

FERC Formula Rate Resurgence

Transmission Cost Recovery Revisited

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FERC transmission formula rates are experiencing a revival. For many years, transmission formula rates or TFRs worked behind the scenes, quietly providing a return of and on wholesale transmission investments. A confluence of market conditions, new laws, and FERC orders has changed that.

As transmission investment increases and as more transmission owners use TFRs for cost recovery, the importance of these rates to regulators, vertically integrated utilities, transmission developers, and customers is skyrocketing.

Now the FERC formula rate stands at center stage, squarely in the spotlight. This resurgence matters because the emerging TFRs function as the revenue engine at the critical intersection of utility financials, the competitive transmission process promoted in FERC Order No. 1000, retail and wholesale rate jurisdiction, and national energy policy goals for enhancing the transmission grid. In short, utility leaders, federal and state regulators, Transcos, investors, and policymakers are all watching – or should be watching – to see how the renewal of FERC formula rates turns out.

Historical Perspective

FERC permits utilities to set rates through formulas as opposed to stated rates that are numerically fixed. In a formula rate, the formula itself is the rate. As costs vary from year to year, the costs are simply plugged into the formula to determine the resultant charges.

This process spares the utility the time, resources, and risk of filing a new rate case every time transmission-related costs increase. Also, if the formula is properly designed, it helps ensure that the utility's rates do not become too high or too low as costs and loads change over time, protecting buyer and seller alike.

When approving a TFR, FERC approves the formula itself. FERC does not approve the inputs to the formula or the charges resulting from applying those inputs to the formula. The inputs are primarily sourced from the FERC Form 1.

Certain inputs like Return on Equity (ROE) and depreciation rates do not change each year. Other key inputs like transmission plant, O&M expense, and A&G expense are updated annually. The TFR usually includes an after-the-fact true up mechanism to avoid over- or under-recovery of actual revenue requirements.

Adopting a TFR does not put ratemaking on autopilot, as critics claim. Eliminating full-blown rate cases does shrink stakeholder input, as FERC requires utilities to establish procedures called Protocols that allow interested parties to review the formula rate inputs.

The Protocols provide safeguards to make the TFRs transparent. They also ensure that utilities use the correct input data and perform the calculations according to the approved formula. Each year, parties have the right to challenge those inputs or the implementation of the formula when they discover errors. However, parties do not have the right to challenge the formula

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TFRs. Across the country, rates crept up each year as transmission plant investment grew under regional transmission expansion plans. Then a number of factors came together to push the humble TFR onto the main stage.

Changes Converge

A slight shift began in 2012, when FERC initiated an investigation of the MISO Protocols to examine the scope of participation, the transparency of information exchange, and the ability of customers to challenge the application of the MISO formula.

In July 2014, FERC issued a staff guidance document for electric utilities' annual formula rate updates to address common deficiencies that impeded the ability to review and verify that rates are consistent with the formula.

On the same day, FERC directed ten utilities to file new or revised Protocols to address some of these shortcomings. Meanwhile, the cost of debt continued to decline. Downward pressure on ROE grew. As a result, the scrutiny of TFRs expanded beyond the Protocols. For example, in December 2014, NYISO filed a FERC TFR in Docket No. ER15-572, which prompted numerous protests about not only the Protocols, but also the TFR calculations and ROE.

Then the 2017 Tax Cuts and Jobs Act turned the spotlight on to TFRs by reducing the federal corporate income tax rate from thirty-five percent to twenty-one percent, effective January 1, 2018. Many utilities hard-coded the income tax rates into their formulas; rectifying this requires a FERC filing.

The tax cuts also called attention to deferred income taxes.

itself without filing a complaint under Section 206 of the Federal Power Act.

Throughout the last decade, formula rates proliferated without notoriety. In 2015, all thirteen new transmission owners in SPP filed for cost recovery using

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FERC asserted that because of the federal corporate income tax rate reduction, a portion of an ADIT liability collected from customers would no longer be due from public utilities to the IRS. This would be considered excess ADIT and must be returned to customers.

FERC issued a proposed rule in late 2018 and the final ADIT Rule in Order No. 864 in November 2019. The rule required utilities with TFRs to adjust their rate bases for excess or deficient ADIT. The ADIT Rule also required them to add a new permanent worksheet into their rate templates to annually track such information. This precipitated a wave of TFR compliance filings through 2020 that continues today.

Of course no discussion of FERC formula rates would be complete without tackling ROE. Debates around ROE and the method for determining it are not new. In this instance, however, the effect of ROE on TFRs was exacerbated simply by timing. On the same day FERC issued the ADIT Rule, FERC adopted a new base ROE methodology and applied it in a pair of complaint cases against MISO (Docket Nos. EL14-12 and EL15-45).

These orders delivered a one-two punch to the rate analysts working in formula rate circles, setting the stage for more filings and more daunting protests. FERC revised the methodology again on rehearing on May 21, 2020, which will undoubtedly prompt even more filings.

But it doesn't end there. All this attention on ROE, tax rates, and ADIT magnified the customer scrutiny of other items in the formula rates.

Deferred tax assets may correspond to unfunded reserves, which customers argued should be excluded from rate base. Customers also focused on regulatory assets, claiming that FERC requires pre-approval of all regulatory assets for inclusion in rates.

Under the Protocols, debate over these items spurred more informal and formal challenges. Such challenges are littered with arguments over the certainty of anticipated investments, the difference between current and contingent liabilities, and other under-appreciated subtleties of utility accounting practices. FERC resolved a formal challenge of this sort for Ameren Illinois in late 2019, and for Duke Energy Progress in early 2020. Similar challenges continue today.

State Regulators' Interests

Retail ratemaking also plays a part in the formula rate revival. Retail customers rely on transmission too, but in many states, how much those customers pay for transmission is the purview of state regulators, not FERC. Utilities in several jurisdictions like Kansas, Texas, and Arizona allow special line items on retail bills that collect transmission costs from end-users.

Some of these mechanisms use the annual revenue requirement from the TFR as a basis for allocating transmission costs to retail customers. Other utilities incorporate the TFR revenue requirement into stated retail rates in traditional rate filings. In both instances, state regulators have a strong interest in the TFR because they rely on those calculations to make sure utilities do not double-recover transmission costs.

State commissions have also been vocal challengers to several TFR filings, claiming that either the proposed Protocols or more critical TFR elements like ROE are unreasonable. For example, in 2015, the Kansas Corporation Commission filed a rate complaint with FERC claiming that the ROE approved in Westar Energy's FERC TFR was too high. After FERC approves formula rates, state commissions routinely participate in customer meetings and in the annual information exchanges under the Protocols.



Delicate Policy Balance

Taken together, these factors place FERC at the fulcrum of a delicate policy balance. On the one hand is the recognition of transparency and declining cost of capital favoring low rates. On the other hand is the promotion of transmission investment to enhance the national energy infrastructure.

Speaking of promotion, transmission investment incentives also play a part in the formula rate renaissance. FERC has provided incentives to utilities to build transmission since at least 2005. The Energy Policy Act of 2005 directed the Commission to provide rate incentives to spur expansion and reduce grid congestion.

FERC allowed increases above the base ROE for particularly challenging projects, for forming a Transco, for joining an RTO or ISO, or for the use of an advanced transmission technology. FERC also allowed recovery of some abandoned plant costs, a return on construction work in progress, and regulatory asset treatment for pre-commercial operations costs. FERC refined these incentives in a 2012 policy statement.

Most recently, in March 2020, FERC issued a proposed

rule in Docket No. RM20-10 that broadly revisits all of these incentives. Many TFR templates include built-in worksheets for the various incentives, all of which may require revisions when FERC issues a final order.

Finally, FERC Order No. 1000 established the framework for competition in transmission investment. Many Transcos filed TFRs before ever bidding – let alone winning – any projects. The goal was to remove uncertainties around cost recovery to improve their odds of winning projects in the RTO and ISO transmission bidding process.

These TFRs are approved and sit idle until the developer wins a project. But with recent debate and dueling consultant reports on the effectiveness of Order No. 1000 and its competitive framework, even the TFRs on standby awaiting a project are subject to change.

What's Next?

None of these converging considerations alters the fact that FERC supports increased investment in the grid. FERC has encouraged utilities to rely on TFRs both for administrative efficiency and for timely cost recovery. This is not likely to change. A significant majority of FERC-jurisdictional utilities recover their transmission costs through formula rates.

TFRs provide a clear advantage for transmission owners to recover their actual costs as transmission costs rise. Utilities relying on stated rates during a transmission buildout phase are leaving money on the table.

This is especially true for utilities that provide substantial wholesale network service under their FERC tariffs, because of the arcane math FERC uses for this service. If a utility is planning any significant transmission build-out, the formula rate is the most advantageous ratemaking tool available.

During 2019, several utilities that are not members of RTOs

or ISOs filed to replace their stated rates with formula rates. That trend will likely continue in 2020 and beyond. Most TFR filings are resolved by settlement rather than through hearing litigation. Settlements make accepted FERC treatment of contentious issues more uncertain.


Applicants argue that a TFR is superior to a stated rate because it permits recovery of the actual investments in a timely manner.

Adopting a transmission formula rate does not put ratemaking on autopilot, as critics claim. FERC requires utilities to establish procedures called Protocols allowing parties to review formula rate inputs.

They also claim TFRs provide greater certainty for cost recovery, which encourages capital expenditures to improve transmission infrastructure. None of these arguments is going away, but stakeholder scrutiny will not diminish either. FERC will have to weigh these contrasting considerations carefully.

At bottom, FERC formula rates provide a strong incentive for grid expansion. Collectively, the parties to these proceedings are likely to press further into the details of

the formulas, drilling down into the calculations with greater granularity while also increasing transparency.

FERC will undoubtedly ensure that this is done without jeopardizing its policy goal of promoting the resilience, reliability, and security of the bulk power system. But for now, everyone is anxiously waiting to find out precisely how FERC achieves this balance. 

JULY 10 IS NIKOLA'S BIRTHDAY!

The Memorial Center of Nikola Tesla is rated as the number one place to visit on tripadvisor, if you happen to find yourself at Tesla's birthplace, Smiljan, Croatia. Hold off on this trip perhaps until the pandemic passes. The museum is dedicated to one of the greatest scientific minds to contribute to the business of electricity, born on July 10, 1856. Tesla is estimated to hold some three hundred patents, although a few are lost to time, and you can find a list of most of them from twenty-six countries on a Wikipedia page.

Tesla was a man of many accomplishments, including the rotating magnetic field, the AC motor, the Tesla coil, and according to the U.S. Supreme Court, the invention of the radio. Tesla sent his first wireless recording from his lab in New York City to a boat on the Hudson River some twenty-five miles away in 1897. He invented all that we associate with the radio including tuners and antennas, but another inventor, Guglielmo Marconi, took the credit. By the time the U.S. Supreme Court ruled in 1943 that the patent filed by Tesla took precedence, Marconi already was known as the father of the radio. Justice was particularly slow in this case as Tesla had died earlier that year.

It's no wonder that a genius inventor of Tesla's renown has become embedded in popular culture in many ways. In fact, if you go online and google Tesla, the first information and ads that pop up all have to do with cars, thanks to Elon Musk and his popular electric cars sold under the brand of that name. Indeed, now there's an electric truck manufacturer named Nikola. Google on July 10, 2009 celebrated Tesla's birthday by displaying a google doodle on its search home page showing the 'G' as a Tesla coil.