

April 25, 2017

Via Electronic Filing

Hon. Kimberly D. Bose
Secretary
Federal Energy Regulatory Commission
888 First St., N.E.
Washington, DC 20426

Re: *Nogales Transmission, L.L.C. and Nogales Frontier Operations, L.L.C.*,
Docket No. EL17-30-___ – Supplement to Petition for Declaratory Order

Dear Ms. Bose:

Pursuant to Commission's Staff request, the Applicants in this proceeding, Nogales Transmission, L.L.C. ("Nogales Transmission") and Nogales Frontier Operations, L.L.C. ("Nogales Operations"), hereby supplement their December 21, 2016 Petition for Declaratory Order ("Petition"). The following additional information is provided in response to Staff's questions:

1. Additional detail concerning the upstream ownership of Nogales Transmission and Nogales Operations, including (a) Nogales Transmission's affiliation with UNS Electric, Inc. ("UNSE") and Tucson Electric Power ("TEP") and (b) the distinction between the ultimate owners of Nogales Transmission and Nogales Operations.

Nogales Transmission: As indicated in the Petition, Nogales Transmission will be 75 percent owned by Nogales Holdings, L.L.C. ("Nogales Holdings"), an indirect wholly-owned subsidiary of Hunt Power, L.P. In turn, Hunt Power, L.P. is an indirect subsidiary of Hunt Consolidated, Inc. ("HCI"), a diversified holding company for a privately-owned group of entities based in Dallas, Texas. HCI is owned and managed by the Ray L. Hunt family.

The other 25 percent ownership interest in Nogales Transmission will be held by MEH Equities Management Company ("MEH"), which is a subsidiary of Millennium Energy Holdings, Inc., which in turn is a subsidiary of UNS Energy Corporation. UNS Energy Corporation is the ultimate U.S. corporate parent company of UNSE and TEP, both of which are regulated vertically-integrated utilities, and is an indirect wholly-owned subsidiary of Fortis Inc. As a result of this ownership structure, by virtue of

common upstream ownership by UNS Energy Corporation, MEH is an affiliate of UNSE and TEP.

Nogales Operations: Nogales Operations is a wholly-owned subsidiary of Shary Holdings, L.L.C. (“Shary Holdings”). Shary Holdings is owned 1 percent by SUIP Holdings, L.L.C. and 99 percent by SU Investment Partners, L.P. (“SU Investment”). SUIP Holdings, L.L.C. is owned 100 percent by SU Investment Partners, L.P., which in turn is 100 percent owned by Hunter L. Hunt and members of his family.

Distinctions between Hunt Ownership Interests in Nogales Operations and Nogales Transmission: Nogales Transmission and Nogales Operations are legally distinct entities that have distinct upstream ownership chains that are in turn owned by different Hunt family entities. Thus, Nogales Transmission is owned by HCI, which is owned and managed by the Ray L. Hunt family; this is the HCI ownership chain. In contrast, Nogales Operations is in the SU Investment ownership chain, which is owned by Hunter L. Hunt and members of his family.

2. Additional detail on the structure of the lease, payments under the lease, and when the lease will be in place.

As explained in the Petition, the purpose of a lease between Nogales Transmission and Nogales Operations is to permit the upstream owners of Nogales Holdings (which will be the 75 percent owner of Nogales Transmission) to qualify as a real estate investment trust (“REIT”). The REIT structure is an investment vehicle that allows Nogales Transmission to access efficient sources of capital needed to finance the Project while Nogales Operations has full operational control of the Project facilities. By transferring operational control of the Project to Nogales Operations and receiving an appropriate portion of its income in the form of rent for the transmission assets, Nogales Transmission would qualify as an asset to be held by a REIT entity at an appropriate time in the future.

Although a lease does not currently exist, the Applicants anticipate that Nogales Transmission would execute a long-term lease of all of its assets and associated capacity rights in the Project to Nogales Operations, and Nogales Operations would have the exclusive right to use the facilities and the responsibility for operating and maintaining the facilities and complying with all regulatory and reliability requirements. The lease will be an arm’s-length transaction negotiated between Nogales Transmission and Nogales Operations. Nogales Operations will make annual rent payments to Nogales Transmission in exchange for the exclusive right to manage the assets. Nogales Operations will also be responsible for bearing the cost of additional expenses under the lease such as insurance premiums, taxes and other costs associated with leasing, servicing, insuring, maintaining, repairing and operating the system.

The terms of the lease have not yet been established, but the Applicants anticipate that the initial term will be at least 4 years, in order to ensure that the lease qualifies as a

lease for REIT purposes, with automatic renewal options. To comply with the IRS REIT regulations, the lease must transfer operational control over the transmission assets to Nogales Operations, and the lease terms must provide the tenant (Nogales Operations) with the opportunity to earn a profit, or suffer a loss, from its operations. Additionally, it is anticipated that there will be a fixed base rent amount, which will constitute the majority of the rental payments, and a variable rent component that will be based on specified Nogales Operations financial performance metrics. As is typical for projects at this stage of development, the precise parameters of the lease will be negotiated at the time that the other commercial arrangements for the Project are negotiated and finalized. Finally, as set forth in the Petition (at 7), the lease will not permit Nogales Operations to transfer, assign, surrender, or otherwise cease to be the operator of the Project without prior Commission approval.

3. Why captive customers (specifically, of UNSE and TEP) will not be at risk as a result of the ownership structure (in which their upstream parent has an indirect ownership interest in Nogales Transmission).

MEH, an unregulated affiliate of TEP and UNSE, intends to invest in Nogales Transmission. MEH has no wholesale or retail electric customers, and no ability to charge costs to either TEP or UNSE customers without the express consent of the Arizona Corporation Commission (“ACC”), which regulates the retail electricity rates of TEP and UNSE, or the Commission, which regulates the wholesale electricity rates of TEP and UNSE.

An impermissible cost shift (*i.e.*, whereby Nogales Operations seeks to shift costs to the captive customers) cannot occur absent costs of the Nogales Project being moved into customers’ rates, either at wholesale or retail. Such rates would be based on the cost-of-service of the utility providing service to the captive customers, either through stated (fixed) rates or formula rates. In the case of stated (fixed) rates, the costs would be scrutinized in rate cases; in the case of formula rates, they would be identified through annual formula rate update processes. As a result, the applicable regulators as well as potentially affected customers would have an opportunity to identify and object to any attempted improper cost shift.

4. Additional explanation of how Nogales Operations is assuming full market risk for the Project.

As explained in the Petition, Nogales Operations will lease from Nogales Transmission all of Nogales Transmission’s assets and associated capacity rights in the Project, and thereby have exclusive operational control over the Project. As a result, Nogales Operations, which is the entity seeking negotiated rate authority in the Petition, will have assumed all market risk associated with the Project. Thus, Nogales Operations will be fully exposed to the risk of earning a profit, or suffering a loss on operations. Nogales Operations will bear the risk of the Project because it does not own or control a traditionally regulated transmission system or a franchised service territory, and

therefore it does not have captive customers that could be required to take service on, or pay the costs of, the Project.

Nogales Operations is not a vertically integrated utility with any existing customers (captive or otherwise), so there are no captive ratepayers to whom Nogales Operations could impermissibly shift Project costs if the Project's capacity is not subscribed by willing buyers.¹ Although Nogales Transmission will be affiliated, via common upstream ownership interests held by MEH, with two vertically integrated utilities in the region (UNSE and TEP), as indicated above MEH cannot charge costs to either UNSE or TEP captive customers (retail or wholesale) without the scrutiny of the ACC, the Commission, and ratepayers in rate cases or formula rate update processes. Similarly, Nogales Operations is affiliated, via common upstream ownership by SU Investments, with Sharyland Utilities, L.P. ("Sharyland"), an electric utility serving retail and wholesale customers in the Electric Reliability Council of Texas ("ERCOT") region. Sharyland is fully regulated by the Public Utility Commission of Texas, so any attempt to shift Project costs to Sharyland's customers would be similarly subject to regulatory scrutiny, which thereby precludes any inappropriate cost shifting and makes clear that Nogales Operations is bearing the full market risk of the Nogales Project.

As a merchant project that is bearing the full market risk of the Project, Nogales Operations is not proposing in the Petition that any interconnecting utilities be compelled to compensate Nogales Operations for any system benefits that the Project provides. Rather, if the Project provides measurable benefits on interconnecting systems, Nogales Operations may seek compensation for such benefits only through voluntary negotiations with applicable grid operators.²

To provide additional assurance that Nogales Operations will not improperly seek to shift costs to captive ratepayers, Nogales Operations' books and records will comply with the Uniform System of Accounts in Part 101 of the Commission's Regulations and will be subject to examination as required in Part 41 of the Commission's Regulations. Such accounting and audit requirements will ensure that Project costs are recovered only from those customers that voluntarily enter into contracts with Nogales Operations for service on the Project.³

¹ See, e.g., *Sea Breeze Pacific Juan de Fuca Cable, LP*, 112 FERC ¶ 61,295, at 62,327 (2005) (granting negotiated rate authority to merchant transmission developer that assumed full market risk for project because it "has no existing customers that will be asked to assume any risks of failure or underperformance").

² See *Neptune Regional Transmission System, LLC*, 96 FERC ¶ 61,147, at 61,634 (2001) (rejecting merchant transmission developer proposal to receive compensation for system benefits); *TransEnergie U.S. Ltd.*, 98 FERC ¶ 61,147, at 61,499, 61,501-02 (2002) (approving market risk component of request for negotiated rate authority by merchant transmission project where users of adjacent grids would not be required to contribute to project costs through mandatory grid use charges).

³ See, e.g., *Montana Alberta Tie, Ltd.*, 116 FERC ¶ 61,071, at 61,418 (2006) (approving market risk component of request for negotiated rate authority by merchant transmission developer given commitment of developer to comply with, among other things, Parts 101 and 41). Consistent with more recent merchant

5. The potential impact the Southline Project will have on the *Chinook* “just and reasonable” analysis.

The Southline Project will have no impact on the “just and reasonable” analysis for the Nogales Project. As proposed, the Southline Project comprises 1,000 MW of bi-directional transmission capacity in southern New Mexico and southern Arizona with operations anticipated to be phased into service beginning in 2019. The Southline Project consists of a “New Build” Section of approximately 240 miles of 345-kV double-circuit transmission line and associated facilities (connecting the existing Afton Substation, south of Las Cruces, New Mexico, and the existing Apache Substation, south of Willcox, Arizona) and an “Upgrade” Section of approximately 120 miles of aging 115-kV Western Area Power Administration transmission line that would be upgraded to double-circuit 230 kV (connecting the Apache Substation to the existing Saguaro Substation, northwest of Tucson, Arizona).

In contrast, the Nogales Project would comprise a high-voltage, direct current (“HVDC”) interconnection between the UNSE system near Nogales, Arizona and the Mexican National Electric System in Sonora, Mexico. The first phase of the Nogales Project would consist of a 150-MW HVDC converter located at a new substation located on property currently owned by TEP, the Gateway Substation; a new 3-mile 138-kV transmission line that would originate at UNSE’s Valencia Substation in Nogales, Arizona and extend to the west and south to the new Gateway Substation; and a new approximately 2-mile 230-kV transmission line would extend south from the Gateway Substation to the U.S.-Mexico border where it would interconnect with a transmission line to be constructed in Mexico. The second phase, to be constructed at a time that has not yet been determined, would expand the HVDC converter capacity to 300 MW.

Thus, the Nogales Project essentially offers a fundamentally different transmission product than the Southline Project. The Nogales Project involves a back-to-back HVDC converter station to allow transfers of power between two asynchronous, cross-border power grids, whereas the Southline Project is a domestic east-west long line, and thus capacity on one project would not be substitutable for capacity on the other. Additionally, the Nogales Project is smaller in scale, both in terms of MW available on the project as well as distance (miles), whereas the Southline Project spans a large portion of southern Arizona and New Mexico. In essence, the two projects involve fundamentally different sets of receipt and delivery points.

transmission project orders, Nogales Operations has requested a waiver of Part 141 of the Commission’s Regulations (other than Sections 141.14 and 141.15) and the Form No. 1, because those reporting requirements do not apply where transmission service is not sold at cost-based rates to captive customers. *See* Petition at 28; *Linden VFT, LLC*, 119 FERC ¶ 61,066, at 61,390 (2007) (approving market risk component of request for negotiated rate authority by merchant transmission developer given commitment of developer to comply with, among other things, Parts 101 and 41).

Finally, as noted in the Petition, the Commission previously has granted negotiated rate authority and accepted capacity allocation proposals by merchant transmission projects that had affiliated projects in the same region.⁴ The planned Southline Project should impose no impediment to granting the Petition here.

6. Alternatives to the Southline and Nogales Projects available to customers in the region.

In considering whether negotiated rates would be “just and reasonable” in the context of a project that has an affiliated project located in the same region, the Commission has considered alternatives available to customers and the potential for barriers to entry or withholding of capacity. For example, in paragraph 38 of the *Chinook* order, the Commission stated:

In determining whether negotiated rates are just and reasonable, the Commission first looks to whether the merchant transmission owner has assumed the full market risk for the cost of constructing a particular transmission project and is not building within the footprint of its own (or an affiliate’s) traditionally regulated transmission system. In such a case, there are no “captive” customers who would be required to pay the costs of the project. The Commission will also consider whether the merchant transmission owner or an affiliate already owns transmission facilities in the particular region of the project; what alternatives customers have; whether the merchant transmission owner is capable of erecting any barriers to entry among competitors; and whether the merchant transmission owner would have any incentive to withhold capacity.²⁶

[²⁶] For example, negotiated rates may be appropriate when the service on a neighboring public utility under cost-of-service rates—essentially capped at the utility’s cost of expansion—can provide a reasonable alternative. A further check on the negotiated rates could exist where the price customers are willing to pay for transmission service is disciplined by the difference in generation prices at the ends of the line (i.e., the market price of generation on either side of the line).⁵

Applicants have explained above and in the Petition how the Nogales Project satisfies these *Chinook* criteria. As the applicant for negotiated rate authority, Nogales Operations is assuming the full market risk for the Project, and mechanisms will be in place to ensure that no costs of the Project are shifted to the captive customers of the

⁴ See *Lucky Corridor, LLC*, 151 FERC ¶ 61,072, at PP 7, 9, 22 (2015) (granting negotiated rate authority to merchant transmission developer where developer’s affiliate with negotiated rate authority already was developing a merchant transmission project in same region); *Plains and Eastern Clean Line, LLC*, 148 FERC ¶ 61,122, at P 15 (2014) (same).

⁵ *Chinook Power Transmission, LLC*, 126 FERC ¶ 61,134, at P 38, *order on reh’g*, 128 FERC ¶ 61,074 (2009).

utilities affiliated with Nogales Operations or with Nogales Transmission. The response to question 5 above also explains how the Southline Project has different characteristics and offers different products than the Nogales Project, which should provide further assurance to the Commission that there is no risk of captive customers improperly bearing the risks of the Nogales Project.

The Nogales Project, either alone or along with Southline Transmission, is not capable of erecting barriers to entry. The Project will be a cross-border facility operating under a Presidential Permit that requires open access transmission. In fact, the Project will operate under a Commission-approved open access transmission tariff (“OATT”) that requires it to provide service to customers under the Commission rules and to expand its facilities on a cost-of-service basis (subject to receiving necessary regulatory approvals or permits).

Moreover, the Presidential Permit is not exclusive in the sense that other potential transmission providers can apply for similar cross-border facilities. Neither the Nogales Project nor the Southline Project has any market power that would enable either of them to erect a barrier to any potentially competing project. Thus, the Nogales Project will create opportunities for market participants that might not otherwise exist. Customers will have the same alternatives on either side of the border that they have today; but with the Nogales Project, those customers will be able to evaluate additional potential opportunities that the Project makes available, and voluntarily take advantage of those opportunities that make economic sense.

Similarly, Nogales Operations will have no incentive to withhold capacity. As a merchant project, the Project must attract sufficient customers for its capacity to be financially viable. Withholding any of that capacity would be akin to financial suicide, as that would preclude the financing and construction of the Project. Additionally, Nogales Operations will be able to generate sufficient revenues to make its lease payments only if it obtains customers that will use the Project. Because the Nogales Project and Southline Project offer different products, Nogales Operations lacks any incentive to withhold capacity on its Project to try to get market participants to use the Southline Project.

* * *

The Applicants herein have provided additional details to respond to Staff's questions and thereby address any concerns regarding the potential for improper shifting of costs, withholding, or other forms of market power abuse. Please contact us should you have any additional questions or need additional information.

Respectfully submitted,

/s/ Daniel E. Frank
James M. Bushee
Daniel E. Frank

*Counsel for Nogales Transmission, L.L.C. and
Nogales Frontier Operations, L.L.C.*

Certificate of Service

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in this proceeding.

Dated at Washington, DC this 25th day of April, 2017.

/s/ Allison E. Speaker
Allison E. Speaker