

THE REQUIREMENTS OF THE “JUST AND REASONABLE” STANDARD: LEGAL BASES FOR REFORM OF ELECTRIC TRANSMISSION RATES

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The return [on a public utility company's assets] should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate . . . to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally.¹

According to the North American Electric Reliability Council (NERC), electric transmission capacity in the United States is not keeping pace with demand for electric power. As a result, electric reliability and the development of competitive electricity markets could be impaired.²

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1. *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679, 693 (1923).

2. NORTH AMERICAN ELECTRIC RELIABILITY COUNCIL, RELIABILITY ASSESSMENT 1999-2008 7 (May 2000) (“Very few bulk transmission line additions are planned. Only 6,978 miles . . . (230kV and above) are planned throughout North America over the next ten years. This represents only a 3.5% increase in circuit miles. . . . The majority of the proposed transmission projects are for local system support.”). Furthermore, NERC warns, “transmission systems [are] increasingly challenged to accommodate demands of evolving competitive electricity markets. Market-driven changes in transmission usage patterns, the number and complexity of transactions, and the need to deliver replacement power to capacity-deficient areas are causing new transmission limitations to appear in different and unexpected locations.” NORTH AMERICAN ELECTRIC RELIABILITY COUNCIL, RELIABILITY ASSESSMENT 1998-2007 6 (September 1998). In its comments on the FERC Notice of Proposed Rulemaking on Regional Transmission Organizations (hereinafter RTO NOPR), NERC emphasized that “the number and complexity of transactions on the grid is growing enormously.” Comments of North American Electric Reliability Council on FERC's Notice of Proposed Rulemaking, Regional Transmission Originals, Docket No. RM99-2, 15 (Aug. 23, 1999). As demands on the transmission system continue to increase, NERC warns, “the ability to deliver remote resource to load center will deteriorate.” *Id.* In Order No. 2000, the Commission acknowledged the lack of transmission: “It appears that the planning and construction of transmission and transmission-related facilities may not be keeping up with increased requirements.” Order No. 2000, *Regional Transmission Organi-*

Transmission rate reform, to encourage new investment in transmission infrastructure, is an essential ingredient in the remedy for the "transmission investment gap." This article reviews the fundamental principles of public utility ratemaking to inform or remind the reader that the traditional "just and reasonable" standard for transmission rates under the Federal Power Act (FPA) is sufficiently flexible to permit, given a sufficient factual predicate, the Federal Energy Regulatory Commission (FERC or Commission) to reform its rate policies to reflect new demands on the nation's transmission networks. The law permits the Commission to establish rates adequate to attract capital needed to expand and improve the nation's electric transmission facilities to the extent required to satisfy such demands. A variety of new ratemaking methods, including the "innovative" rate treatments proposed in the Commission's recent Order No. 2000, are well within the Commission's legal authority.

The Transmission Investment Gap. The Secretary of Energy recently asserted that "America is a superpower, but it's got the [electric transmission] grid of a Third World nation."³ Although this is certainly an exaggeration, transmission "grids" in the United States are now performing a function they were not designed to perform, i.e., to function as "interstate superhighways" for both wholesale and retail sales of enormous quantities of electric power.⁴ According to the NERC, the gap between capacity and demand is widening: "Business is increasing on the transmission system, but very little is being done to increase the load serving and transfer capa-

zations, III F.E.R.C. STATS. & REGS. ¶ 31,089, 30,998 (1999) [hereinafter Order No. 2000].

3. Rebecca Smith, *Deregulation and Heavy Demand Leave Electricity Providers Short for the Summer*, WALL ST. J., May 11, 2000, at A1. (quoting Secretary Richardson).

4. Historically, transmission facilities were designed primarily to serve local service territories and to serve, through interconnection with adjacent networks, as a "safety net" or "backstop" for maintaining system equilibrium. See, e.g., ERIC HURST, *ELECTRIC RELIABILITY: POTENTIAL PROBLEMS AND POSSIBLE SOLUTIONS 2* (May 2000). Over the past decade, however, the growth of competition, both wholesale and retail, has meant that transmission networks must now handle an unprecedented level of "traffic," not only in terms of the volume of power flows, but also the number, pace, and complexity of market transactions for wholesale power. *Id.* The transmission "wheeling" provisions of the Energy Policy Act of 1992 and the "open access" rules of Order Nos. 888 and 889, issued by the Commission in 1996, sparked a veritable explosion of interstate commerce in wholesale electric power. In the past ten years, according to Karl Stahlkopf (Vice President of the Electric Power Research Institute), the number of wholesale power transactions has grown by 400%, "so that many utilities are handling as many transactions in an hour as they used to conduct in a day." Karl Stahlkopf, *Comments of Edison Electric Institute on FERC's Proposed Rulemaking, Regional Transmission Organizations*, Appendix J, 1 (1999). See also Order No. 2000, *supra* note 2, at 30,997 (noting that from 1995 to 1999, wholesale sales by power marketers increased from 1.8 million MWh to over 400 million MWh). During the same period, electric loads on the transmission grid have increased approximately 35%. In the twenty-four States that have moved to competition, transmission has been "unbundled" from local distribution functions and subjected to FERC jurisdiction (bundled transmission falls under State jurisdiction). At the same time, the Commission has aggressively pursued a policy of promoting the voluntary formation of regional transmission organizations (RTOs), which are entities that have operational control over transmission facilities. As a result of these developments, the transmission industry faces new responsibilities to the public, greater commercial risks, and heightened regulatory uncertainties.

bility of the bulk transmission system.”⁵ A primary cause of the lack of capacity appears to be declining investment in improvement and expansion of transmission facilities.⁶ Electric industry analysts argue that, due to increased risks in the restructured environment, greater incentives are needed to spur the attraction of scarce capital needed to expand and improve the grid.⁷ It is also widely agreed that to provide such incentives, the transmission “pricing”⁸ policies of the FERC must be reformed to address the “transmission investment gap.”⁹ Voices advocating transmission pricing reform have included the NERC,¹⁰ the Department of Energy,¹¹ and Members of the Commission.¹²

5. NERC, RELIABILITY ASSESSMENT, 1999-2008 34 (May 2000). Furthermore: “As the demand on the transmission system continues to rise, the ability to deliver energy from remote resources to demand centers is deteriorating. New transmission limitations are appearing in different and unexpected locations as the generation patterns shift to accommodate market-driven energy transactions,” and the connection of new, market-responsive merchant capacity that was not considered at the time the transmission system was designed. *Id.* at 34. Again: “Delivering energy to deficient areas in any direction and amount that market forces desire [is] difficult and, at times, not possible.”

6. Although this shortage of capacity is the product of several factors, including siting issues at the state and local level, the lack of incentives to invest in new transmission seems to be a primary cause. According to NERC, “transmission providers . . . may find it difficult to justify investment in new upgraded transmission facilities without proper incentive. . . . [U]ntil sufficient incentives are put in place, the growth in transmission capacity is not likely to keep pace with the business or reliability needs of the system.” NORTH AMERICAN ELECTRIC RELIABILITY COUNCIL, RELIABILITY ASSESSMENT 1998-2007 34 (1998). According to Eric Hurst, annual investment in new transmission has declined by approximately \$100 million per year in the past two decades. ERIC HURST, ELECTRIC RELIABILITY: POTENTIAL PROBLEMS AND POSSIBLE SOLUTIONS 10 (2000).

7. Along with the growth of wholesale competition and the “unbundling” of transmission assets, the risk “profile” of the transmission industry has changed dramatically. Statement of Paul R. Moul, Southern California Edison Company, Docket No. ER97-2355-000, at 1. Because investors tend to be risk averse, “increased uncertainty will require compensation for the higher risk related thereto.” *Id.*

8. The terms “pricing” and “ratesetting” or “ratemaking” are used interchangeably in this article, because a rate is essentially a price fixed by the government. *See, e.g., FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 601 (1944) (“Rate-making is indeed but one species of price-fixing.”).

9. *See, e.g., NERC, RELIABILITY ASSESSMENT 1999-2008 7* (2000) (“It is yet unclear if appropriate incentives exist to prompt transmission system additions and reinforcements to support the needs of a competitive energy market. [A]dequate pricing incentives . . . must be developed to deal with the need for new transmission lines for an open market.”).

10. The NERC has counseled reform in this area as a remedy for transmission constraints. In comments filed with the Commission, the NERC called for incentives to increase transmission capacity and secure the benefits of competition: “transmission rates must provide incentives to get the right amount of transmission infrastructure built. . . . We must make sure that shortages of transmission capacity do not restrict power flows and limit the benefits that otherwise could be achieved from competitive electricity markets.” North American Electric Reliability Council, Comments on FERC RTO NOPR, August 23, 1999, at 14.

11. *See, e.g., DEPARTMENT OF ENERGY, FINAL REPORT OF THE TASK FORCE ON ELECTRIC SYSTEM RELIABILITY, INCENTIVES FOR TRANSMISSION ENHANCEMENT 111* (Sept. 29, 1998). This report, known as the “Sharp Report” (for its principal author, Dr. Philip Sharp), expressly links the problem of inadequate transmission to a lack of investment: “Restructuring of the electric-power industry and unbundling of transmission from generation create challenges for reliably operating the existing transmission system and raise concerns about the future adequacy of transmission planning and incentives for investment in transmission enhancements.” *Id.*

12. According to Commissioner Curt Hebert, incentive regulation can satisfy the interests of

The transmission investment gap is not simply a financial abstraction. It directly implicates and threatens consumer interests in the restructured electricity marketplace. The widening gap between transmission capacity and growing demands on the system threatens to make transmission function as more of a "bottleneck" than a "pipeline" for increasingly competitive markets in electricity.¹³ A chronic lack of transmission capacity could seriously threaten electric reliability and the development of electric competition, thereby depriving consumers of lower prices and better service.¹⁴

Order No. 2000 and Incentives for RTO Formation. In Order No. 2000, the Commission acknowledged that the development of regional markets for wholesale power in the wake of Order Nos. 888 and 889 has "placed new stresses on regional transmission systems."¹⁵ The Commission found that to alleviate such stresses and encourage transmission expansion, all transmission facilities should be operated by "regional transmission organizations" (RTOs).¹⁶ Rather than mandate RTO participation, the Commission wisely chose to rely on a voluntary approach, giving prospective RTO participants the "flexibility to develop mutually agreeable regional arrangements. . . ."¹⁷ The Commission also indicated a desire to avoid litigation over the question of whether the Commission has legal au-

both transmission providers and consumers. Incentive rates, he wrote, can "resolve the regulatory impasse between industry seeking higher return on investment, and customers claiming that the monopolistic regime of transmission requires cost-based rates with low rates of return." Hon. Curt L. Hebert, *The Quest for an Inventive Utility Regulatory Agenda*, 19 ENERGY L.J. 1, 14 (1998). Specifically, incentives will use profits to ensure reliability and quality service: "With additional opportunity for profit, the industry will build the type of transmission grid that will provide the level of reliability required by customers. The lower rates and improved customer service resulting will satisfy the demands of consumers." *Id.* Similarly, Commissioner Linda K. Breathitt has expressed concern about inadequate ROEs established for some utilities upon joining RTOs: "it is imperative that RTOs have the incentive to expand the grid and ensure an adequate transmission infrastructure to address constraint and congestion issues." Commissioner Linda K. Breathitt, Remarks at the EEI Member Workshop, Washington, D.C., July 19, 2000. See also Linda K. Breathitt, *Higher Transmission ROEs Would Boost RTOs*, THE ENERGY DAILY, July 20, 2000; Chairman James Hoecker, Speech of *Competition and Electricity Networks, Here and Abroad* (June 20, 2000) (discussing possible incentive rate treatments enumerated in Order No. 2000).

13. Leonard S. Hyman, *Transmission, Congestion, Pricing, and Incentives*, IEEE POWER ENGINEERING REV. Aug. 1999, at 4.

14. The NERC warns that the growing lack of capacity could seriously affect the reliability of electric service and could "short-circuit" competition, denying consumers the promised benefits of better service at lower prices. In Order No. 2000 the Commission acknowledged the NERC's concerns, warning that transmission planning and construction "may not be keeping up with increased requirements." Order No. 2000, *supra* note 2, at 30,998 (citing NERC Reliability Assessment).

15. *Id.* at 30,997.

16. See also Order No. 2000, *supra* note 2, at 31,033 ("[W]ith respect to economic and engineering issues affecting reliability, operational efficiency, and competition in the electric industry, it is clear that RTOs are needed to resolve impediments to fully competitive markets."). An RTO is an entity that controls the interstate transmission facilities in a given region, but does not own or control the generation and distribution assets connected to such facilities. It may take a variety of forms, such as an independent system operator (ISO), under which vertically integrated utilities retain ownership of the transmission network, but must relinquish operational control to the ISO, or a transco, which is a for-profit company that both owns and controls the transmission facilities.

17. *Id.*

thority to mandate RTOs.¹⁸

To promote its policy of voluntary RTO formation, Order No. 2000 provides for “favorable” or “innovative” rate treatments to facilitate RTO formation.¹⁹ According to the Commission, “[w]e believe that it is critically important for RTOs to develop ratemaking practices that . . . provide incentives for transmission owning utilities to efficiently operate and invest in their systems. In particular, the Commission encourages RTOs to develop and propose innovative ratemaking practices, particularly with respect to efficiency incentives.”²⁰ Specifically, Order No. 2000 provides for the Commission’s consideration of a variety of “innovative” rate treatments, including performance-based rates, return on equity (ROE) reforms, and non-traditional cost-valuation methods.²¹ The regulatory text enumerates these rate treatments as follows:

- (i) A transmission rate moratorium, which may include proposals based on formerly bundled retail transmission rates;
- (ii) Rates of return that (a) are formulaic; (b) consider risk premiums and account for demonstrated adjustments in risk; or (c) do not vary with capital structure;
- (iii) Non-traditional depreciation schedules for new transmission investment;
- (iv) Transmission rates based on levelized recovery of capital costs;
- (v) Transmission rates that combine elements of incremental cost pricing for new transmission facilities with an embedded-cost access fee for existing transmission facilities; or
- (vi) Performance-based transmission rates.²²

It must be noted that the incentive pricing language of Order No. 2000 does not bind the Commission to apply any of these rate treatments. Order No. 2000 only requires the Commission to “consider” incentive rate proposals advanced by RTO applicants and participants.²³ Its proposed rate reforms nevertheless represent a willingness to expand upon, or even depart from, its historic methods in order to ensure that transmission rates accurately reflect new risks and responsibilities faced by transmission pro-

18. Order No. 2000, *supra* note 2, at 31,034. It should be noted that the Commission did not say that it lacks legal authority to mandate RTOs, and it expressly recognized the possibility of requiring RTO participation as a condition for receiving approvals for market-based rates and mergers. *Id.* at 31,034. The question of whether the Commission has legal authority to mandate market structure, by requiring RTO participation or by other structural means beyond its traditional ratemaking function, is beyond the scope of this article. See generally Order No. 2000, *supra* note 2, at 31,039-31,046 for discussion of the Commission’s legal authority with respect to RTOs.

19. Order No. 2000, *supra* note 2, at 31,034. Although the decision whether to join an RTO is left to the individual transmitting utility, all transmitting utilities are required to make certain informational filings explaining their plans to participate in an RTO or, if they have no such plans, to explain their reasons for not doing so.

20. Order No. 2000, *supra* note 2, at 31,171.

21. Regional Transmission Organizations, 18 C.F.R. § 35.34(e)(2) (2000).

22. *Id.* See *infra*, Part 4 for a discussion of these rate treatments.

23. 18 C.F.R. § 35.34(e)(1). The burden of development of such rate treatments rests principally on the RTO applicants. The Commission is not required to develop rate proposals *sua sponte* and applicants are required to include detailed justifications for their rate proposals, including a cost-benefit analysis and an explanation of how the rate treatment will further the purposes of RTOs in general. See generally 18 C.F.R. 35.34(e).

viders in the competitive marketplace.

Legal Questions. The increasing attention to the need for pricing reform, particularly in the context of Order No. 2000's innovative rate proposals, raises important legal questions. Under the FPA and applicable constitutional standards, the Commission is obliged to set transmission rates at levels that are "just and reasonable." What are the boundaries of the FERC's discretion in applying the just and reasonable standard? Does the Commission have sufficient legal authority to depart from historic methods and adopt new ones (such as the rate treatments proposed in Order No. 2000) in order to close the transmission investment gap? Is the just and reasonable standard a "mere vessel into which meaning must be poured,"²⁴ or does it bind the Commission to a particular method, formula, or set of mathematically or scientifically ascertainable factors? Specifically, under *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia*²⁵ and *Federal Power Commission v. Hope*,²⁶ precisely how much latitude has the Commission in determining whether a rate is adequate to "raise the money necessary for the proper discharge of its public duties?"²⁷ In discharging its duties to ensure that rates are just and reasonable and to otherwise protect the public interest, is the Commission permitted to take into consideration non-cost factors such as the long-term adequacy and reliability of transmission networks? What guidance, if any, does the FPA provide in answering these questions? Although the seasoned practitioner may observe that such questions were answered years ago in the development of Commission and court precedent, changing times require their reexamination.

As a matter of administrative law, is the Commission free to depart from its own precedents and established methods for the sake of advancing new policy goals? If so, what justifications, if any, must the Commission give in support of its change in method or policy? If the Commission has discretion to employ new policies and new rate treatments, but chooses not to, does it act arbitrarily and capriciously?²⁸

Additional legal and policy questions arise in the discussion of possible legislation to guide the Commission's ratemaking activity. Assuming that the Commission has ample discretion to "break new ground" in its transmission pricing policies, but chooses not to, what legislative approaches could effectively channel the Commission's discretion in the direction of setting rates that will encourage transmission expansion? Could such legislation be consistent with the just and reasonable standard of cur-

24. *Farmers Union Cent. Exch. v. FERC*, 734 F.2d 1486 (D.C. Cir. 1984) (quoting *Williams Pipeline Co.*, 21 F.E.R.C. ¶ 61,260, 61,594 (1982)) (interpreting the phrase "just and reasonable" in the Interstate Commerce Act, 49 U.S.C. § 1(5): "The phrase in question, 'just and reasonable,' is a high-level abstraction. It is a mere vessel into which meaning must be poured.").

25. *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Virginia*, 262 U.S. 679 (1923).

26. *FPC v. Hope*, 320 U.S. 591 (1944).

27. *Bluefield*, 262 U.S. at 693.

28. 5 U.S.C. § 706(2)(A).

rent law, or would it displace or even violate that standard?

Summary of Conclusions. The Article concludes that the Commission is authorized by the Constitution, the FPA, and its own policy statements to change its methods of regulation as needed to close the transmission investment gap. In doing so, the Commission may modify or even abandon old methods for the sake of protecting consumers' present and future interest in a vigorous and reliable transmission grid. Under current law, the Commission is not required to use a particular formula or method in setting rates. The Commission is, however, required to ensure that returns on transmission investments are adequate to attract the capital that a transmission provider needs to perform its public duties, including, arguably, a duty to maintain reliable, high-capacity transmission networks that are adequate to meet the demands of competitive electricity markets. The Commission's reformed policies to achieve these goals would likely withstand federal court review, provided they are supported by substantial evidence and coherent justification. Likewise, legislation to channel the Commission's discretion could be consistent with the just and reasonable standard.

Summary of Parts. The article proceeds in five parts. Part One, "The Modern Just & Reasonable Standard: Constitutional Requirements," examines the requirements of *Hope* that the "end result," not a particular method, governs the application of the just and reasonable standard.²⁹ It also examines the requirement that the return on a regulated entity's assets be sufficient to attract the capital needed for the performance of the entity's public duties, both present and future. Part One argues that promoting a reliable, high-capacity transmission grid could fall within the category of a transmission provider's public duties and therefore, rates should enable grid expansion accordingly. Part Two, "The Modern Just & Reasonable Standard: Federal Power Act Text and Legislative History," examines the FPA to determine what guidance, if any, the Act provides the Commission in applying the just and reasonable standard. This Part concludes that, while there is little in the Act that specifically qualifies the standard or limits the Commission's discretion, several provisions (particularly under the Energy Policy Act of 1992 (EPAct)) suggest that the Commission has a statutory responsibility to promote the overall adequacy of transmission networks. Part Three, "The Modern Just & Reasonable Standard: Administrative Law Principles," sets forth the basic requirements of federal administrative law applicable to transmission ratemaking under the FPA. It explains that, as a matter of administrative law, the court's obligation of review under the just and reasonable standard is strictly limited to a determination of whether the Commission has engaged in reasoned decision-making supported by substantial evidence. The Commission is, therefore, free to depart from precedent, provided that it acknowledges and carefully justifies such departure.

29. *Hope*, 320 U.S. at 602 ("[I]t is the result reached not the method employed which is controlling.").

Part Four, "FERC Rate Policies Through Order No. 2000," provides an overview of certain actions and policy statements of the Commission on transmission pricing. This Part includes discussion of Order No. 2000's proposed incentive rate treatments and various other innovative methods of considering transmission costs, higher returns on equity, incentive and performance based pricing, and negotiated and market-based rates. In conclusion, Part Five, "Legislative Options," considers possible legislative approaches to facilitate transmission pricing reform. This part includes a legal analysis of the transmission pricing provisions of certain bills introduced in the 106th Congress.

PART 1. THE MODERN JUST & REASONABLE STANDARD: CONSTITUTIONAL REQUIREMENTS

Section 205 of the FPA provides that any rate that is "not just and reasonable is hereby declared unlawful."³⁰ Section 206 gives the Commission authority to determine whether a rate is just and reasonable and, if it is not, to determine the rate.³¹ The FPA, itself, provides very little explicit guidance regarding content or limits of the just and reasonable standard, or how the standard should be applied to particular cases.³² What little guidance there is for applying the just and reasonable standard must be drawn from the caselaw interpreting sections 205 and 206 and comparable provisions of the Natural Gas Act (NGA) and other statutes that use the term just and reasonable in a similar manner.³³

As this Part discusses, the courts' traditional starting point in interpreting the term just and reasonable has been an analysis of the Takings Clause implications of rate regulation under the Fifth and Fourteenth Amendments.³⁴ The purpose of this Part is to ascertain the substantive

30. 16 U.S.C. § 824d(a) ("All rates and charges made, demanded, or received by any public utility for or in connection with the transmission or sale of electric energy subject to the jurisdiction of the Commission . . . shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.").

31. 16 U.S.C. § 824e(a) (providing that, upon determination that a rate or charge is "unjust, unreasonable, unduly discriminatory or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order.").

32. See, e.g., *City of Chicago v. FPC*, 458 F.2d 731, 749 (D.C. Cir. 1971), *cert. denied*, 405 U.S. 1074 (1972). ("The words ['just and reasonable'] themselves have no intrinsic meaning applicable alike to all situations."). See further discussion *infra* Part 2 of the just and reasonable requirement under the FPA.

33. Because the NGA and the FPA are very similar in text and structure, they are interpreted consistently. See, e.g., *Transmission Access Policy Study Group v. FERC*, 2000 WL 762706, at *8 (D.C. Cir. June 30, 2000) ("[W]e have repeatedly recognized the similarity of the two statutes and held that they should be interpreted consistently."), citing *Environmental Action v. FERC*, 996 F.2d 401, 410 (D.C. Cir. 1993); *Tennessee Gas Pipeline Co. v. FERC*, 860 F.2d 446, 454 (D.C. Cir. 1988); and *Arkansas La. Gas Co. v. Hall*, 453 U.S. 571, 577 n. 7 (1981).

34. The Fifth Amendment provides that: "private property [shall not] be taken for public use, without just compensation." U.S. CONST. amend. V. The "just compensation" clause of the Fifth Amendment has been interpreted to apply to the States through the due process clause of the Fourteenth Amendment. See generally U.S. CONST. amend. XIV ("[No] State shall deprive any person of

content, if any, of the just and reasonable standard in light of the Constitution's requirements, and to determine the nature and limits of the Commission's obligation under the standard. This Part reaches three broad conclusions: (1) neither the Constitution nor the FPA mandates the use of a particular method, formula, or set of factors in applying the just and reasonable standard, rather, it is the "end result" that matters; (2) the Commission is required to set rates at levels that accommodate both investor and consumer interests, sufficient to allow a public utility to perform its "public duties;" such duties arguably include maintenance and, in some instances, construction of transmission networks vigorous enough to meet the reliability and capacity demands of consumers in competitive markets; and (3) the Commission has discretion to take into account, not only the present, but the future interests of the public, arguably including the public's interest in the long-term reliability and commercial adequacy of transmission infrastructure.

(A) No Particular Formula Or Method Required; End Result Test; Zone of Reasonableness

Under the Fifth Amendment, the government may not take private property for "public use" without paying "just compensation."³⁵ In the context of ratemaking by regulatory agencies, at least since the Railroad Commission Cases,³⁶ the Supreme Court has held that in the context of ratemaking, public utilities have a constitutional right to earn a sufficient return.³⁷ In other words, the government must allow a regulated industry to earn a reasonable rate of return on its investment. This is because an unreasonably low rate would effect an unconstitutional taking of the industry owners' property without just compensation. As the Supreme Court explained in *Bluefield*, "[r]ates which are not sufficient to yield a reasonable rate of return . . . are unjust, unreasonable, and confiscatory, and their enforcement deprives the public utility company of its property in viola-

life, liberty, or property, without due process of law. . ."). Although the applicable caselaw tends to refer to the Fifth and Fourteenth Amendments as if they both apply to the federal government, it should be noted that, strictly speaking, the Fourteenth Amendment applies only to the States and, therefore, only the Fifth Amendment applies to the ratemaking by federal agencies. The constitutional analysis under both provisions is, however, the same.

35. U.S. CONST. amend. V.

36. *Railroad Comm'n Cases v. Farmers Loan & Trust Co.*, 116 U.S. 307 (1886).

37. *Id.* See also *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307-8 (1989) ("The guiding principle has been that the Constitution protects public utilities from being limited to a charge for their property serving the public which is so 'unjust' as to be confiscatory. . . . If the rate does not afford sufficient compensation, the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments."); *FPC v. Natural Gas Pipeline Co. of Am.*, 315 U.S. 575, (1942) ("By long standing usage in the field of rate regulation, the 'lowest reasonable rate' is one which is not confiscatory in the constitutional sense"); *Covington & Lexington Turnpike Rd. Co. v. Sandford*, 164 U.S. 578, 597 (1896) (A rate is too low if it is "so unjust as to destroy the value of [the] property for all the purposes for which it was acquired," and thereby "practically deprive[s] the owner of property without due process of law.").

tion of the Fourteenth Amendment."³⁸

The Old Rule: Smyth v. Ames. The question of how to determine whether a rate is "sufficient to yield a reasonable rate of return" has always been an "embarrassing question."³⁹ Beginning with the Supreme Court's opinion in *Smyth v. Ames*,⁴⁰ the Court's analysis focused on a method of determining the "fair value" of the utility's property "used and useful to the public" at the time the rate is set.⁴¹ The Court held that "the basis of all calculations" used to ascertain "fair value" was to include "the present as compared with the original cost of construction."⁴² In subsequent cases, the Court reversed several agency rate decisions because the agency had not adequately considered the "reproduction cost," as opposed to original cost, of the regulated company's facilities.⁴³ Thus, the Court established a rule that the Takings Clause required the use of the "present value" method.⁴⁴

Justice Brandeis' Proposed "Prudent Investment" Rule. The fair value rule "suffered from practical difficulties."⁴⁵ Part of the problem was that the "fair value" could not be determined accurately because it depended upon the earnings expected under the rate to be set.⁴⁶ Concurring with the judgment in *Missouri ex rel. Southwestern Bell*,⁴⁷ and dissenting in *McCardle v. Indianapolis Water Co.*,⁴⁸ Justice Brandeis argued that present value was too difficult to determine and urged that an "original cost" or "prudent investment" standard would be easier to apply.⁴⁹ Thus, both the majority and Justice Brandeis in these cases sought to attach specific methods to the requirements of the Takings Clause. The "prudent investment" rule proffered by Justice Brandeis nevertheless prefigured the modern just and reasonable standard by shifting the focus away from the present "fair value" or reproduction cost of the rate base to the "investor interest in return on investment," which is a key element of the *Hope* "end

38. *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679, 691 (1923).

39. *Smyth v. Ames*, 169 U.S. 466, 546 (1898).

40. *Id.*

41. *Smyth*, 169 U.S. at 547.

42. *Id.*

43. See, e.g., *McCardle v. Indianapolis Water Co.*, 272 U.S. 400 (1926); *Missouri ex rel. Southwestern Bell Tel. Co. v. Pub. Serv. Comm'n*, 262 U.S. 276, 291 (1923). See also RICHARD J. PIERCE AND ERNEST GELLHORN, *REGULATED INDUSTRIES* 96 (1994).

44. See also RICHARD J. PIERCE AND ERNEST GELLHORN, *REGULATED INDUSTRIES* 97-98 (1994).

45. *Id.* at 308.

46. *FPC v. Hope*, 320 U.S. 591 (1944). See also ALFRED E. KAHN, *THE ECONOMICS OF REGULATION* 39-41 (discussing circularity and other practical difficulties of the fair value method).

47. *Missouri ex rel. Southwestern Bell Tel. Co. v. Pub. Serv. Comm'n*, 262 U.S. 276, 291 (1923).

48. *McCardle v. Indianapolis Water Co.*, 272 U.S. 400 (1926).

49. *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 309 (1989) (discussing Justice Brandeis's dissent in *Missouri*); See also RICHARD J. PIERCE AND ERNEST GELLHORN, *REGULATED INDUSTRIES* 98 (1994).

result” test which requires a balancing of investor and consumer interests.⁵⁰

Hope: End Result Test. It was not until the 1944 case of *FPC v. Hope Natural Gas* that the Supreme Court decided to “withhold its legislative hand” and leave the choice of methods to the regulatory agency.⁵¹ The *Hope* opinion made clear that the NGA does not require the use of a specific method or formula for calculating a reasonable rate: “Congress . . . provided no formula by which the ‘just and reasonable’ rate is to be determined. It has not filled the details of the general prescription.”⁵² It follows that Congress has delegated its legislative authority to the ratemaking agency to the extent necessary to “fill” such details.⁵³ Accordingly, “the Commission [is] not bound to the use of any single formula or combination of formula in determining rates.”⁵⁴ This is so even if the method used is internally inconsistent, provided the overall result is just and reasonable: “an otherwise reasonable rate is not subject to constitutional attack by questioning the theoretical consistency of the method that produced it.”⁵⁵ The important thing for constitutional purposes is the result of the rate, not the underlying method: “it is the result reached not the method employed which is controlling.”⁵⁶ Thus, “[t]he fact that the method employed to

50. See, e.g., *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1181 (D.C. Cir. 1987) (reversing Commission order excluding certain plant investment from rate base).

51. ALFRED E. KAHN, *THE ECONOMICS OF REGULATION* 40, n. 45 (quoting “the immortal words of Lord Mountararat”).

52. *FPC v. Hope*, 320 U.S. 591, 600-01 (1944).

53. See, e.g., *Permian Basin Area Rate Cases*, 390 U.S. 747, 776 (1968) (“[T]he legislative discretion implied in the rate making power necessarily extends to the entire legislative process, embracing the method used in reaching the legislative determination as well as that determination itself. . . . It follows that rate-making agencies are not bound to the service of any single regulatory formula; they are permitted, unless their statutory authority otherwise plainly indicates, ‘to make the pragmatic adjustments which may be called for by particular circumstances.’”). The constitutional aspects of delegation of legislative authority to a ratemaking agency are discussed in Part 3, *infra*.

54. *Hope*, 320 U.S. at 602. See also *Wisconsin v. FPC*, 873 U.S. 294, 309 (1963) (“[T]o declare that a particular method of rate regulation is so sanctified as to make it highly unlikely that any other method could be sustained would be wholly out of keeping with this Court’s consistent and clearly articulated approach to the question of the Commission’s power to regulate rates. It has repeatedly been stated that no single method need be followed by the Commission in considering the justice and reasonableness of rates.”); *Grand Council of the Crees (of Quebec) v. FERC*, 198 F.3d 950 (D.C. Cir. 2000) (“In interpreting the statutory provision, ‘just and reasonable,’ the Supreme Court has emphasized that ‘the Commission [is] not bound to the use of any single formula or combination of formulae in determining rates.’” (quoting *Hope* at 602)).

55. *Duquesne*, 488 U.S. at 314 (addressing whether a rate set by a State public utility commission was reasonable). Moreover,

The adoption of a single theory of valuation as a constitutional requirement would be inconsistent with the view of the Constitution this Court has taken since [*Hope*]. . . . [C]ircumstances may favor the use of one ratemaking procedure over another. The designation of a single theory of ratemaking as a constitutional requirement would unnecessarily foreclose alternatives which could benefit both consumers and investors.

Id. at 316. *Duquesne*, 488 U.S. at 314 (citing *Wisconsin v. FPC*, 373 U.S. 294 (1963) (gas case holding that the Commission is not limited to a single method in determining the whether a rate is just and reasonable)).

56. *Hope*, 320 U.S. at 602. Moreover, “[i]f the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry . . . is at an end.” *Id.*

reach that result may contain infirmities is not . . . important. . . ."⁵⁷

In *Duquesne Light Co. v. Barasch*,⁵⁸ the Pennsylvania public utility commission used a variant of the "historical cost/prudent investment system" for determining rates.⁵⁹ The appellant regulated utilities did not allege that the "total effect" of the rate determined under this system was unjust or unreasonable.⁶⁰ Instead, as the Court noted, they argued that "the Constitution requires that subsidiary aspects of Pennsylvania's rate-making methodology be examined piecemeal."⁶¹ Among other things, they attacked a "theoretical inconsistency" in the legislation underlying the Commission's method, namely a selective application of the "used and useful" requirement normally associated with the old present value approach.⁶² Even though the State of Pennsylvania had chosen to use certain elements of the old present value rule of *Smyth*, the court was apparently unwilling to attack the rate order on methodological grounds alone and upheld the Commission's decision.

Zone of Reasonableness. The principal reasons for deferring to the agency on matters of rate determination are the economic complexity and prudential character of the rate determination. As the Supreme Court observed in *Duquesne*, "[t]he economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result."⁶³ In view of these practical difficulties, ratemaking is "less a science than an art."⁶⁴ Because of the broadly pragmatic character of the ratemaker's task, "[s]tatutory reasonableness is an abstract quality represented by an area rather than a pinpoint. It allows a substantial spread between what is unreasonable because too low and what is unreasonable because too high."⁶⁵ The rate in a particular case need only fall within a zone of reasonableness to satisfy the just and reasonable standard: "there is no single cost-recovering rate, but a zone of reasonableness. . . ."⁶⁶ In theory, the zone of reasonableness has a floor below which the rate would be confisca-

57. *Hope*, 320 U.S. at 602. See also *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 314 (1989). ("The Constitution protects the utility from the net effect of the rate order on its property. Inconsistencies in one aspect of the methodology have no constitutional effect on the utility's property if they are compensated by countervailing factors in some other aspect.")

58. *Duquesne*, 488 U.S. 299 (1989).

59. *Id.* at 310.

60. *Duquesne*, 488 U.S. at 311.

61. *Id.* at 313.

62. *Duquesne*, 488 U.S. at 313.

63. *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 314 (1989). Moreover, "[t]he Constitution is not designed to arbitrate these economic niceties. Errors to the detriment of one party may well be canceled out by countervailing errors or allowances in another part of the rate proceeding." *Id.* at 314.

64. *Public Serv. Co. of New Mexico v. FERC*, 832 F.2d 1201 (10th Cir. 1987) ("Although ringing of mathematical precision, the calculation of just and reasonable rate is less a science than an art."). See also *FPC v. Conway*, 426 U.S. 271, 278 (1976) (rejecting the proposition that "ratemaking is an exact science and that there is only one level at which a wholesale rate can be said to be just and reasonable. . . .").

65. *Montana-Dakota Util. Co. v. Northwestern Pub. Serv. Co.*, 341 U.S. 246, 251 (1951).

66. *FPC v. Conway*, 426 U.S. 271, 278 (1976).

tory and a ceiling above which the rate would be exploitative.⁶⁷ The extent to which the Commission has discretion to “lean” in one direction or the other within the zone is not entirely clear.⁶⁸

Flexibility to Serve Public Interest. In *Duquesne*, the Supreme Court also emphasized the importance of leaving the State or regulatory commission a free hand to “decide what ratesetting methodology best meets their needs in balancing the interests of the utility and the public.”⁶⁹ For the Court to identify a single method as a constitutional requirement “would unnecessarily foreclose alternatives which could benefit both consumers and investors.”⁷⁰ Because the reasonable balance of consumers and investor interests may vary widely according to the diversity of circumstances, the regulator is free to use whatever method or methods will yield a reasonable result.⁷¹ The regulator’s duty to balance these interests takes precedent over any slavish adherence to precedent or traditional method for its own sake.

Indeed, when the interests of consumers and investors require it, the ratemaker’s methodological discretion is not even limited to the field of cost-based methods. Although the “no single formula” doctrine of *Hope* arose from debates over historical cost versus present (reproduction) costs, the principle has been applied in the context of non-cost-based theories as well, such as market-based rate treatments.⁷²

67. See, e.g., *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1177 (D.C. Cir. 1987) (stating that zone of reasonableness is “bounded at one end by the investor interest against confiscation and at the other by the consumer interest against exorbitant rates”) (quoting *Washington Gas Light Co. v. Baker*, 188 F.2d 11, 15 (D.C. Cir. 1950)); *Farmers Union Cent. Exchange, Inc. v. FERC*, 734 F.2d 1486, 1502 (D.C. Cir. 1984) (holding that the FERC may approve rates that fall within zone of reasonableness where rates are neither “less than compensatory” nor “excessive”); *City of Chicago v. FPC*, 458 F.2d 731, 750-51 (D.C. Cir. 1971) (affirming that rates must be high enough to attract investors but low enough to prevent exploitation of consumers), *cert. denied*, 405 U.S. 1074 (1972).

68. The standards for determining a zone of reasonableness and a particular rate within that zone are discussed in subparts (2) and (3) of this Part.

69. *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 316 (1989).

70. *Id.* As discussed in the remaining subparts of this Part, this point is critical is discussion of pricing reform promote investment in new transmission capacity.

71. See generally *Permian Basin Area Rate Cases*, 390 U.S. 747, 790 (1968): “We must reiterate that the breadth and complexity of the Commission’s responsibilities demand that it be given every reasonable opportunity to formulate methods of regulation appropriate for the solution of its intensely practical difficulties.” Also,

we see no objection to its use of a variety of regulatory methods. Provided only that they do not together produce arbitrary or unreasonable consequences, the Commission may employ any ‘formula or combination of formulas’ it wishes, and is free ‘to make the pragmatic adjustments which may be called for by particular circumstances.’

Id. at 800 (quoting *FPC v. Natural Gas Pipeline Co.* 315 U.S. 575, 586 (1942)).

72. See, e.g., *Permian*, 390 U.S. 747 (1968) (upholding as just and reasonable area rate methodology that did not account for costs of individual gas producers); *Mobil Oil Corp. v. FPC*, 417 U.S. 283, 308 (1974) (noting that, in *Permian*, the Commission “had not adhered rigidly to a cost-based determination of rates, much less one that based each producer’s rates on his own costs”); *Farmers Union*, 734 F.2d 1486, 1503 (D.C. Cir. 1984) (“non-cost factors may legitimate a departure from a rigid cost-based approach. The mere invocation of a non-cost factor, however, does not alleviate a reviewing court of its duty to assure itself that the Commission has given reasoned consideration to each of the pertinent

Summary of Subpart (A). To summarize this subpart, in answering the constitutional question of whether a rate is confiscatory, the rate-maker's task is a pragmatic one, focusing on the real-world needs of consumers and industry, not on historical continuity or methodological purity for its own sake. Neither the Constitution nor the FPA requires that the Commission use a particular method or formula in determining rates or the cost basis of rates; indeed, the Commission is not even required to base rates on costs, provided that the overall result of the rate determination is "just and reasonable," i.e., falls within the zone of reasonableness.

(B) Substantive Requirements of The Just and Reasonable Standard

Bluefield: Sufficient Capital to Discharge Public Duties. In determining whether the "end result" itself is just and reasonable for constitutional purposes, the agency must consider certain factors. In the pre-*Hope*, but still often cited case of *Bluefield Waterworks Co. v. Public Service Comm'n of West Virginia*,⁷³ the Court held that "[t]he return [on a public utility company's assets] should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate . . . to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties."⁷⁴ "Disclosure of public duties" arguably includes consideration of the consumer's interest in a reliable transmission network with sufficient capacity to bear the demands of competition.⁷⁵

The Court in *Bluefield* also held that the utility's return must be "equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties. . . ."⁷⁶ Here again, the Court does not delineate the field of "other business undertakings" that have "corresponding risks and uncertainties." Thus, the Court has not required the Commission to limit its return calculations to a comparison with a specific category of industries.

Hope. In *Hope*, the Court emphasized that the important thing is not the method or even the choice of "control group" of other enterprises, but rather the end result. The question remains, however, what constitutes a just and reasonable end result? The reasonableness of the result is not a function of methodological consistency. Nor is it a function of a narrowly conceived notion of protecting the consumer from "exploitation" in the

factors."). See generally Joseph T. Kelliher, *Pushing the Envelope: Development of Federal Electric Transmission Access Policy*, 42 AM. U. L. REV. 543, 568 (1993) ("The FPA does not limit FERC to cost-based methodologies, however, and the courts have deferred to the agency's reasoned choice regarding ratemaking methods.") Use of non-cost based methods is discussed in this part and subsequent parts of this Article.

73. *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Virginia*, 262 U.S. 679 (1923).

74. *Id.* at 692-93.

75. See discussion *infra* of *Permian Basin* and Subpart 3.

76. *Bluefield*, 262 U.S. at 692.

form of marginally higher rates.⁷⁷ As the court stated in *Hope*, “the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks.”⁷⁸ Indeed, the regulator should consider the investor’s “legitimate concern with the financial integrity of the company whose rates are being regulated.”⁷⁹ The return must include not only operating costs, but also the capital costs of running a viable business enterprise. Echoing *Bluefield*, *Hope* provides additional guidance on this point: “[The] return . . . should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.”⁸⁰ The Court did not define the term “confidence,” nor did it specify how much capital is enough to “maintain” credit or to constitute an “attraction” of capital: “From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business.”⁸¹ To ensure that sufficient revenue is available to cover capital costs, the rate of return must be comparable to returns in industries with similar risks: “the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks.”⁸²

The Court neither imposed nor proposed a method for measuring the risks faced by “other enterprises,” or for comparing such risks with those faced by the regulated firm. Nor did the Court specify whether the field of “other enterprises” should be limited to firms in the same industry, e.g., electric or gas utilities, or even to regulated industries in general. The Court did not say that the regulated firm should earn the same returns as, for example, the manufacturing or financial services industries, or the average return earned by the Standard & Poors 500 companies. On the other hand, the Court did not say that they should *not* earn the same returns as such industries. The term “corresponding risks” suggests that the Commission should compare the regulated firm to other firms that are in comparable circumstances, e.g., that the Commission should compare regulated gas firms with other regulated gas firms. However, the term should not be read so narrowly. It could be read in terms of “quantity” or level of risk, rather than in term of specific industry characteristics or regu-

77. This is particularly the case in the area of transmission rates, where the transmission portion of the rate constitutes a relatively small portion of the overall price for delivered power, and transmission itself constitutes a critical link in the overall efficiency and proper functioning of the market. As Alfred Kahn explains, the quality and reliability of the service provided by a regulated utility may justify marginal increases in rates: “the nature of our dependence on public utility services is typically such that customers may correctly be *more* interested in . . . the reliability, continuity, and safety of the service than in the price they have to pay.” ALFRED E. KAHN, *THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS* 21 (1998).

78. *FPC v. Hope*, 320 U.S. 591, 603 (1944).

79. *Id.*

80. *Hope*, 320 U.S. at 603.

81. *Id.* (“These [costs] include service on the debt and dividends on the stock . . .”).

82. *Hope*, 320 U.S. at 603 (emphasis added). See generally A. LAWRENCE KOLBE ET AL., *THE COST OF CAPITAL: ESTIMATING THE RATE OF RETURN FOR PUBLIC UTILITIES* 13 (1984).

latory circumstances.⁸³

Jersey Central: Continued Focus on Investor Interest. Subsequent cases have confirmed *Hope's* focus on the investor interest. In *Jersey Central*, the D.C. Circuit court reversed an order of the Commission to exclude certain stranded investments from a rate base.⁸⁴ Reviewing the development of the just and reasonable standard, the court noted that "placing prudent investments in the rate base would seem a more sensible policy than a strict application of 'used and useful' [as under *Smyth v. Ames*], for under this approach it is the investment, and not the property used, which is viewed as having been taken by the public."⁸⁵ Although the court did not apply the "prudent investment rule" as advanced by Justice Brandeis, it nevertheless found that the Commission's failure to address whether such exclusion would allow the utility to "maintain financial integrity" and "attract capital" (as required under *Hope*) was reversible error.

Duquesne: Consideration of Changing Risks. In *Duquesne*, the Supreme Court acknowledged that questions regarding adequacy of capital have "constitutional overtones."⁸⁶ The *Hope* end result doctrine, according to the Court, "does not dispense with all of the constitutional difficulties when a utility raises a claim that the rate which it is permitted to charge is so low as to be confiscatory. . . ."⁸⁷ Whether a particular rate is unjustly or unreasonably low depends, the Court stated, "to some extent on what is a fair rate of return given the risks under a particular rate-setting system, and on the amount of capital upon which the investors are entitled to earn that return."⁸⁸ This does not mean that the Constitution requires the use of a particular method in determining the "fair rate of return." It does mean that, in setting rates, the regulator must take into account the risks faced by industry.

83. The Court in *Hope* also noted that the Commission had considered a "vast array of data bearing on the natural gas industry, related businesses, and general economic conditions." *Hope*, 320 U.S. at 604. The Court also acknowledged the Commission's finding, based on certain specified factors, that the company was in a "strong position to attract capital." *Id.* at 605. The Court did not elaborate regarding the nature of the "related businesses," but presumably found it appropriate that the Commission would examine a "vast array" of data, including "general economic conditions," because it upheld, "in view of these various considerations," the Commission's determination that the return is just and reasonable. *Hope*, 320 U.S. at 604-05.

84. *Jersey Cent. Power and Light Co. v. FERC*, 810 F.2d 1168 (D.C. Cir. 1987).

85. *Id.* at 1181.

86. *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 310 (1989).

87. *Id.*

88. *Duquesne*, 488 U.S. 310. See also *Permian Basin Area Rate Cases*, 390 U.S. 747, 790 (1968) (acknowledging the Commission's broad discretion but noting that "[a]lthough neither law nor economics has yet devised generally accepted standards for the evaluation of rate-making orders it must, nonetheless, be obvious that reviewing courts will require criteria more discriminating than justice and arbitrariness if they are sensibly to appraise the Commission's orders."). Moreover:

The delegation of the power to prescribe rates is accompanied by standards to which FERC, as delegate, must conform. . . . Surely, FERC enjoys substantial discretion in its ratemaking determinations; but, by the same token, this discretion must be bridled in accordance with the statutory mandate that the resulting rates be 'just and reasonable.'

Farmers Union Cent. Exchange v. FERC, 734 F.2d 1486, 1501 (1984).

Permian Basin: Assessment of Public Interest. As noted, *Bluefield* required that rates be sufficient to allow a utility to discharge its “public duties.” The Commission’s duty to consider public duties is not limited to a formulaic analysis of costs or expected levels of investment. As the Supreme Court stated in *Permian Basin*, “[t]he Commission cannot confine its inquiries either to the computation of costs of service or to conjectures about the prospective responses of the capital market; it is instead obliged at each step of its regulatory process to assess the requirements of the broad public interests entrusted to its protection by Congress.”⁸⁹

In light of the pragmatic nature of the Commission’s mandate, it must be free to use whatever method best ensures the attraction of capital adequate for the discharge of “public duties.” The Commission must also be free to change its methods to reflect changes in circumstances over time. As the Court recognized in *Bluefield*, “[a] rate of return may be reasonable at one time, and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally.”⁹⁰

The importance of this constitutional principle of flexibility in rate-making cannot be gainsaid, particularly in the context of the transmission capacity. To the extent that interstate transmission service is an integral part of electric service, particularly for the purpose of maintaining system reliability in a cost-effective manner, it is certainly an activity affected with the public interest.⁹¹ This is all the more the case in connection with growing competition in interconnected wholesale markets.⁹² The public’s interest in reliable electric service at competitive prices is apparent.⁹³ The reliable provision of an essential service, however, goes to the heart of the

89. *Permian Basin*, 390 U.S. at 791.

90. *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm’n of W. Virginia*, 262 U.S. 679, 693 (1923) (emphasis added).

91. See, e.g., *Otter Tail Power Co. v. United States*, 410 U.S. 366, 378 (1973) (discussing the significance of transmission as an essential facility for “isolated electric power systems”); *Gainesville Utils. v. Florida Power Corp.*, 402 U.S. 515, 519-20 (discussing the role of transmission interconnections in maintaining system equilibrium, freeing isolated systems from the “necessity of constructing and maintaining its own equipment”).

92. See, e.g., *Transmission Access Policy Study Group v. FERC*, 2000 WL 762706, *5 (D.C. Cir. 2000) (acknowledging that “[a]s entry into wholesale power generation markets increased . . . the ability of customers to gain access to the transmission services necessary to reach competing suppliers became increasingly important.”) (quoting Order No. 888, F.E.R.C. STATS. & REGS. ¶ 31,036, at 33,062).

93. See, e.g., *Transmission Access Policy Study Group*, 2000 WL 762706 at *5 (acknowledging the FERC’s findings regarding the for “access to competitively priced electric generation” and the “substantial benefits” to consumers of lower electricity pricings resulting from wholesale competition) (quoting Open Access NOPR F.E.R.C. STATS. & REGS. ¶ 32,514, 33,052). The primary consumer interest in electric power markets is reliable, high-quality electric service. In the high-tech economy and infrastructure of the United States today, this means not only keeping the lights on, but also eliminating disruptions or fluctuations in the flow of power required to keep personal and business computers, sophisticated health care equipment, air and rail traffic control systems, and the myriad other precision, electricity-dependent systems and technologies upon which our economy and our very lives depend. See generally ALFRED E. KAHN, *THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS* 21 (1998).

regulator's consideration of the public interest.⁹⁴ When the lights go out, the ratepayer is deprived of the economic good for which he paid. As a result, the reliable electric power service and the public utility have failed to meet the "public's needs."⁹⁵ As electric power markets develop, the "proper discharge of [a utility's] public duties" arguably should include transmission expansion to satisfy the growing demands of reliability and competition, as well as to satisfy the investor's interest in earning a reasonable return.

In light of the consumer's interest in reliable, high-capacity transmission networks, it appears that the consumer and investor interests converge on the issue of providing rate incentives for transmission capacity expansion, to the extent that new investment must be attracted to enable a transmission provider to perform its public duty of providing reliable transmission service for increasing volumes of electric power. This fact is very significant for applying the *Hope* requirement of "balancing of the investor and the consumer interests" in the process of determining just and reasonable rates.⁹⁶

(C) Future Public Interest

Hope and Bluefield. Under *Hope*, the regulator is not limited to consideration of the "present value" of a utility's property. Rather, the regulator is bound to balance the consumer and investor interests, and to consider the overall effect of the rate on the utility's ability to attract capital, particularly such capital as is needed to perform its "public duties."⁹⁷ Nei-

94. See, e.g., *Bluefield*, 262 U.S. at 688 (discussing just and reasonable rates in the context of "the public service of supplying water to the city of Bluefield and its citizens").

95. *Boroughs of Ellwood City v. FERC*, 731 F.2d 959, 967 (D.C. Cir. 1984) (rates must be sufficient to "assure that enough capital is attracted to the utility to enable it to meet the public's needs.") (citing *FPC v. Hope*, 320 U.S. 591, 603 (1944)). For the purposes of balancing the interests of consumers and investors, there are however limits to what constitutes the "public interest." It does not include economic externalities such as environmental considerations, however important such matters may be to the public interest broadly construed. See, e.g., *Grand Council of the Crees (of Quebec) v. FERC*, 198 F.3d 950, 956-57 (D.C. Cir. 2000) (holding that just and reasonable rate review does not include environmental considerations and that "Where (as here) the grant of ratemaking authority stems from congressional concern over market power . . . the object may be stated as to set 'prices equal to those that the firm would set if it did not have monopoly power; that is, to replicate a 'competitive price.'").

96. *FPC v. Hope*, 320 U.S. 603 (1944). Furthermore, an increase in transmission prices must be viewed in perspective of the overall price for delivered power. In the RTO final rule, the Commission acknowledged that transmission accounts for an average of only six to seven percent of the "bottom line" on a customer's electric bill. See also Order No. 2000, *supra* note 2, at 31,191, n. 653 ("[The] total costs of transmission service represents about six to seven percent of the average customer's bill, and raising transmission prices even as high as 25 percent in order to attract capital adds only two percent to the overall electric bill.") (citing Comments of Salomon Smith Barney, Global Power Group, on RTO NOPR). In view of the relatively small percentage of the price of power accounted for by transmission, as compared to the potential benefits of expanded networks, "the Commission should be much more concerned about underinvestment, not overinvestment, in the transmission grid. Stated another way, an efficient transmission grid is a prerequisite to achieving competitive generating markets, and the potential benefits for consumers far exceed any limited overinvestment that may occur on transmission service." Order No. 2000, *supra* note 2, at 31,191-92.

97. *Bluefield Waterworks & Improvement Co. v. Pub. Serv. Comm'n of W. Virginia*, 262 U.S.

ther *Hope* nor *Bluefield* imposed a specific temporal framework on the scope of property value, consumer interests, or the performance of public duties. Indeed, the broad public interest mandate of these cases suggests that a regulatory commission should take a long view, as well as a broad view, of a utility's public duties.

Permian Basin. Subsequent cases suggest that the FERC has a duty to consider the future, as well as the present interests of the public. In *Permian Basin Area Rate Cases*,⁹⁸ the Supreme Court summarized the duties of a reviewing Court in applying the *Hope* "end result" test, holding that the court must, among other things, "determine whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant *public interests, both existing and foreseeable*."⁹⁹ The Court further held that the FERC must assess the "consequences" of its rate order on the "character and future development of the industry."¹⁰⁰

In *Permian Basin*, the Commission employed an "area" method of rate regulation, whereby rates for different geographic areas were set at different levels to advance a policy of promoting increased exploration and production of natural gas within certain areas.¹⁰¹ The Court made it clear that the rate need not be based exclusively on costs and rate of return, but could be used to advance policy goals not directly related to cost.¹⁰² The Commission could, within the zone of reasonableness, "employ price functionally in order to achieve relevant regulatory purposes; it may, in particular, take fully into account the probable consequences of a given price level for future programs of exploration and production."¹⁰³ The Commission furthermore linked the need for methodological flexibility to the Commission's duty to protect consumers, "[t]he Commission's responsibilities necessarily oblige it to give continuing attention to values that may be reflected imperfectly by producers' costs; a regulatory method that excluded as immaterial all but current or projected costs could not properly serve the consumer interests placed under the Commission's protection."¹⁰⁴ If

679, 693 (1923).

98. *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968).

99. *Id.* (emphasis added).

100. *Permian Basin*, 390 U.S. at 792.

101. *Id.* at 796-97.

102. *Permian Basin*, 390 U.S. at 796-97, 815. See also *Mobil Oil Corp. v. FPC*, 417 U.S. 283 (1974) (upholding Commission area gas rate order and rejecting the argument that a "rate must be based entirely on some concept of cost plus a reasonable rate of return. We rejected this argument in *Permian Basin* and we reject it again here. The Commission explicitly based its additional 'non-cost' incentives on the evidence of a need for increased supplies.").

103. *Permian Basin*, 390 U.S. at 797.

104. *Id.* at 815. (cited in *Mobil Oil Corp. v. FPC*, 417 U.S. 283, 309-10 (1974)). Similarly, in *Mobil Oil Corp. v. FPC*, another area rate gas case, the Supreme Court held that the Commission could use area method as an "appropriate mechanism for protecting the public interest," in view of a "serious and growing domestic gas shortage." In view of such shortage, the Court held that it was reasonable for the Commission to conclude that area-differential rates (as opposed to uniform increases) were an

the Commission is free under the NGA to use innovative rate treatments to address a shortage of gas, it should follow that the Commission has authority under the FPA to use new rate treatments, including non-cost-based methods, to address a lack of transmission capacity.

Farmer's Union: No "Creamy Returns." It could be objected that the Commission cannot rationally link its rate methods to the policy goal of increasing transmission capacity, because the lack of transmission capacity is caused by many factors other than return levels set by the FERC (such as State siting issues). Speculation regarding possible future increases in transmission capacity would not be a reasonable substitute for solid cost figures and ROEs ascertained by traditional methods. In *Farmers Union Central Exchange v. FERC*,¹⁰⁵ the D.C. Circuit overturned a Commission rate order setting oil pipeline ceilings. The court held that the ceilings would allow "egregiously extortionate" prices if reached in practice and "creamy returns" on the pipeline assets.¹⁰⁶ The Commission had justified the ceiling levels on the grounds that the "consumer's interest in low pipeline rates is 'submicroscopic' while the real threat to the public is underinvestment in needed oil pipelines."¹⁰⁷ The Commission's error in this case, however, was that it produced little or no evidence in support of its claim that higher rates would spur an increase in pipeline capacity: "Without reliance on the record or any other source, [the] FERC simply stated that '[e]verybody agrees that the nation needs and will need more pipeline plant.' [citation omitted] No attempt was made to forecast future need for capacity or to estimate the relationship between rate of return and attraction of capital for new plant."¹⁰⁸ Thus, the Commission simply failed to base its decision on adequate evidence.¹⁰⁹

How much evidence is sufficient to establish a "rational connection" between a particular rate treatment and the policy goal of expanding capacity? *Mobil Oil* may serve as a guide on this point. In that case, the Commission acknowledged that numerous factors other than price would affect levels of gas production and that it could not determine "the precise amount of additional gas supply that would be found and dedicated to interstate sales as a result of this formula."¹¹⁰ The Court noted that the

appropriate means of discharging its "responsibility to maintain adequate supplies at the lowest reasonable rate could better be discharged by [the area rate method]." *Mobil Oil*, 417 U.S. at 320-21. Thus, in this case, the Court held that it was reasonable for the Commission use rates to promote an increase in supply of a critical resource.

105. *Farmers Union Cent. Exchange v. FERC*, 734 F.2d 1486 (1984).

106. *Id.* at 1494-95, 1497.

107. *Farmers Union*, 734 F.2d at 1494-95.

108. *Id.* at 1495 n27.

109. On this issue, *Farmers Union* is essentially a textbook administrative law case illustrating the arbitrary and capricious standard, which requires a regulatory agency to show a "rational connection between the facts found and the choice made." *Farmers Union*, 734 F.2d at 1499. (quoting *Burlington Truck Lines v. United States*, 371 U.S. 156, 168 (1962)). It does not stand for the proposition that the Commission must mathematically pinpoint the amount of increased capacity that that will result from the rate order.

110. *Mobil Oil Corp. v. FPC*, 417 U.S. 283, 318 (1974).

Commission had nevertheless considered “massive evidence on supply, demand, and the relationship between the two.”¹¹¹ On this basis, the Court found that the “record sufficiently supports the Commission’s conclusion” that its area rate method would be “more likely to lead to the immediately increased capital necessary in the face of a crisis.”¹¹²

TAPS v. FERC. The recent case of *Transmission Access Policy Study Group v. FERC*¹¹³ (hereinafter *TAPS*) supports the view that the FERC has an obligation to consider the future public interest in setting rates under sections 205 and 206 of the FPA.¹¹⁴ In connection with Order No. 888, the Court applied the just and reasonable standard to the Commission’s rate determination related to stranded cost recovery. The Commission’s rate determinations under the Order provided for retail stranded cost recovery in situations where State laws did not provide for recovery of such costs.¹¹⁵ The Commission noted in the Order that “[r]ecovery of this type of cost through a transmission rate is obviously not the norm, but is necessitated by the need to deal with the transition costs associated with this Rule.”¹¹⁶ In this context, the Court noted the “wide discretion the FPA affords [the] FERC to determine what constitutes ‘just and reasonable rates’ and ‘undue discrimination. . . .’”¹¹⁷ The Court also acknowledged the “unusual circumstances created by an industry change as fundamental as Order 888’s open access requirement.”¹¹⁸ Thus the Court established the premise that “unusual circumstances” in connection with the establishment of a new policy warrant the use of novel methods of ratemaking.

Order No. 888 was intended to supply a long-term, albeit “structural,” remedy to a perceived “systemic” problem of discrimination in transmission access, implicating consumer interests.¹¹⁹ To the extent that this rate determination was ancillary to the overall purposes of Order No. 888, it

111. *Id.* at 318.

112. *Mobil Oil*, 417 U.S. at 319-20.

113. *Transmission Access Policy Study Group v. FERC*, 2000 WL 762706, at *9 (D.C. Cir. June 30, 2000) [hereinafter *TAPS*].

114. Although the case addresses issues of access to existing facilities rather than expansion of such facilities, the Court’s discussion of the Commission’s ratemaking authority are apposite independent of questions surrounding the Commission’s authority to mandate unbundling and open access on a generic basis. See *infra* Part 3 of the article for discussion of *TAPS* in the context of *Chevron* deference.

115. *TAPS*, 2000 WL 762706 at *49.

116. *Id.* at 49 (quoting Order 888-A, III F.E.R.C. STATS. & REGS. ¶ 31,048, at 30,418).

117. *TAPS* at *49.

118. *Id.*

119. “The Commission decided . . . that relying upon voluntary arrangements and [case-by-case orders under FPA § 211] would not remedy the fundamentally anti-competitive structure of the transmission industry. Instead, the Commission concluded, such a piecemeal approach would result in an inefficient ‘patchwork’ of transmission systems nationwide. ‘The ultimate loser in such a regime is the consumer.’” *Transmission Access Policy Study Group v. FERC*, 2000 WL 762706, at *6 (D.C. Cir. June 30, 2000) (quoting Notice of Proposed Rulemaking, *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services By Public Utilities; Recovery of Stranded Costs By Public Utilities and Transmitting Utilities* [1988-1998 Proposed Regs.] IV F.E.R.C. STATS. & REGS. ¶ 32,514 (1995)).

follows that this case supports the view that the FERC may consider the future public interest in making transmission rate determinations. Likewise, in advancing a policy of improving the reliability and capacity of the transmission grid,¹²⁰ the Commission arguably has authority to provide innovative rate treatments.¹²¹

Summary of Part 1. This Part showed that the Constitution permits the Commission to consider the future adequacy of transmission networks in applying the "capital attraction" standards of *Hope* and *Bluefield*. The next Part shows that the text of the FPA, and its underlying policies, further support the view that the Commission is permitted to consider transmission adequacy issues in setting transmission rates.

PART 2. THE MODERN JUST & REASONABLE STANDARD: FEDERAL POWER ACT REQUIREMENTS

In addition to the requirements of the Constitution, the Commission's ratemaking decisions are subject to certain standards under the FPA, principally sections 205 and 206 of the Act.¹²² Under these sections, rates charged by transmitting utilities must be "just and reasonable and not unduly discriminatory or preferential."¹²³ The Act does not specifically define the term "just and reasonable," and the legislative history of the 1935 Act is silent regarding the meaning of the phrase.¹²⁴

Implied Broad Authority. What the FPA does not say may be of equal significance to what it does say. Nothing in the FPA requires the Commission to uphold the regulatory *status quo* at a given point in time. As noted, the FPA does not require the use of a specific methodology or formula.¹²⁵ Therefore, the statutory scope of the Commission's authority is very broad. Section 309 of the FPA confirms this point, authorizing the Commission to issue orders "necessary or appropriate to carry out the provisions of this [Act]."¹²⁶

120. Order No. 2000 embodies such a policy: "efficiency benefits of improved transmission service will be captured by producers and customers of generation, not transmission providers; therefore, greater incentives for RTOs to provide good transmission operations and efficient investments in the grid are warranted." Order No. 2000, *supra* note 2, at 31,192.

121. Order No. 2000 provides for consideration of innovative rate treatments to incent RTO formation and grid investment. *See also* Order No. 2000, *supra* note 2.

122. 16 U.S.C. §§ 824e-824f (1985).

123. 16 U.S.C. § 824f (1985).

124. *See generally* FPA, §§ 205-206, 16 U.S.C. § 824d-824e (1985).

125. *See also supra* note 86 and accompanying text.

126. 16 U.S.C. § 825h. It should be noted that Section 309 is identical to the administrative powers provision of the Natural Gas Act. 16 U.S.C. § 825h. In *Permian Basin*, the Court held that the Commission could use a particular, unconventional pricing method to achieve "relevant regulatory purposes." *Permian Basin Area Rate Cases*, 390 U.S. 747, 797 (1968). *See also* *FPC v. Texaco, Inc.*, 417 U.S. 380, 389 (1974) (noting that the Supreme Court "has repeatedly held that the width of administrative authority must be measured in part by the purposes for which it was conferred") (citing *Permian Basin*, 390 U.S. at 776-77). In support of this point, the Court cited the administrative powers provision of the NGA, which provides that the Commission has the power to perform any acts or issue any regulations "necessary or appropriate to carry out the provisions of this [chapter]." *Id.* at 797

FPA Transmission Adequacy Policy. Other sections of the FPA suggest that the Commission has a duty to promote the maintenance and expansion of vigorous, efficient transmission networks to support reliability and commerce. Section 202(a) of the FPA sets forth the purposes of “assuring an abundant supply of electric energy throughout the United States with the greatest possible economy and with regard to the proper utilization and conservation of natural resources. . . .”¹²⁷ Ensuring an “abundant supply” of electricity with the “greatest possible economy” arguably presupposes a properly functioning, reliable, high-capacity transmission network.¹²⁸ In addition to its duty to “divide the country” into districts for the “voluntary interconnection and coordination” of transmission facilities, the section sets forth a general duty to “promote and encourage such interconnection and coordination within each such district and between such districts.”¹²⁹ Construction or modification of transmission facilities needed to achieve such interconnection and coordination is a highly capital-intensive enterprise. To the extent that it can, the Commission arguably has an obligation under section 202(a) to set transmission rates at levels that are high enough to encourage such construction and modification.

Transmission Rate Standards Under EPAct and FPA Sections 211 and 212. In 1992, Congress passed the Energy Policy Act of 1992 (EPAct), which, among other things, amended sections 211 and 212 of the FPA to require the Commission to apply certain standards in setting rates in connection with mandatory transmission orders under section 211.¹³⁰ Section 212, as amended, requires the Commission to permit a utility, subject to mandated open access, to recover “all the costs incurred in connection with the transmission services and necessary associated services, including, but not limited to, an appropriate share, if any, of legitimate, verifiable and economic costs, including taking into account any benefits to the transmission system of providing the transmission service, and the costs of any

(quoting 15 U.S.C. § 717o). Specifically, the Court held that the Commission could use a non-cost-based area method to encourage gas exploration and production. 16 U.S.C. § 825h (“The Commission shall have the power to perform any and all acts, and to prescribe, issue, make, amend, and rescind such orders, rules, and regulations as it may find necessary or appropriate to carry out the provisions of this chapter.”).

127. 16 U.S.C. § 824a (1985).

128. To achieve the purposes in section 202(a),

the Commission is empowered and directed to divide the country into regional districts for the voluntary interconnection and coordination of facilities for the generation, transmission, and sale of electric energy, and it may at any time thereafter, upon its own motion or upon application, make such modifications thereof as in its judgment will promote the public interest.

Id. Thus, it seems to follow that “voluntary interconnection and coordination” for the sake of ensuring an abundant electricity supply are in the public interest.

129. 16 U.S.C. § 824a (1985).

130. Pub. L. No. 102-486, Title VII, §§ 721-722 (1992). Section 211, as amended, authorizes the Commission to order, on a case-by-case basis, transmitting utilities to provide open access transmission service. Under section 211(a), a utility or supplier may apply to the Commission for an order requiring a transmitting utility “to provide transmission services (including any enlargement of transmission capacity necessary to provide such services) to the applicant. . . .” 16 U.S.C. § 824j(a) (1985).

enlargement of transmission facilities."¹³¹ Section 212(a) further provides that rates "shall promote the *economically efficient transmission* and generation of electricity and shall be just and reasonable, and not unduly discriminatory or preferential. . . ." ¹³² Such rates shall also "ensure that, to the extent practicable, costs incurred in providing the wholesale transmission services, and properly allocable to the provision of such services, are recovered from the applicant for such order and not from a transmitting utility's existing wholesale, retail, and transmission customers."¹³³

Order No. 888 effectively by-passed sections 211 and 212 by accomplishing through generic rulemaking what the sections were intended to allow the Commission to accomplish on a case-by-case basis.¹³⁴ Nevertheless, the EPAct amendments to section 212 are significant in three respects: (1) the legislative history of these provisions sheds additional light on the meaning of the just and reasonable standard in general; (2) although the text of section 212 applies on its face only to transmission provided pursuant to an open access order under section 211, the legislative history of section 212's pricing provisions suggests that the same pricing standards and policies set forth in section 212 should apply with equal force to transmission rates set pursuant to sections 205 and 206;¹³⁵ and (3) the rate provisions of section 212(a) generally express a policy in favor of transmission expansion.

(1) *EPAct Section 212(a) and the Just and Reasonable Standard.* Although, as mentioned above, the legislative history of the FPA is silent regarding the meaning of the just and reasonable standard, the legislative history of the EPAct confirms the principles established by the courts. For example, in a floor statement upon the adoption of the EPAct conference report, Senator Malcolm Wallop, ranking Republican on the Senate Energy and Natural Resources Committee and Republican Floor Manager of the bill, cited the *Hope* "end result" test and emphasized the breadth of the Commission's discretion in determining whether the end result reasonably satisfies the interests of both investors and consumers.¹³⁶

(2) *Applicability of Section 212 Requirements to Section 206 Rate Orders.* Significantly, the legislative history of section 212 suggests that the

131. 16 U.S.C. § 824k(a) (emphasis added).

132. *Id.* (emphasis added).

133. 16 U.S.C. § 824k(a).

134. See also *Transmission Access Policy Study Group v. FERC*, 2000 WL 762706, at *9 (D.C. Cir. June 30, 2000) (finding that the Commission has authority under FPA §§ 205 and 206 to order open access generically, independent of its §§ 211-212 authority).

135. See note 136 *infra*.

136. 138 CONG. REC. S17,566, S17,622 (daily ed. Oct. 8, 1992) (statement of Sen. Wallop). Senator Wallop observed:

[U]nder the general statutory standard, the FERC has some discretion to rely on a mix of factors in determining whether a rate is just and reasonable, i.e., in determining whether 'the end result' constitutes 'a reasonable balancing, based on factual findings, of the investor interest in maintaining financial integrity and access to capital markets and the consumer interest in being charged non-exploitative. . . .

requirements of full cost recovery for expanded transmission should apply to all transmission rates set by the Commission, not just to rates set as a result of a section 212 interconnection order.¹³⁷ The legislative history also suggests that the pricing requirements of section 212 should apply in any instance in which the FERC orders transmission services under section 203 or section 205 for whatever reason.¹³⁸ Subsequently, in Order No. 888, the Commission did precisely that—relying in part on sections 205, 211, and 212, it ordered open access to transmission service by generic rule.¹³⁹ Thus, consistent with the legislative history, the pricing standards set forth in section 212(a) arguably should apply to all rates set in connection with transmission services provided pursuant to Order No. 888. In other words, to the extent that these sections apply to rate orders under sections 205 and 206, the Commission is arguably required to take transmission expansion costs into account in determining all rates.¹⁴⁰

(3) *Transmission Expansion Policy.* At a minimum, the transmission cost language of section 212 indicates a policy concern for adequacy of transmission facilities to support wholesale competition. In particular, the requirement that rates permit recovery of costs for “enlargement” of transmission facilities supports such a policy. Also, the requirement that rates promote “economically efficient” transmission suggests a policy in favor of transmission networks of optimal capacity to handle the demands of competitive electricity markets.

This Part showed that the FPA prescribes no particular requirements for applying the just and reasonable standard, but it provides additional support for the view that the Commission has legal authority to set rates at levels sufficient to promote investment in transmission infrastructure for the future needs of consumers.

137. See also 138 CONG. REC. S17,613 (daily ed. Oct. 8, 1992) (statement of Sen. Johnston). Senator Johnston, Chairman of the Committee on Energy and Natural Resources, engaged Senator Wallop in a colloquy, in which Senator Wallop asked: “Do the pricing provisions of new FPA section 212(a) apply only to FERC-ordered transmission pursuant to section 211, or do they also apply to the pricing of transmission pursuant to other authorities under the FPA?” Johnston replied: “I see no reason why these new pricing principles should not be applied by the FERC to other transmission orders. It would make good policy sense to do so.” *Id.* See also Joshua Z. Rokach, *Transmission Pricing Under the Federal Power Act: Applying a Market Screen*, 14 ENERGY L.J. 95, 96 (1993).

138. See also 138 CONG. REC. S17,566, S17,619 (daily ed. Oct. 8, 1992) (statement of Sen. Wallop). Senator Wallop observed:

[I]f for some reason not based on this legislation the FERC concludes that it has a legitimate claim of authority to require transmission services under section 203 or section 205 (which I do not believe they do), the FERC should adopt the pricing criteria and standards included in amended FPA sections 211 and section 212 because they provide the clear intent of Congress with regard to any non-voluntary transmission services.

Id.

139. See also Order No. 888, F.E.R.C. STATS. & REGS. ¶ 31,036 (1996).

140. See discussion *infra* Part 4 of this article where the Commission adopted this interpretation of section 212(a) in its 1994 Transmission Pricing Policy Statement.

PART 3. THE MODERN JUST & REASONABLE STANDARD:
ADMINISTRATIVE LAW PRINCIPLES

Parts 1 and 2 concluded that the Constitution and the FPA require, not the use of a particular method, but only an "end result" whereby the utility is able to attract sufficient capital to maintain investor confidence and perform its "public duties." But *who* decides whether the particular methods and formulas the Commission chooses are adequate to achieve the Constitutionally and statutorily required end result, the Commission or the courts? To what extent, if at all, is the judiciary authorized to "second-guess" the policy choices made by the Commission?

In the first instance, the policy choice underlying a rate determination by a federal regulatory agency is made by Congress in the agency's authorizing statute. Because ratemaking matters are enormously complex, Congress chose to delegate the bulk of its legislative authority to agencies such as the FERC. Congress limited the exercise of the delegated authority only by certain general standards.¹⁴¹ As noted, in the case of FERC ratemaking, the principal statutory limit placed on the Commission is that its rates be "just and reasonable."¹⁴²

In *Hope*, the Court confined its just and reasonable review of the Commission's rate order to a common-sense examination of whether the "end result" resulted in confiscation within the meaning of the Fifth Amendment.¹⁴³ It could be argued that the Court's determination of whether a rate was confiscatory itself requires the Court to substitute its judgment for that of the Commission. The distinction between "end result" review and "method" review is nevertheless arguably the basis for the Court's relatively deferential approach in the decades following *Hope*.¹⁴⁴

The courts have deferred to regulatory commissions on matters of method and detail for at least two fundamental reasons. The first reason is purely practical. As the Supreme Court noted in *Chevron v. NRDC*,

141. Under Article I of the Constitution, the power to make laws belongs to Congress alone. *See also* U.S. CONST., article I ("All legislative powers granted herein shall be vested in a Congress of the United States"). Ratemaking is essentially a legislative task. *See, e.g.*, *Permian Basin Area Rate Cases*, 390 U.S. 747, 776 (1968) (discussing the "legislative discretion implied in the rate making power").

142. As discussed, the FPA also generally expresses the policy goal of ensuring the availability of reliable, adequate transmission facilities.

143. *See also* James Hoecker, *Used and Useful: Autopsy of a Ratemaking Policy*, 8 ENERGY L.J. 303, 308 (1987) (*Hope* decision "circumscribed judicial review of agency ratemaking decisions" by restricting courts to question of whether 'end result' was unjust or unreasonable).

144. Between 1944 and 1986, for example, the Supreme Court did not review a single State ratemaking case under the Takings clause. Richard J. Pierce, Jr., *Public Utility Regulatory Takings: Should the Judiciary Attempt to Police the Political Institutions?*, 77 GEO. L.J. 2031, 2046 (noting that, in declining to hear such cases, "the Court implicitly reaffirmed its decision to allocate near total control over ratemaking to political institutions. . .").

“[j]udges are not experts in the field. . . .”¹⁴⁵ Ratemaking is a specialized task involving analysis of enormous quantities of data using a variety of technical economic and financial concepts. The sheer practical burden of reviewing each “subordinate element” of an ROE formula or rate base accounting scheme seemed to be a major factor in the Court’s “retreat” from “method” review.¹⁴⁶

The second reason for the Court’s deference is the constitutional principle of the separation of powers. Under Articles I and III, legislative power belongs to Congress; the judiciary, by contrast, is authorized only to “say what the law is,” not to make the law.¹⁴⁷ Ratemaking is essentially a legislative enterprise involving legislative-style factfinding (involving enormous quantities of data) and the characteristically legislative task of balancing multiple, competing policy considerations and political factions. Thus, the methodological elements of ratemaking are not only beyond the Court’s technical competence, but also beyond the Court’s constitutional authority.¹⁴⁸ Thus, under *Chevron*, when a statutory term is broad or unclear, the courts generally defer to the agency’s expertise in exercising its delegated authority.¹⁴⁹

It could be objected that substantive judicial review is necessary to prevent the politics of a particular President’s administration from unduly influencing an agency’s regulatory policy. According to *Chevron*, however, “an agency to which Congress has delegated policy-making responsi-

145. *Chevron v. Natural Resources Defense Council*, 467 U.S. 837, 865 (1984).

146. See also Richard J. Pierce, Jr., *Public Utility Regulatory Takings: Should the Judiciary Attempt to Police the Political Institutions?*, 77 GEO. L.J. 2031 (discussing institutional limits of the courts to engage in substantive review of ratemaking decisions of regulatory commissions).

147. *Marbury v. Madison*, 1 Cranch 137, 177 (1803). See also U.S. CONST., art. I (All legislative power herein granted shall be vested in a Congress of the United States. . . .); U.S. CONST. art. III (“The Judicial Power of the United States shall be vested in a Supreme Court, and in such inferior courts as the Congress may from time to time ordain and establish.”).

148. See also *Chevron*, 467 U.S. at 865 (Observing that judges “are not part of either political branch of the Government” and must not substitute their “personal policy preferences” for the determinations of the regulatory agency).

149. In *Chevron*, the Supreme Court addressed a challenge to the Reagan Administration EPA’s interpretation of the term “stationary source” in the Clean Air Act Amendments of 1977. *Id.* at 840. The Act required a rigorous permitting process for each new “stationary source” of certain pollutants. *Chevron*, 467 U.S. at 840. The EPA reasoned that all pollution-emitting devices within the same industrial facility could qualify as a single stationary source. *Id.* at 840-42. The petitioners argued that the purposes of the Clean Air Act would be better served by requiring that each single device be subject to the permitting regime. *Chevron*, 467 U.S. at 859-66. In other words, the petitioners effectively asked the Court to hold that the EPA had failed to choose the best policy to advance the purposes of the Act. The Court refused to substitute its judgment for that of the agency on constitutional grounds:

When a challenge to an agency construction of a statutory provision, fairly conceptualized, really centers on the wisdom of the agency’s policy, rather than whether it is a reasonable choice within a gap left open by Congress, the challenge must fail. In such a case, federal judges – who have no constituency – have a duty to respect legitimate policy choices made by those who do. The responsibilities for assessing the wisdom of such policy choices and resolving the struggle between competing views of the public interest are not judicial ones: ‘Our Constitution vests such responsibilities in the political branches.’ . . .

Id. at 866.

bilities may, within the limits of that delegation, properly rely upon the incumbent administration's views of wise policy to inform its judgments."¹⁵⁰ The agency's legislative regulations are "given controlling weight unless they are arbitrary, capricious or manifestly contrary to the statute."¹⁵¹

Chevron deference applies to regulatory actions of the FERC within the context of electric transmission ratemaking under the FPA sections 205 and 206.¹⁵² As noted, ratemaking is a legislative activity. Accordingly, the Administrative Procedure Act (APA) includes rate orders under the definition of a legislative rule.¹⁵³ Under the APA and *Chevron*, the FERC rate determinations are therefore subject to the arbitrary and capricious standard of review.¹⁵⁴ The arbitrary and capricious standard and the substantial evidence standard are distinct standards. Arbitrary and capricious review generally applies to rulemakings; whereas, under the APA, the substantial evidence standard applies only to formal adjudications subject to special hearing procedures under APA §§ 556-57.¹⁵⁵ Although FERC rate determinations are not subject to these procedures,¹⁵⁶ the FPA specifically provides that the Commission's findings of fact are conclusive if supported by "substantial evidence."¹⁵⁷ Therefore, the two standards seem to be used interchangeably in the context of FERC rate determinations.¹⁵⁸

Reasonableness and the Arbitrary and Capricious Standard. Under both *Chevron* step 2, and the arbitrary and capricious test, a court's review focuses on whether the agency's decision is reasonable and whether the agency considered the "relevant factors."¹⁵⁹ A "reasonable" decision need not be the "best" decision as viewed by the court. There need only be a "rational connection between the facts found and the choice made."¹⁶⁰ The

150. *Chevron v. Natural Resources Defense Council*, 467 U.S. 837, 866 (1984).

151. *Id.*

152. *See, e.g., TAPS v. FERC*, 2000 WL 762706, at *9 (D.C. Cir. June 30, 2000) ("[T]he deferential standard of *Chevron* . . . governs our review of [the] FERC's interpretation of FPA §§ 205 and 206.")

153. The APA definition of a legislative rule (as opposed to an adjudication) includes "the approval or prescription for the future of rates." 5 U.S.C. § 551(4) (1996).

154. Under the APA, the court is obliged to "hold unlawful and set aside" an agency action that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A) (1996).

155. 5 U.S.C. §§ 556-57 (1996).

156. Although section 206 provides that the determination of the justness and reasonableness of a rate shall be made "after a hearing had upon its own motion or upon complaint," the statute does not require that the hearing be "on the record" within the meaning of 5 U.S.C. § 553(c), and therefore the standards for formal rulemaking do not apply. *See, e.g., United States v. Florida E. Coast Ry. Co.*, 410 U.S. 224 (1973).

157. 16 U.S.C. § 8251(b) (1985) ("The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive.")

158. Although, in theory, the substantial evidence standard is more rigorous than the arbitrary and capricious test, the distinction between the two tends to be blurred in practice. *See generally* DAVIS AND PIERCE, ADMINISTRATIVE LAW TREATISE, § 11.2.

159. *Citizens to Preserve Overton Park v. Volpe*, 401 U.S. 402, 416 (1971).

160. "The court must examine the Commission's reasoning to determine whether it considered the relevant factors and drew a rational connection between the facts found and the choice made." *Associated Gas Distributors v. FERC*, 824 F.2d 981, 1016 (D.C. Cir. 1987).

court has no authority to “substitute its [policy] judgment for that of the agency.”¹⁶¹ Rather, the court need only ensure that the policy choice is coherently presented and justified by the facts, and that the agency has not failed to consider relevant factors in the rulemaking record.¹⁶² In general, this standard is “highly deferential” to the FERC.¹⁶³

In *TAPS*, the D.C. Circuit applied the arbitrary and capricious standard to the Commission’s variable treatment of stranded costs in rate determinations under Order No. 888.¹⁶⁴ Certain petitioners claimed that the FERC acted arbitrarily and capriciously in determining that just and reasonable transmission rates include “retail stranded cost recovery in some circumstances but not others.”¹⁶⁵ Specifically, they noted that rates must be just and reasonable and not unduly discriminatory. Therefore, they argued, by approving different transmission rates (some including stranded costs and others not including such costs), the Commission acted arbitrarily and capriciously. In response, the court stated that those petitioners “ignore the wide discretion the FPA affords FERC to determine what constitutes ‘just and reasonable rates’ and ‘undue discrimination,’ as well as the unusual circumstances created by an industry change as fundamental as Order 888’s open access requirement.”¹⁶⁶ The court held that the mere fact that some transmission rates include stranded costs, while others do not, does not by itself make the rate determination arbitrary and capricious. Rather, the court added, “petitioners must show that there is no reason for the difference. . . . We think [the] FERC has provided a convincing explanation for the difference.”¹⁶⁷

Typically, a rate determination fails the arbitrary and capricious test only if the Commission fails to provide a coherent, or at least somewhat thorough, explanation. In *North Carolina Utilities v. FERC*,¹⁶⁸ for example, the court held that the Commission’s use of a novel “hypothetical capital structure” used to calculate ROE, and its decision to allow the company a rate of return at the high end of the zone of reasonableness, were arbitrary and capricious.¹⁶⁹ The Commission provided “no explanation” of why its

161. *Overton Park*, 401 U.S. at 416.

162. See, e.g., *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168 (D.C. Cir. 1987) (“where . . . the Commission has reached its determination by flatly refusing to consider a factor to which it is undeniably required to give some weight, its decision cannot stand.”) (citing *Overton Park*, 401 U.S. at 416).

163. See also *Indiana Municipal Power Agency v. FERC*, 56 F.3d 247 (D.C. Cir. 283), upholding the Commission finding that coal supply prices allegedly including a premium passed on to wholesale electricity customers were not unjust or unreasonable under the FPA. In *Indiana*, the court observed that, “[b]ecause ‘issues of rate design are fairly technical and, insofar as they are not technical, involve policy judgments that lie at the core of the regulatory mission,’ our review of whether a particular rate design is ‘just and reasonable’ is highly deferential.” *Id.* at 252 (citations omitted).

164. *TAPS v. FERC*, 2000 WL 762706, at *9 (D.C. Cir. June 30, 2000)

165. *Id.* at *48.

166. *TAPS*, 2000 WL 762706 at *49.

167. *Id.*

168. *North Carolina Utils. v. FERC*, 42 F.3d 659 (D.C. Cir. 1994).

169. *Id.* at 663.

reached by reasoned decisionmaking and supported by substantial evidence, we are obliged to defer to its technical ratemaking expertise."¹⁸⁴

Burden of Proof. Under the substantial evidence standard, the burden of proof is on the party seeking to overturn a rate determination of the Commission.¹⁸⁵ In general, the challenger's obligation to present evidence sufficient to outweigh the Commission's claim that it has met the substantial evidence standard.¹⁸⁶ The challenger, in other words, must meet a higher standard than the Commission. The Commission need only show that its decision was based upon substantial evidence, whereas the challenger must show that the Commission's evidence does not clear the relatively low substantial evidence threshold.

Obligation to Acknowledge and Justify Departures From Precedent. When an agency departs from a prior precedent or settled policy, neither the Constitution, the FPA, nor the APA forbids the Commission to break with precedent. However, the reasoned explanation for the new interpretation must include an acknowledgment and explanation for the departure.¹⁸⁷ Without reasoned explanation for abrupt departures from prior agency positions, a reviewing court lacks a sufficient basis in the record for deferring to the expertise of the agency—i.e., the record must not only provide sufficient justification for the new policy itself, but also for the change of policy.¹⁸⁸ Without such justification, the agency's action is arbitrary and capricious within the meaning of the APA.¹⁸⁹

This principle applies to departures from ratemaking precedents.¹⁹⁰

184. *Id.* at 1560. See also *Associated Gas Distribs. v. FERC*, 824 F.2d 981, 1030 ("We do not require that FERC reach any particular conclusion; we merely mandate that it reach its conclusion by reasoned decisionmaking."); *Environmental Action v. FERC*, 996 F.2d 401, 407 (D.C. Cir. 1993) (upholding ceiling rates for gas as just and reasonable on account of "fairly technical" nature of rate-making).

185. The case of *Anaheim, Riverside, Banning, Colton, and Azusa, California v. FERC* illustrates the difficulties faced by the party seeking reversal of an ROE determination. *Anaheim v. FERC*, 669 F.2d 799, 803 (D.C. Cir. 1981) (finding that the Commission's decision to reject Edison's contentions was "supported by substantial evidence in the record). See also *Permian Basin* 390 U.S. at 767 ("A presumption of validity therefore attaches to each exercise of the Commission's expertise, and those who would overturn the Commission's judgment undertake 'the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences.'") (quoting *Hope* at 602).

186. *Anaheim*, 669 F.2d at 803.

187. The court in *Motor Vehicles Manufacturers Association* nevertheless insisted that an agency changing its course "must supply a reasoned analysis" justifying its change of policy. *Id.* See also *Mobil Oil Corp. v. EPA*, 871 F.2d 149 (D.C. Cir. 1989) (finding that an agency's reinterpretation of statutory language is entitled to deference, "so long as the agency acknowledges and explains the departure from its prior views").

188. See, e.g., *Pauley v. Bethenergy Mines, Inc.*, 501 U.S. 680, 698 (1991) (noting that the case for judicial deference is less compelling with respect to "agency positions that are inconsistent with previously held views").

189. *Mobil Oil Corp.*, 871 F.2d 149.

190. See, e.g., *Atchison v. Wichita Bd. of Trade*, 412 U.S. 800, 802 (1973) (Reversing Interstate Commerce Commission order approving increased rail rates and holding that the ICC "did not explain its apparent departure from precedent in a manner sufficient to permit judicial review of its policies.").

The D.C. Circuit has applied this principle in cases involving the FERC's rate determinations. For example, in *Boston Edison Co. v. FERC*,¹⁹¹ the court found that "the law simply requires a commission, wishing to depart from a prior rule or prior precedent, to focus on the departure, to decide to change, and to explain why it has done so."¹⁹² Likewise, in *Tennessee Gas Pipeline Co. v. FERC*,¹⁹³ the court emphasized that the Commission is "free to adopt a minority position in the financial and economic communities," such as an unconventional variant of the DCF method.¹⁹⁴ "But it must say so, and, if the rejection is inconsistent with prior decisions, explain the change," the court added. In this case, the Commission had rejected the "efficient market theory," an element of a particular DCF method, apparently without providing adequate justification for the departure.¹⁹⁵ The court noted that the Commission "appears quite wedded to DCF analysis and to efficient market theory as its theoretical mainstay. . . ."¹⁹⁶ This case highlights the Commission's obligation, particularly in the ROE context, to provide thorough justification for any departure from conventional DCF practice.

Conclusion to Part 3. This Part showed that the courts' review of rate determinations is highly deferential, particularly regarding matters of method and detail. The Commission must nevertheless support its rate determinations under the just and reasonable standard with carefully reasoned arguments and substantial evidence. The Commission is free to change its policies to reflect new conditions, but must take particular care to justify such departures from precedent. The next Part discusses particular areas in which the Commission has proposed to reform its ratemaking policies.

PART 4. FERC PRICING POLICIES THROUGH ORDER NO. 2000

The preceding parts of this article examined the legal boundaries of transmission ratemaking from the standpoint of constitutional, statutory, and administrative law doctrines. An examination of the Commission's own application of these doctrines in its ratemaking decisions and policy statements further illustrates the breadth of the Commission's discretion

191. *Boston Edison Co. v. FERC*, 885 F.2d 962 (1st Cir. 1989) (upholding FERC's adjustment of a utility's rate of return to take into account general decline in interest rates).

192. *Id.* at 966 (citing *Atchison*). See also *Northern California Power Agency v. FERC*, 37 F.3d 1517, 1522 (D.C. Cir. 1994) (Holding that the FERC order applying a certain uniform discount rate was consistent with reasoning of prior order, but noting that "[i]t is true that an agency acts arbitrarily when it departs from its precedent without giving any good reason."). But see *Environmental Action v. FERC*, 996 F.2d 401, 411 (D.C. Cir. 1993) (Noting that, when prior decisions are "readily distinguishable," the Commission "may distinguish precedent simply by emphasizing the importance of considerations not previously contemplated, and that in so doing it need not refer to the cases being distinguished by name.").

193. *Tennessee Gas Pipeline Co. v. FERC*, 926 F.2d 1206 (D.C. Cir. 1991).

194. *Id.* at 1211.

195. *Tennessee Gas Pipeline*, 926 F.2d at 1211.

196. *Id.*

and the diversity of rate methods that it has considered. Although methods already used or acknowledged by the Commission may provide guideposts along the way to the outer boundaries of the Commission's authority, they do not necessarily determine those boundaries. Given the breadth of the Commission's discretion as discussed in Parts 1 through 3, these boundaries may, and probably do, go significantly beyond even the most innovative methods the Commission may have employed or even acknowledged.

This Part examines the Commission's pricing policies in five areas. First is a discussion of general statements of policy, focusing on the 1994 Transmission Pricing Policy Statement (TPPS) and, more recently, Order No. 2000. Second and third are the two areas that comprise traditional cost-of-service ratemaking: second, ROE policies, with discussion of certain recent Commission and Administrative Law Judge (ALJ) decisions, and ROE reforms proposed in Order No. 2000; and third, cost calculation policies, including certain non-traditional methods set forth in Order No. 2000. Fourth is a discussion of Commission policies on incentive, or performance-based ratemaking (PBR) treatments that go beyond the traditional cost-of-service approach to ratemaking. This section includes a discussion of the rate moratorium, and PBR rate treatments proposed in Order No. 2000. Fifth is a discussion of the future possibility of market-based and negotiated transmission rates. These discussions include review of the legal basis for the methods employed or proposed.

(A) FERC Statements on Transmission Pricing Reform—In General

Pricing Reform Policy Statements. For almost the past decade, the FERC has recognized the need for pricing reform to benefit electricity consumers and promote investment in electric utility facilities. In its 1992 Policy Statement on Incentive Regulation, the Commission declared that certain incentives could "result in lower rates to consumers and provide utilities the opportunity to earn higher returns."¹⁹⁷ In 1994, the Commission issued a policy statement focusing on electric transmission rates. This TPPS acknowledged that the development of wholesale competition under EPAct "underscore[d] the importance of ensuring that our transmission pricing policies promote economic efficiency, fairly compensate utilities for providing transmission services, reflect a reasonable allocation of transmission costs among transmission users, and maintain reliability of the grid."¹⁹⁸ The TPPS also specifically addressed the need for transmission expansion: "It is critical that transmission services be priced in a manner that appro-

197. *Incentive Ratemaking for Interstate Natural Gas Pipelines, Oil Pipelines and Electric Utilities: Policy Statement on Incentive Regulation*, 61 F.E.R.C. ¶ 61,168, 61,587.

198. *Inquiry Concerning the Commission's Pricing Policy for Transmission Services Provided by Public Utilities Under the Federal Power Act; Policy Statement*, [Regs. Preambles 1991-1996] III F.E.R.C. STATS. & REGS. ¶ 31,005, 31,136 (1994) [hereinafter TPPS]. "It is important to gain practical experience with alternative transmission pricing approaches in order to assess how best to accommodate the current and future needs of the industry in providing efficient and reliable power supply as the industry becomes increasingly competitive." *Id.* at 31,139.

priately compensates transmission owners and creates adequate incentives for system expansion when such expansion is efficient.”¹⁹⁹

Order No. 2000. More recently, the Commission has addressed the need for incentive regulation to promote transmission expansion in connection with RTO formation. In Order No. 2000, the Commission acknowledged that transmission pricing reform is necessary as a result of industry restructuring, and that adjustments must be made to compensate for the special risks inherent in RTO participation that may discourage the voluntary formation of RTOs. Order No. 2000 states that “transmission pricing reform is needed as a result of the rapid restructuring of the industry that is underway, particularly with respect to changes in the ownership and control of transmission assets, and changes in the transmission services being provided in competitive generating markets.”²⁰⁰ The Commission concluded that, “[a]s a result of these changes . . . [it] needs to mitigate various ‘disincentives’ that may prevent transmission owners from efficiently operating their systems.”²⁰¹ Moreover, RTO participants “should be accorded transmission pricing that reflects the financial risks of turning facilities over to an RTO and that reflects other changes in the structure of the industry.”²⁰² The Commission also acknowledged the concerns of commenters who believe that investment in transmission is inadequate to support competition.²⁰³

As noted, the regulatory text of Order No. 2000 specifically enumerates eight types of “innovative” or incentive rate treatments the Commis-

199. TPPS, *supra* note 198, at 31,149.

200. Order No. 2000, *supra* note 2, at 31,191.

201. *Id.* For example:

Commenters cite to the potential that transmission owners will earn lower returns for providing unbundled transmission service than they earned for providing bundled service, even though risks associated with transmission ownership have increased. . . . One source [of increased risk] is the potential for bypass of transmission assets due to distributed generation and the phasing out of older generators from service. Other sources are directly related to RTO formation. For example, some commenters assert that stand-alone transmission companies (e.g., transcos) are riskier because they have a less-diversified portfolio of assets than a vertically integrated utility. Other commenters argue that participation in an ISO is inherently riskier, suggesting that increased risk comes from ownership of transmission assets that are ceded for purposes of operational control to another, non-affiliated entity.

Order No. 2000, *supra* note 2, at 31,191.

202. *Id.* at 31,172.

203. Order No. 2000 states:

Other commenters argue that a reevaluation of transmission pricing is needed because it is absolutely critical that the transmission grid support competitive generating markets, and the only way that the Commission can ensure this will happen is to pursue pricing policies that encourage it. Some commenters suggest that because the contribution of transmission to total costs of energy is relatively small, overinvestment in transmission will not significantly affect delivered electricity prices. Further, the Commission should be much more concerned about underinvestment, not overinvestment, in the transmission grid. Stated another way, an efficient transmission grid is a prerequisite to achieving competitive generating markets. . . .

Id. at 31,191.

sion would consider to encourage RTO participation.²⁰⁴ It is worth noting that RTO applicants who file for an innovative rate treatment must include: (1) a “detailed explanation” of how the rate treatment would help achieve the goals of an RTO, including the goal of “investment in the transmission system and reliability benefits to consumers;” (2) a cost-benefit analysis; and (3) a detailed explanation of why the proposal is “appropriate” for the RTO.²⁰⁵ The applicant must also “support” any such proposal as “just, reasonable, and not unduly discriminatory or preferential.”²⁰⁶ Such data could help ensure that a Commission order approving an innovative rate treatment meets the substantial evidence standard under the APA.²⁰⁷

(B) ROE

Within the context of traditional cost-of-service ratemaking, return on equity is perhaps the most critical and hotly contested element of a transmission rate. Although the methodological difficulties of valuing the rate base on which the ROE is earned may be great, determining the proper level for the ROE may be an even greater challenge, not only as matter of economics, but also of policy. As Alfred Kahn observes, “there is no objective, unequivocal method of ascertaining the cost of capital, even for a particular regulated company at a particular time and place; the process requires the exercise of a good deal of judgment, and judgments will inevitably differ as to the results.”²⁰⁸

Under the *Hope* doctrine the Commission is not bound to use any particular method. This applies with particular force in the context of calculating the ROE. Although the Commission has historically used various versions of the discounted cash flow (DCF) method of calculating the ROE, the Commission is not bound to use any particular version of the DCF method, or use the DCF method at all. As the D.C. Circuit court explained in *Tennessee Gas Pipeline Co. v. FERC*,²⁰⁹ although a particular variant of the DCF method may be a commonly accepted method of calculating the ROE, the Commission is nevertheless “free to adopt a minority position in the financial and economic communities.”²¹⁰ Moreover, the DCF is not required by the Constitution or by statute:

Tennessee does not argue that the Fourteenth Amendment enacted the Efficient Market Hypothesis, or DCF for that matter. Nor, indeed, does it claim the Natural Gas Act or the Administrative Procedure Act did so. If the Commission proposes to reject either the Efficient Market Hypothesis or

204. The regulatory text is quoted *supra* in the introduction.

205. 18 C.F.R. 35.34(e)(1).

206. Order No. 2000, *supra* note 2, at 31,171.

207. See *supra* Part 3.

208. ALFRED E. KAHN, *THE ECONOMICS OF REGULATION* 43 (1998).

209. *Tennessee Gas Pipeline Co. v. FERC*, 926 F.2d 1206 (1991).

210. *Id.* at 1211.

DCF methodology, we therefore assume that it is free to do so.²¹¹

The court noted, however, that the Commission “appears quite wedded to DCF analysis and to efficient market theory as its theoretical mainstay. . . .”²¹² Accordingly, as a matter of administrative law, the Commission would be required to acknowledge a rejection of the DCF and “explain the change.”²¹³

American Electric Power. A recent initial decision by a FERC ALJ acknowledged the fact that the FERC is not constitutionally bound to use a particular method for calculating the ROE. In *American Electric Power Co., Central and South West Corp.*,²¹⁴ the ALJ observed that “[a]pplying the [*Bluefield* and *Hope*] standards requires the analysis of all available data. Thus, rather than rely on a single methodology, [a witness for the applicant] considered several methods of determining the cost of common equity.”²¹⁵ Significantly, the ALJ rejected the “conventional” DCF methodology, at least as applied to the facts of this case, stating that it was based on “unrealistic assumptions” which produced ROEs so low (5.65% and 6.44%, respectively, for AEP and CSW) “as to conclusively demonstrate its invalidity.”²¹⁶ Instead, the ALJ accepted the utilities’ alternative methodologies that produced a composite ROE of 11.75% for the merged company.²¹⁷ Although the alternative methods were “modifications to [the] conventional DCF methodology,” the case nevertheless illustrated the need to assess “all available data” and the fact that no specific method is required.²¹⁸

Southern California Edison. Despite its acknowledged legal discretion, the Commission’s trial staff, ALJs, and, to an extent, the Commission itself have tended to adhere to DCF methods.²¹⁹ The 1999 Southern California Edison (SoCal Ed or Edison) proceeding²²⁰ provides a good illustration of both the Commission’s flexibility and its “conservative” tendencies on the controversial issue of ROE calculations. In this case, the ALJ issued an initial decision (ID) recommending a rate of return on equity of 9.68% for Edison’s transmission assets, approximately two percentage points below the return Edison previously received on these same assets from the State of California.²²¹ The ALJ also would have denied Edison the right to recover about \$20 million annually in overhead costs that state

211. *Tennessee Gas Pipeline Co.*, 926 F.2d at 1211.

212. *Id.*

213. *Tennessee Gas Pipeline Co.*, 926 F.2d at 1211. See also *supra* Part 3 for discussion of administrative law requirements for actions inconsistent with Commission precedent.

214. *American Elec. Power Co.*, 89 F.E.R.C. ¶ 63,007 (1999) (initial decision).

215. *Id.*

216. 89 F.E.R.C. ¶ 63,007.

217. *Id.*

218. 89 F.E.R.C. ¶ 63,007.

219. See, e.g., discussion of *Tennessee Gas Pipeline Co. v. FERC* *supra* at notes 211 and 212 and accompanying text.

220. *Southern California Edison Co.*, 86 F.E.R.C. ¶ 63,014 (1999) (initial decision).

221. *Id.*

regulators previously allowed.²²² This decision sparked an outcry from the industry,²²³ and even certain members of Congress,²²⁴ on the grounds that the decision, particularly if upheld by the Commission, would discourage investment in transmission assets committed to RTO control.

In an opinion issued almost sixteen months later, the Commission reversed the ALJ's ROE determination, awarding SoCal Ed an ROE of 11.60%, almost two percentage points higher than the ROE determined by the ALJ.²²⁵ Taking exception to the ALJ's decision, Edison had argued that the 9.68% ROE set by the ALJ "fails to reflect the significant risks that [SoCal Ed] faces in the restructured electric utility environment, and reduces [the SoCal Ed] ROE substantially below levels previously allowed by the [California Commission] on the same assets for the same service."²²⁶ In calculating the ROE, the ALJ had relied on a "2-step" DCF method, involving a determination of both present and expected future dividend yields on common stock.²²⁷ The Commission had previously used the 2-step DCF method in calculating ROEs for natural gas pipeline companies.²²⁸ On review of the ALJ's decision in this case, however, the Commission determined that "significant differences exist in the electric utility industry and the natural gas pipeline industry which warrant the continued use of different growth rates in the DCF models for each."²²⁹ Rather than reject the use of the DCF method altogether, the Commission chose to use a different variant of the DCF method. Rather than of using the 2-step DCF, the Commission applied the "standard, constant growth DCF model previously relied upon by the Commission in calculating an ROE for an electric utility company."²³⁰ Thus, the Commission's SoCal Ed decision

222. 86 F.E.R.C. ¶ 63,014.

223. See, e.g., Letter from CEOs of 35 investor-owned utilities to James Hoecker, July 16, 1999, re: Southern California Edison Company, Docket Nos. ER97-2355-000, et al. In this letter, the CEOs emphasized the consequences of lower ROEs for transmission investment, protesting that,

[a]t the very least, jurisdictional utilities should not be penalized by revenue reductions as a result of complying with state restructuring, joining a regional transmission organization . . . and transferring transmission assets from state to FERC jurisdiction. Affirmation of the Initial Decision by the Commission would be broadly interpreted as a tremendous disincentive for utilities to join RTOs. Finally, low rates of return on equity would discourage attraction of capital for need investment in transmission expansion and upgrades.

Id.

224. See, e.g., Letter from Rep. Richard Burr to James Hoecker, July 15, 1999 (Noting decision in Southern California Edison case and observing, "I have become increasingly concerned that current law and regulation may not provide adequate incentives for investment in transmission, including the construction of new lines, upgrade of existing lines and deployment of new technology that could increase the capacity of our transmission systems.").

225. *Southern California Edison Co.*, 92 F.E.R.C. ¶ 61,070, 61,256 (2000).

226. *Id.* at 61,257 (quoting Southern California Edison's Brief on Exceptions, at 7).

227. For a description of the two-step DCF method see *Southern California Edison* at 61,260-1; see generally Win Whittaker, *The Discounted Cash Flow Methodology: Its Use in Estimating A Utility's Cost of Equity*, 12 ENERGY L.J. 265 (1991).

228. 92 F.E.R.C. ¶ 61,070, at 61,260.

229. *Id.* at 61,261.

230. 92 F.E.R.C. ¶ 61,070, at 61,261.

does not signal an abandonment of DCF methods for determining the ROE under the just and reasonable standard. Indeed, the Commission emphasized the hoary status of the “standard” constant growth method. The Commission nevertheless acknowledged that “[s]hould circumstances in the industry change, in the future, we will reevaluate our methodology, as necessary.”²³¹

The more significant aspect of the Commission’s decision was its consideration of risk in choosing an ROE level within the zone of reasonableness established by the constant growth DCF method it employed. Although the Commission regarded much of the evidence presented on risk as “disputed” or “speculative,” it nevertheless acknowledged that the risks faced by Edison were higher than those in the proxy group of companies used in the Commission’s DCF analysis.²³² Because the proxy companies were otherwise comparable but had not transferred their transmission assets to an ISO, the Commission adjusted Edison’s rate upward within the zone of reasonableness established on the basis of the constant growth DCF calculation.²³³

Order No. 2000. In Order No. 2000, the Commission acknowledged that traditional methods of calculating the ROE may no longer be adequate: “We . . . recognize that historical data typically used to evaluate ROEs may not be reliable since it reflects a different industry structure from the one that exists recently.”²³⁴ The Commission further acknowledged that “new approaches” to the ROE calculation are warranted.²³⁵ The regulatory text of the Order requires the Commission to consider rates of return that are “(a) formulary; (b) consider risk premiums and account for demonstrated adjustments in risk; or (c) do not vary with capital structure. . . .”²³⁶

Formula Rates. A formula rate would “decouple a transmission owner’s earnings from its own equity valuation, and would tie it more to external standards such as industry-wide performance.”²³⁷ This approach would be “consistent with the benchmarking that may occur under PBR.”²³⁸ As discussed below, PBR-type “benchmarking” is consistent with the just and reasonable standard, provided that the end result is reasonable. Also, as discussed, the just and reasonable standard does not require the Commission to use a particular method or formula; a formula rate proposed by an RTO applicant would thus be permissible, provided that the

231. *Id.* at 61,261.

232. 92 F.E.R.C. ¶ 61,070, at 61,261.

233. *Id.*

234. Order No. 2000, *supra* note 2, at 31,193.

235. *Id.* The Order apparently would not, however, be used as a “vehicle for generic reform of the current discounted cash flow method for calculating return.” Joshua Z. Rokach, *Stand-Alone Transmission: RTOs in the New Millenium*, 39 (No. 2) INFRASTRUCTURE (ABA Section of Public Utility, Communications, and Transportation Law) (Winter 2000).

236. 18 C.F.R. § 35.34(e)(2)(ii).

237. Order No. 2000, *supra* note 2, at 31,193.

238. *Id.*

Commission were to support its approval with substantial evidence and reasoned argument.

Risk Adjustments. The Order acknowledges that rate treatments should account for the risks associated with transmission ratemaking to provide a reasonable rate of return. “[W]e agree that the uncertainty associated with the transition of the industry, and in particular participation in RTOs, may increase risks in the short-run. . . . We recognize that in this era of rapid change, new approaches to setting [the] ROE may be needed to implement this standard.”²³⁹ The Commission emphasized, however, that any risk adjustments made would be consistent with its duties under the just and reasonable standard: “Certainly, our goals have not changed, which are to ensure that customers have access to nondiscriminatory service at just and reasonable rates, and that transmission owners have an opportunity to earn a reasonable rate of return on their investment.”²⁴⁰ As discussed, under the *Hope* and *Bluefield* standards, the Commission is required to take changing risks into consideration in setting rates.²⁴¹ Also, again, the Commission is not bound to a particular method as long as it provides a reasoned justification for its choice of method.²⁴²

Rates Not Varying With Capital Structure. The Order also notes the possibility of “allowing a transmission owner to seek a return on invested capital, independent of its exact capital mix.”²⁴³ Here again, the Commission is free to use whatever method it chooses, provided the end result is just and reasonable, as justified by substantial evidence.

Rate Moratoriums. It should also be noted that the Order’s proposed rate moratorium (discussed below under “Performance Based Rates”) “may be tied to the existing transmission rate level, or to the existing return on equity.”²⁴⁴

(C) Costs

The legislative history of EPAAct suggests that the pricing standards for transmission ordered under sections 211 and 212 apply to rates for non-mandatory transmission under sections 205 and 206.²⁴⁵ The Commission itself embraced this broad interpretation of section 212 in the TPPS: “[I]n the interest of developing a uniform transmission pricing policy, we will apply these same principles to the pricing of transmission service whether that service is provided under section 205, 206, or 211 of the FPA.”²⁴⁶ Sec-

239. Order No. 2000, *supra* note 2, at 31,193.

240. *Id.*

241. *See also supra* Part 1.

242. *See also supra* Part 3.

243. Order No. 2000, *supra* note 2, at 31,193.

244. *Id.*

245. *See also supra* discussion in Part 2.

246. In 1999, Chairman Hoecker apparently accepted this view. In an appendix to a recent letter to Chairman Bliley, he noted that subsections (a) and (c) of the proposed section 217 of H.R. 2944 “appear to be modeled on existing FPA section 212(a)” and that the Commission “has construed section 212(a) to be consistent with sections 205 and 206.” Letter from Chairman Hoecker to Chairman

tion 212(a), as summarized in the TPPS, requires transmission rates to permit the recovery of all “legitimate, verifiable and economic costs, including taking into account any benefits to the transmission system of providing the transmission service, and the costs of any enlargement of transmission facilities. . . .”²⁴⁷

Incremental Pricing. Traditionally, the cost basis for transmission rates consisted of the “rolled-in embedded cost” of the transmission facilities on a non-distance-sensitive or “postage stamp” basis, including the costs of new facilities or improvements to existing facilities.²⁴⁸ As the 1994 TPPS notes, the Commission began in the early 1990s to “address the industry’s changing needs by modifying its historical transmission pricing policy. . . .”²⁴⁹ Specifically, the Commission began to permit certain types of “incremental” cost pricing, whereby utilities were allowed to charge transmission-only customers either the embedded costs for the entire system, including improvements, or incremental expansion costs, but not both. This has been called “or” pricing or *Northeast Utilities Pricing*, referring to the Commission decision that established this policy.²⁵⁰

In 1994, the TPPS declared that “the Commission is prepared to move beyond ‘or’ pricing to consider other pricing alternatives.”²⁵¹ For example, the Commission expressed willingness to consider including “various combinations” of the following pricing approaches: “(1) a traditional contract path approach or a flow-based approach; (2) costs aggregated at the utility level, at a zonal level, or at the line-by-line level; and (3) various cost concepts for rate design, such as embedded cost, ‘or’ cost, incremental cost, or short-run marginal cost.”²⁵² The TPPS also expresses openness to certain methods that would “exceed the traditional revenue requirement,” such as “[r]eplacement cost methods” and “long-run marginal cost methods.”²⁵³

The TPPS emphasized, however, that “[n]ot all of these possible combinations, however, would necessarily satisfy our principles.”²⁵⁴ Specifically, the Commission named “postage-stamp ‘and’ pricing” as an example of an “unacceptable” pricing method.²⁵⁵ “And” pricing means setting rates that compensate a transmission provider for both the costs of existing facilities (embedded average costs) and the additional costs of expansion (incremental cost), for the use of a given facility by a transmission-only

Bliley, Appendix B, § 11, Dec. 23, 1999. Curiously, however, Chairman Hoecker did not express support for the proposed section 217; instead he recommended deleting the pricing reform provision from the bill “to avoid confusion and unnecessary litigation.” *Id.*

247. TPPS, *supra* note 198, at 31,140.

248. *Id.* at 31,137.

249. TPPS, *supra* note 198, at 31,137.

250. *Id.* at 31,138 (citing *Northeast Utils. Serv. Co.*, 58 F.E.R.C. ¶ 61,070).

251. TPPS, *supra* note 198, at 31,138.

252. *Id.* at 31,145.

253. TPPS, *supra* note 198, at 31,147.

254. *Id.* at 31,145.

255. TPPS, *supra* note 198, at 31,146.

customer.²⁵⁶ The Commission rejected “and” pricing partly because it regarded the method as violating its “fairness” principle.²⁵⁷ This principle required that third-party transmission customers not be required to “subsidize” native load customers.²⁵⁸

Order No. 2000. In Order No. 2000, the Commission did not reject the TPPS policy against “and” pricing, but expressed openness to considering rates that combine incremental and embedded costs.²⁵⁹ Specifically, one of the “innovative” rate treatments the Commission stated it would consider for RTO applicants is as follows: “[t]ransmission rates that combine elements of incremental cost pricing for new transmission facilities with an embedded-cost access fee for existing transmission facilities.”²⁶⁰ In the preamble of the Order, the Commission stated that “it is appropriate for the Commission to provide flexibility for pricing new facilities” by combining incremental and embedded costs in a single rate.²⁶¹ The Commission expressed the concern that such rate treatments “have the potential to lead to higher prices for new transmission services, and also potential to lead to overinvestment in transmission facilities, e.g., where generation redispatch could accomplish the same objective at lower cost.”²⁶² Despite such concerns, these rate treatments, “if carefully constructed, will create appropriate incentives for efficient investment in new transmission facilities.”²⁶³ This is a significant statement by the Commission, suggesting a willingness to reform its policies where useful to advance the key policy goal of encouraging new transmission investment.

Despite the Commission’s previous rejection of “and” pricing (in the TPPS), there is no reason why the method would be inherently unjust or unreasonable. The Commission has broad discretion in applying the just and reasonable standard. Higher prices for new transmission services

256. *Id.*

257. TPPS, *supra* note 198, at 31,146.

258. *Id.* at 31,143.

259. It should be noted, however, that in the order on rehearing of Order No. 2000, the Commission clarified that it had not rejected the TPPS policy against “and” pricing and stated that:

While the pricing proposals we will entertain for RTOs may combine elements of embedded cost rates and incremental cost rates, they do not constitute corporate ‘and’ pricing. Indeed, we have already approved these rate forms for most existing ISOs, noting for example, that it is acceptable to charge both a non-pancaked access fee based on embedded costs and an incremental charge reflecting opportunity costs or expansion costs.

Order on Rehearing, *Regional Transmission Organizations*, 90 F.E.R.C. ¶ 61,201 (2000).

260. 18 C.F.R. 35.34(e)(2)(v). The Order also enumerates two other cost-related innovative rate treatments: “non-traditional depreciation schedules for new transmission investment” and “[t]ransmission rates based on levelized recovery of capital costs . . .” *Id.* Although the potential importance of these methods for promoting transmission investment should not be minimized, the limited scope of this Article precludes extended discussion of these approaches. It should suffice to note that these approaches are further examples of the Commission’s acknowledged discretion in choosing cost-basis valuation methods consistent with the requirements of the just and reasonable standard.

261. Order No. 2000, *supra* note 2, at 31,194.

262. *Id.*

263. Order No. 2000, *supra* note 2, at 31,194.

would not necessarily be an unjust end result. On the contrary, the fact that transmission customers must pay both the incremental cost of new construction and a share of embedded costs arguably does not necessarily run afoul of the just and reasonable standard, for three reasons. First, the transmission-only customers are both the occasion for the new construction (and should, therefore, be responsible for incremental costs), and are users of the existing system (and should pay for a pro rata share of such use). Second, the method may be a superior approach to ensuring that transmitting utilities are justly compensated for their opportunity costs when lines are congested and encouraging the expansion of transmission facilities while such congestion remains an obstacle to system efficiency.²⁶⁴

Third, as *TAPS* makes clear, there is nothing inherently unjust or unreasonable in charging different rates for different categories of customers, provided an adequate policy rationale exists.²⁶⁵ In *TAPS*, certain petitioners claimed that the FERC acted arbitrarily and capriciously by “determining that just and reasonable transmission rates include retail stranded cost recovery in some circumstances but not others.”²⁶⁶ The court rejected this argument, citing the broad discretion of the Commission to fashion rates that reasonably serve its policy objectives. “In making this argument, the [petitioners] ignore the wide discretion the FPA affords [the] FERC to determine what constitute ‘just and reasonable rates’ and ‘undue discrimination,’ as well as the unusual circumstances created by an industry change as fundamental as Order [No.] 888’s open access requirement.”²⁶⁷ Furthermore, “[j]ust because some transmission rates include retail stranded costs while others does not alone make Order [No.] 888 arbitrary and capricious; rather, petitioners must show that there is no reason for the difference.”²⁶⁸ Similarly, under Order No. 2000, the Commission would include incremental costs in some rates, but not others. This distinction, provided it is supported with reasoned justification, would not be unjust or unreasonable.²⁶⁹

In addition to “and” pricing, Order No. 2000 lists two other novel rate treatments related to cost calculation: (1) “[n]on-traditional depreciation schedules for new transmission investment;”²⁷⁰ and (2) “[t]ransmission rates based on levelized recovery of capital costs.”²⁷¹

Non-Traditional Depreciation Schedules. Specifically, the Commission is willing to consider accelerated depreciation as a means of recover-

264. See generally *id.* at 31,143 (discussing opportunity costs when lines are congested).

265. *TAPS v. FERC*, 2000 WL 762706 (D.C. Cir. 2000).

266. *Id.* at *48.

267. *TAPS*, 2000 WL 762706 at *49.

268. *Id.* (citing *AGD*, 824 F.2d at 1009).

269. As noted, a rate treatment filed by an RTO applicant must include a detailed explanation of why the treatment is just and reasonable. Such explanation would assist the Commission in articulating a reasoned justification for its rate order.

270. 18 C.F.R. § 35.34(e)(2)(iii).

271. *Id.*

ing “prudent costs [stranded] under traditional ratemaking policies.”²⁷² The Commission found that concerns over stranded transmission costs are “speculative at this point in the industry’s restructuring,”²⁷³ but would nevertheless be willing to consider non-traditional depreciation schedules in the event that “certain limited transmission facilities become stranded.”²⁷⁴ The Commission’s authority to provide for stranded costs recovery through transmission rates, under appropriate circumstances, is clear.²⁷⁵

Levelized Rates. According to Order No. 2000, a levelized rate is “designed to recover all capital costs through a uniform, nonvarying payment over the life of the asset, just as a traditional home mortgage payment does.”²⁷⁶ Order No. 2000 also notes that the Commission has held in several recent proceedings that both levelized and nonlevelized rates can yield “reasonable results, depending on the circumstances.”²⁷⁷ Despite concerns that levelized rates for RTOs “may raise RTO transmission rates in the short-run,” the Commission found that “consistent with our discussion . . . of how market restructuring may require innovation in transmission pricing, we believe that levelized rates may be appropriate in circumstances, as here, where an RTO reflects a fresh start with respect to the provision of transmission services. . . .”²⁷⁸ Here again, a Commission order allowing a levelized rate would be well within its discretion, provided the end result is reasonable and its decision is supported with sound reasoning and substantial evidence.

(D) Incentive Pricing

Beyond cost-of-service methodology, a myriad of approaches and methods are available for performance-based and other “incentive ratemaking” methods that use cost-of-service as a baseline, but then allow a utility to implement cost-saving and service-enhancing measures without losing the benefit of its cost baseline for purposes of calculating its return.²⁷⁹ As noted in Part 1, the flexibility of the FPA is not limited to the choice among traditional cost-based ratemaking methods. A just and reasonable rate need not be calculated on the basis of cost exclusively, primarily, or at all. As the Commission explained in its Incentive Ratemaking Policy Statement of 1992, “[i]ncentive regulation differs from traditional

272. Order No. 2000, *supra* note 2, at 31,194.

273. *Id.*

274. Order No. 2000, *supra* note 2, at 31,194.

275. See also TAPS v. FERC, 2000 WL 762706 (D.C. Cir. 2000). (discussing the Commission’s authority to include stranded cost elements in certain transmission rates). See also discussion of TAPS in connection with “and” pricing above.

276. Order No. 2000, *supra* note 2, at 31,193.

277. *Id.* (citing *American Elec. Power Corp.*, 88 F.E.R.C. ¶ 61,141, 61,441-42 (1999); *Allegheny Power Serv. Corp.*, 85 F.E.R.C. ¶ 61,275, 62,117 (1998); *Kentucky Utils. Co.*, 85 F.E.R.C. ¶ 61,274, 62,100-03 (1988)).

278. Order No. 2000, *supra* note 2, at 31,194.

279. See also Hon. Curt L. Hebert, Jr., *The Quest for an Incentive Utility Regulatory Agenda*, 19 ENERGY L.J. 1 (1998) (discussing incentive-based ratemaking plans).

regulation in that it . . . divorce[s] rates from the underlying cost-of-service."²⁸⁰ Incentive regulation is consistent with the Commission's authority under the FPA, provided the end result is "just and reasonable."²⁸¹ As the Commission stated "[i]ncentive ratemaking is consistent with our general ratemaking authority. The Commission is not required to follow any specific type of ratemaking formula and is not limited to designing rates based upon traditional cost-of-service ratemaking under either the Natural Gas Act (NGA) or the Federal Power Act (FPA)."²⁸² In the same policy statement, the Commission recognized the benefits of incentive regulation: "[i]n order to enhance productive efficiency in non-competitive markets, the Commission will allow utilities to propose incentive rate mechanisms as alternatives to traditional cost-of-service regulation. Such proposals should result in lower rates to consumers, and provide utilities the opportunity to earn higher returns."²⁸³ The Commission cited numerous natural gas cases in support of its authority to implement incentive rates.²⁸⁴

Subsequently, in the TPPS, the Commission acknowledged that "the electric utility industry is continuing to evolve and we must ensure that our policies do not impede the continued development of competitive bulk power markets, or the development of new market structures and transmission arrangements."²⁸⁵ It also expressed openness to "consider pricing proposals necessary to accommodate such developments," noting that "[s]ome of the proposals discussed in this proceeding may exceed the traditional embedded cost revenue requirement."²⁸⁶

Order No. 2000. In Order No. 2000, the Commission recapitulated its previous statements of support for incentive pricing: "the Commission has been receptive to PBR proposals, at least since issuance of the Policy

280. *Incentive Ratemaking for Interstate Natural Gas Pipelines, Oil Pipelines, and Electric Utilities*, 61 F.E.R.C. ¶ 61,168, 61,588 (1992).

281. As the Court observed in *Permian Basin*, "a regulatory method that excluded as immaterial all but current or projected costs could not properly serve the consumer interests placed under the Commission's protection." *Permian Basin Area Rate Cases*, 390 U.S. 747, 815 (1968). See also *supra* Part I discussion of *Permian Basin* and non-cost factors in Part I.

282. 61 F.E.R.C. ¶ 61,168, at 61,593.

283. *Id.* at 61,587.

284. "These cases affirm that the Commission is not required to follow any specific type of rate-making formula and is not limited to designing rates for the utilities it regulates based on traditional cost-of-service ratemaking. The Commission is free to set rates to provide incentives so long as there is a correlation between the incentive and the result induced." 61 F.E.R.C. ¶ 61,168, at 61,594, (citing, e.g., *Public Serv. Comm'n, State of N.Y. v. FPC*, 487 F.2d 1043 (D.C. Cir. 1973); *City of Charlottesville v. FERC*, 661 F.2d 945, 949 (D.C. Cir. 1981) ("The Natural Gas Act fails to prescribe specific standards for ratemakers to follow."); *Farmer's Union Cent. Exchange Co. v. FERC*, 734 F.2d 1486 (D.C. Circuit), *cert. denied sub nom.* 469 U.S. 1034 (1984) (stating that "changing characteristics of regulated industries may justify the agency's decision to take a new approach to the determination of just and reasonable rates . . . [and that] non-cost factors may legitimize departure from a rigid cost-based approach")).

285. TPPS, *supra* note 198, at 31,147.

286. *Id.*

If technological and economic developments continue to increase the contestability of transmission as a product, the Commission's legal justifications for market-based wholesale rates could be applied to transmission rates in the not-too-distant future. A brief examination of the legal bases for market-based rates is therefore appropriate. To receive approval to charge market-based rates for wholesale power sales, the Commission requires a showing that: (1) the applicant does not have market power in generation; (2) the applicant does not have market power in transmission; (3) there are no barriers to entry; and (4) there will be no affiliate abuse or reciprocal dealing.²⁹⁹ This policy is rooted in numerous Commission decisions and federal court opinions upholding the use of market-based rates for wholesale electric power, as consistent with the just and reasonable standard.³⁰⁰ For example, in the 1998 case, *Louisiana Energy and Power Authority v. FERC*, the D.C. Circuit upheld the use of market-based rates for wholesale power.³⁰¹ Although the case involved wholesale power sales, not transmission, the court seemed to suggest that market-based rates would be appropriate for either power sales or transmission service, provided that effective competition exists: "The Federal Power Act requires that all rates demanded by public utilities for the transmission or sale of electric energy be 'just and reasonable.' . . . Where there is a competitive market, the [Commission] may rely on market-based rates in lieu of cost-of-service regulation to ensure that rates satisfy this requirement."³⁰²

299. *Heartland Energy Servs., Inc.*, 68 F.E.R.C. ¶ 61,223, at 62,060 (1994). See, e.g., *Pinnacle West Capital Corp.*, 91 F.E.R.C. ¶ 61,290 (2000); *Wayne-White Counties Elec. Coop.*, 89 F.E.R.C. ¶ 61,282 (1999); *Entergy Servs., Inc.*, 58 F.E.R.C. ¶ 61,234, at 61,752-53 (1992) ("In previous instances in which it has granted market-based rates, the Commission has made an explicit determination that the rates fell within a zone of reasonableness.").

300. This approach is also consistent with the legislative history of EPAct, which nevertheless did not expressly authorize market-based rates. According to Senator Wallop, market-based rates in certain cases will fall within the zone of reasonableness: "In cases where the relevant market for delivered bulk power is competitive, the market price will best reflect the true value of the use of facilities and promote the economically efficient allocation of resources." 138 CONG. REC. S17,566, S17,618 (daily ed. Oct. 8, 1992) (statement of Sen. Wallop). Moreover, "[t]hese provisions are flexible enough to allow incentives for transmission services, including market-based pricing in competitive bulk power markets." 138 CONG. REC. S17,566, S17,618 (daily ed. Oct. 8, 1992) (statement of Sen. Wallop).

301. See also *Louisiana Energy and Power Authority v. FERC*, 141 F.3d 364 (D.C. Cir. 1998).

302. *Id.* The court in this case did not discuss the requirements of the just and reasonable standard, but noted that "[u]nder its precedents, the Commission approves applications to sell electric energy at market-based rates only if the seller and its affiliates do not have, or adequately have mitigated, market power in the generation and transmission of such energy, and cannot erect other barriers to entry by potential competitors." *Louisiana Energy and Power Auth. v. FERC*, 141 F.3d 364 (D.C. Cir. 1998) (citing 68 F.E.R.C. ¶ 61,223, at 62,060; *Louisville Gas & Elec. Co.*, 62 F.E.R.C. ¶ 61,016, 61,143-44 (1993)). See also *Elizabethtown Gas Co. v. FERC*, 10 F.3d 866, 870 (D.C. Cir. 1993). In this case, the petitioners contended that permitting wholesale power rates amounted to "virtual deregulation" and is "utterly at odds with its NGA obligation to insure that rates are cost-based so that consumers will be protected from abuse at the hands of natural gas companies." *Id.* Citing the Supreme Court's statement that "the prevailing price in the market cannot be the final measure of 'just and reasonable' rates mandated by the Act," *FPC v. Texaco, Inc.*, 417 U.S. 380, 397 (1974), they argued that the Commission was required to remain within the traditional cost-of-service ratemaking framework. *Elizabethtown Gas*, 10 F.3d at 870. The court rejected this argument, noting (1) that the court's statement in

In Order No. 2000, the Commission reiterated its position that market-based rates (for wholesale sales) can be appropriate under certain conditions: "The Commission has a responsibility under FPA sections 205 and 206 to ensure that rates for wholesale power sales are just and reasonable, and has found that market-based rates can be just and reasonable where the seller has no market power."³⁰³

Conclusion of Part 4. This Part provided an overview of the Commission's ratemaking policies to show that the Commission has advocated reform in numerous areas over the past decade. Recent attention to the apparently ever-widening transmission investment gap, however, suggests that the Commission's project of reform is far from complete. Order No. 2000 challenges practitioners and utilities to propose innovative rates. Significantly, the Commission has demonstrated its openness to certain reforms in specific proceedings.³⁰⁴ The next section, Part 5, discusses legislative options for encouraging or directing the Commission to implement such reforms as may be needed to promote new investment in transmission infrastructure.

PART 5. LEGISLATIVE OPTIONS

The preceding parts of this Article discussed the boundaries of the FERC's legal authority to reform its transmission pricing policies. This Article concludes that the Commission has very broad discretion to use new pricing methods that will better reflect the risks and circumstances of the restructured transmission industry. The Commission has made strong statements and taken significant actions towards meaningful pricing reform, particularly in Order No. 2000. It has been argued, however, that much remains to be done. What if internal political or ideological divisions, or simply inertia, prevent the Commission from implementing an effective reform policy? If the Commission lacks the resources to reform its policies, what external actions could encourage the Commission to act more quickly and decisively?

New commissioners appointed by a new President could change the Commission's policies substantially.³⁰⁵ Beyond changes in the composition

FPC v. Texaco was in the context of lack of effective competition and that a determination by the Commission that such competition exist was sufficient justification for permitting market-based rates; and (2) that the just and reasonable standard does not require use of "any single pricing formula." *Elizabethtown Gas*, 10 F.3d at 870 (quoting *Mobil Oil Exploration v. United Dist. Co.*, 498 U.S. 211, 224 (1991)).

303. Order No. 2000, *supra* note 2, at 31,044.

304. *See, e.g.*, International Transmission Company, 92 F.E.R.C. ¶ 61,276 (2000). In this proceeding, the Commission permitted, contingent upon the satisfaction of several significant conditions, "innovative rates" for the International Transmission Company (ITC). Such rates would be higher than the wholesale rates of the ITC's predecessor in interest, Detroit Edison Company, by 0.8 mils per kWh or, according to intervenors, 48%. Significantly, one of the conditions for approval is that ITC become a "fully independent transco," defined as a transco with "no active or passive ownership interests by market participants."

305. *See also* *Chevron v. Natural Resources Defense Council*, 467 U.S. 837, 865 (1984) (agency may legitimately take into account the views of the "incumbent administration" in revising its policies).

of the Commission, legislation may be the best means of inducing reform. This Part addresses possible legislative approaches by which the Commission could be prompted, enabled, or more strongly directed to change its transmission pricing policies to address the transmission investment gap more effectively. This part includes discussion of transmission pricing provisions of certain bills introduced in the 106th Congress, as well as suggestions for alternative legislation. It also addresses the legal boundaries for each legislative proposal discussed.

H.R. 2944: The Electricity Competition and Reliability Act. In the 106th Congress, three bills contained similar language specifically establishing new standards for transmission ratemaking: H.R. 2786, H.R. 2944, and S. 2098.³⁰⁶ This discussion focuses on the language of H.R. 2944 as reported by the House Committee on Commerce, Subcommittee on Energy and Power.³⁰⁷ This bill would amend the FPA by adding a new section 217, "Standards for Establishing Rates, Charges, Terms, and Conditions for Transmission Service," comprised of provisions for transmission cost recovery, voluntary "innovative" pricing policies (including incentive pricing), negotiated and market-based rates, a related rulemaking mandate, and provisions requiring certain reports to Congress related to transmission pricing.³⁰⁸ In view of the broad discretion possessed by the Commission under existing law, these provisions are fully consistent with the existing just and reasonable standard, and are almost entirely consistent with existing Commission policies.

H.R. 2944: Cost Recovery Provisions. Subsection (a) of the proposed FPA section 217 would require the Commission, in reviewing transmission rates under the Act, to "permit a transmitting utility to recover all of the costs incurred by the utility in connection with the transmission services and necessary associated services, including, but not limited to, the costs of any enlargement of transmission facilities."³⁰⁹ Subsection (b) would further require the Commission to "take into account the incremental cost and the benefit to interconnected transmission systems of such facilities."³¹⁰ Subsection (c) would require that rates set pursuant to subsections (a) and (b)

See also supra Part 3 for discussion of *Chevron* and agency policy changes.

306. H.R. 2786, the Interstate Transmission Act (introduced by Rep. Thomas C. Sawyer (D-OH)), included a section entitled "Economically Efficient Transmission Service and Expansion of Transmission Networks," which would have amended the FPA by adding a new section 217, "Standards for Establishing Rates, Charges, Terms, and Conditions for Transmission Service." H.R. 2944, the Electricity Competition and Reliability Act (introduced by Rep. Tom Bliley (R-VA)), as reported by the Subcommittee on Energy and Power, contained a virtually identical pricing reform section, with the addition of the provisions requiring certain reports to Congress related to transmission pricing. S. 2098, the Electric Power Market Competition and Reliability Act (introduced by Sen. Frank Murkowski), contained language virtually identical to the innovative rate provisions of H.R. 2786 and H.R. 2944, but none of the other pricing reform provisions of those bills.

307. Electric Competition and Reliability Act, H.R. 2944, 106th Cong. (1999) (as reported by the House Committee on Commerce, Subcommittee on Energy and Power (October 28, 1999)).

308. *Id.* at § 105 (amending the FPA to add a new § 217).

309. H.R. 2944, 106th Cong. §217 (1999).

310. *Id.*

promote “the economically efficient transmission . . . , the expansion of transmission networks, the introduction of new transmission technologies, and the provision of transmission services by regional transmission organizations.”³¹¹ Subsection (c) further requires that such rates shall prevent cost-shifting to non-jurisdictional services and be “just and reasonable and not unduly discriminatory or preferential.”³¹²

These provisions require the Commission to permit recovery of “all” transmission-related costs. Does this include costs that the Commission deems to have been imprudently incurred, or does it otherwise provide a perverse incentive for a utility to “pad” its transmission-rate base? No. This provision must be read in light of the further requirement that such rates be “just and reasonable.” Under the just and reasonable standard, the Commission is free to exclude costs that it deems were imprudently incurred or otherwise unreasonable.³¹³ It should also be noted that the essentially identical term “all the costs” appears in FPA section 212(a).³¹⁴

Otherwise, the “all costs” provision simply directs the Commission to do what it has always done in reviewing rates under the FPA: permit the utility to recover its costs. Such costs must include the costs of enlargement of transmission facilities. This would be consistent with the usage of FPA sections 211 and 212.³¹⁵ As noted, the Commission’s 1994 Transmission Policy Statement embraced the cost recovery requirements of section 212(a) for all transmission rates.³¹⁶

The requirement that the Commission take into account the “incremental cost and benefit to interconnected transmission systems” is essentially the same as the policy set forth in the 1994 TPPS, which recognized the need for incremental cost pricing and closely tracks the language of section 212(a). The requirement that rates promote “economically efficient transmission” closely tracks the requirements of FPA section 212(a). Using the legislative history of section 212(a) as a guide, this provision would apparently encourage, but not require, the Commission to withdraw from review in cases where negotiated ratemaking would achieve a just and reasonable result.³¹⁷ This provision should not, however, be construed

311. H.R. 2944, *supra* note 309.

312. *Id.*

313. *See generally* *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168 (D.C. Cir. 1987) (denying recovery of certain costs deemed imprudently incurred).

314. FPA, § 212(a), 16 U.S.C. 824k. These provisions are quoted in full *supra* Part 2.

315. Section 211(a), in reference to increasing transmission capacity, states:

Any electric utility, federal power marketing agency, or any other person generating electric energy for sale for resale, may apply to the Commission for an order under this subsection requiring a transmitting utility to provide transmission services (including any enlargement of transmission capacity necessary to provide such services) to the applicant.

16 U.S.C. § 824j. The term “enlargement” is also used with respect to expansion of generation capacity. *See also* FPA § 207 (16 U.S.C. 824f).

316. *See also supra* Part 4.

317. *See also* 138 CONG. REC. S17,566, S17,619 (daily ed. Oct. 8, 1992) (statement of Sen. Wallop). According to Senator Wallop:

Adding the modifier ‘economically’ to the word ‘efficient’ calls to the FERC’s attention that

as conflicting with or undermining the cost-recovery requirements of the subsections (a) and (b).³¹⁸ The requirement that rates promote the “expansion of transmission networks,” which closely tracks the transmission expansion language of section 212(a), would codify the Commission’s existing policy of promoting transmission expansion.³¹⁹

The provision that rates shall promote the “introduction of new transmission technologies” would express the same policy as the transmission expansion standard. Transmission expansion can be achieved not only by construction of new lines, but also by retrofitting existing systems with cutting-edge devices that have the effect of increasing transmission capacity by improving efficiency. Appropriate rates will help promote introduction of such technologies, to the extent that such introduction is likely to take place in the normal course of a significant transmission expansion program backed by adequate investment capital. The emphasis on new technologies, as opposed to simple expansion, would further the policy of Order No. 2000 of promoting “efficient use and investment in transmission facilities.”³²⁰

The requirement that rates promote “the provision of transmission services by [RTOs]” suggests a policy of promoting the efficient use of and investment in transmission facilities by RTOs, as advanced in Order No. 2000.³²¹ The requirement that rates prevent cost-shifting to non-jurisdictional services simply amplifies the requirement that the Commission permit “all” transmission costs to be recovered in rates. Customers for non-regulated services should not be required to subsidize verifiable transmission-related costs.

Finally, all rates must be just and reasonable and not “unduly discriminatory.” This language is identical to language in section 206. Even

the science of economics has developed sophisticated doctrine on market efficiency. The FERC should draw on that knowledge in its cases and needs to identify situations where FERC can reasonably withdraw from transaction-by-transaction review.

Id.

318. See also 138 CONG. REC. S17,566, S17,622 (daily ed. Oct. 8, 1992) (statement of Sen. Wallop). According to Senator Wallop:

The statement that such rates, charges, terms and conditions also will ‘promote the economically efficient transmission and generation of electricity and shall be just and reasonable, and not unduly discriminatory or preferential’ does not in any way legally reduce the mandatory requirements imposed on the FERC to permit such recovery of all incurred costs by the transmitting utility. . . .

Id.

319. Also, as noted *supra* Part 2, FPA section 212(a) also provides for recovery of the costs of “enlargement” of transmission facilities.

320. See also *supra* Part 4.

321. *Id.* The meaning of this provision outside the RTO context is unclear. How can a non-RTO transmission rate “promote” the provision of transmission services by RTOs? Would this provision require that such rates penalize non-RTO transmitting utilities? Reading this provision to require a penalty would be inconsistent with the other, non-RTO-specific requirements that rates promoted transmission expansion and the introduction of new technologies. Also, expansion of any transmission provider’s facilities would likely promote RTO transmission services to the extent that the overall efficiency and capacity of the nation-wide interconnected grids are improved.

without this language, all rates would still be subject to the just and reasonable standard under sections 205 and 206. It has been suggested that the transmission pricing provisions of H.R. 2944 could be an unwarranted departure from the established FPA standards, and that the language would somehow violate the FPA's just and reasonable standard or force the FERC to set transmission rates that go beyond the "zone of reasonableness."³²² The standards set forth in the proposed section 217 are, on the contrary, wholly consistent with the just and reasonable standard as it is set forth in the text of the Act and as it has been interpreted by the courts. Use of the phrase just and reasonable in the proposed section 217, removes any doubt regarding the consistency of such standards with the historic just and reasonable standard, emphasizing that the clarifications of subsections (a) and (c) would not "preempt" that standard, or in any way require the Commission to exceed the bounds of the standard as previously interpreted by the courts. Thus, such additional specifications would be consistent with the just and reasonable standard.

At most, such additional requirements would constitute a limitation or channeling of the FERC's discretion within the historic bounds of the just and reasonable standard, not a grant of new or broader authority. The new standards certainly would not require the Commission to approve "unjust" or "unreasonable" rates. Nor would these standards authorize the Commission to set rates that fall outside the zone of reasonableness under current law; rather, they would simply require that the Commission take into account, within the "zone of reasonableness," the need for expanded and improved transmission facilities in determining what constitutes a just and reasonable rate.

It should be noted that section 212(a) also provides that rates set pursuant to section 211 "shall promote the economically efficient transmission and generation of electricity and shall be just and reasonable, and not unduly discriminatory or preferential."³²³ It should be noted that the just and reasonable language of this section was drawn verbatim from the original just and reasonable language of FPA sections 205 and 206.³²⁴ Thus, the additional requirements of the section do not override the just and reasonable standard, as the legislative history confirms.³²⁵ On the contrary, sec-

322. The official section-by-section summary of H.R. 2944, issued by the House Commerce Committee after the markup, suggests that the proposed pricing provisions are potentially inconsistent with current law:

it is unclear how FERC should balance current law and the new provisions. For example, under current law FERC has authority to approve rates that range from confiscatory to monopoly rents, the 'zone of reasonableness.' The pricing provisions added by the Sawyer amendment appear to require FERC to approve rates that are higher than it would approve under current law – and closer to monopoly rents – if such rates promote the economically efficient transmission of electric energy or promote expansion.

STAFF OF HOUSE COMM. ON COMMERCE, 1ST SESS., SECTION-BY-SECTION SUMMARY OF H.R. 2944 5-6 (Comm. Print 1999).

323. 16 U.S.C. § 824k.

324. See also *supra* Part 2.

325. According to Senator Johnston, section 212(a), including the language requiring that rates

tion 212(a) simply channels the FERC's authority within the bounds of what would otherwise be "just and reasonable."³²⁶ Thus, just as rates set under section 212 must be "just and reasonable," consistent with existing law, so rates that would be set under the the proposed section 217 would likewise be required to be just and reasonable in the same manner.

Rates reflecting the economic efficiency and cost recovery requirements of section 212(a) would fall well within the "zone of reasonableness," as defined by the courts.³²⁷ Congress apparently intended to limit the FERC's discretion, in the context of section 212 orders, within what it would otherwise be under sections 205 and 206. "[The FERC's] discretion is intentionally constrained by the specific pricing directions provided by Congress, with the resulting rate being in the zone of reasonableness."³²⁸

promote economically efficient transmission, does not override the just and reasonable standard: "[A]ll cost recovery under new FPA section 212(a) is still bound by the requirement that rates, charges, terms and conditions must be just and reasonable and not unduly discriminatory or preferential." 138 CONG. REC. S17,566, S17,612 (statement of Sen. Johnston in colloquy with Sen. Wallop). The legislative history of section 212 emphasizes the legal pedigree of section 212's just and reasonable standard. See also 138 CONG. REC. H 11399, H 11400 (daily ed. Oct. 5, 1992) (statement of Rep. Sharp). In the House floor debate on the EPAct conference report, Representative Sharp stated:

I am particularly pleased that the provision concerning the pricing of transmission services maintains the traditional broad statutory approach of the original Federal Power Act (FPA). The FERC must retain sufficient discretion to apply the traditional, time-tested FPA standards - just and reasonable, and not unduly discriminatory or preferential - to particular cases as electricity markets evolve. I would note that H.R. 776 repeats these words verbatim from the current act, and makes them the centerpiece of our pricing provision.

Id. See also 138 CONG. REC. H 11,399, H 11,412 (daily ed. Oct. 5, 1992) (statement of Rep. Moorhead in colloquy with Rep Sharp). According to Representative Sharp:

These traditional standards are the central features of the bill's pricing section. They have served the country well over the past 50-plus years, because they provide FERC with guidance respecting Congress' intent while preserving the discretion FERC needs to carry out Congress' goals in specific cases over time. Specifically, just-and-reasonable has been interpreted to preclude the collection of excessive profits, sometimes called monopoly rents and our inclusion of the standard in the bill is intended to continue that interpretation.

Id.

326. "These pricing provisions encompass the 'just and reasonable' standard, but provide more detailed requirements for the FERC to apply in order to assure that when the FERC mandates transmission service (including enlargement of facilities) . . . it does not force the transmitting utility or its customers to subsidize the provision of these services." 138 CONG. REC. S17,566, S17,618 (daily ed. Oct. 8, 1992) (statement of Sen. Wallop).

327. See also 138 CONG. REC. S17,566, S17,618 (daily ed. Oct. 8, 1992) (statement of Sen. Wallop). As Senator Wallop explained: "The specific pricing directions of new FPA section 212(a) will govern the establishment of the rate for the ordered transmission services, as long as the resulting rate is within the zone of reasonableness and is not otherwise unduly discriminatory or preferential." 138 CONG. REC. S17,566, S17,618 (daily ed. Oct. 8, 1992) (statement of Sen. Wallop).

328. 138 CONG. REC. S17,566, S17,622 (daily ed. Oct. 8, 1992) (statement of Sen. Wallop). According to Senator Wallop:

The statement that such rates, charges, terms and conditions also will 'promote the economically efficient transmission and generation of electricity and shall be just and reasonable, and not unduly discriminatory or preferential' does not in any way legally reduce the mandatory requirements imposed on the FERC to permit such recovery of all incurred costs by the transmitting utility. . . . Consequently, the FERC's otherwise applicable discretion to set rates, charges, terms and conditions under the FPA will of necessity be much more narrow.

Similarly, the cost recovery provisions of H.R. 2944 would channel the FERC's discretion, but would not require or authorize the FERC to set transmission rates at levels beyond or outside the zone of reasonableness or otherwise inconsistent with the just and reasonable standard.

H.R. 2944: Voluntary Innovative Pricing Provisions. Subsection (d) would require the Commission to "encourage innovative pricing policies voluntarily filed by transmitting utilities," including policies that (1) provided incentives to transmitting utilities to participate in RTOs; (2) limit charging of multiple rates for transmission service by RTOs; (3) minimize cost-shifting among existing customers within an RTO; (4) encourage "efficient and reliable operation" of transmission networks through congestion management, performance-based or incentive ratemaking, and "other measures;" and (5) encourage "efficient and adequate investment in and expansion of" RTO transmission facilities.

These provisions are consistent with the policy of Order No. 2000 to promote efficient use of and investment in RTO transmission facilities. The Commission has ample legal authority to implement incentive or performance based rate treatments.³²⁹ Rate treatments that encourage efficiency, reliability, and transmission investment and expansion are consistent with the requirements of the *Hope* and *Bluefield* cases that rates be adequate to attract capital needed for the discharge of a utility's public duties. Such treatments would also advance the FPA policies in favor of adequate and reliable transmission. By incenting RTO formation, these policies would also further the purposes of FPA section 202(a), which directs the Commission to "encourage the voluntary interconnection and coordination of facilities for the generation, transmission, and sale of electric energy. . . ."³³⁰

It should be noted that the innovation pricing provisions of H.R. 2944 require only that the Commission consider such treatments. It does not require that they be approved, even if they were to meet the standards set forth in Order No. 2000. Also, the burden of development of such rate treatments remains on the RTO applicant and no special provision is made for advance declaration by the Commission of whether a particular rate treatment would be approved. These provisions would nevertheless send a clear signal that Congress intends the Commission to give serious consideration to such treatments for all transmitting utilities applying to participate in RTOs.

H.R. 2944: Negotiated Rates and Effective Competition. Sections (e) and (f), respectively, provides that the Commission "may permit" negotiated transmission rates (without regard to costs) between willing parties, and where the Commission finds effective competition, market-based transmission rates. These sections do not require the Commission to permit such rates, and in the case of market-based rates, would permit such

Id.

329. See also *supra* Part 4.

330. 16 U.S.C. § 824a(a).

rates only when "effective competition" exists. This requirement is consistent with existing law and Commission practice regarding market-based rates.

H.R. 2944: Rulemaking and Reports. Section (g) would require the Commission to issue a rulemaking providing for performance-based or incentive-pricing policies under subsection (d) and negotiated rates under subsection (e).³³¹ As noted above, the Commission would not be required to accept such rates. As a matter of constitutional law, Congress is free to impose whatever standards it chooses on ratemaking procedures, provided they do not compel a confiscatory result.³³²

Subsections (h) and (i) would require the Commission to submit certain reports to Congress on (1) its policies to encourage transmission expansion through incentive or "other similar market-oriented approaches;" and, (2) a comparison of returns on transmission investments with returns earned by "a sample of United States companies from other industrial sectors." These requirements reflect policies of facility adequacy and capital attraction consistent with the FPA, the *Hope* and *Bluefield* standards, and Order No. 2000.

Alternative Legislative Approaches. The transmission pricing provisions of H.R. 2944 are, to the extent that they recapitulate existing law and Commission policy, primarily permissive and hortatory. The cost recovery provisions in particular, while providing a strong signal of congressional concern for transmission expansion, essentially add no new requirements beyond the existing boundaries of the just and reasonable standard. Although the rulemaking provisions could provide a significant incentive to advance the Commission's incentive and negotiated rate policies, the Commission would not be required to accept any such rates.

To assist the Commission in addressing transmission capacity issues promptly and effectively, it may be useful for Congress to qualify the Commission's mandate under sections 205 and 206 in a more forceful manner than would be required by H.R. 2944. The range and content of new standards Congress could provide would be limited only by the requirement that such standards not compel a confiscatory result in any rate matter. Specific congressional standards or prescriptions for rate-making are by no means inherently incompatible with the just and reasonable standard. Ratemaking is a highly complex, legislative process that is ideally suited for an expert regulatory body. But it is nevertheless an exercise of delegated legislative authority. Congress has, in several instances, coupled specific requirements with a just and reasonable standard in the electric power context.³³³ In *Duquesne*, the Supreme Court stated that "[i]t

331. The rulemaking would provide definitions and standards, including (1) a method for calculating baseline rates (including certain price caps); (2) an index mechanism; and (3) time periods for later adjustments of initial rates; and (4) specification of excluded costs.

332. See also *supra* Part 1.

333. See also FPA § 212(a) (rates for compelled transmission access must be just and reasonable and meet various additional criteria discussed in Parts 2 and 3 of this article); PURPA § 210 (b), (d) (codified at 16 U.S.C. 824a-3)(providing for rates for purchase of congenerated power by electric utility

cannot seriously be contended that the Constitution prevents state legislatures from giving specific instructions to their utility commissions. We have never doubted that state legislatures are competent bodies to set utility rates.³³⁴

The same reasoning applies, *a fortiori*, to Congress's authority over the Commission. Alternative legislative approaches within Congress' authority could include codifying Order No. 2000's incentive rate provisions or other standards clarifying the application of the just and reasonable standard to transmission rates. Congress could also enact procedural provisions to reduce the uncertainties related to voluntary filings. For example, the Commission could be required to issue declaratory orders advising prospective RTO applicants of whether their proposed innovative rate filings would be consistent with applicable standards.

CONCLUSION

This Article is intended to inform or, more likely, remind the reader that the constitutional and statutory requirements for ratemaking by the Commission remain constant, even if, as has been the case over the last decade, there is major change in the circumstances in which those requirements are applied. The fundamentals are clear. Rates must be sufficient to attract the capital necessary for the "proper discharge of public duties," but the time-honored just and reasonable standard is flexible. The Commission must permit rates that will enable the transmission provider to remain healthy enough to discharge its public duties, but it has ample discretion to employ any ratemaking method it chooses, even to permit "market-based rates," so long as it supports its choice by substantial evidence. Both the FPA and governing principles of administrative law repose significant authority with the Commission. In light of changes in the electric industry structure in recent years, and the growing consensus that the transmission investment gap threatens both reliability and competition, the Commission has recognized its ability to adopt new methods for judging rates. The Commission has even invited transmission providers to submit innovative rates. This situation presents a challenge for transmission providers, their advocates, and policymakers, specifically for Commissioners and Members of Congress. Practitioners should reexamine the contours of the Commission's constitutional and statutory mandate as outlined in cases that may be so familiar as to be overlooked. Closing the transmission investment gap should strengthen reliability of electric service, spur development of new technology to improve transmission operations, and permit more vigorous competition. To accomplish this goal through transmission rate policies will require rigorous discovery of the facts and a fresh application of the time-honored just and reasonable stan-

must be just and reasonable and meet certain incremental cost requirements).

334. *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 313 (1989) (rejecting petitioner's argument that legislative mandate of a "used and useful" standard in valuing utility property impermissibly interfered with the public utility commission's duty to balance consumer and investor interests).

ard, consistent with those facts. This new approach must emphasize the congruence of consumer and investor interests in reliable, high-capacity transmission networks.
