

MAY THE FERC RELY ON MARKETS TO SET ELECTRIC RATES?

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I. INTRODUCTION

In the aftermath of spectacular failures of electricity markets it previously approved, the Federal Energy Regulatory Commission (FERC) accelerated its pursuit of a deregulatory agenda for the electric utilities and services under its jurisdiction. The essence of this approach is to supplant traditional agency rate setting with market mechanisms to determine wholesale electricity and bulk transmission rates.¹ Seeking to lessen its role as rate dispute umpire and administrative rate setter, the FERC is attempting to restructure the industries it regulates and redefine itself to achieve an agency “vision” of “[d]ependable, affordable energy *through sustained competitive markets*.”² An explicit goal is to “[f]oster [n]ationwide [c]ompetitive [e]nergy [m]arkets as a [s]ubstitute for [t]raditional [r]egulation.”³ Notwithstanding the FERC’s forceful efforts to implement the new “vision” and goals, are markets a lawful substitute for rate regulation? I conclude they are not.

The current initiative to implement the FERC vision is a 612 page July 31, 2002 Notice of Proposed Rulemaking to create agency structured markets with a “Standard Market Design” for setting rates (*SMD NOPR*).⁴ If adopted, the rule would establish markets managed by new entities, denominated by the FERC as “Independent Transmission Providers” (ITPs). These “independent” private utilities would be approved by the FERC to be controllers of the bulk power transmission grids, and rate-setters. The *SMD NOPR* would require transmission-owning utilities to transfer control of their facilities to ITPs.⁵ Each

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1. “Until just under ten years ago, virtually all sales were made at traditional cost-of-service rates or via cost-based formulas. Since then, the Commission has allowed sellers to sell at ‘market-based rates’ In brief, the Commission requires that sellers demonstrate that they do not ‘dominate’ (have undue market power) in generation, do not dominate transmission, and cannot impose barriers to entry.” Peter Fox-Penner, et al., *Competition in Wholesale Electric Power Markets*, 23 ENERGY L.J. 281 (2002).

2. *FERC Strategic Plan FY 2002 – FY 2007*, 1 (emphasis added), available at <http://www.ferc.gov/About/mission/SP-09-18-02.pdf> (last visited Feb. 22, 2003).

3. *FERC Strategic Plan FY 2002 - FY 2007*, at 2, Goal 2 (emphasis added). Objective 2.1 is to “[a]dvance [c]ompetitive [m]arket [i]nstitutions [a]cross the [e]ntire [c]ountry,” and Objective 2.2 is to “[e]stablish [b]alanced, [s]elf-[e]nforcing [m]arket [r]ules.” *Id.* (emphasis added).

4. Notice of Proposed Rulemaking, *Remedying Undue Discrimination Through Open Access Transmission Service and Standard Electricity Market Design*, [1998-2002 Proposed Regs.] F.E.R.C. Stats & Regs. ¶ 32,563, 67 Fed. Reg. 55,451 (proposed Aug. 29, 2002) (to be codified at 18 C.F.R. pt. 35) [hereinafter *SMD NOPR*].

5. “We also propose that no later than September 30, 2004, or such date as the Commission may

ITP would create and manage six markets (hence the "Standard Market Design") to set variable rates for components of wholesale electricity and transmission service. These agency-fostered bazaars would use "spot" markets to set rates only for day-ahead and real time balancing purposes. Generators and energy marketing utilities would obtain "market-based rate" orders from the FERC. These orders would allow rates to be determined by the ITP markets, so that the tariffs and rate schedules filed by the utilities would not disclose the actual rates demanded or charged.⁶ The spot market rates would be complemented by rates set privately in unfiled bilateral, off-spot market contracts.⁷

This article addresses whether the FERC has power under existing law to use markets for setting rates. It does not address the merits or wisdom of the spot market rules, or other controversial proposals contained in the *SMD NOPR* proposal (such as assertion of FERC jurisdiction over the transmission component of previously bundled state-regulated retail rates).⁸ Basic features of the *SMD NOPR* are highlighted to illustrate the agency's emphasis on creating private markets and using market mechanisms to set rates, and to distinguish the proposed rules from rate filing and rate fixing requirements of the Federal Power Act of 1935 (FPA). Several Supreme Court decisions involving federal regulatory agency efforts to rely upon markets to set rates are examined. The FERC's legal justifications for market based rates, and the lower court opinions upon which they are based, are also reviewed.

The article concludes that if the issue of the FERC's market based electricity rate initiatives were squarely presented in litigation, the court would likely apply the clear language of the FPA, and its longstanding judicial interpretations, to bar the FERC from using market prices to set rates. In particular, the FERC market based rate making initiative conflicts with the statutory duty of FERC jurisdictional utilities publicly to file schedules of reasonable rates demanded and charged under Section 205 of the FPA, and

establish, only Independent Transmission Providers would operate Commission-jurisdictional facilities." *Id.* at 55,469 (emphasis added). In *Atlantic City Elec. Co. v. FERC*, 295 F.3d 1 (D.C. Cir. 2002), however, the District of Columbia Circuit Court of Appeals held that FERC approval is not required for a utility seeking to withdraw from the PJM transmission organization. Thus, the utility was free to withdraw from the Independent System Operator (ISO) and file new rates under the traditional FPA regimen, subject to all the FPA procedures and FERC review of its new rates.

6. "[M]any of the regulations which customarily apply to traditional public utilities have been waived or relaxed for power marketers. For example . . . they are permitted to charge market-based rates Power marketers need not file their accounting records Power marketers need not file their accounting records with the Commission" *How to Get Market-Based Rate Approval*, FERC Power Marketer Information, available at <http://www.ferc.gov/Electric/pwrmkt/Pmhow.htm> (last visited Feb. 22, 2003).

7. "Central to the Standard Market Design concept is its reliance on bilateral contracts entered into between buyers and sellers. The resource adequacy requirement strongly encourages such long-term contracts. The short-term spot markets . . . are intended to complement bilateral procurement We expect that market participants will strike an appropriate balance between bilateral contracts and spot market transactions." *SMD NOPR*, *supra* note 4, at 34,282.

8. For a detailed critique of the merits of the *SMD NOPR* proposals, see generally *Comments of the Colorado Office of Consumer Counsel, New Mexico and Rhode Island Attorneys General, Utah Committee of Consumer Service, Public Utility Law Project, and National Consumer Law Center Under*, 67 Fed. Reg. 55,452 (Nov. 15, 2002), available at <http://www.tellus.org/general/news/fercnopr.pdf> (last visited Feb. 22, 2003).

deviates from the process prescribed by statute for remedying undue discrimination and fixing by the agency of non-discriminatory, reasonable rates under Section 206 of the FPA.

II. KEY FEATURES OF THE FERC *SMD NOPR*

The FERC issued an evolutionary series of generic orders to foster the creation and operation of private day-ahead and real-time electricity spot markets to perform the rate-setting function. In 1996, in *Order 888*,⁹ the FERC inspired utilities voluntarily to form transmission grid and market operating entities, the "Independent System Operators" (ISOs), which were new private utilities formed by transmission owners and other industry "stakeholders." Five ISOs were approved including single-state ISOs in California and New York. Next, in *Order 2000*,¹⁰ the FERC sought voluntary participation across state lines to form "Regional Transmission Organizations" (RTOs) to manage the bulk power grid and establish larger interstate regional markets. In the 2002 *SMD NOPR*, the FERC abandons the voluntary approach and proposes to mandate the creation and utilization of ITPs.¹¹ The *SMD NOPR* suggests a "Pro Forma Standard Market Design Tariff" containing rules for six ITP spot markets for various components of electric service: three day-ahead markets and three real-time markets. The proposed component markets are for (1) Energy, (2) Regulation service, and (3) Operating reserves.

The new Standard Market Design contains a number of design features of spot markets now operated by PJM Interconnection (PJM) and New York Independent System Operator (NYISO). The ITP utilities running the spot markets would not be required to set just and reasonable rates. The FERC would issue market based rate orders, as is current practice, allowing sellers to dispense with filing their rates and notice of rate changes upon a demonstration that certain FERC criteria are met. Thus, the actual rates demanded by sellers would not be filed in advance with the FERC. Advance notice of proposed changes in rate schedules would not be filed subject to FERC review and possible refund, nor would the proponent of a rate change bear the burden of demonstrating the new rates are just and reasonable. The proposed spot market rules prohibit contemporaneous public disclosure of the rates demanded by each seller. A "locational market price" (LMP) is established. It is based on what the market will bear at a given time and location, and may have extreme variations at times

9. Order No. 888, *Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities and Recovery of Stranded Costs by Public Utilities and Transmitting Utilities and Recovery of Stranded Costs by Public Utilities*, F.E.R.C. Stats. & Regs. [Regs. Preambles Jan. 1991-June 1996] ¶ 31,036 (1996), 61 Fed. Reg. 21,540 (1996) (codified at C.F.R. pts. 35 & 385) [hereinafter *Order 888*].

10. Order No. 2000, *Regional Transmission Organizations*, F.E.R.C. Stats. & Regs. ¶ 31,089 (1999), 65 Fed. Reg. 809 (2000) (codified at C.F.R. pt. 35) [hereinafter *Order 2000*].

11. The proposed regulations include a new Subpart G to 18 CFR pt. 35 entitled "Procedures and Requirements Regarding Non-Discriminatory Open Access Transmission Services and Standard Market Design." *SMD NOPR*, *supra* note 4, at 34,409. Section 35.35(b)(1) defines an "Independent Transmission Provider" as "any public utility . . . that administers the day-ahead and real-time energy and ancillary services markets in connection with its provision of transmission services pursuant to the pro forma tariff [prescribed by FERC in the *SMD NOPR*] and that is independent . . ." *Id.*

of high demand or transmission congestion. LMP rates for all sellers are set at the same level, which is the rate demanded by the seller of the last increment of supply needed to satisfy demand at a particular time.¹² Thus the rate of one seller may be set by the higher demand of another whose bid clears the market. The *SMD NOPR* conflates “marginal cost” and “marginal price” concepts, suggesting a relationship between the rates set by the spot market and marginal cost. Even assuming it is appropriate to apply short run marginal cost doctrines for pricing all electricity in the market, there is no requirement in the NOPR for bidders in the proposed spot markets actually to file rates offering their supply at their marginal costs. Rather, the sellers bid in “prices,” not necessarily their “costs,” and it is the *price* that “clears the market” which sets the rates for all.

In sum, LMP rates constantly fluctuate, are not contained in filed tariffs, are not mathematically derivable from formulas, and are established by private entities who are themselves excused from establishing just and reasonable rates. Rates are not reviewed by the FERC before being changed, rates demanded by sellers are secret except for revelation of the market clearing price paid to all, and rates may not be subject to refund even if later found by the agency to be unjust or unreasonable.¹³

The regulator’s mission envisioned in the *SMD NOPR* also shifts. This shift is from trench level investigation and review of proposed rate changes by utilities and complaint determination to a new and loftier role, that of market architect and overseer. In its “Strategic Goals,” the FERC has indicated since 2001 that it wants to “[f]oster nationwide competitive energy markets as a substitute for traditional regulation.”¹⁴ A recent General Accounting Office (GAO) report, however, questions whether the agency’s capabilities and enforcement powers, originally designed for the traditional rate setting paradigm, are sufficient tools for an effective market overseer.¹⁵ Putting aside the issues whether the FERC has embarked on a wise venture, or whether the agency can implement it effectively, we now turn to the question whether this quantum shift of the agency’s role and mission is possible under existing law.

III. THE FEDERAL POWER ACT OF 1935

A federal regulatory agency’s powers are conferred by statute and must be grounded in statutory language:

12. “The marginal price of energy at a particular location and time - that is, the energy LMP - is the additional cost of procuring the last unit of energy supply that buyers and sellers at that location willingly agree on to meet the demand for energy. That is, it is the price that ‘clears the market’ for energy.” *SMD NOPR*, *supra* note 4, at 34,323. The notion that buyers and sellers “willingly agree” on price is strained. All of the sellers’ offering prices are secret, and thus not knowable by buyers, who may have statutory or contractual duties to provide service to customers, and only learn the market clearing price after it is announced by the market operator.

13. Despite findings that rates were unreasonable in the California ISO market, the FERC initially held it cannot order full refunds. This is the subject of various pending legal challenges.

14. *Energy Markets: Concerted Actions Needed by FERC to Confront Challenges That Impede Effective Oversight*, GAO-02-656, Table 4, 69 (June 2002), available at <http://www.Gao.gov/new.items/d02656.pdf> (last visited Feb. 22, 2003). As mentioned previously, the 2002-2007 Strategic Plan also includes a similar goal and objectives to rely on markets to set rates.

15. *Id.*

As a federal agency, FERC is a 'creature of statute,' having 'no constitutional or common law existence or authority, but *only* those authorities conferred upon it by Congress.' Thus, if there is no statute conferring authority, FERC has none¹⁶ In the absence of statutory authorization for its act, an agency's 'action is plainly contrary to law and cannot stand.'¹⁶

The question whether the FERC possesses authority to create a market-based rates regimen requires an examination of the longstanding provisions of the FPA, the statutory fount of the FERC's authority in electricity matters. The FPA is based on the classic federal regulated industry paradigm originally established by the Interstate Commerce Act of 1887. The essence of that paradigm is quite simple:

- The basic legal standard is that all rates made, demanded, or received shall be just and reasonable, and that any rates which are not just and reasonable are unlawful;¹⁷
- Rates must be non-discriminatory;¹⁸
- Price visibility and transparency is achieved through initial public filing of schedules of rates, bilateral contracts, terms and conditions, which are open for inspection by the public, purchasers, and potential competitors;¹⁹
- Sixty days' notice of the proposed rate change is mandatory with the burden of proof upon the proponent of the rate change;²⁰

16. Atlantic City Elec. Co. v. FERC, 295 F.3d 1 (D.C. Cir. 2002) (citations omitted).

17. Just and reasonable rates.

All rates and charges made, demanded, or received by any public utility for or in connection with the transmission or sale of electric energy subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

16 U.S.C. § 824d(a) (2003).

18. Preference or advantage unlawful.

No public utility shall, with respect to any transmission or sale subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

16 U.S.C. § 824d(b) (2003).

19. Schedules.

Under such rules and regulations as the Commission may prescribe, every public utility shall file with the Commission, within such time and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection schedules showing all rates and charges for any transmission or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

16 U.S.C. § 824d(c) (2003).

20. Notice required for rate changes.

Unless the Commission otherwise orders, no change shall be made by any public utility in any such rate, charge, classification, or service, or in any rule, regulation, or contract relating thereto, except after sixty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the sixty days' notice herein provided for by an order specifying the changes

- Administrative power and duty of the regulatory body to ensure just and reasonable rates, by hearing complaints, reviewing rates, and modifying them, with effective administrative refund remedies;²¹ and
- No rate other than the filed rate can be charged.²²

Once a filed rate is approved by the agency, it binds both buyers and sellers with "the force of law."²³ The Supreme Court has rejected a request for deviation from filed rates tainted by fraud stating "*not even a court can authorize commerce in the [electricity] commodity on other terms.*"²⁴ The "filed rate doctrine" requires a court to enforce the filed rate, against either a buyer or a seller seeking to establish another rate, and is the statutory bulwark against price discrimination.²⁵ "The duty to file rates with the Commission . . . and the

so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

16 U.S.C. § 824d(d) (2003).

21. Suspension of new rates; hearings; five-month period.

Whenever any such new schedule is filed the Commission shall have authority, either upon complaint or upon its own initiative without complaint, at once, and, if it so orders, without answer or formal pleading by the public utility, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the public utility affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of such five months, the proposed change of rate, charge, classification, or service shall go into effect at the end of such period, but in case of a proposed increased rate or charge, the Commission may by order require the interested public utility or public utilities to keep accurate account in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts are paid, and upon completion of the hearing and decision may by further order require such public utility or public utilities to refund, with interest, to the persons in whose behalf such amounts were paid, such portion of such increased rates or charges as by its decision shall be found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the public utility, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible.

16 U.S.C. § 824d(e) (2003).

22. The only exception to the statutory regimen for rate changes is a fuel adjustment cost provision, which allows filed rates to fluctuate in accordance with a filed formula based on variations in the cost of fuel, with both the formula and fuel purchasing practices subject to review and refund.

As used in this subsection, the term "automatic adjustment clause" means a provision of a rate schedule which provides for increases or decreases (or both), without prior hearing, in rates reflecting increases or decreases (or both) in costs incurred by an electric utility. Such term does not include any rate which takes effect subject to refund and subject to a later determination of the appropriate amount of such rate.

16 U.S.C. § 824d(f)(4) (2003).

23. *Lowden v. Simonds-Shields Lonsdale Grain Co.*, 306 U.S. 516, 520 (1939); *see also* *AT&T Corp. v. City of New York*, 83 F.3d 549, 552 (2d Cir. 1996) (stating that filed tariffs attain "the force of law and are not simply contractual"). *Id.*

24. *Montana-Dakota Co. v. Northwestern Pub. Serv. Co.*, 341 U.S. 246, 251-52 (1951).

25. "The considerations underlying the doctrine . . . are preservation of the agency's primary jurisdiction

obligation to charge only those rates . . . have always been considered essential to preventing price discrimination and stabilizing rates.”²⁶ This statutory bias for stable and predictable rates is implemented through longstanding official FERC regulations:

Section 35.1 Application; obligation to file rate schedules and tariffs.

(a) Every public utility shall file with the Commission and post, in conformity with the requirements of this Part, full and complete rate schedules, as defined in Sec. 35.2(b), *clearly and specifically setting forth all rates and charges for any transmission or sale of electric energy subject to the jurisdiction of this Commission*, the classifications, practices, rules and regulations affecting such rates and charges *and all contracts* which in any manner affect or relate to such rates, charges, classifications, services, rules, regulations or practices, as required by section 205(c) of the Federal Power Act).

(e) No public utility shall, directly or indirectly, *demand*, charge, collect or receive any rate, charge or compensation for or in connection with electric service subject to the jurisdiction of the Commission, or impose any classification, practice, rule, regulation or contract with respect thereto, which is different from that provided in a rate schedule required to be on file with this Commission unless otherwise specifically provided by order of the Commission for good cause shown.²⁷

The opportunity under the FPA for sellers to negotiate bilateral contract rates does not undercut the initial obligation to file rates demanded or charged. Also, contract rates, while negotiable, are not deregulated. All contracts are required to be filed. They become part of the filed rates, and are subject to administrative review.²⁸ Thus, under the language of the FPA and longstanding regulations, there is no authority for the FERC to relax rate and contract filing requirements and “authorize commerce in the commodity on other terms.”²⁹

The *SMD NOPR* invokes no specific statutory language of the FPA expressly authorizing the transformation to a market rate regimen. Rather, the FERC’s legal justification is that the new system is a systemic remedy for pervasive utility discrimination under the current regimen. The *SMD NOPR* in Appendix C catalogs a number of instances of alleged rate discrimination,³⁰ and

over reasonableness of rates and the need to insure that regulated companies charge only those rates of which the agency has made cognizant.” *Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571, 577-78 (1981) (citation omitted).

26. *Maislin Indus., U.S., Inc. v. Primary Steel*, 497 U.S. 116 (1990). More completely, “[i]n order to render rates definite and certain, and to prevent discrimination and other abuses, the statute required the filing and publishing of tariffs specifying the rates adopted by the carrier, and made these the *legal* rates . . .” *Arizona Grocery Co. v. Atchison, Topeka, and Santa Fe Ry. Co.*, 284 U.S. 370, 384 (1932) (emphasis in original).

27. *Conservation of Power and Water Resources*, 18 C.F.R. pt. 35.1(a), (e) (2003) (citation omitted).

28. Contract rates may be more binding than filed rates, in that the contracts may provide that the contract rates will not be superceded by subsequently filed rates. The potential conflict between filed rates and long term contracts, in which contract terms and conditions might be modified by new rate filings, is typically addressed by contract boilerplate provisions in which the parties decide whether to let subsequent changes in the filed rates modify the original contract bargain. See generally *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956); *FPC v. Sierra Pac. Power Co.*, 350 U.S. 348 (1956).

29. *Montana-Dakota*, 341 U.S. at 251.

30. Some instances of “undue rate discrimination” involve vertically integrated transmission providers

posits as a remedy the creation of ITPs to manage the grid and run the six spot markets with market based rates. Specifically, the FERC found the operation of transmission systems under the FERC's current open access transmission tariff permits:

[U]ndue discrimination in the provision of transmission service;

Utilities owning transmission facilities and participating in power markets continue to possess substantial transmission market power and retain the ability to unduly discriminate in the provision of transmission service and spot market energy market services;

[L]ack of standardized wholesale electric market design allows undue discrimination within and across regions, can result in unjust and unreasonable pricing and allocation of transmission and *permits the exercise of market power (and thus unjust and unreasonable rates)* in power markets; and

[P]roper price signals are not being sent to the marketplace, with the result that *market-based rates in many places are distorted*, and reasonably³¹ accurate price signals necessary for infrastructure additions and are not being sent.

Notwithstanding the perceived discrimination and distortion of existing market rates, the FERC did not suspend any rates it believed to be discriminatory, commence proceedings to fix new rates in accordance with the procedure of FPA Section 206, or order refunds. Rather, the agency proposed a new market rate system, which it assumes will end the perceived discrimination and correct the flaws of ISO markets that have failed. Regulatory action regarding rate setting would be limited to situations when market power is exercised and would generally be prospective, such as changing market rules to set maximum limits on rates demanded in narrow geographic areas deemed by the agency to have insufficient competition, or canceling market-based rate orders of sellers who manipulate the market, requiring them to file traditional rates.

In sharp contrast to the FERC's approach, the existing statutory scheme prescribes different remedies. FPA Section 205 addresses the discrimination issue explicitly by requiring utilities to file reasonable rates; forbidding them to discriminate in the rates they demand, charge, or file; and requiring price visibility and transparency through the filing of all rates and contracts openly, subject to public inspection. In addition, FPA Section 206 specifically prescribes how the FERC can fix rates believed by the agency or a private complainant to be discriminatory by establishing new rates in accordance with a specific hearing process and refund procedure.

The *SMD NOPR* skirts meaningful discussion of the statutory duty of utilities to file reasonable rate schedules for all services under Section 205 and the established procedure for the agency to fix allegedly discriminatory rates

serving their bundled retail customers in "bundled rate" states that did not open generation service to competition.

31. *SMD NOPR*, *supra* note 4, at 34,304 (emphasis added). The FERC cites nothing in its statutory charter giving it the duty or power to see that "proper price signals are sent to the marketplace, and does not explain why fixing just and reasonable rates under traditional regulation could not send "proper price signals." *Id.*

under Section 206 so that they conform to the just and reasonable standard. No statutory language expressly giving the FERC the power to establish an alternative, market system exists, and none is claimed in the *SMD NOPR*. Indeed, legislative efforts to grant the FERC explicit authority to adopt market-based rates failed in the 107th Congress.³²

IV. THE FERC STANDARD FOR ALLOWING MARKET BASED RATES

In recent years, the FERC began granting market based rate authorizations to individual generators and other energy marketer utilities. The standard the FERC employs for granting such market-based rate orders involves an assessment whether the seller and its affiliates have market power in generation or transmission, or can deter market entry by competitors, generally allowing up to a 20% share of the relevant market. Recognizing inadequacy of that standard, the FERC now follows an interim "Supply Margin Assessment" screen pending completion of a generic rulemaking proceeding.³³ While the agency has not finally decided what standard to use, the essence of these market-based rates is that no definite rates or rate changes are actually filed by the utility. Also, the FERC has issued a regulation completely waiving the need to show a lack of market power for recently built generating facilities.³⁴ The actual rate under the SMD proposal for locational marginal pricing is whatever price the market will bear at any given place and point in time, subject to a nationwide cap of \$1,000 per MWH and localized caps that depend upon specific findings of market power in load pockets. This, of course, is fundamentally inconsistent with the plain language of the FPA, which requires filing of "schedules showing all rates and charges" before they are effective.³⁵ A market-based rate, which continually

32. Energy Policy Act of 2002, S. 1766, 107th Cong. § 203 (2001). If enacted, this bill would have amended Section 205 of the Federal Power Act to authorize the FERC to "determine whether a market-based rate for the sale of electric energy subject to the jurisdiction of the Commission is just and reasonable and not unduly discriminatory or preferential." *Id.* The Senate bill passed but there was no House counterpart.

33. *AES Power Marketing, Inc.*, 97 F.E.R.C. ¶ 61,219 (2001).

34. Power sales at market-based rates.

(a) Notwithstanding any other requirements, any public utility seeking authorization to engage in sales for resale of electric energy at market-based rates *shall not be required to demonstrate any lack of market power in generation* with respect to sales from capacity for which construction has commenced on or after July 9, 1996. (b) Nothing in this part – (1) Shall be construed as preempting or affecting any jurisdiction a state commission or other state authority may have under applicable state and federal law, or (2) Limits the authority of a state commission in accordance with state and federal law to establish (i) Competitive procedures for the acquisition of electric energy, including demand-side management, purchased at wholesale, or (ii) Non-discriminatory fees for the distribution of such electric energy to retail consumers for purposes established in accordance with state law.

Conservation of Power and Resources, 18 C.F.R. pt. 35.27 (2003) (emphasis added).

35. Schedules.

Under such rules and regulations as the Commission may prescribe, every public utility shall file with the Commission, within such time and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection *schedules showing all rates and charges* for any transmission or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

fluctuates with market prices, simply cannot be reconciled with the statutory requirement of schedules "showing" the rates demanded or charged.

The proposed SMD "pro forma tariff" requires the rates demanded by sellers of electricity and by providers of transmission service to be kept confidential. In a total reversal of the FPA provisions requiring price visibility, rates demanded by sellers are concealed:

[T]he Independent Transmission Provider shall make public Bid information from the Energy, Ancillary Services, and Transmission markets (but not the names of the Bidders making these Bids) three months after the Bids are submitted Prior to such disclosure, Bid information submitted to the Independent Transmission Provider by Market Participants shall be considered Confidential Information.³⁶

Thus, the "bids" in the spot markets, which are the rates *demanded* by sellers, are secret and cannot be known and compared by the public or potential purchasers contemporaneously when the rates are actually demanded or charged by the sellers at the ITP markets.³⁷ According to the FERC, the reason for this lack of transparency and price concealment is to promote competition.

The amount particular competitors bid is generally considered confidential business information. Disclosure of such information may lead to a reduction in competition because it will allow competitors to learn what their competitors are bidding and could lead to price collusion or coordination [T]he Commission must recognize the need to keep bid information confidential in order to promote competition. In addition *Section 205 of the FPA refers to the posting of rates and charges, not bids*, and the actual charges for power [established by the market clearing bid] are contemporaneously disclosed.³⁸

The passage quoted above exempting sellers' "bids" - which plainly are the rates at which they offer to sell - from public disclosure is difficult to reconcile with the statutory requirement that "[a]ll rates and charges made, *demanded*, or received . . . shall be just and reasonable,"³⁹ and the companion provision that "every public utility shall file with the Commission . . . and shall keep open in convenient form and place for public inspection schedules showing *all* rates and charges for any transmission or sale subject to the jurisdiction of the Commission"⁴⁰ The FPA reflects Congress' policy judgment that sunshine, transparency, and price visibility will expose collusive pricing, gaming tactics, and will deter discrimination, thus rendering irrelevant the FERC's revisionist opinion that open, visible pricing fosters price fixing and deters competition. Promotion of competition, it should be noted, is not a statutory objective of the FPA. Rather, the primary purpose of the FPA is to protect consumers. The quarterly filing requirements for bilateral contract sales by sellers with market

16 U.S.C. § 824d(c) (2003) (emphasis added).

36. SMD NOPR, *supra* note 4, at 34,437-38.

37. Although it is proposed that the sellers make their bid and cost data available to the ITP's private "Market Monitor," that data too would be confidential: "All information obtained by the [Market Monitoring Unit], that is specific to a Market Participant, shall be treated confidentially." SMD NOPR, *supra* note 4, at 34,496.

38. *San Diego Gas & Elec. Co. v. Sellers of Energy and Ancillary Service*, 95 F.E.R.C. ¶ 61,115, 61,364 (2001) (emphasis added).

39. 16 U.S.C. § 824d(a) (2003).

40. 16 U.S.C. § 824d(c) (2003).

based rate authority do not satisfy the FPA requirement that all contracts be filed and reviewed by the FERC for reasonableness before they take effect. The summary reports required by the FERC are incomplete and retrospective, so off-spot market buyers seeking to enter into bilateral contracts cannot contemporaneously see the rates being charged by the same seller to other bilateral buyers, and cannot see the rates demanded by the seller in the spot markets.

V. REGULATORY AGENCY RELIANCE ON MARKET RATES: THE SUPREME COURT DECISIONS

Initiatives of federal regulatory agencies to lighten traditional regulation, and to embrace market substitutes for direct rate making are not new. A trio of cases over a three-decade span illustrates that the Supreme Court has not looked with favor on federal regulatory agencies unilaterally revising the system of regulation without congressional action to change the regulatory paradigm the agency is charged by statute to implement. Significantly, the Supreme Court, with remarkable consistency, has refused to allow substitution of market rates for regulation, even when the statutory scheme was perceived to be flawed and outdated, or when the agency's proposal for reinventing its role and adopting market substitutes for regulation seemed plausible, workable, attractive, and economically sound. In the context of colossal electricity market failure in California, and the exercise of market power in other FERC-approved ISO and RTO markets, heated controversy over the *SMD NOPR*, and the lack of congressional consensus to adopt or to ratify the FERC's current "vision," the possibility of litigation increases. Therefore, these decisions deserve careful review.

A. FPC v. Texaco, Inc.:⁴¹ Lightened Regulation of Small Natural Gas Producers.

In 1974, the Supreme Court considered a situation where the FERC's predecessor, the Federal Power Commission (FPC), attempted to change the mode of regulation of smaller producers of natural gas by substituting an agency-devised regimen that relaxed direct price regulation but nonetheless was intended to achieve the statutory goal of reasonable rates through market forces. The Supreme Court upheld the flexibility and general power of the agency to utilize novel rate setting techniques, but firmly rejected reliance on market prices to set rates.

For the purposes of the proceedings that may occur on remand, we should also stress that in our view the prevailing price in the marketplace cannot be the final measure of 'just and reasonable' rates mandated by the Act. It is abundantly clear from the history of the Act and from the events that prompted its adoption that Congress considered that the natural gas industry was heavily concentrated and that monopolistic forces were distorting the market price for natural gas... In subjecting producers to regulation because of anticompetitive conditions in the industry, Congress could not have assumed that 'just and reasonable' rates could

41. *FPC v. Texaco, Inc.*, 417 U.S. 380 (1974).

conclusively be determined by reference to market price⁴²

....

*In concluding that the Commission lacks the authority to place exclusive reliance on market prices, we bow to our perception of legislative intent. It may be, as some economists have persuasively argued, [footnote omitted] that the assumptions of the 1930's about the competitive structure of the natural gas industry, if true then, are no longer true today. It may also be that control of prices in this industry, in a time of shortage, if such there be, is counterproductive to the interests of the consumer in increasing the production of natural gas. It is not the Court's role, however, to overturn congressional assumptions embedded into the framework of regulation established by the Act. This is a proper task for the Legislature where the public interest may be considered from the multifaceted points of view of the representational process.*⁴³

The *Texaco* decision is not merely interesting history or a useful prism through which to view the FERC's contemporary effort to shift from traditional regulation to a regimen of market-based rates. At the time *Texaco* was decided, the ratemaking provisions of the Natural Gas Act and the Federal Power Act were similar, and precedents under those statutes were cited and followed interchangeably by the courts, without distinction between natural gas and electricity cases.⁴⁴ Although the natural gas regulatory scheme has since been changed by Congress to authorize more reliance on market forces, the traditional rate filing and rate fixing paradigm for electricity has not changed; therefore, the principles of *Texaco* still have continued vitality with respect to the FERC's current assertion of power to implement a market-based rate regimen.⁴⁵ Like the Natural Gas Act at the time of *Texaco*, the FPA does not grant the FERC authority to relax requirements for public filing of just and reasonable rates and contracts, and direct rate regulation. The FERC's current goal to supplant regulation with market-based rates clearly is at odds with the Supreme Court's direction to the agency in *Texaco*. Because it might be argued that the Supreme Court's direction to the FPC not to use market rates is stale,⁴⁶ it is instructive to

42. *Id.* at 397-400.

43. *Texaco*, 417 U.S. at 400 (emphasis added).

44. In *Montana-Dakota Util. Co. v. Northwestern Pub. Serv. Co.*, 341 U.S. 246 (1951), the Federal Power Act rather than the Natural Gas Act applied, but as we have previously stated, the relevant provisions of the two statutes "are in all material respects substantially identical." *FPC v. Sierra Pac. Power Co.*, 350 U.S. 348, 353 (1956).

45. No intervening statutory changes since *Texaco* authorize FERC to adopt a market-based rate regimen. The enactment by Congress of the Energy Policy Act of 1992 (Pub. L. No. 102-486), fostered the entry of new competitors to sell electricity, but did not authorize market-based rates. Although some merchant generators were granted exemption from holding company act requirements, the law did not amend Sections 205 or 206 of the Federal Power Act, which still require filing by utilities of "just and reasonable" rates and contracts.

46. The passage of time since *Texaco* was decided does not erode its force, because any argument to disregard it as outmoded:

misconceives the deference this Court must accord to longstanding and well-entrenched decisions, especially those interpreting statutes that underlie complex regulatory regimes. Adherence to precedent is, in the usual case, a cardinal and guiding principle of adjudication, and '[c]onsiderations of *stare decisis* have special force in the area of statutory interpretation, for here, unlike in the context of constitutional interpretation, the legislative power is implicated, and Congress remains free to alter

see how the Supreme Court reacted to other more recent federal regulatory agencies' efforts to adopt market rates.

*B. Maislin Industries v. Primary Steel:*⁴⁷ *Negotiated Rates*

In 1990, an effort by the Interstate Commerce Commission (ICC) to lighten its regulation of certain motor carriers for the purpose of introducing competition and market forces was struck down. In *Maislin*, the ICC allowed rates to be set by negotiation, even though the governing statute did not allow variance from filed rates. The Supreme Court disallowed the deviation from the statutory scheme, stating:

For a century, this Court has held that the Act, as it incorporates the filed rate doctrine, forbids as discriminatory the secret negotiation and collection of rates lower than the filed rate . . . By refusing to order collection of the filed rate solely because the parties had agreed to a lower rate, the ICC has permitted the very price discrimination that the Act by its terms seeks to prevent.⁴⁸

In response to criticism that the decision was out of step with deregulatory trends, evidenced by the statutory authorization of contract rates for some other carriers, Justice Scalia stated:

While this plainly reflects an intent to deregulate, it reflects an intent to deregulate within the framework of the existing statutory scheme. Perhaps deregulation cannot efficiently be accomplished within that framework, but that is Congress' choice, and not the Commission's or ours. It may well be . . . that, after the 1980 amendments and the various administrative changes that the Commission has made by rule, "[t]he skeleton of regulation remains; the flesh has been stripped away"⁴⁹ But it is the skeleton we are construing, and we must read it for what it says.⁴⁹

Thus, the *Maislin* court adhered to the statutory rate regulation paradigm despite claims of the regulatory agency that events had rendered the statutory system outmoded and less efficient than the new system established by the agency, which relied on market forces rather than regulation to achieve reasonable rates. The Federal Power Act, unlike the statute considered in *Maislin*, allows utilities to negotiate bilateral rate contracts. However, under the FPA, all rate contracts are required to be filed for public inspection. The rate contracts then become part of the filed rates, and they are subject to the FERC's review. Such contract rates are easily distinguished from, and do not legitimate either the new spot market regimen the FERC is introducing, or non-contemporaneous reporting of bilateral contract summaries by generators and energy marketers. For purposes of this discussion, the thrust of *Maislin* reaffirms the basic principle of *Texaco*, which declares that a regulatory agency cannot revise or reinvent the statutory paradigm.

*C. MCI v. AT&T:*⁵⁰ *Lightened Regulation of Non-Dominant Long Distance*

what we have done.'

California v. FERC, 495 U.S. 490, 499 (1990) (citation omitted).

47. *Maislin Indus., U.S., Inc. v. Primary Steel*, 497 U.S. 116 (1990).

48. *Id.* at 130.

49. *Maislin*, 497 U.S. at 138 (citation omitted).

50. *MCI Telecomm. Corp. v. AT&T Co.*, 512 U.S. 218 (1994).

Carriers

More recently, the Supreme Court reined in the Federal Communications Commission (FCC) when that regulatory agency, also seeking to spur competition and deregulation, waived rate filing by non-dominant long distance telephone carriers (whom the agency believed lacked market power). The waiver was done notwithstanding blanket provisions of the statute requiring *all* providers to file reasonable rates, not just those with market power. Writing for the Court, Justice Scalia stated:

What we have here, in reality, is a fundamental revision of the statute, changing it from a scheme of rate regulation in long distance common carrier communications to a scheme of rate regulation only where effective competition does not exist. That may be a good idea, but it was not the idea Congress enacted into law in 1934

. . . .

As we noted earlier this Term, there is considerable debate in other forums about the wisdom of the filed rate doctrine, and, more broadly, about the value of continued regulation of the telecommunications industry. But our estimations, and the Commission's estimations, of desirable policy cannot alter the meaning of the Federal Communications Act of 1934. For better or worse, the Act establishes a rate-regulation, filed-tariff system for common-carrier communications, and the Commission's desire to 'increase competition' cannot provide [it] authority to alter the well-established statutory filed rate requirements. As we observed in the context of a dispute over the filed-rate doctrine more than 80 years ago, such considerations address themselves to Congress, not to the courts.⁵¹

The FERC's new regimen, which relies on markets for setting rates, is also "a fundamental revision of the statute,"⁵² with a fallback to "a scheme of rate regulation only where effective competition does not exist."⁵³ Analogous to the situation in *MCI*, the FERC's market based rate orders are dispensed upon a finding that the generator or other seller lacks market power, they relieve the seller of the duty to charge, demand and receive only just and reasonable rates, they dispense with filing and review of the proposed rate changes and actual rates to be charged, and they allow for continually fluctuating market-based rates.⁵⁴ A slight difference in *MCI* is that the FCC entirely detariffed new entrants it believed lacked market power, while the FERC is approving filed tariffs which contain no actual rates in them, as they are said to be "market-based" rates set by sellers and buyers. The result is the same, with actual rates demanded and proposed rate changes not filed by the utility, not determinable, and not open to contemporaneous public inspection.

The unifying conclusion of the Supreme Court's three-decade trio of

51. *Id.* at 231-34 (citations omitted).

52. *MCI*, 512 U.S. at 234.

53. *Id.* The FERC has threatened to revoke market-based rate authority of utilities who exercise market power or manipulate rates. See generally *Fact-Finding Investigation of Potential Manipulation of Electric and Natural Gas Prices*, 99 F.E.R.C. ¶ 61,272 (June 4, 2002). The market based rate authority was not actually revoked.

54. The market power test utilized by the FERC in granting market-based rate permission is controversial, but for purposes of this analysis, its effectiveness is irrelevant if there is no authority to relax statutory requirements.

lightened regulation and market rate decisions in *Texaco - Maislin - MCI* is that a federal regulatory agency cannot recast the regulatory paradigm established by Congress, and cannot waive or ignore longstanding statutory requirements in the name of introducing market forces or competition to accomplish its regulatory mission, even if the agency believes that the conditions that once required direct price regulation have changed, that its new scheme will be superior, that it is incapable of effectively fulfilling the statutory mission of rate regulation or that the end result will still fulfill the ultimate statutory goals. The FERC's latest actions and latest proposals must be seen for what they are, a radical overthrow of the longstanding statutory regimen of the FPA, replacing rate filing by utilities and rate setting by the agency with unregulated prices set in a private marketplace.

VI. THE FERC'S DEFENSE OF MARKET-BASED RATES

The FERC defended its deregulatory and market based rate initiatives in a recent case challenging aspects of the market-based rate regimen. In that case, refunds were sought for unreasonable rates established in the FERC-approved California ISO spot markets.⁵⁵ The FERC's defense of market-based rates was rationalized with the follow analysis.

Market-based rates are permitted by the FPA. Use of market-based rates has been approved as satisfying the just and reasonable standard in certain circumstances. The prerequisite for approval of market-based rates is a finding that the seller lacks or has mitigated its market power in the relevant market. So long as a seller lacks market power and thus buyers have alternatives, market-based rates will meet the just and reasonable standard. This satisfies the FPA § 205(e) standard that use of market-based rates by a seller is just and reasonable.⁵⁶

There is no direct quotation of any statutory language, however, for the agency's assertion that market-based rates are permitted by the FPA.⁵⁷ It is evident that the FERC can point to neither statutory language nor a Supreme Court opinion supporting its installation of a system of market-based rates. Rather, the legal authority invoked rests upon a doctrine of the Court of Appeals for the District of Columbia spawned in *Elizabethtown Gas Co. v. FERC*,⁵⁸ subsequently reiterated by that court in varying formulations, but never scrutinized or approved by the Supreme Court. The doctrine of *Elizabethtown* as invoked by the FERC may be summarized as follows:

- Requirements for rate filing and administrative rate regulation were adopted by Congress solely to address monopolistic practices of utilities in the past.
- Rate filing and review becomes unnecessary if competition is introduced because then utilities are no longer monopolies and will not have market power to sustain inflated rates or bar entry by new competitors.

55. *State of California, ex rel. Bill Lockyer, Att'y Gen. of Cal. v. British Columbia Power Exch. Corp.*, 100 F.E.R.C. ¶ 61,295 (Sept. 23, 2002) [hereinafter *Bill Lockyer*].

56. *State of California, ex rel. Bill Lockyer, Att'y Gen. of Cal. v. British Columbia Power Exch. Corp.*, 99 F.E.R.C. ¶ 61,247, 62,062 (May 31, 2002) (citations omitted).

57. *Bill Lockyer*, *supra* note 55, at 61,295.

58. *Elizabethtown Gas Co. v. FERC*, 10 F.3d 866 (D.C. Cir.1993).

- The FERC is free to lighten regulation and adopt market-based utility rates if it finds that utilities now lack market power under market power standards set by the agency.
- The FERC is also free to lighten regulation, and adopt market-based utility rates, even when utilities do have market power, if the FERC administratively creates, structures and monitors markets, and places some outside limits on the exercise of market power, such as market price caps.⁵⁹

Preliminarily, it should be immediately apparent that this doctrine repudiates the essence of the Supreme Court's *Texaco - Maislin - MCI* decisions. In these cases, the Supreme Court held that the FPC (FERC's predecessor), the ICC, and the FCC could not waive statutory requirements even though the agency believed that conditions had changed so that competition and market forces existed to control the rates of those for whom regulation was lightened, so that as an end result, the rates would be reasonable despite the departure from full statutory compliance. With this overview in mind, we turn next to a closer examination of the *Elizabethtown* doctrine and the other authorities cited by FERC as the legal justification for market-based rates.

A. *Elizabethtown Gas*

The District of Columbia circuit court opinion in *Elizabethtown* is the key precedent upon which the legal foundation of the FERC's claimed authority to implement market based rates is premised. Because of its watershed significance, the full discussion of the FERC's authority by the Circuit Court in that case is repeated below:

Market-based pricing

The petitioners contend that the FERC's approval of market-based pricing for Transco's merchant service constitutes "virtual deregulation" and is "utterly at odds with its NGA obligation to insure that rates are cost-based so that consumers will be protected from abuse at the hands of natural gas companies." Pointing to the Supreme Court's statement that "the prevailing price in the market cannot be the final measure of 'just and reasonable' rates mandated by the Act," the petitioners maintain that the FERC was required to adhere to its historical policy of basing rates upon the cost of providing service plus a fair return on invested capital.

In our view, that is not a tenable position. First, nothing in *FPC v. Texaco, Inc.* precludes the FERC from relying upon market-based pricing. The Supreme Court's point in that case was only that where the Congress has "subjected producers to regulation because of anticompetitive conditions in the industry," the market cannot be the "final" arbiter of the reasonableness of a price. In *Texaco*, the Commission had failed even to mention the "just and reasonable" standard; it appeared to apply only the "standard of the marketplace" in reviewing the "reasonableness" of a rate. Here, in contrast, the FERC has made it clear that it will exercise its § 5 authority (upon its own motion or upon that of a complainant) to assure that a market (*i.e.*, negotiated) rate is just and reasonable. Second, the Supreme Court "has repeatedly held that the just and reasonable standard does not compel the Commission to use any single pricing formula . . .," and we have indicated that when there is a competitive market the FERC may rely upon market-based prices in lieu of cost-of-

59. See generally *id.*

service regulation to assure a “just and reasonable” result.

Here the Commission specifically found that “Transco’s markets are sufficiently competitive to preclude it from exercising significant market power in its merchant function” In support of this conclusion, the FERC noted that “Transco will be providing comparable transportation service with respect to all gas supplies whether purchased from Transco or its competitors” and that “adequate divertible gas supplies exist” to assure that Transco will have to sell at competitive prices. The petitioners point to no record evidence to the contrary. It appears, therefore, that Transco will not be able to raise its price above the competitive level without losing substantial business to rival sellers. Such market discipline provides strong reason to believe that Transco will be able to charge only a price that is “just and reasonable” within the meaning of § 4 of the NGA.

In their reply brief, the petitioners alter the focus of their argument, contending that the Restructuring Settlement is inconsistent with the various reporting requirements of the NGA. This contention appears nowhere in the petitioners’ original brief and they cite no reference to it in their various pleadings before the FERC. Accordingly, pursuant to § 19(b) of NGA, we do not reach this contention.⁶⁰

The last paragraph quoted above vitiates the force of the decision. It makes clear that the court never adjudicated the issue whether the market rates approved by the FERC were in conflict with the statutory provisions requiring utilities “to file rate schedules and give advance notice of changes.”⁶¹ Thus, the *Elizabethtown* court totally avoided grappling with rate filing requirements, which are the very core of the statutory scheme. The Supreme Court underscored the pivotal role of filed rates in its *MCI* decision:

[T]his Court has repeatedly stressed that rate filing was Congress’s chosen means of preventing unreasonableness and discrimination in charges: “[T]here is not only a relation, but an indissoluble unity between the provision for the establishment and maintenance of rates until corrected in accordance with the statute and the prohibitions against preferences and discrimination.” “The duty to file rates with the Commission, [the analog to § 203(a)], and the obligation to charge only those rates, [the analog to § 203(c)], have always been considered essential to preventing price discrimination and stabilizing rates.” As the *Maislin* Court concluded, compliance with these provisions “is ‘utterly central’ to the administration of the Act.” Much of the rest of the Communications Act subchapter applicable to Common Carriers, and the Act’s Procedural and Administrative Provisions, are premised upon the tariff filing requirement of § 203. For example, § 415 defines “overcharges” (which customers are entitled to recover) by reference to the filed rate. The provisions allowing customers and competitors to challenge rates as unreasonable or as discriminatory, would not be susceptible of effective enforcement if rates were not publicly filed.⁶²

The *Elizabethtown* decision places great weight on a statement in *Texaco* that Congress had “subject[ed] producers to regulation because of anticompetitive conditions in the industry,”⁶³ and then draws the incorrect

60. *Elizabethtown*, 10 F.3d at 870-71 (citations omitted).

61. *Id.* at 871 (citations omitted).

62. *MCI Telecomm. Corp. v. AT&T*, 512 U.S. 218, 230-31 (1994).

63. *Elizabethtown*, 10 F.3d at 870. (citing *FPC v. Texaco, Inc.*, 417 U.S. 380, 397 (1974)). The full text of the portion of the *Texaco* decision on which *Elizabethtown* relies is:

[W]e should also stress that, in our view, the prevailing price in the marketplace cannot be the final measure of “just and reasonable” rates mandated by the Act. It is abundantly clear from the history

conclusion that the FERC is free to rely on market prices if it believes that conditions have changed since enactment of the statute so that a sufficiently competitive market has replaced one in which sellers possessed market power. The reference in *Texaco* to historical conditions when the FPA was enacted merely supported the Supreme Court's explanation of the meaning of the FPA. That meaning of the statutory language does not change even if original market conditions change. Thus, *Elizabethtown* adopts the very approach the Supreme Court said should not be taken, usurping the role of Congress, by allowing the FERC to overturn legislative assumptions concerning market power that are "embedded into the framework of regulation established by the Act."⁶⁴ In *MCI*, decided subsequent to *Elizabethtown*, the Supreme Court rejected the argument advanced by the agency and by the dissenting opinion in that case, that the advent of competition rendered compliance with the statutory scheme unnecessary and superfluous for utilities deemed by the agency not to have market power.⁶⁵ The FERC has now gone farther in the *SMD NOPR* to decide that it can create the markets, design them to be competitive, predict they will work as designed, rely on its future results, and stop setting rates. But in Part IV of *Texaco*, the Supreme Court directly addressed that notion and squarely rejected it.⁶⁶

Third, the *Elizabethtown* decision conflates the argument against market-based rates with a "straw man" argument that the statute compels a particular methodology, the traditional cost of service method of setting rates to provide a fair opportunity to recover operating costs and a reasonable return on the utility's equity investment. Because the Supreme Court has given the agency broad latitude in choosing the method it uses to set rates, arguments to compel judicially any one particular type of cost based regulation are probably foredoomed.⁶⁷ The essential teaching of *Texaco*, however, is that while there are many ways for the agency to set just and reasonable rates, there is one forbidden methodology that the FERC cannot embrace, and that is market-based rates.

Fourth, tacitly recognizing the force of *Texaco*, the *Elizabethtown* opinion weakly attempts to distinguish it, characterizing it as an instance where the agency had wholly abdicated its duty to see that rates are just and reasonable.⁶⁸

of the Act and from the events that prompted its adoption that Congress considered that the natural gas industry was heavily concentrated and that monopolistic forces were distorting the market price. . . . Hence, the necessity for regulation. . . .

Texaco, 417 U.S. 380 at 399. The *Elizabethtown* decision attempts to undercut the Supreme Court's explicit conclusion that "the prevailing price in the market place *cannot* be the final measure of 'just and reasonable' rates mandated by the Act," by finding a change in the market circumstances said to have originally motivated Congress to enact the FPA. *Id.* (emphasis added).

64. *Elizabethtown*, 10 F.3d at 870.

65. *MCI*, 512 U.S. at 235-38.

66. *Texaco*, 417 U.S. at 400-01.

67. In other decisions, the circuit court for the District of Columbia has indicated that a "just and reasonable" requirement is a cost standard. *Kootenai Electric Cooperative v. FERC*, 192 F.3d 144, 149 (D.C. Cir. 1999) (citing *Farmers Union Central Exchange v. FERC*, 734 F.2d 1486, 1504 (D.C. Cir. 1984)).

68. "Here, in contrast [to *Texaco*], the FERC has made it clear that it will exercise its § 5 authority (upon its own motion or upon that of a complainant) to assure that a market (*i.e.*, negotiated) rate is just and reasonable." *Elizabethtown*, 10 F. 3d at 870.

Actually, the agency did not go so far in *Texaco*. In *Texaco*, the agency order eliminated:

*almost all filing requirements. The rates of small producers would no longer be directly regulated but would be subjected to indirect regulation through the review of purchased gas costs of the pipelines and large producers to whom these small producers sell.*⁶⁹ . . .

. . . .

[T]he small producers could sell gas at the price the market would bear, even though in excess of maximum rates set for producers in pertinent area rate proceedings. Furthermore, they would have “no refund obligations with respect to increased rates, if any, collected for sales regulated hereunder to pipelines. . . .”⁷⁰

. . . .

The Commission finally asserted that “[w]e intend to review the prices established in new contracts or contract amendments relating to sales by small producers to assure the reasonableness of the rates charged by such producers pursuant to the action we are taking herein. In the event we determine that this approach is inimical to the interests of consumers, we shall take further action to protect the consumers The Commission does not contend in this Court that the Act permits it to exempt small-producer rates from regulation or to regulate those rates by any criterion less demanding than the just-and-reasonable standard mandated by [sections] 4 and 5 of the Act” *The Commission does not assert here that it is free under the Act to equate just and reasonable rates with the prices for gas prevailing in the market place.*⁷¹

Similarly, in the *SMD NOPR*, the FERC purports not to be abandoning the just and reasonable standard, claiming instead to satisfy it by watching market prices. But as in *Texaco*, the FERC is not imposing a just and reasonable standard on the rates demanded by utilities in the markets, is not enforcing that standard, and is not providing a full refund remedy for a lack of compliance with it.⁷² There is no just and reasonable rate standard for the prices set by the ITP who will run the six markets and establish the prices. Rather, the rate becomes the charge demanded in the market.

The mitigation measures proposed by the FERC, if they were used, would spring only from findings that the market is not working as intended, not from determinations of the reasonableness of the rates actually demanded and charged. The absence of any requirement in the *SMD* that the bidders’ demanded rates be reasonable constitutes a complete abandonment of the requirement in Section 205(a) of the FPA that not only all rates actually charged, but also all rates “demanded” must be just and reasonable.⁷³

69. *FPC v. Texaco, Inc.*, 417 U.S. 380, 382-3 (1974) (emphasis added).

70. *Id.* at 384 (emphasis added).

71. *Texaco*, 417 U.S. at 401 (emphasis added).

72. Also, with respect to newer generating plants, FERC regulations dispense with any finding that the utility lacks market power. 16 CFR §35.27. Thus, a precondition for the *Elizabethtown* doctrine is also absent. Similarly, *Elizabethtown* suggests that any market-based negotiated rates it approved were fully revisable and presumably refundable, but there is no clear way to challenge as unreasonable a market-based rate and obtain a full refund.

73. A rule and tariff condition that sellers must file just and reasonable rate demands, based on some

In the *SMD NOPR*, the agency asserts it will monitor the functioning of the new indirect method of setting rates through the agency's redesigned markets. But in *Texaco*, the agency had not totally eliminated all filing requirements, and had also argued without success there that it would achieve an end result of just and reasonable rates indirectly.

The Supreme Court expressed some doubt in *Texaco* about whether indirect regulation on some basis other than market prices could be achieved, but did not rule it out, "providing that it insures that the rates paid by pipelines, and ultimately borne by the consumer, are just and reasonable."⁷⁴ The FERC has not shown that the *SMD NOPR* system of market-based rates *insures* that the rates ultimately paid by consumers will be just and reasonable. A comparable argument might be that the purchasers of electricity in the proposed ITP markets would be limited in their retail rates and thus would have the incentive to exercise control over the price of their wholesale purchases at market based rates. That assumption simply does not hold in jurisdictions where utilities can pass their wholesale costs through to retail customers.⁷⁵ Also, even if the purchasers complained, it may be too late, as Section 206 complaints are only designed to head off unreasonable prospective increases, not to reset rates retroactively. Rather than enforce a just and reasonable standard for energy sold in the spot market, and recognizing the risk of unreasonable spot market rates with no effective remedy, the FERC has suggested that purchasers who wish reasonable prices should not buy very much at the unregulated prices in the new markets. But the FPA has no exception for balancing transactions or spot markets and requires all rates to be filed and to be just and reasonable.

Lastly, the *Elizabethtown* decision rests upon judicial assumptions that market rates will always yield just and reasonable rates. Such faith in the market was rejected by Congress when it adopted the Federal Power Act and has been rejected by the Supreme Court as a basis for departing from statutory requirements. In *MCI*, the Court held that "what we have here . . . is effectively the introduction of a whole new regime of regulation (or of free-market competition), which may well be a better regime but is not the one that Congress established."⁷⁶

B. Louisiana Energy and Power Authority (LEPA)

The leading case cited by the FERC as authority for introducing market-based electric rates is *Louisiana Energy and Power Authority v. FERC*.⁷⁷ The *LEPA* decision largely repeats the *Elizabethtown* doctrine and its rationale for

approved measure of their marginal costs or other formula, subject to notice, review and refund, might cure this problem. It does not, however, cure other anomalies of the uniform price auction. *Texaco*, 417 U.S. at 401.

74. *Id.*

75. While state regulators may question the prudence of a retail utility's purchased power portfolio and purchasing practices in the various wholesale markets, states lack power to conclude that FERC-approved wholesale rates are unreasonable. *Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571 (1981). The scope of federal preemption and state prudence review is at issue in *Entergy Louisiana, Inc. v. Louisiana Pub. Serv. Comm'n*, 815 So.2d 27 (5th Cir. 2002), *cert. granted*, 71 U.S.L.W. 3486 (U.S. Jan. 17, 2003).

76. *MCI Telecomm. Corp. v. AT&T Co.*, 512 U.S. 218, 234 (1994).

77. *Louisiana Energy and Power Auth. v. FERC*, 141 F.3d 364 (D.C. Cir. 1998).

allowing the agency to depart from statutory requirements:

The Federal Power Act requires that all rates demanded by public utilities for the transmission or sale of electric energy be "just and reasonable." [16 U.S.C. § 824d(a)]. Where there is a competitive market, the FERC may rely on market-based rates in lieu of cost-of-service regulation to ensure that rates satisfy this requirement. [*Cf. Elizabethtown Gas Co. v. FERC*, 10 F.3d 866, 870 (D.C. Cir.1993) (discussing "just and reasonable" rate requirement of Natural Gas Act).] Under its precedents, the Commission approves applications to sell electric energy at market-based rates only if the seller and its affiliates do not have, or adequately have mitigated, market power in the generation and transmission of such energy, and cannot erect other barriers to entry by potential competitors.⁷⁸

The FERC relies on this statement in *LEPA* as authority for importing the rationale of *Elizabethtown*, a decision under the Natural Gas Act, into interpretations of the Federal Power Act to justify market-based rates for electricity.⁷⁹ Also, other commentary has relied on *LEPA* as the fount of the FERC's legal authority for market-based electricity rates.⁸⁰ Just as the parties in *Elizabethtown* failed to raise the rate filing issues, however, "*LEPA [did] not challenge FERC's general policy of permitting market-based rates in the absence of market power.*"⁸¹ Accordingly, the issue of the FERC's authority to adopt market-based rates was never properly raised by the parties or adjudicated by the circuit court in either *Elizabethtown* or *LEPA*.

Finally, *LEPA* gave weight to the FERC's finding that a generator lacked market power due to the size of its market share. Even if it did have market power, weight was given to the FERC's "reasonable agency prediction about the future impact of its own regulatory policies to which we ordinarily defer,"⁸² which was that any market power would be dissipated with the FERC's open access transmission regimen, established by Order 888, was implemented. Under the *Texaco - Maislin - MCI* trilogy, of course, such optimism and blind faith in markets designed by the agency is inadequate to justify departure from a statutory regimen for regulation, rate filing and agency rate determination. In the aftermath of the California debacle,⁸³ and other less well known market failures,⁸⁴ the Court of Appeals for the District of Columbia may disavow

78. *Id.* at 365; see generally *Heartland Energy Servs., Inc.*, 68 F.E.R.C. ¶ 61,223, 62,060 (1994); *Louisville Gas & Elec. Co.*, 62 FERC ¶ 61,016, 61,143-44 (1993).

79. As previously discussed, the Natural Gas Act and the Federal Power Act once had congruent statutory schemes, and precedents were interchangeably cited. *Elizabethtown*, however, was decided after Congress had taken major steps to deregulate the sale of wholesale natural gas. In contrast, there has been no congressional change in the statutory paradigm for setting electricity rates. Thus, it does not follow that *Elizabethtown* has relevance to electricity regulation under the Federal Power Act.

80. Carmen L. Gentile, *The Mobile-Sierra Rule: Its Illustrious Past and Uncertain Future*, 21 ENERGY L. J. 353, n.2 (2000). In *LEPA*, "the court seemed to suggest that market-based rates would be appropriate for either power sales or transmission service, provided that effective competition exists . . ." *Id.*

81. *Louisiana Energy and Power Authority v. FERC*, 141 F.3d 364, 366, n.2 (D.C. Cir. 1998) (emphasis added).

82. *Id.*

83. Timothy P. Duane, *Regulation's Rationale: Learning from the California Energy Crisis*, 19 YALE J. ON REG. 471 (Summer 2002).

84. In just one day, June 26, 2000, "[a]ccording to the NYISO, consumers bore over \$100 million in excess costs before bid mitigation could be applied. As a result, and in light of FERC's unwillingness to allow

paternity of the *LEPA* market-based rate doctrine in a case that properly raises the issue.

*C. Grand Council of the Crees v. FERC*⁸⁵

The third District of Columbia Circuit Court case cited by the FERC as authority for its adoption of market-based electricity rates is *Grand Council of the Crees*. The actual holding of that case, however, is that plaintiffs lacked standing to challenge the absence of environmental considerations in approving a market-based rate order. It could not and did not determine anything other than that those plaintiffs had no standing to sue. Nevertheless, the case discusses in *dictum* the practice of lifting regulation and granting market based rates:

Pursuant to § 205(c) of the Federal Power Act ("FPA"), 16 U.S.C. § 824d(c) (1994), a power marketer that seeks to engage in electricity sales under the jurisdiction of the Federal Energy Regulatory Commission must place its rate schedule on file with the Commission. H.Q. Energy requested the Commission to accept for filing a rate schedule authorizing it to sell power at market-based rates. In reviewing such applications, the Commission demands that the power marketer establish that it, and its affiliates, either do not have, or have adequately mitigated, market power in both generation and transmission.

The applicant must also establish that it cannot erect barriers to entry, and that there is no evidence of other behavior perceived as anticompetitive, such as affiliate abuse or reciprocal dealing.⁸⁶

The circuit court thus cites the FERC as the authority for the doctrine that an agency may dispense with statutory rate filing requirements if it attests to a lack of market power and has optimism that the market will work. As previously shown, this doctrine is simply out of step with the relevant Supreme Court decisions in *Texaco*, *Maislin* and *MCI* which say that even assuming a market is competitive and prices are close to "true" marginal cost, that system of setting rates cannot be implemented because Congress rejected market approaches when it adopted the FPA.

D. Market Rules as the Rates

In response to an attack on market-based rates, on the ground that they are indefinite, the FERC provided an Orwellian response: the market rules are the filed rates, and under these rules one may be certain of one thing, that the rates charged are indefinite.⁸⁷

retroactive price corrections, the NYISO subsequently implemented an automated mechanism for mitigating bids prior to setting the market-clearing price" Paul Peterson et al., *Best Practices in Market Monitoring*, SYNAPSE ENERGY ECON., p. 18-19 (Nov. 9, 2001), (citing NYISO, *Exigent Circumstances Filing of the [NYISO]*, p. 80, (May 17, 2001)), available at <http://www.synapseenergy.com/Downloads/report-pjm-advocate-best-practices-market-monitoring.PDF> (last visited Apr. 1, 2003). The "Automated Mitigation Procedure" adopted to constrain prices in New York is challenged in *Dynegy Power Marketing, Inc. v. FERC*, No. 02-1009 (D.C. Cir.), pending argument April 14, 2003.

85. *Grand Council of the Crees v. FERC*, 198 F.3d 950 (D.C. Cir. 2000).

86. *Grand Council of the Crees*, 198 F.3d at 953 (citations omitted).

87. *State of California, ex rel. Bill Lockyer, Att'y Gen. v. British Columbia Power Exch. Corp.*, 99 F.E.R.C. ¶ 61,247 (May 31, 2002).

When tariffs with market-based rates are approved by the Commission, purchasers know in advance that, to borrow the Complaint's language (at 9), the rates could "fluctuate widely and rapidly (every hour or less in the ISO and PX) according to supply and demand and any other consideration taken into account by buyers and sellers in the course of business." Based on such possible fluctuations, purchasers can predict in advance the consequences of relying, for example, on last minute spot purchases in a sellers' market.⁸⁸

The FERC thus concedes the actual rates demanded and charged cannot be known or predicted in advance; they are not fixed and there are no schedules showing the actual rates. As stated by Justice Scalia when he sat on the Court of Appeals for the District of Columbia, in the context of a dispute over whether new rates take effect when the FERC issues the order establishing the principles upon which rates should be modified, or later, when the rates developed from application of those principles are actually filed:

The difference between the parties on this central issue boils down to a disagreement over what it means to "fix" a rate within the meaning of 16 U.S.C. § 824e(a). It is uncontested (and uncontestable) that under current FERC practice no numerical rate is specified until after the compliance filing is accepted. *The assumption of the Commission's argument, however, is that to "fix" a rate within the meaning of the statute it is enough to prescribe the legal and accounting principles which, properly applied, will yield one particular rate; whereas petitioners maintain that the statute means what it says, and requires the rate itself to be specified. We agree with petitioners, since we think the provision must be read in light of the Federal Power Act's primary purpose of protecting the utility's customers.* The wholesale purchasers of electricity cannot plan their activities unless they know the cost of what they are receiving, particularly if they are retailers, who must calculate their appropriate resale rates, but also if they are large-scale purchaser-users. *Providing the necessary predictability is the whole purpose of the well established "filed rate" doctrine, which "forbids a regulated entity to charge rates for its services other than those properly filed with the appropriate federal regulatory authority."* In direct frustration of this goal, FERC's new policy of making rates effective as of the date of an order setting forth no more than the basic principles pursuant to which the new rates are to be calculated would make unforeseeable liabilities a regular consequence of rate adjustments under § 206.⁸⁹

Under the SMD regimen, ascertainable rates would never be filed or fixed by the utilities or by the FERC, contrary to the plain language and purpose of the FPA, and thus they suffer from the same infirmity as the inchoate "rates"

88. *Id.* at 61,253. See also *In re California Power Exchange Corp.*, 245 F.3d 1110, 1116 (9th Cir. 2001)(contrasting consequences of reliance on spot purchases with those based on managing risks through long-term contracts); July 25 Order at 61,506 n. 31 (*noting when market-based rates are used, buyers "can predict that rates will fluctuate"*) (emphasis added). On rehearing, the FERC stated that "where market-based rate authority has been granted, the later filing of quarterly reports detailing actual sales made, in conjunction with the earlier-filed umbrella tariff, satisfies all purposes of the filed rate doctrine." *State of Cal., ex rel. Bill Lockyer, Att'y Gen. v. British Columbia Power Exch. Corp.*, 100 F.E.R.C. ¶ 61,295, 61,301 (Sept. 23, 2002). The rehearing decision claims that this subsequent filing of charges collected through the spot markets or contracts, and the subsequent agency review of past rates charged avoids the thrust of *MCI* and *Maislin*. It does not cite *Texaco* and does not address the larger principle of *MCI*, *Maislin*, and *Texaco*, which is that the statute bars market-based rates. The rehearing decision again relies on *Elizabethtown* and *LEPA*, which as demonstrated above, never really decided the issue whether market-based rates are permissible under the FPA. *Id.* at n.9.

89. *Electrical Dist. No. 1 v. FERC*, 774 F.2d 490, 492-93 (D.C. Cir. 1984) (citations omitted) (emphasis added).

invalidated under Justice Scalia's opinion in *Electrical Dist. No. 1*. This failure to file and fix reasonable rates was also a common flaw of each of the deregulatory schemes that were disapproved by the Supreme Court in the *Texaco - Maislin - MCI* trilogy.

VII. CONCLUSION

The FERC's assertion of legal authority to introduce market-based rates is founded on several rulings of the Court of Appeals for the District of Columbia, which upon close review did not actually decide whether market-based rates are permissible under the FPA. The FERC policy is contrary to rulings of the Supreme Court which have not allowed regulatory agencies to lighten statutory requirements upon an agency's finding or prediction that market power is absent or controlled, and market prices will yield just and reasonable rates. Lack of a clear regulatory paradigm is deleterious not only to the electric industry and its finance, but also to consumer interests and the larger societal concerns for reliable electricity provided and priced on a reasonable, stable, and predictable basis. The proposal in the *SMD NOPR* for a nationwide system of market-based rates necessarily must be addressed to Congress. It is possible that Congress will respond with a new regimen to resolve the legal authority issues. After the debacle of California, however, such legislation will need to go much farther than merely ratifying the FERC *SMD NOPR* initiative, and must now take into account issues not previously addressed by the FERC and not fully within its jurisdiction, including: (1) the interests of consumer/voters nationwide; (2) concerns of the bundled retail states over unbundling and federal jurisdiction over all transmission rates; (3) the distinct possibilities that wholesale and retail rates will be driven up, not down, by the FERC's proposed market mechanisms; and (4) the absence of federal universal service policy sufficient to protect low income electricity consumers from market price volatility and market rate increases.

Without a legislative solution, some aggrieved party may bring the issue of the FERC's lack of statutory authority to the Supreme Court, which, if consistent with its earlier precedents, will bring down the agency's alternative market-based rate regimen. A collapse of the market-based rate regimen would again require all the FERC jurisdictional utilities publicly to file their rates, rate changes, and contracts, subject to agency scrutiny for reasonableness and refund, a regulatory system which has endured for decades, and from which consumers and utilities have seen substantial benefits.