BEFORE THE
ARKANSAS PUBLIC SERVICE COMMISSION

IN THE MATTER OF THE APPLICATION OF AEP SOUTHWESTERN TRANSMISSION COMPANY, INC. FOR RECOGNITION AS A PUBLIC UTILITY WITH POWERS OF EMINENT DOMAIN AND CERTIFICATED FOR THE PUBLIC CONVENIENCE AND NECESSITY TO OWN AND OPERATE TRANSMISSION FACILITIES IN THE STATE OF ARKANSAS AND THE APPLICATION OF SOUTHWESTERN ELECTRIC POWER COMPANY TO TRANSFER CERTAIN SPECIFIED CECPN AUTHORITY AND RESPONSIBILITIES TO AEP SOUTHWESTERN TRANSMISSION COMPANY, INC.	)	**Docket No. 11-050-U**

ATTORNEY GENERAL'S BRIEF IN RESPONSE TO ORDER NO. 5

NOW COMES the Consumer Utilities Rate Advocacy Division of the Arkansas Attorney General's Office (CURAD) in response to Commission Order No. 5 in Docket 11-050-U:

I. Introduction and Description of Legal Issues

In Order No. 5, the Commission issued an invitation to the parties to file briefs "regarding the issue of federal preemption raised by the General Staff for the first time in Staff Counsel's opening statement as well as an assessment of the benefits to SWEPCO's Arkansas ratepayers associated with the Commission's approval of SW Transco/SWEPCO's Application."[1] Since the inception this docket, the parties have had some difficulty agreeing on the issues in contention, and unfortunately, that disagreement was apparently not resolved by the time of the hearing. In this brief we hope to explain what the legal disagreement is, how it relates to the underlying policy question inherent in the request for a CCN to establish a transmission-

[1] Order No. 5 at 1.

only company, and why CURAD contends that the scope of federal pre-emption is sufficiently narrow that granting applicants' desired relief is ultimately not in the public interest.

In its opening statement, Staff characterized CURAD's position as seeking to deny SWEPCO recovery of charges incurred under the Southwest Power Pool ("SPP") Open Access Transmission Tariff ("OATT"). [2] This is **NOT** CURAD's position. Staff also stated in its opening statement that a refusal to include SPP OATT charges in setting retail rates would "trap" costs, which is impermissible under federal law. CURAD does not dispute that retail rate orders that conflict with FERC jurisdictional rates or allocations are pre-empted under the Federal Power Act. Instead CURAD's position is that a conflict would only arise when retail regulators fail to give effect to FERC rates or allocations. When setting retail rates, this Commission is not required by federal law to accept FERC determined revenue requirements, returns on equity, capital structures, depreciation rates, or any other input used to set wholesale rates; this Commission need only defer to FERC rates or allocations within the wholesale electricity market.

II. Factual Context for the Legal Issues

On May 6, 2011, AEP Southwestern Transmission Company, Inc. ("SW Transco") and Southwestern Electric Power Company ("SWEPCO") (collectively "applicants") filed an application requesting a Certificate of Convenience and Necessity for SW Transco to own and operate transmission facilities and for the transferral of certain Certificates of Environmental Compatibility and Public Need to build electric transmission lines from SWEPCO to SW

[2] T. at 24-26.

Transco.[3] Ultimate ownership of both companies would remain with American Electric Power.[4] SW Transco would be an affiliate of SWEPCO.[5] Applicants have therefore proposed a corporate reorganization of how transmission will be financed, operated, and paid for.[6]

The broad question at issue in this docket is whether "public convenience and necessity require or will require" the establishment of AEP Southwestern Transmission Company as a public utility.[7] To decide this question, this Commission must judge whether the benefits to the public outweigh the costs. No party to this docket contests that the services SW Transco would provide the public would be essentially identical to services that SWEPCO would provide the public, so the public would not see improved services.[8] What is contested is how the formation of this new company will affect the public's costs. The applicants claim there will be lower costs to the public in the form of decreased financing costs.[9] CURAD contends that the applicants have overstated those benefits, but does not deny the possibility of their existence.[10] The contentious issue is whether this corporate reorganization would allow the applicants to exploit ratemaking differences between state and federal jurisdictions to increase the rates paid by SWEPCO retail ratepayers, or whether SWEPCO has already insured that the rate increases are inevitable.

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[3] Application at 1.
[4] *Id.* at 1-2.
[5] *Id.* at 7.
[6] Direct Testimony of William Marcus at 28, T. at 302.
[7] Ark. Code Ann. § 23-3-201(a).
[8] *See, e.g.* Responses to Questioning of Lisa Barton by Commissioner Reeves. T. at 69 ("All of the services provided to Southwest Transco will be the same services, for example, that approximately 1600 transmission employees will do for all of the operating companies that is has and for all of the Transcos it has.").
[9] Application at 6-7.
[10] *See, e.g.* Direct Testimony of William Marcus at 29, T. at 303.

The key regulatory difference is that FERC ratemaking yields much higher revenue requirements than APSC ratemaking for the exact same investment. Although FERC and the APSC use similar formulas to calculate rates, FERC uses assumptions that favor utility investors at the expense of utility ratepayers.[11] FERC's allowed revenue requirements are higher than the APSC's by virtue of higher allowed returns on equity, more expensive imputed capital structure, faster depreciation, and more taxes.[12] Using the estimates put forth by one of SWEPCO's witnesses, ratepayers will pay roughly 38% more for the same transmission investment when FERC sets the revenue requirement than when the APSC sets the revenue requirement. It is therefore in the interests of utility investors to structure their businesses in such a way that new transmission investment is recovered using FERC ratemaking treatment, and their sales transactions are structured such that the authority of state regulators, such as the APSC, to set revenue requirements is pre-empted as broadly as possible. In this way, their investments will be more profitable. Applicants have acknowledged that AEP established transmission-only companies in response to FERC policies designed to encourage transmission investments.[13]

The basis for Staff and applicants' contention that retail customers will be **obligated** to accept FERC revenue requirements for transmission lies in SWEPCO's membership in the SPP Regional Transmission Organization ("RTO"). Although SWEPCO is a transmission owner in SPP, SPP acts as SWEPCO's transmission provider.[14] SWEPCO has turned operation of its transmission system over to SPP, which operates it in coordination with many neighboring

[11] *See* Direct Testimony of Sandra S. Bennett, Table 2, at 16 (comparing FERC ratemaking with state retail regulator ratemaking), T. at 227.
[12] *See id.*
[13] Rebuttal Testimony of Joshua D. Burkholder at 4, T. at 185.
[14] SPP OATT, § 1 at 66.

transmission systems. The SPP OATT governs the terms, conditions, and rates for the many services SPP provides to its members. The SPP OATT governs how transmission customers compensate SPP for its services, and how transmission owners are compensated for the use of the systems they own. Although stakeholders, including the APSC, may attempt to influence its contents, approval of the SPP OATT is entirely FERC jurisdictional. Therefore, calculations of its rates use FERC assumptions to produce FERC revenue requirements as described above.

Over the course of this docket, certain terms describing the effects of costs paid under the SPP OATT have become confused. In his Direct Testimony, CURAD's witness William Marcus testified regarding his belief that SWEPCO believed itself entitled to a form of transmission rider different that that received by other Arkansas members of SPP.[15] Mr. Marcus testified to his understanding that in its next general rate case SWEPCO would seek a transmission rider that would pass **all** of its transmission costs, both services and investments, to retail ratepayers using FERC revenue requirements.[16] This form of a transmission cost recovery rider would be very different from the riders approved for other Arkansas utilities that are SPP members, which did not seek to recover the costs of all transmission investments using FERC revenue requirements through their riders.[17] Rather, the other Arkansas SPP utilities' riders included recovery of payments to other utilities for transmission investments, recovery of SPP administrative fees, and customer credits for certain revenues received under the SPP OATT.[18] The phrase "OATT

[15] Direct Testimony of William Marcus at 7-8, T. at 281-82.
[16] *Id.*
[17] Direct Testimony of William Marcus at 11-12, T. at 285-86.
[18] *Id.* Empire District Electric and Oklahoma Gas and Electric, the other investor owned Arkansas jurisdictional utilities in SPP, only recover charges under Schedules 11 (Base Plan Zonal Charge and Region-wide charge) and 1a (Tariff Administration Service) of the SPP OATT. EDE and OG&E's riders also net certain FERC jurisdictional revenues against the charges. OG&E APSC Tariff at Sheets 76.2-76.4 and EDE APSC Tariff at Sheet 33.2-33.3

Tracker" first appeared in the rebuttal testimony of Joshua D. Burkholder, and appeared to describe a transmission rider consistent with Mr. Marcus's understanding of the rider SWEPCO desired, *i.e.* a rider that passed the cost of **all** costs of transmission to retail ratepayers using FERC revenue requirements, including both ongoing transmission expenses and returns on transmission investments.[19] SWEPCO's terminology shifted again in the Sur-surrebuttal testimony of Sandra S. Bennett so that "OATT Tracker" became "OATT Costs."[20] Although "OATT Costs" may have been intended to more broadly allow for collection through base rates or a through a rider, it had the effect of causing considerable confusion as to the nature of CURAD's position, which continued through opening statements at the hearing. There SWEPCO's attorney described the question to be "whether SWEPCO is entitled to fully collect its FERC OATT"[21] and claimed CURAD questioned whether SWEPCO could fully recover "the costs it pays SPP for the transmission *service* it uses."[22] Staff continued the trend, describing the issue as recovery of "OATT expenses" and "transmission service."[23]

Some background on the SPP OATT is relevant to understanding CURAD's actual position. When a vertically integrated utility, such as SWEPCO, becomes a member of SPP, it assumes two roles that are relevant. First, as a load serving entity it is a transmission customer of SPP, and pays SPP to operate its transmission system.[24] Second, because SWEPCO has contributed its transmission system for SPP's operation, it is also a transmission owner.[25] As a

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CURAD understands SWEPCO's preferred transmission cost recovery rider would at least include Schedule 9 (Network Integration Transmission Service) charges.

[19] Rebuttal Testimony of Joshua D. Burkholder at 3, T. at 184.
[20] Sur-surrebuttal of Sandra S. Bennett at 4, T. at 235.
[21] T. at 8.
[22] T. at 11 (emphasis added).
[23] T. at 25.
[24] SPP OATT § I(1)(T)
[25] *Id.*

transmission customer, SWEPCO pays under the OATT for the (now effectively regional) transmission system that it needs to serve its load.[26] As a transmission owner, SWEPCO is credited with revenues collected under the OATT for contributing operation of its transmission system to the RTO.[27] SWEPCO, the vertically integrated utility, pays itself for the use of its own transmission system.[28] Because of the circular nature of these payments, Schedule 9, § 1 of the SPP OATT allows SPP members that are both transmission owners and transmission customers to elect not to pay certain monthly demand charges that it would otherwise receive back from SPP.

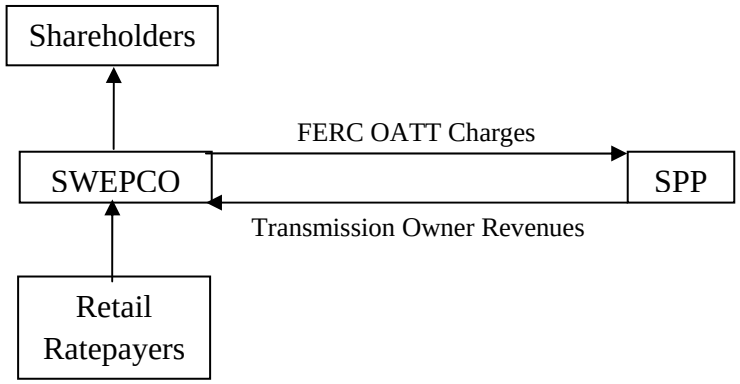
Because transmission operations are now regionalized, part of what SWEPCO pays for transmission goes to other transmission owners, and part of the revenues it receives comes from other transmission customers. The prices paid, and terms of, all of these transactions are, to the best of CURAD's knowledge at this time, entirely subject to FERC jurisdiction. When the APSC sets SWEPCO's retail rates, it considers SWEPCO's existing revenues, expenses, and property committed to public use. These include revenues and expenses incurred that are FERC jurisdictional. A visual depiction of the status quo (*i.e* SWEPCO owns all of its own transmission) with SWEPCO as a member of SPP is shown below. Each arrow represents a monetary stream, with the horizontal arrows set using FERC revenue requirements; it should be

[26] *See* Attachment H of the SPP OATT (containing formula rate templates used in determinations of the charges paid by transmission customers for use of the transmission system) and Schedule 9 of the SPP OATT (Network Integration Transmission Service).

[27] *See* Attachment L of the SPP OATT (containing provisions for disbursements of revenue collected under the SPP OATT to transmission owners).

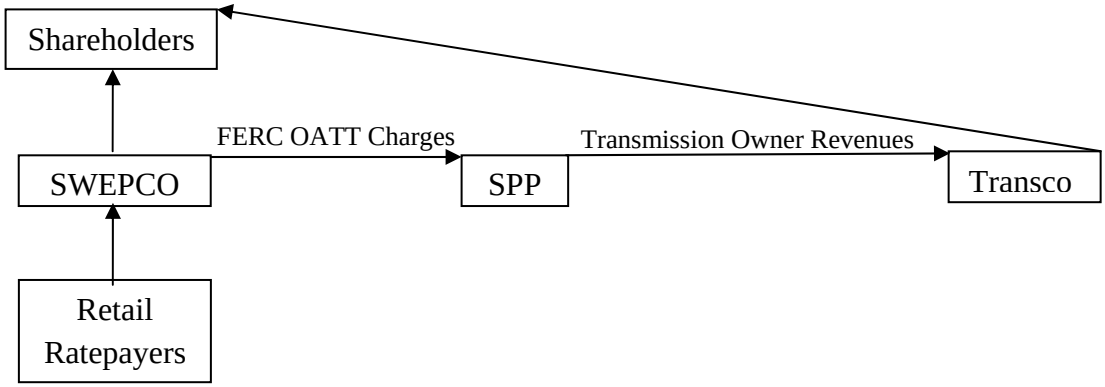
[28] *See* Cross Examination of Sandra Bennett, T. at 255 (confirming that SWEPCO both pays and receives revenue for transmission from SPP). It also pays other transmission owners for using their systems, but at least some of its payments are to itself for using SWEPCO (or other AEP Companies)-contributed transmission. It should be noted that SWEPCO is in the same zone used to set revenue requirements with other AEP companies in SPP. *See* addendum 1 to Attachment H of the SPP OATT.

noted that this diagram is simplified to exclude other SPP members. Arrows connected to SWEPCO are relevant for retail ratemaking.



When SW Transco makes transmission investments, and contributes those investments to the RTO, it will be in its role as a transmission owning member in SPP. As SW Transco does not serve load, it will not pay SPP for use of its transmission system.[29] It will, however, be paid as a transmission owner, and those rates will be set by FERC.[30] SWEPCO, the vertically integrated utility, will no longer have to fund capital investments in transmission, but it will not receive the revenues either. Note that the revenue arrow has shifted, and that revenues previously received by SWEPCO will now be received by SW Transco.

[29] *See* Direct Testimony of Robert Pennybaker at 9-10 , T. at 150-51 (explaining the role of SW Transco in SPP).
[30] Direct Testimony of William Marcus at 23, T. at 297.



The effects of SW Transco building transmission will be as follows. The same investments will be made in the same transmission, regardless of which entity builds them. SWEPCO will incur the same OATT charges for use of the transmission system as if it built transmission itself. However, the transmission owner will now be SW Transco, so the revenue under the OATT will be directed to SW Transco, not to SWEPCO. SWEPCO has the same expenses it has in the second figure, but less FERC jurisdictional revenues and a smaller rate base. With less offsetting FERC jurisdictional revenue, retail ratepayers will be exposed to higher levels of FERC expense, which will more than offset the decrease caused by a smaller SWEPCO-owned rate base. Effectively, FERC will now be the regulator responsible for turning the long-term investment into a revenue requirement which is passed on to retail ratepayers in SWEPCO's next general rate case.

If SWEPCO's preferred transmission rider is approved, then retail ratepayers will have their rates for all transmission investment set using FERC revenue requirements. This would have the same effect on retail rates as ignoring the transmission owner revenues diverted when new transmission is built by SW Transco. If the APSC decides those revenues do not matter for

ratemaking purposes, or that SWEPCO should recover **all** costs of its transmission system using FERC revenue requirements, then no incremental harm to ratepayers would occur from its current application to establish a transco in Arkansas, because the Commission would have approved this rate increase anyway.

III. Legal Argument – Only FERC Rates and Allocations Pre-Empt State Commissions' Jurisdiction, Not FERC Revenue Requirements

State utility regulators have general power allowing them to set the terms and conditions of retail sales. However, they may not make determinations that conflict with FERC orders concerning the rates and terms of wholesale sales, or terms and conditions of transmission.[31] To determine the bounds of retail regulator's powers, the bounds of FERC pre-emption must be examined.

Congressional purpose is the "ultimate touchstone" in pre-emption cases.[32] There are three routes by which federal law preempts state law. The first when there is explicit statutory language pre-empting state law.[33] Second, state law is pre-empted "in a field that Congress intended the Federal Government to occupy exclusively."[34] "Finally, state law is pre-empted to the extent that it actually conflicts with federal law."[35] In the Federal Power Act, Congress explicitly limited federal jurisdiction to "the transmission of electric energy in interstate commerce and to the sale of electric energy at wholesale in interstate commerce."[36] In so doing, Congress gave no explicit language pre-empting state law, and did not indicate intent for the federal government to exclusively occupy utility ratemaking. Congress therefore limited the

[31] *Mississippi Power v. Miss. ex rel. Moore*, 487 U.S. 354, 372-73 (1988).
[32] *Medtronic v. Lohr*, 518 U.S. 470, 485 (1996).
[33] *English v. General Electric Company*, 496 U.S. 72, 78 (1990).
[34] *Id.* at 79.
[35] *Id.*
[36] 16 U.S.C. § 824(a).

scope of federal pre-emption in utility retail ratemaking to situations where there is an actual conflict.

As Congress granted FERC authority over "the sale of electric energy at wholesale in interstate commerce," the pre-emption question is where state retail rates conflict with FERC's authority to set wholesale rates.[37] FERC has "plenary authority over interstate wholesale rates."[38] However, the scope of federal regulation extends "only to such matters which are not subject to regulation by the States."[39] It is well settled law that "a state utility commission must allow, as reasonable operating expenses, costs incurred as a result of paying a FERC-determined wholesale price."[40] FERC's authority extends to wholesale power allocations, and a state Commission may not set rates in a manner conflicting with a FERC wholesale allocation.[41] When retail ratemaking conflicts with FERC costs or allocations, it may result in an impermissible trapping of costs.[42] However, just because wholesale rates increase, it does not mean that retail rates must increase. [43] Wholesale costs may be treated as any other costs, and increases may be offset by changes in other factors relevant to ratemaking, such as other revenues. Finally, the authority of this Commission is limited by the constitutional requirement to set sufficient rates so public utilities are not subjected to an uncompensated taking of private

[37] *Id.*
[38] *Nantahala Power & Light v. Thornburg*, 476 U.S. 953, 966 (1986) (citing *Pub Serv. Co. of Colorado v. Public Utilities Comm'n*, 644 P.2d 933, 941 (1982)).
[39] 16 U.S.C. § 824(a).
[40] *Mississippi Power*, 487 U.S. at 373.
[41] *Id.*
[42] *Nantahala*, 476 U.S. at 970.
[43] *See id.* at 968.

property. A utility is entitled to rates that give it a fair opportunity to earn "a fair return upon the value of that which it employs for the public convenience."[44]

Returning to the present case, the policy question before the APSC is whether the costs will be the same to retail ratepayers in building transmission in an affiliate instead of in the vertically integrated utility. In the next rate case, the Commission must set SWEPCO's retail rates so as to provide "a fair return upon the value of that which it employs for the public convenience." [45] The Commission will consider the expenses paid and revenues received by SWEPCO. Federal law will pre-empt the Commission from making any rulings that conflict with FERC decisions on wholesale rates and allocations. CURAD is currently unaware of any situation whereby an expense paid by a utility under the SPP OATT, which contains both costs and allocations, would not have to be passed through to retail ratepayers. Therefore, in SWEPCO's next rate case, the APSC will consider all of SWEPCO's prudently incurred expenses (which will include expenses under the SPP OATT), all of SWEPCO's revenues (including revenues earned under the SPP OATT), the amount of property it has dedicated to the public convenience, its capital structure, etc., and then determine rates that will allow SWEPCO a fair opportunity to earn a fair return on its investments. It will do that for **all** property owned by SWEPCO and used to serve the public convenience, which includes transmission. Cost of capital will be determined by this Commission.

The difference between the status quo, where SWEPCO builds its own transmission, and the SW Transco scenario, where new construction is built within SW Transco, is as follows. Under the SW Transco scenario, SWEPCO will still pay the same SPP OATT charges for use of

[44] *Bluefield Co. v. Pub. Serv. Comm'n*, 262 U.S. 679, 690 (1923).
[45] *Id.*

the transmission system, but it will have less property dedicated to the public convenience on which it must be allowed an opportunity to earn a return, and less revenue generated for use of its transmission system since wholesale revenues are now diverted to the Transco affiliate. It will pay SW Transco, and indirectly its investors, FERC rates for use of the transmission system, but it will not receive FERC revenue. As a result, this Commission will be indirectly be forced to use FERC revenue requirements (higher ROEs, unfavorable capital structures, etc.) in making retail rates. This is because SWEPCO will be paying another company to use the other company's transmission, instead of paying itself to use its own transmission, and this payment will be at FERC wholesale rates. For new transmission investments, the process of turning the transmission portion of the balance sheet into a revenue requirement will be ceded to FERC. The retail revenue requirement will be the same as column 2 on Ms. Bennett's table.[46] If a transmission investment stays in SWEPCO's rate base, then the SPP OATT expenses will be based on the revenue requirement in column 1 of Ms. Bennett's table, the revenues by another process,[47] and the final return necessary to compensate SWEPCO for its investment will use the assumptions from column 3 of Ms. Bennett's table.[48] Without a rate case to provide real world numbers, we cannot say what the impact will be, but the table is useful for discussion purposes.[49]

In order for the shifting of transmission investment to SW Transco not to matter to retail ratepayers, all future transmission investments made by SWEPCO would have to use FERC ratemaking assumptions. This would happen if the Commission grants the so-called "OATT

[46] Direct Testimony of Sandra S. Bennett, Table 2, at 16 (comparing FERC ratemaking with state retail regulator ratemaking), T. at 227.
[47] The revenues distributed under Attachment L of the SPP OATT are NOT presented in Ms. Bennett's Table 2.
[48] Direct Testimony of Sandra S. Bennett, Table 2, at 16 (comparing FERC ratemaking with state retail regulator ratemaking), T. at 227.
[49] Direct Testimony of William Marcus at 8, T. at 282.

Tracker" rider, under which this Commission would not use its authority to create revenue requirements, but instead use FERC-generated revenue requirements. This also could happen if the Commission chose to ignore the revenues SWEPCO receives as a transmission owner, and rely instead on the payments SWEPCO makes for transmission service as a basis for setting the transmission portion of the retail revenue requirement for base rates. Finally, this could happen if the current pre-emption doctrine were expanded to forbid state retail regulators from creating revenue requirements (or making other assumptions preceding actual ratemaking) conflicting with FERC's wholesale revenue requirements during the ratemaking process. It is well-settled law that the Commission may not ignore the costs and allocations determined by FERC that are inherent in those payments when it sets retail rates. However, CURAD disputes that the Commission must accept FERC revenue requirements for wholesale sales when it sets revenue requirements used for setting retail rates.

Because the Commission is not required to accept FERC revenue requirements when setting retail rates, the question of whether granting a CCN to SW Transco is in the public interest depends on how the Commission chooses to craft the transmission component of SWEPCO's revenue requirement in the next rate case. Should the Commission choose to set a retail revenue requirement in line with FERC's revenue requirements used to set wholesale rates, then the small financing benefits might be enough to tip the scales such that the certification of the new company is in the public interest. Until that question is decided, we cannot know whether this requested certification is in the public interest. Therefore the application should be dismissed without prejudice.

IV. Conclusion

CURAD understands Staff and SWEPCO's position to be that the Commission must use FERC transmission revenue requirements in setting wholesale rates. Only if the revenue requirement used to set retail rates is identical to the wholesale revenue requirement will retail ratepayers not be harmed by the proposed reorganization. Existing law does not require this Commission to accept FERC revenue requirements for setting retail rates, only the prices and quantities of FERC-approved wholesale sales in interstate commerce. The guaranteed harm of paying higher prices for the same service more than offsets the possible small reduction in financing costs. Allowing future transmission investments needed to serve SWEPCO ratepayers to occur in SW Transco is therefore not currently in the public interest, and the Commission should deny the application without prejudice.

WHEREFORE, CURAD respectfully requests that the Commission deny SWEPCO and SW Transco's application for a CCN without prejudice, and for all other just and proper relief.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Emon O. Mahony , do hereby certify that on the 30th day of March, 2012, I provided a copy of the above to the following at the indicated email address or by first class mail, postage prepaid, if no email address is indicated:

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