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Navigating Regulatory Challenges to Utility Sector Growth

Energy

Electric Utilities

Electric utilities face new risks and opportunities in a changed business model. In this Bloomberg BNA Insights, Stephen M. Spina and J. Daniel Skees of Morgan, Lewis & Bockius LLP look at how regulatory changes have provided new opportunities for utilities to build transmission facilities and achieve significant revenue and profit growth.



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Over the last two decades the traditional electric transmission business model has changed dramatically. No longer is a utility's profitability directly connected to load growth. Load growth—to the extent it exists—is undercut by energy efficiency and the expansion of distributed generation. Moreover, regulatory changes have stripped utilities of their tradi-

tional exclusive right to build new transmission facilities in their service territories.

This creates both unprecedented risk and new opportunities for electric utilities. The loss of load growth places utilities at risk of business stagnation in the absence of new revenue streams. Historically, utilities could rely on ever-expanding load, allowing utilities to sell more electricity each year, which in turn required the construction, operation and maintenance of new distribution and transmission facilities as well as new generators. Because utilities generally earn a set rate of return for their costs, the more money they spent serving load, the more money they made. In the last half of the 20th century, load growth in the U.S. slowly dropped from around 12 percent a year to 2 percent a year. The 21st century has not been as kind. During the 2007-2009 recession, load growth briefly went *negative*, and is projected to average just under 1 percent through 2040.

This drop in load growth has sent public utilities searching for new revenue sources, and recent regulatory changes have provided an opportunity for utilities to again see higher profits, albeit in a more competitive marketplace. These opportunities have come in the

form of mandated competition in transmission development. Even with flat load growth, significant new transmission is needed due to changes in system flows stemming from changes in the location of load, as well as a desire to reach more economical or more environmentally friendly generation. Utilities successful in this new market can achieve significant, guaranteed returns on major, multi-decade investments, with returns on equity above 10 percent.

The transmission investment possibilities created by regulatory development include: (a) competitive transmission development using cost-of-service rates, (b) merchant transmission using negotiated rates, and (c) special-purpose transmission projects such as projects providing system resiliency. The regulatory framework—and related risks—differ for each project type, but each offers similar opportunities for significant, long-term returns for utilities in search of new income streams.

Order No. 1000 Competitive Transmission.

Responding to the perceived need for greater investment in transmission, in 2011 the Federal Energy Regulatory Commission issued Order No. 1000, directing public utilities to establish regional planning organizations that would use detailed processes to identify and collectively resolve their transmission needs. The Order No. 1000 regional planning process requires the identification of those needs, including reliability needs (e.g. expansion to address load changes), economic needs (primarily reductions in transmission congestion), and public policy requirements established by state or federal laws or regulations such as access to renewable energy resources. Once those needs are combined and analyzed, utilities can then determine whether there are any transmission projects in their regions that could resolve the needs of multiple utilities more efficiently or cost effectively than the utilities building smaller projects on their own. After identifying such projects, each region conducts its own process to identify an entity to build that project.

This developer selection process relies on the most significant change in Order No. 1000—incumbent utilities no longer have a federal “right of first refusal” to develop any transmission projects in their franchised service territory. Instead, with small exceptions, any transmission project identified through the Order No. 1000 regional planning processes must be open to competition. A winning developer then has the opportunity to recover the cost of developing, operating and maintaining the transmission projects, along with a reasonable rate of return, which is generally referred to as a “cost-of-service” rate. A cost-of-service rate allows the utility to charge rates based on the cost to provide the transmission service along with a rate of return set through a regulatory proceeding.

This provides a unique opportunity for existing electric utilities. An electric utility in the southeastern U.S. can participate in a regional planning process in the northwestern U.S. and, if successful, develop a transmission project in an area far from that utility’s traditional home. If that utility has flat load growth in its own franchised service territory, it is unlikely to have an opportunity to build transmission and recover on

that transmission investment from its ratepayers. However, because that utility was selected to build transmission in another region of the country, that utility can obtain full recovery, including a significant rate of return, from other utilities’ ratepayers. This provides not only substantial benefits to the utility’s bottom line through a steady rate of return for decades but also the political benefit of achieving those returns without any cost to its traditional ratepayers and without any potentially contentious regulatory proceedings for rate increases.

Merchant Transmission.

Another opportunity for utilities has arisen in the merchant transmission space, which also allows utilities to make capital investment with strong, long-term returns, but with certain unique advantages over cost-of-service rates, along with some increased risks.

Merchant transmission projects do not use cost-of-service rates. Instead, the merchant transmission developer holds a formal open season for interested customers or conducts a broad and public open solicitation for potential customers. After selecting customers, the developer then negotiates the price for transmission capacity with those customers.

This can be attractive to customers because the merchant transmission developer must bear the risk of bringing the project to market; if the transmission project is late or fails entirely to come online, the developer bears that cost absent the voluntary agreement by the customers to engage in risk-sharing. This stands in contrast to traditional cost-of-service transmission development where certain “abandonment” costs can be recovered from ratepayers if the project fails for reasons outside the developer’s control.

Merchant transmission projects are also very attractive to developers because they present more upside potential. Developers of cost-of-service projects will make their set rate of return based on their costs to construct, operate and maintain the project. This caps their profit at the return approved by FERC. A merchant transmission developer’s profits are not capped by regulation in that manner. Instead, a merchant transmission developer is free to negotiate the rate it charges. If that negotiated rate is, for example, \$2 per megawatt hour (/MWh) for transmission capacity, and the developer can manage its costs so that it only costs \$1.7/MWh to provide the transmission service, the difference is pure profit for the developer.

The ability to increase profits by increasing the delta between the negotiated rate charged and the actual cost to the developer of providing service makes the merchant transmission option increasingly attractive. Particularly for utilities experienced in transmission development and operation, successfully constructing and operating merchant projects can produce profit margins above those otherwise available in the regulated space, although not without risk if the project fails.

Special-Purpose Transmission.

The final category of transmission investment that provides profit opportunities for utilities in an era of flat load growth includes those projects built by individual utilities, in their own service territories, for policy reasons that do not fit within the traditional Order No. 1000-defined categories of transmission needs.

System resiliency projects provide a good example.

As a result of various threats to the physical security of transmission facilities throughout the U.S., FERC recently approved a reliability standard on physical security, requiring transmission-owning utilities to identify their most critical transmission substations, analyze the threats to those substations and develop and implement security plans to protect those substations from the identified threats. For most utilities, this has resulted in plans to install thick walls, guards, cameras and other protections at their critical substations.

These protections provide significant security improvements, and the costs of those protections are generally recoverable in transmission rates, again providing a level of return on investment to those utilities. But such protections are not the only, or best, solution to the security risk posed by physical threats. In addition to hardening substations against attacks, utilities can invest in efforts to make their overall transmission systems more resilient to isolated attacks.

Utilities can achieve this resiliency by reducing the impact of individual substations on the reliability of service to end users. For example, many major cities are dependent on only a handful of large transmission substations. The loss of one or two entire substations in those circumstances could black out the entire city, possibly for weeks at a time. Utilities may build walls for those substations as strong as prudence allows, but in a competition between the strength of the walls and the power of the bomb or other attack method, the terrorist planner has the advantage. To provide greater resiliency to the system and avoid ever-increasing investments in more and higher walls, a utility could instead split the handful of transmission substations serving the city into a web of smaller substations with smaller transmission lines. Such an arrangement is much less susceptible to physical attacks because even a coordinated attack that removed multiple substations from service would not significantly affect the ability of the utility to serve that city.

For a utility facing flat or declining revenue growth, these resiliency projects provide a unique advantage. This construction would not be dependent on load growth and, because these projects are typically single-utility projects in a utility's own franchised service territory, a utility can undertake these projects without

competition. Once built, these facilities would use cost-of-service rates through which the utility would achieve its approved rate of return for decades.

Given the novelty of these resiliency projects, state approvals for transmission siting and prudence, as well as challenges to transmission rates at the federal level, would be a concern. But by focusing on limited areas with critical loads such as major cities, industrial centers and large military bases utilities can make a strong case for these major capital investments.

Conclusion.

Changes in the economics of the electric industry and the long-standing regulatory rules for transmission development provide unique opportunities. Although the business model is changing and many utilities cannot rely on their local economies to provide strong, continued profit growth, the transmission investment field—which can provide significant returns on investment—is expanding.

Not only are there new opportunities for utilities to build new transmission facilities in their own service territories in response to regulatory initiatives such as system resiliency, there are also opportunities to build transmission projects throughout the country, a much broader field of investments than what was traditionally available to utilities.

Utilities successful in pursuing these opportunities by taking advantage of these regulatory changes can achieve significant revenue and profit growth through expanded capital investments, leveraging the recent regulatory changes affecting transmission to overcome the sluggish load growth that has historically driven utility profits.

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