

CONTRACT NEGOTIATIONS UNDER PURPA AND THE IMPACT OF RECENT DEVELOPMENTS ON TRANSACTIONS BETWEEN ELECTRIC UTILITIES AND COGENERATION AND SMALL POWER PRODUCTION FACILITIES

G. Philip Nowak*

Congress enacted the Public Utility Regulatory Policies Act of 1978 ("PURPA") as a part of the National Energy Act.¹ As part of a comprehensive program for the conservation and efficient use of energy, Congress sought to encourage the use of "cogeneration" and the development of "small power production facilities."² Cogeneration refers to the sequential production of electric energy and steam or other forms of useful energy (such as heat) which can be used for industrial, commercial, heating, or cooling purposes.³ Small power production facilities, for purposes of PURPA, include facilities which produce electric energy "solely by the use, as a primary energy source, of biomass, waste, renewable resources, or any combination thereof" and have production capacities of no more than 80 megawatts of electricity.⁴

In authorizing the Federal Energy Regulatory Commission ("FERC" or the "Commission") to encourage the development of cogeneration and small power production facilities, Congress sought to overcome existing barriers to the development of these potentially significant sources of energy. Prior to PURPA, electric utilities frequently refused to purchase electric energy from cogenerators and small power producers or offered to purchase energy from such facilities only at unreasonably low rates. Utilities, moreover, often charged cogenerators and small power producers discriminatory rates for supplementary, back-up, and maintenance power. The regulation of cogeneration and small power production facilities by federal and state authorities also imposed burdens that discouraged the development of these types of resources.⁵ Congress attempted to remove these barriers through the enactment of PURPA.⁶

FERC promulgated rules to fulfill the mandates of PURPA. The U.S. Court of Appeals for the District of Columbia Circuit recently vacated two of the rules — the so-called "full avoided cost" and "interconnection" rules — which were deemed essential to the development of cogeneration and small power production

*Partner, Arnold & Porter, Washington, D.C.; B.A., Yale University, 1966; J.D., Vanderbilt University, 1969; Member District of Columbia Bar. Various aspects of this article appeared in the March 22, 1982 and September 13, 1982 issues of the *Legal Times*. The author wishes to acknowledge the valuable assistance provided by Annmarie Levins in the preparation of this article.

¹PURPA is codified at 16 U.S.C. §§ 2061 *et seq.* (Supp. III 1979).

²See section 201, which amends the Federal Power Act by adding 16 U.S.C. § 796 (17)(22) (Supp. III 1979), and section 210, which amends the Federal Power Act by adding 16 U.S.C. § 824-3 (Supp. III 1979).

³16 U.S.C. § 796(18)(A) (Supp. III 1979).

⁴*Id.* at § 796(17)(A).

⁵Cogenerators and small power producers were, for example, subject to regulation under the Federal Power Act, 16 U.S.C. §§ 791, *et seq.* (1976), and the Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79, *et seq.* (1976). Such facilities were also subject, in many cases, to state laws and regulations dealing with the organization and operation of electric utilities and governing the rates utilities may charge consumers. See 123 Cong. Rec. 32403 (1977) (remarks of Sen. Durkin); *id.* at 32419 (remarks of Sen. Hart); *id.* at 32437 (remarks of Sen. Haskell). See also Conference Report on the Public Utility Regulatory Policies Act, H.R. Rep. No. 1750, 95th Cong., 2d Sess. reprinted in 1978 U.S. Code Cong. & Ad. News 7797.

⁶For a discussion of PURPA and the ways in which Congress sought to encourage the use of cogeneration and the development of small power production facilities, see Nowak and Watts-FitzGerald, *Regulatory Incentives for Development of Cogeneration Facilities*, 13, Nat. Resources Law. 613 (1981).

facilities.⁷ Over strong objection, the court denied a petition for rehearing and suggestion for rehearing *en banc*.⁸ As a result and at the Commission's urging, Congress currently is considering legislation which would effectively reverse the decision in *American Electric Power Service Corporation v. FERC* ("AEP") by amending PURPA. The proposed amendments would not, however, eliminate all of the problems currently impeding the rapid development of cogeneration and small power production facilities. At the same time, FERC and the American Paper Institute, an intervenor in the AEP case, have filed petitions for writs of certiorari seeking review by the Supreme Court of the judgment of the court of appeals. The Court has granted these petitions.

This article begins with an analysis of the FERC rules which were challenged in the AEP case and which are likely to have the greatest impact on the structuring of transactions between electric utilities and cogenerators and small power producers. It then considers the likely disposition of the AEP case by the Supreme Court and the possibility that Congress will enact legislation amending PURPA and thereby effectively negate the impact of the decision in the AEP case. Finally, the article discusses some of the problems which should be considered in structuring arrangements between electric utilities and cogenerators and small power producers under PURPA and the FERC rules and the impact which these recent developments will have on such transactions.

I. RULES ENACTED PURSUANT TO PURPA

PURPA mandated that FERC prescribe rules requiring electric utilities to sell power to, and purchase power from, qualifying cogenerators⁹ and small power production facilities¹⁰ ("qualifying facilities"). PURPA also required the Commission to adopt rules exempting qualifying facilities from certain federal and state laws applicable to electric utilities.¹¹ The rules promulgated by FERC to achieve the goals of PURPA required electric utilities, *inter alia*, to purchase power from qualifying facilities at rates equal to the utilities' full "avoided costs"¹² and to interconnect with qualifying facilities.¹³ The Commission also adopted rules giving qualifying facilities the option to engage in the simultaneous purchase and sale of electric energy¹⁴ and for determining which cogenerators and small power producers qualified under PURPA.¹⁵

A. Full Avoided Cost

PURPA specifies the rates at which FERC may require electric utilities to purchase power from qualifying cogenerators and small power producers:

The rules prescribed . . . shall insure that, in requiring any electric utility to offer to purchase electric energy from any qualifying cogeneration facility or qualifying small power production facility, the rates for such purchase —

⁷*American Electric Power Service Corporation v. FERC*, 675 F.2d 1226 (D.C. Cir. 1982).

⁸*Id.* at 1246.

⁹A "qualifying cogeneration facility" is defined at 16 U.S.C. § 796(18)(B) (Supp. III 1979). See discussion accompanying notes 35-37, *infra*.

¹⁰A "qualifying small power production facility" is defined at *id.* § 796(17)(C).

¹¹*Id.* at § 824a-3(e).

¹²18 C.F.R. § 292.304(b)(2)-(4) (1981).

¹³*Id.* at § 292.303(c)(1).

¹⁴*Id.* at § 292.304(b)(4).

¹⁵*Id.* at § 292.201-206.

(1) shall be just and reasonable to the electric consumers of the electric utility and in the public interest, and

(2) shall not discriminate against qualifying cogenerators or qualifying small power producers.

No such rule prescribed . . . shall provide for a rate which exceeds the incremental cost to the electric utility of alternative electric energy.¹⁶

FERC promulgated a rule requiring electric utilities to purchase power at rates equal to their full avoided costs from “new capacity” of qualifying facilities.¹⁷ The Commission specified the factors to be taken into account in determining avoided costs, including, *inter alia*, the amount of energy available from a qualifying facility during peak periods and the utility’s ability to decrease its use of fossil fuel or defer adding new capacity to its facilities because of the availability of electric energy from cogenerators and small power producers.¹⁸ Additionally, FERC provided that the rate for purchases from other than new capacity could be less than full avoided costs, if it is determined that the lower rate is consistent with PURPA’s requirements and sufficient to encourage cogeneration and small power production.¹⁹

FERC offered several reasons for adopting the full avoided cost rule. First, the Commission believed that the rule furthered PURPA’s essential goal of encouraging the use of cogeneration and small power production. In answering commenters who argued for a rate between qualifying facilities’ costs and utilities’ avoided costs, FERC noted:

[I]n most instances, if part of the savings from cogeneration and small power production were allocated among the utilities’ ratepayers, any rate reductions [would] be insignificant for any individual customer. On the other hand, if these savings are allocated to the relatively small class of qualifying cogenerators and small power producers, they may provide a significant incentive for a higher growth rate of these technologies.²⁰

Second, the Commission reasoned that a “split-the-savings” rate for purchases would require analysis of qualifying facilities’ production costs, the traditional approach to setting rates for electric utilities. Since it was Congress’ intent to exempt qualifying facilities from traditional utility regulation, FERC contended that consideration of qualifying facilities’ costs was inconsistent with PURPA. The full avoided cost rule looked only to utilities’ costs and thus did not subject qualifying facilities to traditional regulation in setting rates for the purchase of their electricity.²¹

Finally, FERC cited comments that “ratepayers and the nation as a whole will benefit from the decreased reliance [on] scarce fossil fuels such as oil and gas, and the more efficient use of energy,” and that under the full avoided cost rule, “the utilities’ customers are kept whole, and pay the same rates as they

¹⁶16 U.S.C. § 824a-3(b) (Supp. III 1979).

¹⁷18 C.F.R. § 292.304(b)(2)-(4) (1981). Under the rules, new capacity is capacity from a facility on which construction was commenced on or after November 9, 1978. *Id.* at 304(b)(1).

¹⁸*Id.* at § 292.304(e)(1)-(4).

¹⁹*Id.* at § 292.304(b)(2). State regulatory authorities make these determinations with respect to purchases by electric utilities over which they have ratemaking authority. Nonregulated utilities make such determinations for themselves.

²⁰45 Fed. Reg. 12222 (Feb. 25, 1980).

²¹*Id.*

would have paid had the utility not purchased energy and capacity from the qualifying facility."²² The Commission concluded, therefore, that the full avoided cost rule satisfied its obligation under PURPA to set rates for the purchase of electricity from qualifying facilities that are just and reasonable, non-discriminatory, and in the public interest.²³

B. Interconnection

PURPA authorizes FERC to order, upon application of any electric utility, federal power marketing agency, geothermal power producer, or qualifying facility, "the physical connection of any cogeneration facility, any small power production facility, or the transmission facilities of any electric utility," with the facilities of the applicant.²⁴ The Commission must afford notice and the opportunity for an evidentiary hearing and, thereafter, make certain findings before ordering interconnection.²⁵ In accordance with this mandate, FERC promulgated a general rule providing that "any electric utility shall make such interconnections with any qualifying facility as may be necessary to accomplish purchases or sales" under PURPA.²⁶ In so doing, FERC seemed to bypass the procedural requirements specified in PURPA.

The interconnection rule, moreover, did not contain the substantive requirements specified in Sections 210 and 212 of the Federal Power Act ("FPA"). For example, Section 210(c) authorizes the Commission to issue an interconnection order with respect to a qualifying facility only if (1) the interconnection is in the public interest; (2) it would encourage overall conservation of energy or capital, optimize the efficiency of the use of facilities and resources, or improve a utility system's reliability; and (3) it satisfies the requirements of Section 212.²⁷ Section 212 of the FPA requires the Commission to make various findings before it can issue an interconnection order. FERC must find, *inter alia*, that the interconnection is "not likely to result in a reasonably ascertainable uncompensated economic loss" for any utility or qualifying facility, will not place an "undue burden" on any party, will not "unreasonably impair the reliability" of the utility, and will not "impair" the utility's ability to "render adequate service to its customers."²⁸

The Commission argued, however, that the evidentiary hearing specified in PURPA is not the exclusive method by which interconnection can be obtained. Thus, in its view, it need not make the findings specified in Sections 210 and 212 of the FPA. FERC claimed that "PURPA provides a general mandate for the Commission to prescribe rules necessary to encourage cogeneration and small power production," and according to the agency, this charge provides "sufficient authority to require interconnection."²⁹ The Commission noted, moreover, that PURPA's basic goal of encouraging cogeneration and small power

²²*Id.*

²³16 U.S.C. § 824a-3(b)(1) (Supp. III 1979).

²⁴*Id.* at § 824i(a)(1).

²⁵*Id.* at § 824i(b)-(c).

²⁶18 C.F.R. § 292.303(c) (1981).

²⁷U.S.C. § 824i(c) (Supp. III 1979).

²⁸*Id.* at § 824k(a).

²⁹45 Fed Reg. 12221 (Feb. 25, 1980).

production would be greatly hindered if each qualifying facility had to participate in an evidentiary hearing to obtain interconnection. The “complex procedures” required by PURPA “would, in most circumstances, significantly frustrate the achievement of the benefits of this program.”³⁰

Finally, FERC relied on the language in Section 212(e) of the FPA, as amended by PURPA, which states that no provision of the FPA shall be treated as requiring the use of Section 210 of the Act “in lieu of any other authority of law” or “as limiting, impairing, or otherwise affecting any other authority of the Commission under any provision of law.”³¹ In the Commission’s view, this language makes clear that the procedures specified in PURPA do not constitute the exclusive prerequisites to interconnection orders. FERC believed that its authority to encourage cogeneration and small power production under PURPA provided an independent basis for the general interconnection rule which it adopted.³²

C. *Simultaneous Purchase and Sale*

As a complement to the full avoided cost rule, FERC adopted a rule providing for the simultaneous purchase and sale of electric energy at the option of qualifying facilities.³³ This rule permits a cogenerator or small power producer to “sell” all of its output to an electric utility at the rate determined by the utility’s avoided costs — even though none of the power is actually transmitted to the utility — while simultaneously “buying” at the utility’s normal rate all of the electric energy necessary to run the qualifying facility’s operations. The latter rate is based on the utility’s average costs and, therefore, may be less than its full avoided costs. In promulgating the simultaneous purchase and sale rule, FERC took the position that the rule “is necessary and appropriate to encourage cogeneration and small power production.”³⁴

D. *Fuel Use and Qualification*

PURPA defined “qualifying cogeneration facility” as a cogeneration facility which

- (i) the Commission determines, by rule, meets such requirements (including requirements respecting minimum size, fuel use, and fuel efficiency) as the Commission may, by rule, prescribe; and
- (ii) is owned by a person not primarily engaged in the generation or sale of electric power (other than electric power solely from cogeneration facilities or small power production facilities).³⁵

The FERC rule defining qualifying cogenerators focuses on fuel efficiency — providing specific operating and efficiency standards which cogenerating facilities must meet to qualify for the benefits of PURPA.³⁶ The Commission

³⁰*Id.*

³¹16 U.S.C. § 824k(e) (Supp. III 1979).

³²45 Fed. Reg. 12221 (Feb. 25, 1980).

³³18 C.F.R. § 292.304(b)(4) (1981).

³⁴45 Fed. Reg. 12223 (Feb. 25, 1980).

³⁵16 U.S.C. § 796(18)(B) (Supp. III 1979).

³⁶18 C.F.R. § 292.205 (1981).

specifically declined Congress' invitation to make fuel use a consideration in defining qualifying facilities. According to a staff paper, "a restriction on the use of gas or oil for cogeneration imposed by the Commission, could discourage cogeneration at the lower heat input levels, while not significantly reducing the use of oil or natural gas."³⁷ In addition, Congress had given the Department of Energy the power to restrict the use of petroleum or gas as a primary energy source for large cogeneration facilities.³⁸ Thus, FERC concluded that restrictions on fuel use by qualifying cogenerators were not appropriate.

II. THE AEP CASE

In response to the court of appeals' decision in the *AEP* case, FERC filed a petition for rehearing and suggestion that the rehearing be *en banc*. Both requests were denied. Accordingly, the Solicitor General on behalf of FERC and the American Paper Institute ("API"), an intervenor in the case, have filed petitions for writs of certiorari, which the Supreme Court has granted. The Court should, in accordance with its normal schedule, render a decision on the merits of the case before the end of its current term in June 1983.

A. *The Court of Appeals' Decision*

In the *AEP* case, the court vacated the FERC rules requiring electric utilities pay full avoided costs for power purchased from qualifying facilities and to interconnect with such facilities. The court upheld the simultaneous purchase and sale rule, as well as FERC's decision not to include fuel use among the requirements of qualification under PURPA.³⁹

1. *Full avoided cost rule.* The court of appeals vacated the full avoided cost rule⁴⁰ because the Commission had "not adequately justified its adoption of the full avoided cost standard."⁴¹ Although Congress could have required FERC to establish rates at full avoided costs, it did not do so. The court said that Congress, instead, specified the factors which the Commission was to consider in establishing rates under PURPA. The rates set by FERC must, in addition to not discriminating against qualifying facilities, be "just and reasonable to the electric consumers of the electric utility and in the public interest."⁴² In its

³⁷44 Fed. Reg. 38875 (July 3, 1979).

³⁸See Powerplant and Industrial Fuel Use Act of 1978, 42 U.S.C. §§ 8301, *et seq.* (Supp. II 1978). See discussion accompanying note 71, *infra*.

³⁹PURPA recently survived constitutional challenge in *FERC v. Mississippi*, ___ U.S. ___, 102 S.Ct. 2126 (1982). In that case, a federal district court declared Titles I and III and Section 210 of PURPA to be facially unconstitutional. In an unreported opinion, the district court had held that these sections exceeded Congress' power under the Commerce Clause and constituted an invasion of state sovereignty, contrary to the Tenth Amendment. The Supreme Court reversed, with four justices dissenting as to two different parts of the majority's holding. The majority found that Titles I and III of PURPA did not require any state regulatory authority or nonregulated utility to adopt or implement a specific rate design or regulatory standards. *Id.* at 2132. Moreover, the Court held that Section 210 "does nothing more than preempt conflicting state enactments in the traditional way." *Id.* at 2137. In light of these findings, the Court thought PURPA fell well within congressional authority.

⁴⁰18 C.F.R. § 292.304(b)(2)-(4) (1981). See text accompanying notes 16-23, *supra*.

⁴¹675 F.2d at 1232.

⁴²16 U.S.C. § 824a-3(b)(1) (Supp. III 1979).

Conference Report, Congress described the incremental or avoided cost standard as the *maximum* rate which FERC could set:

[T]he utility would not be required to purchase electric energy from a qualifying cogeneration or small power production facility at a rate which exceeds the lower of the rate described above, namely a rate which is just and reasonable to consumers of the utility, in the public interest, and nondiscriminatory, or the incremental cost of alternate electric energy. This limitation on the rates which may be required in purchasing from a cogenerator or small power producer is meant to act as an *upper limit* on the price at which utilities can be required under this section to purchase electric energy.⁴³

Thus, in the court's view, Congress clearly did not conclude that rates equal to "full avoided costs" were "just and reasonable" in all cases. Accordingly, FERC's task in setting rates under PURPA is to consider three specific criteria: (1) whether the rates are "just and reasonable to the electric consumers of the electric utility," (2) whether they are "in the public interest," and (3) whether the rates discriminate against qualifying facilities. The maximum rate the Commission may establish in light of these factors is equal to full avoided costs. The court held that the Commission did not consider these criteria, or at least that, in doing so, it did not adequately set forth its process of consideration or rationale. Instead, the Commission reached "the simplistic and uniform conclusion that the full avoided cost standard would be just and reasonable in every case and that this was necessary to encourage [the development of qualifying facilities] in every case."⁴⁴

The court of appeals found wanting each of the reasons FERC offered to justify the full avoided cost rule. The court stated that the Commission had failed to "demonstrate the factual basis for its conclusion of 'insignificant' savings" to consumers under alternative rate-setting rules. The court pointed out that "Congress surely knew . . . that inevitably the impact of FERC's rules per consumer will be less than the impact per cogenerator."⁴⁵ Nevertheless, Congress directed FERC to consider consumers' interests in setting rates under PURPA. While the Commission "may be right in its conclusion," the court held that the "just and reasonable" standard required FERC to make explicit findings about the impact of its rules on the utilities' customers.⁴⁶ In promulgating the avoided cost rule, the Commission had not done so.

Although the court of appeals agreed with FERC that Congress intended to exempt qualifying facilities from traditional kinds of utility regulation, it was unimpressed with the Commission's claim that alternatives to the full avoided cost rule necessarily entailed such regulation. FERC could have set a rate at some percentage of full avoided costs, the court said, without becoming involved in traditional kinds of utility regulation. Like the full avoided cost rule, a rule specifying a percentage of full avoided costs would look only to the utilities' costs, and not to the qualifying facilities' costs, in setting rates.⁴⁷

FERC noted, in its one-paragraph discussion of the percentage of full avoid-

⁴³Conference Report on the Public Utility Regulatory Policies Act, H.R. Rep. No. 1750, p. 98, 95th Cong., 2d Sess. reprinted in 1978 U.S. Code Cong. & Ad. News 7797, 7832 (emphasis added).

⁴⁴675 F.2d at 1233.

⁴⁵*Id.* at 1234.

⁴⁶*Id.*

⁴⁷*Id.*

ed costs approach, that a qualifying facility normally will only produce energy if the marginal cost of its production is less than the price it receives for the output. Accordingly, the Commission concluded:

If some fixed percentage is used, a qualifying facility may cease to produce additional units of energy when its costs exceed the price to be paid by the utility. If this occurs, the utility will be forced to operate generating units which either are less efficient than those which would have been used by the qualifying facility, or which consume fossil fuel rather than the alternative fuel which would have been consumed by the qualifying facility had the price been set at full avoided costs.⁴⁸

To the court of appeals, "the bare unquantified possibility that a rule permitting rates at less than full cost *might* be insufficient to encourage the last kilowatt hour of cogeneration" was not an adequate basis for preferring the full avoided cost rule to a percentage rule. Thus, on remand, the court expects the Commission "to take a harder look at, especially, the percentage of avoided cost approach."⁴⁹

Finally, the court of appeals found that FERC had not adequately considered market forces in evaluating the rate necessary to encourage cogeneration and small power production. Balancing the interests of cogenerators, consumers, and the public, as PURPA commanded, required the Commission to consider competitive forces in determining the type and degree of regulation necessary. The court stated:

*the command that the interests of consumers and the public be taken into account contemplates consideration of the degree to which market forces may encourage utilities to purchase, and cogenerators to sell, a substantial amount of cogenerated power at a price lower than the statutory limit.*⁵⁰

On remand, the Commission may find that qualifying cogenerators and small power producers are not in a competitive market,⁵¹ and, therefore, that rules like the full avoided cost rule are necessary to encourage these facilities to produce energy. The court said, however, that "this is precisely the sort of determination which FERC should make explicit and explain, and it has not done so."⁵²

The intent of PURPA, according to the court of appeals, was to strike a balance among the interests of consumers of electricity, the public interest, and the interests of qualifying facilities. On remand, therefore, the Commission "should allocate the benefits more evenly between . . . [qualifying facilities] and the utilities if the utilities can demonstrate that, under a percentage of avoided cost approach, an allocation less heavily favoring the [qualifying facilities] is in the public interest and the interest of the utilities' electric consumers, and will not disproportionately discourage" the development of qualifying facilities.⁵³

2. *Interconnection rule.* The court of appeals vacated the Commission's rule providing that a utility "shall make such interconnections with any qualifying

⁴⁸45 Fed. Reg. 12222-23 (Feb. 25, 1980).

⁴⁹675 F.2d at 1234.

⁵⁰*Id.* at 1235 (emphasis in original).

⁵¹The court noted that utilities may be monopsonistic with respect to cogenerators. *Id.* at 1236.

⁵²*Id.*

⁵³*Id.* at 1234.

facility as may be necessary to accomplish purchases or sales [of electric energy].⁵⁴ It held that the interconnection rule “is inconsistent with the Federal Power Act (FPA), as amended and added to in relevant part by PURPA.”⁵⁵ In so holding, the court rejected FERC’s interpretation of its authority under PURPA.

Section 210(b) of the FPA, as amended by PURPA, requires the Commission to give appropriate notice and afford interested parties an opportunity for an evidentiary hearing before issuing an interconnection order.⁵⁶ No such procedural requirements were mandated under the Commission’s general interconnection rule. Likewise, the Commission’s rule did not require it to make any of the findings specified in Sections 210 and 212 of the FPA before ordering interconnection.⁵⁷ The Commission’s interconnection rule, the court concluded, “would in effect exempt qualifying [facilities] from the . . . procedural and substantive requirements” set forth in Sections 210 and 212 of the FPA.⁵⁸ Thus, the court found the rule to be directly contrary to PURPA’s explicit terms that

[n]o qualifying small power production facility or qualifying cogeneration facility may be exempted . . . from the provisions of section 210, 211, or 212 of the Federal Power Act . . . or the necessary authorities for enforcement of any such provision under the Federal Power Act.⁵⁹

The court of appeals did not find FERC’s arguments in support of the interconnection rule persuasive. It rejected out of hand the Commission’s contention that compliance with the “literal meaning” of Sections 210 and 212 would be unduly burdensome for qualifying facilities, on the one hand, and unnecessary to safeguard the interests of electric utilities, on the other. Whatever “the wisdom and popularity” of FERC’s view, the court found it “necessarily unavailing when Congress has explicitly chosen a policy to the contrary.”⁶⁰

The court of appeals was unconvinced, moreover, by the Commission’s argument that Section 210(a) of PURPA, which authorized FERC to prescribe rules “necessary to encourage cogeneration and small power production,” gave it sufficient authority to order interconnections independently of the procedural and substantive requirements of Sections 210 and 212 of the FPA. In the court’s view, “section 212(e) of the FPA was intended to keep specific grants of authority from being vitiated by the general limitations on authority in sections 210 and 212.”⁶¹ The section does not, therefore, support FERC’s claim because “there is no specific grant of authority” to FERC. The court reasoned:

[W]e have a relatively *specific limitation* on authority in PURPA section 210(e)(3) which must control over the relatively *general grant* of authority in FPA section 212(e). The general directive of section 212(e) does not give the Commission a mandate to consign detailed provisions of PURPA itself to the wastebasket as meaningless surplusage.⁶²

⁵⁴18 C.F.R. § 292.303(c)(1) (1981). See text accompanying notes 24-32, *supra*.

⁵⁵675 F.2d at 1239.

⁵⁶16 U.S.C. § 824i(b) (Supp. III 1979).

⁵⁷See text accompanying notes 27-32, *supra*.

⁵⁸675 F.2d at 1239.

⁵⁹16 U.S.C. § 824a-3(e)(3) (Supp. III 1979).

⁶⁰675 F.2d at 1240.

⁶¹*Id.*

⁶²*Id.* (emphasis in original).

Finally, the court of appeals found no evidence to support FERC's contention that Section 210(e)(3) requires the Commission to hold a hearing and make specified determinations only when cogenerators and small producers are the "targets" of applications requesting interconnection, and are not required when qualifying facilities seek to interconnect with electric utilities. Although the interpretation of Section 210(e)(3) in this way, in an effort to harmonize it with Section 210, was "interesting and not inherently implausible," the court was unwilling to accept it in the absence of support in PURPA itself or its legislative history.⁶³ The court was, nevertheless, somewhat sympathetic to FERC's concern that participation in evidentiary hearings would be unduly burdensome for cogenerators and small power producers. It noted, therefore, that "the Commission need not impose substantial administrative burdens on those facilities, but rather can adopt streamlined procedures."⁶⁴

3. *Other provisions.* The court of appeals upheld the Commission's rule which requires electric utilities, at the option of qualifying facilities, to engage in simultaneous purchase and sale transactions.⁶⁵ The court found two arguments for the rule persuasive. First, in the absence of the rule, qualifying facilities which consumed all of the energy they produced would be treated differently than those which sold their actual surplus to utilities.⁶⁶ Second, and more importantly, the court thought that PURPA itself might require the simultaneous purchase and sale rule:

The statute requires nondiscriminatory rates for cogenerators, and it is at least plausible that the Commission could find that *not* invoking a simultaneous transaction rule would in fact result in cogenerators paying discriminatory rates. That is, in the absence of a simultaneous transaction rule and assuming that there was no physical purchase or sale between the utility and the cogenerator, the person who chose to cogenerate would pay more for his power than the person who chose to buy from a utility.⁶⁷

The court of appeals rejected the petitioners' claim that FERC had not taken the interests of consumers and the public into account in promulgating the simultaneous purchase and sale rule. Since Congress intended PURPA to remove obstacles to cogeneration and small power production, including those created by the unwillingness of utilities to purchase electricity from alternative producers at appropriate rates, the court was "inclined to give a great deal of deference to FERC's regulations."⁶⁸

The court of appeals also held that the Commission was not required to include criteria relating directly to "fuel use" in its rules for determining which cogenerators are deemed to be "qualifying facilities."⁶⁹ PURPA stated that the

⁶³*Id.* at 1240-41.

⁶⁴*Id.* at 1240.

⁶⁵18 C.F.R. § 292.304(b)(4) (1981). See text accompanying notes 33-34, *supra*.

⁶⁶75 F.2d at 1237.

⁶⁷*Id.*

⁶⁸*Id.* at 1238. Seemingly to justify its different treatment of the full avoided cost rule, the court added in a footnote: "Of course, this deference does not extend to regulations not promulgated in conformity with the statute." *Id.* at n.45.

⁶⁹18 C.F.R. § 292.205 (1981). See text accompanying notes 35-38, *supra*.

Commission *may* prescribe requirements which include fuel use; it did not say that it *must* include fuel use as a requirement.⁷⁰ In addition, the court found that

FERC considered the advantages and disadvantages of fuel use criteria, but concluded that the burdens they would place on cogeneration, the presence of FERC's fuel *efficiency* criteria, the power of the Department of Energy (DOE) to restrict the fuel use of the largest cogeneration facilities, and the relative pricing of non-petroleum utility power all rendered fuel use criteria unnecessary and undesirable.⁷¹

Thus, the court concluded that FERC's rejection of fuel use criteria was a "reasonable, adequate response to the charge Congress gave it in section 201 of PURPA," and upheld the rule.⁷²

B. Denial of Petition for Rehearing

FERC petitioned the court of appeals for a rehearing in the *AEP* case and suggested that the rehearing be *en banc*. The petition was denied. The panel which rendered the original decision, composed of Chief Judge Robinson and Judges Wilkey and Ginsberg, prevailed on a 3-2 vote. Judges Wald and Mikva voted for rehearing. The remaining six judges, an unusually high number, did not participate in the decision. Also highly unusual was the panel's explanation of its original decision and the strong statement filed by Judges Wald and Mikva.

The majority's memorandum indicates that the panel may have tried to soften somewhat the impact of its opinion. It stated, for example, that "[t]he Commission . . . has read into the opinion much more than the court put there."⁷³ With regard to the full avoided cost rule, the panel conceded that "[s]ome of the suggested considerations expressed in the opinion may indeed have ready answers. . . . If that is so, it should not be burdensome for FERC to supply them."⁷⁴ The court reiterated that the Commission could adopt "streamlined procedures" in connection with the issuance of interconnection orders. The court also repeated, however, that if streamlined procedures proved to be unduly burdensome, FERC had no choice but to return to Congress:

The court was not insensitive to the objective FERC sought to accomplish, but . . . a court is not the proper forum to repair a congressional product that may have been less than fully considered.⁷⁵

Judges Wald and Mikva felt that a rehearing *en banc* was appropriate because of "the importance of the issues to major new energy programs" and because of "serious doubts over the panel's resolution of those issues."⁷⁶ They believed that the Commission's justification of the full avoided cost rule "seems reasonable" and that nothing further was "necessary to satisfy the requirements of the Administrative Procedure Act, 5 U.S.C. § 706(2)(A)." Likewise, they stated that the Commission's interpretation of the law concerning interconnection "is a plausi-

⁷⁰675 F.2d at 1241.

⁷¹*Id.* at 1242.

⁷²*Id.* at 1244.

⁷³675 F.2d at 1246.

⁷⁴*Id.*

⁷⁵*Id.*

⁷⁶*Id.* at 1247.

ble one and appears to be more closely in line with Congress' expressed desire to encourage cogeneration."⁷⁷

C. *Petitions for Writs of Certiorari*

The Solicitor General on behalf of FERC, and API both filed petitions for writs of certiorari seeking review by the Supreme Court of the court of appeals' judgment in the *AEP* case.⁷⁵ The Court recently granted these petitions and thereby agreed to consider the lower court's decision to vacate the full avoided cost rule and to invalidate the rule requiring interconnection between electric utilities and qualifying facilities. Petitioners contend that by overturning these two FERC rules, the *AEP* decision will have "significant, adverse impacts upon national energy policy" and will substantially thwart the congressional purpose of PURPA — *i.e.*, to conserve energy by encouraging the development of cogeneration and small power production facilities.⁷⁹

1. *Full avoided cost rule.* FERC begins by addressing what it believes is the unarticulated basis for the court of appeals' "hostility" to the full avoided cost rule — "the notion that the Commission lacks authority to adopt such a rule, whatever justifying reasons it might proffer."⁸⁰ Relying on Section 210(b) of PURPA, the Commission contends that the law expressly authorizes it to adopt a rule based on full avoided costs. That section precludes FERC from adopting a rule which provides for the establishment of "a rate which exceeds the incremental cost to the electric utility of alternative electric energy."⁸¹ Since full avoided cost is the same as incremental cost, the setting of such a rate, in the Commission's view, is not only permitted under PURPA but is also reasonable. According to FERC, the "courts are without authority to set aside any rate selected by the Commission which is within a 'zone of reasonableness,' " and a rate set at or below full avoided costs falls within that "zone."⁸²

Respondents, in their brief in opposition to the petitions for writs of certiorari, appear to take the position that, as a matter of law, the rate at which electric utilities purchase power from qualifying facilities must be set at some level below full avoided costs.⁸³ They contend that "[o]ne of Congress' purposes in enacting Section 210 of PURPA was to provide consumers with a share of the benefits of purchase transactions between cogenerators and utilities."⁸⁴ Thus, in respondents' view,

Should the Commission adopt a rule that provides a sharing of benefits (*i.e.*, a rule not requiring purchase rates to equal full avoided cost), the review by any appellate court will necessarily be different, and less inquisitive, than in the instant case.⁸⁵

⁷⁷*Id.*

⁷⁸Petition For a Writ of Certiorari to the United States Court of Appeals For the District of Columbia Circuit, No. 82-226 (filed Aug. 9, 1982) ("FERC Petition"); Petition For a Writ of Certiorari to the United States Court of Appeals For the District of Columbia Circuit, No. 82-34 (filed July 8, 1982) ("API Petition"). The Supreme Court granted the petitions at its conference on October 8, 1982. 51 U.S.L.W. 3275 (U.S. Oct. 12, 1982).

⁷⁹API Petition at 8; FERC Petition at 11.

⁸⁰FERC Petition at 18.

⁸¹16 U.S.C. § 824a-3(b) (Supp. III 1979).

⁸²FERC Petition at 18. *See* API Petition at 18.

⁸³Brief of Respondents in Opposition, Nos. 82-226 and 82-34 (filed Sept. 7, 1982) ("Brief in Opposition").

⁸⁴*Id.* at 17.

⁸⁵*Id.* at 19. *But see* discussion accompanying notes 43-44, *supra*.

FERC also emphasizes that, contrary to the lower court's perception, "the Commission's full avoided cost rule does not require that *actual* rates be set at full avoided cost."⁸⁶ Although PURPA requires the states to implement the Commission's rules, any state regulatory authority and any nonregulated electric utility may apply to FERC for a waiver of its rules.⁸⁷ Electric utilities and qualifying facilities, moreover, are free to negotiate contract prices below full avoided cost rates.⁸⁸ The very purpose and intended effect of the full avoided cost rule, according to the Commission, is merely to set the context for bargaining between utilities and qualifying facilities. Nonetheless, FERC concedes that, in the event the parties fail to agree, the utility would be required to pay the full avoided cost rate.⁸⁹

The Commission contends further that, "[a]s we have shown," the "full avoided cost rule is the result of a reasonable balancing" of the interests of qualifying facilities, the utilities' electric consumers, and the public.⁹⁰ The petition, however, does not contain such a showing. FERC argues instead that the court below did not indicate how it "could better support in a rulemaking record" any different rate.⁹¹ The Commission states that

the full avoided cost rule was adopted as a predictive judgment based on agency expertise regarding the rate level necessary to encourage future cogeneration and small power production, and that factual justification was neither possible nor required. . . . There is no reason to believe, and indeed it is unlikely, that a subsequent rulemaking would produce a better record in this regard.⁹²

API argues that the court of appeals "created a critical gap in the comprehensive regulatory framework promulgated to implement PURPA," thereby crippling the program.⁹³ If the *AEP* decision is allowed to stand, persons or companies considering owning or investing in a qualifying facility would not only be "without the basis necessary to estimate revenue streams for their projects" but would face the prospect of "unduly prolonged" price negotiations — "a discouraging prospect at best for project developers."⁹⁴ The decision, moreover, jeopardizes the continued operation of qualifying facilities currently in place and generating power. Such facilities which are selling power to electric utilities without the benefit of a contract, or pursuant to a contract cancellable in the event of a materially adverse change in the existing law, now face the prospect that their arrangements may be changed in significant respects.⁹⁵

Finally, both petitioners contend that the court of appeals applied the wrong standard of review in vacating the full avoided cost rule. As a result, the court, according to API, "substituted its judgment of a reasonable rate for that of the Commission."⁹⁶ Although the *AEP* court never specified the standard of review that it applied, it cited *Public Systems v. FERC*⁹⁷ in support of its decision to vacate

⁸⁶*Id.* at 19. See API Petition at 6 n.6.

⁸⁷18 C.F.R. § 292.403 (1981).

⁸⁸*Id.* at § 292.301(b)(1)-(2).

⁸⁹FERC Petition at 20, n.16; API Petition at 14, n.21.

⁹⁰FERC Petition at 21.

⁹¹*Id.*

⁹²*Id.* at 22.

⁹³API Petition at 14.

⁹⁴*Id.*

⁹⁵*Id.* at 15.

⁹⁶*Id.* at 18.

the rule. There, the court applied the “substantial evidence” test to an informally promulgated rule, relying on specific statutory provisions that “the finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive.”⁹⁸ Judges Wald and Mikva agreed that the appropriate standard in the *AEP* case was not substantial evidence, but rather the arbitrary and capricious test.⁹⁹

Neither FERC nor API undertakes to address “head on” the primary basis for the court of appeals’ decision in the *AEP* case — *i.e.*, that, in setting the full avoided cost rate, the Commission did not consider the three criteria specified in PURPA or at least did not explain its rationale for establishing such a rate. Indeed, FERC now argues, in essence, that a “factual justification” for the full avoided cost rule is “neither possible nor required” and that “it is unlikely, that a subsequent rulemaking would produce a better record in this regard.” Even if the Commission is correct in these arguments, however, the court of appeals’ action is nevertheless sustainable. In essence, the decision in *AEP* only requires the Commission to explain its rule explicitly in terms of all of the interests protected by PURPA. FERC’s failure to meet this formal obligation is enough to justify the court’s vacating and remanding the rule. Thus, it is unlikely that the Supreme Court will reverse the court of appeals’ decision to vacate the full avoided cost rule on these bases.

As FERC conceded in its petition for rehearing, moreover, the difference between the substantial evidence and the arbitrary and capricious tests is “largely semantic.”¹⁰⁰ More importantly, given the court of appeals’ view of FERC’s record in promulgating the full avoided cost rule, the arbitrary and capricious test is likely to have produced the same result. The lower court said “that FERC has failed to meet its obligation to provide the public with the reasoned consideration, decisionmaking, and opinion which it is required to give.”¹⁰¹ In denying rehearing, the court reiterated that “the central point [is] that FERC never bothered to present a cogent justification of its rule in light of the statutory instructions.”¹⁰²

The leading case on the application of the arbitrary and capricious standard, *Citizens of Overton Park, Inc. v. Volpe*,¹⁰³ would support the same result reached by the court of appeals in the *AEP* case. According to the Supreme Court in *Overton Park*, to apply the arbitrary and capricious test, “the court must consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment.”¹⁰⁴ Given the court’s view that FERC failed to consider factors it was statutorily required to take into account in promulgating a rate for the purchase of electricity, it could justifiably vacate the full avoided cost rule under the arbitrary and capricious standard. It is unlikely, therefore, that the Supreme Court will reverse the lower court’s decision on this basis.

⁹⁸606 F.2d 973 (D.C. Cir. 1979), cited in 675 F.2d at 1234, n.36.

⁹⁹606 F.2d at 979, n.28. The statutes in question were the Natural Gas Act, 15 U.S.C. § 717r(b) (1976) and the FPA, 16 U.S.C. § 825(b) (1976).

¹⁰⁰675 F.2d at 1247.

¹⁰¹Petition for Rehearing and Suggestion for Rehearing En Banc, pp. 6-7, citing *American Public Gas Association v. FPC*, 567 F.2d 1016, 1029 (D.C. Cir. 1977) cert. denied, 435 U.S. 907 (1978).

¹⁰²675 F.2d at 1234.

¹⁰³*Id.* at 1246.

¹⁰⁴401 U.S. 402 (1971).

¹⁰⁵*Id.* at 416.

2. *Interconnection rule.* The Commission contends that, in vacating the rule requiring interconnection between electric utilities and qualifying facilities, the court of appeals overlooked the background and purpose of Sections 210 and 212 and, therefore, misconstrued Section 210(c)(3)(B) of PURPA.¹⁰⁵ The purpose of Section 210, in the Commission's view, was threefold: First, it authorized FERC to issue an order *sua sponte*, which it previously could do only in emergency situations. Second, the section empowered the Commission to require entities not otherwise subject to its jurisdiction (*e.g.*, intrastate utilities, power pools, and municipally owned utilities) to establish interconnections. Third, it extended the right to apply for interconnection orders to qualifying facilities which previously might not have fallen within the Commission's jurisdiction.¹⁰⁶

In this light, FERC contends

by stating that no qualifying facility may be "exempted" from the provisions of Section 210 of the Power Act, Congress meant that such facilities may not be excused from the burden imposed by FPA Section 210, *i.e.*, the burden of being subject to the Commission's authority to order an interconnection.¹⁰⁷

The Commission overlooks — or perhaps intentionally ignores — the fact that Section 210(e)(3) also precludes the exemption of qualifying facilities from the provisions of Sections 211 and 212 of the FPA. It also fails to cite any legislative history in support of its construction of the governing statutory provisions of PURPA, a failure which the court of appeals found troublesome.

As both petitioners contend, there is precedent for the proposition that the courts should defer to " 'the construction of a statute by those charged with its execution . . . unless there are compelling indications that it is wrong.' "¹⁰⁸ Courts generally, however, are not as willing to defer to agency judgments on statutory interpretation as they are on questions of fact.¹⁰⁹ The court of appeals' refusal to find authority for the interconnection rule which is part of a general mandate, when faced with a specific provision to the contrary, is also in keeping with basic canons of statutory construction.¹¹⁰

Nonetheless, it is abundantly clear, as petitioners contend, that "Congress' overriding purpose in enacting Section 210 of PURPA was to encourage cogeneration and small power production."¹¹¹ Congress believed that the unwillingness of electric utilities to interconnect with such facilities was a major deterrent to their development. The court of appeals' decision, according to FERC, would

undermine that congressional purpose by requiring a full-scale administrative adjudication before a utility could be compelled to agree to purchase electricity from a qualifying facility. As a result, qualifying facilities would be subjected to the very type of public utility regulation from which Congress sought to insulate them.¹¹²

¹⁰⁵FERC Petition at 12-15.

¹⁰⁶*Id.* at 13-14.

¹⁰⁷*Id.* at 15.

¹⁰⁸*N.Y. Dep't of Social Services v. Dublino*, 413 U.S. 405, 421 (1973). *See also* API Petition at 11-14.

¹⁰⁹*See, e.g., N.L.R.B. v. Highland Park Mfg. Co.*, 341 U.S. 322 (1951). *See also* W. Gellhorn, C. Byse, and P. Strauss, *Administrative Law*, 297-324 (1979).

¹¹⁰*See Clifford F. MacEvoy Co. v. United States*, 322 U.S. 102 (1944); *D. Ginsburg & Sons, Inc. v. Popkin*, 285 U.S. 204 (1932).

¹¹¹FERC Petition at 16; API Petition at 8-9.

¹¹²FERC Petition at 16.

API contends that the decision below "eviscerates the intent of Congress and gives utilities a powerful tool with which they can return to the *status quo ante*."¹¹³ And Judges Wald and Mikva concluded that the lower court's construction of the statute in this connection "erect[ed] a formidable, perhaps insurmountable, roadblock" to the development of cogenerators and small power production facilities.¹¹⁴

Interpretation of the interconnection rule involves complex issues of statutory construction. As construed by the court of appeals, however, PURPA falls short of its objective. The decision which the Supreme Court has been asked to make on the interconnection rule, therefore, is a close one. Since the Supreme Court considers PURPA very significant legislation,¹¹⁵ there is a greater likelihood that the Court will reverse the court of appeals' decision in this regard.

D. FERC Action in Light of AEP

Assuming the Supreme Court affirms the court of appeals' decisions in the *AEP* case, the Commission would not be precluded by the decision in *AEP* from once again adopting the full avoided cost rule. Indeed, the deficiencies that the court of appeals identified in the initial promulgation of the rule seem to be fairly easily remedied. The court made clear, however, that it "expect[s] the Commission to take a harder look at . . . the percentage of avoided cost approach."¹¹⁶ Practically, this direction seems to require FERC to do two things if it wishes to readopt the full avoided cost rule.

First, FERC must explain fully its reasons for thinking that a percentage of avoided cost rate is necessarily inferior to the full avoided cost rate from the standpoint of encouraging cogeneration and small power production. This issue is essentially an empirical one. In light of *AEP*, the Commission should offer at least some empirical basis for its conclusion in favor of the full avoided costs rule. In recent testimony on proposed amendments to PURPA, C. M. Butler III, Chairman of the Commission, claimed that an "exhaustive analysis of the market forces which affect the development decisions of potential owners of qualifying facilities . . . is a task beyond the abilities of the Commission. It calls for a mammoth modeling exercise in which assumptions would be no better than guesswork."¹¹⁷ The decision in *AEP*, however, especially as amplified in the majority's memorandum denying rehearing, does not call on FERC to make such an analysis. Rather, the court of appeals has only directed FERC to make the avoided cost rule with specific reference to the factors mandated by PURPA. This task requires some empirical analysis, but not the "exhaustive" and "mammoth" project envisioned by Chairman Butler.

Second, FERC must explicitly weigh the disincentives created by a percentage approach against the interests of consumers of electricity and the public, which may be benefited by a percentage of full avoided cost rule. If there is empirical support for the view that the full avoided cost rule is necessary to

¹¹³API Petition at 9.

¹¹⁴675 F.2d at 1247.

¹¹⁵FERC v. Mississippi, ___ U.S. ___, 102 S.Ct. 2126 (1982). See note 40, *supra*.

¹¹⁶675 F.2d at 1234.

¹¹⁷Statement of C. M. Butler III before the Subcommittee on Energy Conservation and Power, House Committee on Energy and Commerce (June 15, 1982), at 4.

encourage cogeneration and small power production, it should not be especially difficult for the Commission to find that the balance of interests favors the adoption of such a rule.

The court of appeals' decision to vacate the interconnection rule is more troublesome for cogenerators and small power producers. A qualifying facility desiring to interconnect with an electric utility will now have to participate in an evidentiary hearing in accordance with Section 210 of the FPA. In addition, FERC is required under Sections 210 and 212 to make a number of specific findings before it can order interconnection.¹¹⁸ In view of these requirements, it is highly unlikely that an interconnection order can be issued without protracted proceedings. Even after such proceedings, the Commission may decide that it should not or cannot order interconnection. Thus, the *AEP* decision could make it considerably more difficult for qualifying facilities to interconnect with unwilling utilities.

The court of appeals suggested, and the respondents in the *AEP* case contend, that the Commission could adopt "streamlined procedures" to enable qualifying facilities to satisfy more readily the requirements of Sections 210 and 212 of the FPA. According to respondents, FERC "can and should" adopt procedures that are "simple and expeditious and only rarely require a hearing" and

even where evidentiary hearings are required, the FERC can reasonably simplify them to a substantial degree — for example, by narrowing the issues to actual disputes of fact, by strictly confining the parties to what is relevant and by commanding expedition.¹¹⁹

The determinations which FERC must make under Sections 210 and 212 — whether interconnection is in the "public interest," whether it will place an "undue burden" on any party, whether it will not "unreasonably impair the reliability" of the utility, and whether it will not "impair" the utility's ability to "render adequate service" to its customers¹²⁰ — involves complex factual issues which must be decided on a case-by-case basis and which, with rare exceptions, the Commission will not be able to make without an evidentiary hearing.

The court of appeals, moreover, gave no indication of the kind or degree of streamlining which might be appropriate. Should FERC decide to take this course, it faces some incalculable risk of being overruled for modifying procedures too much. In addition, despite the respondents' assertions, it is not obvious how the Commission could avoid making the difficult findings required by Sections 210 and 212 even under streamlined procedures.¹²¹ Finally, any modification of the standards of a full evidentiary hearing are likely to be challenged as prejudicial by parties resisting interconnection. The delay caused by such litigation may well eliminate any of the benefits gained by streamlining procedures initially.

¹¹⁸See text accompanying notes 27-28, *supra*.

¹¹⁹Brief in Opposition at 27-32.

¹²⁰See the discussion accompanying footnotes 27-32, *supra*.

¹²¹16 U.S.C. § 824(a)(1)-(4) (Supp. III 1979).

III. RECENT LEGISLATIVE DEVELOPMENTS

Even before it filed its petition for a writ of certiorari, the Commission urged Congress to amend PURPA.¹²² Congress is currently considering legislation, introduced by Sen. Gordon J. Humphrey (R-N.H.) and Rep. Richard L. Ottinger (D-N.Y.), which would amend the law to require that, as a matter of federal policy, electric utilities purchase power from qualifying facilities at rates equal to the utilities' full avoided costs.¹²³ However, both bills would also permit state regulatory authorities and nonregulated utilities to establish different rates for purchases from qualifying facilities if such authorities and utilities are able to show that different rates are "sufficient" to encourage cogeneration and small power production, do not discriminate against qualifying facilities, and are in the interest of ratepayers and the public.¹²⁴

Additionally, both of the proposed amendments of PURPA would require electric utilities, as a matter of federal law, to interconnect with qualifying facilities. In return, qualifying facilities would have to pay all the "reasonable" costs of such interconnection. Rep. Ottinger's bill explicitly includes among reasonable costs those incurred by utilities to ensure the safety of employees and the public and to avoid the impairment of system reliability. Both bills would require the referral of disputes between regulated electric utilities and qualifying facilities over interconnection to state regulatory authorities. Disputes involving nonregulated utilities would be resolved by FERC, as currently provided in PURPA.¹²⁵

The amendments would require electric utilities to purchase electricity from qualifying facilities at the full avoided cost rate and would establish FERC's authority to order interconnection under PURPA without satisfying the procedural and substantive requirements specified in Sections 210 and 212 of the FPA, as amended by PURPA.¹²⁶ To this extent, the legislation would eliminate the uncertainties caused by the decision in *AEP*. Enactment of the legislation would not necessarily eliminate all of the problems which have impeded the rapid development of cogeneration and small power production facilities. The bills do not make clear, for example, whether utilities must purchase electricity from qualifying facilities at a full avoided cost rate while state regulatory authorities or nonregulated utilities determine if lower standards are justified. Such determinations would be time-consuming and likely to result in litigation.

¹²²See Statement of C. M. Butler, III before the Subcommittee on Energy Conservation and Power, House Committee on Energy and Commerce (June 15, 1982).

¹²³S. 1885 (as proposed to be amended by Senate Amendment No. 1452, 18 May 1982) and H.R. 6500, 97th Cong., 2d Sess. (1982).

¹²⁴*Id.*

¹²⁵16 U.S.C. § 824a-3(h)(2)(A) (Supp. III 1979).

In addition to the provisions which specifically address the problems created by the *AEP* case, Sen. Humphrey proposes amending PURPA's restriction on utility ownership of qualifying cogenerators. Under PURPA, a qualifying cogenerator by definition "is owned by a person not primarily engaged in the generation or sale of electric power (other than electric power solely from cogeneration facilities or small power production facilities)." 16 U.S.C. § 796(18)(B)(ii) (Supp. III 1979). The amendment would strike this provision from PURPA and add the following subsection to Section 210:

Nothing in this Act shall preclude a State agency from exercising to establish limitations on ownership of qualifying cogeneration or small power production facilities by persons primarily engaged in the generation or sale of electric power (other than electric power solely from cogeneration facilities or small power production facilities).

¹²⁶16 U.S.C. § 824i(b)-(c) and § 824k(a) (Supp. III 1979).

Additionally, the pending legislation would not eliminate the problems involved in calculating full avoided costs and determining the effects of lower rates on the development of energy sources to be fostered by PURPA. Chairman Butler testified to the numerous complications that arise in trying to translate the full avoided cost standard into practical rules for designing rates and computing actual costs for individual utilities.¹²⁷ He noted that the states used many different methods of computing costs under the Commission's rules implementing Section 210 of PURPA, and stated:

As a result of the problems associated with calculating incremental costs, some states are developing rates which may exceed the actual incremental cost of an electric utility. Under such circumstances, qualifying facilities would be subsidized at the expense of the purchasing utility's ratepayers [T]he full avoided cost standard may, in some cases, be applied in a way which encourages inefficient cogeneration or small power production and simultaneously discourages utilities from pursuing their own long-term least-cost generating alternatives.¹²⁸

Similarly, it would be difficult for state regulatory authorities and nonregulated utilities — as it has been for the Commission — to determine the effect, if any, a rate less than full avoided costs would have on the development of cogeneration and small power production. In Chairman Butler's view, "it is impossible to make more than a very rough estimate" of the impact of rates below avoided costs.¹²⁹

It now appears unlikely that the pending legislation to amend PURPA will be enacted during this session of Congress. Presumably, it will, in that case, be reintroduced in 1983. However, the delay will prolong the period of uncertainty created by the *AEP* decision. Moreover, while the pending legislation might solve the immediate problems created by the decision of the court of appeals in the *AEP* case, it does not deal with all of the obstacles which have delayed — and, indeed, may create other potential "road blocks" which would impede — the development of cogeneration and small power production facilities.

IV. TRANSACTIONS BETWEEN ELECTRIC UTILITIES AND QUALIFYING FACILITIES

Until PURPA's requirements are more definitively established, there may well be a reluctance to develop cogeneration and small power production facilities. The hesitation to proceed with such development will be most evident in those situations where interconnection is necessary; companies may be reluctant to make commitments to proceed with projects before knowing what PURPA will require. Where interconnection is not an issue, the current uncertainty should not preclude the development of qualifying facilities, except perhaps those of marginal benefit — *i.e.*, those whose production costs approach the utilities' full avoided costs.

¹²⁷Statement of C. M. Butler III before the Subcommittee on Energy Conservation and Power, House Committee on Energy and Commerce (June 15, 1982).

¹²⁸*Id.* at 5.

¹²⁹*Id.* at 6.

A. *Modification of PURPA or the FERC Rules*

A basic decision which electric utilities and qualifying facilities must now make, as a result of the *AEP* decision, is whether to condition their agreements on possible changes in PURPA or the FERC rules.¹³⁰ Electric utilities will, quite naturally, want to preserve their rights to alter or terminate the contract if favorable changes occur in the law or administrative rules. Provisions permitting cancellation of contracts in the event of a materially adverse change in existing law are not uncommon in regulated industries. At present, it appears that new developments in this area are likely to be favorable to utilities. Utilities will now seek, therefore, to include provisions in any agreement which will permit them to modify, renegotiate, or even terminate the contract upon the occurrence of such developments.

Conditioning the agreement on changes in PURPA or the FERC rules may not be acceptable to qualifying facilities, particularly those seeking long-term financing for their projects. Including such a provision in the agreement also perpetuates a degree of uncertainty. For example, it would permit the electric utility at some future — but unspecified — time to adjust, and most likely reduce, the rate it pays the qualifying facility for power. At the extreme, the repeal of PURPA could allow an electric utility, under these circumstances, to terminate the contract and to refuse to deal further with the qualifying facility or to deal only on what might be considered inequitable or discriminatory terms. Conditioning the agreement in this manner could also necessitate frequent modification or renegotiation of the contract. Qualifying facilities may, therefore, be hesitant to accept contracts which may be modified or terminated with any change in the law or administrative rules.

B. *Setting Rates*

Cogenerators and small power producers negotiating contracts for the sale of power to electric utilities will, of course, want to be paid the maximum amount. Prior to the *AEP* decision, the rates for such capacity and electric energy normally were set at the electric utilities' full avoided costs. Utilities now are likely to resist paying full avoided cost rates unless the agreement is made contingent on FERC promulgating an acceptable rule under PURPA requiring such rates. In light of the current uncertain situation, the parties might, *inter alia*, do the following:

First, the parties can establish rates equal to the electric utility's full avoided costs, but condition those rates on any applicable changes in PURPA or the FERC rules. This will protect the utility by permitting it to alter — or even terminate — the contract, should there be favorable changes in the law, such as a modification of the full avoided cost rule. The impact of such developments can be limited by restricting any modifications to the price provisions of the agreement and by specifically providing that changes in PURPA or the FERC rules shall not result in termination of the contract.

¹³⁰Changes in PURPA and the FERC rules will also require modification of state regulations promulgated in accordance with the law.

Second, the parties can set the rates to remain in effect regardless of developments stemming from the *AEP* case. In these circumstances, the electric utility is likely to seek rates below its full avoided costs, equal perhaps to some percentage of those costs. The ultimate rates will depend on how the parties perceive the possibilities that the Supreme Court will reverse the *AEP* decision on the full avoided cost rule, or, should the Court affirm the decision, that the Commission, on remand, will readopt the rule. The status of the pending legislation requiring the payment of a rate equal to full avoided costs must also be considered.

1. *Energy payments.* Qualifying facilities are entitled to a payment for the electric energy which they generate. In some cases, state regulatory agencies have set on-peak and off-peak rates to be used in calculating the amount of the energy payments, at least for small qualifying facilities. These rates normally are based on incremental fuel and purchase power costs. If a cogenerator or small power producer did not participate in the proceedings at which these rates were established, it will want to determine the method that was used to calculate the rates, verify that the data used are consistent with the electric utility's forecasts, and ensure that the calculations have been performed properly.

The parties are not bound by the rates set by the state regulatory authority or nonregulated utility. They may agree on different rates or a method for establishing the rates to be used in calculating the amount of the energy payment. Once there is agreement on the rates, however, the calculation of the amount of the monthly energy payment is usually fairly straightforward. The cogenerator or small power producer should be entitled to an amount equal to the agreed-on rates, times the total number of kilowatt peak and non-peak hours of electric energy actually generated by the qualifying facility.

2. *Capacity payments.* A qualifying facility also may be entitled to a capacity payment. This will depend on whether the electric utility with which it deals already has available excess capacity. Under those circumstances, the development of a cogeneration or small power production facility will not enable the utility to forgo or "avoid" adding further capacity, at least in the short run. Some state regulatory agencies, for example, have determined that no capacity credits are available from specified electric utilities. Again, where the state regulatory authority or nonregulated utility has set rates, the parties may adopt them or may develop their own method of determining the amount of the capacity credits.

Whether a particular qualifying facility is entitled to a capacity payment will depend on its ability to make firm power available to the electric utility. The utility may want to retain the right to decide what constitutes dependable capacity. The manner in which this will be determined, however, should be agreed on by the parties and specified in the contract. The factors that may be considered in determining dependable capacity include:

- the availability of capacity from the qualifying facility during the utility's daily and seasonal peak period;
- the expected or demonstrated reliability of the qualifying facility;
- the utility's ability to dispatch the qualifying facility; and
- the terms of any contract, including the duration of the obligation, termination notice requirement, and sanctions for noncompliance.¹³¹

¹³¹See 18 C.F.R. § 292.304(e) (1981).

Some qualifying facilities, particularly the larger ones, are extremely reliable, with unscheduled outages occurring only infrequently. In many cases, in fact, these facilities are at least as reliable as the generating units maintained and operated by electric utilities. The reliability of such units — *i.e.*, the percentage of time they operate — usually ranges from 60 to 80 percent. A cogenerator or small power producer, therefore, should anticipate having to dedicate its output to the utility on an equivalent basis. It will be difficult for the utility to insist that the qualifying facility meet a higher standard than it can satisfy. It is important, therefore, for the qualifying facility to obtain and evaluate data on the performance of the utility's generating units.

The parties might agree, for example, that in order to qualify for a capacity payment, the cogenerator or small power producer's capacity must be available to the electric utility at least 70 percent of the time. This "capacity factor" would be calculated for a given month by dividing the total megawatt hours of electric energy produced by the qualifying facility during that month by the capacity of the cogenerator or small power producer times the total number of hours during the month. This result then would be stated in terms of a percentage.

Thus, if a qualifying facility agreed to provide 10 megawatts of capacity and makes available 6,900 megawatt hours of electric energy during the month, the capacity factor, assuming the month contains 720 hours, would equal 95.8 percent. The cogenerator or small power producer, therefore, would be entitled to a monthly capacity payment. The amount of the payment would be computed by multiplying the number of kilowatts provided during the month times the capacity credit per kilowatt month. Assuming the monthly capacity credit is \$2.50 per kilowatt month, using the above example, the payment would be \$23,958.

The capacity payment should continue during periods of scheduled outages. A qualifying facility may want, moreover, to ensure that if it fails to develop firm power as agreed (during, for example, an unscheduled outage), it will not lose permanently its right to capacity payments. A cogenerator or small power producer also will want to limit, as much as possible, the period during which it must forgo such payments. In order to minimize its loss as a result of a forced outage, a qualifying facility may seek to ensure that once it again demonstrates that it is providing firm power, the utility must make capacity payments retroactive to the time when the unscheduled outage ended.

C. Simultaneous Buy/Sell Arrangements

In many cases, the rate at which electric utilities will sell power to qualifying facilities is less than their full avoided costs. In these circumstances, a cogenerator or small power producer can benefit by agreeing to a simultaneous purchase and sale arrangement. The FERC rules permit a qualifying facility to "sell" the utility all of its output, even though it may be used for internal purposes and not actually transmitted to the utility, at the utility's full avoided costs, while simultaneously "buying" all of the electric energy that it needs at the utility's standard rates. By "selling" the power that it generates at rates higher than those which it pays for its purchases, a cogenerator or small power producer can reduce its electrical costs.

Since a qualifying facility will benefit only if the rates paid by the electric utility exceed the utility's normal charges, it is essential to determine to what extent and for how long this situation will exist. By studying the utility's long-term forecasts, the qualifying facility can determine whether it would benefit more from a simultaneous purchase and sale or a "netting" arrangement — *i.e.*, one in which the qualifying facility simply purchases the excess power that it needs. The cogenerator or small power producer may seek, moreover, to reserve the right to change from a simultaneous purchase and sale situation to a "netting" arrangement as circumstances dictate. This option to switch should be available if the utility retains the right to alter the rate it pays for power as a result of changes in its avoided costs. Such a provision also would protect the qualifying facility against changes in the rates as a result of a modification in the full avoided cost rule.

D. Contract Term

The term of the contract will depend, *inter alia*, on the qualifying facility's need for financing and general desire to secure the arrangements it makes with the electric utility. A cogenerator or small power producer may seek a fixed, long-term agreement that is not subject to modification or termination whenever PURPA or the FERC rules change, as a result of the *AEP* case or otherwise. On the other hand, the utility may want to avoid being bound by an agreement containing provisions that may be less favorable than those ultimately required by the law. The court of appeals admonished the Commission, for example, "to take a harder look at, especially, the percentage of avoided cost approach."¹³² It is possible, therefore, that if the Supreme Court affirms the *AEP* decision and Congress does not amend PURPA, the Commission will require the establishment of rates for the purchase of power from qualifying facilities at some level below full avoided costs.

In order to obtain a fixed long-term contract that is not conditioned on changes in PURPA or the FERC rules, it may be necessary for the qualifying facility to make certain concessions, such as accepting rates or an average payment for its power over the term of the contract that is less than full avoided costs. Such an arrangement would protect the electric utility against possible favorable changes in the law and, accordingly, would increase the likelihood that it would agree to a long-term contract.

E. Provision of Power

Provisions relating to the electric utility's obligation to provide power to the cogenerator or small power producer may be crucial and a very important aspect of the negotiations. A qualifying facility, for example, will want to ensure that it will be entitled to purchase supplemental power from the utility at nondiscriminatory rates — *i.e.*, at the same rates available to other customers with similar loads or other cost-related characteristics. PURPA currently

¹³²675 F.2d at 1234.

guarantees this right to qualifying facilities.¹³³ If the contract will be for a long term and will not be contingent on changes in PURPA or the FERC rules, the cogenerator or small power producer should insist upon the inclusion of a provision to this effect in the contract.

The qualifying facility will also want to ensure that it will be able to purchase power from the electric utility during maintenance periods. Cogenerators and small power producers should attempt, to the extent possible, to schedule maintenance during off-peak hours, when electric rates are lowest. Likewise, the qualifying facility will want to ensure the availability of emergency power. Its goals should be to make arrangements similar to those normally existing between electric utilities. Utilities typically provide for the provision of emergency power at regular rates, with no additional demand charge, for emergencies of a short, specified duration.¹³⁴

V. CONCLUSION

The court of appeals' decision in the *AEP* case has draped a shroud of uncertainty over the development of cogeneration and small power production facilities. This situation may persist for some time, while the Supreme Court reviews the *AEP* decision, and while Congress considers amendments to PURPA. Moreover, if the Court affirms the court of appeals, and if the law is not amended, FERC will be required to engage in further rulemaking. In the interim, the development of cogenerators and small power producers will continue, though perhaps not at the pace envisioned by Congress when it enacted the law. The development of such facilities will continue in circumstances where electric utilities recognize the potential benefits of these resources and, accordingly, agree to interconnect with qualifying facilities. Similarly, such development will proceed where it makes good financial and business sense despite the fact that, ultimately, utilities may not be required to pay rates equal to their full avoided costs for power purchased from qualifying facilities. In these cases, as arrangements between electric utilities and qualifying facilities are shaped under PURPA and the FERC rules, the parties must be cognizant of the current developments in this area and take into account the fact that further changes are inevitable. This situation is not, however, unlike those frequently encountered by corporate decision makers.

¹³³18 C.F.R. § 292.305(b) (1981).

¹³⁴The FERC rules require electric utilities to sell "interruptible" power — power that may be cut off by the utility under certain specified conditions — to qualifying facilities. 18 C.F.R. § 292.305(b)(1) (1981). Such power normally is provided at considerably lower rates. Depending on the nature of the qualifying facility's operations, the availability of interruptible power may provide the opportunity for substantial savings in electrical costs.