

INTERCONNECTION ISSUES: GENERATORS' PERSPECTIVE

In response to suggestions of the Commission staff, the Electric Power Supply Association (EPSA)¹ prepared this summary of the major issues that would need to be addressed in a rulemaking to standardize generation interconnection agreements and procedures. Although the paper was drafted before the Commission issued its Advance Notice of Proposed Rulemaking (“ANOPR”) in Docket No. RM02-1-000, EPSA’s comments are, in large measure, very consistent with the proposals set forth in the ANOPR.

EPSA is a national trade association representing competitive power suppliers active in U.S. and global power markets. EPSA’s members, which include power generators, power marketers and suppliers of goods and services to the electric power supply industry, share a commitment to bringing the benefits of competition to all electric customers. The comments contained in this paper represent the position of EPSA as an organization, but not necessarily the views of any particular member with respect to any issue.

I. INTERCONNECTION RIGHTS

As the Commission has recognized, the *pro forma* tariff was designed to accommodate an industry structure that did not include merchant generation (where a facility is constructed before entering into agreements with specific customers). EPSA appreciates the Commission’s efforts to implement the *pro forma* tariff in a way that accommodates the rapidly emerging merchant generation industry, beginning with its recognition in *Tennessee Power* that interconnection is a component of transmission service that can be requested separately from the delivery component of transmission service.

Once the Commission clarified that interconnection was protected by the umbrella of the *pro forma* tariff’s terms and conditions, the industry began wrestling with the issue of what rights come with interconnection when requested in advance of the delivery component of transmission service. EPSA recognizes that these have been difficult and contentious issues, and this simply reflects the fact that the *pro forma* tariff terms and conditions are not easily severed into interconnection and delivery components. As a result, there are many views about what rights are conveyed under the *pro forma* tariff at the interconnection stage, not only among transmission providers, but among generation developers as well.

EPSA urges the Commission to take this opportunity to evaluate these issues, not against the usual framework of what can be read into the literal terms of the *pro forma* tariff, but rather against the broader framework of ensuring that generator interconnection is consistent with and supports the open access transmission services that are offered under the *pro forma* OATT. The

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emergence of merchant generation is beneficial to consumers because merchant generators assume risks that would, in days past, have been borne by consumers who supported new generator entry with long-term contracts that generally shifted most risks to the purchaser. But if merchant generators cannot evaluate future markets and position themselves to make efficient use of the services provided under the *pro forma* tariff – both point-to-point and network services – efficiencies will be lost and consumers will ultimately pay the price in the form of higher generation costs.

For these reasons, EPSA supports Option A1-3 set forth in staff's discussion paper which would define multiple interconnection products. This option recognizes that a one-size fits-all approach does not accommodate the diverse business models that are used by generation developers. Nor does a one-size-fits-all approach recognize the different transmission products that are offered under the *pro forma* OATT.

EPSA urges the Commission to establish two standard products:

- **Minimum Interconnection Option:** This option would continue the approach reflected in *Tennessee Power* which identifies the upgrades that are needed solely due to the interconnection. The Commission should clarify that the studies that evaluate minimum interconnection would make no assumption that the generator will be placing additional loads on the grid.
- **Network Resource Option:** This option would evaluate the new facility in the same manner that the transmission provider evaluates its own resources for service to native load. It would also require the transmission provider to incorporate the generator in its transmission plans on the same basis that the transmission provider plans for its own generating plants. Historically, transmission planning has been founded on the premise that the integrated grid must permit the loads on that grid to access all of the generation resources connected to that grid. The fact that virtually all new projects are merchant generation does not change the validity of this premise, and it makes no sense to conduct transmission planning on the assumption that loads will only access some of the generators connected to the grid – those of the transmission provider.

EPSA urges the Commission to confirm that, while these two standard products will always be available, interconnection customers are also permitted to request Optional Deliverability Assessments in conjunction with either standard product. In addition, the Commission should ensure that there are no arbitrary restrictions on the number of Optional Study requests or the scenarios evaluated in the Optional Studies. Unfortunately, these optional deliverability assessments are the only primitive tool that merchant generators have to evaluate future access to markets and to sponsor additional upgrades in advance of commercial operation if necessary to ensure timely access to those markets. While these Optional Deliverability Assessments will not protect merchant generators from all market risks, they will in most circumstances make those risks more manageable, and the customers requesting optional

assessments will pay for their cost in any event. In the end, consumers benefit because they obtain more timely access to competitive generation alternatives than is the case today.²

EPSA also asks the Commission to clarify that the generator has the option to select an interconnection option after receiving the results of the studies. While it may sometimes be the case that the interconnection customer knows in advance what interconnection option best serves its needs, it will often be the case that information produced by the studies will form the basis of the selection.

In addition, once the study is completed, the generator should be permitted to “lock in,” through a right of first refusal, whatever available transmission capacity was assumed to exist at the time of the deliverability assessment, or that otherwise was identified in the assessment as being required in order for the requesting generator to, in fact, be deliverable. Specifically, if a transmission request was received that would utilize capacity identified as available in the study, the generator would be allowed to match that request. While generators currently have the ability to reserve transmission capacity at the beginning of the interconnection process for later use, given that, at least for the time being, they can only request point-to-point transmission service, these advance reservations are truly speculative when made so far in advance of the project’s in-service date and when the generator likely does not know each of the transmission paths for which the point-to-point service should be requested. Moreover, there does not appear to be any good reason to require such a speculative reservation unless, at a minimum, another party stands ready to purchase the capacity in question. However, the right of first refusal would allow the generator to delay the assessment of this risk and the benefit of making an advance transmission reservation until such time as another use has been identified. This would reduce the need for preemptive transmission reservations, ensure more efficient use of the transmission network, and ultimately reduce costs to consumers.

EPSA also urges the Commission to address the possibility that all upgrades may not be completed before the project’s in-service date. It is often the case that the transmission provider can accommodate interconnection in advance of completion of all upgrades as long as there are special protection procedures or equipment in place. This option should be made available to the interconnection customer.

II. COST ALLOCATIONS

Not surprisingly, many of the Commission’s orders dealing with interconnection deal with cost responsibility. However, because of the Commission’s recent orders, the Commission’s policies are now firmly established and provide a workable foundation for interconnection in advance of requests for transmission service.

EPSA urges the Commission to codify its existing policies and practices, including:

- The demarcation between system upgrade and direct assignment facilities continues to be defined under the standards best described in *Public Service Company of Colorado*:

² This proposal is consistent with footnote 5 of FERC Staff’s discussion paper, dated October 5, 2001, and found at the Commission’s website at: http://www.ferc.fed.us/calendar/commissionmeetings/discussion_papers/10-11-01/E1RevisedRecommendations_1.pdf.

The Commission has long held that an integrated transmission grid is a cohesive network moving energy in bulk. Because the grid operates as a single piece of equipment, the Commission has consistently priced transmission service based on the cost of the grid as a whole. The Commission has rejected the direct cost assignment of grid facilities even if the grid facilities would not be installed but for a particular customer's service. The Commission has reasoned that, even if a customer can be said to have caused the addition of a grid facility, the addition represents a *system* expansion used by and benefiting *all* users due to the integrated nature of the grid. . . . The Commission has reserved direct assignments for only those transmission facilities which fall into what we have referred to as an "exceptional category" consisting of radials which are so isolated from the grid that they are and will remain non-integrated.

Nothing in the Commission's new pricing policy changes or undermines these fundamental premises. There continues to be only one service – service over the *entire* grid – and both native load and third-party customers "use" the entire grid, including any expansion. Similarly, other native load and third-party customers benefit from integrated grid upgrades.

The only change in our new policy is how to price grid service. . . . While we now permit utilities to price on the basis of this incremental grid cost, we are not directly assigning grid additions. We are not dismembering the grid or directly assigning its newest components.³

Under this long-standing precedent, transmission facilities that are not system upgrades and, therefore qualify for direct assignment, are the rare exception today, just as they were when the facilities associated with generator interconnection involved the transmission provider's own plants. Distinctions based on the purpose of the upgrade (*e.g.*, increasing capacity, maintaining reliability, addressing stability or relieving a constraint) are simply not relevant. Indeed, any facility constructed or modified in order to achieve one of these goals, by definition, should be deemed to be a network facility.

- To the extent that interconnection customers pay for upgrades at the interconnection stage, credits should be provided against transmission services obtained in the future. Consistent with Commission orders, credits may used for point-to-point and network services, are based on the reservation of service or designation as network resource rather than physical delivery of output to the system, and may be assigned to the transmission customer of record if not the generator. Credits must reflect not only the direct costs of construction that are billed to the customer, but also any tax gross ups that the customer is required to pay.⁴

³ *Public Service Company of Colorado*, 59 FERC ¶ 61,311 (1992), *reh'g denied*, 62 FERC ¶ 61,103 at 61,061 (1993) ("*PSColorado*") (emphasis in original) (footnotes omitted).

⁴ The last section of this memo deals with tax issues in more detail.

- Generators should not be responsible for O&M costs associated with system upgrades.
- When facilities that are directly assigned to a generator are subsequently used to provide service to other parties, the transmission provider must recalculate the direct assignment charge to reflect the new uses. The interconnection agreement must not only recognize the need to recalculate the rate, but must also make it the responsibility of the transmission provider to perform the rate recalculation. It is unreasonable for the transmission provider to take the position that any rate relief will be limited to amounts that the first user is able to negotiate with the second. The transmission provider has the obligation under the Federal Power Act to ensure that rates for jurisdictional services are just and reasonable, and charges for use of direct assignment interconnection facilities are no different in this regard.
- In addition to reaffirming these existing policies and precedents, EPSA urges the Commission to continue its recently announced policy with respect to interest on upgrades. While the Commission may believe that there are policy reasons to require generators to “pre-pay” for transmission services by funding the capital costs for upgrades in advance of interconnection, there is no legitimate basis to deny generators the time-value of their prepayments. Certainly, if the transmission provider were to fund these investments, it would be entitled to interest (AFUDC prior to being placed in service, and a fair return on capital thereafter).
- Finally, EPSA also urges the Commission to remove the restriction that credits may be used only with respect to services involving the facility that funded the upgrade. A system upgrade benefits all transmission users and supports all transactions on the integrated grid. There is no reason to treat the upgrade contribution of an interconnection customer as prepayment only with respect to certain uses of those facilities. Certainly, if a network transmission customer funds an upgrade to the system based on reaching a specific network resource, it is not precluded from using that transmission service to reach other resources. Similarly, if a point-to-point transmission customer funds a system upgrade, that transmission customer is not precluded from redirecting its transaction to other available points. Interconnection funded upgrades should be treated no differently. Indeed, one could reasonably argue that both the amount and the timing of the credit should be driven not by the amount of transmission reserved, but by the capability of the generator upon which the need for the upgrades were determined. At a minimum then, to the extent the generator obtains transmission services that do not involve the facility directly (e.g., obtaining replacement power when the generator is out of service, or redispatching its portfolio of units to minimize operating costs), credits associated with grid investments funded by the generator should be usable for any transmission service on that grid.

III. CONSTRUCTION-RELATED OUTAGE COSTS

Oftentimes, transmission lines must be taken out of service in order to modify the existing system, add new facilities and/or delivery points, perform routine maintenance, or interconnect a new generator or other customer. Recently, some transmission owners have proposed that, when lines are taken out of service as part of the generator interconnection process, the interconnection customer shall be liable for the impact of that outage on the transmission owner or other parties, *e.g.*, liable for increased power supply costs or the lost profits of other suppliers whose transactions were impacted.

EPSA urges the Commission to resist any proposals that would single out generator interconnection as the sole circumstance when outage costs are allocated to a specific customer. Certainly, outages have real economic impacts on market participants, and should be avoided or minimized. However, as the Commission has recognized in its prior rulings, this type of provision places a risk on generators that it cannot foresee and cannot protect itself against. Imposing a significant and unpredictable risk on new generators will simply deter new entry or increase the financing costs, both to the detriment of consumers who then truly would face higher market prices for energy. Moreover, these types of outage provisions are merely symptomatic of the real problem; *i.e.*, the failure to develop well designed, regional markets, which include market-drive congestion management options and that provide market participants with the means to hedge against outage risks of all types.

IV. QUEUING ISSUES

Queuing controversies are always contentious and complicated. While queuing serves the purpose of establishing priority for general application processing, the need for queuing is primarily driven by the requirement that generators pay for upgrades that would not have been required “but for” the interconnection. The “but for” analysis, in turn, requires that each project be studied serially, a practice that greatly extends and complicates the study process. Further complexity is added because the queue order (based on when the application reached a specific milestone) does not always coincide with the planned in-service date of the project. Add to this the fact that generation development requires some flexibility, to allow changes in timelines and milestones as conditions in the market or externalities impact the project’s development plan, and the queue quickly becomes an impediment rather than a tool for fair and efficient interconnection.

EPSA understands that these are difficult and complex issues; however, these problems are not insurmountable. Yet, transmission providers have generally been unable or unwilling to develop practices that will rationalize this process, presumably because, in a vertically integrated utility, efficiency and innovation in generator interconnection are not a top priority. This rigidity and lack of creativity has led to inflexible and irrational rules that serve only to make the generation interconnection process more costly than necessary. Again, consumers will ultimately bear the cost of this inflexibility in the form of higher generation costs.

Unfortunately, as long as the Commission requires generators to pay for upgrades at the interconnection stage, queuing will be necessary. EPSA urges the Commission to ensure that the need for queuing for cost allocation does not drive all other aspects of the interconnection process. Among the matters that must be addressed are:

- Construction sequencing procedures should be adopted that accommodate differences in the queuing order and the development schedules for each project. Some examples are described below
- If a later queued project has an earlier in-service date and this requires the acceleration of an upgrade that, under the “but for” rules, is the cost responsibility of the project with a later in-service date, there should be a process that ensures that each project’s schedule can be accommodated efficiently and the costs of acceleration addressed in an equitable manner.

- To reflect uncertainties that earlier-queued projects may not go forward and, therefore, their planned upgrades may become the responsibility of a later-queued generator, the later-queued generator should be give a range of possible upgrade costs based on potential scenarios with respect to earlier-queued generators. This addresses the later-queued generator's need for sufficient certainty to assess the economics of the project, without resorting to irrational rules (*e.g.*, requiring a project that is terminating its application to construct the upgrades that it would have funded so that those costs are not re-allocated to the project next-in-line).

EPSA urges the Commission not to exclude construction from the activities that the interconnection customers may request that the transmission provider begin in advance of completion of the interconnection application process. The construction timeline for transmission facilities may often exceed that of a generation project. As long as the interconnection customer agrees to compensate the transmission provider for advance construction, the transmission provider is held harmless and the risk of a delayed generation in-service date is reduced.

EPSA urges the Commission to adopt provisions that allow the generator to suspend work without losing queue position. The development of a generation project is complex and subject to unexpected complications that may change the project development schedule. For example, if the consequence of a 3 month delay in the interconnection process is that a peaking facility misses the summer season, the merchant developer may find that the best business solution is to redirect the turbine to another site that can be expedited in order to make earlier use of the equipment. However, if there are limitations on suspension rights at the first site, these business options are foreclosed. Merchant developers must have the ability to restructure business plans when circumstances change the timing or economics of the initial plans. While suspension options should not be unlimited, they should also not be so circumscribed that they do not fulfill their purpose or promise.

EPSA also requests that the Commission require that transmission system information and completed interconnection analyses be made available on a systematic basis. The studies used by the transmission provider to assess interconnection requests should be made available to potential new interconnection customers so that they themselves could perform their own assessments in advance of an interconnection request in order to assist in verifying the results of whatever study ultimately is performed by the transmission provider. Furthermore, when studies are completed, the customer should have access to all assumptions, workpapers, input data and models so that it can evaluate the study results directly. And, after an IA has been executed and/or filed with the Commission, the study results should be posted on OASIS.

V. DEFINED PRACTICES

The Commission's reliance on Good Utility Practice, and the discretion that grants the transmission provider, often results in confusion, at best, and the opportunity to create impediments to entry, at worst. While not all circumstances and contingencies can be predicted in advance, there is a large segment of interconnection and operating practices that can be defined in advance, thereby providing certainty and eliminating the opportunity for the transmission provider to take actions that are inconsistent with the Commission's open access goals.

VI. NEGOTIATION PARAMETERS

There is a tension between the perceived benefits of non-negotiable *pro forma* agreements, the complexity of project development, and the evolving Commission policies that the Commission must address.

EPSA urges the Commission not to prohibit negotiation of the *pro forma* IA terms. The perceived benefits of non-negotiable IAs are that they reduce opportunities for controversy and simplify the interconnection process. While that might be a reasonable conclusion for a some types of commercial activities, it oversimplifies the process of developing new generators and interconnecting them to the grid. A reasonable amount of flexibility is required to permit negotiation on commercial terms (*e.g.*, specialized assignment provisions to reflect the requirements of the project's lenders) and project development terms (*e.g.*, the negotiation of project specific study procedures to accommodate factors not under the generator's control). It is often the case that interconnection customers and transmission providers are able to negotiate mutually agreeable IA provisions that differ from project to project and better facilitate the specific interconnection. Complete inflexibility in the IA terms would prevent these negotiations even if the different terms have a beneficial impact on the project or its financing.

The Commission should also ensure that there are no arbitrary limits imposed on the interconnection customer with respect to negotiation. A negotiated solution is always preferable to litigation before the Commission limits on the time made available for negotiation will simply foster more litigation.

EPSA urges the Commission to reject provisions that delay interconnection activities until all disputed issues have been resolved. There is no justification for delaying the entire interconnection because some matters are in dispute. Indeed, this type of provision will simply deter the customer from exercising its right to dispute certain provisions. Moreover, as long as the interconnection customer agrees to hold the transmission provider harmless, these types of provisions serve no legitimate purpose.

VII. APPLICABILITY OF INTERCONNECTION AGREEMENT TERMS PENDING COMMISSION REVIEW OF DISPUTE

While the Commission may find it appropriate to impose loss of queue position for failure to adhere to interconnection requirements, queue position should not be at risk if the application of the requirement has been disputed and placed before the Commission for resolution. The ability to dispute interconnection requirements would be nullified if the customer must adhere to the disputed provision pending Commission resolution. For example, if the customer is disputing the amount of the credit requirements, but it is forced to satisfy those credit requirements pending Commission resolution of the dispute, the ability to avoid an unreasonable requirement is lost. Similarly, if the customer is disputing a deadline for satisfying a specific requirement, but will lose its queue position if it does not satisfy the deadline pending dispute resolution, the ability to avoid the unreasonable deadline is lost. The Commission should clarify that queue position cannot be lost based on failure to adhere to terms that the customer has disputed and asked the

transmission provider to bring to the Commission for resolution. Of course, after the Commission resolves the dispute, the customer would be required to promptly adhere to any Commission ruling.

VIII. OBLIGATIONS IMPOSED ON INTERCONNECTING GENERATORS AND RELATED COMPENSATION ISSUES

EPSA urges the Commission not to allow interconnection agreement terms that have the effect of allowing the transmission provider to curtail deliveries from the generator under terms that differ from the OATT. Many interconnection provisions grant the transmission provider the authority to dictate curtailment to address reliability problems. EPSA agrees that there may be circumstances when a particular generator must reduce its output to prevent an imminent emergency. However, interconnection terms dealing with these situations are often worded so broadly that they effectively rewrite the OATT curtailment terms as they apply to generators interconnected to the system.

EPSA urges the Commission not to include in an interconnection agreement provisions which require the generator to provide real or reactive power or ancillary services to the transmission provider. Alternatively, these provisions should be limited to emergency situations. The Commission has taken great care to unbundle electricity products. However, by incorporating generator imbalance terms, reactive power requirements and even emergency service obligations in the interconnection agreement, the Commission is reblurring the bright lines that had been drawn. Generators want to provide ancillary services, and they want to offer their output and reactive power during emergency and non-emergency periods alike. However, these arrangements should be addressed separately from the interconnection agreement which should be limited to the transmission services obtained from the transmission provider only. Thus, while it is reasonable to include in the interconnection agreement the specifications for reactive capability that the unit will exhibit, it is inappropriate to impose obligations on the generator to provide reactive power to the transmission provider in the interconnection agreement.

The Commission must ensure that, with respect to any services that a generator may be required to provide, emergency or otherwise, the generator has the ability to set the rates, terms and conditions of those services. It is inappropriate - - and at odds with the Federal Power Act - - for the transmission provider to dictate the terms of services provided by the generator.

IX. ENSURING TIMELY INTERCONNECTION: STEP-IN RIGHTS, LIQUIDATED DAMAGES, AND MEANINGFUL SCHEDULES

In all cases, the interconnection customer should be given the option to contract with third parties to construct the necessary interconnection facilities and upgrades. Alternatively, at a minimum, the interconnection customer must be given the option to expedite the process of construction and installation by contracting with third parties where timely completion of construction by a transmission provider is unlikely. The interconnection customer should be able to contract with third parties when (1) the customer provides prior written notice to the transmission provider; (2) any construction by such third parties is conducted pursuant to terms and conditions that are acceptable to the transmission provider; and (3) the transmission provider has the option of providing the customer with a preferred list of qualified construction firms. These safeguards allow the transmission provider to be assured that construction will be conducted according to the transmission provider's standards while permitting the customer to maintain the schedule set forth in the IA.

Not only should the IA provide step-in rights for an interconnection customer to contract with a third party to complete the construction in the event the transmission provider is unable to do so in accordance with the construction schedule, but the interconnection customer must also have the ability to seek liquidated damages for any such delay. If the transmission provider is unwilling to provide liquidated damages to the interconnection customer if it fails to meet the construction schedule set forth in the IA, it is essential that the interconnection customer have the option, in the first instance, to contract with a third-party contractor, who will provide such a safeguard, to complete construction. The interconnection customer's concern is that if construction is not completed in accordance with the construction schedule set forth in the IA, it will be exposed to monetary damages as a result of a delay for which it cannot prevent or guard against. It is not equitable to hold an interconnection customer responsible for the transmission provider's inability to meet the construction schedule. For example, if the transmission provider does not complete construction of the interconnection facilities by the date set forth in the IA (which date will be mutually agreed upon by the parties), the interconnection customer will be prevented from commencing testing of its facility, which, in turn, will delay the facility's commercial operation date. Thus, the interconnection customer should be compensated for any damages it suffers as a result of such delays.

Finally, there should be consequences when the transmission provider fails to adhere to schedules imposed under the interconnection procedures. Currently, adherence to the established schedule is the exception, rather than the rule. Indeed, particularly in the case of an unbundled transmission provider, unless that provider faces meaningful consequences for failing to meet the established schedule for processing the interconnection request, performing studies, and establishing the interconnection, there is little incentive to facilitate the interconnection of a competitor.

X. CREDIT REQUIREMENTS AND INSURANCE

EPSA does not disagree that appropriate credit requirements should be imposed. However, the credit requirements must recognize the many types of credit security that are commercially reasonable, and all of these should be available to the interconnection customer. Limiting interconnection customers to only a few options for credit security increases the cost of interconnection unnecessarily and ultimately increases costs for consumers. EPSA understands that the credit requirements may vary based on the customer's specific situation. However, it makes no sense to limit credit options to the few that every customer is likely to meet. Instead, the presumption should fall the other way, *i.e.*, all credit vehicles are acceptable subject to the customer's demonstration that its situation limits its use of some of those options. For example, parental guarantees should be among the available options, subject to the customer's demonstration that its parental guarantee is adequate.

Credit requirements should also recognize that, at any point in time, a transmission provider's cost exposure will vary depending on, among other things, the obligations that the transmission provider has committed to vendors and the amounts that the customer has paid to date. The IA must recognize that the transmission provider is not immediately at risk for the full amount of the construction cost and, in fact, there is likely no point in time when the transmission provider would be at risk for the entire amount. Requiring an interconnection customer to provide security in excess of the amount required at any one point in time is unreasonable and it simply increases the cost of constructing new generation. As long as the transmission provider receives security in advance that is sufficient to cover the transmission

provider's then-current financial exposure, it will be adequately protected against any financial harm.

EPSA also urges the Commission to guard against the tendency of transmission providers to impose onerous insurance requirements that are duplicative of the credit requirements. The proper amount of insurance is a function not only of potential risks and losses, but the ability of the insured to pay any potential claims. Insurance requirements in contracts generally are designed as a "back stop" to contractual indemnification obligations, where the contractor lacks sufficient assets and thus poses a risk of insolvency. EPSA also urges the Commission to allow generators that are credit worthy to self insure.

XI. INDEMNIFICATION

EPSA urges the Commission to ensure that indemnification provisions apply to the interconnection customer as well as the transmission provider. While the Commission does not require reciprocal indemnification with respect to the delivery component of transmission service under the OATT, the interconnection component of transmission service presents a different situation. When the transmission provider is providing the delivery component of transmission service, there is a simple and one-sided relationship. The relationship between an interconnecting generator and transmission operator is more complex and definitely two-sided. The concerns underlying the Commission's refusal to impose an indemnification obligation on transmission customers in the transmission service context simply do not carry the same force in the interconnection context. In Order Nos. 888 and 888-A, the Commission concluded that there was no need to impose an indemnification obligation on the transmission provider because, "[a]s the [pro forma] tariff does not obligate the customer to perform any services on behalf of the transmission provider, there is no comparable basis for imposing an indemnification obligation on the transmission provider."⁵ Indeed, the *pro forma* OATT governs only the provision of transmission service by the transmission provider. The absence of any obligation on the part of a transmission customer to provide services, transmission or otherwise, in effect shields it from third party suits as a matter of course and thus, under the Commission's reasoning, eliminates the customer's need for indemnification by the transmission provider. The same does not hold true in the interconnection context. An IA delineates the obligations and responsibilities of the interconnecting generators and utilities with respect to the construction, ownership, operation and maintenance of interconnection facilities and upgrades as well as parallel operation of the parties' systems that go well beyond the provision of transmission service. Interconnecting generators are routinely obligated under IAs to perform interconnection-related services and activities. Clearly, the performance by *either* party of these obligations could subject the other to third party suits for which indemnification is proper.

XII. ISSUES SPECIFIC TO RTOS

⁵ Order No. 888 at 31,756 ("[t]he customer is taking service from the transmission provider and may appropriately be asked to bear the risks of third-party suits arising from the provision of service to the customer under the tariff").

A. Grandfathering

The Commission has wrestled with grandfathering issues each time it advanced its open access goals. EPSA understands the tension between honoring contracts and ensuring that all uses of the transmission grid are compatible going forward. RTOs in formation either ignore this tension (and simply move for the abrogation of existing contracts) or oversimplify this tension (and overlay existing agreements with new terms that may conflict with or duplicate existing contracts). EPSA urges the Commission to reject both of these inflexible approaches. The presumption that there are massive inconsistencies between existing IAs and RTO practices and procedure almost always is invalid. Certainly, there may be some differences that must be recognized. For example, inconsistencies in operating practices there prevent the RTO from meeting its obligations must be recognized. But there is no obvious reason to disturb all financial arrangements simply because the RTO will be adopting different financial arrangements for new projects.

Interconnection customers should have the opportunity to demonstrate that all or many of the provisions of existing IAs are not incompatible with RTO operating practices and procedures. And when there are incompatibilities or duplication that must be resolved in favor of the RTO practice, the parties to the existing IA should be required to negotiate in good faith to revise the IA to eliminate those conflicts, as well as duplications (it would be unreasonable to require an interconnection customer to continue to adhere to operating provisions in its existing IA simply because they do not conflict with those adopted by the RTO).

B. Coordination With Adjacent Systems

As the Commission has emphasized in several recent orders, independence is compromised when transmission owners are overly involved in the interconnection process. EPSA agrees with the Commission that, when transmission owners are overly involved in the interconnection process, it creates not only the opportunity for bias in favor of the transmission owners' own generation, but also the perception of bias, and that both circumstances create barriers to entry by new generation.⁶

One of the key requirements of the Order No. 2000 is that RTOs control the interconnection process so that market participants (the transmission owners) will not be involved in that process. This requirement will be undermined to the extent that the RTO's

⁶ For example, in its order on PJM's proposed RTO, the Commission noted concerns raised about independence of and potential for bias in processing interconnection requests and stated:

We conclude that efficient decision-making on investments in transmission facilities requires that the entire interconnection process must be under the decision control of the RTO. PJM must be responsible for all aspects of the interconnection process. Customers would deal with and sign interconnection and study agreements with PJM alone. To the extent that PJM requires the expertise and services of the TOs or others in providing interconnections services, PJM may enter into appropriate contracts with such entities. *PJM Interconnection LLC*, 96 FERC ¶ 61,061 at 61,234 (2001) ("*PJM*").

interconnection process automatically involves neighboring systems, *e.g.*, the neighboring distribution system (a/k/a, the transmission owner). In a number of cases, the Commission has rejected arguments that requests for service under the *pro forma* OATT must be cleared by neighboring transmission systems or conditioned on the availability of transmission capacity on other transmission systems.⁷

Certainly, there will be circumstances when there is a need for communication and coordination with neighboring systems. In fact, this should be a standard requirement for neighboring RTOs. However, the interconnection procedures and agreement should not contain any provisions that require the transmission provider to involve “local distribution” utilities and transmission systems that do not participate in an RTO in the interconnection process as a matter of course. Unlike local distribution companies and non-participating transmission owners, neighboring RTOs will be required to satisfy all of the requirements of Order No. 2000, including the independence requirements.

XIII. TAX ISSUES

Section 118(b) of the Internal Revenue Code, as amended in 1986, provides that contributions in aid of construction (“CIACs”) are taxable if received from a customer.⁸ Soon after the 1986 amendments became law, however, it became clear that Congress had not intended to make payments for utility interconnection by qualified cogeneration facilities (“QFs”) under PURPA taxable. In IRS Notice 87-82⁹ and Notice 88-129,¹⁰ the Internal Revenue Service (“IRS”) held that payments by a QF to its utility customer were not taxable CIACs, because the QF was not a “customer” of the utility. Subsequently, the IRS issued a number of Private Letter Rulings under Notice 88-129. Some of those rulings were issued to non-QFs, where the facts were analogous to those in Notice 88-129. Notice 88-129 is still the IRS’s official position on what constitutes a CIAC under current law.¹¹ Between 1988 and 1999, few utilities required any kind of tax gross up with respect to payments to build interconnection facilities. Around the

⁷ *Commonwealth Edison Co.*, 96 FERC ¶ 61,158 at 61,191 (2001); *See also*, *American Electric Power Co.*, 93 FERC ¶ 61,151 (2000) (rejecting Tennessee Valley Authority’s (“TVA”) request that AEP’s IA with a generator be conditioned on TVA’s study and compensation for upgrade costs related to the interconnection). These rulings should remain in effect for services provided in a pre-RTO environment.

⁸ Prior to the 1986 amendments, contributions to utilities were not taxable if the contributions were not added into rate base.

⁹ Notice 87-82, 1987-2 C.B. 389.

¹⁰ Notice 88-129, 1988-2 C.B. 541.

¹¹ The application of I.R.C. Section 118(b) and Notice 88-129 to “Transco” RTO’s, which are typically organized as limited liability companies (“LLC’s”), is not clear. The IRS initially ruled that I.R.C. Section 118 was a codification of earlier case law and that such case law continued to apply in a non-corporate context. *See* Tech. Adv. Mem. 79-50-002 (Aug. 2, 1979) (subsequently revoked without explanation by Tech. Adv. Mem. 90-32-001); Tech. Adv. Mem. 80-38-037 (June 24, 1980). In 1982, however, the IRS opined that because an LLC is not a corporation, I.R.C. Section 118 does not apply, and that any contributions in a non-corporate context would be taxable under I.R.C. Section 61. Gen. Couns. Mem. 38,944 (Dec. 27, 1982). The IRS has not released any rulings or other official announcements with respect to non-corporate CIACs since that time, despite numerous changes made to the tax law, including I.R.C. Section 118.

beginning of last year, however, the IRS stopped issuing rulings on behalf of interconnection customers that did not fall squarely within the four corners of Notice 88-129. In April of this year, the IRS and Treasury Department issued their 2001 Business Plan, in which the IRS finally admitted publicly that it was re-thinking the treatment of interconnection payments in light of deregulation.¹² Accordingly, it is presently unclear whether any amounts paid by interconnection customers to construct Interconnection Facilities and Interconnection System Upgrades will be taxable, either to the RTO or to the transmission owners. It is expected that the IRS will publish new guidance on this issue before the end of this year.

In light of the foregoing uncertainty, EPSA proposes that the following tax provisions be inserted in any *pro forma* IA adopted by the Commission.

__._ **Taxes.**

__._.1 **Indemnification for Contributions in Aid of Construction.** The Parties intend that all payments made by Generator to RTO for the installation of the RTO Interconnection Facilities and the Interconnection System Upgrades shall be non-taxable contributions to capital in accordance with the Internal Revenue Code and any applicable state tax laws and shall not be taxable as contributions in aid of construction under the Internal Revenue Code and any applicable state tax laws. RTO shall not include a gross-up for income taxes in the amounts it charges Generator for such contributions. Notwithstanding the foregoing, to the extent that any Governmental Authority determines that RTO's receipt of such payments constitutes income to RTO or any Transmission Owner that is subject to taxation, Generator shall protect, indemnify and hold harmless either RTO or Transmission Owner, as applicable, from all claims by any such Governmental Authority for any tax, interest and/or penalties associated with such determination. Generator's liability for taxes shall be calculated in accordance with *Ozark Gas Transmission Corp.*, 56 FERC ¶61,349 (1991), using a discount rate equal to __.%.¹³ Generator's estimated tax liability in the event of such determination shall be stated in Attachment A. RTO shall notify Generator in writing within thirty days of receiving notification of such determination by a Governmental Authority. Upon the timely written request by Generator and at Generator's expense, RTO shall (or, as applicable, RTO shall cause Transmission Owner to) appeal, protest, seek abatement of, or otherwise oppose such determination. RTO (or, as applicable, Transmission Owner) reserves the right to make all decisions with regard to the prosecution of such appeal, protest, abatement or other contest, including the compromise or settlement of the claim. RTO shall (or, as applicable, RTO shall cause Transmission Owner to) cooperate

¹² See Treasury Dep't Office of Tax Policy and IRS, "2001 Priority Guidance Plan," Item 14 under "General Tax Issues" ("Guidance concerning the treatment of interconnection payments by public utilities."), April 26, 2001; reprinted in Daily Tax Report (BNA, Apr. 27, 2001) at L1, L7; Highlights & Documents (Tax Analysts, Apr. 27, 2001) at 1387, 1390.

¹³ An interconnection customer is entitled to know how any tax gross up is calculated prior to executing the IA in order to ensure that the tax gross up, for which it is liable, is reasonable. As previously noted by the Commission, the formula set forth in *Ozark Gas Transmission Corp.* is a reasonable method of calculating the tax gross up.

and consult in good faith with Generator regarding the conduct of such appeal, protest, abatement or other contest. Generator shall pay to RTO on a periodic basis as invoiced by RTO the documented reasonable cost of prosecuting such appeal, protest, abatement or other contest. Generator shall not be required to pay RTO and/or any Transmission Owner for the tax, interest and/or penalties prior to the seventh day before the date on which RTO and/or any Transmission Owner (i) is required to pay the tax, interest and/or penalties or other amount in lieu thereof pursuant to a compromise or settlement of the appeal, protest, abatement or other contest, (ii) is required to pay the tax, interest and/or penalties as the result of a final, non-appealable order by a Governmental Authority, or (iii) is required to pay the tax, interest and/or penalties as a prerequisite to an appeal, protest, abatement or other contest. If such appeal, protest, abatement or other contest results in a determination that RTO or any Transmission Owner is not liable for any portion of any tax, interest and/or penalties for which Generator has already made payment to RTO, or a clarification of or change in law makes it reasonably clear that such sums are not subject to federal income taxation, RTO shall (or, as applicable, RTO shall cause Transmission Owner to) promptly refund to Generator any payment attributable to the amount determined to be non-taxable, plus any interest or other payments RTO receives or may be entitled to with respect to such payment.

___.2 Private Letter Ruling. At Generator's request and expense, RTO shall (or, as applicable, RTO shall cause Transmission Owner to) file with the Internal Revenue Service a request for a Private Letter Ruling as to whether any of the sums paid, or to be paid, by Generator to RTO pursuant to this Agreement are subject to federal income taxation. RTO and Generator shall cooperate in good faith with respect to such request for a Private Letter Ruling. If the Private Letter Ruling concludes that such sums are not subject to federal income taxation, or a clarification of or change in law makes it reasonably clear that such sums are not subject to federal income taxation, Generator's obligations under Article 12 shall be reduced accordingly.¹⁴

___.3 Other Taxes. Upon the timely request by Generator and at Generator's expense, RTO shall (or, as applicable, RTO shall cause Transmission Owner to) appeal, protest, seek abatement of, or otherwise contest any tax (other than federal income tax) asserted or assessed against RTO or any Transmission Owner for which Generator may be required to reimburse RTO or any Transmission Owner under the terms of this Agreement. Generator and RTO (and any Transmission Owner required to contest such taxes) shall cooperate in good faith with respect to any such contest. No payment shall be payable by Generator to RTO or any Transmission Owner for such taxes until they are

¹⁴ Although payments made by the interconnection customer are intended to be treated as non-taxable contributions to capital, the IRS is presently studying the issue, and an administrative announcement is anticipated some time this year. If that announcement makes it clear or a Private Letter Ruling concludes that the amounts paid by the interconnection customer to the RTO and/or any Transmission Owner are not subject to federal income tax, the interconnection customer should be able to reduce any credit assurances it may be required to provide to the RTO.

assessed by a final, non-appealable order by any Court or agency of competent jurisdiction, unless such payment is a prerequisite to an appeal or abatement.¹⁵

The above provisions not only ensure that the RTO or the Transmission Owner is indemnified for any tax liability, but also that the interconnection customer is only required to pay taxes that are, in fact, owed.¹⁶

These provisions assume that the *pro forma* IA will be a two-party agreement between the RTO and the interconnection customer, and not a three-party agreement which includes Transmission Owners. All of the references to the “Transmission Owner (as applicable)” are required because the RTO will not always own the transmission facilities.¹⁷ In some cases, the RTO will merely operate the facilities for the Transmission Owners that retain ownership (“non-divesting Transmission Owners”).

In these circumstances, the interconnection customer will make payments to the RTO, but to the extent that the RTO does not own transmission assets, such payments will be attributed for tax purposes to the non-divesting Transmission Owner as the owner of the Interconnection Facilities and Interconnection System Upgrades.¹⁸ As such, the non-divesting Transmission Owner, and not the RTO, will be liable for any tax imposed upon the payments made by the generator to the RTO for such costs.¹⁹ Because such a non-divesting Transmission Owner will be the taxpayer, it will also be the only party able to contest the taxability of such payments, seek a Private Letter Ruling, or receive a refund from the IRS for any overpayment of tax. There must be some mechanism that enables the interconnection customer to compel the non-divesting Transmission Owner to seek a refund, contest an assessment, and obtain a Private Letter Ruling.²⁰

The above provisions do not fully address this issue. Although they attempt to cure these problems by requiring the RTO to cause the Transmission Owner to take certain actions where

¹⁵ As indicated by the Commission in *Entergy Services, Inc.*, 94 FERC ¶61257, an interconnection customer that agrees to indemnify a transmission owner for taxes must be entitled to a refund of amounts paid for taxes that are not ultimately due. Consequently, an interconnection customer must be entitled to contest an assessment of taxes for which it is responsible.

¹⁶ As noted above, the interconnection customer must be entitled to transmission credits for any taxes paid for Interconnection System Upgrades.

¹⁷ See Sections 1.40 and 1.41 of the *pro forma* IA proposed by EEI (definitions of “Transmission Provider” and “Transmission Provider Interconnection Facilities”).

¹⁸ See, e.g., *Culbertson v. Comm’r*, 337 U.S. 733, 739-40 (1949) (Court emphasized “first principle of income taxation: that income must be taxed to him who earns it.”); *Askew v. Comm’r*, T.C. Memo 1995-100 (1985), *aff’d* 805 F.2d 830 (1986) (Court rejected taxpayer’s argument that he was mere agent or conduit; payment made to taxpayer’s wholly-owned corporation was attributed to taxpayer, and he was liable for the related tax).

¹⁹ *Askew v. Comm’r*, *supra*.

²⁰ The Commission has previously acknowledged that an interconnection customer should not be required to pay the taxes of the transmission owner unless the former is entitled to a refund in the event it is determined that the amounts paid for the Interconnection Facilities and System Upgrades are not subject to income taxation. See *Entergy Services, Inc.*, 94 FERC ¶ 61,257 (2001).

the RTO does not own the RTO Interconnection Facilities and Interconnection System Upgrades, this language does not go far enough because there is no link between the RTO and the non-divesting Transmission Owner that will enable the interconnection customer to compel the non-divesting Transmission Owner to act. Unless interconnection customers and RTOs are able to negotiate differences from the *pro forma* IA on a case-by-case basis, which would defeat part of the purpose of having a uniform agreement, these issues must be resolved before a *pro forma* IA is adopted by the Commission.

A number of approaches are available to the Commission to address these issues. The most straightforward approach would be for the Commission to require that the RTO own all RTO Interconnection Facilities and System Upgrades paid for by the interconnection customer.²¹ This would make the RTO the tentative taxpayer with respect to the receipt of such payments, and would allow the interconnection customer to deal with the RTO directly concerning Private Letter Rulings and tax refunds associated with the CIAC issue. Alternatively, the Commission could require that back-to-back provisions be included in the operating agreements to be entered into between the RTO and the non-divesting Transmission Owners, that would put interconnection customers in the same position they would be in if they were to deal directly with such non-divesting Transmission Owners on these issues. Finally, the Commission could require that separate agreements be entered into between the interconnection customers and the non-divesting Transmission Owners related solely to the tax issues, which would incorporate essentially the same language as that proposed above, or that, for RTOs which are not “transcos,” the *pro forma* IA be a three-party agreement which includes the non-divesting Transmission Owner.

²¹ If the RTO owns all RTO Interconnection Facilities and System Upgrades, the references to Transmission Owner in the proposed tax section would not be required.