MARKET-BASED RATEMAKING AND THE WESTERN ENERGY CRISIS OF 2000 AND 2001

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I. INTRODUCTION

The Federal Energy Regulatory Commission (FERC) has recognized, at least in theory, the inescapable economic truth that competitive electricity markets, like other competitive markets, will experience high prices under conditions of relative scarcity and low prices under conditions of relative abundance. In practice, however, the FERC has not hesitated to impose restraints on sustained high wholesale electricity prices during periods of relative scarcity without considering, much less determining, whether such high prices are inconsistent with the outcome that a competitive market would produce or be expected to produce. There is perhaps no better example of the FERC's apparent cognitive dissonance of the realities of economic scarcity than the various market mitigation measures the FERC imposed as a consequence of the severe and sustained scarcity conditions experienced in and around California during 2000 and 2001.[1] The legal rationale for the FERC's schizophrenic policy throughout the Western energy crisis appears to have been a concern that sustained high wholesale electricity prices, whatever the cause, somehow ran afoul of the FERC's statutory obligation under section 205 of the Federal Power Act (FPA) to ensure that rates are just and reasonable.

The FERC's willingness to modify market outcomes in the name of just and reasonable ratemaking, without regard to whether those outcomes are consistent with what a competitive market would produce, raises two fundamental and interrelated questions. First, as a matter of law, can the FERC rely on the market to set rates for the sale of electricity at wholesale? Second, to the extent that the FERC can lawfully rely on the market to set rates, are such market-based rates deemed to be just and reasonable if they are consistent with the outcomes a competitive market would produce or be expected to produce?

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1. While this article addresses the FERC's market-based rate policies with respect to the area in and around California during 2000 and 2001, the FERC's tortured efforts at market mitigation are by no means limited to this time period or region. The FERC has also had a difficult time establishing market-based rate rules in regional wholesale electricity markets elsewhere that contain localized areas of transmission congestion or "load pockets." On the one hand, the FERC has recognized the need for market-based price signals that reflect localized scarcity conditions and thus create efficient incentives for entry of new supply and/or demand reduction. On the other hand, the FERC has been unwilling to implement market rules that allow market prices within load pockets to rise to scarcity levels, and instead has implemented cost-based bid mitigation for existing generation suppliers. *See, e.g., New England Power Pool*, 102 F.E.R.C. ¶ 61,112 (2003); *Devon Power, L.L.C.*, 103 F.E.R.C. ¶ 61,082 (2003).

As we explain below, the answer to both of these questions is a resounding "yes." The FPA permits the FERC to institute a market-based rate regime for wholesale sales of electricity so long as two conditions are met: (1) the FERC makes a reasoned determination that the relevant market is likely to produce competitive market outcomes; and (2) market participants are provided a means to protect themselves in the future should the FERC's prediction about future market outcomes prove to be incorrect. Since the FERC authorizes an entity to make sales at market-based rates, those rates can and should be deemed to be just and reasonable to the extent that they are consistent with competitive market prices. To presume otherwise would defeat the very purpose of a market-based rate regime and invite the FERC to rely on a legally suspect, hybrid form of market-based and cost-of-service ratemaking that is worse than a retreat to pure cost-of-service ratemaking. As we argue below, that is precisely what the FERC appears to have done in response to the Western energy crisis of 2000 and 2001.

Section II of this article describes the legal basis for the FERC's ratemaking under section 205 of the FPA. In doing so, we describe the evolution of the judicial interpretation of "just and reasonable" rates from a narrowly conceived understanding based on the utility's cost-of-service to a broader view that encompasses rates determined by the market. In section III, we provide a description of the FERC's market-based rate regime, and explain the FERC's consistent defense of its market-oriented approach to ratemaking from both a legal and a policy perspective. In section IV(A), we provide the background of the Western energy crisis of 2000 and 2001, including the various market fundamentals that caused wholesale power prices to rise during this period. In sections IV(B) and (C), we explain how the FERC, through its words, continued to defend its market-based rate policies throughout the Western energy crisis but, in practice, abandoned these policies and imposed cost-based price mitigation. In imposing cost-based price mitigation, the FERC failed to determine that the high prices in and around California during 2000 and 2001 were not the result of a competitive market during conditions of scarcity. In section V of this article, we describe the legal and policy implications of the FERC's abrupt deviation from its established market-based rate policies and its imposition of a hybrid regime under which a seller of electric energy is entitled to receive only the lower of a cost-based rate or the market price.

II. LEGAL BASIS FOR FERC RATEMAKING

Under the FPA, rates and charges for wholesale sales of electric energy must be "just and reasonable"[2] and not "unduly discriminatory or preferential . . . ."[3] The statutory requirement that rates for the FERC jurisdictional sales be just and reasonable prohibits excessive rates. The statutory requirement also has been interpreted, together with the "due process" clause of Fifth and Fourteenth Amendments to the U.S. Constitution, as guaranteeing regulated public utilities an opportunity to recover prudently

2. 16 U.S.C. § 824d(a) (2003).
3. 16 U.S.C. § 824e(a) (2003).

incurred investments and a reasonable return on invested capital.[4] As we explain below, within these confines, the FERC has broad discretion as to the means by which it ensures that rates are just and reasonable, including reliance upon market-based rates.

III. THE EVOLUTION OF JUST AND REASONABLE COST-OF-SERVICE RATES

The concept of just and reasonable rates pre-dates the FPA and its sister statute, the Natural Gas Act (NGA), and has evolved steadily from a very narrowly conceived understanding grounded in the "fair value" of utility assets to a broader view that encompasses not only fixed rates, but also formula and market-based rates. In *Smyth v. Ames*,[5] an 1898 decision reviewing the constitutionality of a Nebraska statute for the regulation of railroads, the Supreme Court described the balance that must be struck in establishing just and reasonable rates without violating the takings clause. The Court explained:

> It cannot be assumed that any railroad corporation, accepting franchises, rights and privileges at the hands of the public, ever supposed that it acquired, or that it was intended to grant to it, the power to construct and maintain a public highway simply for its benefit, without regard to the rights of the public. But it is equally true that the Corporation performing such public services and the people financially interested in its business and affairs have rights that may not be invaded by legislative enactment in disregard of the fundamental guarantees for the protection of property. The corporation may not be required to use its property for the benefit of the public without receiving just compensation for the services rendered by it. How such compensation may be ascertained, and what are the necessary elements in such an inquiry, will always be an embarrassing question.[6]

The *Smyth* Court offered at least a partial answer to this "embarrassing question" in declaring "the basis of all calculations as to the reasonableness of rates to be charged by a corporation maintaining a highway under legislative sanction must be the *fair value* of the property being used by it for the convenience of the public."[7]

The Supreme Court elaborated upon the rights of the regulated utility in *Bluefield Water Works and Improvement Co. v. Public Service Commission*, stating: "Rates which are not sufficient to yield a reasonable return on the value of property used at the time it is being used to render the service are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility

4. Duquesne Light Co. v. Barasch, 488 U.S. 299, 310 (1989); FPC v. Hope Natural Gas Co., 320 U.S. 591, 603, 605 (1944); Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n, 262 U.S. 679, 692-93 (1923).

5. Smyth v. Ames, 169 U.S. 466 (1898).

6. *Id.* at 546. *See also* Munn v. Ill., 94 U.S. 113, 127-28 (1876) (quoting Aldnutt v. Inglis, 12 East 527 (1810)):

> There is no doubt that the general principle is favored, both in law and justice, that every man may fix what price he pleases upon his own property, or the use of it; but if for a particular purpose the public have a right to resort to his premises and make use of them, and he have a monopoly in them for that purpose, if he will take the benefit of that monopoly, he must, as an equivalent, perform the duty attached to it on reasonable terms.

7. *Smyth*, 169 U.S. at 546 (emphasis added).

company of its property in violation of the Fourteenth Amendment."[8] The Court further explained:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.[9]

At the same time, there was some question as to the continued reliance on the "fair value" standard enunciated in *Smyth*. Justice Brandeis concurred in the *Bluefield* decision by means of a concurring statement in *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*,[10] in which he and Justice Holmes opined that "[t]he so-called rule of [*Smyth*]" was "legally and economically unsound"[11] because:

> The rule of *Smyth v. Ames* set[] the laborious and baffling task of finding the present value of the utility. It is impossible to find an exchange value for a utility, since utilities, unlike merchandise or land, are not commonly bought and sold in the market. Nor can the present value of the utility be determined by capitalizing its net earnings, since the earnings are determined, in large measure, by the rate which the company will be permitted to charge; and, thus, the vicious cycle would be encountered. So, under the rule of [*Smyth*], it is usually sought to prove the present value of a utility by ascertaining what it actually cost to construct and instal [*sic*] it; or by estimating what it should have cost; or by estimating what it would cost to reproduce, or to replace, it.[12]

Ultimately, Justices Brandeis and Holmes concluded that the fair value standard left little room for meaningful judicial review, because it "not only fail[ed] to furnish any applicable standard of judgment, but direct[ed] consideration of so many elements, that almost any result may be justified."[13]

Twenty-one years after *Bluefield*, in *Federal Power Commission v. Hope Natural Gas Co.*, the Court effectively abandoned the *Smyth* fair value standard in favor of a more flexible, result oriented approach for determining the justness and reasonableness of rates. After observing that Congress, in enacting the NGA, "ha[d] provided no formula by which the 'just and reasonable' rate is to be determined,"[14] the Court stated:

> The fixing of prices, like other applications of the police power, may reduce the value of the property which is being regulated. But the fact that the value is reduced does not mean that the regulation is invalid. It does, however, indicate that "fair value" is the end product of the process of rate-making not the starting

8. *Bluefield*, 262 U.S. at 690.
9. *Id.* at 692-93.
10. Missouri ex rel. Southwestern Bell Tel. Co. v. Pub. Serv. Comm'n, 262 U.S. 276 (1923).
11. *Id.* at 290.
12. *Missouri*, 262 U.S. at 292-93 (emphasis added).
13. *Id.* at 297-98.
14. FPC v. Hope Natural Gas Co., 320 U.S. 591, 600 (1944).

> point as the [lower court] held. The heart of the matter is that rates cannot be made to depend upon "fair value" when the value of the going enterprise depends on earnings under whatever rates may be anticipated.[15]

The Court went on to explain:

> It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the [NGA] is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.[16]

On that basis, the Court stated that it is not "important to this case to determine the various permissible ways in which any rate base on which the return is computed might be arrived at" because "the *end result* in this case cannot be condemned under the [NGA] as unjust and unreasonable . . . ."[17] Subsequent decisions, most notably the Court's 1989 decision in *Duquesne*, have placed additional emphasis on the principle that a rate methodology cannot be "examined piecemeal" but rather that "[t]he overall impact of the rate orders" on the utility matters from a constitutional perspective.[18]

With the effective abandonment of the fair value standard in *Hope*,[19] the courts have recognized an ever-increasing number of ways by which just and reasonable rates may be established. For example, in *In re Permian Basin Area Rate Cases*,[20] the Supreme Court reviewed a series of orders in which the FERC's predecessor, the Federal Power Commission (FPC), established maximum rates for natural gas production. The FPC based these rates on producing areas instead of attempting to evaluate each producer's cost-of-service.[21] The Court reiterated that the NGA does not require the FPC "to adopt as just and reasonable any particular rate level" and that "courts are without authority to set aside any rate selected by the [FPC] which is within a 'zone of reasonableness.'"[22] Applying this standard, the Court found that the FPC had not abused or exceeded its authority in adopting a system of area ratemaking.[23]

IV. THE ADVENT OF MARKET-BASED RATES

As stated above, section 205 of the FPA does not require that the FERC rely exclusively on an individual public utility's cost-of-service, or otherwise

15. *Id.* at 601 (citations omitted).

16. *Hope*, 320 U.S. at 602.

17. *Id.* at 603 (emphasis added).

18. Duquesne Light Co. v. Barasch, 488 U.S. 299, 312-13 (1989).

19. Farmers Union Cent. Exch. v. FERC, 584 F.2d 408, 414 (D.C. Cir. 1978) (explaining that, in *Hope*, "the Supreme Court decisively reversed its field and became openly critical of talismanic reliance on 'fair value'").

20. *In re* Permian Basin Area Rate Cases, 390 U.S. 747 (1968).

21. The Court noted that "the administrative burdens placed upon the [FPC] by an individual company costs-of-service standard were . . . extremely heavy." *Id.* at 757. Indeed, the FPC had "stated . . . that 'if our present staff were immediately tripled, and if all new employees would be as competent as those we now have, we would not reach a current status in our independent producer rate work until 2043 A.D.–eighty two and one half years from now.'" *Permian Basin*, 390 U.S. at 757 n.13 (citation omitted).

22. *Permian Basin*, 390 U.S. at 767.

23. *Id.* at 789-90.

prescribe a single means by which the FERC is to ensure that rates are "just and reasonable." Some have argued, however, that this ratemaking flexibility does not go so far as to permit the FERC to use markets as a lawful substitute for rate regulation.[24] This argument seems to be without substantive legal basis. As discussed below, the courts have held that the FERC may rely on market forces to ensure that prices satisfy the statutory standard of just and reasonable rates, provided that (1) the FERC makes the necessary determination that the market is likely to produce outcomes that are consistent with what a competitive market would produce, or would be expected to produce, and (2) market participants are provided a means of prospective redress should the market prove to be uncompetitive in the future.

A. Texaco

In the 1974 decision, *FPC v. Texaco, Inc.*,[25] the Supreme Court reviewed the decision of the U.S. Court of Appeals for the District of Columbia Circuit, setting aside an order of the FPC that exempted all existing and future sales by "small producers" of natural gas from direct regulation under section 4 of the NGA.[26] In the order under review, the FPC insisted that its approach did not constitute deregulation of sales by small producers because the FPC would continue to regulate such sales indirectly through its regulation of the pipelines and large producers to which small producers sell their natural gas.[27] While emphasizing that the FPC possesses "great discretion as to how to insure just and reasonable rates," the Court remanded the case for further proceedings based on the FPC's failure to make clear that it was not exempting small producers from the statutory requirement that rates be "just and reasonable."[28]

As a threshold matter, the Court found "nothing in the [NGA] which requires the [FERC] fix the rates chargeable by small producers by orders directly addressed to them or which proscribes the kind of indirect regulation undertaken here."[29] To the contrary, the Court explained:

> The [NGA] directs that all producer rates be just and reasonable but it does not specify the means by which that regulatory prescription is to be attained. That every rate of every natural gas company must be just and reasonable does not require that the cost of each company be ascertained and its rates fixed with respect to its own costs.[30]

The Court then turned to the question of whether the underlying FPC order was "invalid for failure to comply with the [NGA]'s requirement that the sale

24. Gerald Nordlander, *May the FERC Rely on Markets to Set Electric Rates?*, 24 ENERGY L.J. 65, 66-67 (2003) (arguing that the FERC's market-based rate regime "conflicts with the statutory duty of FERC jurisdictional utilities publicly to file schedules of reasonable rates demanded and charged under [s]ection 205 of the FPA, and deviates from the process prescribed by statute for remedying undue discrimination and fixing by the agency of non-discriminatory, reasonable rates under [s]ection 206 of the FPA.")

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

26. *Id.* at 394.

27. *Texaco*, 417 U.S. at 384.

28. *Id.* at 394-96.

29. *Texaco*, 417 U.S. at 387.

30. *Id.* at 394.

price for gas sold in interstate commerce be just and reasonable."[31] In this regard, the Court concluded that, "[a]t the very least, the order is so ambiguous that it falls short of that standard of clarity that administrative orders must exhibit."[32] The FPC's order "d[id] not expressly mention the just-and-reasonable standard."[33]

The Court responded to the "implication" of the FPC's order "that reasonableness would be judged by the standard of the marketplace"[34] by making clear that, for purposes of the remand proceedings:

> [T]he prevailing price in the marketplace cannot be the final measure of 'just and reasonable' rates mandated by the [NGA]. It is abundantly clear from the history of the [NGA] 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. Hence, the necessity for regulation . . . .[35]

The Court concluded, however, that while reference to the market does not conclusively establish just and reasonable rates, "[t]his does not mean that the market price of gas would never, in an individual case, coincide with just and reasonable rates . . . ."[36]

B. Pennzoil

In its 1979 decision, *FERC v. Pennzoil Producing Co.*,[37] the Supreme Court responded to an apparent misapprehension on the part of the FERC that *Texaco* prevented the FERC from relying upon market forces to set rates. In the orders under review in *Pennzoil*, the FERC declined to grant individualized relief from the effect of area rates where the affected producers sought relief based on their payments of royalties tied to the "market value" or "market price" of natural gas.[38] The Court read the FERC's orders as suggesting that, under *Texaco*, the FERC "is 'not free' and that 'it does not have the power' to give individualized relief where escalating royalty costs are a function of, or are otherwise based upon, an unregulated market price for the product the sale of which in the interstate market is regulated by the [FERC]."[39] The Court explained that this interpretation of *Texaco* was erroneous, and that *Texaco* did not hold that the FERC did not have the "authority to permit rate increases based on royalty costs tied to the unregulated market for natural gas."[40] Rather, the Court explained, its

> concern in *Texaco* was that rates of small producers might be totally exempted from the [NGA], and we did not indicate that producer or pipeline rates would be *per se* unjust and unreasonable because related to the unregulated price of natural

31. FPC v. Texaco, Inc., 417 U.S. 380, 394 (1974).
32. *Id.* at 395-96.
33. *Texaco*, 417 U.S. at 396.
34. *Id.*
35. *Texaco*, 417 U.S. at 398 (footnote omitted).
36. *Id.* at 398-99 (citations omitted).
37. FERC v. Pennzoil Producing Co., 439 U.S. 508 (1979).
38. *Id.* at 508.
39. *Pennzoil*, 439 U.S. at 516. (footnote omitted).
40. *Id.* at 516.

> gas. *Texaco* did not purport to circumscribe so severely the [FERC]'s discretion to decide what formulas and methods it will employ to ensure just and reasonable rates. Indeed, the decision underscored the wide discretion vested in the [FERC].[41]

C. Farmers Union

In its 1984 decision, *Farmers Union Central Exchange, Inc. v. FERC*,[42] the U.S. Court of Appeals for the District of Columbia Circuit reviewed a FERC order specifying a generic ratemaking methodology for oil pipelines regulated under the Interstate Commerce Act (ICA). In the underlying order, the FERC had not made any determination that the market for oil transportation was workably competitive. Nevertheless, the FERC adopted a generic ceiling rate that, in the FERC's words, would ensure "creamy returns" to oil pipelines.[43] The *Farmers Union* court found that the FERC's order "contravenes its statutory responsibility to ensure that oil pipeline rates are 'just and reasonable.'"[44]

The court stressed that, while the "FERC enjoys substantial discretion in its ratemaking determinations . . . , this discretion must be bridled in accordance with the statutory mandate that the resulting rates be 'just and reasonable.'"[45] While acknowledging that "[t]he 'just and reasonable' statutory standard is . . . not very precise, and does not unduly confine FERC's ratemaking authority,"[46] the court did not find the standard so flexible as to permit the FERC to concern itself solely with "'*egregious* exploitation and *gross* abuse,'" and "'*gross* overreaching and *unconscionable* gouging . . . .'"[47] The court also rejected the FERC's interpretation of the legislative history of the ICA as justifying an interpretation of the just and reasonable standard under the ICA as "requir[ing] far less stringent rate regulation than the same statutory standard requires for other regulated industries . . . ."[48]

The *Farmers Union* court found that the FERC, in relying on its own conclusions that "oil pipeline rate regulation is (1) unimportant to consumers at large, and (2) best left to 'regulation' by market forces in most cases," had "improper[ly] depart[ed] from the basic congressional mandate to ensure that oil pipeline charges are 'just and reasonable.'"[49] While the court did not rule out the possibility that market forces could ensure that rates would satisfy the just and reasonable standard, it found that in this instance the FERC's reliance on market

41. *Pennzoil*, 439 U.S. at 516-17 (citing *Texaco*, 417 U.S. at 387). The Court's reading of its *Texaco* holding in *Pennzoil* stands in stark contrast to the views of some commentators that *Texaco* stands for the proposition that the FERC cannot rely on the market to set just and reasonable rates. Nordlander, *supra* note 24, at 78-79. Interestingly, Nordlander's article does not cite, much less discuss, *Pennzoil*.

42. Farmers Union Cent. Exch., Inc. v. FERC, 734 F.2d 1486 (D.C. Cir. 1984).

43. *Id.* at 1497.

44. *Farmers Union*, 734 F.2d at 1490.

45. *Id.* at 1501 (citing *Texaco*, 417 U.S. at 394 (1974); Atchison, Topeka & Santa Fe Ry. Co. v. Wichita Bd. of Trade, 412 U.S. 800, 806 (1973)).

46. *Farmers Union*, 734 F.2d at 1501.

47. *Id.* at 1502 (citations omitted) (quoting *Williams Pipe Line Co.*, 21 F.E.R.C. ¶ 61,260, 61,649, 61,597 (1982)) (emphasis added).

48. Farmers Union Cent. Exch., Inc. v. FERC, 734 F.2d 1486, 1503 (D.C. Cir. 1984).

49. *Id.* at 1501.

forces as the principal means of rate regulation was "misplaced."[50] The court explained that under the FERC's order there would be

> a range of permissible prices that would exceed the "zone of reasonableness" by definition, unless competition in the oil pipeline market drives the actual prices back down into the zone. But *nothing in the regulatory scheme itself acts as a monitor to see if this occurs or to check rates if it does not. That is the fundamental flaw in the [FERC]'s scheme.*
>
> Congress may indeed have imposed the requirement that rates be "just and reasonable" in order to restore the "true" market price – the price that would result through the mechanism of a truly competitive market – for purchasers of the regulated service or goods. In setting extraordinarily high price ceilings as a substitute for close regulation, FERC assumed that, with the wide exposed zone between the ceiling and the "true" market rate, existing competition would ensure that the actual price is just and reasonable. Without empirical proof that it would, this regulatory scheme, however, runs counter to the basic assumption of statutory regulation, that "Congress rejected the identity between the 'true' and the 'actual' market price."[51]

The *Farmers Union* court emphasized that a "[m]ov[e] from heavy to lighthanded regulation within the boundaries set by an unchanged statute can, of course, be justified by a showing that under current circumstances the goals and purposes of the statute will be accomplished through substantially less regulatory oversight."[52] For example, the court indicated that a regulatory scheme to ensure competition in the oil pipeline market could keep rates within the zone of reasonableness, which defines just and reasonable rates. Still, the lack of a regulatory scheme to ensure such competition meant that the FERC could not show that the rates, which resulted from its newly articulated ratemaking principles, could and would be contained within the zone of reasonableness.

D. Elizabethtown

In its 1998 decision, *Elizabethtown Gas Co. v. FERC*,[53] the U.S. Court of Appeals for the District of Columbia Circuit clarified the meaning of *Texaco* and the requirements of *Farmers Union*. In *Elizabethtown*, the court reviewed a series of FERC orders that approved restructuring settlements by which a pipeline, regulated under the NGA, unbundled its natural gas transportation and sales services. In approving the settlement, "the FERC authorized [the pipeline] in advance 'to establish and to change' individually negotiated rates free of customer challenge under section 4 of the NGA" with further review available only under section 5 of the NGA.[54]

The court specifically rejected petitioners' arguments that, under *Texaco*,

50. *Farmers Union*, 734 F.2d at 1508.

51. *Id.* at 1509-10 (emphasis added) (citations omitted) (citing FPC v. Texaco, Inc., 417 U.S. 380, 397-98 (1974); FPC v. Sunray DX Oil Co., 391 U.S. 9, 25 (1968); Texaco, Inc. v. FPC, 474 F.2d 416, 422 (D.C. Cir. 1972)).

52. *Farmers Union*, 734 F.2d at 1510 (citation omitted) (citing Black Citizens for a Fair Media v. FCC, 719 F.2d 407, 413 (D.C. Cir. 1983)).

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

54. *Id.* at 869. In relevant part, sections 4 and 5 of the NGA are substantively identical to sections 205 and 206 of the FPA, respectively.

the FERC could not approve market-based pricing for natural gas sales regulated under section 4 of the NGA, but instead "was required to adhere to its historical policy of basing rates upon the cost of providing service plus a fair return on invested capital."[55] According to the court, *Texaco* does not preclude the FERC from using market-based ratemaking:

> The Supreme Court's point in [*Texaco*] 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 [FERC] 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 [section] 5 authority . . . to assure that a market (*i.e.*, negotiated) rate is just and reasonable.[56]

As to the assertion that the FERC could not depart from cost-of-service ratemaking, the *Elizabethtown* court explained:

> The Supreme Court "has repeatedly held that the just and reasonable standard does not compel the [FERC] 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-service regulation to assure a "just and reasonable" result.[57]

In *Elizabethtown*, the court said the FERC had "specifically found that '[the pipeline]'s markets are sufficiently competitive to preclude it from exercising significant market power in its merchant function . . . .'"[58] Because "[i]t appear[ed] . . . that [the pipeline] w[ould] not be able to raise its price above the competitive level without losing substantial business to rival sellers," the court added, there was "strong reason to believe that [the pipeline] w[ould] be able to charge only a price that is 'just and reasonable' within the meaning of [section] 4 of the NGA."[59]

E. Louisiana Energy

In its 1998 decision in *Louisiana Energy and Power Authority v. FERC*,[60] the U.S. Court of Appeals for the District of Columbia Circuit applied *Elizabethtown* when it rejected a challenge to FERC orders authorizing market-based rate sales of electric power. At the outset, the court made it clear that, "[w]here 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 th[e] requirement" of section 205 of the FPA that "all rates demanded by public utilities for the transmission or sale of electric energy be 'just and reasonable.'"[61]

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

56. *Id.* (quoting FPC v. Texaco, Inc., 417 U.S. 380, 396-97, 399 (1974)) (citations omitted).

57. *Elizabethtown*, 10 F.3d at 870 (citation omitted) (quoting Mobil Oil Exploration v. United Distrib. Co., 498 U.S. 221, 224 (1991)).

58. *Id.* at 870-71 (quoting Transcontinental Gas Pipe Line Corp., 55 F.E.R.C. ¶ 61,446, 62,334 (1991)).

59. Elizabethtown v. FERC, 10 F.3d 866, 871 (D.C. Cir. 1993).

60. Louisiana Energy & Power Auth. v. FERC, 141 F.3d 364 (D.C. Cir. 1998).

61. *Id.* at 365 (citing *Elizabethtown*, 10 F.3d at 870) (citation omitted). The petitioner did "not challenge FERC's general policy of permitting market-based rates in the absence of market power." *Louisiana Energy*, 141 F.3d at 366 n.2.

In granting market-based rate authorization, the FERC determined that the seller "lacked market power in the generation of electric energy, and that by filing an open-access transmission tariff . . ., [the seller] mitigated its market power over transmission."[62] The court found the FERC's conclusions in this regard to be reasonable.[63]

In addition, the court accepted the FERC's reliance on future complaint proceedings under section 206 of the FPA as a means of protecting buyers in the event that the FERC's "sanguine predictions about market conduct turn out to be incorrect . . . ."[64] The court stated that

> [w]hile this escape hatch might be insufficient if [petitioner] had shown a substantial likelihood that FERC's predictions [regarding the ability of the seller to exercise market power in generation or transmission] would prove incorrect, it provides an appropriate safeguard against the uncertainties of FERC's prognostications where there has been no such showing.[65]

F. Grand Council

In its 2000 decision in *Grand Council of the Crees v. FERC*,[66] the U.S. Court of Appeals for the District of Columbia Circuit again discussed the breadth of the FERC's market-based ratemaking authority and the relevance of the *Hope* case in a market-based rate regime. In examining the petitioner's standing to seek review of FERC orders granting market-based rate authority to a Canadian company, the court, citing *Hope*, reiterated that the FERC was "'not bound to the use of any single formula or combination of formulae in determining rates.'"[67] Rather, the court explained that

> "[t]he fixing of 'just and reasonable' rates[ ] involves a balancing of the investor and the consumer interests." Both interests . . . are tied directly to the transaction regulated: "the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated," while there is a "consumer interest in being charged non-exploitative rates."[68]

The court also suggested that a "grant of ratemaking authority stem[ming] from congressional concern over market power" like that in the FPA, "justifies the agency's relaxing its grip when such power is absent . . . ."[69]

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62. *Louisiana Energy*, 141 F.3d at 369.

63. *Id.* at 370.

64. *Louisiana Energy*, 141 F.3d at 370. Section 206 of the FPA provides that if the FERC determines that a rate that had been determined to be just and reasonable is unjust or unreasonable, the FERC shall "determine the just and reasonable rate . . . to be thereafter observed . . . ." 16 U.S.C. § 824e(a) (2003).

65. Louisiana Energy and Power Auth. v. FERC, 141 F.3d 364, 370-371 (D.C. Cir. 1998) (footnotes omitted).

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

67. *Id.* at 956 (quoting FPC v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944)).

68. *Grand Council*, 198 F.3d at 956 (citations omitted) (citing *Hope,* 320 U.S. at 602; Jersey Cent. Power & Light Co. v. FERC, 810 F.2d 1168, 1178 (D.C. Cir. 1987)).

69. *Id.* (citing Tejas Power Corp. v. FERC, 908 F.2d 998, 1004 (D.C. Cir. 1990)).

> In a competitive market, where neither buyer nor seller has significant market power, it is rational to assume that the terms of their voluntary exchange are reasonable, and specifically to infer that price is close to marginal cost, such that the seller makes only a normal return on its investment.

Grand Council, 198 F.3d at 956 (quoting *Tejas Power*, 908 F.2d at 1004).

V. THE FERC HAS CONSISTENTLY AND VIGOROUSLY DEFENDED ITS MARKET-BASED RATE REGIME FROM BOTH A LEGAL AND A POLICY PERSPECTIVE

A. Overview of the FERC's Market-Based Rate Regime

Under the FERC's existing market-based rate regime, the FERC grants a public utility the blanket authorization to make wholesale sales of electric energy at market-based rates if the utility can demonstrate that it "and its affiliates do not have, or adequately have mitigated, market power in the generation and transmission of . . . energy . . . ."[70] An applicant for market-based rate authorization must also demonstrate that neither it, nor its affiliates, control any inputs to power production that would permit it to erect barriers to market entry by its competitors.

The FERC's involvement does not end once the FERC grants a public utility market-based rate authorization. Rather, the FERC retains "general oversight" over the utility to ensure that market pricing is in fact producing rates that are consistent with a competitive market.[71] In fact, the FERC may revoke a utility's market-based rate authorization if the utility subsequently develops the ability to exercise market power or erect barriers to market entry.[72] As noted earlier, the *Louisiana Energy* court accepted the FERC's reliance on future complaint proceedings under section 206 of the FPA as a means of protecting buyers in the event that the [FERC]'s "sanguine predictions about market conduct turn out to be incorrect . . . ."[73] To perform its oversight function, the FERC requires each utility with market-based rate authorization "to inform the [FERC] . . . of any change in status that would reflect a departure from the characteristics the [FERC] has relied upon in approving market-based pricing"[74] or "to report such changes every three years in conjunction with an updated market analysis."[75] Additionally, the FERC requires sellers with market-based rate authority to provide data on individual market-based transactions on a quarterly basis.[76]

In the context of evaluating whether market pricing is in fact producing rates that are consistent with a competitive market, the FERC has expressed the necessity of distinguishing "between the exercise of . . . market power and true scarcity pric[ing] when demand is high."[77] Scarcity pricing refers to the concept "that, during shortages, the prices for energy should rise to reflect supply scarcity

70. Louisiana Energy and Power Auth. v. FERC, 141 F.3d 364, 365 (D.C. Cir. 1998) (footnote omitted) (citing *Heartland Energy Servs., Inc.*, 68 F.E.R.C. ¶ 61,223, at 62,060 (1994)).

71. Interstate Natural Gas Ass'n v. FERC, 285 F.3d 18, 31, 34 (D.C. Cir. 2002).

72. *AEP Power Mktg., Inc.*, 97 F.E.R.C. ¶ 61,219, 61,969 (2001).

73. *Louisiana Energy*, 141 F.3d at 370.

74. *Heartland Energy Servs., Inc.*, 68 F.E.R.C. ¶ 61,223, 62,066 (1994).

75. *Delmarva Power & Light Co.*, 76 F.E.R.C. ¶ 61,331, 62,584 (1996).

76. Order No. 2001, *Revised Public Util. Filing Requirements*, F.E.R.C. STATS. & REGS. ¶ 31,127, 67 Fed. Reg. 31,043 (2002), *order on reh'g*, 100 F.E.R.C. ¶ 61,074 (2002), *order on reh'g*, 100 F.E.R.C. ¶ 61,342 (2002).

77. *California Indep. Sys. Operator Corp., Investigation of Wholesale Rates of Public Util. Sellers of Energy & Ancillary Servs. in the W. Elec. Coordinating Council*, 100 F.E.R.C. ¶ 61,060, 61,246 (2002).

to encourage reductions in demand and additional investment in supply."[78] The FERC cautioned through a 2002 Notice of Proposed Rulemaking (SMD NOPR) that "[i]f some degree of scarcity pricing is not allowed, and generation only recovers short-term marginal costs, then some generators needed for reliability could fail to recover their full costs and may be retired."[79] The FERC has further warned that, in the absence of scarcity pricing, "prices could be held so low that investors decline to invest in needed generation, transmission and demand-side projects because they do not see a reasonable expectation of recovering their costs."[80]

VI. THE FERC HAS CONSISTENTLY SUPPORTED MARKET-BASED RATEMAKING FOR WHOLESALE SALES OF ELECTRIC ENERGY

Beginning with its earliest orders, which granted to individual sellers the blanket authority to sell electric energy at wholesale at market-based rates, the FERC has consistently defended the lawfulness of its market-based ratemaking policies under the FPA. Further, the FERC has emphasized the policy advantages of such an approach over traditional cost-of-service ratemaking. The FERC has stated that it "has the authority to approve market-based rates. The only predicate that the courts and the [FERC] have determined is required is a showing that the regulated company lacks market power or specific conditions will sufficiently mitigated [*sic*] that power."[81] The FERC has approved "market-oriented" rates only when it has found "that [the seller] has characteristics that provide us with sufficient assurance that it lacks market power and that its rates will fall within a zone of reasonableness."[82] More recently, the FERC has concluded that the "view that only cost-based or formula rate models satisfy the [section 205] statutory framework fundamentally misapprehends the [FERC]'s ratemaking authority."[83] The FERC explained:

> 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 [section] 205(e) standard that use of market-based rates by a seller is just and reasonable.[84]

Similarly, the FERC has consistently supported the concept of market-based ratemaking for wholesale sales of electric energy from a policy perspective by

78. *Midwest Indep. Transmission Sys. Operator, Inc.*, 102 F.E.R.C. ¶ 61,280, 61,884 (2003).

79. Notice of Proposed Rulemaking, *Remedying Undue Discrimination Through Open Access Transmission Serv. & Standard Elec. Mkt. Design*, F.E.R.C. STATS. & REGS. ¶ 32,563, 34,365 (2002), 67 Fed. Reg. 58,751 (proposed Sept. 18, 2002) (to be codified at 18 C.F.R. pt. 35) [hereinafter *SMD NOPR*].

80. *Id.*

81. *KN Interstate Gas Transmission Co.*, 76 F.E.R.C. ¶ 61,134, 61,726 (1996) (citing Elizabethtown Gas Co. v. FERC, 10 F.3d 866, 870 (D.C. Cir. 1993)).

82. *Citizens Power & Light Corp.*, 48 F.E.R.C. ¶ 61,210, 61,776 (1989). The seller in *Citizens* was authorized to make sales at freely negotiated rates subject to a requirement that the buyer certify that the sales price was below its avoided cost. *Id.* at 61,779.

83. *California ex rel. Bill Lockyer, Attorney Gen.*, 99 F.E.R.C. ¶ 61,247, 62,062 (2002), *reh'g denied*, 100 F.E.R.C. ¶ 61,295 (2002).

84. *Id.* (citations omitted).

maintaining that the "'benefit of a competitive market is that it enhances efficiency.'"[85] Early in the process of formulating its market-based ratemaking rules and procedures, the FERC concluded that "[t]raditional cost-of-service rate regulation is not always adequate to meet these needs [for new generation supply] 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."[86] The FERC has further determined that "the growing presence of independent power generators has led to highly efficient new capacity coming on line. The evidence is clear that market incentives can lead to highly efficient plant operations."[87]

VII. THE FERC'S MARKET-BASED RATEMAKING IN THE CONTEXT OF THE WESTERN ENERGY CRISIS OF 2000-2001

A. Background of the Western Energy Crisis

Beginning in the summer of 2000 and continuing into early 2001, the West, in particular California, experienced severe and sustained scarcity conditions in its electricity and natural gas markets, which resulted in power blackouts and associated service interruptions for commercial and industrial customers.[88] During the same period, the wholesale power prices skyrocketed in spot markets in and around California, which threatened the financial viability of California's two largest investor-owned utilities.[89] As indicated in a FERC staff report, prepared in the fall of 2000 and released on November 1, 2000,[90] "a general scarcity of power in the West and increased costs to produce power were factors causing these high prices."[91] The November 1, 2000 Staff Report also indicated that the market rules for the organized, bid-based spot markets administered by the California Power Exchange Corporation (the Cal PX) and the California Independent System Operator Corporation (the Cal ISO), "exacerbated the situation and contributed to the high prices."[92]

In a series of orders issued in *San Diego Gas and Electric Co.* (the Western Refund Proceeding),[93] the FERC attempted to grapple with the dramatic and

85. *City of Corona v. Edison Co.*, 101 F.E.R.C. ¶ 61,240, 62,027 n.16 (2002) (quoting *Public Serv. Co.*, 49 F.E.R.C. ¶ 61,346, at 62,243 (1989)). "[E]nhancing efficiency, by competition, can help achieve the goal of ensuring the lowest cost energy to consumers in the long run, consistent with reliable service." *Id.* (citing *Public Serv. Co.*, 25 F.E.R.C. ¶ 61,469 (1983)).

86. *Entergy Servs., Inc.*, 58 F.E.R.C. ¶ 61,234, 61,753 (1992).

87. Notice of Proposed Rulemaking, *Regional Transmission Organizations*, F.E.R.C. STATS. & REGS. ¶ 32,541 (1999), 64 Fed. Reg. 31,389 (proposed May 13, 1999) (to be codified at 18 C.F.R. pt. 35).

88. Nicholas W. Fels & Frank R. Lindh, *Lessons from the California "Apocalypse:" Jurisdiction Over Electric Utilities*, 22 ENERGY L.J. 1, 11-12 (2001); Michael A. Yuffee, *California's Electricity Crisis: How Best to Respond to the "Perfect Storm,"* 22 ENERGY L.J. 65 (2001).

89. Fels & Lindh, *supra* note 88, at 11-12.

90. Staff Report to the Federal Energy Regulatory Commission on Western Markets and the Causes of the Summer 2000 Price Abnormalities, No. 144196[1] (Nov. 1, 2000), *available at* http://www.ferc.gov/industries/electric/Indus-act/wem/2000-4.asp (last visited Oct. 5, 2003) [hereinafter November 1 Staff Report].

91. *Id.* at 1-4.

92. November 1 Staff Report, *supra* note 90, at 1-4.

93. *San Diego Gas & Elec. Co.* 93 F.E.R.C. ¶ 61,121 (2000) [hereinafter November 1, 2000 Order]; *San*

sustained increases in wholesale power prices, which occurred in and around California from mid-May of 2000 through early June of 2001. In the November 1, 2000 Order in the Western Refund Proceeding, which was issued concurrently with the release of the November 1, 2000 Staff Report, the FERC emphasized that the wholesale electricity markets in the West during the summer of 2000 "exhibited certain market fundamentals that would be expected to cause prices to rise."[94] The FERC then specifically enumerated the following "market fundamentals" that affected the Cal ISO and Cal PX spot markets:

> Input costs increased as the cost of fuel, emission credits and O&M expenses increased. Sustained demand increased, requiring increased reliance on generating resources that would have been more expensive to operate even if input prices had not increased. Conditions in the Northwest decreased amounts of hydropower supply usually available to the market which, combined with a failure to bring new generation into service over the last decade, resulted in a true scarcity of generation.[95]

With the presence of such market fundamentals, the FERC added, "prices are expected to rise – and indeed they must rise to induce the investment in new capacity that is needed to serve customers adequately."[96] The FERC also suggested that these market fundamentals, together with the "dysfunctional market rules" of the Cal PX and Cal ISO, impacted spot market prices because they "may [have] permit[ted] sellers to exercise market power."[97] The FERC subsequently reaffirmed its view that the combination of market fundamentals and defective market rules and structures drove high and volatile spot market prices throughout the crisis period.[98] As discussed below, the FERC never found, during the Western energy crisis, that any individual seller possessed or exercised market power, or that market-based rates exceeded the prices that would have been expected in a competitive market under conditions of scarcity.[99]

B. By its Words, the FERC Continued to Defend its Market-Based Rate Regime Throughout the Western Energy Crisis

Throughout the Western energy crisis of 2000 and 2001, the FERC staunchly defended its market-based rate regime, as applied to the wholesale markets in and around California, concluding that it remained "free to adopt market-based rates" and even a flawed market structure does not demand a return

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Diego Gas & Elec. Co., 93 F.E.R.C. ¶ 61,294, 61,981 (2000) [hereinafter December 15, 2000 Order]; *San Diego Gas & Elec. Co.*, 94 F.E.R.C. ¶ 61,245 (2001) [hereinafter March 9, 2001 Order]; *San Diego Gas & Elec. Co.*, 95 F.E.R.C. ¶ 61,115 (2001) [hereinafter April 26, 2001 Order]; *San Diego Gas & Elec. Co.*, 95 F.E.R.C. ¶ 61,418 (2001) [hereinafter June 19, 2001 Order]; *San Diego Gas & Elec. Co.*, 96 F.E.R.C. ¶ 61,120 (2001) [hereinafter July 25, 2001 Order]; *San Diego Gas & Elec. Co.*, 97 F.E.R.C. ¶ 61,293 (2001) [hereinafter December 19, 2001 Order]; *San Diego Gas & Elec. Co.*, 99 F.E.R.C. ¶ 61,160 (2002) [hereinafter May 15, 2002 Order]; *San Diego Gas & Elec. Co.*, 102 F.E.R.C. ¶ 61,317 (2003) [hereinafter March 26, 2003 Order].

94. November 1, 2000 Order, *supra* note 93, at 61,358.

95. *Id.* at 61,358-59 (footnotes omitted).

96. November 1, 2000 Order, *supra* note 93, at 61,359.

97. *Id.* at 61,359.

98. April 26, 2001 Order, *supra* note 93, at 61,354; December 19, 2001 Order, *supra* note 93, at 61,218.

99. December 15, 2000 Order, *supra* note 93, at 61,981.

to cost-of-service ratemaking.[100] The FERC explained:

> In adopting market-based rates, the [FERC] must: (1) provide a clear and reasoned analysis of the need for market-based pricing to promote the statutory objectives of the FPA; (2) support its decision with substantial evidence; and (3) assure that the resultant market-based rate falls within a "zone of reasonableness." Having adopted a market-based approach for the California market, nothing requires the [FERC] to revert to a cost-of-service ratemaking approach whenever it finds flaws in the market structure.[101]

The FERC further recognized in the Western Refund Proceeding that high power prices in a market-based rate regime were not, in and of themselves, unjust and unreasonable, and that high scarcity prices may, in fact, have been necessary to attract investment in generation infrastructure. For example, the FERC explained in its November 1, 2000 Order that historically, prior to the introduction of competitive electricity markets, "[t]he need to ensure an adequate supply of generation usually was met through requirements imposed by states on franchise utilities to build or buy adequate power resources to meet demand consistently."[102] The FERC contrasted this traditional command-and-control approach to generation supply with the current market-based approach:

> Today, however, in states such as California, the adequacy of local power resources depends, not just on state requirements, but also on whether market prices are sufficient to elicit adequate supplies, through construction or otherwise. In other words, when supply is driven by market price instead of regulatory requirements, ratepayer interests may no longer depend solely on whether current prices are deemed too high, but also on whether prices are too low to elicit new supplies over time.[103]

The FERC's comments in the November 1, 2000 Order were consistent with its more recent recognition in the SMD NOPR that scarcity pricing is necessary, in a well-functioning competitive market, to encourage necessary investment in infrastructure.[104]

Moreover, in its December 15, 2000 Order, the FERC concluded that a market-based rate approach to ratemaking is preferable to cost-of-service regulation, even in the context of the Western energy crisis, because "traditional cost-of service pricing . . . reflects the cost of the assets without any regard to

100. June 19, 2001 Order, *supra* note 93, at 62,559 (citing Louisiana Energy & Power Auth. v. FERC, 141 F.3d 364 (D.C. Cir. 1998)); Elizabethtown Gas Co. v. FERC, 10 F.3d 866, 870 (D.C. Cir. 1993); Midcoast Interstate Transmission, Inc. v. FERC, 198 F.3d 960, 968 (D.C. Cir. 2000)).

101. June 19, 2001 Order, *supra* note 93, at 65,559 (footnote omitted) (citing Environmental Action v. FERC, 996 F.2d 401, 411 (D.C. Cir. 1993)). The FERC "has never bound itself to a rule requiring either rigid regulation or textbook markets." *Id.* Likewise, relying on *Elizabethtown*, *Louisiana Energy*, and *Grand Council*, the FERC defended the lawfulness of its market-based rate regime in denying a complaint brought by the California Attorney General in March 2002, claiming that market-based rate sales by generators and marketers into spot markets operated by the Cal-ISO and Cal-PX, as well as certain bilateral spot market sales, were unlawful under the FPA because they included neither the specific, numeric rates that characterize cost-of-service tariffs, nor the clearly identified components that characterize formula rate tariffs. *California ex rel. Bill Lockyer, Attorney Gen.*, 99 F.E.R.C. ¶ 61,247, 62,062 (2002), *reh'g denied*, 100 F.E.R.C. ¶ 61,295 (2002).

102. November 1, 2000 Order, *supra* note 93, at 61,358.

103. *Id.*

104. *SMD NOPR*, *supra* note 79.

market conditions."[105] The FERC recognized that, under cost-based ratemaking, California's retail rates were among the highest in the country. The FERC clearly signaled its continued support for its market oriented policies by concluding that "[t]he one thing that California needs most is new supply and a return to traditional cost-of-service ratemaking will not encourage supply to enter the California market."[106]

Despite the FERC's enthusiastic declarations in support of its established market-based rate regime, the FERC's Commissioners appeared to be deeply divided on the issue of whether the FERC should adhere in practice to its market-based rate policies in the face of sustained high prices in and around California. On the one hand, Commissioner, and later Chairman, Curt Hébert strongly advocated the continuation of a market-oriented approach. He argued:

> California ratepayers will benefit from the restructuring of the California energy market *only* when the market is allowed to operate without artificial restraints designed by regulators and politicians who believe that they know best how to serve energy customers. The [FERC] needs to act now to ensure that energy suppliers have an incentive to enter capacity-starved California markets, that local load-serving utilities have strong reason to hedge against price risk, that entrepreneurs have a motivation to develop new products and technologies, and that consumers share a motivation to conserve.[107]

On the other hand, Commissioner Massey urged a departure from the FERC's established market-based rate policies and the adoption of cost-based price mitigation in California as the solution to the Western energy crisis. He argued from the outset of the crisis in favor "of a hard price cap for the spot markets . . . , calculated on a generator-by-generator basis at each generator's variable operating costs plus a reasonable capacity adder . . . ."[108] Commissioner Massey further stated that he saw no reason for the FERC to be shy about acknowledging that "[t]here is still an important role for cost-of-service regulation where markets are not adequate."[109]

C. By its Actions, the FERC Abandoned its Market-Based Rate Regime and Imposed Cost-Based Mitigation in the West

Despite the language in its orders during the Western energy crisis, which

105. December 15, 2000 Order, *supra* note 93, at 61,995.

106. *Id.* at 62,008.

107. December 15, 2000 Order, *supra* note 93, at 62,031 (Hébert, Comm'r, concurring) (emphasis added). Commissioner Hébert's remarks highlight a significant factor in the California crisis over which the FERC had only limited control, namely the lack of adequate demand response. The principle aspect of this problem, or at least the most obvious, was the State of California's failure to allow retail rate increases that would adequately reflect higher wholesale prices. Yuffee, *supra* note 88, at 71. The FERC pressed the State, the Cal ISO, and the State's utilities to adopt demand response measures. *Id.* at 61,982; June 19, 2001 Order, *supra* note 93, 62,554-55. The FERC even proposed a requirement of a demand response program for demand-side bids into the Cal ISO markets, but was forced to withdraw the proposal when it proved technically infeasible. April 26, 2001 Order, *supra* note 93, 61,357; June 19, 2001 Order, *supra* note 93, 62,554-55. Nonetheless, the FERC recognized that demand response is primarily an issue of State concern. December 15, 2000 Order, *supra* note 93, 61,982.

108. December 15, 2000 Order, *supra* note 93, at 62,031-32 (Massey, Comm'r, concurring).

109. June 19, 2001 Order, *supra* note 93, 62,574 (Massey, Comm'r, concurring).

defended its existing market-based rate policies, the FERC reacted to sustained high prices in and around California during 2000 and 2001 by imposing price mitigation based on short-run variable (i.e., operating) costs. The FERC did so without evaluating prices or making a determination that the high prices experienced during the Western energy crisis were not consistent with competitive market outcomes under conditions of scarcity. In so doing, the FERC effectively abandoned its market-based ratemaking regime as justified under *Farmers Union*, *Elizabethtown*, *Louisiana Energy*, and *Grand Council*, under which market-based rates that are consistent with competitive market outcomes are presumed to fall within the "zone of reasonableness" defining just and reasonable rates. The FERC, perhaps out of political expediency, abandoned the lawful parameters of its market-based rate regime to deliver prices below scarcity levels to the west.

VIII. THE FERC'S IMPOSITION OF PRICE MITIGATION IN THE WEST

Beginning with its April 26, 2001 Order, the FERC responded to high prices by establishing bid mitigation procedures applicable in the Cal ISO spot markets during capacity reserve deficiencies.[110] These bid mitigation procedures were subsequently adapted to serve as full time price caps for all spot market transactions in the Western Systems Coordinating Council (WSCC) for the period of June 21, 2001 through July 12, 2003 (Prospective Mitigation Period).[111]

The FERC's bid mitigation during the Prospective Mitigation Period was based on a so-called Cal ISO "Proxy Price" that was intended to mimic generation suppliers' variable or short-run operating costs, and not intended to include scarcity rents, opportunity costs,[112] or credit risks,[113] which are normally considered components of "marginal costs." [114] The FERC also offered

110. April 26, 2001 Order, *supra* note 93, at 61,358-65.

111. July 11, 2002 Order, *supra* note 93, at 61,187-88. The procedures were originally slated to remain in effect through September 30, 2002. June 19, 2001 Order, *supra* note 93, at 62,567. However, in July 2002, the FERC replaced the procedures with a hard cap for the period of July 12, 2002 through September 30, 2002. July 11, 2002 Order, *supra* note 93, at 61,187-88.

112. April 26, 2001 Order, *supra* note 93, at 61,359 n.29.

113. June 19, 2001 Order, *supra* note 93, at 62,564.

114. In economics, the concept of "marginal" refers to the incremental addition of a unit of production. For example, "marginal cost" refers to the cost of producing that incremental unit, regardless of when those costs are actually incurred. This concept is important in economics because decisions to increase or reduce output, for example, depend on the relationship between marginal cost and the revenue that is earned from an incremental unit of production (also known as "marginal revenue"). Measuring marginal cost raises a number of difficult issues, particularly with respect to when the costs of producing an incremental unit are incurred. As a general matter, when there is excess supply relative to demand, the capital cost associated with delivering an additional unit of output is fixed. It is therefore possible to measure marginal costs excluding capital costs; this is generally referred to as "short-run marginal costs." However, when new capacity is needed to balance supply and demand, as may occur under conditions of scarcity, the capital costs for this new capacity also will need to be recovered so that the investor receives a reasonable return of and on this capital investment. These costs, variable operating costs plus capital costs for new investment to balance supply and demand, is generally referred to as "long-run marginal cost." ALFRED E. KAHN, THE ECONOMICS OF REGULATION: ECONOMIC PRINCIPLES AND INSTITUTIONS, 65-75, 87-89 (1988). In a long-run competitive equilibrium in an electricity market, prices will be at the level that just covers long-run marginal cost. STEVEN STOFT, POWER SYSTEM ECONOMICS: DESIGNING MARKETS FOR ELEC., 126-129 (2002). Thus, in the long-run, competitive prices must

generators an additional alternative, and stated that generators dissatisfied with its mitigation mechanism could "propose cost-based rates for their entire portfolio of generating facilities in the WSCC in a [s]ection 205 filing with cost support including a reasonable rate of return on investment that reflects the unique conditions in California."[115] Other suppliers, such as power marketers, were required to bid into the Cal ISO real-time spot market at zero dollars per megawatt hour.[116] The mitigated Cal ISO clearing price would serve as the price cap for spot market sales throughout the WSCC during any reserve deficiency (i.e., during hours when reserve levels were below 7%). During non-reserve deficiency periods, the FERC capped spot market prices at a level equal to 85% of the highest hourly mitigated market clearing price during an hour when there was a reserve deficiency (defined as reserves of 7.5% or less).

Later, beginning with its July 25, 2001 Order, the FERC used a methodology derived from the mitigation procedures for the Prospective Mitigation Period to calculate refunds owed for sales in the Cal PX and Cal ISO spot markets during the period of October 2, 2000 through June 20, 2001 (Refund Period). Although the resulting price is described as a mitigated market clearing price, it has been used only as a price ceiling, and not as a floor.[117] The FERC explained: "the ceiling price approach, in which refunds for each hour would be computed using the lower of [the] mitigated market clearing price . . . or the actual clearing price as the just and reasonable rate, should be used to calculate refunds."[118] Moreover, in determining the mitigated market clearing price, the FERC decided to ignore actual supply and demand conditions in the market for natural gas, the largest component of short-run variable costs for natural gas fired generation. Instead, the FERC relied upon assumed natural gas prices calculated by using production area prices plus a tariff based allowance for transportation costs plus an additional allowance for fuel compression charges.[119] The FERC made this decision even though the FERC staff report that formed the basis for this determination found that "some portion of these price levels reflected legitimate scarcity," though "the portion attributable to scarcity alone" could not be calculated.[120]

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be equal to long-run marginal cost. If in the long-run competitive prices are below long-run marginal cost, there will be scarcity.

115. June 19, 2001 Order, *supra* note 93, at 62,564.

116. December 19, 2001 Order, *supra* note 93, at 62,192.

117. May 15, 2002 Order, *supra* note 93, at 61,655.

118. *Id.*

119. March 26, 2003 Order, *supra* note 93, at 62,069.

120. Staff of the FERC, Final Report on Price Manipulation in Western Markets, FERC No. PA02-2-000, ES-8 (March 2003), *available at* http://www.caiso.com/docs/2003/03/26/2003032610020115827.pdf (last visited Oct. 19, 2003) [hereinafter Western Markets Report]. The Western Markets Report found that California spot gas prices would have closely tracked producing area prices plus transportation but for "the distorting influence of electric market dysfunction and attempted price manipulation." *Id.* at IV-2. At the same time, the Western Markets Report stated that the FERC's staff "d[id] not believe the effects of scarcity c[ould] be separated from those of market dysfunction and price manipulation," and thus, recommended that generators be made whole for the gas prices they actually paid, but that this recovery be made on a dollar-for-dollar basis and not be part of the mitigated market clearing price. *Id.* As at least one set of market observers concluded, under this approach, the FERC's staff removed,

> not only the effects of market manipulation but also the effects of typical, fundamental market

A. The FERC did not Make Any Effort to Determine Whether Sustained High Prices During the Western Energy Crisis were Inconsistent with Competitive Market Outcomes

Significantly, the FERC mitigated prices downward for both the Refund and Prospective Mitigation Periods without making a determination that sellers exercised market power, or that any or all of the difference between actual or potential market prices and mitigated market prices could not be explained by market fundamentals. In other words, the FERC ordered prospective mitigation and refunds for market-based rate transactions without finding that the market rates were not just and reasonable as understood under the long line of cases interpreting just and reasonable rates in the context of a market-based rate regime. Rather, the FERC simply concluded, without analysis, "that the market structure and rules for wholesale sales of electric energy in California had caused, and continued to have the potential to cause, unjust and unreasonable rates for short-term energy during certain times and under certain conditions . . . ."[121] The FERC further found "that certain market rules do interfere with the functioning of the market and, taken together, *may* permit sellers to exercise market power,"[122] although it had made neither a finding that "all rates, at all times, were unjust and unreasonable" in the Cal ISO and Cal PX spot markets, nor a finding "that any individual sellers exercised or abused market power."[123]

In ordering prospective price mitigation, the FERC did not make any findings about actual exercises of market power or market outcomes unexplained by a competitive market under conditions of scarcity. Instead, the FERC relied on its finding "in the December 15, 2000 Order that, because of the flawed market rules and structures in place, there was a *potential* for the exercise of market power in the California spot market under certain conditions and that a mitigation plan, therefore, was necessary."[124]

Similarly, in ordering refunds retroactively to October 2, 2000, the FERC made no finding that rates during the Refund Period were inconsistent with competitive market prices under conditions of a "true scarcity of generation."[125] Instead, the FERC bypassed the premise for its initial grant of market-based rate authority (i.e., that rates freely negotiated by a seller that lacks or has adequately mitigated market power will necessarily be just and reasonable). The FERC did nothing more than recite its prior conclusion in the December 15, 2000 Order, that flawed market "structure and rules, in conjunction with an imbalance of

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> forces. To take such a view is to fundamentally reject the dynamics of a market economy. As a result, the calculated prices do not represent the scarcity of natural gas that Staff acknowledges existed during the crisis.

David Clement, Bob Ineson, Larry Makovich, Mike Zenker, *Price Revision in Western Energy Markets: What Standard for Market Intervention?*, 2 (CERA Decision Brief, May 2003), *at* http://www.cera.com (last visited Oct. 19, 2003).

121. June 19, 2001 Order, *supra* note 93, at 62,557.

122. November 1, 2000 Order, *supra* note 93, at 61,359 (emphasis added).

123. December 15, 2000 Order, *supra* note 93, at 61,998.

124. April 26, 2001 Order, *supra* note 93, at 61,354 (emphasis added).

125. November 1, 2000 Order, *supra* note 93, at 61,359.

supply and demand in California, had caused, and continued to have the potential to cause, unjust and unreasonable rates for short term energy under certain conditions."[126] On rehearing, the FERC rejected the argument that it erred in ordering refunds in the absence of any findings that any market participant exercised market power or that rates were inconsistent with the prices a competitive market would have produced, asserting:

> Individual seller analysis was not required to find the rates unjust and unreasonable here, particularly as a single market clearing price applied to any given sale. All sellers received the same price. These circumstances make it appropriate to analyze all sellers as a whole. . . . [T]he underlying problem was that the single price auction, in conjunction with other components of market structure and market rules, was no longer producing just and reasonable rates.[127]

While this argument is at least responsive to the question of why the FERC ordered refunds in the absence of any *particularized* findings that market-based rates could not be explained by competitive market conditions, it overlooks the fact that the FERC never made any finding that, during the Refund Period, observed market-based rates were inconsistent with the prices a competitive market would have produced.

Nowhere in its analysis did the FERC suggest, much less find, that market-based rates that were supposedly unjust and unreasonable resulted from a lack of workable competition in the Cal ISO and Cal PX spot markets, or were otherwise inconsistent with the prices to be expected in a competitive market under conditions of scarcity. This analytic failure is both glaring and remarkable in light of the FERC's own recognition that high market prices during the Western energy crisis were, at least in part, attributable to a "true scarcity of generation," a circumstance in which "prices are expected to rise—and indeed they must rise to induce the investment in new capacity that is needed to serve customers adequately."[128] The FERC, however, never made, or even attempted to make, a determination as to what extent high prices resulted from competitive market conditions (i.e., prices that should not have been subject to mitigation) versus structurally uncompetitive markets and/or anti-competitive market behavior (i.e., prices that should have been subject to mitigation). Instead, the circular logic of the FERC's orders in the Western Refund Proceeding strongly suggested that the FERC concluded that it did not like the consequences of sustained high prices in the Cal ISO and Cal PX spot markets and thus assumed that those markets were

126. July 25, 2001 Order, *supra* note 93, at 61,500.

127. December 19, 2001 Order, *supra* note 93, at 62,218.

128. November 1, 2000 Order, *supra* note 93, at 61,358-59 (citations omitted). Indeed, even more glaring, expert economic testimony in the record in the Western Refund Proceeding indicates that, over the life of the Cal ISO and Cal PX spot markets (including 2000 and 2001), prices were at or below the leveled long-run marginal cost levels necessary to induce new entry of generation, while mitigated prices were far below this level. Reply Comments of Williams Energy Marketing and Trading Co., *San Diego Gas & Elec. Co.*, No. EL00-95-000, 4, 16-32 (2003), *available at* http://www.williams.com/about/features/docs/ca_replybrief_032003.pdf (last visited Oct. 5, 2003). If correct, Dr. Hieronymus's analysis suggests that unmitigated market prices during the Western energy crisis of 2000 and 2001 were, in fact, consistent with the prices that would and should have been expected in a competitive market under conditions of scarcity. To date, the FERC has never addressed, acknowledged, or attempted to perform a similar type of analysis in any of its orders or reports relating to the Western Refund Proceeding.

broken or "dysfunctional."[129]

The FERC's cost-based remedy was no better reasoned than its diagnosis of dysfunction. The FERC characterized its "marginal cost based approach"[130] to price mitigation in the West as a means of "replicat[ing] the price that would [have been] paid in a competitive market . . . ."[131] Under the FERC's approach, generators recovered scarcity rents only up to the short-run variable cost of the least efficient generator dispatched. In other, less politically-charged proceedings, however, the FERC itself has recognized that price mitigation "that results in a price equal to the marginal cost of the highest cost unit dispatched may not properly reflect the scarcity of generation," and therefore may be inadequate to encourage investment.[132]

IX. THE LEGAL AND POLICY IMPLICATIONS OF THE FERC'S ABANDONMENT OF ITS ESTABLISHED MARKET-BASED RATE REGIME AND ADOPTION OF A HYBRID RATEMAKING REGIME

Notwithstanding its pronouncements in defense of market-based ratemaking, the FERC has, in its orders in the Western Refund Proceeding, effectively abandoned its market-based rate regime in favor of a hybrid ratemaking regime in which wholesale sellers of electric energy are entitled to receive only the lower of a cost-based rate or the market price. While arguably motivated by a desire to ensure that its market-oriented policies survive the political controversy attendant upon the Western energy crisis of 2000 and 2001, the FERC's confused and conflicted application of its market-based rate regime in the Western Refund Proceeding is legally suspect and, from a policy perspective, worse than simply retreating to a pure cost-of-service approach to ratemaking.

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129. December 15, 2000 Order, *supra* note 93, at 61,982.

130. December 19, 2001 Order, *supra* note 93, at 61,214.

131. *Id.* at 62,212.

132. *New England Power Pool and ISO New England, Inc.*, 100 F.E.R.C. ¶ 61,287, 62,267 (2002), *on reh'g*, 101 F.E.R.C. ¶ 61,344, 62,427 (2002).

> [I]n seeking to craft market rules of general applicability that would have given it authority to roll prices in California back to politically acceptable levels, the [FERC] has given itself an impossible task. The extreme and unique situation in California, spilling over into western markets more generally, led to market conditions that could not have been avoided with market rules that are consistent with the operation of competitive power markets. Some of the *ad hoc* interpretations of "competitive" behavior in the California Refund Proceeding, Docket No. EL00-95-075 (e.g., setting prices based on short run marginal costs, ignoring start up and no load costs), were they to be applied generally in determining acceptable conduct, would lead to prices below long run marginal costs and thus below the levels required to support new entry.

Comments of Exelon Corporation, Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations (Nos. EL01-1-118-000, EL01-118-001) (Comments of William H. Hieronymous) (comments submitted in accordance with the FERC's June 26, 2003 Order), *available at* http://ferris.ferc.gov/idmws/nvcommon/NVViewer.asp?Doc=9762900:0 (last visited Oct. 19, 2003) (citations omitted).

A. The FERC's Cost-Based Mitigation in the West Cannot Be Justified Under Either Judicial Precedent Interpreting the Just and Reasonable Standard or the FERC's Own Orders Establishing Standards for Market-Based Rates

Clearly, the FERC enjoys considerable discretion "to devise methods of regulation capable of equitably reconciling diverse and conflicting interests."[133] The FERC cannot, however, "arbitrarily switch back and forth between [ratemaking] methodologies in a way which require[s] investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others . . . ."[134] *Farmers Union*, *Elizabethtown*, *Louisiana Energy*, and *Grand Council*, as well as the FERC's various orders defining its standards for granting market-based rate authorization, simply cannot be read to define a zone of reasonableness for market-based rates that excludes high-priced or otherwise politically unpopular competitive market outcomes. Like other agencies, the FERC must provide a reasoned basis for any departure from established precedent.[135] The FERC cannot have a rule under which rates negotiated by sellers and buyers in a workably competitive market will necessarily be "just and reasonable" on Monday but then another rule for Tuesday under which negotiated rates are "unjust and unreasonable."[136] This is precisely what the FERC has done in declaring market-based rates in the Cal ISO and Cal PX markets during the Refund Period and in spot markets throughout the WSCC during the Prospective Mitigation Period to be unjust and unreasonable.

Even if the FERC's abrupt deviation from its established market-based rate policies could be justified under *Farmers Union*, *Elizabethtown*, *Louisiana Energy*, and *Grand Council*, and under its own orders defining its market-based rate standards, the specific price mitigation methodology adopted in the Western Refund Proceeding would still be legally suspect in *Bluefield*, *Smyth*, *Missouri*, and *Hope* (*Hope-Bluefield*). By mitigating clearing prices only when the market price is higher than short-run variable or marginal costs, the FERC established a presumption that a seller is entitled to recover the lower of its cost or the market price. Such a presumption may very well be confiscatory and, in any event, is hardly calculated to allow for market prices, which are sufficient to elicit adequate supplies.

As a conceptual matter, there can be little doubt that a ratemaking regime in which a public utility is allowed to charge only rates equal to the lower of a cost-based rate or the market price would likely result in confiscatory rates that would be unlawful under the *Hope-Bluefield* line of cases. Under such a regime, the public utility would have the opportunity to recover only the cost of its prudently incurred investments, plus a reasonable return, during periods when market prices equal or exceed cost. Over time, unless market prices were *never* below

133. *In re* Permian Basin Area Rate Cases, 390 U.S. 747, 767 (1968), *reh'g denied*, 392 U.S. 917 (1968).

134. Duquesne Light Co. v. Barasch, 488 U.S. 299, 315 (1989).

135. *See generally* Shell Oil Co. v. FERC, 664 F.2d 79, 82-84 (5th Cir. 1981); Mitchell Energy Corp. v. FERC, 580 F.2d 763, 765 (5th Cir. 1978); Ashland Exploration, Inc. v. FERC, 631 F.2d 817 (D.C. Cir. 1980).

136. *Shell Oil*, 664 F.2d at 83 (the FERC cannot have "a rule for Monday, and another for Tuesday, a rule for general application, but denied outright in a specific case.") (quoting NLRB v. Sunnyland Packing Co., 557 F.2d 1157, 1160 (5th Cir. 1977)).

cost, the public utility would have no opportunity to recover its prudently incurred costs plus a reasonable return, and the overall impact of the ratemaking regime would appear to be constitutionally objectionable, even under *Duquesne*. In other words, a lower-of-cost-or-market regime would generate lawful rates only when the market-based rate component was rendered superfluous.

There is no doubt that some will argue that the constitutional calculus of *Hope* and *Bluefield* changes with the move from an industry dominated by franchised public utilities with a statutory obligation to serve, to an industry populated by market-based rate sellers more at liberty to suspend or to cease unprofitable operations. This argument ignores the fact that even a franchised public utility has the constitutional right to cease unprofitable operations,[137] and there is no indication that the existence of this right has been construed as mitigating the regulator's obligation to allow non-confiscatory rates. Moreover, the argument that a statutory obligation to serve is a necessary element of a takings claim would prove too much. If true, it would render the *Hope-Bluefield* precedent inapplicable to rates for wholesale sales set under the FPA. Outside of certain exceptional circumstances, no public utility, whether a traditional, vertically integrated public utility, a merchant generator, or a power marketer, has a statutory obligation to make wholesale sales under the FPA.[138] Obviously, the courts *have* applied *Hope-Bluefield* precedent in the context of rates for wholesale sales of electricity established pursuant to the FPA.[139] For present purposes, however, the issue is largely moot, because the exceptional circumstances surrounding the Western energy crisis meant that, for much of the relevant time period, generators *were* in fact under a legal obligation to make electricity available to Western markets.[140]

The rates established under the market mitigation procedures adopted for both the Prospective Mitigation and Refund Periods are equal to the lower of the actual market clearing price, or a "mitigated" market clearing price, derived from the short-run variable cost of the last unit dispatched. In other words, the FERC has presumptively set rates equal to the lower of a cost-based rate or a price determined by the market. For high-cost sellers, such as the owners of the

137. Brooks-Scanlon Co. v. R.R. Comm'n, 251 U.S. 396 (1920).

138. A public utility may undertake a *contractual* obligation to make wholesale sales of electricity, and public utilities may also be have *contractual* obligations to make generating units available to wholesale markets as a condition to membership in a power pool or similar organization. *See generally Blumenthal*, 103 F.E.R.C. ¶ 61,344 (2003) (discussing relevant provisions of the Restated New England Power Pool Agreement).

139. Jersey Cent. Power & Light Co. v. FERC, 810 F.2d 1168, 1170 (D.C. Cir. 1987) (finding that "[t]he substantive *Hope* . . . issue" was "squarely before us" in a case involving rates for wholesale sales of electricity). *See also* Public Serv. Co. of N.M. v. FERC, 832 F.2d 1201, 1211-12 (10th Cir. 1987); Union Elec. Co. v. FERC, 668 F.2d 389, 392-93 (8th Cir. 1981); Public Serv. Co. of Ind. v. FERC, 575 F.2d 1204, 1214 (7th Cir. 1978) (all applying the *Hope-Bluefield* analysis in the context of wholesale sales of electricity).

140. Notice of Issuance of Emergency Orders, 65 Fed. Reg. 82,989 (2000) (relating to orders issued by the Secretary of Energy in mid-December 2000 requiring generators to make sales to the Cal ISO); April 26, 2001 Order, *supra* note 93, at 61,355-57 (establishing a "must-offer" requirement for all generators interconnected with, or whose power is transmitted over the transmission grid controlled by the Cal ISO to make all of their capacity available in real time during all hours when it was available and not already scheduled to run under bilateral agreements); June 19, 2001 Order, *supra* note 93, at 62,551-54 (affirming and clarifying the "must-offer" requirement established in the April 26, 2001 Order).

marginal units used to set the mitigated clearing price and marketers who entered into forward purchase contracts with the assumption that market prices would be relatively high, the FERC lower-of-cost-or-market approach inevitably results in rates that, at least in isolation, are confiscatory. These rates are confiscatory because the sellers will recover their costs only during periods when the market price exceeds cost. As made clear in *Duquesne*, the lawfulness of the rates under *Hope* and *Bluefield* will not be considered on a "piecemeal" basis but rather in light of the overall impact on the public utility.[141] Nonetheless, under the *Hope-Bluefield* line of cases, the lawfulness of the FERC's actions as applied to high-cost suppliers deriving a substantial proportion of their revenues from the affected markets may depend in large measure upon the adequacy of the safety valves offered by the FERC. The FERC has purported to offer some, but not all, sellers an opportunity to be made whole if the presumptive rate proves insufficient.

Sellers who made sales during the Refund Period will have an opportunity, when refunds have finally been calculated, to "demonstrate that the rates were inadequate based on consideration of all costs and revenues, not just certain transactions."[142] Similarly, generators, but not other sellers, will be allowed to recover certain verifiable natural gas procurement costs, even though those costs will not be part of the market mitigation clearing price. As a practical matter, the FERC is unlikely to issue a final decision on refund liability before the fall of 2003. Consequently, suppliers will not have an opportunity to make their case for full cost recovery until at least two years after the fact. Particularly if suppliers are required to make refunds with interest prior to being accorded the opportunity to justify higher, compensatory rates,[143] they will have effectively been subjected to confiscatory rates for at least two years before obtaining relief.[144] As the Supreme Court observed over three quarters of a century ago: "[p]roperty may be as effectively taken by long-continued and unreasonable delay in putting an end to confiscatory rates as by an express affirmance of them . . . ."[145]

141. Duquesne Light Co. v. Barasch, 488 U.S. 299, 312-13 (1989).

142. December 19, 2001 Order, *supra* note 93, at 62,254.

143. The FERC's intent in this regard remains unclear, because, to date, it has only indicated that this opportunity will be provided "after the conclusion of the refund hearing" and has not specified when refunds will be required to be paid. May 15, 2002 Order, *supra* note 93, at 61,656.

144. A requirement to pay interest effectively deprives the public utility of the time value of the refunded monies. As a practical matter, even if the refund requirement were stayed pending the outcome of proceedings in which suppliers will be allowed to justify higher rates, the overhanging potential refund liability has required suppliers to reserve significant amounts of cash that could otherwise be invested in ongoing business activities or distributed to shareholders. Moreover, in part as a result of the Cal PX's bankruptcy, many suppliers have not been fully paid for sales during the relevant time period.

145. Smith v. Ill. Bell Tel. Co., 270 U.S. 587, 591 (1926) (footnotes omitted). *See also* MCI Telecomms. Corp. v. FCC, 627 F.2d 322 (D.C. Cir. 1980).

> Many of the same considerations that impel judicial protection of the right to a "speedy trial" in criminal cases or implementation of civil decrees with all deliberate speed are not inapposite in agency deliberations. Those situations generally involve protection of constitutional rights, but delay in the resolution of administrative proceedings can also deprive regulated entities, their competitors or the public of rights and economic opportunities without the due process the Constitution requires.

The FERC gave generators several options for sales during the Prospective Mitigation Period. First, generators could attempt to cost justify their rates above the mitigated clearing price. In doing so, they were precluded from including components designed to recover scarcity rents, opportunity costs,[146] or credit risks.[147] Second, generators could "propose cost-based rates for their entire portfolio of generating facilities in the WSCC in a [s]ection 205 filing with cost support including a reasonable rate of return on investment that reflects the unique conditions in California."[148] Not surprisingly, given the FERC's rulings on cost-based rates for reliability must-run (RMR) units in California,[149] no generator took the FERC up on its offer to apply for cost-based rates to apply for the duration of the Prospective Mitigation Period. In particular, the FERC's refusal to permit recovery of acquisition premiums in RMR contracts[150] made this option a virtual non-starter for generators who paid two and three times book value for generation divested by California's investor-owned utilities. Further, the FERC's invitation to cost justify higher bids failed to prove to be particularly meaningful in practice, since it rejected all attempts to justify higher rates.[151] While not particularly appealing as practical matter, the "safety valves" provided to generators for Prospective Mitigation Period could conceivably prove to be sufficient to pass muster under the *Hope-Bluefield* line of cases. The same cannot be said for other sellers, who were offered no means of recovering any costs above the mitigated market-clearing price.

According to the FERC, marketers would still have "an opportunity to earn a reasonable return on purchased energy" during the Prospective Mitigation Period, because the mitigated market clearing price "will be above the costs of the generators from which the marketers obtain their portfolio of energy."[152] This rationale is unpersuasive as it rests on the assumption that a rational, lower cost generator will give profits to marketers by selling at below market prices.

The FERC's position as to load-serving entities (LSEs) is, if anything, even less persuasive. After noting that "LSEs purchase power in order to serve their native load obligations," the FERC stated that, "[t]o the extent [they] have excess capacity to sell, the proceeds of those sales serve to reduce the sunk costs of the purchased power costs their customers would otherwise would pay."[153] The fact that LSEs are expected to earn reasonable returns on their State regulated retail sales hardly justifies subjecting them to confiscatory rates for their FERC regulated wholesale sales.[154]

Id. at 341.

146. November 1, 2001 Order, *supra* note 93, at 61,359 n.29.

147. June 19, 2001 Order, *supra* note 93, at 62,564.

148. *Id.*

149. *Duke Energy Moss Landing, L.L.C.*, 83 F.E.R.C. ¶ 61,318, 62,303-05 (1998), *order on reh'g*, 86 F.E.R.C. ¶ 61,227, 61,815-18 (1999).

150. *Id.*

151. *San Diego Gas & Elec. Co.*, 96 F.E.R.C. ¶ 61,254 (2001); *San Diego Gas & Elec. Co.*, 97 F.E.R.C. ¶ 61,012 (2001); *San Diego Gas & Elec. Co.*, 97 F.E.R.C. ¶ 61,290 (2001).

152. June 19, 2001 Order, *supra* note 93, at 62,564-65.

153. December 19, 2001 Order, *supra* note 93, at 62,214.

154. *Cf.* Brooks-Scanlon Co. v. R.R. Comm'n, 251 U.S. 396 (1920):

B. The FERC's Hybrid Ratemaking Approach Constitutes Bad Public Policy because it does not Allow for Market Prices that are Sufficient to Elicit Adequate Supplies

Even if the FERC's cost-of-service "safety valves" are sufficient to allow its lower-of-cost-or-market regime to skim over the *Hope-Bluefield* bar, the FERC's implementation of such a regime represents exceedingly bad public policy. Such an approach asks investors to shoulder all of the risks of a market-based regime without any of the rewards. Even if sellers are ultimately permitted to recover their full costs for the Refund Period or Prospective Mitigation Period, there is no assurance that they will be made whole over the longer term. This will include periods of surplus when market prices are inadequate to permit recovery of fixed costs, and no regulator is acting to place a cost-based floor under prices. As noted in a decision resolving a conflict between cost-based affiliate pricing rules adopted by the Securities Exchange Commission (SEC) for registered holding company systems and the FERC's lower-of-cost-or-market rule for affiliate pricing, "the SEC 'has long recognized' that a lower-of-cost-or-market interpretation would *effectively eliminate affiliate transactions* by preventing investors from keeping profits when cost is below market (to offset losses when cost is above market)."[155] When a lower-of-cost-or-market approach is applied to all transactions in a particular region, it should not be surprising that investors will be reluctant to invest in the power sector not only in that region, but also in any region to which a similar regime could be extended in the future.

In addition, such an approach truncates price signals essential to spur new investment by capping prices at levels that do not fully reflect true scarcity. The FERC itself has recognized that "without proper price signals to attract transmission projects and generation resources, infrastructure improvements will be slow or not forthcoming at all."[156] Regulatory limits on market prices to prevent them from reaching scarcity levels under conditions of scarcity is particularly poor public policy in light of the FERC's own recognition of the need to provide "sufficient incentives to build sorely needed new generation and transmission necessary to provide reliable service in the future."[157] Moreover, such a market-based rate policy is likely to be not only counterproductive but also self-perpetuating: price mitigation below scarcity prices begets insufficient incentives, which begets scarcity, which begets new price mitigation below scarcity levels, and so forth.

> A carrier cannot be compelled to carry on even a branch of business at a loss, much less the whole business of carriage. . . . The plaintiff may be making money from its [unregulated] sawmill and lumber business but it no more can be compelled to spend that than it can be compelled to spend any other money to maintain a [regulated] railroad for the benefit of others who do not care to pay for it.

Id. at 399.

155. Ohio Power Co. v. FERC, 954 F.2d 779, 785 n.6 (D.C. Cir. 1992) (emphasis added).

156. *New England Power Pool and ISO New England, Inc.*, 100 F.E.R.C. ¶ 61,287, 62,270 (2002).

157. December 15, 2000 Order, *supra* note 93, at 61,981.

X. CONCLUSION

The FERC has the legal authority under the FPA to rely on market forces as means of ensuring that rates are "just and reasonable." Moreover, rates determined by market forces are "just and reasonable" if they are consistent with the outcomes a competitive market would produce or be expected to produce. The FERC cannot, and if it desires to encourage investment in infrastructure, should not, adopt a market-based rate regime in which a seller receives less than the price a competitive market would produce or be expected to produce. In an apparent attempt to deflect political criticism of its market-based rate regime, however, the FERC adopted such an approach in addressing the Western energy crisis of 2000 and 2001. The FERC's efforts appear to have done little to allay the concerns of those opposed to market-based ratemaking and have left proponents and supporters of market-based rates, not to mention prospective investors, puzzled by what the FERC means when it says that it remains committed to developing "markets."

In the end, the FERC should have chosen between the approaches advocated by Commissioners Hébert and Massey instead of attempting to split the difference. Had the FERC chosen Commissioner Hébert's approach and given more than mere rhetoric to letting market forces set prices, market participants, investors, and legislators would know that the FERC was genuinely committed to letting markets work in California and elsewhere. Had the FERC chosen Commissioner Massey's approach and spoken the language of cost-based ratemaking, the FERC and the courts that will inevitably review its orders, would have had clear metrics by which to ensure that rates would be adequate to ensure much needed investment. While people might have doubted the FERC's commitment to market-based ratemaking, at least one would have reason to believe that when the FERC says "markets," it means "markets," and not a regime in which certain market outcomes simply are not permitted, regardless of whether those outcomes are consistent with the outcome a competitive market would produce or be expected to produce.