# Will Incentives Get More Transmission Infrastructure Built?

*by Robert W. Gee, President, Gee Strategies Group LLC*

The power blackout of August 14 of last year was a wakeup call that something is seriously amiss with the country's electric power delivery system. Although an exhaustive government-led investigation concluded that the immediate cause of the blackout that day was largely due to ineffective and uncoordinated reliability management of the grid – along with poor vegetation management – knowledgeable observers have indicated that this incident also underscores a long-festering concern of hard asset adequacy given the system's fragility and lack of resiliency. No doubt the overarching policy issues of sufficient reliability standards, along with proper grid supervision and control, will continue to dominate discussion in courts, regulatory arenas, and Congressional cloakrooms. But it is unlikely during the interim that significant amounts of capital will be invested to enhance the means by which power is delivered to homes and businesses.

This is a serious problem. The growth of electricity demand in our economy, which over the years riveted our attention and resources to encourage newer, cleaner, and more efficient power generation capacity, has left an insufficient commitment of capital in the transmission segment of the power delivery business. Further exacerbating the situation, the breakup of the "family of assets" that used to reside under the traditional, vertically integrated utility in many venues has left – if not an abandoned orphan – something akin to a neglected, transmission stepchild. Having exercised poor parental supervision, we're now paying a price.

The solution offered in some circles is to reinvigorate investment by offering incentives to invest. Such incentives can take several

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**EnergyPulse Special Issue**
*21st Century T&D*
Spring 2004

forms. One approach would be through assignment of a reward premium to the utility's regulated equity rate of return. Typically, rates of return are awarded based on, among other things, references to comparable investment alternatives. Equity returns also are a function of anticipated costs of money over the foreseeable time period. The rationale behind assigning a premium to an authorized return rests on the premise that "business as usual" will not suffice to jump-start the type of management and investor behavior needed to address critical gaps likely to widen for the foreseeable future.

This type of incentive approach would be legislatively authorized by the House of Representatives' version of the energy bill still pending in Congress. Without specificity, it directs the Federal Energy Regulatory Commission (FERC) to utilize rate incentives. Additionally, a similar recommendation appeared in a report issued last year by one foundation-funded, blue-ribbon panel. The National Commission on Energy Policy called for "higher rates of return for approved measures, increased certainty of recovery, and performance-based rewards that share system savings between shareholders and users" to address inadequate investment in transmission.

This was the apparent reasoning of the FERC last year when it proposed adopting a policy to allow transmission-owning utilities to enjoy, for new transmission investment, a generic one percent mark-up to the customarily set equity rate of return. The FERC also proposed awarding additional return premiums of one half a percent for companies that participated in Regional Transmission Organizations (RTOs), and one and a half percent for RTO participants who meet certain independent-ownership requirements. The transmission investment incentive was part of a broader package of "carrots" designed to encourage voluntary structural reform of the firms who own and operate the grid.

Predictably, FERC's generic rate mark-up proposal has been lauded by most transmission-owning utilities, and sharply criticized by consumer advocates, commercial and industrial consumers, and some public power entities who are dependent upon transmission-owning utilities to deliver them power. Among their objections: current returns are ample to incentivize investment; this measure would be ineffective since transmission constitutes only about 10 percent of total grid assets, with the remainder under retail state jurisdiction; a reward premium would unjustly enrich utilities for making investments they are already legally required to undertake; investment rewards should be targeted only to those that remediate congestion; and enhancing the certainty of cost recoupment is the real issue, accomplished by allowing the current rate recovery of precertification expenses.

Were we in a purely business-as-usual setting, some of these objections would undoubtedly have merit. However, FERC's approach has logic when coupled with its rate incentives for structural reform regarding RTO membership and independent ownership requirements. Above all else, uncertain regulation currently stands as the paramount obstacle impeding new investment. Irrespective of whether one agrees with FERC's philosophical direction in striving for greater uniformity of market standards, the greatest weakness impeding investment has been the fundamental failure to provide the vision of an end-state for the grand experiment called restructuring. If financial incentives could accelerate structural reform and enhance regulatory certainty, and if any significant new investment could be encouraged, the fiscal impact on ratepayers may be worthwhile relative to the total cost of delivered power since transmission makes up only about 10 percent of that cost.

Additionally, the incremental cost from adjusting an equity return may pale when contrasted with what ratepayers already pay from the current cost of power failures. In an oft-cited survey conducted in 2000, the Electric Power Research Institute (EPRI) found that the country's annual exposure to power outages and disturbances ranged from $120 billion to $180 billion. If correct, consumers already pay this annual sum because these costs are absorbed in the form of higher costs for goods and services

One objection to FERC's proposed incentives for new investment, RTO membership, and transmission asset divestiture is that the cumulative cost to consumers could be as high as $13 billion over the duration of the incentives. As the EPRI survey demonstrates, cost exposure to that sum over a multi-year period could be dwarfed by the annual cost savings capable of being realized from improved reliability, and lessened outages and disturbances.

FERC has not offered up a silver bullet. It has, however, spawned a vigorous debate over how much we value reliability, what we (as a country) would be willing to pay for it, what steps we should consider to move us forward, and at what price we might ultimately concede that something – anything! – must be done.

Other incentives or mechanisms may have better merit than FERC's proposed prescription. But today's lesson should be: out-of-the-box thinking got us in the jam we are today, and most likely only out-of-the-box solutions will get us out of it.

Incentives aren't the ultimate answer, but they need to stay on the table. □

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