

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

Indicated Generation Owners	)	
	)	Docket No. EL19-70-000
	)	

**REPLY BRIEF ON CAPITAL STRUCTURE AND COST OF CAPITAL  
OF INDICATED GENERATION OWNERS, ELECTRIC POWER SUPPLY  
ASSOCIATION, AND PJM POWER PROVIDERS GROUP**

The Indicated Generation Owners,<sup>1</sup> Electric Power Supply Association (“EPSA”), and PJM Power Providers Group (“P3”)<sup>2</sup> (collectively, “Petitioners”) respectfully submit this reply brief in response to comments filed in response to the Federal Energy Regulatory Commission’s (“Commission”) Order Establishing Paper Hearing Procedures, issued in this proceeding on July 16, 2020.<sup>3</sup> Petitioners respectfully request that the Commission approve the use of the cost of capital and capital structure elements of the PJM Cost of New Entry Study (“PJM CONE Study”) as a reasonable proxy for merchant generators’ return in calculating proposed revenue

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<sup>1</sup> Indicated Generation Owners are: Competitive Power Ventures, Inc.; J-Power USA Development Co., Ltd.; Panda Power Generation Infrastructure Fund LLC (“Panda”); and Vistra Energy Corporation.

<sup>2</sup> P3 is a non-profit organization that supports the development of properly designed and well-functioning markets in the PJM region. Combined, P3 members own approximately 67,000 megawatts of generation assets, produce enough power to supply over 50 million homes in the PJM region covering 13 states and the District of Columbia. For more information on P3, visit [www.p3powergroup.com](http://www.p3powergroup.com). The comments contained in this filing represent the position of P3 as an organization, but not necessarily the views of any particular member with respect to any issue.

<sup>3</sup> *Indicated Generation Owners*, 172 FERC ¶ 61,033 (2020) (“Briefing Order”). The filings submitted include: Dominion Zone Parties, Initial Comments, Docket No. EL19-70-000 (Aug. 31, 2020) (“DZPs Comments”); American Electric Power Service Corp., Comments, Docket No. EL19-70-000 (Aug. 31, 2020) (“AEP Comments”); Edison Electric Institute, Motion to Intervene and Comments, Docket No. EL19-70-000 (Aug. 31, 2020) (“EEI Comments”); Office of the People’s Counsel for the District of Columbia and the Maryland Office of People’s Counsel, Paper Hearing Brief, Docket No. EL19-70-000 (Sep. 1, 2020) (“OPCs Brief”).

requirements and cost-based rates for providing reactive power service to the PJM Interconnection, L.L.C. (“PJM”) market.<sup>4</sup>

## ARGUMENT

### **The Commission Should Grant the Requested Declarations Regarding Capital Structure and Cost of Capital Because They Are Reasonable, Sensible, and Will Avoid Needless and Burdensome Litigation**

Resolving the capital structure and cost of capital issues set for briefing in this paper hearing procedure will help facilitate settlement of reactive power cases and provide clarity and transparency to all parties going forward. The comments and briefs in this paper hearing procedure confirm that litigation over these issues has proven incredibly costly for all involved and produced more work for the Commission’s staff than is necessary or sensible. Resolving these issues here is vitally important. Given the enormous cost to fully litigate capital structure and cost of capital issues at hearing, parties are daunted by the prospect of producing full and detailed factual records when the real questions are legal and policy-related—whether certain proxies are acceptable for merchant generators to use in formulating reactive power rates in PJM’s territory. This docket offers the chance to provide that critical guidance.

#### **A. The PJM CONE Study Provides A Conservative Proxy for All Three Components Of The Rate of Return For Reactive Power Rates.**

As the Commission knows, a merchant generator’s rate of return or weighted average cost of capital consists of three parts: cost of debt, cost of common equity (or “ROE”), and capital structure.<sup>5</sup> The D.C. and Maryland People’s Counsels (“OPCs”), American Electric Power

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<sup>4</sup> See Indicated Generation Owners, Petition for Declaratory Order, Docket No. EL19-70-000 (May 3, 2019) (“Petition”); Indicated Generation Owners, Electric Power Supply Association, and PJM Power Providers Group, Initial Brief on Capital Structure and Cost of Capital, Docket No. EL19-70-000 (Aug. 31, 2020) (“Petitioners Initial Brief”).

<sup>5</sup> See *PJM Interconnection, L.L.C.*, 167 FERC ¶ 61,029 at P 104 (2019), *rehearing denied*, 171 FERC ¶ 61,040 (2020).

(“AEP”), and the Dominion Zone Parties (“DZPs”) all zero in on just one of these components: the return on common equity or ROE.<sup>6</sup> And they do so to the exclusion of the two other components of the rate of return,<sup>7</sup> both of which significantly impact the overall proxy calculation. As demonstrated earlier in this proceeding, the PJM CONE Study took a comprehensive view of “the cost structure of merchant generators,” and was not limited just to “rate of return on capital investment” but instead considered that issue as well as capital structure and cost of debt.<sup>8</sup> A reasonable proxy for merchant generators must reflect the greater risk of merchant generators for *each* of these components. And the PJM CONE Study has accomplished that task, providing “the most representative proxy available to ... merchant generators ... in reactive rate cases.”<sup>9</sup>

Contrary to the DZPs’ argument that a “proxy is intended to be conservative,”<sup>10</sup> the Commission has already explained that proxies are meant to be comparable to and representative of the risks faced by the filing entity, not an estimate purposefully slanted in any particular way.<sup>11</sup>

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<sup>6</sup> See OPCs Brief at 2-10; DZPs Comments at 3-10; AEP Comments at 3-6.

<sup>7</sup> Additionally, no commenter has submitted any evidence taking issue with the Commission-approved PJM CONE’s cost of debt or capital structure.

<sup>8</sup> See Petition, Affidavit of Paul M. Sotkiewicz at ¶¶ 13, 18.

<sup>9</sup> See Petitioners Initial Brief, Amended Affidavit of Michael R. Borgatti at ¶ 14.

<sup>10</sup> DZPs Comments at 6 (quoting Briefing Order at P 20).

<sup>11</sup> See Briefing Order at P 24. When the Commission and the Courts have addressed the proxy requirement, they have stressed that the proxy must be *comparable*, and have not introduced a requirement that they be conservative. See, e.g., *Proxy Group Policy Statement*, 123 FERC ¶ 61,048 at PP 48, 50 (2008); *Petal Gas Storage, L.L.C. v. FERC*, 496 F.3d 695, 699 (D.C. Cir. 2007)) (“That proxy group arrangements must be risk-appropriate is the common theme in each argument. The principle is well-established.”); *id.* (“[t]he principle captures what proxy groups do, namely, provide market-determined stock and dividend figures from public companies comparable to a target company for which those figures are unavailable.”); see also *FPC v. Hope Nat. Gas Co.*, 320 U.S. 591, 603 (1944) (“the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks”); *Martha Coakley, Mass. Attorney Gen. v. Bangor Hydro-Elec. Co.*, Opinion No. 531, 147 FERC ¶ 61,234 at PP 144-145 & n.285 (2014) (where the Commission took into account market considerations and was “less confiden[t] that the midpoint of the zone of reasonableness . . . accurately reflects the [ROE] necessary to meet the Hope and Bluefield capital attraction standards.”), *vacated on other grounds by* 854 F.3d 9 (D.C. Cir. 2017).

In any event, the actual disagreement here is over whether the PJM CONE Study is sensible and reasonable to use in practice in the calculation of reactive power rates. Importantly, the Commission has already found its results to be just and reasonable. Indeed, by many measures, the PJM CONE Study has produced reasonable and reliable, and (yes) conservative results for all three cost of capital elements, and the “Petition thus asks the Commission to confirm a conclusion it has already reached: that these figures appropriately reflect the risks and costs of financing in the PJM region.”<sup>12</sup> In its latest iteration the PJM CONE Study found, and the Commission accepted as just and reasonable, sensible figures for cost of debt, ROE and capital structure.<sup>13</sup> All that the Petition seeks here is to recognize and reaffirm the reasonableness of the application of that already-completed work in the context of reactive power rates.

While the Petitioners strongly disagree with the DZPs’ assertion that an acceptable proxy must be even *more* conservative than the just and reasonable PJM CONE figures,<sup>14</sup> the general concern underlying their assertion is misplaced: the Commission has found that the PJM CONE figures are just and reasonable estimates of the risks that merchant generators face and are

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<sup>12</sup> Indicated Generation Owners, Motion for Leave to Answer and Answer at 15, Docket No. EL19-70-000 (Jun. 18, 2019) (“Petitioners’ Answer”).

<sup>13</sup> *PJM Interconnection, L.L.C.*, 167 FERC ¶ 61,029 at PP 88, 105, 108, 111 (2019) (approving a 6% cost of debt, 13% ROE, and “debt-equity ratio of 55 percent-45 percent” for capital structure), *rehearing denied*, 171 FERC ¶ 61,040 (2020). Comparable studies conducted by different consultants have been performed for the New York Independent System Operator and ISO New England, Inc. and have reached similar results. Concentric Energy Advisors, *ISO-NE CONE and ORTP Analysis* at 41 (Jan. 13, 2017) (“A return on equity of 13.4% represents an appropriate return under equilibrium market risk conditions.”), *included in* ISO New England, Inc., Filing of CONE and ORTP Updates, Docket No. ER17-795 (filed Jan. 13, 2017), *filing accepted* 161 FERC ¶ 61,035 (2017), *rehearing denied* 170 FERC ¶ 61,052 (2020); Analysis Group, Inc. and Lummus Consultants International, Inc., *Study to Establish New York Electricity Market ICAP Demand Curve Parameters* at 60 (Sept. 13, 2016) (“Based on this information, AGI recommends a ROE of 13.4 percent”), *included in* New York Indep. Sys. Operator, Inc., Proposed ICAP Demand Curves for the 2017/2018 Capability Year and Parameters for Annual Updates for Capability Years 2018/2019, 2019/2020 and 2020/2021, Docket No. ER17-386 (filed Nov. 18, 2016), *filing accepted subject to condition* 158 FERC ¶ 61,028 (2017), *rehearing denied* 160 FERC ¶ 61,020 (2017).

<sup>14</sup> See DZPs Comments at 6-8.

eminently suitable here.<sup>15</sup> The point of a proxy is that it generally represents the risk that an entity faces, not systematically more or systematically less risk than the data would otherwise indicate. Indeed, the Commission will adjust proxy groups and accept new proxies so that they accurately represent the risk of the entity seeking ROE.<sup>16</sup> And the Commission has taken hedging strategies into account as well.<sup>17</sup>

**B. The Commission Has Rejected Calls for A Piecemeal, Separate Risk Analysis of Every Component of a Company’s Operations in Favor of a Holistic Analysis That Considers the Risk of the Entire Enterprise.**

Commenters also argue that an ROE developed for a merchant generator based on its *market* risks cannot be applied to reactive power where a generator is guaranteed *cost*-based recovery for reactive power service. The Commission has flatly rejected the claim that a merchant generator’s guaranteed rate of return from a reactive power tariff changes the generator’s risk profile and compels a separate analysis of the risks of merchant activities versus the risks involved in reactive power production. As explained earlier in this docket, in the *Chehalis* proceeding, the

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<sup>15</sup> See Petition, Affidavit of Paul M. Sotkiewicz at ¶¶ 15-22. And, further undercutting the DZPs’ contentions, one state commission has in fact treated an ROE higher than that used by the PJM CONE Study as conservative and adjusted it upwards to better reflect a merchant generator’s risks. It did so at Dominion’s urging. Compare Interim Decision, *In re PURA Implementation of June Special Session Public Act 17-3* at 24-25, Docket No. 18-05-04 (Conn. Pub. Utils. Reg. Auth. Dec. 5, 2018) (“Based on the analysis presented by Dominion discussed above, the Authority finds that the market-required return on the tied up investment is likely to be at least 15% under a merchant operation scenario. This is based on a comparison of an assumed rate of return requirement of 13.4% for a merchant natural gas plant, adjusted upward to account for some added risk associated with operating a merchant nuclear plant.” (footnote omitted)) with *PJM*, 167 FERC ¶ 61,029 at P 105 (finding “a 13 percent ROE ... just and reasonable”).

<sup>16</sup> *Proxy Group Policy Statement*, 123 FERC ¶ 61,048 at PP 48, 50 (citing *Petal Gas Storage, L.L.C. v. FERC*, 496 F.3d 695, 699 (D.C. Cir. 2007)); see also *Petal Gas Storage*, 496 F.3d at 699 (explaining that the point of “proxy groups” is to provide figures “comparable to” the entity seeking to establish or change its rates).

<sup>17</sup> Petitioners’ Answer at 17-18 & nn. 60-61 (citing *PJM Interconnection LLC*, 149 FERC ¶ 61,183 at P 81 (2014); *PJM Interconnection LLC*, 153 FERC ¶ 61,035 at P 58 (2015)). As explained earlier in this proceeding, the untenable conclusions of the *Panda Stonewall* initial decision actually reinforce the need for Commission guidance here, rather than undermine it. See *id.* at 19-20.

Commission’s Trial Staff argued that financial risks of merchant generators could be disaggregated by the services they offer—and the Commission roundly rejected that argument.<sup>18</sup> This “separate risk analysis” of “every component of a company’s operations” was “an approach that the Commission has never taken” and refused to take in *Chehalis*.<sup>19</sup>

Despite that binding precedent, several parties trot out that same argument again here. The OPCs argue that the Commission should abandon its long-held policy that the capital attraction standard is evaluated for the entity as a whole—they ask for it to be applied “on a fine-grained, service-by-service basis, in order to more precisely identify the cost of the equity actually employed in providing the service at issue.”<sup>20</sup> They argue this policy should be changed because the entity-wide policy dates from a time when the unbundled functions were all rate-regulated and now they are not.<sup>21</sup>

This argument, however, does not address the key insight in *Chehalis* – “reactive power operations are not a stand-alone part of” merchant generator operations when it comes to credit and capital attraction.<sup>22</sup> Nor have the OPCs provided *any* evidence to dispute the fact that this core principle still applies. And with respect to *Chehalis*’ focus on capital attraction, the Supreme Court has stated that “the return to the equity owner should be commensurate with the returns on investments in other enterprises having corresponding risks ... [and] should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract

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<sup>18</sup> Petitioners Answer at 16-17, nn.53-56 (explaining *Chehalis Power Generating, L.P.*, 123 FERC ¶ 61,038 at PP 168-170 (2008)).

<sup>19</sup> *Chehalis*, 123 FERC ¶ 61,038 at P 170.

<sup>20</sup> OPC Brief at 5.

<sup>21</sup> OPC Brief at 4-5.

<sup>22</sup> *Chehalis*, 123 FERC ¶ 61,038 at P 170.

capital.”<sup>23</sup> How the regulated enterprise works and how it attracts capital are the predicate facts to regulation; the Commission must set just and reasonable rates in context of how the industry actually functions, and in order to “assure confidence in the financial integrity of the” utilities it regulates.<sup>24</sup> It should not try to impose an artificial and illogical regulatory construct onto the way that merchant generators operate; clearly, merchant generators do not acquire some capital for the development and construction of the generation facility and other (less expensive) capital for constructing the internal pieces of that generator that enable its capability to provide reactive power.<sup>25</sup>

Finally, the D.C. Circuit has endorsed this entity-wide approach even where there were “selling” and “buying” companies trading with one another inside of a holding company system.<sup>26</sup> Where “investors ... purchase equity in the entire” operation, it was correct for the Commission to focus on the “entire electric operations of [the operation] in setting the rate of return.”<sup>27</sup> And thus in selecting appropriate proxy groups the Commission looks to find a group that is “representative of the business risks of the regulated firm whose rates are at issue” on an entity-wide basis.<sup>28</sup>

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<sup>23</sup> *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). *Bluefield Water Works & Improvement Co. v. Public Service Comm’n*, 262 U.S. 679 (1923).

<sup>24</sup> See *Petal Gas Storage*, 496 F.3d at 699-700 (quoting *Hope Natural Gas*, 320 U.S. at 603).

<sup>25</sup> See Petition, Affidavit of Paul M. Sotkiewicz at ¶ 19 (“The decision to make a merchant power plant investment is based solely on the returns to *the entire project*” (emphasis added)).

<sup>26</sup> *Louisiana Public Service Commission v. FERC*, 688 F.2d 357, 362 (5th Cir. 1982).

<sup>27</sup> See *id.*

<sup>28</sup> See *Proxy Group Policy Statement*, 123 FERC ¶ 61,048 at P 49 (referencing *Petal Gas Storage*). Note also that FERC’s ROE proxy group policies for natural gas and oil pipelines have endorsed an enterprise-wide approach even though pipeline operations may not be the only line of business of the firms in the proxy group. See *id.* at PP 8, 50-51.

**C. The Burdensome Cost of Litigating These Issues and Settling Cases in the Absence of Commission Guidance Can Be Avoided by Swift Commission Action Here.**

As AEP rightly observed towards the end of its initial comments, proxies “should serve to minimize litigation on reactive power revenue requirement filings.”<sup>29</sup> The current policy status quo does not minimize litigation at all, rather it encourages parties to fight over the correct proxy to employ because the Commission has not definitively endorsed the PJM CONE Study as a just and reasonable proxy. Making matters worse, some parties have also insisted on re-litigating issues settled by Commission precedent long ago,<sup>30</sup> multiplying the litigation burden for merchant generators.

These factors have led to situations where, as explained earlier in this paper hearing procedure, “merchant generators are unlikely to undertake the significant costs of litigation solely to obtain a Commission ruling on” “questions of law and policy,” even where questions are important and repeatedly recur.<sup>31</sup> Parties often are forced to concede these matters not because of a concern about the merits, but rather because parties cannot justify the cost of continuing to litigate them in individual cases. This practice, in the end, robs the “Commission of an opportunity to provide much needed guidance”<sup>32</sup> that could break this vicious cycle. That opportunity is presented here, as these are cost of capital and capital structure “questions of law and policy that do not turn on the facts relating to a particular generator.”<sup>33</sup> In light of these difficulties, the Commission

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<sup>29</sup> AEP Comments at 5. Litigation costs are a form of transaction costs that reduce the efficiency of wholesale power markets; higher litigation costs can also lead merchant power entities to face higher financing costs that account for the uncertainty around returns to certain revenue streams of the entire project. These higher costs would ultimately be reflected in other parts of the PJM markets.

<sup>30</sup> See Petitioners Initial Brief, Amended Affidavit of Michael R. Borgatti at ¶ 33.

<sup>31</sup> *Id.* at ¶ 9.

<sup>32</sup> *Id.*

<sup>33</sup> Petitioners’ Answer at 20.



should take every opportunity to streamline the reactive power ratesetting process and provide definitive guidance that parties and the Commission's Trial Staff can then implement in individual reactive power proceedings.

### CONCLUSION

For the above reasons and as set forth in Indicated Generation Owners' Petition, Answer, and Initial Brief, the Petitioners respectfully request that the Commission approve the use of the cost of capital and the capital structure in the PJM CONE Study as a reasonable proxy for merchant generators' return in calculating a reactive power rate within PJM.

Dated: September 30, 2020

Respectfully submitted,

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*On behalf of the PJM Power Providers  
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## CERTIFICATE OF SERVICE

Pursuant to Rule 2010 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.2010, I hereby certify that I have this day served the foregoing document upon the parties identified on the Commission's official service list by electronic means.

Dated at Washington, D.C. this 30th day of September, 2020.

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