

**UNITED STATES OF AMERICA  
BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION**

**Standardizing Generator Interconnection            )           Docket No. RM02-1-000**  
**Agreements and Procedures                            )**

**COMMENTS OF THE EDISON ELECTRIC INSTITUTE**

The Edison Electric Institute (EEI)<sup>1</sup> is pleased to submit these comments in response to the Federal Energy Regulatory Commission’s (“FERC” or “Commission”) Standardizing Generator Interconnection and Procedures Notice of Proposed Rulemaking (“NOPR”).<sup>2</sup> These comments represent the views of the Alliance of Energy Suppliers (Alliance), the EEI Transmission Group, the EEI Distributed Generation Task Force and the Tax Analysis Research Subcommittee.<sup>3</sup> The Alliance is a division of EEI that represents generators in domestic wholesale markets. The Alliance members and EEI’s transmission providers participated extensively in the stakeholder collaborative that formed the foundation of much of this NOPR.

EEI has long supported a national, standard generator interconnection agreement and interconnection procedures in order to facilitate the development of new generation. As the Commission is aware, starting in July 2001, EEI’s two business units – the Transmission Group and the Alliance of Energy Suppliers – worked to negotiate a Model EEI Generator

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<sup>1</sup> EEI’s U.S. members serve nearly 95 percent of the customers of the shareholder-owned segment of the industry and about 70 percent of all consumers of electricity in the United States. EEI’s members generate almost 70 percent of the nation’s electricity and own approximately 70 percent of the transmission facilities in our nation.

<sup>2</sup> RM02-1-000 Standardizing Generator Interconnection Agreements and Procedures, Notice of Proposed Rulemaking, 99 FERC ¶ 61,086 (April 24, 2002) (NOPR).

<sup>3</sup> EEI’s member companies will file comments on their own behalf.

Interconnection Procedures and Interconnection Agreement (Model IP/IA). EEI sought input from the Electric Power Supply Association, the American Public Power Association, and the National Rural Electric Cooperative Association and held an all-day collaborative. The Model IP/IA was filed with the Commission on October 22, 2001. The Commission then carried on the important stakeholder process input necessary to move toward industry consensus. EEI is pleased to have participated in initiating this important effort and participating throughout.

EEI commends the Commission for forging a new approach to rulemaking by first issuing an ANOPR that both sought industry comments on a straw proposal and asked participants to develop a consensus document to be filed in the docket, followed by this NOPR. EEI believes that the industry responded with energy, hard work and good faith to the Commission's challenge. The industry became engaged in numerous meetings, sought an extension for filing the draft agreements and the comments, continued with intensive negotiating and drafting group meetings, filed the draft Interconnection Agreement and Interconnection Procedures on January 11, 2002 and Comments on January 28, 2002.

EEI believes that the process evolved to adapt to the requirements of the task and that the outcome, while not perfect, was quite good. The task, as became clear over the course of the collaborative, was to draft two agreements, an IA and an IP. With 20/20 hindsight, it is clear that less time could have been spent on large group and plenary work and more time could have been spent on negotiating and drafting the agreements themselves. Accordingly, EEI strongly supports the Commission's new approach to rulemakings, but recommends that the Commission do additional scoping work at the beginning of the process to tailor the process more closely to the task at hand.

In order to comply with the Commission's directions regarding page limitations, EEI is providing one set of comments that are sectioned according to business unit views and

representation: (1) The Alliance of Energy Suppliers; (2) Transmission/ Distributed Generation  
and (3) Tax Analysis Research Subcommittee.

# THE ALLIANCE OF ENERGY SUPPLIERS

## **Executive Summary**

The Alliance of Energy Suppliers (Alliance) submits its comments on the NOPR which the Federal Energy Regulatory Commission (FERC) issued on April 24, 2002. The Alliance is a division of the Edison Electric Institute which represents generators in domestic wholesale electricity markets. The Alliance, together with EEI's Transmission Group, devoted considerable effort to the consensus standardized procedures that form the foundation for much of this NOPR. While other divisions of EEI are submitting comments in this documents, the aggregate size of EEI's comments will be within the Commission's 30 page limit.

The IA and IP represent a quantum advance in the development of a single uniformly applicable set of interconnection requirements nation-wide. The Alliance of Energy Suppliers is confident that the adoption of the IA and IP will expedite the construction of reliable and competitive new generation to relieve supply shortages and the establishment of a national market for electricity governed by an integrated set of rules and procedures.

As more fully set forth in its comments below, the Alliance of Energy Suppliers:

- endorses the Commission's decision to address the question of the proper allocation of costs for interconnection facilities and network upgrades in the instant docket.
- supports the Commission's decision in the NOPR to allow generators the "fair and equitable recovery of costs for investment in Interconnection Facilities deemed network upgrades and which provide network benefits.
- supports the application of the Commission's interconnection pricing policy in anticipation of the Commission's standard market design proceeding.
- urges the Commission to permit generators and transmission providers to separately agree on the terms and conditions for certain services that a generator may provide.
- urges the Commission not to delay the issuance of the Final Rule in this interconnection proceeding on account of regional differences that may be accommodated during the compliance phase of this proceeding.
- urges the Commission to require transmission owners and transmission providers to enter into the interconnection documents to ensure a one-stop interconnection window for generators.
- urges the Commission to require non-jurisdictional transmission owners to adopt the IA and IP as a condition of their use of jurisdictional transmission facilities.
- urges the Commission to reinstate an insurance provision originally offered during the stakeholder process.

## Comments

### **1. The NOPR Properly Allocates Responsibility for the Costs of Interconnection Facilities and Network Upgrades That Provide a Network Benefit**

The Alliance of Energy Suppliers supports the treatment of interconnection costs proposed by the Commission in the IA and IP. Consistent with the Commission's proposal in the NOPR, the Alliance of Energy Suppliers believes that the costs of network upgrades that create a network benefit and resolve reliability issues should be recovered through a myriad of mechanisms, which include transmission credits, cash refunds and also alternative forms of reimbursement (such as financial transmission rights).

The Alliance maintains that refunds for network upgrades that present a network benefit should be paid by the transmission provider within a reasonable time frame. The Commission continues to apply its policy of not allowing for the direct assignment of network facilities and instead allowing for proper cost allocation that recognizes that “the addition represents a system expansion used and benefiting all users due to the integrated nature of the grid.”<sup>4</sup> Where a network benefit is shown, the Commission's IA proposes that the refunds for network upgrade costs (plus interest) should be paid “within five years from the date the network upgrades are placed in service, so long as the transmission provider continues to receive payments for transmission service with respect to the Facility during such period.”<sup>5</sup> The concern the Alliance has is what if a party other than the generator (such as a tollor who contracts separately for transmission service from the facility) fails to make a transmission service payment? Should the generator be denied a due refund because a third party fails to meet its OATT-based payment obligations to the transmission provider? The Alliance of Energy Suppliers believes that

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<sup>4</sup> NOPR at 21-22

<sup>5</sup> IA, §11.4.1.

generators should not have to bear the credit risk of the transmission provider’s customers. The transmission provider is best situated to ensure and enforce the payment of transmission service rates, by means of security structures (such as letters of credit or guarantees), in its OATT. Therefore, the Alliance of Energy Suppliers proposes that the refund payment should not be contingent on the receipt by the transmission provider of payments, but should be payable for so long as transmission service from the pertinent facility is contracted for. However, consistent with the objective of appropriate cost recovery, the Alliance believes that transmission providers also should be afforded the certainty of cost recovery and the avoidance of trapped costs for the necessary transmission investment to be made.

## **2. The Commission Should Maintain its Policy of Providing Transmission Refunds When its Standard Market Design Rule is Implemented**

The Commission invites comments<sup>6</sup> on whether the generator interconnection pricing regime adopted under this rulemaking is consistent with the locational pricing methodology in the standard market design proceeding (“SMD”).<sup>7</sup> The Alliance of Energy Suppliers believes that it is infeasible at the present time to determine which interconnection pricing system should replace the current Commission policy of providing for transmission credits or refunds for network upgrades that provide a network benefit, as provided in the IA.

## **3. The Generator Should be Compensated for Services Provided to the Transmission Provider on the Basis of Negotiated Rates**

The IA proposes that the generator be compensated for reactive power that its facility provides or is required to absorb in accordance with an “applicable rate schedule then in effect”.<sup>8</sup> The Alliance of Energy Suppliers proposes that, consistent with the treatment of generator service compensation elsewhere in the IA,<sup>9</sup> the generator should be compensated for such

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<sup>6</sup> NOPR II(F)(3).

<sup>7</sup> Docket RM01-12.

<sup>8</sup> IA, §11.6.

<sup>9</sup> IA, §9.6.3.

services either on the basis of an agreement negotiated and agreed to by the generator and the transmission provider or in accordance with an applicable rate schedule then in effect. If neither situation applies, then, consistent with the IA,<sup>10</sup> the generator should be compensated at the rate that would have been in effect at the time service is provided under the terms of a schedule subsequently filed with the Commission or other appropriate agency. The Alliance of Energy Suppliers believes that such a system of compensation will best serve the nascent market for ancillary services, many of which are yet undefined and may be specific to the region and the type of facility.

Generators should not be constrained by being required to identify and price services in a rate schedule in advance of their development. The Alliance of Energy Suppliers proposes that the parties reach an agreement independently of the IA and OATT. In the absence of such an agreement or rate schedule (if any), the service would be priced at such rates as may subsequently be accepted by the Commission for filing.

**4. There Should be No Functional Distinction Between the Transmission Provider and Transmission Owner for Purposes of the Interconnection.**

The Alliance of Energy Suppliers endorses the approach in the NOPR to the distinction between the transmission provider and the transmission owner. The NOPR states that the transmission provider should be required to sign the IA (and various agreements under the IP) because the interconnection service will be provided under the transmission provider's OATT.<sup>11</sup> The Commission proposes that each of the transmission providers and, "to the extent necessary," the transmission owners, be signatories to the interconnection documents.

Each of the transmission providers and transmission owners should sign the IA and the various study agreements under the IP best to ensure the proper allocation of rights and

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<sup>10</sup> Id.

<sup>11</sup> Id. at §II(E)(6).

obligations to the interconnecting entities. Each interested party thereby becomes a part of the process and has a vested interest in its proper functioning. Interconnection and the reliable functioning of the grid require a single set of documents to govern interconnection service. For generators, this approach also provides an efficient time-saving one-stop window at which to arrange interconnection service, rather than being forced to contract with different parties for different aspects of the same transaction. Therefore, the Alliance of Energy Suppliers proposes to revise the definition of “Transmission Provider” in the IA and the IP to include “Transmission Owner” in accordance with the terms of the NOPR.

**5. Non-Public Utility Entities Should be Required to Adhere to the Terms of the Interconnection Documents as a Condition of their Use of the Applicable Transmission System**

The Alliance of Energy Suppliers endorses the Commission’s proposal in the NOPR “that any non-public utility that wishes either to take advantage of, or to continue to take advantage of, open access on a public utility’s transmission system, must adopt [the IA and IP] into its own reciprocity service.”<sup>12</sup> As in Order 888,<sup>13</sup> the Final Rule in this proceeding should contain a reciprocity provision applicable to any entity that owns, controls or operates interstate transmission facilities and that takes service under an OATT, including a non-public utility, or any affiliate of a transmission-owning entity. Requiring non-jurisdictional entities to abide by the national rules and standards will ensure the uniform application of the interconnection terms and conditions that is the goal of this rulemaking proceeding.

**6. The IA Should Reinstate Insurance Provisions Originally Offered During the Stakeholder Process in Response to the ANOPR**

The Commission states that the OATT contains no provision requiring insurance although it acknowledges that the ERCOT agreement, which the Commission reviewed for

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<sup>12</sup> NOPR, at §II(G)(2).

<sup>13</sup> Order No. 888 at 31,760-63; Order No. 888-A at 30,281-87.

reference purposes, does contain an insurance provision.<sup>14</sup> It is not clear why the Commission did not include *any* provision concerning insurance. Although it is infeasible in a *pro forma* document on a generic basis to stipulate the appropriate levels of insurance for all facilities – which necessarily will be of varying complexity and replacement cost the Alliance of Energy Suppliers believes that the generator and transmission provider should be required to maintain certain minimum levels of insurance relating to their respective facilities as agreed to by the parties.

### **Conclusion**

In conclusion, the Alliance of Energy Suppliers endorses the interconnection principles articulated in the NOPR and as detailed in the IA and IP. The interconnection structure provided in the NOPR is transparent and its uniform application on a national basis is designed to shift the prevailing case-by-case approach of the Commission to interconnection policy and to achieve the reliability and adaptability goals articulated by the Commission in the ANOPR.

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<sup>14</sup> NOPR, §II(G)(a).

# DISTRIBUTED GENERATION

## **Executive Summary**

EEl agrees that small generators should have streamlined and expedited access to the grid and that the general 40-45 day timeline to study the impact of the generation addition will be sufficient in most situations. Moreover, we support the Commission's view in the NOPR that the small generator should pay all the costs incurred to interconnect with the utility.

While generally supportive of the small generator provisions proposed in the NOPR, EEl suggests that the Commission not impose standard Interconnection Procedures ("IP") and Interconnection Agreements ("IA") on distribution-level interconnections. As drafted, the Small Generator provisions apply transmission business practices inappropriately to distribution utilities. Moreover, the Commission's action will conflict with state procedures already in place and under development nationwide. Jurisdictional questions also arise, which could be avoided by deferring distribution interconnection to the states and to those RTOs where member utilities have voluntarily incorporated distribution interconnection into their business practices and procedures.

Failing that request, the Commission must modify the proposed interconnection procedures, especially for distribution voltages. Of particular concern is the question of trapped costs: the Commission must ensure that utilities recover the costs of interconnecting DG on the distribution system.

The eligibility requirements for small generators attached to distribution should reflect the emerging consensus forming around the country, of a 10 MW limit. The Commission should consider streamlining interconnection procedures further for the smallest generators and for different sized distribution circuits. Procedures should also allow more time for generators that are relatively large for their interconnection circuit. They should also accommodate the complexity of interconnecting on downtown distribution networks and systems in other urban

areas, where primary circuits are tied together or where circuits are looped. In these circumstances, the Commission should not require the payment of liquidated damages.

The Commission should avoid specifying the studies to be conducted. In many instances, distribution utilities will be able to combine or waive the studies listed in IP Section 14.4, but will have to conduct other studies not listed. The Commission should also clarify how the requirement in Section 14.3 that small generators join the same queue as the large generators will work alongside the expedited procedures in Section 14.4.

The Commission might consider establishing different regulation for different generation size categories, such as 1 kW –50 kW, 51 kW – 500 kW, 501 kW – 2, 000 kW, 2,001 kW- 10 MW. Interconnection procedures also should take into account distribution system voltage classes, such as 15 kV, 25 kV, and 35 kV in establishing a maximum-sized generator eligible for streamlined procedures. These size bands are illustrative; the Commission should convene a collaborative or initiate another process to determine the appropriate generic sizes.

The Commission should harmonize the provisions in IP Sections 14.2.2, 14.2.3, and 14.4 to insure that utilities do not incur uncompensated costs from frivolous interconnection requests.

Finally, the Commission should clarify the term “immediate vicinity,” as used in IP sections 14.1 and 14.4. The Commission also needs to clarify how its interconnection pricing policy will work for distribution upgrades.

This portion of these comments responds to the small generator provisions in the NOPR, FR 22253-9, and to Section 14 of the Interconnection Procedures document, FR 22289-90.

## **Comments**

- 1. IP Section 14.2.2 Correctly Requires the Small Generator to Pay for the Costs of Interconnection Study and Provides for Expedited Analysis**

The Commission is on firm ground in rejecting calls from the Small Generator Caucus to subsidize the interconnection of small generators. In addition to the NOPR's equity argument, the Commission should recognize that subsidies skew the competitive marketplace and produce inefficiency and higher rates.

As EEI explained in its comments to the ANOPR, we support DG and see a significant potential for it.<sup>15</sup> There is no need for subsidies, which have no place in a market intended to replace inefficient decisions based on regulation with efficient decisions resulting from competitive forces. The Commission should continue to require the DG installer to pay for studies.

EEI agrees in principle with IP Section 14.2.3. There should be very few interconnections with small generators where the lengthy procedures outlined in the IP should be necessary.

## **2. The Commission Should Reconsider Its Decision to Apply The Small Generator Provisions to Wholesale Transactions on Distribution Facilities.**

EEI suggests that the Commission not impose standards on distribution-level interconnections. As drafted, the Small Generator provisions apply transmission business practices inappropriately to distribution level systems. The design and operating characteristics of distribution systems, both radial and network, differ in significant ways from the higher-voltage transmission system. The development of such procedures is best left to local utilities and state regulators.

Various provisions of Section 14 of the IP are inappropriate for the subset of small generators attached to the distribution system. For example, the studies specified in IP 14.4 might not be appropriate for distribution-level interconnections. Also, the requirement that all

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<sup>15</sup> Comments of Edison Electric Institute, Standardizing Generator Interconnection Agreements and Procedures, Docket RM02-1-000, February 1, 2002.

small generators join the same queue as large generators, as well as the 20-MW eligibility criterion, regardless of the size of the circuit, make little sense.

The Commission regulation of distribution interconnection raises complex jurisdictional questions. Many transmission owners have structurally separated from distribution. In some cases, the transmission provider and distribution utility are no longer even affiliated with one another. The NOPR could bring within Commission regulation distribution companies that have no other business before the Commission, imposing a whole new layer of regulatory costs.

Utilities could also find themselves under conflicting requirements between state and federal regulation. The possibility arises that the utility might incur costs to study small generator interconnections quickly that cannot be recovered in retail rates. This could result if the distribution utility is under rate freezes or performance-based regulation at the state level, or if the utility under traditional regulation has just had a rate case. The Commission must ensure its regulations do not put utilities in an impossible situation of adhering to conflicting federal and state regulations. To ensure that utilities do not face trapped costs, the Commission should not impose procedures on distribution-level interconnections.

Any Commission action on distribution interconnection would occur at a time when great strides are being made in the states. NARUC is developing model agreements and procedures for small generator interconnection to distribution.<sup>16</sup> Under the Commission's proposed applicability criteria, a small generator could qualify for expedited procedures simply by declaring its intention of making sales for resale, whether or not it actually ever sells in that market. This proposal is a blanket invitation to forum shop, undermining all of the state activity.

Language differences in the NOPR and IP Section 14.1 cause jurisdictional ambiguity. The NOPR specifies that Section 14 "will apply only when a generator interconnects to the

transmission provider's transmission system or makes wholesale sales *in interstate commerce* at either the transmission or distribution voltage level.” NOPR at 22253, emphasis added. Section 14.1 of the proposed IP dropped the modifier “in interstate commerce.” It states: “[t]his Section 14 applies only to Small Generators that are located on the transmission provider's Transmission System or whose transaction(s) involves sale for resale.” NOPR IP, at 22289.

The NOPR language is congruent with the plain reading of the Federal Power Act, but the language in IP Section 14.1 goes one step farther, asserting Commission authority over all sales for resale, not just those in interstate commerce. It is unclear if the Commission has authority over energy sales for resale using distribution lines that do not cross state lines, or where the energy does not enter the interstate transmission system.

As the Supreme Court made clear in *New York vs. FERC*, the Commission *may* defer to states matters subject to the Commission jurisdiction. Since states have ample authority over distribution interconnections and several are already implementing standards, the Commission should defer to the states policies governing DG interconnection to the distribution grid for sales for resale. Deferring regulation of distribution interconnections to the states eliminates the problems of forum shopping the proposed IP would create, and ensures that unbundled distribution companies are not subject to Commission regulation.

### **3. If the Commission Decides To Regulate Distribution-Level Interconnections, the IP Procedures Need to Be Modified**

The Small Generator provisions in the proposed IP, while acceptable in principle, need refinement, especially in regards to the subset of small generators connected to utility distribution networks. At the outset, different eligibility criteria are necessary. To ensure that Commission regulations are consistent with what is becoming standard around the country, 10

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<sup>16</sup> A few states have already individually developed standards for distribution level interconnections, including Texas, California, and New York. Several other states, including Indiana, Virginia, Wisconsin, Michigan, and Ohio, have initiated proceedings to develop standards for distribution-level interconnections.

MW should be the maximum sized generator eligible for streamlined interconnection.<sup>17</sup> There might also be justification for more streamlined procedures for the smallest generators connected to the distribution grid. In general, the larger the generator, the larger the impact on the distribution system.<sup>18</sup> With different requirements for specific generator and circuit size categories, utilities could implement further streamlining. Also, studies other than the ones listed in Section 14.4 might be necessary for distribution interconnection.<sup>19</sup>

Regardless of the size of the DG unit or distribution line, the Commission should permit a utility more time to study the interconnection if the new DG will lead to an aggregate DG impact in excess of 15% of the minimum daily peak-load in kVA on the circuit. Interconnection procedures also should allow greater scrutiny of DG connections to distribution network systems and looped circuits frequently found in the downtowns of cities and other urban areas.<sup>20</sup> There must be no liquidated damages should a large DG relative to the circuit require greater scrutiny. The IP should also provide a mechanism to stop the clock without penalty if the utility needs additional information from the generator.

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<sup>17</sup> For example, the Institute of Electrical and Electronics Engineers (IEEE) is using 10 MVA as the cut-off for its draft standard P-1547. Texas has established a different set of standards for “On-site distributed generation (or distributed generation)” that apply to generators smaller than 10 MW connected at voltages below 60 kV. PJM also uses 10 MW for small generators to qualify for expedited interconnection.

<sup>18</sup> The Commission might establish procedures for interconnecting size categories, such as these: 1-50 kW, 51-500 kW, 501-2,000 kW, and 2,001 kW – 10 MW. Interconnection procedures also need to take into account distribution system voltage classes, such as 15 kV, 25 kV, and 35 kV in establishing a maximum-sized generator eligible for streamlined procedures. EEI offers these numbers as illustrative; the Commission should establish a collaborative to identify the appropriate size categories generically across the country. EEI strongly disagrees with the unrealistic and unreasonable proposals put forward by the Small Generators Caucus in the ANOPR.

<sup>19</sup> For example, short circuit calculations will be necessary to determine the DG contributions to fault currents. A protection study will review existing coordination and protection devices to ensure they are appropriate when the DG operates and, if they are inappropriate, to develop the solution. Another study that may be needed is a system impact study, which models power flows to determine if operation of the proposed DG will lead to conductor or equipment overloads, system protection problems, potential islanding with distribution utility load, power quality problems such as voltage flicker and harmonic distortion, and/or unacceptable voltage levels.

<sup>20</sup> Typical downtown network service consists of two or more primary distribution feeders electrically tied together utilizing network protectors to form one power source for one or more customers. Loop circuits use reclosers, making the attachment of a generator difficult due to reclosing logic and changes in relay protection.

The Commission should modify the process proposed in IP Section 14.4 and 14.3. With a large enough staff and assuming large upgrades are not needed, utilities could meet with a small generator within 10 business days and perform the two studies called for in sequential periods of 15 calendar days period, but such a structured process could be inconsistent with the actual study requirements. The Commission should require a single time period of 45 days to study the impact of the generation addition after the receipt of a completed interconnection application. The utility would study whether the interconnection will require grid modifications, suggest the best way to make the modifications, and quantify the upgrade costs. The Commission also should also clarify how the queuing in IP Section 14.3 fits into the sequence. The Commission should allow utilities extra time to sturdy interconnections that require large upgrades.

The requirement in Section 14.1 that utilities reuse transmission studies is inappropriate because distribution, being more dynamic than the transmission system, is routinely reconfigured. Distribution studies quickly become obsolete. If the study is three months old before the customer decides to install DG, the Commission should allow the utility to re-estimate the interconnection costs.

EEI is concerned about frivolous DG interconnection applications and about a customer who applies to install DG but then changes its mind and avoids paying the bill after the utility has already incurred expenses. Given the speed of the study, EEI sees little point in waiving the application fee. Under the timeline proposed in IP Section 14.4 and 14.2.2, the customer has 59 days at most to pay for the first study after filing the completed application. Any customer unable to provide up front a portion of the funds that will be necessary in only two months is not serious about installing a distributed generator.

#### **4. In Regulating Transmission-level Small Generator Interconnections, The Commission Should Use A Modified PJM Approach**

In regulating the interconnection for the subset of small generators attached to the *transmission* system, the Commission should start with the small generator provisions of the PJM tariff filed with the Commission. Some of the provisions that may be appropriate for *transmission* providers may not be appropriate for *distribution* utilities.

#### **5. The Commission Should Clarify Various Provisions of IP Section 14**

The term “immediate vicinity” is unclear. As used in IP section 14.1, it refers to the limiting point at which the utility may look for grid impacts. The Commission should specify that “immediate vicinity” refers to the distribution system from the point of interconnection to the point of primary current protection and voltage control, which is typically, though not necessarily, the distribution substation.

Finally, the Commission must establish a different pricing policy for most distribution-level interconnections, which were built to deliver power to, and not to receive power from, individual customer premises. To effect the two-way flow, utilities in many cases will need to make modifications which would not be necessary but for the installation of DG. Many of these upgrades require extensive reworking of relay protection schemes in areas remote from the “immediate vicinity” of the generator. Since the upgrades only benefit the customer installing the DG, that customer should pay for the upgrades. If the customer does not have to consider the costs of upgrades, inefficient decisions will result, and other utility customers will pay more as a result of the customer’s installation of DG. Moreover, stand-alone distribution companies have no transmission customers to share the transmission costs that would result if the DG did not pay for the full costs of interconnection. Otherwise, utilities would have to raise the rates of its retail customers, a clear subsidy to the DG customer.

**Tax Analysis  
Research  
Subcommittee**

## Executive Summary - Taxation Issues

It is in the interest of electricity consumers, generators and transmission providers, to fund the capital investment in interconnection facilities and network upgrades without the added cost of income taxes imposed on the interconnection transaction. Any additional income taxes and associated costs such as interest, penalties and costs of preserving favorable tax treatment (such as internal costs and attorneys' fees) which are incurred as a result of interconnection transactions should be treated similarly to any other reimbursable cost incurred by the transmission provider and, as such, should be paid by the generator on a fully grossed-up basis. These costs are substantial and should be expected to add at least 30 percent or more to the cost of the interconnection facilities.

Section II.E.5 of the NOPR, and Article 5.14 of the Standard Generator Interconnection and Operating Agreement ("IA") address the treatment of income taxes. These provisions are intended to "ensure that the rates, contracts, and practices affecting jurisdictional transmission do not reflect an undue preference or advantage and are just and reasonable"<sup>21</sup> as the provisions relate to the Commission's "clarification that provides transmission providers with full reimbursement in the future if the Internal Revenue Service (IRS) determines that these type of events are taxable."<sup>22</sup> In this regard, EEI believes this Commission's intentions in the NOPR are: (1) Payments made by generators to transmission providers should not be subject to income taxes; (2) generators are to bear the economic cost of interconnection facilities including any tax, interest, and penalty imposed on payments made by generators to transmission providers for interconnection facilities; and (3) transmission providers may recover the economic cost of network upgrades in regulatory rates, including any income tax, other tax, interest, and penalty

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<sup>21</sup> NOPR at 9.

imposed on payments made by generators to transmission providers for the temporary funding of network upgrades.<sup>23</sup>

In order to properly effect these policies, the Commission should take into account three important points. First, while the Commission, generators and transmission providers desire that payments for interconnection facilities and network upgrades (sometimes referred to herein collectively as interconnection transactions) made by generators to transmission providers not be subject to tax, the treatment of such payments or transfers is not certain at this time. There is a tax risk, as discussed more fully below, for payments and transfers of property pursuant to the IA. While this tax risk may be reduced by the changes proposed herein, it will not be eliminated. Second, some tax risk will continue through the term of the IA because certain actions subsequent to the transfer of funds or property may cause the transfer to be taxed. Third, while the indemnification provisions of Article 5.14.3 attempt to allocate the risk for tax, interest and penalties to the generator with respect to payments for or property transfers of interconnection facilities, that allocation of burden is only effective if the generator is able and willing to perform on its obligation to the transmission provider. The prospect that a generator will be unwilling or economically unable to reimburse the transmission provider for taxes that may be imposed on the transmission provider exposes the transmission provider to risk under the proposed IA.

## **Comments**

### **1. In the Interests of Consumers, EEI Recommends that the Commission Adopt Tax Policies That Will Keep Tax Payments Low**

Consumers of electricity, generators and transmission providers share a common interest in funding the capital investment in interconnection facilities and network upgrades without the

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<sup>22</sup> Ibid., page 24.

<sup>23</sup> Article 11.4.1 provides that transmission provider will repay payments made by generators for network upgrades over a period not exceeding five years with interest.

added cost of income taxes imposed on the interconnection transaction. These costs are substantial and would add at least 30 percent or more to the cost of the interconnection transactions. This Commission's policy on the treatment of income tax and related costs should be adopted with a full recognition of both the tax and credit risks associated with interconnection transactions.

## **2. Tax Risk**

Interconnection transactions present tax risks. This Commission must understand that the IRS has been willing to allow non-shareholder contribution to capital treatment only for very specific interconnection transactions described by the notices. See Notice 1988-129, Notice 1990-60, and Notice 2001-82. The IA, however, departs from these notices. For example, this Commission has proposed a policy that generators will receive transmission credits on network upgrades. The effect of transmission credits on the potential taxation of interconnection transactions (including payments for both interconnection facilities and network upgrades) is uncertain. Neither the IRS nor the courts have considered the effect of transmission credits on interconnection transactions. Thus, the introduction of transmission credits is an additional fact that may jeopardize the favorable tax treatment that the IRS has permitted in only limited circumstances. Similarly, some generators have favored the policy of allowing generators to terminate the IA by giving the transmission provider 30-days notice. See Article 2.3.1. Other generators and transmission providers recognize that this provision may be construed by the IRS as a violation of its historic and current requirement for a long-term agreement between the generator and the transmission provider and result in taxation of the interconnection transaction. See Notice 88-129 and Notice 2001-82.

Additional uncertainty has been added recently by the IRS interpretation that its notices only apply to one of the requirements of non-taxability -- the issue of whether the generator is

the customer of the transmission provider for purposes of section 118(b) of the Internal Revenue Code of 1986. The IRS is now asking taxpayers to “represent” that they satisfy a five part test set out by the Supreme Court in *United States v. Chicago, Burlington & Quincy R.R. Co.*, 412 U.S. 401 (1973) for determining whether a payment or transfer of property is a nonshareholder contribution to capital under section 118(a). See PLR 200134021 (August 27, 2001) in which the IRS ruled that the proposed transfer of interconnection facilities was a nonshareholder contribution to capital under section 118(a) solely on the basis of the taxpayer’s representations. When a ruling has been issued based on such representations, an IRS auditor may nonetheless contest the IRS’s own ruling by contesting the validity of any taxpayer representation relied on therein. Thus, the taxpayer is at risk for any contest over the representations, which are highly factual and subject to various interpretations.

Another tax risk is that the IRS will not issue guidance on the tax treatment of a particular IA. The IRS has not committed itself to provide nontaxable treatment for property transfers or payments made under the terms of the proposed IA. While the IRS has indicated that it is willing to issue private letter rulings outside of the scope of Notice 2001-82, it also followed that practice in the past for a period of years and then changed its practice by refusing to rule on transactions that did not fall squarely under the facts of the published notices.

### **3. Credit Risk**

Generators, transmission providers, and this Commission seem to recognize that interconnection transactions involve a tax risk. Generators want to minimize or eliminate the costs of providing transmission providers with adequate security for the indemnifications that generators provide for the costs of taxes, interest, penalties, and other related costs.

Transmission providers want assurance that appropriate security is provided to support the

indemnifications provided by generators under the IA. One way to deal with this risk is for the Commission and other regulatory bodies to assess the risk and determine that it is prudent for ratepayers to bear the costs when generators are unable or unwilling to perform. This Commission and others could conclude that, with appropriate safeguards, allowing transmission providers to recover the potential tax, interest and related costs from ratepayers is reasonable and an appropriate way to deal with the possibility that certain generators may not be able to perform on their indemnification obligations. Thus, the Commission should adopt a policy that would allow recovery through rates in these circumstances.

Should this Commission or any other regulatory commission determine that it is not reasonable for transmission providers to recover these costs in rates it would seem unreasonable to impose those same risks on transmission providers. Instead it seems entirely consistent with the Commission's policy to impose the cost of that risk on generators.

In those cases in which this Commission or another commission does not permit a transmission provider to recover the costs in rates for any reason (e.g., prudence, a rate freeze, transmission rates that are not unbundled, or regulatory timing that would delay recovery of the costs), the transmission provider should have discretion in determining the appropriate level of security required from the generator. This security might include irrevocable letters of credit from a financially responsible institution (e.g., banks regulated by the Comptroller of the Currency); the guarantee of the generator's parent; or a cash advance on which the generator might receive interest once the security is released. In addition, the transmission provider should be permitted to use a right of offset provision to recover from the generator any income taxes and other costs subject to indemnification.

Should the generator and the transmission provider not agree on the appropriate level of security, however, this Commission should require the generator to obtain, at generator's sole

expense, an irrevocable letter of credit in favor of the transmission provider. The letter of credit would be payable in the event one or more governmental authority determines that the transaction is taxable. The amount of the letter of credit should cover the potential taxes, interest, and other costs on the transaction, be nonrevocable for the term of the IA, and provide that the transmission provider, by its sole action, is permitted to collect from the bank the amount claimed on the basis of appropriate evidence that a governmental authority is imposing tax on the interconnection transaction. This letter of credit procedure would allow the market to determine the level of risk in a particular transaction over the term of the IA and would impose the economic cost of that risk on the generator.

#### **4. Proposed Changes to the NOPR and IA**

The Commission should adopt changes to the IA consistent with IRS Notice 2001-82. This would include the elimination of transmission credits<sup>24</sup> and the 30-day termination right granted generators.<sup>25</sup> EEI is willing to work with the Commission and the IRS to further improve the likelihood that the IRS will provide non-taxable treatment on interconnection transactions.

With respect to the quality of the indemnity provided to transmission providers to protect them, the Commission should adopt the following changes. First, the Commission should allow transmission providers to place into rates currently any additional income tax and related costs resulting from a taxable interconnection arrangement in which transmission providers are unable

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<sup>24</sup> The elimination of transmission credits does not necessarily mean that the generator would bear the cost of network upgrades. It appears that this Commission views advances by generators to transmission providers for network upgrades as loans repaid through transmission credits or cash. EEI understands that the issue of which party bears the cost of network upgrades will be commented upon in this rulemaking proceeding. This portion of our comment does not take a position on that issue, but simply comments on improving the tax treatment of the NOPR as proposed. Nonetheless, in the interest of obtaining favorable tax treatment for interconnection transactions, this Commission should consider the elimination of transmission credits without regard to the party on which it chooses to impose the cost as a means of enhancing the likelihood that interconnection transactions will remain nontaxable.

<sup>25</sup> The same result can be obtained by defining the damages for which the generator is liable in the event of prematurely terminating the IA. See Article 4.2.

to recover such cost from generators (e.g., the generator is in bankruptcy or is no longer in existence). This Commission also should encourage other ratemakers to allow similar treatment when prudent. Second, in situations where transmission providers are unable to adjust their transmission rates for this added cost because this Commission or other ratemakers believe ratepayers should not bear the tax and credit risk of generators or other regulatory restrictions (e.g., transmission rates are not unbundled and require state commission approval), the Commission should allow transmission providers to determine the level of security needed from generators in particular transactions to ensure that shareholders of transmission providers will not bear the cost.

To adopt these changes, the Commission could amend Article 5.14.3, of the IA in to read as follows:

Indemnification for Taxes Imposed Upon Transmission Provider.

Notwithstanding Article 5.14.1, generator shall protect, indemnify and hold harmless transmission provider from income taxes imposed against transmission provider as a result of payments or property transfers made by generator to transmission provider under this Agreement, as well as any interest and penalties, other than interest and penalties attributable to any delay caused by transmission provider. Transmission provider shall not include a gross-up for income taxes in the amounts it charges generator under this Agreement unless (i) transmission provider has determined in good faith, that the payments or property transfers made by generator to transmission provider should be reported as income subject to taxation or (ii) any Governmental Authority directs transmission provider to report payments or property as income subject to taxation in which cases transmission provider may include a gross-up for income taxes. In the event a gross-up for income taxes is required, transmission provider shall provide to generator a computation reflecting how the amount was calculated. In the absence of regulatory authority that allows transmission provider to include the amount of any default on this indemnification in current rates, transmission provider may require generator to provide security (such as a parental guarantee, letter of credit, or cash advance) in an amount equal to generator's estimated liability under this Article 5.14 for taxes and interest that transmission provider may be required to pay to one or more Governmental Authorities. In the event generator and transmission provider do not agree on the security, generator shall obtain, at generator's sole expense, a letter of credit from a domestic bank regulated by the Comptroller of the Currency. Such letter of credit, by its terms, shall not be

revocable for the full-term of this Agreement, and shall provide transmission provider, in its sole discretion, the right to require payment from the bank for any tax and interest claimed by a Governmental Authority upon providing written evidence of the Governmental Authority's claim for the tax and interest on the payments or property transferred by the generator to the transmission provider and without any consent by the generator.

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As indicated above, EEI suggests that the Commission consider permitting the transmission providers to include in rates amounts not reimbursed by generators. This could be done by inserting at the end of the last paragraph of section II.E.5 of the NOPR.

In addition, to the extent (i) both parties follow the terms and procedures as provided for in this section II.E. 5 and Article 5.14 of the IA, (ii) the transaction results in a taxable event to the transmission provider, and (iii) the transmission provider is unable to recover from the generator the entire amount of tax, interest and other related penalties and costs resulting from the taxable event (due to bankruptcy of the generator or other events), the transmission provider shall be permitted to currently recover the remaining balance from ratepayers consistent with the general ratemaking procedures of this Commission. The remaining balance shall accrue interest calculated in accordance with the methodology set forth in 18 C.F.R. §35.19a(a)(2)(iii)(A).

## **5. Summary**

The Commission has taken the first step in balancing the individual tax-related goals of transmission providers and generators. The proposed standard interconnection agreement contains procedures that attempt to provide transmission providers with adequate security and generators with reasonable costs in meeting their obligations (see §5.14 – Taxes, of the April 24, 2002 IA). The Commission must take the final step in this convergence of its goals by properly evaluating these risks. We believe that this is best done by this Commission and others deciding whether these risks should properly be borne by ratepayers, and if not, by allowing market forces to quantify the cost of the particular level of risk associated with each interconnection transaction.

## **CONCLUSION**

For the foregoing reasons, EEI respectfully requests that the Commission consider adopting the recommendations proposed above.

Respectfully Submitted,

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