. The following list identifies the currently operating RTOs and ISOs in the United States, as well as the regions they serve:

- ISO New England: New England (Northeast)
- New York ISO: State of New York
- PJM Interconnection, L.L.C.: Mid-Atlantic and Portions of Midwest
- Midwest ISO: Midwest
- SPP RTO: Portions of South Central and Southwest
- California ISO: Nearly all of California

While each of these RTOs and ISOs serves a portion of a single country, and the European TSOs generally serve an entire country, similar coordination and cross-border transaction issues arise in both settings. The issue of transmission pricing for cross-border sales of electricity has not been handled uniformly in the United States, as discussed below. Troutman Sanders respectfully submits that the European debate on this subject can be informed by the lively debate that has already occurred (and continues today) within the United States.

B. Cost-of-Service Transmission Pricing in the United States.

While the pricing of transmission for inter-regional transfers is a very specific rate issue, it is useful to set forth the general approach to transmission ratemaking in the United States to

² It should be noted that the word “operate” is used intentionally here to deliver a precise meaning. RTOs and ISOs do not “own” the transmission facilities, but the transmission owners (largely investor-owned) have given over operational control of their transmission facilities to the various ISO or RTO organizations.

better establish the context for these comments. While the commodity component of the electric industry (generation) has been subjected to competitive forces, transmission remains a monopoly service that is generally regulated on a cost-of-service basis. In practice, a transmission owner files a transmission “rate case” with FERC, and FERC establishes a rate using traditional cost-of-service regulation principles. This approach establishes a “revenue requirement” for the transmission owner through the following formula:

$$RR = E + (V-D)r$$

where “RR” = Revenue Requirement; “E” = Operating Expenses; “V” = Value of Property; “D” = Accrued Depreciation; and “r” = Rate of Return. The revenue requirement is the amount of money that the transmission owner is entitled to collect and is coupled with a denominator equal to the number of billing determinants (customers) to establish a rate.

The rates calculated through the above-described methodology allow a transmission owner to fully recover its revenue requirement and are charged to a transmission owner’s “network and native load customers.” These customers are, generally speaking, captive customers not engaged in point-to-point inter-regional transfers. Thus, a question that immediately arises is what to do with revenues that a transmission owner may derive from providing point-to-point transmission service for inter-regional transfers (*e.g.*, charges paid by customers in other areas who use the transmission owner’s facilities to import or export energy). Generally, the answer to this question is that these revenues are applied as a “revenue credit,” and serve to lower the rates paid by network and native load customers. For this reason, the prospect of eliminating charges for inter-regional transfers, in the interest of promoting efficient cross-border power transactions, has become an emotional issue in certain parts of the United States because it pits the interests of customers in different regions or states against one another.

C. Transmission Rate Pancaking as Disincentive to Efficient Trades.

Over the past decade, regulators in both the European Union and the United States have recognized that the traditional pricing structure for cross-border power transactions -- in which customers are charged a separate fee by each successive transmission owner on the transmission path for the use of its facilities -- can create substantial disincentives to otherwise efficient trades. In 1999, for example, FERC described this problem as follows:

Except for transactions within the ISOs now in place, transmission customers are faced with additional access charges for every utility border they cross. The distances need not be great to be assessed two, three or more access charges for a single transaction. This duplication can severely restrict the area in which generation can economically be secured.³

That description mirrors ERGEG's observation that "the need for wholesale market players wishing to trade across borders to pay two or more sets of transmission tariffs," also known as "pancaking" of tariffs, "would tend to promote trade within a Member State at the expense of potentially more efficient trades and competition in trade between Member States."⁴

To address such concerns, FERC has encouraged the growth of RTOs and ISOs, within which transmission rate pancaking is eliminated. FERC has also ordered or otherwise approved the elimination of rate pancaking between certain RTOs and ISOs. Among other benefits that are intended to flow from these policies, FERC has stated that implementing non-pancaked rates allows RTOs and ISOs to "expand the market for generation to a large region," and that "[a] wider area served by a single rate means more generation is economically available to any customer which means greater competition for energy."⁵

³ *Regional Transmission Organizations*, Order No. 2000, FERC Stats. & Regs. [Regs. Preambles 1996-2000] ¶ 31,089 at 31,174 (1999), *on reh'g*, Order No. 2000-A, FERC Stats. & Regs. ¶ 31,092 (2000), *petitions for review dismissed sub nom., Public Utility Dist. No. 1 of Snohomish County, Wash. v. FERC*, 272 F.3d 607 (D.C. Cir. 2001)

⁴ Cover Note at Section 2.1. The term "rate pancaking" reflects the idea that as power moves from one system to the next, the charges imposed by each successive transmission owner stack up like pancakes.

⁵ Order No. 2000 at 31,174-75.

D. Alternatives to Transmission Rate Pancaking.

The decision to eliminate transmission rate pancaking in certain regions of the United States has often been coupled with debate over what transmission pricing structure should take its place. In addressing that issue, a recurring question for FERC has been how much responsibility for the costs of transmission facilities should be assigned to parties that are located outside of the region in which those facilities are located. An important consideration for FERC in answering that question is who benefits from the transmission facilities in question. In some instances, FERC has emphasized wide-ranging benefits associated with the expansion of energy markets and, therefore, has favored comparatively straightforward cost assignment methodologies rather than attempting to match benefits and costs precisely. In other instances, FERC has adopted a narrower view of the benefits associated with eliminating rate pancaking and has attempted to more precisely align cost assignments with those benefits.

1. “License Plate” Rates.

One alternative transmission pricing structure that FERC has approved repeatedly is termed a “license plate” rate because it provides access to a regional transmission system at a single rate, rather than requiring a customer to pay pancaked rates, but that single rate may vary based on where the customer is located.⁶ Under a license plate rate structure, the single rate paid by customers within any given pricing zone is designed to recover the costs of the transmission facilities within that zone, in return for which the customers gain access to the entirety of a larger region’s transmission system. FERC has found this structure to be appropriate, at least on an initial and interim basis, on the grounds that transmission owners have largely constructed their existing transmission facilities to serve their local load, and that eliminating rate pancaking leads

⁶ *Id.* at 31,176. Further explaining the “license plate” nomiker, FERC has stated that registering a car in one state within the United States, paying that state’s fees, and obtaining a license plate from that state allows that car to be driven on the roads and highways of all other states within the United States. *Id.* at n. 619.

to broader transmission access that benefits all market participants.⁷ Indeed, FERC's acceptance of license plate rates was an important component of the agreements that led to the establishment of nearly all of the RTOs and ISOs in the United States.⁸ More recently, FERC emphasized the wide-ranging benefits that would accrue to all market participants when it accepted a license plate rate structure as the basis for eliminating an "inefficient inter-regional seam" (e.g., rate pancaking) between the New York ISO and ISO New England.⁹

Even as it has approved the use of license plate rates, however, FERC has expressed concerns about this pricing structure. For example, FERC has stated:

Because license plate rates allocate the cost of facilities to local load, they can present an impediment to construction of new facilities that benefit remote load because local regulators with authority over siting of such facilities are reluctant to approve construction of such facilities if local load will bear the cost but not receive commensurate benefits.¹⁰

FERC has also stated that by allocating the costs of all transmission facilities locally, license plate rates "can result in abrupt cost shifts" as the portion of the transmission owner's revenue requirement that was previously recovered from customers in other zones under pancaked rates would instead be borne by customers within the license plate pricing zone in which particular transmission facilities are located. FERC has sometimes sought to alleviate such cost shifts by incorporating "lost revenue" recovery mechanisms into the license plate rate structure.¹¹ In one instance, FERC imposed a non-transaction-based surcharge on importing load as a rate

⁷ See, e.g., *Midwest Indep. Transmission Sys. Operator, Inc.*, 109 FERC ¶ 61,168 at PP 56-60 (2004).

⁸ See *Pac. Gas and Elec. Co.*, 81 FERC ¶ 61,122 at 61,500, 61,504 (1997) (California ISO); *Pennsylvania-New Jersey-Maryland Interconnection*, 81 FERC ¶ 61,257 at 62,248-49 (1997) (PJM Interconnection, L.L.C.); *New England Power Pool*, 83 FERC ¶ 61,045 at 61,238 (1998) (ISO New England); *Midwest Indep. Transmission Sys. Operator, Inc.*, 84 FERC ¶ 61,231 at 62,166-68 (1998) (Midwest ISO); *Central Hudson Gas & Elec. Corp.*, 86 FERC ¶ 61,062 at 61,211-12 (1999) (New York ISO).

⁹ *ISO New England, Inc.*, 109 FERC 61,147 at P 63 (2004), *on reh'g*, 110 FERC ¶ 61,111 at P 21 (2005).

¹⁰ *Midwest Indep. Transmission Sys. Operator, Inc.*, 109 FERC ¶ 61,168 at P 60 (2004).

¹¹ *Id.* at P 58, citing *Alliance Cos.*, 94 FERC ¶ 61,070 (2001); *PJM Interconnection, LLC and Allegheny Power Co.*, 96 FERC ¶ 61,060 (2001); *Midwest Indep. Transmission Sys. Operator, Inc.*, 98 FERC ¶ 61,076 (2002).

mechanism intended to allow transmission owners to collect for a transition period the revenues that they would have received but for the elimination of rate pancaking.¹² That transitional rate mechanism itself generated substantial controversy, in part because of concerns that it placed an unfair burden on load, when generators, marketers, and other market participants in both importing and exporting pricing zones also benefit from the elimination of rate pancaking.¹³

2. “Postage Stamp” Rates and Other Alternatives

Because of FERC’s and certain transmission owners’ concerns about long-term reliance on license plate rates, other possible replacements for a rate pancaking regime have also received considerable attention. At the opposite end of the spectrum from license plate pricing, which allocates the costs of transmission facilities to customers in the zone where those facilities are located, is a pricing structure that has been termed a “postage stamp” rate. Postage stamp pricing establishes a single transmission rate that is applicable to all customers in a region, without variation based on where a customer is located, on the theory that all customers benefit from the availability of a larger energy market and should contribute toward the cost of all transmission facilities that make such a market possible. To date, FERC has expressed concern about adopting postage stamp pricing for RTOs or ISOs, because this rate structure “spreads the cost of transmission facilities throughout the region on a regional average basis, resulting in significant cost shifts from higher to lower cost regions.”¹⁴ Nonetheless, postage stamp pricing has notable

¹² *Midwest Indep. Transmission Sys. Operator, Inc.*, 109 FERC ¶ 61,168 at P 61 (2004). *See also Midwest Indep. Transmission Sys. Operator, Inc.*, 105 FERC ¶ 61,212 (2003).

¹³ It is interesting to note that ERGEG appears to have avoided this pitfall by proposing that contributions to the inter-TSO compensation fund “shall be paid equally by the entities of origin and destination (exporting and importing countries).” Explanatory Note at Section 3.3.

¹⁴ *Midwest Indep. Transmission Sys. Operator, Inc.*, 109 FERC ¶ 61,168 at P 56 (2004).

proponents, including several parties to an ongoing FERC case that is examining whether it is just and reasonable for PJM Interconnection, L.L.C. to continue using license plate rates.¹⁵

Another possible replacement for a rate pancaking regime combines postage stamp rates and license plate rates by making each applicable to a class of transmission facilities, generally as defined by voltage. Such “highway-byway” proposals are based on the assumption that higher-voltage facilities play a greater role in inter-regional transfers and, therefore, provide greater benefits to customers in other regions than do lower-voltage facilities. In turn, these proposals call for the costs of higher-voltage “highway” facilities to be allocated widely on a postage stamp rate basis, while the costs of lower-voltage “byway” facilities are allocated locally on a license plate rate basis. Critics contend that any choice of a voltage cut-off to distinguish highway and byway facilities is arbitrary, and FERC has stated that “generalizations about the function of transmission facilities operating at different voltage levels” do not adequately analyze the actual function of facilities in supporting regional reliability or regional markets.¹⁶ Despite these concerns, highway-byway pricing also has notable proponents, again including parties to the ongoing FERC case that is examining whether it is just and reasonable for PJM Interconnection, L.L.C. to continue using license plate rates.¹⁷

Finally, certain Transmission Owners in the United States have proposed replacing a rate pancaking regime with a “usage-based” pricing structure that would rely on a simulation model to project what pricing zones will import energy from other zones, and then allocate to customers in the importing zones a portion of the costs of the exporting zones’ transmission facilities.

FERC rejected that proposal as unsupported, finding that it “relies upon numerous assumptions

¹⁵ See, e.g., FERC Docket No. EL05-121-000, “Initial Brief of the Commission Trial Staff,” May 17, 2006.

¹⁶ *Midwest Indep. Transmission Sys. Operator, Inc.*, 109 FERC ¶ 61,168 at P 64 (2004).

¹⁷ See, e.g., FERC Docket No. EL05-121-000, “Initial Brief of American Electric Power Service Corporation and Allegheny Power,” May 17, 2006.

and forecasts that have not been supported and are in dispute” and “does not satisfactorily address how the usage-based allocation will be coordinated with the assignment of the cost of new facilities to those who benefit from the facilities.”¹⁸

E. Informing the European Debate.

As discussed above, the United States has attempted to use a variety of approaches in tackling the thorny issue of transmission pricing for cross-border sales of electricity. In the interest of allowing remote generators on the “other side of the border” to compete on a more level playing field, those approaches have generally disfavored a transaction-by-transaction charge (the old rate pancaking system). While the approaches considered in the United States have the advantage of aiding in the development of large and liquid wholesale markets for generation, those approaches have also at times created substantial controversy, as reflected in contentious regulatory battles at FERC over who should properly bear what costs.

It appears that ERGEG’s proposal is an attempt to capture the best of both worlds. For example, ERGEG calls for eliminating the transaction-by-transaction charges associated with rate pancaking, and also seeks to defuse the potentially contentious debate over load-based charges by assigning cost responsibility to both “the entities of origin and destination” and by allowing charges to be “trued up” after the fact.¹⁹

In addition to these characteristics, it is worth noting that it may be preferable to “keep things simple” in areas where there is relatively little cross-border activity, much as the New

¹⁸ *Midwest Indep. Transmission Sys. Operator, Inc.*, 109 FERC ¶ 61,168 at P 65 (2004). It is interesting to note that ERGEG appears to have avoided a pitfall associated with the use of forecast data. In contrast to the “usage-based” proposal rejected by FERC, ERGEG’s proposal includes a true-up mechanism that would act as a check on inter-TSO compensation payments that are imposed based on forecast data. Explanatory Note at Section 3.5 (“Ex-post adjustments of paid compensations shall be made when necessary to reflect costs actually incurred Monthly provision payments of compensations will be based on ex-ante calculations using forecast data from cross border flows to be hosted by each TSO and from the transmission network costs incurred by the hosting of these cross border flows Based on data collected during the year an ex-post annual settlement will be carried out for the purpose of reconciliation to finalize the compensation payments of each year.”).

¹⁹ Explanatory Note at Sections 3.3, 3.5.

York ISO and ISO New England were able to eliminate rate pancaking between their markets without the need for a “lost revenue” recovery mechanism, forward-looking “true up,” or other rate design change. A closer look at that situation reveals that two factors made that result possible: (1) the volume of cross-border traffic was relatively small compared to other inter-regional situations (*e.g.*, Midwest ISO and PJM Interconnection, L.L.C.), and (2) regulators were willing to let transmission owners recover the increment of revenues related to cross-border transactions from their own network and native load customers. As European markets continue to develop, and assuming proper consensus among sovereign nations can be achieved, alternative potentially comprehensive transmission rate designs may also warrant consideration.

III. CONCLUSION.

The United States has devoted significant effort over the past decade to developing transmission pricing policies that promote efficient cross-border sales of electricity. While debate on that issue is ongoing, weighing the advantages and disadvantages of the various transmission pricing structures that FERC has considered as alternatives to a rate pancaking regime may assist ERGEG in avoiding pitfalls that have emerged in the United States. In addition, the substantial controversy that has surrounded some of those proposals illustrates that there are benefits to transmission pricing structures that are “straightforward to understand and verify.”²⁰ For all of these reasons, the lively debate that has already occurred (and which continues today) within the United States on the issue of transmission pricing for cross-border sales of electricity can inform the European debate on the same subject.

²⁰ Cover note at Section 4.3.

We appreciate the opportunity to comment on ERGEG's proposal.

Respectfully submitted,
