

# WHITHER ORDER NO. 888?

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## INTRODUCTION

In 1996 the Federal Energy Regulatory Commission (FERC) adopted a landmark rulemaking, Order No. 888,<sup>1</sup> to eradicate undue discrimination in the provision of electric transmission service. Order No. 888 required vertically integrated utilities to provide transmission service on an unbundled basis pursuant to a *Pro Forma* Open Access Transmission Tariff (OATT). The purpose of this remedy was to place competitors on the same footing as vertically integrated utilities in obtaining access to the transmission grid and thereby facilitate increased competition in bulk power markets. The form of the remedy – “unbundling” transmission from commodity sales service – had been used successfully in the natural gas pipeline industry and thus was anticipated to solve the undue discrimination problem in the electric industry as well.

This hope soon faded, however. Only three years later, the FERC in 1999 found that Order No. 888’s “functional unbundling” approach had not proven effective in eradicating undue discrimination and that only a *structural* separation of transmission from generation could eliminate undue discrimination once and for all.<sup>2</sup> The FERC therefore adopted a new rulemaking, Order No. 2000, to encourage vertically integrated utilities to divest operational control over their transmission grids to Regional Transmission Organizations (RTOs). But this rulemaking also proved an incomplete success. RTOs formed in many regions, but not in the Southeast, Northwest or Southwest. Due to fears of market malfunction in organized markets following the California electricity crisis and greater federal control following the FERC’s controversial Standard Market Design (SMD) rulemaking,<sup>3</sup> these regions have shunned RTOs in favor of more incremental steps towards transmission independence.<sup>4</sup>

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1. Order No. 888, *Promoting Wholesale Competition Through Open Access Nondiscriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, [Regs. Preambles 1991–1996] F.E.R.C. STATS. & REGS. ¶ 31,036 (1996), 61 Fed. Reg. 21,540 (1996) (to be codified at 18 C.F.R. pts. 35, 385) [hereinafter Order No. 888], *order on reh’g*, Order No. 888-A, F.E.R.C. STATS. & REGS. ¶ 31,048 (1997), *order on reh’g*, Order No. 888-B, 81 F.E.R.C. ¶ 61,248, 62 Fed. Reg. 64,688 (1997), *order on reh’g*, Order No. 888-C, 82 F.E.R.C. ¶ 61,046 (1998), *aff’d in relevant part sub nom.*, *Transmission Access Policy Study Group v. FERC*, 225 F.3d 667 (D.C. Cir. 2000), *aff’d sub nom.*, *New York v. FERC*, 535 U.S. 1 (2002).

2. Order No. 2000, *Regional Transmission Organizations*, [Regs. Preambles 1996–2000] F.E.R.C. STATS. & REGS. ¶ 31,089, 31,015–17 (2000), 65 Fed. Reg. 809 (2000) (to be codified at 18 C.F.R. pt. 35) [hereinafter Order No. 2000], *order on reh’g*, Order No. 2000-A, F.E.R.C. STATS. & REGS. ¶ 31,092, 65 Fed. Reg. 12,088 (2000), *aff’d sub nom.*, *Pub. Util. Dist. No. 1 v. FERC*, 272 F.3d 607 (D.C. Cir. 2001).

3. Notice of Proposed Rulemaking, *Remedying Undue Discrimination Through Open Access Transmission Service and Standard Electricity Market Design*, F.E.R.C. STATS. & REGS. ¶ 32,563, 67 Fed. Reg. 63,327 (2002) [hereinafter SMD NOPR].

4. In the Southeast region, the Entergy System has received approval to install an Independent Coordinator of Transmission. *Entergy Servs., Inc.*, 110 F.E.R.C. ¶ 61,295 (2005). Duke Energy recently submitted a proposal to have the Midwest Independent System Operator, Inc. (MISO) oversee and administer certain aspects of its OATT. In the Pacific Northwest, several utilities have sought to form Grid West as a regional transmission operator that provides greater independence but does not meet all the requirements of Order No. 2000. *Bonneville Power Admin.*, 112 F.E.R.C. ¶ 61,012 (2005). In the Southwest, Tucson Electric

Order No. 888 therefore continues to govern wholesale electric markets in large portions of the country, which, in turn, has created a policy dilemma for the FERC. The FERC has found Order No. 888 to be ineffective in eradicating undue discrimination, yet its chosen remedy, structural separation through RTO formation, has yet to take hold in several regions. In 2004, Commissioner Joseph Kelliher noted this problem and urged his colleagues to consider reforming Order No. 888. With Commissioner Kelliher now assuming the Chair, there seems little doubt that the FERC will reform Order No. 888 in the next two years.<sup>5</sup>

This article explores the question of what to do with Order No. 888 and, in particular, the concern that it has not solved the undue discrimination problem. The article subdivides the inquiry into two questions. The first considers the *scope* of the undue discrimination problem and, specifically, whether undue discrimination remains sufficiently pervasive to merit the reform of Order No. 888 in the first place. The answer to this important question proves quite elusive, however, because there are no empirical studies on the matter and, without such data, it is hard to tell whether discrimination is rampant, episodic or something in between.

I therefore focus most of my attention on second question, which considers the *nature* of the undue discrimination problem. In the FERC's view, the nature of the problem is that (i) vertically integrated utilities retain both the incentive and ability to discriminate against their competitors, and (ii) Order No. 888 cannot blunt discriminatory conduct because it is often difficult to detect. I think this characterization is satisfactory as far as it goes. It is true that, in some instances, there can be an incentive to discriminate and it also is true that, in some instances, discrimination can be difficult to detect. But to say that discrimination can occur and go undetected is not to say very much. Any regulatory regime can, of course, be violated, but that, standing alone, does not tell us much about whether or how to reform it.

In considering whether and how to reform Order No. 888, I think a closer look at the context in which many discrimination claims arise should be considered. Many discrimination claims occur when transmission capacity is congested.<sup>6</sup> I do not think this is an accident. Although some might argue that congestion provides the perfect cover for denying access to competitors, another hypothesis should be considered — i.e., when capacity is congested, and disputes over its allocation arise, the disputes often turn on which rules *should* apply, not whether they have in fact been applied correctly, because the law is so

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and Arizona Public Service have agreed to install independent market monitors. *Tucson Elec. Power Co.*, 109 F.E.R.C. ¶ 61,272 (2004); *Arizona Pub. Serv. Co.*, 109 F.E.R.C. ¶ 61,271 (2004).

5. Order Terminating Proceeding, *Remedying Undue Discrimination Through Open Access Transmission Service and Standard Electricity Market Design*, F.E.R.C. STATS. & REGS. ¶ 31,192, 70 Fed. Reg. 43,140 (2005) ("The Commission has also indicated that it intends to consider revisions to the Order No. 888 *pro forma* Open Access Transmission Tariff to reflect the electric utility industry's and the Commission's experience with open access transmission over the last decade."); Notice of Inquiry, *Preventing Undue Discrimination and Preference in Transmission Service*, F.E.R.C. STATS. & REGS. ¶ \_\_\_\_, 70 Fed. Reg. 55,796 (2005) (Docket No. RM05-25-000) (initiating notice of inquiry regarding reform of Order No. 888) [hereinafter Notice of Inquiry re Order 888].

6. A simple perusal of the list of discrimination claims contained in Order No. 2000 and the SMD NOPR would support that premise. See Order No. 2000, *supra* note 2, at 31,008–12; SMD NOPR, *supra* note 3, at 34,288–92 (citing a range of customer complaints that they are repeatedly "denied comparable access to the grid.").

ambiguous in this area.

The FERC agrees with this alternative hypothesis to a limited degree. The FERC has acknowledged that Order No. 888 is not overly prescriptive in certain areas and that, in these areas, utilities have significant discretion, which, in turn, makes discrimination difficult to detect.<sup>7</sup> This, again, is true as far as it goes, but I would take the premise one step further. Although subjectivity can frustrate the detection of undue discrimination, it also frustrates a determination of whether undue discrimination *is occurring in the first place*.<sup>8</sup> In the context of Order No. 888,<sup>9</sup> “discrimination” means violating the OATT in a manner that favors the utility’s generation business. But this event – violating the OATT – presupposes a *known rule* to violate. And the known rules for capacity measurement and allocation are few and far between.

This distinction is more than a quibble, as is evident when we consider the question of remedies. If, as some suggest, the real problem is a persistent determination by utilities to discriminate against their competitors, then one might easily conclude that tougher penalties are in order. Tougher penalties should, after all, reduce the incentive to discriminate by making aberrant conduct unprofitable. But if the rules for measuring and allocating scarce capacity are not clear, and the disputes typically turn on what rules *should* apply – not whether they have, in fact, been applied correctly – then tougher penalties will do us little good. One can hardly deter unlawful conduct until one identifies what conduct is required by law. The FERC has recognized this truism in other contexts, such as its Market Behavior Rules,<sup>10</sup> and it would do well to acknowledge it in reforming Order No. 888.

I may or may not be correct that the unclear rules for measuring and allocating scarce capacity are the *primary* problem with Order No. 888. But it need not be the primary or only one to merit serious attention. Few participants in regions governed by Order No. 888 would contend that the capacity measurement and allocation rules are clear. Indeed, many RTOs using the *Pro*

7. Order No. 2003, *Standardization of Generator Interconnection Agreements and Procedures*, F.E.R.C. STATS. & REGS. ¶ 31,146, 30,523–24 (2003), 68 Fed. Reg. 49,846 (2003) (codified at 18 C.F.R. § 35) (many decisions under the OATT are “subjective” and “a Transmission Provider that is not an independent entity has the ability and the incentive to exploit this subjectivity to its own advantage.”) [hereinafter Order No. 2003].

8. The FERC recently recognized this in its Notice of Inquiry on Order No. 888. Notice of Inquiry re Order 888, *supra* note 5, at 55,797 (discretion “not only makes it difficult for public utilities to comply, but makes it difficult for the Commission to identify violations”).

9. In other areas of the law, discrimination is defined as the differential treatment of two or more classes, but the law does not impose a normative benchmark on either class; rather, it requires only that the nonfavored class be treated equally, however good or bad that treatment may be. An example is the Equal Protection Clause of the U.S. Constitution. See JOHN HART ELY, *DEMOCRACY & DISTRUST: A THEORY OF JUDICIAL REVIEW* 88–135 (Harvard Univ. Press 1980). By contrast, Order No. 888 imposed specific normative standards, i.e., the requirement to provide two services (point-to-point and network) pursuant to a standardized tariff (the “*Pro Forma* Tariff”), to remedy undue discrimination. See Order No. 888, *supra* note 1, at 31,636.

10. *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations*, 105 F.E.R.C. ¶ 61,218, 62,142 (2003) (recognizing “the need to provide reasonable bounds within which conditions on market conduct will be implemented so as not to create unlimited regulatory uncertainty for individual market participants or harm to the marketplace in general” and “that a stable marketplace with clearly defined rules would benefit both customers and market participants . . .”). Critics of this rulemaking would no doubt contend, however, that the rule does not live up to the foregoing quotations, namely that it does *not* provide “reasonable bounds” on prohibited conduct, but rather leaves those bounds open ended to preserve the FERC’s flexibility to deal with future forms of manipulation. This question is beyond the scope of this article.

*Forma* Tariff have been bedeviled by the same uncertainties, thereby reinforcing the notion that the rules themselves are a problem, not simply their misapplication by discriminating transmission owners.

If I am close to the mark in diagnosing the problem (or one of them), then what should be done about it? I have two suggestions and, in particular, two standards for judging the reform of Order No. 888. The first standard is "clarity," which requires that the FERC's rules be known and understood by transmission providers and their customers. This may seem a simple thing, but Order No. 888 fails this test in certain respects. I provide a few notable examples of this in Section II. The second standard is "transparency," which considers whether one can tell if the FERC's rules are being followed. Order No. 888 (and its companion, Order No. 889)<sup>11</sup> fare much better under this standard, but there are still a few improvements that can be made. I note a few in Section III.B. I also suggest that there is a relationship between the two standards, such that the *less* clarity there is as to what *should* be done the *more* transparency there should be as to what *is* being done.

The last section of the article considers what penalties (or remedies) should apply when a violation of Order No. 888 has in fact occurred. I recommend, not surprisingly, that the FERC adopt clearer guidelines as to precisely which violations will result in which penalties. I also recommend that the penalties be applied in a manner that takes into account the nature and effectiveness of the compliance program of the defendant. These recommendations have two related purposes, the first being to reduce enforcement and compliance costs by creating greater certainty and the second being to encourage greater internal controls at vertically integrated utilities by tailoring enforcement policy to reward that behavior (and to punish a lack of internal controls). The question of which penalties are applied to which behavior will remain important because, even if FERC clarifies important elements of Order No. 888, some level of discretion will remain, as will some level of nontransparency, thereby providing opportunities, however reduced, for undue discrimination.

## I. THE SCOPE OF THE UNDUE DISCRIMINATION PROBLEM

Order No. 888 held that the transmission network is a natural monopoly and that transmission owners have both the incentive and ability to use it to favor their own generation sales.<sup>12</sup> Although Order No. 888 was designed to blunt that ability to discriminate, the FERC in Order No. 2000 found that "opportunities for undue discrimination continue to exist that may not be remedied adequately by [the] functional unbundling [remedy of Order No. 888]."<sup>13</sup> The FERC was even more emphatic in its proposed SMD rulemaking, finding that "[v]ertically integrated transmission owners and operators continue to use their interstate transmission facilities in ways that inhibit competition in wholesale power

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11. Order No. 889, *Open Access Same-Time Information System and Standards of Conduct*, F.E.R.C. STATS. & REGS. ¶ 31,035 (1996). It should be noted that Order No. 2004 superseded Order No. 889 on issues concerning the FERC's Standards of Conduct.

12. "It is in the economic self-interest of transmission monopolists, particularly those with high-cost generation assets, to deny transmission or to offer transmission on a basis that is inferior to that which they provide themselves." Order No. 888, *supra* note 1, at 31,682.

13. Order No. 2000, *supra* note 2, at 31,015.

markets . . . .”<sup>14</sup> Similarly, the FERC in Order No. 2003 found that many decisions required by the *Pro Forma* Tariff are “subjective” and, because of that, “a Transmission Provider that is not an independent entity has the ability and the incentive to exploit this subjectivity to its own advantage.”<sup>15</sup>

Despite these clear and consistent findings regarding the nature of the problem, the FERC has not to date identified *how much* of a problem it is. Both Order No. 2000 and the SMD rulemaking avoided this issue, resting instead on anecdotal evidence of undue discrimination and the premise that the “perception” of discrimination is itself harmful to the market.<sup>16</sup> In neither case did the FERC consider empirical data regarding how often discrimination occurs, in what form and with what adverse affects on the economy (e.g., allocative or productive inefficiencies). This was, however, understandable under the circumstances. First of all, empirical evidence on the scope of the problem is very difficult to collect, particularly if, as I contend below, it is hard to weed out actual instances of discrimination from disputes over the application of ambiguous rules.<sup>17</sup> Second, isolating the scope of the discrimination problem was arguably unnecessary in Order No. 2000 and the SMD NOPR because they sought to achieve *other* important market reforms at the same time. The FERC’s RTO and standard market design initiatives sought to reduce pancaked transmission rates, internalize parallel flow (i.e., addressing the “contract path” problem), and create centralized, more efficient markets for energy, capacity and ancillary services. Given these broader reforms, it was unnecessary to consider whether undue discrimination *standing alone* was sufficiently serious to merit the structural separation of generation from transmission.<sup>18</sup>

This important question therefore remains unanswered as the FERC considers reforming Order No. 888. Although I too do not know whether the scope of the problem is large or small, I think there are reasons not to be overly pessimistic. When Order No. 888 sought to eradicate undue discrimination, it did so as an *end* in and of itself and also as a *means* to foster the development of competitive wholesale markets.<sup>19</sup> On the latter score, Order No. 888 seems to have fared quite well. Since Order No. 888 was adopted, new entry by merchant generators has flourished.<sup>20</sup> Importantly, this new entry has not been

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14. SMD NOPR, *supra* note 3, at 34,288.

15. Order No. 2003, *supra* note 7, at 30,523–24.

16. Order No. 2000, *supra* note 2, at 31,017 (“we continue to believe that perceptions of discrimination are significant impediments to competitive markets.”); SMD NOPR, *supra* note 3, at 34,289–93 (identifying instances of discrimination by vertically integrated utilities.).

17. Even in Order No. 888 the FERC did not conduct an empirical analysis of discrimination to support its unbundling remedy, but rather relied on anecdotal evidence of discrimination and the observation that vertically integrated utilities have a continuing incentive to discrimination to favor their generation. The D.C. Circuit upheld this approach, as it had for the natural gas pipeline industry, because it does not take an empirical study to show that “an unsupported stone will fall.” *Associated Gas Distribs. v. FERC*, 824 F.2d 981, 1008 (D.C. Cir. 1987).

18. See ICF CONSULTING, ECONOMIC ASSESSMENT OF RTO POLICY (Feb. 26, 2002) (projecting efficiency benefits of RTO markets).

19. Order No. 888, *supra* note 1, at 31,634 (“Today the Commission issues three final, interrelated rules designed to remove impediments to competition in the wholesale bulk power marketplace and to bring more efficient, lower cost power to the Nation’s electricity consumers.”).

20. ELEC. POWER SUPPLY ASS’N, BUY OR BUILD? POWER PURCHASES OR POWER PLANT OWNERSHIP: MAKING THE BEST CHOICE FOR CUSTOMERS 1 (July 2004) (“competitive generators and combined heat and power generators have added approximately 160,000 megawatts of generating capacity in the United States

limited to RTO or ISO markets, but rather has occurred in markets governed by Order No. 888. For example, according to the NERC Winter Assessment (2004–2005), the Entergy region now has the largest reserve margin in the country by several measures – due almost entirely to development by independent merchant generators since Order No. 888 was adopted.<sup>21</sup> The Midwest is a success story as well. *Prior* to the Midwest ISO commencing operations, new merchant generation helped push that region to a reserve margin of approximately 20% – a stark contrast to the severe supply shortages experienced in 1998–1999 in that region.<sup>22</sup> Other regions governed by Order No. 888, including the Southwest and certain portions of the Southeast, have witnessed significant new merchant development as well. When the new entry in these regions is contrasted with the recurring supply problems in California, one could not be faulted for wondering whether unpredictable regulation and price caps can pose a more significant threat to new entry than any perceived flaws in Order No. 888. (This is not, however, a point I will explore here, for it could consume an article all its own.)<sup>23</sup>

The recent audit findings of the Commission's Office of Market Oversight and Investigations (OMOI) also support a more measured critique of Order No. 888. The Commission's enforcement arm has been quite aggressive in recent years and has documented problems at several utilities, such as "quality control errors" in calculating available transmission capacity,<sup>24</sup> the failure to post certain lower voltage transmission paths on OASIS,<sup>25</sup> the treatment of certain facilities as a single node rather than as multiple nodes,<sup>26</sup> and internal meetings that "could lead" to inappropriate information exchanges.<sup>27</sup> Although the importance of these problems should not be discounted, it also would be an overstatement to say that these investigations have revealed "rampant" discrimination through the industry that would support discarding the functional unbundling approach altogether. To be sure, structural separation (e.g., RTOs) would eliminate most of these remaining issues, but it seems hard to find evidence that the functional unbundling remedy of Order No. 888 is a complete failure.

To all this one might ask "so what"? Put more elegantly, the "so what" question asks why it matters whether new entry has occurred, or whether alleged violations are "limited" in scope, if undue discrimination remains a problem? I

since 1997 . . ."). It should be noted, however, that EPSA's statistics likely include generation divested by utilities to merchant generators, not solely new capacity added by merchant generators.

21. See *infra* Section II.A discussing the issue of whether this generation, once constructed, had adequate transmission capacity to deliver energy to load.

22. POTOMAC ECON., LTD., 2002 STATE OF THE MARKET REPORT MIDWEST ISO i (2003).

23. I am also not suggesting that Order No. 888 alone is responsible for the new entry of merchant generation. The Energy Policy Act of 1992 and state restructuring legislation were important factors as well. EPA reduced barriers to entry for generation and, without that, the merchant industry would not be where it is today. State restructuring efforts also no doubt encouraged significant generation development, including in areas still governed by Order No. 888 given the anticipation by developers that retail access would soon spread to those regions as well. The retail access movement died, however, in the wake of the California crisis and rising natural gas prices in 2000–2001. See generally John S. Moot, *Economic Theories of Regulation and Electricity Restructuring*, 25 ENERGY L.J. 273 (2004).

24. See *Entergy Servs., Inc.*, 109 F.E.R.C. ¶ 61,281, 62,329 (2004) (citing OMOI audit that identified several quality control problems).

25. See *Tucson Elec. Power Co.*, 109 F.E.R.C. ¶ 61,272 (2004).

26. See *Ariz. Pub. Serv. Co.*, 109 F.E.R.C. ¶ 61,271 (2004).

27. See *Fla. Power Corp.*, 111 F.E.R.C. ¶ 61,243 (2005).

agree with the “so what” point and certainly do not mean to suggest that undue discrimination has been eradicated or that its effects are benign. Residual undue discrimination could be having more subtle effects, such as delaying (albeit not denying) new entry or skewing generation dispatch decisions once new entry has occurred. My point is fairly narrow, namely that much of the available evidence suggests that Order No. 888 has enjoyed significant success in facilitating new entry, and that its failures in the area of undue discrimination are not a reason to scrap it entirely. This does not mean that improvements cannot be made and surely they can. As I explain in the next section, the less sure we are about the *scope* of the problem the more it matters how we define the *nature* of the problem when designing any needed reforms.

## II. THE NATURE OF THE UNDUE DISCRIMINATION PROBLEM

In the absence of empirical data on the scope of the undue discrimination problem, one can only make an educated guess as to what, if anything, to do about whatever level of discrimination remains. That educated guess, in turn, requires certain assumptions regarding the *nature* of the problem. The FERC’s traditional assumption, first announced in Order No. 2000, has been that functional unbundling is ineffective to squelch undue discrimination because vertically integrated utilities retain both the incentive and ability to discriminate against their competitors. As I indicated earlier, if this were the main defect in Order No. 888, one might focus on adopting tougher penalties for undue discrimination.<sup>28</sup> After all, tougher remedies would have two benefits. First, they should deter undue discrimination by making it unprofitable.<sup>29</sup> Second, tougher remedies would represent a targeted approach that avoids structural remedies that *assume* that discrimination is rampant, when, in fact, we do not know whether it is.

I would agree that meaningful remedies (penalties) are necessary to deter undue discrimination (and discuss them further in Section III. D below), but a remedy can only deter unlawful conduct if the regulated person knows what conduct is proscribed.<sup>30</sup> It is on this latter point where we have the problem. Many discrimination claims occur when capacity is scarce, which is precisely the

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28. This is no longer a theoretical exercise, as the FERC was recently given broad new civil penalty authority under the FPA. Then-Commissioner (now Chairman) Joseph Kelliher recently explored the issue of penalties as it pertains to market manipulation, but his points could apply in some instances to the issue of undue discrimination. Hon. Joseph T. Kelliher, *Market Manipulation, Market Power, and the Authority of the Federal Energy Regulatory Commission*, 26 ENERGY L.J. 1 (2005).

29. This broad generalization is, of course, true only in theory because it skirts the difficult question of precisely *which* penalties or remedies are optimally efficient in encouraging lawful behavior without imposing more costs (e.g., enforcement and compliance costs) than they save. For a discussion of the issue as it pertains to federal securities laws, see, e.g., John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301 (2004); John S. Baker, Jr., *Reforming Corporations Through Threats of Federal Prosecution*, 89 CORNELL L. REV. 310 (2004); Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857 (1984). There also is a considerable body of work by economists on the efficiency of various forms of law enforcement and penalties for noncompliance. See, e.g., Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. OF POL. ECON. 169 (1968); George J. Stigler, *The Optimum Enforcement of Laws*, 78 J. OF POL. ECON. 526 (1970); Louis Kaplow & Steven Shavell, *Optimal Law Enforcement with Self-Reporting of Behavior*, 102 J. OF POL. ECON. 583 (1994); A. Mitchell Polinsky & Steven Shavell, *The Optimal Tradeoff between the Probability and Magnitude of Fines*, 69 AM. ECON. REV. 880 (1979).

30. *Id.* (literature discussing deterrent effect of various penalties and law enforcement approaches).

area in which the FERC's rules are the least prescriptive and, in some instances, nonexistent. The lack of clear rules for capacity measurement and allocation presents not only a normative deficiency – if we do not have clear rules for measuring and allocating scarce capacity, it would be hard to imagine that we have *efficient* rules, which means we have a public policy problem even in the absence of discrimination – but the lack of clear rules also makes it difficult to determine whether discrimination is occurring in the first place. I illustrate this problem by describing below the rules for (i) measuring transmission capacity, and (ii) allocating capacity as between bundled and unbundled loads. By picking these examples, I do not suggest that they stand alone (there are certainly other examples as well), nor do I suggest that *every* aspect of Order No. 888 compliance is uncertain. Order No. 888 did an admirable job in creating specific tariff rules to govern many aspects of transmission service, thereby creating uniformity across the grid in many areas and reducing compliance and transaction costs. The point here is that this job was incomplete in important respects, which, in turn, has created many controversies that have acquired the discrimination moniker.

*A. Measuring Available Transmission Capacity under the OATT*

A transmission grid is not like a glass of water whose capacity can be measured easily. Rather, it is an integrated network of thousands of nodes such that each transaction can affect hundreds of others.<sup>31</sup> It is thus no simple matter to measure or ration capacity on the grid and, because of this, one might have expected the FERC to be quite explicit as to how utilities should measure the capacity available to satisfy requests for service under the OATT. But it was not. The *Pro Forma* Tariff creates a blank appendix (Attachment C) that each utility is asked to fill out to describe how it will calculate available transmission capacity (ATC).<sup>32</sup> The compliance issues created by this lack of prescription are obvious. As the FERC acknowledged in its recent Notice of Inquiry (NOI) on the calculation of ATC (ATC NOI), “there is as yet no industry-wide standard for calculating ATC.”<sup>33</sup> This, of course, makes it difficult to determine whether any *particular* method violates Order No. 888's mandate to provide transmission service on a nondiscriminatory basis.

The difficulties created by this lack of prescription are illustrated by the

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31. Paul L. Joskow, *Deregulation and Regulatory Reform in the U.S. Electric Power Sector*, in DEREGULATION OF NETWORK INDUSTRIES: WHAT'S NEXT? 155 (Sam Peltzman & Clifford Winston eds. 2000) (“Competitive generation markets on electric power networks are most appropriately conceptualized as spatial markets with demand (or loads) and differentiated generators dispersed across the network's geographic expanse.”). This is why, early in the electricity restructuring debate, Professors Hogan and Joskow (and others) argued that a single entity should both operate the grid and the energy markets using it.

All of the credible models for creating new competitive electricity markets recognize that there must be a single network operator responsible for controlling the physical operation of a control area, coordinating generator schedules, balancing loads and resources in real time, acquiring ancillary network support services required to maintain reliability, and coordinating with neighboring control areas.

*Id.* at 155–56.

32. Order No. 888, *supra* note 1, app. D, attachment C.

33. Notice of Inquiry, *Information Requirements for Available Transfer Capability*, F.E.R.C. STATS. & REGS. ¶ 35,549, 35,903 (2005) [hereinafter ATC NOI].



recent disputes occurring on the Entergy system.<sup>34</sup> Over the past five years, an enormous influx of merchant capacity (approximately 17,000 MW) has resulted in significant transmission constraints and, with those, denials of transmission access. The generators have complained loudly and often.<sup>35</sup> In response, Entergy adopted a series of reforms that proved quite controversial. Initially, Entergy used an ATC methodology that models “interfaces” with other control areas, but did not measure constraints that are “internal” to a given system. Because most of the new merchant capacity was internal to the Entergy system, this methodology proved inadequate and Entergy supplemented it with a simplified method for evaluating internal constraints (the “Generator Operating Limit” standard).<sup>36</sup> This change was initially well received because it allowed generators to receive certain transmission capacity without requesting a system study,<sup>37</sup> but it also was not without its problems,<sup>38</sup> and Entergy soon proposed a more sophisticated method then in use by both the MISO and SPP RTOs. This method, called the “available flowgate methodology” (AFC), was also initially well received because it provided a more accurate picture of the grid and one that would adjust quickly to reflect changes in system conditions.<sup>39</sup> But here too, the honeymoon was short. The increased sophistication also meant increased complexity and some generators received less capacity than they thought they deserved.

All of this created quite a harangue over whether Entergy was using these technologies to discriminate against its competitors.<sup>40</sup> On the one hand, generators asserted that these technologies were being applied to shut them out from competing against Entergy’s older, less efficient gas-fired facilities. On the other hand, Entergy asserted that it was taking reasonable, incremental steps to provide a more accurate assessment of transmission constraints on its grid. The FERC, not knowing precisely who was right, set the disputes for hearing.<sup>41</sup>

This is all quite interesting by itself, but what is notable, for purposes of this article, is that Order No. 888 had little to say about the matter. Not only is Order No. 888 silent on the myriad of modeling questions that comprise the debate over the AFC methodology, it is, of course, silent as to whether the AFC method, the GOL method, or any other method should be used. To be sure, some of this silence is understandable. The industry best practices evolve over time and there is certainly no reason for the FERC to stifle them by locking one in for all time.

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34. It should be noted that the author represented Entergy in certain of these disputes.

35. See *Entergy Servs., Inc.*, 109 F.E.R.C. ¶ 61,281 (2004) (listing complaints of market participants regarding denials of access).

36. *Entergy Servs., Inc.*, 102 F.E.R.C. ¶ 61,281, 62,007 (2003).

37. *Entergy Servs., Inc.*, 103 F.E.R.C. ¶ 61,270 (2003) (finding internal GOL methodology “appears to be superior to the status quo”); 102 F.E.R.C. ¶ 61,281, at 61,897 (finding external GOL methodology “appears to be superior to the status quo”).

38. 109 F.E.R.C. ¶ 61,281, at 62,329–30 (citing OMOI audit that identified several quality control problems).

39. *Entergy Servs., Inc.*, 106 F.E.R.C. ¶ 61,115 (2004). The FERC found that the AFC method “appeared to be an improvement over the then-current process of evaluating short-term transmission service requests . . .” 109 F.E.R.C. ¶ 61,281, at 62,323.

40. *Entergy Servs., Inc.*, 109 F.E.R.C. ¶ 61,281, 62,326–28 (2004).

41. 109 F.E.R.C. ¶ 61,281 (2004). The hearing was later held in abeyance when the FERC approved Entergy’s proposal to install an Independent Coordinator of Transmission to coordinate its transmission operations, including the granting or denying of transmission service requests using the AFC process. *Entergy Servs., Inc.*, 110 F.E.R.C. ¶ 61,296 (2005).

The point here is that the participants to a major discrimination dispute were arguing, in many respects, over what rules *should* apply, not whether a set of clear rules had been misapplied.<sup>42</sup> On a question of such critical importance – how to measure available transmission capacity – this should give the FERC pause before assuming that such disputes are themselves evidence of discrimination. It may well be that some utilities are guilty of applying their chosen ATC methodology unfairly, but it is also no doubt true that the uncertainty as to *which* methodology to use (and *which* assumptions are appropriate in implementing it) is a significant compliance issue that makes the FERC's job more difficult in determining whether undue discrimination continues to occur.

### *B. Allocating Capacity between Bundled and Unbundled Customers*

If measuring ATC is difficult and the rules for doing so unclear, the same can be said for the problem of *allocating* scarce transmission capacity among competing users. This section will not attempt to canvass all the recurring allocation disputes, but rather will focus on a subset of disputes that most frequently involve discrimination claims – i.e., those involving competition between bundled and unbundled customers for scarce transmission capacity. Vertically integrated utilities are often said to “favor” their bundled sales over unbundled service when allocating scarce transmission capacity.

These disputes between bundled and unbundled load arise in part because Order No. 888 required utilities to provide *unbundled* service (point-to-point and network service) through the *Pro Forma* Tariff, but it did not require that *bundled* service (particularly bundled retail<sup>43</sup>) be provided under that Tariff.<sup>44</sup> FERC recognized that this could

result in service under two separate arrangements – an explicit wholesale transmission tariff filed at the Commission and an implicit retail transmission tariff governed by a state regulatory body . . . rais[ing] the possibility that the quality of transmission service for retail purposes will be superior to the quality of transmission service offered for wholesale purposes.<sup>45</sup>

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42. This is not to say that the FERC itself had not answered some of the questions through its review and acceptance of Entergy-specific tariff sheets to implement the GOL or AFC methodologies.

43. A bundled retail customer is a customer that takes generation, transmission and distribution service as a single, bundled product and does not have the opportunity to purchase generation in the competitive market, i.e., is a customer that resides in a non-retail access state.

44. Rather, the FERC stated that “we believe that when transmission is sold at retail as part and parcel of the delivered product called electric energy, the transaction is a sale of electric energy at retail. Under the FPA, [the FERC's] jurisdiction over sales of electric energy extends only to wholesale sales.” Order No. 888, *supra* note 1, at 31,781. Consequently, the FERC held that “we are not requiring the transmission provider to unbundle transmission service to its retail native load nor are we requiring that bundled retail service be taken under the terms of the Final Rule pro forma tariff.” Order No. 888, *supra* note 1, at 31,745. The FERC alternated between indicating that it had no *jurisdiction* to impose such a requirement and the narrower prudential finding that it had such jurisdiction but it would not exercise it. The Supreme Court noted these inconsistencies and interpreted Order No. 888 as resting on the latter rationale. *New York v. FERC*, 535 U.S. 1, 25 n.14. See also *id.* at 38–41 (canvassing the FERC's various statements in its orders, briefs and argument) (Thomas, J., dissenting).

45. Notice of Proposed Rulemaking, *Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, [1982–1995 Proposed Regs.] F.E.R.C. STATS. & REGS. ¶ 32,514, 33,081, 60 Fed. Reg. 17,681 (1995) [hereinafter Order No. 888 NOPR]. See also SMD NOPR, *supra* note 3, at 34,295 (“There are also different rules for bundled retail transmission service and for wholesale and unbundled retail transmission

But the FERC nonetheless limited the reach of Order No. 888 to avoid “numerous difficult jurisdictional issues.”<sup>46</sup> As the FERC later observed in the SMD NOPR, this limitation means that “over 60 percent of load has been subject to various state rules governing the transmission component of bundled retail transactions.”<sup>47</sup> This has created no small amount of uncertainty in determining whether a particular transmission use on behalf of bundled load “discriminates” against unbundled OATT service. I briefly discuss two dimensions of problem below – the reservation of import capacity and the reservation of capacity to serve load growth.

### 1. Importing Power to Serve Bundled Load – the CBM Issue

Transmission interconnections between control areas are the lifeblood of wholesale competition today, but their original purpose was somewhat different. Following the Northeast Blackout of 1965, utilities strengthened their interconnections to increase reliability and, particularly relevant here, with the construction of large scale nuclear and coal generation units in the 1960s and 1970s, stronger interconnections allowed utilities to import power to compensate for the outage of a major unit.<sup>48</sup>

With the advent of open access under Order No. 888, however, it became possible for wholesale customers to reserve this import (or “interface”) capacity and thereby preempt a utility’s ability to import power to serve native load in times of emergency. To protect against such a situation, many utilities reserved a portion of their interface capacity for reliability purposes – typically called a Capacity Benefit Margin (CBM) – which of course had the effect of removing the capacity from sale under the OATT.<sup>49</sup> Not surprisingly, these reservations proved controversial when import capacity became scarce and utilities denied requests for service under the OATT on the basis of a CBM reservation.

When the FERC first considered the CBM issue, it ruled that, if a utility wanted to use an interface, it was required, just like any other OATT customer, to “designate” a network resource on the other side of the interface pursuant to Part III of the *Pro Forma* Tariff.<sup>50</sup> This seemed clear enough (although debates ensued over whether this holding was consistent with Order No. 888’s limitation that the OATT did not apply to bundled sales<sup>51</sup>), and standing alone it seemed to reject the notion of a CBM reservation altogether. But the FERC did not stop there. Rather, at the same time it decided those cases, the FERC initiated an industry-wide notice of inquiry regarding *how* utilities should define and

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services.”).

46. Order No. 888, *supra* note 1, at 31,699. The U.S. Supreme Court upheld that determination. *New York*, 535 U.S. at 13.

47. SMD NOPR, *supra* note 3, at 34,289.

48. *Gainesville Utils. Dept. v. Fla. Power Corp.*, 402 U.S. 515, 518–19 (1971) (“The major importance of an interconnection is that it reduces the need for the ‘isolated’ utility to build and maintain ‘reserve’ generating capacity.”).

49. *Capacity Benefit Margin in Computing Available Transmission Capacity*, 88 F.E.R.C. ¶ 61,099 (1999).

50. *Morgan Stanley Capital Group*, 83 F.E.R.C. ¶ 61,204 (1998); *Wis. Pub. Power Inc. SYSTEM*, 83 F.E.R.C. ¶ 61,198 (1998); *Aquila Power Corp.*, 90 F.E.R.C. ¶ 61,260 (2000), *order on reh’g*, 92 F.E.R.C. ¶ 61,064 (2000), *reh’g denied*, 101 F.E.R.C. ¶ 61,328 (2002), *aff’d sub nom.*, *Entergy Servs., Inc. v. FERC*, 375 F.3d 1204 (D.C. Cir. 2004).

51. 83 F.E.R.C. ¶ 61,198; *Entergy Servs., Inc.*, 375 F.3d 1204.

calculate CBM,<sup>52</sup> thus suggesting that CBM was still permissible in some form. Similarly, in the very cases in which the FERC had struck down CBM reservations, it initiated factual inquiries into *how much* CBM was needed,<sup>53</sup> thus again suggesting that some amount of CBM was still appropriate. This created no small amount of head scratching in the industry, which only intensified when the FERC later declared, in concluding its generic inquiry, that “[we] take no position on the transmission provider’s ability to set aside CBM for generation reliability requirements.”<sup>54</sup>

I recognize that CBM presents difficult issues for the FERC to resolve. On the one hand, CBM reservations reflect an historic practice that was no doubt efficient at the time and there are strong equity arguments for maintaining it now.<sup>55</sup> On the other hand, wholesale customers are correct to ask whether CBM reservations provide utilities an undue advantage over competitors who are limited to reserving capacity under the OATT. The purpose of this article is not to resolve this normative debate, but rather to emphasize the fact that, almost ten years after Order No. 888, the debate continues because the FERC has not resolved it. Indeed, RTOs continue to struggle with the problem of CBM reservations despite their lack of incentive to discriminate against any particular class of customer.<sup>56</sup> Yet, despite the FERC’s agnosticism on the issue, it consistently cites CBM reservations as evidence of undue discrimination.<sup>57</sup>

## 2. Reservations for Load Growth

Another recurring conflict between OATT reservations and service to bundled load involves transmission capacity needed to serve load *growth*. Historically, utilities have planned on a long-term basis to serve the demands of their franchised customers, including the load growth of those customers. When Order No. 888 was enacted, utilities feared that wholesale customers, using their rights under Order No. 888, could reserve the transmission capacity needed to serve native load growth.<sup>58</sup> The FERC sought to alleviate those fears, stating

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52. See *Capacity Benefit Margin in Computing Available Transmission Capacity*, 86 F.E.R.C. ¶ 61,313 (1999).

53. See *Entergy Operating Cos.*, 87 F.E.R.C. ¶ 61,156, 61,626 (1999).

54. *Capacity Benefit Margin in Computing Available Transmission Capacity*, 88 F.E.R.C. ¶ 61,099, 61,237 (1999).

55. Comments of the Available Transfer Capability Working Group of the North American Electric Reliability Council, *Capacity Benefit Margin in Computing Available Transmission Capacity*, FERC Docket No. EL99-46-000, at 12 (May 7, 1999) (“Elimination of [the current practice of reserving a capacity benefit margin associated with transmission tie capacity] would deny the load-serving entities access to the generation diversity of the Interconnection to meet their reliability requirements, which is the very reason the interconnections were first established.”).

56. See, e.g., *PG&E Nat’l Energy Group*, 99 F.E.R.C. ¶ 61,187 (2002); *PJM Interconnection, L.L.C.*, 101 F.E.R.C. ¶ 61,345 (2002).

57. SMD NOPR, *supra* note 3, at 34,293 (stating that transmission providers have reserved “excessive amounts of capacity benefit margin (CBM) to serve their own load . . .”); ATC NOI, *supra* note 33, at 35,903.

58. Order No. 888, *supra* note 1, at 31,693 (“EEI and many IOUs argue that native load and network transmission customers should have first priority to existing capacity for their reasonably forecasted load requirements because that capacity was constructed to provide service to them and was paid for by them.”). As noted in this quotation, the conflict was principally between point-to-point service, on the one hand, and service to native load and network customers, on the other. To the extent that a utility had wholesale network customer load, that load might side, in some circumstances, with the utility on this question and against point-to-point reservations.

that “public utilities may reserve existing transmission capacity needed for native load growth and network transmission customer load growth reasonably forecasted within the utility’s current planning horizon.”<sup>59</sup> The problem, however, was how such a “reservation” would be accomplished. How does a transmission provider “reserve” capacity for load growth when the OATT reservation rules do not apply bundled retail sales?<sup>60</sup>

There are many dimensions to this problem, but I will focus on one example because it highlights the problem being considered here. The clash between load growth reservations and OATT service often arises when point-to-point customers seek to “roll over” a long-term reservation pursuant to Section 2.2 of the OATT.<sup>61</sup> Order No. 888 gives utilities the right to deny such a “rollover” if it would trump capacity needed for load growth,<sup>62</sup> but Order No. 888 was silent as to precisely *how* this should be done. When the disputes first arose, the FERC rejected load growth reservations for lack of a showing of “specific, reasonably forecasted native load.”<sup>63</sup> The FERC suggested that, to provide such specificity, utilities could submit “a resource plan submitted to and accepted by [a] state commission including projections of the transmission provider’s need for additional transmission capacity in the future to serve native load.”<sup>64</sup>

These resource plans proved a poor tool for this purpose, however. In almost every circumstance, the FERC found that it could not locate in such plans sufficient data to support the native load growth reservation.<sup>65</sup> This should not have been surprising, however, because the purpose of a state resource plan is to ensure that *all* firm load is served reliably through a combination of generation and transmission assets,<sup>66</sup> not to isolate the capacity needed to serve load *growth* alone. Importantly, these problems afflicted both “nonindependent” transmission providers like American Electric Power and the Southern Company,<sup>67</sup> as well as RTOs seeking to apply the *Pro Forma* Tariff.<sup>68</sup> Again, the problem was in no small measure due to the vagueness of the rules

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59. Order No. 888, *supra* note 1, at 31,694.

60. SMD NOPR, *supra* note 3, at 34,295 (“There are also different rules for bundled retail transmission service and for wholesale and unbundled retail transmission services.”).

61. Section 2.2 gives long-term firm transmission customers the right to “roll over” their capacity reservation at the end of their contract term, which, in effect, allows them a perpetual reservation, provided they are willing to “match” the price of any competing request at the end of the term. Order No. 888, *supra* note 1, app. D § 2.2.

62. Order No. 888, *supra* note 1, at 31,694.

63. *Id.*

64. *Am. Elec. Power Serv. Corp.*, 101 F.E.R.C. ¶ 61,384, 62,597–98 (2002).

65. *Id.* at 62,597 (rejecting reservation based on resource plan because transmission provider “has not provided specific supporting information as to how it came up with [the load growth] number or how that number would be relevant to the service at issue . . .”). See also *Nev. Power Co.*, 112 F.E.R.C. ¶ 61,072, 61,561 (2005) (noting that Transmission Provider’s load and resource plan “indicates that the required import capacity to serve native load beyond 2013 exceeds the import capacity reserved for native load,” but finding that Transmission Provider “has not provided any support to justify the reported values for required import capacity.”).

66. It should be noted that utility resource plans would typically consider the transmission requirements of all firm customers, but not the generation requirements of unbundled customers (e.g., municipals or cooperatives) unless those requirements had been identified through network resource designations or long-term point-to-point service reservations.

67. *S. Co. Servs., Inc.*, 108 F.E.R.C. ¶ 61,093 (2004). See also *supra* note 64.

68. *Southwest Power Pool, Inc.*, 109 F.E.R.C. ¶ 61,041 (2004).

themselves. Yet, here too the FERC has characterized these disputes as "evidence" of undue discrimination.<sup>69</sup>

### III. REFORMING ORDER NO. 888

I now turn to the question of how to reform Order No. 888 and, in particular, what to do about the lack of clear rules for measuring and allocating scarce capacity. I decline to offer normative prescriptions about what the rules *should* say, but rather recommend two standards – clarity and transparency – to govern how those rules are designed and implemented. I discuss each in turn, followed by a discussion of how they relate to each other. I then conclude with a short discussion of a related and important topic, namely which remedies should apply when a violation of the rules has in fact occurred.

#### A. Clarity

The clarity standard does not demand that the FERC's rules be perfect; it just requires that they be known and understandable. I use these two adjectives – "known" and "understandable" – on purpose. In most circumstances they connote the same thing – to know something is usually to understand it – but they can diverge in one important circumstance. A rule may be "known," but not "understood," when the FERC takes a stand on an issue but no one can figure out quite what that stand means. The rule on load growth reservations is a good example. The FERC has made it quite clear that a utility cannot deny a rollover request without a justifiable load growth reservation, but no one has yet figured out quite how to do that. The rule itself is clear, but how to implement it is not. One might say this makes the rule itself unclear and this is, of course, true. But the point remains that rules can be unclear either because the FERC has not yet decided an issue, or because it has decided an issue but provided no clear path to its implementation.<sup>70</sup>

Order No. 888 fails the clarity test in important respects (*see* Section II),<sup>71</sup> but this is understandable to some degree. Order No. 888 was not designed to answer every question itself, but rather, like any rule, contemplated that certain implementation questions would be resolved over time. This has not happened, however, in part because the FERC's focus soon shifted elsewhere. Since 1999 the FERC's priority has been to encourage RTO formation and the creation of more efficient market designs, not to fix all the uncertainties associated with Order No. 888. The FERC therefore devoted many of its scarce resources to the former, as well as to addressing the all-consuming California electricity crisis. Much of this, however, is now behind us. The California litigation is winding

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69. *See* SMD NOPR, *supra* note 3.

70. Clarity should not be confused with *uniformity*. The FERC can adopt generic rules that apply to all transmission providers or it can allow differences by region or utility if there is a justification for doing so, or it can do a little of both. Whichever course is chosen, however, the rules by nation, region or utility can be made clearer, regardless of whether they are uniform, although allowing for variations by region means that such clarity must be provided case-by-case rather than by rule.

71. Although it is beyond the scope of this article, it should be noted that Order No. 889 (and its successor, Order No. 2004) does not fare well under the clarity test in many respects. There are several important areas in which the Standard of Conduct rules are unclear, difficult to apply, or both, particularly in the area of planning to serve bundled retail load and the authority of officers and directors to make certain important business decisions (e.g., approving large capital expenditures or significant contracts).

down, all but two RTOs (California and SPP) have Day 2 markets, and RTO formation efforts in other regions have virtually ceased. It is perhaps now time to devote more resources to providing greater clarity to the capacity measurement and allocation rules under Order No. 888. Given that Order No. 888 will continue to govern large portions of the country for several years to come, this should produce dividends in terms of reducing enforcement and compliance costs and, if the rules themselves are improved, increasing the efficient use of the grid.

The American Public Power Association's (APPA) recent report, *Restructuring at the Crossroads: FERC Electric Policy Reconsidered*, supports this view. The APPA urges the FERC to reform Order No. 888 and, in doing so, recognize that the lack of clear rules cannot be divorced from the issue of undue discrimination:

There are undoubtedly some instances where residual discrimination still exists. Such discrimination can be addressed effectively, without the complications that RTOs introduce, by focusing on *clarifying* and *enforcing* open access rules. . . . FERC should undertake a comprehensive look at ways its open access regime could be improved through *clearer rules or changes to improve efficiency*. For example, lack of clarity or specificity with respect to calculation and posting of Available Transmission Capacity ("ATC") has led to concerns by some APPA members about manipulation of ATC calculations. To date, FERC has chosen to address these issues primarily on a case-by-case basis, rather than making and enforcing rule changes to assure that calculations are auditable and transparent. Similarly, protocols for processing transmission reservation queues and procedures regarding the exercise of rollover rights could use a fresh look.<sup>72</sup>

Fortunately, it appears that the FERC may be moving in this direction as well. As this article was being submitted for publication, the FERC issued an NOI on the calculation of ATC.<sup>73</sup> The ATC NOI, building in part on a NERC report on ATC calculation, seeks comment on ways to standardize ATC calculation across the industry. This is certainly a positive development, although the ATC NOI continues to recognize only part of the problem. The ATC NOI states that "[t]he lack of clear and consistent methodologies for calculating ATC can allow transmission providers the discretion to control the transmission system to favor their own power sales or those of their affiliates."<sup>74</sup> As I pointed out *supra*, however, this is no doubt true, but it overlooks the more fundamental problem that, without such clear rules, there is no objective benchmark for determining whether discrimination is occurring in the first place.<sup>75</sup> On this score, it is even more encouraging that the FERC in September 2005 issued a Notice of Inquiry regarding Order No. 888 reform that recognized

72. AM. PUB. POWER ASS'N, *RESTRUCTURING AT THE CROSSROADS: FERC ELEC. POLICY RECONSIDERED* 23 (2004) (emphasis added) (footnote omitted), available at <http://www.appanet.org/files/PDFs/APPAWhitePaperRestructuringatCrossroads1204.pdf>.

73. Notice of Inquiry, *Information Requirements for Available Transfer Capability*, F.E.R.C. STATS. & REGS. ¶ 35,549 (2005), 70 Fed. Reg. 34,417 (2005).

74. *Id.* at 35,903.

75. See generally ATC NOI, *supra* note 33. The ATC NOI illustrates this problem in addressing CBM. As it has in prior cases, the FERC continues to refer to CBM reservations that are not tied to network resources as inappropriate, but then seeks comments on how to standardize CBM calculations across the industry. Compare *id.* at ¶ 35,903 with ¶ 35,905–06. Obviously, if every CBM reservation had to rest on a network resource designation under Part III of the OATT, there would be no point in "standardizing" CBM reservations because they, like every other reservation of network service, would be accomplished through the procedures for network resource designations set forth in the OATT.

the need for greater clarity in the rules, as well as the relationship between clarity and FERC's ability to identify instances of discrimination.<sup>76</sup>

### *B. Transparency*

The second standard I recommend is "transparency," which focuses on what *is* being done to comply with the law. The FERC often characterizes the discrimination problem as three fold: (i) utilities have the *incentive* to discriminate, (ii) discrimination is difficult to *detect*, and (iii) once detected, the *remedies* are often inadequate to remedy the harm done. I will put aside the third leg of this formulation because it focuses on compensating victims, which is an important question, but not one that is within the scope of this article. I will focus instead on the first two, which have one thing in common – both turn to some degree on the required level of *disclosure*. Simply put, detection is more likely with adequate disclosure and the incentive to discriminate declines as the probability of detection increases.

Order No. 888, and its companion Order No. 889, fare much better in this area. In Order No. 889, the FERC required, among other things, that a public utility create a web site (OASIS) that would provide information about the grid (e.g., available transmission capacity), as well as information regarding the utility's separation of its generation and transmission employees. As a result, utilities are required to disclose significant data about their systems, including the available capacity at different interfaces. This both reduces transaction costs and aids in the detection of discrimination. The same is true for the requirement that most transmission service requests be handled through OASIS, which, again, reduces transaction costs and, importantly, allows customers (as well as regulators) to see which service requests are being granted and which are being denied and for what reason.

What more can be done in this regard? I have no new mousetraps, but rather offer a few obvious suggestions. On systems where constraints are frequent, and where customers' complaints regarding denials of access are recurring, greater transparency as to the measurement and allocation of scarce capacity may be appropriate. This greater transparency can take several forms, including requiring more detailed descriptions of the methodologies for calculating ATC (whether in OATT Attachment C or in posted business practices), disclosure of the data and models used to implement these methodologies, stakeholder processes designed to provide market participants with a venue for asking questions about these matters or recommending reforms, and independent audits (whether by OMOI or a third party). These points are perhaps obvious, but the fact is that Order No. 888 is virtually silent on these matters and, with ten years of experience under the FERC's belt, reform in this area may be appropriate.

### *C. The Relationship Between Clarity and Transparency*

I now turn to the relationship between the two standards and suggest, as indicated above, that the less clear the rules are as to what *should* be done the more transparency is needed as to what *is* being done. For example, it does not

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76. Notice of Inquiry re Order 888, *supra* note 5, at 55,797 (discretion "not only makes it difficult for public utilities to comply, but makes it difficult for the Commission to identify violations").



take much disclosure to establish compliance with Order No. 888's "first-come, first-served" rule (e.g., electronic time stamps can do the trick), but establishing compliance with ATC calculations is quite another matter, as discussed in the prior section.

There is, however, one important pitfall to avoid: transparency should not become a *substitute* for clarity. Transparency must have a purpose. The contrast between the federal securities laws and Order No. 888 provides a good example. The federal securities laws emphasize disclosure (transparency) because they do *not* generally seek to regulate *conduct*. They proceed instead from the premise that markets will be more efficient, and investors adequately protected, if companies disclose their financial condition and business plans – irrespective of whether that disclosure reveals that they are doing well, doing poorly, brilliant managers, incompetents or whatever. But Order No. 888 proceeds from an altogether different premise. It does not allow utilities to do whatever they want so long as they disclose it, nor does it allow utilities to do whatever they want so long as they treat all customers comparably. Rather, it imposes a set of specific (albeit not completely clear) norms for granting or denying service. In this context, transparency *alone* cannot remedy undue discrimination, much less identify whether it is occurring in the first place.

The CBM issue is a good example. The FERC's generic inquiry into the matter declined to resolve *whether* CBM could be reserved and chose to rely instead on greater transparency as to *what* CBM reservations were being made.<sup>77</sup> I suppose this was better than doing nothing, but not much better. What precisely was this transparency supposed to accomplish? In theory, a customer could file a complaint using the fruits of the resulting disclosure to allege that a particular CBM reservation was discriminatory. But where would that get us? The answer is *right back where we started* – asking, not answering, whether a particular CBM reservation is appropriate. Simply put, if there are no ascertainable standards for determining whether a particular conduct is permissible or prohibited, greater transparency cannot tell us anything about whether the conduct being observed is discriminatory, unlawful or whatever.

I am not suggesting that transparency has no value standing alone, nor that the FERC must resolve every possible dispute *ex ante*. Without greater clarity, transparency can have a different purpose, and it is an important but narrow one. In situations in which the rules are not clear, transparency can allow market participants and the FERC to observe the nature of the conduct that is occurring and consider whether such conduct should be allowed or modified on a *prospective* basis. I stress "prospective" because its primary alternative – imposing a penalty because the FERC finds such conduct to be "discriminatory" – is not a good fit here. Although it is important to deter discriminatory conduct with meaningful remedies (as discussed immediately below), deterrence works only if the regulated community understands the rules of the road. In the absence of clarity, however, a *post hoc* review has little or no deterrent value and may actually be counterproductive by making regulated companies less willing to disclose certain matters in the first place.

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77. *Capacity Benefit Margin in Computing Available Transmission Capacity*, 88 F.E.R.C. ¶ 61,099, 61,237 (1999).

*D. Remedies for Undue Discrimination*

I have thus far posited that stiff penalties will do us little good if there is significant uncertainty about which actions are lawful and which are prohibited. That does not mean, however, that meaningful penalties are unimportant. They clearly are important. If the industry understands the rules it is supposed to apply, and there is sufficient transparency to make violations difficult to conceal, meaningful penalties (or remedies)<sup>78</sup> should have their desired effect – i.e., muting any residual incentive to discriminate. The question then becomes which penalty (remedy) to choose for which violation. I think the answer has two related subparts – (i) the first being that the inquiry should not be entirely *ad hoc*, but rather that the industry should be on notice *ex ante* as to the type of penalties that will apply to particular unlawful behaviors, and (ii) the second being that enforcement policy should create incentives for greater internal controls at vertically integrated utilities because utilities can, if given the proper incentives, be more efficient in preventing unlawful behavior than audits by government agencies. I discuss each briefly in turn.

My philosophy on the first question is, not surprising, similar to that underlying my prior recommendations regarding greater clarity for the capacity measurement and allocation rules. The central thesis of this article is that providing clearer rules and greater transparency regarding the rules for capacity measurement and allocation will reduce compliance and enforcement costs. The same philosophy governs the fashioning of remedies. The industry should understand which penalties (remedies) apply to which violations. This does not mean that the FERC must decide every question *ex ante*, nor place itself in an enforcement straightjacket, leaving it with no discretion to tailor particular remedies to the situation at hand. Rather, it simply means that the FERC should provide some guidance as to which violations it considers particularly troublesome (e.g., is an overly conservative ATC calculation to maintain reliability as troublesome as a transmission employee giving a merchant employee a “tip” that a transmission line will soon be placed into service?). Providing greater clarity in this area should reduce compliance costs (as well as furthering the FERC’s own policies) because companies will distribute their scarce compliance resources to the areas the FERC deems most problematic.<sup>79</sup> The FERC can provide such guidance in any number of ways, such as through a rulemaking to reform Order No. 888, a policy statement regarding the exercise of the FERC’s new civil penalty authority, or new enforcement guidelines adopted by OMOI.

The second question involves a related inquiry, namely how to fashion penalties so that regulated companies will adopt stronger internal controls and thereby further the FERC’s policy goal of reducing the incidence of undue discrimination. It is a related, but separate, inquiry because the former encourages companies to police those areas that the FERC finds most troubling, whereas this inquiry targets the manner in which they police that behavior (i.e.,

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78. See generally Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594 (2005) (The recently passed energy legislation gives the FERC, for the first time, broad civil penalty authority for violations of the Federal Power Act (such authority previously being limited to very discrete areas)).

79. Providing greater clarity in this area should not only reduce compliance and enforcement costs, but also the perception of arbitrariness when different penalties are applied to different companies that have committed similar violations.

through stronger overall management controls).

This, in some respects, is well plowed ground. The Federal Sentencing Guidelines already employ a structure that is “designed so that the sanctions imposed upon organizations and their agents, taken together, will provide just punishment, adequate deterrence, and *incentives for organizations to maintain internal mechanisms for preventing, detecting, and reporting criminal conduct.*”<sup>80</sup> Although not all elements of the Guidelines are relevant to FERC regulation (e.g., the complicated “scoring” method to establish fines and/or terms of imprisonment), the general enforcement philosophy they embody is worth considering. In particular, the Guidelines use certain “aggravating” and “mitigating” factors to adjust penalties and, in doing so, identify several considerations that are equally relevant to energy regulation.

The first two “aggravating” factors are good examples. The first factor considers the organization’s “Involvement in or Tolerance of Criminal Activity,” an inquiry that turns principally on whether certain “high-level personnel . . . participated in, condoned, or [were] willfully ignorant of the offense . . . .”<sup>81</sup> The second factor considers whether the violation is based on “similar misconduct” that occurred in the past.<sup>82</sup> Although these factors are couched in terms of criminal conduct and intent, both have relevance in a civil context as well. A violation of FERC rules by a rogue employee should not be treated the same as a violation by senior officers (or one that occurred with their acquiescence). Similarly, an isolated violation should not be treated the same as a recurring violation.<sup>83</sup>

The two “mitigating” factors are also relevant to FERC regulation. The first mitigating factor considers whether the “offense occurred even though the organization had in place at the time of the offense an effective compliance and ethics program . . . .”<sup>84</sup> The Guidelines set forth detailed requirements for an “effective” compliance program, including the requirement that senior management be actively involved, there be adequate training of employees, ongoing monitoring of compliance, appropriate disciplinary action for violators, etc.<sup>85</sup> The second mitigating factor considers whether the company “reported the offense to appropriate governmental authorities, fully cooperated in the investigation, and clearly demonstrated recognition and affirmative acceptance of responsibility for its criminal conduct . . . .”<sup>86</sup>

Here too, these mitigating factors should be considered by the FERC as its enforcement policy evolves. Today, there are no formal policies that link the relative level of penalties to the effectiveness of the compliance program maintained by the “defendant” utility, nor is there any incentive to self-report violations. One might even argue that there is a *disincentive* to self-report

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80. U.S. SENTENCING GUIDELINES MANUAL ch. 8, introductory cmt. (2004) (emphasis added) [hereinafter GUIDELINES].

81. *Id.* § 8C2.5(b).

82. GUIDELINES, *supra* note 80, § 8C2.5(c).

83. The third and fourth aggravating factors also could be relevant to the FERC practice in specific cases. The third is triggered if the conduct violates a specific prior order or injunctive decree. The fourth considers whether the defendant obstructed or impeded the investigation into the violation. *Id.* § 8C2.5(d), (e).

84. GUIDELINES, *supra* note 80, § 8C2.5(f)(1).

85. *Id.* § 8B2.1.

86. GUIDELINES, *supra* note 80, § 8C2.5(g)(1).

violations today. In 2001, when the new Chair was appointed, he announced that rules violators would “have their heads chopped off” and then the FERC would “stick ‘em up on stakes and everybody else will behave a lot better.” There is certainly nothing wrong with tough or colorful talk of this nature, but when it is not coupled with an enforcement policy that rewards internal compliance and self-reporting, one could argue that the tough talk simply inhibits self-reporting and perhaps self-audits as well.<sup>87</sup> As a newly assembled FERC convenes, perhaps enforcement policy will evolve toward the approach adopted in the Federal Sentencing Guidelines by “offer[ing] incentives to organizations to reduce and ultimately eliminate [unlawful] conduct by providing a structural foundation from which an organization may self-police its own conduct through an effective compliance and ethics program.”<sup>88</sup> This should aid FERC enforcement policy in all areas of regulation, not simply compliance with Order No. 888. It is important that regulated utilities understand that they must not only comply with FERC requirements, but that FERC will deem it very important how they fashion their internal controls to ensure that this happens. Regulated companies that have strong internal controls – with senior management engaged and ultimately responsible for compliance efforts – should be treated differently, when a violation occurs, than those that do not.

#### CONCLUSION

It has been nearly ten years since the FERC adopted Order No. 888. Since that time, Order No. 888 has been criticized in two principal respects, the first being the inefficiency of the physical rights, contract path method for reserving transmission service and the second being the failure of the functional unbundling remedy to eradicate undue discrimination. I offer no views on the first, a topic that is very important but is perhaps better considered by the economists and engineers. My views on the second are hopefully well founded, but they are admittedly of modest value. It is one thing to say, as I do, that the FERC’s rules on capacity measurement and allocation should be clearer and their application more transparent, but that is not easy to do. “Clarifying” the capacity measurement and allocation rules will no doubt plunge the FERC into very technical debates, as well as force it to consider the trade-off between allowing greater flexibility by individual transmission providers to resolve such technical issues and providing greater uniformity in an effort to limit undue discrimination. Similarly, it is easy to say that the FERC’s enforcement policy should be clearer, encourage stronger internal compliance programs, and reward self-reporting, but that too is not easy to do. Developing an enforcement policy requires difficult trade-offs between the flexibility of assigning penalties on an *ad hoc* basis and providing greater uniformity and guidance to the industry, as well as difficult issues regarding which behavior should be rewarded and how the FERC can reasonably assess whether that behavior is (or has) occurred. Yet, despite the difficulty of these tasks, they seem well worthwhile. Meaningful reform in these areas should reduce compliance and enforcement costs and create the proper incentives to prevent undue discrimination, thereby strengthening the

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87. Self-audits raise concerns similar to self-reporting because, if an internal audit identifies a violation, even if that violation is then halted internally, a paper trail has been left for government investigators when they conduct their next audit of the company.

88. GUIDELINES, *supra* note 80, ch. 8, introductory cmt.

effectiveness of Order No. 888 and, in turn, increasing the competitiveness of bulk power markets.

