

# THE TRANSITION TO FULLY COMPETITIVE BULK POWER MARKETS: FEDERAL REGULATORY DEVELOPMENTS IN THE ELECTRIC POWER INDUSTRY

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## I. INTRODUCTION

In recent years, traditional electric utilities have become increasingly dependent upon enhanced competitive conditions in the bulk power market to improve efficiency and secure “least-cost” generation for their franchise and wholesale customers.<sup>1</sup> The industry’s growing reliance on competitive wholesale markets both presaged and overtook the new legislation reflected in the Energy Policy Act of 1992 (EPAct).<sup>2</sup> This article describes the new environment, as revealed in recent Federal Energy Regulatory Commission (FERC) decisions, and discusses its impact on the services and rates of affected utilities.

## II. CONSEQUENCES OF A COMPETITIVE ENVIRONMENT

### A. *Non-Traditional “Market-Based” Ratemaking Applicable to Public Utilities Under the Federal Power Act*

Aware of the efficiency gains and cost savings attainable through competitive wholesale markets, as well as the need to encourage investment in electric generation facilities, the FERC has become increasingly receptive to rate proposals, filed by both franchised public utilities and non-traditional wholesale suppliers, that depart from historical cost-based ratemaking methodologies and provide for market-based pricing of wholesale power sales.<sup>3</sup> Since 1988, the FERC has acted on more than fifty market-

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1. This competition has intensified with the proliferation of “non-traditional” electric generation sources, including Exempt Wholesale Generators (EWGs) (as defined in the Energy Policy Act of 1992 (EPAct), Independent Power Producers (IPPs), Affiliated Power Producers (APPs), and facilities constructed as Qualifying Facilities (QFs) under the Public Utilities Regulatory Policies Act (PURPA).

2. 42 U.S.C.A. §§ 13201-556 (West Supp. 1994).

3. See, e.g., *Entergy Serv., Inc.*, 58 F.E.R.C. ¶ 61,234, at 61,753 (1992). In its decision, the FERC stated:

[T]he electric utility industry is moving from a period of excess supply into a period of new supply needs, and there has been a substantial increase in competitive activity to meet the new capacity requirements. Traditional cost-of-service rate regulation is not always adequate to meet these needs and, at times, competitive markets can provide more efficient, lower-cost capacity for the long term as well as lower-cost energy in the short term.

*Id.*

based rate proposals filed by various wholesale suppliers.<sup>4</sup> Because public utilities' wholesale sales of electricity are subject to FERC's jurisdiction under the Federal Power Act (FPA), a utility's ability to charge market-based rates is not tantamount to complete pricing flexibility. For example, the FERC can and has established various monitoring mechanisms, such as periodic reporting/disclosure requirements,<sup>5</sup> to ensure that market-based rates remain within the so-called "zone of reasonableness" mandated by the FPA.<sup>6</sup> Nonetheless, market-based pricing can result in appreciable efficiency and economic gains to traditional public utilities, both as purchasers of competitively priced generation (to the extent such purchases reduce native load generation costs), and as sellers of capacity and/or energy to off-system purchasers (to the extent sales revenues are used to offset the utility's native load revenue requirements or are flowed through to shareholders).<sup>7</sup>

Regarding sellers, the added revenue generated through market-based sales can be significant. For example, where a selling utility's generating units are low fixed cost units, rates reflecting market value will, under certain market conditions, exceed cost-based rates predicated on either the utility's average system (embedded) costs or unit-specific (incremental) costs.<sup>8</sup> In addition, the ability to make sales at market-based rates renders inapplicable FERC's extensive cost-of-service rate filing requirements<sup>9</sup> and eliminates the need to resolve potentially controversial cost-related issues, such as overruns.<sup>10</sup> The FERC's evaluation of market-based sales rate proposals is based on the fundamental regulatory goal of "ensur[ing] the lowest, reasonable cost energy to consumers, consistent with reliable

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4. See *Cogeneration: Small Power Production-Notice of Public Conference and Request for Comments*, 64 F.E.R.C. ¶ 61,364, at 63,491 (1993) (terminating the proceedings). For additional insight on the subject of market-based sales, see G. William Stafford, *Electric Wholesale Power Sales At Market-Based Rates*, 12 ENERGY L.J. 291 (1991).

5. In some cases, the FERC simply has limited the term of the contract governing the market-based sale. See, e.g., *Pacific Gas & Elec. Co.*, 53 F.E.R.C. ¶ 61,145, at 61,502-03 (1990).

6. See, e.g., *Louisville Gas & Elec. Co.*, 62 F.E.R.C. ¶ 61,016, at 61,148 (1993); *Commonwealth Atl. Ltd. Partnership*, 51 F.E.R.C. ¶ 61,368, at 62,250 (1990). However, the FERC no longer imposes cost-based price caps on market-based sales rates. *Compare Public Serv. Co. of Ind.*, 51 F.E.R.C. ¶ 61,367, at 62,219-20, *order on reh'g*, 52 F.E.R.C. ¶ 61,260, *clarified and modified*, 53 F.E.R.C. ¶ 61,131 (1990), *petition for review denied sub nom.* Northern Ind. Pub. Serv. Co. v. FERC, 954 F.2d 736 (D.C. Cir. 1992), *with Louisville Gas & Elec. Co.*, 62 F.E.R.C. ¶ 61,016, at 61,143 n.15 (1993).

7. In this context, "native load" encompasses a utility's retail franchise customers as well as wholesale customers receiving full or partial requirements service under long-term contractual arrangements.

8. See *Public Serv. Co. of Ind.*, 51 F.E.R.C. ¶ 61,367, at 62,225 n.97. The FERC historically has permitted utilities to use one of several cost-based pricing structures in developing rates for off-system sales. For example, the utility can base its rates on average system costs, the costs associated with a specific generating unit, or the costs associated with underutilized (high fuel cost) units. See *Illinois Power Co.*, 57 F.E.R.C. ¶ 61,213, at 61,699 (1991). For economy energy transactions between and among utilities, the FERC has long accepted the use of "split savings" rates, which are based on the difference between the seller's incremental costs and the buyer's decremental costs. See, e.g., *Montaup Elec. Co.*, 59 F.E.R.C. ¶ 61,198, at 61,683-84 (1992).

9. 18 C.F.R. § 35 (1993).

10. See *Doswell Ltd. Partnership*, 61 F.E.R.C. ¶ 61,196 (1992); *Commonwealth Atl.*, 51 F.E.R.C. ¶ 61,368, at 62,250.

service.”<sup>11</sup> To achieve this goal, the FERC employs the following two independent analyses, both of which scrutinize the utility’s ability to influence the price of a proposed sale and/or purchase of wholesale power: (1) an “affiliate abuse” analysis for those proposals involving affiliate transactions; and (2) a “market power” analysis.

Because affiliate abuses and the resulting inequities and market distortions historically have been a major regulatory concern, the FERC has required “a clear showing of lack of potential affiliate abuse” as a condition to approving market-based pricing.<sup>12</sup> In this regard, the FERC has adopted a “market value” affiliate abuse test to evaluate proposed market-based sales arrangements involving (directly or indirectly) affiliated wholesale power suppliers and purchasers.<sup>13</sup>

Under the “market value” test, the FERC will consider various types of evidence that demonstrate a lack of affiliate abuse: (1) evidence of head-to-head competition between the affiliated seller and unaffiliated suppliers, as demonstrated either through a formal solicitation of competitive bids or through an informal negotiation process; (2) evidence of the prices that unaffiliated buyers were willing to pay for the same or similar service; and/or (3) “benchmark” evidence showing the prices, terms, and conditions governing unaffiliated sellers’ contemporaneous sales for similar service in the relevant market.<sup>14</sup> The FERC has also imposed strict reporting requirements on all affiliated marketers pursuant to which they must notify the FERC of any affiliated transactions.<sup>15</sup> Therefore, the FERC’s “market value” test and reporting requirements ensure that the purchaser has not unduly favored (1) an affiliated seller by purchasing power from the latter in the face of lower-cost alternatives,<sup>16</sup> or (2) an affiliated purchaser by allowing its affiliate to secure lower-cost alternatives otherwise available to it.<sup>17</sup> Conversely, the FERC’s initiatives also ensure that the seller has not unduly favored (1) an affiliated purchaser by selling power to the latter at “bargain basement” prices (to the detriment of its own ratepayers),<sup>18</sup> or (2) an affiliated seller by failing to compete for sales in the affiliate’s market.<sup>19</sup>

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11. *Louisville Gas & Elec. Co.*, 62 F.E.R.C. ¶ 61,016, at 61,143 (footnote omitted). *But see Wallkill Generating Co.*, 56 F.E.R.C. ¶ 61,067 (1991) (accepting a market-based rate proposal without any substantive discussion). Such an approach may suggest the FERC is willing to streamline its approval process in situations which clearly do not raise either affiliate abuse concerns or market power concerns.

12. *Boston Edison Co.*, 55 F.E.R.C. ¶ 61,382, at 62,167 (1991). *See also Kansas City Power & Light*, 67 F.E.R.C. ¶ 61,183, at 61,552 n.1 (1994).

13. *See* 55 F.E.R.C. at 62,168-69; *Ocean State Power II*, 59 F.E.R.C. ¶ 61,360 (1992).

14. 59 F.E.R.C. ¶ 61,360. “If lack of affiliate abuse is demonstrated by benchmark evidence of market value, [*Boston Edison*] does not require that the applicant *also* present evidence of head-to-head competition between the seller and unaffiliated suppliers *and* evidence of prices non-affiliated buyers were willing to pay the seller.” *Id.* at 62,332 n.84 (emphasis in original).

15. *Heartland Energy Servs.*, 68 F.E.R.C. ¶ 61,223, at 62,062 (1994). Affiliated power marketers must also purchase any “non-sales” services from their affiliated utilities at “market value” prices. *Id.*

16. *See* 55 F.E.R.C. at 62,168 n.61.

17. 68 F.E.R.C. at 62,062.

18. *See, e.g., Portland Gen. Exch., Inc.*, 51 F.E.R.C. ¶ 61,108 (1990).

19. 68 F.E.R.C. at 62,062.

FERC's second analysis in determining whether to approve market-based rates for wholesale power sales focuses on the selling utility's market power, or more specifically, its ability to "significantly influence the price in the market by withholding service and excluding competitors for a significant period of time."<sup>20</sup> Only those utilities that lack market power in the relevant market, or that have sufficiently mitigated their market power, for example, by offering open-access transmission, have been allowed to implement market-based rates.

Recently addressing the merits of a market-based rate proposal filed by an investor-owned public utility, the FERC announced "a change in the analysis" heretofore applied by the agency in determining a utility's market power for ratemaking purposes.<sup>21</sup> Succinctly, the scope of FERC's inquiry now turns on the generation source from which market-based sales are contemplated. If a utility proposes to make wholesale sales from existing resources (uncommitted/installed capacity), the utility must demonstrate that neither it nor any of its affiliates (1) is dominant in the sale of generation services in the relevant market(s); (2) has transmission market power in the relevant market(s) (or, if so, the utility and/or its affiliates have adequately mitigated such market power); and (3) owns or controls any other barriers<sup>22</sup> to entry.<sup>23</sup> In contrast, if sales are contemplated from new or unbuilt capacity (the long-run bulk power market), the selling utility need not present evidence of generation dominance. In this case, the FERC will only examine the utility's dominance of transmission facilities and other relevant barriers to entry.<sup>24</sup>

In summary, proponents of market-based sales rates for wholesale energy and/or capacity must, at a minimum, show that (1) "genuine" alternatives from unaffiliated sources are available to the purchaser (alternatives which are presumed to exist if the parties contemplate sales from new or unbuilt generation sources);<sup>25</sup> and that (2) the purchaser has sufficient transmission access to each such alternative. As discussed below, the latter criterion, transmission access, has prompted debate in recent months over the quality and price of such transmission service.

### B. Transmission Access/Pricing

Cognizant of the integral role transmission plays in the creation and preservation of competitive bulk power markets, the FERC has directed

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20. *Doswell Ltd. Partnership*, 50 F.E.R.C. ¶ 61,251, at 61,757 n.12 (1990) (citation omitted).

21. *Kansas City Power & Light Co.*, 67 F.E.R.C. ¶ 61,183 (1994).

22. For example, other barriers to entry might include control over particular generating sites.

23. 67 F.E.R.C. ¶ 61,183. See, e.g., *Louisville Gas & Elec. Co.*, 62 F.E.R.C. ¶ 61,016 (1993); *Nevada Sun-Peak Ltd. Partnership*, 54 F.E.R.C. ¶ 61,264, at 61,769, *order on reh'g*, 55 F.E.R.C. ¶ 61,058 (1991).

24. 67 F.E.R.C. at 61,557. In distinguishing sales from unbuilt generation units (which require no analysis of a utility's generation dominance), the FERC relied on evolving industry and statutory changes which purportedly have eliminated barriers to entry in the long-run market, i.e., the creation or proliferation of EWGs, etc. *Id.*

25. See 54 F.E.R.C. at 61,769. Notably, the FERC in *Nevada Sun-Peak* ruled that self-generation is not an "alternative" for purposes of its market power analysis. *Id.*

much of its effort to determining the parameters of "transmission access" pursuant to sections 211 and 205 of the FPA, or in the case of proposed mergers, section 203.<sup>26</sup>

### 1. Third-Party Transmission Access Under FPA Section 211, as Amended by the EAct

Prior to passage of the EAct, FERC's authority to order third-party wheeling under section 211 of the FPA was, by the agency's admission, extremely limited.<sup>27</sup> The EAct, consistent with its fundamental purpose to spur competition in the generation and bulk power markets, significantly enhances this authority. Pursuant to amended section 211, any electric utility, at least sixty days after submitting a "good faith" request for service to the affected "transmitting utility,"<sup>28</sup> may request the FERC to order transmission access.<sup>29</sup> The FERC may grant such request if it finds that the proposed transmission service (1) is in the public interest; (2) comports with the "just and reasonable," anti-discrimination requirements of section 212 of the FPA;<sup>30</sup> (3) would not "unreasonably impair the continued reliability of" affected utility systems; and (4) would not displace sales of electric energy by the transmitting utility to the applicant under existing contractual arrangements.<sup>31</sup> Notably, however, the EAct expressly con-

26. See, e.g., *Tex-La Elec. Coop. of Tex., Inc.*, 67 F.E.R.C. ¶ 61,019 (1994); *American Elec. Power Serv. Corp.*, 67 F.E.R.C. ¶ 61,168 (1994). See also *Entergy Serv., Inc.*, 62 F.E.R.C. ¶ 61,073 (1993) (applications order), *reh'g granted in part and denied in part*, 67 F.E.R.C. ¶ 61,192 (1994) (merger proposal); *Northeast Util. Serv. Co.*, 56 F.E.R.C. ¶ 61,269 (1991), *orders on reh'g*, 58 F.E.R.C. ¶ 61,070, 59 F.E.R.C. ¶ 61,042 (1992), *aff'd in part and remanded in part sub nom.* *Northeast Util. Serv. Co. v. FERC*, 993 F.2d 937 (1st Cir. 1993), *order on remand*, 66 F.E.R.C. ¶ 61,332 (1994) (merger proposal); *Public Serv. Co. of Ind.*, 51 F.E.R.C. ¶ 61,367 (market-based rate proposal); *Utah Power & Light Co.*, *order on remand*, 57 F.E.R.C. ¶ 61,363 (1991) (merger proposal).

27. Denying an early transmission request under section 211, the FERC emphasized that wheeling was appropriate only in rare circumstances where, for example, service would not disturb existing competitive relationships. See *Southeastern Power Admin. v. Kentucky Util. Co.*, 25 F.E.R.C. ¶ 61,204 (1983).

28. Section 211 permits the FERC to order transmission access by any "transmitting utility." The EAct includes within the definition of "transmitting utilities" both "public utilities" subject to FERC's FPA rate jurisdiction, and "electric utilities" otherwise exempt from FERC's jurisdiction. For example, "transmitting utilities" includes cooperatives regulated by the Rural Electrification Administration. See *New Reporting Requirement Implementing Section 213(b) of the Federal Power Act and Supporting Expanded Regulatory Responsibilities Under the Energy Policy Act of 1992*, 65 F.E.R.C. ¶ 61,324 (1993).

29. On July 21, 1993, the FERC issued a policy statement which implements the relevant provisions of section 213 of the FPA by requiring parties to engage in "good faith" negotiations prior to taking formal action before the FERC under section 211. *Policy Statement Regarding Good Faith Requests for Transmission Services and Responses by Transmitting Utilities Under Sections 211(a) and 213(a) of The Federal Power Act, as Amended and Added by the Energy Policy Act Of 1992*, III F.E.R.C. STATS. & REGS. Preambles ¶ 30,975 (1993).

30. Although, in this context, reference is made primarily to section 211, that section goes hand-in-hand with section 212. Section 212, *inter alia*, sets out the statutory standards governing the rates, terms and conditions of transmission provided under section 211. For example, such rates, terms and conditions must be "just and reasonable, and not unduly discriminatory or preferential." *Id.*

31. See Federal Power Act, 16 U.S.C.A. §§ 824k-824l (West Supp. 1994) (codifying section 211(a-c) of the FPA, as amended). However, the FERC has suggested that even its expanded authority to order third-party transmission under section 211 "does not guarantee access in the same way as would

tinues the FPA's longstanding prohibition against retail wheeling directives.<sup>32</sup>

The FERC already has ruled on case-specific applications under amended section 211 pursuant to the two-pronged ("proposed order" and "final order") decision-making process mandated by section 212(c) of the FPA.<sup>33</sup> These rulings suggest a strong desire on the part of the FERC to expedite the provision of transmission service under section 211 based on an expansive interpretation of its statutory authority.<sup>34</sup>

In *Tex-La Electric Cooperative of Texas, Inc. (Tex-La)*,<sup>35</sup> a transmission-dependent rural electric cooperative filed an application under section 211 requesting the FERC to direct Texas Utilities Electric Company (TU), an interconnected transmission-owning utility,<sup>36</sup> to provide network transmission service<sup>37</sup> for power Tex-La planned to purchase from another utility interconnected with TU.<sup>38</sup> Directing TU to provide the requested network transmission service, the FERC, relying on the breadth of its authority under section 211, summarily rejected several arguments raised by TU. The FERC dismissed TU's argument that section 201 of the FPA, which removes from FERC's jurisdiction facilities "used in the local distribution" of electric energy, limits its ability to order transmission service over local distribution facilities:

Ordering "transmission services" to the wholesale customer in this proceeding, whether or not that service consequently involves some use of facilities that may not be purely "transmission" facilities, is doing no more than what

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access available from a filed, open-access tariff" under section 205. *New Eng. Power Pool*, 67 F.E.R.C. ¶ 61,042, at 61,131 (1994).

32. See 16 U.S.C.A. §§ 824k-824l (West Supp. 1994) (codifying § 211(h) of the FPA).

33. See, e.g., *Florida Mun. Power Agency v. Florida Power & Light Co.*, 65 F.E.R.C. ¶ 61,125, *reh'g dismissed*, 65 F.E.R.C. ¶ 61,372 (1993), *final order*, 67 F.E.R.C. ¶ 61,167 (1994); *Tex-La Elec. Coop. of Tex., Inc.*, 67 F.E.R.C. ¶ 61,019 (1994).

34. Arguably, FERC's objective of accommodating transmission requests under section 211 has been achieved at the expense of orderly administration of the regulatory process and procedural due process. For example, the FERC has denied requests that it convene evidentiary hearings to evaluate the merits of transmission-access proposals under the aforementioned statutory criteria prior to issuance of a final order, noting that "aggrieved" parties may request evidentiary hearings only after issuance of its final orders. See, e.g., *Florida Mun.*, 67 F.E.R.C. at 61,475. Instead, the FERC has relied solely on initial pleadings, including applications and answers thereto, to issue "preliminary" findings which underlie its proposed orders directing transmission access. In addition, the FERC has denied all parties except the applicant and the affected transmitting utility the right to file briefs or other documents prior to issuance of the FERC's final orders.

35. 67 F.E.R.C. ¶ 61,019 (1994).

36. Both Tex-La and TU are members of, and operate within, the Electric Reliability Council of Texas (ERCOT), and thus are not "public utilities" subject to FERC's rate jurisdiction under the FPA.

37. Although there is no industry-wide definition of "network" transmission service, the term is generally used to define that type of service which accords the applicant the flexibility to use multiple receipt and delivery points on the affected transmission grid as needed without paying multiple rates. See, e.g., *Florida Mun.*, 65 F.E.R.C. at 61,599 n.3. In contrast, "point-to-point" transmission service requires that the parties designate by contract specific points of entry into, and out of, the transmission system. See, e.g., *Entergy Serv., Inc.*, 62 F.E.R.C. ¶ 61,073, at 61,375 n.101 (1993).

38. Tex-La claimed that the Power Supply Agreement, pursuant to which it historically purchased power from TU, authorized it to change suppliers during a specific "open window" period prior to 1997. The requested transmission service purportedly was integral to effecting such a change.

we are authorized to do by statute. It is not an assertion of jurisdiction over specific facilities, but rather is an assertion of authority to order specific services . . . . Congress limited the [FERC's] authority to order transmission services only as to two classes of transactions, transmission directly to an ultimate consumer and transmission to a sham wholesaler. Neither class of transactions is present here.<sup>39</sup>

Similarly, in *Florida Municipal Power Agency v. Florida Power & Light Co. (Florida Municipal)*,<sup>40</sup> Florida Municipal Power Agency (FMPA) filed an application under section 211 requesting the FERC to direct Florida Power & Light Company (Florida Power) to provide network transmission service, so as to enable FMPA to integrate existing generation resources and, in turn, enhance the efficiency and reliability of its own services. The FERC rejected arguments, such as requests for an evidentiary hearing,<sup>41</sup> that could have “unnecessarily delay[ed]” the provision of transmission service to FMPA, and ordered transmission access, relying largely on its earlier “preliminary” findings that statutory criteria had been satisfied.<sup>42</sup>

To facilitate transmission access without having to engage in case-specific inquiries under section 211, the FERC announced on July 30, 1993, a “general policy” governing the development and parameters of so-called Regional Transmission Groups (RTGs).<sup>43</sup> As contemplated therein, RTGs would be responsible for, among other things, planning and prioritizing the transmission needs of their members, determining the rates, terms, and conditions of transmission service(s) provided by member utilities, and resolving transmission-related disputes between and among members.<sup>44</sup> In turn, the FERC would accord “special” deference to the decisions reached by RTGs in evaluating their lawfulness under the FPA.

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39. *Florida Mun.*, 67 F.E.R.C. at 61,055-56 (1994) (footnote omitted). In addition, FERC's proposed order suggests that, in order to challenge a transmission request on “reliability” grounds, or grounds that the service would unreasonably impair the reliability of affected transmission systems, evidence of impairment, not simply claims, must be presented at the time answers to the applicant's request are filed with the FERC. *Id.* at 61,054. Similarly, if opposition to the requested transmission service is predicated on its alleged impact on pre-existing non-jurisdictional contractual arrangements between the parties under section 211(c) of the FPA, such impact should be presented to the FERC in responsive pleadings or evidence, inasmuch as the FERC has indicated it will evaluate the non-jurisdictional contract(s) where necessary to resolve the issue. *Id.*

40. 65 F.E.R.C. ¶ 61,125, *reh'g dismissed*, 65 F.E.R.C. ¶ 61,372 (1993), *final order*, 67 F.E.R.C. ¶ 61,167 (1994).

41. 67 F.E.R.C. at 61,475.

42. 65 F.E.R.C. at 61,615-17. However, the FERC rejected FMPA's proposal that the fixed charges for such network service be based on its actual hourly or yearly demands; instead, the FERC adopted in large part Florida Power's proposal that such charges be based on FMPA's load share.

43. *Policy Statement Regarding Regional Transmission Groups; Policy Statement*, III F.E.R.C. STATS. & REGS. Preambles ¶ 30,976 (1993) (Transmission Group Policy Statement). The FERC's policy statement refers to (and is generally patterned after) a “consensus” proposal presented to Congress by various segments of the industry prior to passage of, though ultimately excluded from, the EPAct.

44. The FERC defines RTG as “a voluntary organization of transmission owners, transmission users, and other entities interested in coordinating transmission planning, expansion, operation and use on a regional and inter-regional basis.” *Id.* at 30,870 n.4.

In the latter regard, however, the Transmission Group Policy Statement, while mindful of the fact that geographic and operational disparities among utilities and attendant complexities warrant regulatory flexibility and deference, nonetheless enumerates the "basic components" from which all RTG agreements should be structured. All such agreements, for example, must include provisions which (1) affirmatively obligate member transmitting utilities to provide all types of transmission service to other members, even where transmission requires an enlargement of facilities; (2) require the development of a coordinated regional transmission plan; and (3) provide for detailed decisionmaking procedures and voluntary dispute resolution procedures. The FERC recently confirmed that it intends to adhere closely to the standards outlined in the Transmission Group Policy Statement in determining whether to grant RTG status.<sup>45</sup>

## 2. Third-Party Access Under FPA Sections 205 and 203

To achieve non-discriminatory transmission access, the FERC in early 1994 announced that, where a utility seeks voluntarily to implement an open-access transmission tariff under FPA section 205 (for example, in conjunction with market-based sales rates), the FPA's proscription against undue discrimination/undue preference requires that the transmitting utility "offer third parties access on the same or comparable basis, and under the same or comparable terms and conditions, as the [utility's] uses of its system."<sup>46</sup> More recently, the FERC applied the "comparability" standard

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45. In *Interregional Transmission Coordination Forum*, 64 F.E.R.C. ¶ 61,278 (1993), the FERC denied RTG status to a group of utilities and transmission-users on the ground that the organizational materials presented to it did not comport with the policy statement:

The materials filed do not present a sufficient basis for us to consider at this time giving any special deference to decisions or proposals by [the group] that would affect jurisdictional rates and services under the [FPA], rates and charges contained in agreements entered into by [group] members, or other outcomes arising from [group] processes. Nor do the materials provide a sufficient basis for us to find that [the group] is or is not in the public interest.

*Id.* at 62,964.

46. *American Elec. Power Serv. Corp.*, 67 F.E.R.C. ¶ 61,168, at 61,490 (1994). See also *New Eng. Power Pool*, 67 F.E.R.C. ¶ 61,042, at 61,132 (1994); *Kansas City Power & Light Co.*, 67 F.E.R.C. ¶ 61,183, at 61,557 (1994). Citing the need to "refocus our traditional analysis of undue discrimination" in light of the industry's movement towards competition, the FERC in *American Electric Power* reversed an earlier decision in which it accorded the utility the flexibility to impose service limitations under its proposed transmission tariff, and set for hearing the issue of whether such limitations violate the FPA's prohibition against undue discrimination/undue preference, as reflected in the "comparability" requirement:

Due to changing conditions in the electric utility industry, e.g., the emergence of non-traditional suppliers and greater competition in bulk power markets, the focal point of claims of undue discrimination has changed from discrimination in the treatment of different customers to discrimination in the rates and services the utility offers third parties when compared to its own use of the transmission system.

67 F.E.R.C. ¶ 61,168, at 61,490. See also *Heartland Energy Servs.*, 68 F.E.R.C. ¶ 61,223, at 62,060 (1994). Thus, *American Elec. Power* requires that third-party transmission customers be permitted to use the affected utility's transmission grid in the same manner, and with the same operational flexibility, that the utility uses the grid to effect off-system transactions and to serve native load customers. *Id.* But compare *Entergy Serv., Inc.*, 58 F.E.R.C. ¶ 61,234, order on reh'g, 60 F.E.R.C. ¶ 61,168 (1992), remanded on other grounds sub nom. *Cajun Elec. Power Coop., Inc. v. FERC*, 28 F.3d 173 (D.C. Cir.

to merger applications under FPA section 203.<sup>47</sup> Such a requirement appears predicated on the assumption that the affected utility can provide “comparable,” or equal in quality, transmission services without diminishing the reliability of native load deliveries.<sup>48</sup>

### 3. Pricing of Third-Party Transmission

Guided by the principle that the transmitting utility’s native load customers should at all times be “held harmless,” the FERC has established a two-fold transmission pricing policy. Succinctly, where the proposed transmission requires an expansion of the utility’s facilities, the utility may charge either a system-wide embedded cost transmission rate (which includes the costs of such expansion), or a rate reflecting only the incremental expansion costs associated with the proposed service.<sup>49</sup> Similarly, where the proposed transmission service can be provided through existing facilities, the utility may charge an embedded cost transmission rate or a rate reflecting “legitimate” and “verifiable” opportunity costs.<sup>50</sup> With

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1994) (limiting transmission service offered under open-access tariff to point-to-point service). Query how the FERC’s new comparability standard, purportedly essential to finding a lack of undue discrimination in the provision of transmission services, will affect the lawfulness of open-access tariffs previously approved by the FERC which restrict third-party access to the transmission grid. At a minimum, the FERC’s adoption of the comparability standard arguably exposes such tariffs to challenge under section 206, on the ground that they violate the statute’s undue discrimination provisions.

47. See *El Paso Elec. Co. and South West Servs., Inc.*, 68 F.E.R.C. ¶ 61,181 (1994).

48. See *Northeast Util. Serv. Co.*, 56 F.E.R.C. ¶ 61,269 (1991), *orders on reh’g*, 58 F.E.R.C. ¶ 61,070, at 61,199 (1992) (holding utility may “give priority to providing safe and reliable service to its native load customers using existing transmission capacity built to serve those customers”). In conditioning a proposed utility merger on the merged utility’s commitment to provide firm wheeling service to third-party sellers of generation, the FERC on rehearing in *Northeast Utilities* identified the general parameters of native load priorities to the transmission grid in an open-access regime. In short, although the FERC stated that “under no circumstances” would it require a transmitting utility to provide firm wheeling service out of existing capacity where such service “would impair or degrade reliability of service to native load customers,” it refused to allow the transmitting utility to implement tariff provisions that would elevate off-system non-firm “economy” transactions (which inure to the benefit of native load customers) over firm wheeling service to third parties. 58 F.E.R.C. at 61,199. In so ruling, the FERC relied on its general policy that firm service should always be accorded priority over non-firm service. See also *Entergy Serv., Inc.*, 58 F.E.R.C. ¶ 61,234, at 61,764. (ruling “Entergy may not reserve capacity for non-firm retail and non-firm wholesale customers over firm transmission customers”); *American Elec. Power Serv. Corp.*, 67 F.E.R.C. ¶ 61,168, at 61,491-94 n.11 (1994) (Hoecker, Comm’r, concurring in a memo issued May 19, 1994).

49. For rate design purposes, the FERC continues to afford utilities two options:

- (1) a customer-specific rate that allocates a utility’s total transmission revenue requirement to customers based upon the customers’ contribution to the 12 monthly peaks and dividing that revenue requirement by the customers’ billing determinants; or (2) a non-customer specific rate that divides the utility’s total transmission revenue requirement by the annual system peak as a proxy for capability.

*Florida Power & Light Co.*, 66 F.E.R.C. ¶ 61,227, at 61,529 (1994).

50. *Pennsylvania Elec. Co.*, 58 F.E.R.C. ¶ 61,278, *reh’g denied*, 60 F.E.R.C. ¶ 61,034 (1992), *aff’d*, 11 F.3d 207 (D.C. Cir. 1993). See also *Northeast Utils.*, 58 F.E.R.C. ¶ 61,069 (1992). Certain parties in *Northeast Utilities* argued that “workable competition” must exist before opportunity cost pricing provisions can be adopted. The FERC refused to address these parties’ concerns, finding it unnecessary to “reach the question of whether mitigation of market power is necessary before opportunity cost pricing can be approved.” *Id.* at 61,179. However, FERC’s decision not to decide the issue was likely

regard to opportunity cost pricing, the FERC generally has held that legitimate and verifiable opportunity costs must be capped by incremental expansion costs.<sup>51</sup> However, the FERC recently eliminated the expansion cost cap for short-term transactions "if construction is not a feasible option."<sup>52</sup>

In an Inquiry issued July 7, 1993, the FERC expressed a willingness to reconsider its transmission pricing policy—an ambivalence born in the wake of amended section 212 of the FPA,<sup>53</sup> as well as in widespread opposition from members of the industry.<sup>54</sup> Although the FERC has clarified that the outcome of such inquiry may alter transmission pricing proposals filed in the future,<sup>55</sup> the agency's decisions after *Pennsylvania Electric Co.* nonetheless appear to refine FERC's pricing policy by defining the scope of transmission customers' fixed (embedded) cost responsibility in relation to the utility's native load customers.

In *Florida Municipal*,<sup>56</sup> the FERC accepted (with minor modifications) Florida Power's proposal to charge FMPA a cost-based transmission rate commensurate with the high quality of the network service requested by FMPA, based on the latter's share of the utility's system load:

[FMPA] wants to receive service of exactly the same quality as the service Florida Power provides itself. It wants to be able to use Florida Power's transmission system as freely as Florida Power uses the system to serve Florida Power's native load. . . . Since FMPA wants to be able to use the transmission system exactly as freely as does Florida Power, it must pay a rate that reflects that equality. It must share the costs of the system on the same basis as does Florida Power, on the basis of its load.<sup>57</sup>

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influenced by the fact that the transmitting utility had already agreed to provide firm transmission service to third parties and, therefore, presumably had already "mitigated" any market power it may have had.

51. See *New England Power Co.*, 61 F.E.R.C. ¶ 61,009 (1992).

52. 66 F.E.R.C. at 61,523.

53. Section 212 requires that rates, terms and conditions of transmission service ordered under section 211:

Permit the recovery . . . of all the costs incurred in connection with the transmission services, including, but not limited to, an appropriate share, if any, of legitimate, verifiable and economic costs. . . . Such rates, charges, terms and conditions shall promote the economically efficient transmission and generation of electricity and shall be just and reasonable, and not unduly discriminatory or preferential . . . [and] shall ensure that, to the extent practicable, costs incurred in providing the wholesale transmission services . . . are recovered from the applicant. . . .

16 U.S.C.A. § 824k (West Supp. 1994) (codifying § 212 of the FPA).

54. See *Inquiry Concerning the Commission's Pricing Policy for Transmission Services Provided by Public Utilities Under the Federal Power Act*, III F.E.R.C. STATS. & REGS. ¶ 35,024 (issued July 7, 1993). In this regard, the FERC has expressly limited its rulings in specific cases to the facts and issues before it, noting that future decisions may be affected by the outcome of its pending inquiry on transmission pricing. See *Florida Mun. Power Agency v. Florida Power & Light Co.*, 65 F.E.R.C. ¶ 61,125, *reh'g dismissed*, 65 F.E.R.C. ¶ 61,372, *final order*, 67 F.E.R.C. ¶ 61,167, at 61,481 n.74 (1993).

55. 67 F.E.R.C. ¶ 61,167, at 61,481 n.74.

56. 67 F.E.R.C. ¶ 61,167 (1994).

57. *Id.* at 61,481-82. In so ruling, the FERC rejected FMPA's proposal that its cost responsibility be based on contract demand (as opposed to FMPA's load share).

Therefore, in exchange for transmission service of equal quality to that accorded Florida Power's native load customers, FMPA was required to share equally with native load customers the costs of Florida Power's transmission system.

In addition to quality of service considerations, the FERC has expressed a willingness to examine whether and to what extent utilities may recover stranded investment costs through transmission charges applicable to former wholesale customers.<sup>58</sup> In this regard, the FERC has identified three criteria which the transmitting utility must satisfy to justify the recovery of stranded investment costs through transmission rates:

First, [the utility] must be able to demonstrate that it has incurred generation investments or other obligations on the customer's behalf based on a reasonable expectation at that time that the customer's power contract would be renewed. Second, the customer's cost liability for stranded investment may be no more than what the customer would have contributed to fixed costs under its existing rate had the customer remained on [the utility's] system. Third, [the utility] shall mitigate a customer's stranded investment obligation when the customer leaves the [utility's] system.<sup>59</sup>

In subsequent proceedings, the FERC has permitted utilities to commence recovery of stranded costs, subject to refund, pending the outcome of hearings to determine whether the above criteria are satisfied.<sup>60</sup> However, the FERC will now have to address new issues raised by a recent opinion issued by the D.C. Circuit in which the court indicated that stranded investment recovery provisions included in a utility's open-access transmission tariff may constitute an illegal "tying" arrangement which enhances—rather than diminishes—the utility's market power.<sup>61</sup>

### III. CONCLUSION

The FERC has taken significant steps towards achieving competition in the electric generation and wholesale power markets, mirroring in many respects its longstanding efforts to spur competition in the interstate natural gas industry. However, in light of the legal framework upon which the electric power industry is structured, including the existence of, and obligations associated with, territorial franchises, and the operational complexities attendant to the flow of electricity, the industry must proceed cautiously and advisedly, at the risk of impairing the very electric service the FERC, and Congress, seek to enhance.

Transmission-owning utilities historically have had to balance multiple generation sources, transmission lines, and load centers to ensure reliable, efficient service to native load customers, and concomitantly, to alleviate impacts on interconnected and neighboring utilities, including impacts

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58. See *Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, IV F.E.R.C. STATS. & REGS. ¶ 32,507, 59 Fed. Reg. 35,274 (1994) (to be codified at 18 C.F.R. pt. 35).

59. *Entergy Serv., Inc.*, 58 F.E.R.C. ¶ 61,234, order on reh'g, 60 F.E.R.C. ¶ 61,168, at 61,631 (1992).

60. See, e.g., *Massachusetts Elec. Co.*, 66 F.E.R.C. ¶ 61,036, at 61,059-60 (1994); *Philadelphia Elec. Co.*, 65 F.E.R.C. ¶ 61,303 (1993).

61. See *Cajun Elec. Power Coop., Inc. v. FERC*, 28 F.3d 173 (1994).

associated with loop flows. In light of the practical and, in some instances, legal barriers to grid expansion, the emergence of third-party transmission customers with "comparable" access to the utility's grid necessarily upsets this balance, and, to the extent capacity becomes constrained, may significantly reduce efficiencies and threaten the utility's ability and statutory obligation to serve existing and prospective native load customers.

Competition, while connoting lower electric rates to consumers, cannot inure to the benefit of ratepayers unless the parameters of competition are adequately defined with respect to existing franchise obligations and operational constraints. While the FERC's orders to date reflect an awareness of these issues,<sup>62</sup> the industry must be willing to accommodate its singularities in its transition to competitive wholesale markets.

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62. The FERC's recent Transmission Group Policy Statement, which calls on the participation and expertise of all affected utilities, transmission users, and state representatives, is a noteworthy step. *See supra* notes 43-44 and accompanying text.