

## Report of Committee on Regulations—Parts II and III of the Federal Power Act

In 1985, the Federal Energy Regulatory Commission (FERC or Commission) and the courts decided a number of significant cases pursuant to Parts II and III of the Federal Power Act. These include cases relating to (1) FERC jurisdiction over wholesale rates, (2) scope of FERC authority over filings, (3) differences between initial and changed rates, (4) items includable in filed rates, (5) waivers of filing requirements, (6) the *Mobile-Sierra*<sup>1</sup> doctrine, (7) cost of service and rate design questions, including prudence, recovery for cancelled plant, normalization, fuel charges, spent nuclear fuel disposal costs, working capital, accumulated deferred income tax credits (ADITC), the end result language of the *Hope*<sup>2</sup> case, treatment of construction work in progress (CWIP), generic rate of return, use of multiclass rates, and annualization, (8) the effective date of a section 206 rate, (9) qualifying cogeneration facilities, and (10) interlocking directorates.

### I. FERC JURISDICTION OVER WHOLESALE RATES

In *American Electric Power Service Corporation*,<sup>3</sup> the Commission addressed the question of whether an agreement among affiliated utilities for sharing the costs of ownership and operation of the parent holding company's extra high voltage (EHV) transmission system was a jurisdictional wholesale rate schedule. The FERC rejected arguments that, because the agreement was a cost allocation agreement rather than a wholesale rate tariff, the FERC lacked jurisdiction.

The Commission declared that its jurisdiction extends to any agreement, such as the EHV agreement in issue, that clearly affects rates subject to the jurisdiction of the Commission, and that the Federal Power Act establishes that a sale of transmission services is not a prerequisite to the jurisdiction of the Commission over transmission of electricity in interstate commerce.

The FERC also rejected challenges to its jurisdiction to reallocate electric generating plant among affiliates of the Middle South Utilities (MSU) holding company in *Middle South Energy, Inc.*<sup>4</sup> and *Middle South Services, Inc.*<sup>5</sup>

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1. The *Mobile-Sierra* doctrine is based upon *United Gas Pipeline Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956) and *FPC v. Sierra Pac. Power Co.*, 350 U.S. 348 (1956).

2. *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

3. 32 F.E.R.C. ¶ 61,363 (1985).

4. 31 F.E.R.C. ¶ 61,305 (1985) [hereinafter Opinion No. 234].

5. 32 F.E.R.C. ¶ 61,425 (1985) [hereinafter Opinion No. 234-A]. Opinion Nos. 234 and 234-A were Commission decisions from exceptions to Initial Decisions in two unconsolidated cases. In *Middle S. Energy, Inc.*, 26 F.E.R.C. ¶ 63,044 (1984), the presiding administrative law judge considered the Unit Power Sales Agreement (UPSA) for the purchase of power from the Grand Gulf nuclear power plant (Grand Gulf). The UPSA was signed by Arkansas Power and Light Co. (AP&L), Louisiana Power and Light Co. (LP&L), Mississippi Power and Light Co. (MP&L) and New Orleans Public Service, Inc. (NOPSI), the four MSU Operating Companies. In *Middle S. Servs., Inc.*, 30 F.E.R.C. ¶ 63,030 (1985), the presiding

There, parties had challenged FERC authority to reallocate generating plant on two principal grounds: 1) that the FERC lacks authority to force a purchase and sale<sup>6</sup> of the Grand Gulf nuclear powerplant (Grand Gulf) because of its lack of authority over generating facilities, and 2) because it may not act in a manner which interferes with state regulatory authority pursuant to section 201 of the Federal Power Act.<sup>7</sup> Additionally, they challenged FERC authority to reallocate generating plant in a manner which interferes with administration by the Securities and Exchange Commission (SEC) of the Public Utility Holding Company Act (PUHCA).<sup>8</sup>

In rejecting these arguments, the FERC held that the allocation of Grand Gulf was not a purchase or sale. The Commission instead drew the issue as "the appropriate allocation of costs among integrated companies owned by the same parent," stating: "[T]he real issue is whether rates among those companies are just, reasonable, and not unduly discriminatory."<sup>9</sup> In its lengthy opinion, the Commission also found that it was not exercising impermissible authority over generating facilities, and was not impinging on state authority illegally. The FERC cited *Nantahala Power and Light Company*<sup>10</sup> in support of its contention.

On rehearing, in Opinion No. 234-A, the Commission recognized the holding in the Initial Decision in *Middle South Services, Inc.* that the FERC lacks jurisdiction to force a purchase or sale but reiterated that the MSU situation involved the allocation of costs among affiliated companies, not a forced purchase and sale. As the FERC framed the issue, the controversy was seen as a determination of the "appropriate allocation of costs among integrated companies owned by the same parent."<sup>11</sup> The FERC justified its action as one necessary to achieve just and reasonable rates:

Although Judge Head concluded that the Commission could not compel a utility to purchase from or sell to another, we do not interpret his decision as applying to cases such as this one, where we are dealing with contracts involving jurisdictional sales and where it is necessary to "compel" a different purchase in order to achieve just, reasona-

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administrative law judge considered the 1982 System Agreement among the four MSU Operating Companies, which supplanted a 1973 agreement among those companies.

6. One affiliate, AP&L had not agreed to purchase any Grand Gulf power pursuant to the UPSA under review in this case. However, AP&L was a signatory party to the UPSA. Other affiliates had agreed to purchase amounts of Grand Gulf power different from the amounts ordered by the FERC in the instant case, as follows:

Purchase Pursuant  
to Opinion No. 234

AP&L: 36%  
LP&L: 14%  
MP&L: 33%  
NOPSI: 17%

Purchase Pursuant  
to UPSA

AP&L: 0%  
LP&L: 38.57%  
MP&L: 31.63%  
NOPSI: 29.8%

7. 16 U.S.C. § 824 (1982).

8. 15 *id.* §§ 79-7926 (1982).

9. 31 F.E.R.C. at 61,643.

10. 19 F.E.R.C. ¶ 61,152 (1982); 20 F.E.R.C. ¶ 61,430 (1982). In *Nantahala*, the FERC allocated energy entitlements between two subsidiaries of an industrial customer. However, in *Nantahala*, both subsidiaries had agreed to purchase energy. The FERC did not attempt to distinguish this feature of *Nantahala* directly in either Opinion No. 234 or 234-A.

11. 32 F.E.R.C. at 61,948.

ble, and non-discriminatory rates.<sup>12</sup>

The Commission stated further that unless it had this apparent authority to "compel" a different purchase, it would be unable to order production cost equalization<sup>13</sup> or to "assure" that intercompany transactions are just and reasonable.<sup>14</sup>

Additionally, the FERC stated that, although section 201 grants jurisdiction to the Commission only of matters not subject to state regulation, and "explicitly removes from Commission jurisdiction facilities used for the generation of electric energy (except as specifically provided), it nevertheless explicitly grants jurisdiction over the sale of electric energy at wholesale in interstate commerce."<sup>15</sup> The statutory language, the Commission concluded, clearly gave it jurisdiction over the UPSA, over Middle South Energy, Inc. (MSE), the MSU subsidiary which owns Grand Gulf, and over the allocation of power produced by the Grand Gulf generating plant.

The FERC refused to let the limitation on its authority to regulate generating facilities "nullify" its authority over interstate wholesale sales, where those generation facilities are used for such sales. To do so, it stated, would be inconsistent with the FPA's declaration of policy that federal regulation of wholesale sales of energy in interstate commerce is necessary in the public interest. The FERC relied for its analysis on *Hartford Electric Light Co. v. FPC*,<sup>16</sup> and on *Connecticut Light and Power Company v. FPC*.<sup>17</sup>

A second apparent ground for the FERC's rejection of the argument that reallocation constituted a forced purchase and sale was the Commission's perception of MSU and its affiliates as a highly coordinated and integrated system.<sup>18</sup> It based this decision on the overlapping nature of the affiliates' managements (including officers and directors), and on its conclusion that the System Operating Committee makes the major critical decisions, including decisions to build new generating units.<sup>19</sup> It found that the generating units on the MSU

12. *Id.* at 61,949.

13. A number of parties in the case sought production cost equalization of all or most generating facilities owned by MSU affiliates.

14. 32 F.E.R.C. at 61,949.

15. *Id.* at 61,946.

16. 131 F.2d 953 (2d Cir. 1942), *cert. denied*, 319 U.S. 741 (1943).

17. 324 U.S. 515 (1945). See 32 F.E.R.C. at 61,947-48.

18. The FERC rejected arguments based upon Nantahala Power & Light Co., 19 F.E.R.C. ¶ 61,152 (1982), that it had improperly "pierced the corporate veil" by disregarding the separate identities of the four operating companies without demonstrating that corporate separateness was a sham. 32 F.E.R.C. at 61,955-56. The Commission claimed that it had not pierced the corporate veil. It further stated the issue in *Middle South Energy* was one of just and reasonable rates whereas the issue in *Nantahala* was corporate misuse of company identities. See 32 F.E.R.C. at 61,956.

Additionally, the FERC rejected the argument that if the companies in fact operate as one monolithic system, the FERC would have no jurisdiction because all transactions would be intra-company, rather than wholesale, transactions.

19. The Commission recognized that some autonomy existed among MSU affiliates by finding that there is active participation by individual Operating Companies in the MSU system in several ways, *inter alia*, that the Operating Companies were intimately involved in planning new generation, sought to meet their system needs by volunteering to construct new generation, and decide the specific location, timing, and size of units, and the Operating Companies were required, pursuant to the System Agreement, to own or purchase capability needed for their consumers.

system are planned for the system as a whole.<sup>20</sup>

The Commission distinguished *Southern Company Services, Inc.*,<sup>21</sup> in which the FERC had found it lacked jurisdiction to force a purchase and sale, as unpersuasive precedent on three grounds: (1) *Southern* was decided on a narrow anticompetitive basis; (2) the agreement in *Southern* was not, as here, among commonly-owned affiliates on an integrated system; and (3) Seminole, the challenging party in *Southern*, was not a party to the agreement being contested, and so had a lesser reason or expectation to be "compelled" to purchase energy.<sup>22</sup>

The FERC in Opinion No. 234-A also reviewed and rejected arguments on the issue of State and Federal jurisdiction advanced by the parties requesting rehearing (including the arguments that the effect of Opinion No. 234's equalization of nuclear generation costs amounts to setting equalized retail rates, emasculates the state siting and rate-setting authority, removes from state control the rate base of all nuclear plants and the control over capacity costs, and ignores state interests), thereby reaffirming its earlier decision on these points as well.<sup>23</sup>

In Opinion No. 234, the FERC approved the reasoning and conclusion in the Initial Decision in *Middle South Services, Inc.*, which rejected the argument that any equalization proposal would interfere with state jurisdiction over generating facilities. The initial Decision stated that the FERC had jurisdiction over the 1982 System Agreement because it is a wholesale sale in interstate commerce.<sup>24</sup> It further stated that there was overlapping, concurrent state and federal jurisdiction over MSU and its System Operating Agreement, in that states have control over generating facilities and the FERC has control over wholesale sales.<sup>25</sup> The Initial Decision concluded that the FERC has a broader perspective than individual state commissions and could exercise jurisdiction, but should defer to states where possible.<sup>26</sup>

The FERC distinguished *Arkansas Electric Cooperative Corp. v. Arkansas Public Service Commission*<sup>27</sup> on the basis that the FERC in *Middle South Energy* may claim clear federal preemption. The Commission stated that state regulation would not be allowed where there is such Federal preemption.

In addition to relying on the Initial Decision in *Middle South Services, Inc.* regarding federal/state relations, the Commission rejected any argument that the FERC's jurisdiction was found subordinate to state jurisdiction in *Pacific Gas & Electric Co. v. State Energy Resources Conservation and Development Commission*.<sup>28</sup> The FERC noted that the Court there had recognized the

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20. See 31 F.E.R.C. at 61,651.

21. 20 F.E.R.C. ¶ 61,332 (1982).

22. See 32 F.E.R.C. at 61,949.

23. See *id.* at 61,951-52.

24. See 30 F.E.R.C. at 65,150.

25. See *id.* at 65,151.

26. See *id.*

27. 461 U.S. 375 (1983). In *Arkansas Elec. Coop. Corp.*, the Supreme Court ruled that a state regulatory commission may regulate sales at wholesale by an entity which is not regulated by the FERC.

28. 461 U.S. 190, 205 (1983).

Commission's authority as well as that of the states.<sup>29</sup>

The FERC relied upon the Initial Decision in *Middle South Services, Inc.*, in rejecting arguments that reallocation of Grand Gulf or production cost equalization of all MSU facilities would interfere with the PUHCA.<sup>30</sup> That Initial Decision noted that the FERC is under an obligation to order cost equalization if such an order is necessary for compliance with sections 205 or 206 of the FPA, stated that FERC and Securities and Exchange Commission (SEC) powers are complementary, and concluded that the PUHCA did not give the SEC exclusive jurisdiction over contracts between holding companies and their subsidiaries.<sup>31</sup>

In addition to rejecting arguments that these are jurisdictional impediments to altering allocations of generating plant among MSU operating companies, the FERC, relying upon the Initial Decision in *Middle South Services, Inc.*, rejected arguments that any equalization of generating plant among power pool members would conflict with the goal of promoting power pooling pursuant to the Public Utility Regulatory Policies Act (PURPA)<sup>32</sup>, and section 202(a) of the Federal Power Act. That Initial Decision held that an order requiring equalization would be precedential only as to the factual situation justifying the order, that a utility would be unlikely to eschew power pooling advantages because of the speculative possibility of equalization, and that members of non-affiliated pools could withdraw from the pool if equalization were imposed. It added that the policy favoring promotion of power pools could not be used to block exercise of FERC power pursuant to section 206 of the Federal Power Act.<sup>33</sup>

The FERC also rejected arguments advanced by the Mississippi Public Service Commission (MPSC) that the FERC was equitably estopped from adopting any form of cost equalization because MP&L and MSE had made certain representations to MPSC. It noted that state commissions could not rely upon representations before them as a guarantee that the FERC would not alter an agreement. The FERC also noted that the doctrine of equitable estoppel could not bind the Commission, which made no representations to, and was not a party to, such state proceedings.

Opinion Nos. 234 and 234-A have been appealed to the United States Court of Appeals for the District of Columbia Circuit.<sup>34</sup> Oral argument was held before a three-judge panel on March 24, 1986, and no decision had been issued as of the date of this report.

In *City of Oakland, California v. FERC*,<sup>35</sup> the court reversed a FERC finding that the sale of electricity from Pacific Gas and Electric Company (PG&E) to the city's Port Department, which then conveyed the electricity to businesses at the municipally-owned and operated airport, was not a sale at wholesale. The court held that purchases of interstate electricity by the Port

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29. See 31 F.E.R.C. at 61,644.

30. See *id.* at 61,645.

31. See 30 F.E.R.C. at 65,153-54.

32. 16 U.S.C. § 824a-1(b) (1982).

33. See 30 F.E.R.C. at 65,151-52.

34. *Mississippi Indus. v. FERC*, *appeal docketed*, No. 85-1611 (D.C. Cir. Sept. 26, 1985).

35. 754 F.2d 1378 (9th Cir. 1985).

Department, when transferred and individually metered over its own system, are electric sales at wholesale and subject to FERC jurisdiction.

In analyzing the transactions between the Port Department and the airport businesses, the court first noted that the Federal Power Act plainly defines a wholesale sale as a sale of electricity to any person for resale,<sup>36</sup> and found that "resale" encompassed transactions with "individually-metered tenants." The court observed that the Port Department, specifically established by the city to provide services to the airport, maintained an extensive electric transmission and metering system. The court found significant that each airport tenant had its own meter and was billed individually for the electricity it consumed and found controlling the Supreme Court ruling in *United States v. Public Utilities Commission*,<sup>37</sup> in which individually metered and billed transactions between the Navy and personnel in navy housing were deemed jurisdictional resales. Additionally, the court compared the Port Department to any municipality, exercising all the powers and duties attributed to any political subdivision of a state in carrying out major municipal functions. The court found irrelevant the fact that the Port Department did not supply electricity to the entire city.

Finally, the court dismissed concerns raised by the FERC that any landlord-tenant relationship in which electricity was billed individually to tenants would fall within FERC's wholesale jurisdiction, stating that the FERC should address such concerns to Congress, not the courts.

When PG&E filed with the FERC its rates for the Port Department, the Commission summarily rejected PG&E's attempt to segregate its sales to the Port Department into retail sales, subject to the jurisdiction of the California Public Service Commission, and wholesale sales, subject to FERC jurisdiction.<sup>38</sup> In accord with precedent, the Commission found that the ultimate use of the electricity was indistinguishable at the point of sale, and, therefore, FERC's jurisdiction extended to the entire transaction.

## II. SCOPE OF FERC AUTHORITY OVER FILINGS

In *Municipal Electric Utilities Association of New York State v. Consolidated Edison Company of New York, Inc.*,<sup>39</sup> the FERC declined to consider whether an agreement filed before it was made solely to facilitate a violation of the Niagara Redevelopment Act.<sup>40</sup> Additionally, it declined to exercise jurisdiction over a "lease" which included charges for transmission facilities but only entailed physical distribution facilities.

Here, the direct question was whether Consolidated Edison Company of New York, Inc. (Con Edison) must file with the FERC its "Lease and Operating Agreement" (LOA) with the Westchester County municipal distribution agency (Westchester MDA) pursuant to either section 203 or section 205 of the Federal Power Act. The Municipal Electric Utilities Association of New York

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36. 16 U.S.C. § 824(d) (1982).

37. 345 U.S. 295 (1953).

38. See *Pacific Gas & Elec. Co.*, 33 F.E.R.C. ¶ 61,085 (1985).

39. 33 F.E.R.C. ¶ 61,011 *reh'g denied*, 33 F.E.R.C. ¶ 61,363 (1985).

40. 16 U.S.C. §§ 836-836a (1982).

State (MEUA) claimed that the Westchester MDA and Con Edison sought, through the LOA, to circumvent the Niagara Redevelopment Act, which grants a preference and priority for half the output of the Niagara Project to "public bodies" and rural electric cooperatives. MEUA claimed that the Westchester MDA did not qualify as a "public body" pursuant to that Act. Subsequent to the filing of this Complaint, Con Edison filed the LOA.

The Commission dismissed the MEUA complaint on several grounds. First, it found that the Complaint was moot because Con Edison had filed the agreement in question. Second, it held that it need not decide, in considering the LOA, whether the LOA was used to circumvent the Niagara Redevelopment Act because neither the Westchester MDA nor Con Edison was the licensee of the Niagara Project. Third, it decided that the LOA was not jurisdictional pursuant to section 203 of the Federal Power Act because it leased only distribution, and not transmission, facilities, despite the fact that Con Edison was charging the Westchester MDA a rental based on system-wide costs, including generation, transmission and distribution facilities.

### III. CHARACTERIZATION OF RATES: INITIAL OR CHANGED RATES

In two cases, the FERC dealt with the characterization of rates as initial or filed cases, and in one case, the FERC provided that rates must be subject to refund even though it did not specifically identify such rates as "changed" rates.

In *AEP Generating Company*,<sup>41</sup> the Commission determined that a unit power sales agreement among holding company subsidiaries is a changed rate. Drawing a parallel to its order in *Middle South Energy, Inc.*,<sup>42</sup> the Commission held that in sales between or among affiliates, the intra-corporate relationship does not ensure that there will be an arms-length transaction of "incontrovertibly new" bargained-for electric service which Congress intended to protect by exempting "initial" rates from suspension and refund obligations. Although the Commission's initial order did not expressly determine whether the petitioner's filing constituted an initial rate or a change in rate, upon rehearing, the Commission characterized the filing as a change in rate, declaring it had the authority to "alter the line between initial and changed rates at any time, if [the Commission] proceed[s] on a reasoned basis that is clearly not outside the statutory framework [of the Federal Power Act]."<sup>43</sup>

In *Central Hudson Gas and Electric Corp.*,<sup>44</sup> the Commission accepted for filing, with suspension, a wheeling agreement between Central Hudson Gas and Electric Corp. (Central Hudson) and the Power Authority of the State of New York (PASNY) to transmit Niagara Project preference power for ultimate distribution to Municipal Distribution Agencies (MDA's).<sup>45</sup>

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41. 32 F.E.R.C. ¶ 61,109 (1985).

42. 23 F.E.R.C. ¶ 61,277 (1983).

43. 32 F.E.R.C. at 61,298 (citing *Florida Power and Light Co. v. FERC*, 617 F.2d 809, 816 (D.C. Cir. 1980); *Otter Tail Power Co. v. FERC*, 583 F.2d 399 (8th Cir. 1978), *cert.denied*, 440 U.S. 950 (1979)).

44. 32 F.E.R.C. ¶ 61,429 (1985).

45. Issues in this case were similar to those raised in *MEUA v. Con Edison*, 33 F.E.R.C. ¶ 61,011 (1985).

The commission disagreed with the petitioner's characterization of the filing as "initial rates," subject to treatment under section 35.12 of the Commission's Regulations. Rather, the agreement was characterized as a "change in rate" since the petitioner already provides transmission service to PASNY pursuant to other rate schedules on file with the Commission. The FERC granted rehearing for the purpose of further consideration on this issue.<sup>46</sup>

In the Order on Remand in *City of Oakland v. PG&E*,<sup>47</sup> FERC ordered PG&E to file its wholesale rates and supporting data. The Port Department, in a request for rehearing, asked the Commission to order PG&E to file all past retail rates under which it served the Port Department and to order PG&E to refund all excess charges paid by the Port Department. In its order denying rehearing,<sup>48</sup> the Commission rejected the Port Department's request, claiming that FERC had discretion to determine whether PG&E should file past rates and refund excess payments. In light of the facts of this case, the Commission stated "it would be inequitable to require PG&E to file its past rate schedules . . . and to issue refunds."<sup>49</sup> FERC declined to identify PG&E's rate filing as either an initial or changed rate. However, the Commission stipulated that, as a condition of excusing PG&E's past failure to file rates, the new rates, if unjust and unreasonable, would be subject to refund. Thus, under the unique circumstances of this case, FERC provided the Port Department with changed rate protections while treating PG&E's wholesale rate filing as an initial rate.

#### IV. ITEMS INCLUDABLE IN FILED RATES

A. In *South Carolina Generating Co.*,<sup>50</sup> the FERC allowed a utility to include an item in a filed rate even though an Administrative Law Judge had excluded that item from a previously filed rate.

South Carolina Generating Company, Inc. (SCGC) filed a revision to its unit power sales agreement with its affiliate South Carolina Electric & Gas Co. and included as expenses certain items excluded by the Administrative Law Judge. SCGC sought a waiver of notice in order to allow an effective date coextensive with the effective date of the unit power sales agreement. The Commission denied requests by intervenors to reject the filing on the basis of the decision of the Presiding Administrative Law Judge, holding that the utility had the right to make the unilateral filing but refused to allow the waiver of notice upon objection from intervenors.

B. In *Cliffs Electric Service Company and Upper Peninsula Generating Company*,<sup>51</sup> the Commission established a two-tiered test to determine, on a case-by-case basis, whether industrial companies which generate power inci-

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46. See *Orange and Rockland Utils., Inc.*, Docket Nos. ER85-598-002 through ER85-598-004 and ER85-634-002 through ER85-634-004; *Consolidated Edison Co.*, Docket Nos. ER85-607-002 through ER85-607-004 and ER85-621-002 through ER85-621-004, *Order Granting Rehearing for Purposes of Further Consideration* (Oct. 18, 1985).

47. 31 F.E.R.C. ¶ 61,319 (1985). The Ninth Circuit ruling on this case is discussed in *supra* text accompanying note 35.

48. 32 F.E.R.C. ¶ 61,371 (1985).

49. *Id.* at 61,830.

50. *Id.* ¶ 61,224 (1985).

51. *Id.* ¶ 61,372 (1985).



dental to their primary industrial operations and whether certain small public utility companies should be allowed waivers from compliance with various Commission regulations as it had granted *St. Joe Minerals Corp.*<sup>52</sup> To meet threshold requirement of this test, a petitioner must prove that its generation, transmission or distribution facilities are used for a non-public utility purpose, such as serving a company's own industrial requirements. The Commission created a rebuttable presumption that an industrial power plant was built solely for industrial needs if the facilities are owned, operated and constructed prior to the date of the order by a company whose business is other than being a public utility.

If an industrial company meets the threshold determination, then the Commission will grant regulation waivers if the company meets certain criteria as determined on a case-by-case basis and measured by the following factors:

1. The amount of revenue derived from the jurisdictional transactions relative to the total revenues of the company;
2. Whether the contractual obligation is temporary or permanent service;
3. Whether the company is providing firm or interruptible power.

Petitioners which receive waivers must prove that their jurisdictional rates are just and reasonable.

In applying this test to the petitioners, the Commission found that any company which had as its primary purpose the generation for sale to a requirements customer could not be exempt from any regulations. It granted exemptions to those industrial companies which were selling only their excess capacity to customers on a temporary and interruptible basis. Additionally, the Commission allowed waiver of Uniform System of Accounts regulations for a public utility due to the utility's small size, the small size of the sale, the fact that the sale would replace diesel generation, and the fact that a regulation exempting utilities with total sales less than 10,000 mwh went into effect subsequent to the filing but prior to the order.<sup>53</sup>

## V. THE MOBILE-SIERRA DOCTRINE

In one case, the United States Court of Appeals for the District of Columbia Circuit found the *Mobile-Sierra* doctrine inapplicable to a contract. In another, the FERC refused to apply the doctrine to a unit power sales agreement.

A. In *Cities of Campbell & Thayer v. FERC*,<sup>54</sup> the Cities of Campbell and Thayer (Cities) disputed FERC's decision that their service contracts with Arkansas Power and Light (AP&L) enabled AP&L to seek a rate change unilaterally under section 205 of the Federal Power Act. The court affirmed FERC's decision and rejected the Cities' argument that the contract required Commission approval prior to any rate change taking effect.

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52. 21 F.E.R.C. ¶ 61,323 (1982), *modified on reh'g*, 22 F.E.R.C. ¶ 61,211 (1983). In *St. Joe*, the FERC granted waivers of the Uniform System of Accounts, various reporting requirements, annual charges, regulations relating to securities and assumption of liability, and partial waivers of regulations relating to property disposition and consolidation and the holding of interlocking positions.

53. Classification Criteria, Order No. 390, 28 F.E.R.C. ¶ 61,187 (1984); F.E.R.C. Stats. & Regs. ¶ 30,586 (1984). The utility in question in *Cliffs* had total sales of approximately 8,000 mwh.

54. 770 F.2d 1180 (D.C. Cir. 1985).

The contract provided that rates under the contract could be changed "subject to the approval of . . . regulatory bodies having jurisdiction."<sup>55</sup> The court found that this language did not create a condition precedent to a rate change, but mirrored the customary procedures of a section 205 rate change—the ability to file an effective rate change unilaterally, subject to subsequent Commission approval. Following its own precedent in *Cities of Bethany v. FERC*,<sup>56</sup> the court stated that service contracts must clearly reveal the parties' intent to preclude unilateral rate changes by stating that rates may not change until ordered or approved by FERC. The court indicated its displeasure with having to review this contract interpretation and admonished contract drafters to utilize "careful legal draftsmanship" in the future.

B. In *Middle South Energy*,<sup>57</sup> the FERC, while apparently recognizing the applicability of the *Mobile-Sierra* doctrine,<sup>58</sup> determined that it may modify a *Mobile-Sierra* contract without finding "unequivocal public necessity" to do so.<sup>59</sup>

## VI. COST OF SERVICE AND RATE DESIGN QUESTIONS

In 1985, the FERC and the courts deal with various cost of service and rate design questions, including the following: prudence, recovery for cancelled plant, normalization, fuel charges, spent nuclear disposal costs, working capital, ADITC, the end result language of *Hope*, treatment of CWIP, generic rate of return, use of multiclass rates, and annualization.

### A. Prudence

The FERC made two significant statements on prudence in 1985. First, it found that New England Power Company was prudent in regards to its partial ownership of a cancelled nuclear plant even though a state commission had found a co-owner of that plant to be imprudent. Second, it declined to investigate the prudence of holding company affiliates' entering into an operating agreement and held that state commissions are also precluded from such investigation.

1. The FERC in *New England Power Company*,<sup>60</sup> allowed NEPCO, an 11.16% owner of the cancelled Pilgrim II nuclear plant, to recover from its customers its share of the costs of that plant. In so finding, it overturned an Initial Decision, which had refused recovery.<sup>61</sup> The Initial Decision held that a finding by the Massachusetts Department of Public Utilities (MDPU) shifted the burden of proof on the prudence issue at the FERC from the parties claiming imprudence onto NEPCO, and NEPCO had not met that burden. The

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55. *Id.* at 1186.

56. 727 F.2d 1131, *cert. granted*, 105 S. Ct. 293 (1984).

57. 31 F.E.R.C. ¶ 61,305 (1985).

58. The Commission relied on the finding in the Initial Decision in *Middle S. Energy, Inc.* 23 F.E.R.C. ¶ 61,277 (1983), which found the *Mobile-Sierra* doctrine applicable to the UPSA. *See* Opinion No. 234, 31 F.E.R.C. at 61,644; Opinion No. 234-A, 32 F.E.R.C. at 61,950.

59. *See* *Permian Basin Area Rate Cases*, 390 U.S. 747, 822 (1968).

60. 31 F.E.R.C. ¶ 61,047 (1985).

61. *See* *New England Power Co.*, 27 F.E.R.C. ¶ 63,037 (1984).

MDPU, in a discussion affirmed by the Massachusetts Supreme Court, had found that Boston Edison Company, a joint owner of Pilgrim II, had been imprudent in continuing construction of the plant after June 30, 1980. The Initial Decision found that (1) NEPCO's acceptance of the terms of the joint ownership agreement was imprudent; (2) its acceptance of an exculpatory clause benefitting Boston Edison was imprudent; and (3) that NEPCO's failure to sue Boston Edison was imprudent.

On exceptions to the Initial Decision, NEPCO framed the issue as whether it was reasonable and prudent for it to continue to incur the minimal expenses necessary to "mothball" Pilgrim II. On the other hand, the Staff and MDPU framed the issue in terms of why NEPCO allowed Boston Edison Company to control the project, making NEPCO's ratepayers assume the risk whether Boston Edison's commitment was prudent.

In reaching its conclusion that NEPCO was prudent the Commission also formulated the following prudence test:

In performing our duty to determine the prudence of specific costs, the appropriate test to be used is whether they are costs which a reasonable utility management (or that of another jurisdictional entity) would have made, in good faith, under the same circumstances, and at the relevant point in time.<sup>62</sup>

In determining the appropriate time frame for a prudence investigation, the Commission rejected the approach of the Initial Decision which focused on the utility's conduct in the early 1970's in negotiating the joint ownership agreement and refused to allow NEPCO to recover post-June 1980 costs. Rather, it reviewed whether NEPCO's conduct was imprudent during 1980 and 1981 and stated that it would examine earlier conduct if the 1980-81 conduct appeared questionable.

Furthermore, the Commission took issue with the fact that imprudence, though found by the ALJ, had *not* been determined independently by him. Instead, he had been persuaded by the finding of the MDPU concerning Boston Edison's imprudence, which he then imputed to NEPCO. It stated:

It is one thing for the judge to permit a State commission decision to shift the burden of going forward with evidence, but quite another to allow that decision implicitly to determine the reasonableness of particular costs from the viewpoint of *NEP's* customers.<sup>63</sup>

The Commission reviewed NEPCO's monitoring of its ownership interest in the plant during 1980-81 and determined that NEPCO's decision to fund the option of keeping Pilgrim II available for completion was not imprudent and, therefore, permitted NEPCO to amortize its investment.<sup>64</sup> The Commission determined that NEPCO took a very active role in monitoring the progress of the plant; moreover, its costs to maintain the completion option were only \$187,000 per month during this period.<sup>65</sup>

2. In *AEP Generating Company*,<sup>66</sup> the FERC examined the question of

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62. 31 F.E.R.C. at 61,084.

63. *Id.* at 61,085.

64. *Id.* at 61,086-87.

65. *Id.* at 61,086. The FERC denied rehearing of this opinion in Opinion 231-A, 32 F.E.R.C. ¶ 61,112 (1985).

66. 32 F.E.R.C. ¶ 61,109 (1985).

whether it could consider, in the course of the proceeding, whether the operating companies were wise or prudent in entering into the EHV agreement at issue in that proceeding. Noting that the EHV agreement functions as part of the agreements that comprise the pool relationship, the FERC declined to consider the prudence issue because it claimed that the prudence of being a party to the EHV agreement cannot be considered separately from the prudence of being a party to the entire pool relationship. No party raised questions relating to the prudence of AEP pool membership. Additionally, the FERC stated that a state commission could not inquire into the prudence of an AEP operating company's entering into the EHV agreement without invading FERC jurisdiction.

### B. Cancelled Plant

In *New England Power Company*,<sup>67</sup> the FERC established a generic proceeding to reconsider the appropriate rate treatment of a cancelled plant.

As part of its filing for a rate increase to ten wholesale customers, NEPCO requested cost recovery for its Seabrook Unit 2 plant, on which construction is suspended. The Massachusetts Attorney General, an intervenor, requested summary disposition as to the amortization of Seabrook Unit 2 costs, based on existing Commission precedent embodied in *New England Power Company*.<sup>68</sup>

In Opinion No. 49, the Commission had determined the appropriate recovery for NEPCO's cancelled Salem Harbor No. 5 plant. There, it held that NEPCO could amortize 100% of loss over a five-year period even though only 75% of the plant was designed to be "used and useful" for NEPCO's own customers and 25% was to be sold to other utilities. The FERC justified this latter determination by finding that the preliminary expenditure of funds for Salem Harbor No. 5 would have been no less even if NEPCO had been planning to construct a unit 75% of the size of Salem Harbor No. 5.<sup>69</sup>

In its order denying summary judgment and setting the matter for hearing, the Commission concluded that NEPCO should be permitted in an investigatory hearing to show why Opinion No. 49 may no longer be valid, noting with approval that, because NEPCO sought only a prospective change in abandoned plant treatment, the Commission has "an opportunity to evaluate the issue with reference to a particular utility, but without having to permit rates reflecting a non-conforming practice to take effect subject to refund."<sup>70</sup> Additionally, the FERC found: "The importance of this issue, however, transcends the impact on a single jurisdictional utility. To permit development of the fullest possible record, the Commission will afford the opportunity for other interested persons to participate in this proceeding."<sup>71</sup> To this end, the Commission invited motions to intervene from all interested parties.

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67. *Id.* ¶ 61,453 (1985).

68. Opinion No. 49, 8 F.E.R.C. ¶ 61,054 (1979), *aff'd sub nom.* NEPCO Mun. Rate Comm. v. FERC, 668 F.2d 1327 (D.C. Cir. 1981), *cert. denied*, 457 U.S. 1117 (1982).

69. *See NEPCO*, 8 F.E.R.C. at 61,177-78.

70. 32 F.E.R.C. at 62,043 n.5.

71. *Id.* at 62,042.

The hearing is designed to be a phased proceeding entirely separate from NEPCO's rate increase request. The FERC urged that in the hearing, "[p]articipants should explore whether circumstances warrant reexamination of this policy as well as the economic and legal underpinnings for a cancelled plant policy."<sup>72</sup> The FERC distinguished the NEPCO proceeding from its Notice of Inquiry proceeding, which also considers the question of cancelled plant treatment, finding them to be "essentially complementary."<sup>73</sup> Finally, the Commission emphasized that any change in FERC policy was to be prospective only.

### C. *Normalization, Sale of Nuclear Power Plant*

In *Papago Tribal Utility Authority v. FERC*,<sup>74</sup> the court affirmed a FERC decision to permit Arizona Public Service Company (APS) to normalize investment tax credits. Prior to this rate proceeding, APS rates reflected an immediate flow-through of tax investment credits.

The court rejected Intervenor's assertion that rates that do not reflect tax savings, when realized, are unjust and unreasonable. Instead, the court stated that normalization enables a utility to generate needed capital and reduces rates for a greater number of ratepayers. The court therefore held that the FERC adequately considered both the utility's and ratepayers' interests and made "a reasonable policy choice" in allowing APS to normalize investment tax credits in its wholesale rates. Finally, the court observed that the FERC's decision was in line with Congressional support for normalization of investment tax credits.

The FERC also rejected Intervenor's attempt to force APS to sell all or part of its nuclear power plant where the APS rates did not include costs of that plant. Intervenor argued unsuccessfully that the cost of the plant was included in the APS rate of return in that APS increased its rate of return to attract capital to construct the plant. The court found that there was no indication that the stipulated rate of return included an additional amount for attraction of capital for nuclear plant construction.

### D. *Fuel Charges*

In *City of Vernon v. Southern California Edison Co.*,<sup>75</sup> the cities of Vernon, Anaheim, Riverside, Banning, Colton and Azusa, California (Cities) filed a complaint against Southern California Edison Company (Edison) alleging that Edison had failed to credit its wholesale customers with refunds received from fuel suppliers through its fuel adjustment clause.

The Commission rejected Edison's defense that its fixed rate fuel clause precluded adjustment for post-billing events. It held that the price of fuel for the past period must reflect the actual price paid during that period, including any subsequent reductions applicable to that period. Thus, where that price is

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72. *Id.*

73. *Id.*

74. 776 F.2d 828 (9th Cir. 1985), *cert. denied*, 106 S. Ct. 1515 (1986).

75. 31 F.E.R.C. ¶ 61,113 (1985) *review pending sub nom.* Southern Cal. Edison Co. v. FERC, No. 85-1718 (D.C. Cir. Oct. 3, 1985).

later reduced by supplier refunds, the billings under the fuel clause should be adjusted to account for the fact.

Edison argued that since it had undercollected as a result of its fixed rate fuel clause, it should be permitted to retain the fuel supplier refunds as partial compensation for that loss. The Commission said since Edison could not recover the undercollections so incurred by charging the customers directly, it could not do so indirectly.

Although the Commission ordered refunds of past fuel clause overcharges, it denied the cities' request that Edison be required to automatically pass through the fuel clause any future refunds.

#### *E. Spent Nuclear Fuel Disposal Costs and Working Capital Allowance*

In *Cleveland Electric Illuminating Co. (Phase II)*,<sup>76</sup> the Commission determined two issues: (1) the appropriate amount of accrued spent nuclear fuel disposal costs (SNFDC) to be deducted from rate base; (2) the amount, if any, of "betterments" which may be included in materials and supplies included in the utility's working capital allowance.

The Commission held that it is appropriate to deduct SNFDC revenues from rate base. However, the Commission reduced rate base based upon applying the current wholesale allocation to the total amount of SNFDC collected from all ratepayers, resulting in a rate base reduction of \$16,808. Staff and Intervenor had successfully argued to the presiding administrative law judge that the amount to be deducted from rate base should be determined by applying the wholesale allocator to the amount of SNFDC collected from ratepayers each year since the utility commenced collecting SNFDC. Because the wholesale customers decreased their purchases from the utility, the current wholesale allocator was substantially lower than past wholesale allocators. The latter methodology would have resulted in a rate base reduction of \$165,672.

The Commission reversed an Initial Decision by allowing betterments to be included in rate base until such time as the betterments are identified for use in a particular construction project.<sup>77</sup> In support of its decision, the Commission cited *Union Electric Co.*,<sup>78</sup> and concluded that to exclude from the rate base M&S eventually used for construction purposes would preclude investors from receiving a current return on their investment.

The Commission noted that in prior opinions it has rejected adjustments to the M&S balance on account of betterments because of the speculative nature of such adjustments. It agreed that M&S used for betterments do not belong in the working capital allowance, but emphasized that the primary issue with respect to rate base calculation is when the principle should apply.

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76. 32 F.E.R.C. ¶ 61,381 (1985).

77. "Betterments" are used to improve or enlarge existing plant, rather than to maintain it. The Initial Decision had ordered the utility to deduct amounts attributable to betterments from the amount for materials and supplies (M&S) included in the utility's working capital.

78. 12 F.E.R.C. ¶ 61,239 (1980), *aff'd*, *Union Elec. Co. v. FERC*, 668 F.2d 389 (8th Cir. 1981).

### F. *Accumulated Deferred Income Tax Credits*

In *Florida Power and Light Company*,<sup>79</sup> Florida Power and Light Company (FP&L) tendered for filing a proposed two-step increase in its rates for transmission service to four customers under long-term firm service contracts. In its order accepting for filing and suspending the proposed rates, the Commission summarily directed the power company to exclude ADITC from its capital structure. FP&L filed for rehearing, asserting that an Internal Revenue Service (IRS) auditor decided that FERC's exclusion of these tax credits from the capital structure was inconsistent with the IRS Code and the IRS regulations and would result in a loss of the tax credit.

The Commission, in considering FP&L's request, noted that the IRS auditor said that the exclusion of ADITC from capital structure will result in a flow through of benefits more rapid than ratably over the life of the assets. The Commission pointed out that it had rejected this argument in *Public Service Co. of New Mexico*<sup>80</sup> (PNM).

In PNM, the Commission stated that the IRS Code precluded a reduction in cost of service—as determined without regard to tax credits—greater than a ratable portion of the credits. Therefore, the Commission held that the proper comparison is one between the company's cost of service with ADITC excluded from of the capital structure on one hand, and the company's cost of service if the investment tax credit were unavailable on the other hand.

In the case at issue, the Commission declined to stray from the established position. Also, the Commission noted that it attaches little weight to the auditor's opinion. The Commission, in its conclusion, determined that reconsideration of its views concerning the exclusion of ADITC from capital structure was premature and thus denied FP&L's application for rehearing.

### G. "End Result" Test

In *Jersey Central Power and Light Co. v. FERC*,<sup>81</sup> the court reversed its initial opinion following a request for rehearing by Jersey Central Power and Light Co. (Jersey Central). The court based its original decision, affirming FERC orders summarily directing Jersey Central to file reduced rates eliminating carrying charges on an investment in a cancelled nuclear plant, on suggestions by the FERC that the "end result" test set down in *FPC v. Hope Natural Gas Co.*,<sup>82</sup> did not apply to a utility overall but only to individual rate base items.<sup>83</sup> Jersey Central petitioned for rehearing and the FERC subsequently stated that the court misunderstood the FERC's position.

According to the court, in its initial opinion, its understanding was that the FERC interpreted the "end result test" in *Hope Natural Gas* to apply only "to those assets which valid Commission rules permit to be included in the rate

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79. 32 F.E.R.C. ¶ 61,068 (1985).

80. 9 F.E.R.C. ¶ 61,351 (1979).

81. 768 F.2d 1500 (D.C. Cir. 1985).

82. 320 U.S. 591 (1944).

83. *Jersey Central Power and Light Co. v. FERC*, 730 F.2d 816, 823 (D.C. Cir. 1984), *vacated* 768 F.2d 1500 (D.C. Cir. 1985).

base." This interpretation was based upon the FERC statement that "the reasonableness of [the] end result cannot be evaluated without regard to the individual components which comprise a rate."<sup>84</sup> The FERC, while still defending its summary decision, claimed to the court that the court had misinterpreted the FERC decision in its initial order.

The court reexamined the issue and concluded that the end result test in *Hope Natural Gas* applied to both the calculation of the rate of return on invested assets and to the base calculation of the proper rate base. The court explained that the FERC is not chartered to insure utilities against the hazards of not making a profit, but noted that FERC orders which deny investors a fair rate of return fell outside the zone of reasonableness set out in *Permian Basin Area Rate Cases*.<sup>85</sup>

In addition, the court rejected the FERC's argument that it must disallow inclusion of cancelled plant in rate base because of the decision in *NEPCO Municipal Rate Committee v. FERC*,<sup>86</sup> stating that the FERC misgauged the importance of the *NEPCO* decision. The court explained that under *Hope Natural Gas*, it could not decline to review the reasonableness of the FERC's balancing of consumer and investor interests merely because FERC adopted one of several methods of computing a rate base which was previously approved. It added that it does not matter that some of the determinations that go into the making of a rate order are correctly made if the end result is unreasonable.

The court vacated its original decision and remanded the case to the Commission for a hearing in which Jersey Central could present its evidence on the inadequacy of the rates allowed it. Judge Bork wrote the majority opinion, Judge Ginsburg a concurring opinion and Judge Mikva a dissenting opinion.

In response to a petition for rehearing filed by Jersey Central's wholesale customers, Allegheny Electric Cooperative, Inc. and certain New Jersey Boroughs that the decision on rehearing would virtually eliminate FERC's use of summary disposition and would elevate, for the first time, the investor side of *Hope's* required balancing of consumer and investor interests into a substantive rule of rate-making, the court then vacated its opinion and granted a hearing *en banc*.<sup>87</sup> Oral argument was heard on January 30, 1986. The parties' *en banc* arguments essentially mirror those noted above. The court has yet to issue its decision.

#### H. Construction Work in Progress

In *Mid-Tex Electric Cooperative, Inc. v. FERC*,<sup>88</sup> petitioners, wholesale customers of electric utilities, sought court review of a new FERC rule permitting utilities to include in their rate bases 50% of their investment in construction work in progress (CWIP). While the court accepted FERC's policy rationale for adopting the rule, the court vacated portions of the rule and remanded to FERC for reconsideration of the rule's effect on price squeeze and "double

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84. *Id.* (citing Jersey Central Power & Light Co., 20 F.E.R.C. ¶ 61,083 at 61,181 (1982)).

85. 390 U.S. 747 (1968).

86. 668 F.2d 1327 (D.C. Cir. 1981), *cert. denied*, 457 U.S. 1117 (1982).

87. See 776 F.2d 364 (D.C. Cir. 1985).

88. 773 F.2d 327 (D.C. Cir. 1985).



whammy”<sup>89</sup> situations.

The court accepted FERC’s policy rationales for adopting the CWIP rule. Not only did the court find that CWIP in rate base is consistent with the used and useful doctrine, it also agreed that the rule benefits the public as long as resulting rates are reasonable. Thus, by affirming the substantive policies underlying the 50% CWIP rule, the court upheld the FERC’s authority to issue the rule. Subsequent to remand, the FERC issued an interim rule which implements the original 50% CWIP rule with minor modifications.<sup>90</sup> Although the Commission invited comments on alternative methods to deal with potential price squeezes and double whammies, specific complaints will be addressed only on case-by-case basis. However, responding to concerns raised by the court, the FERC’s interim rules provide that where a utility should reasonably expect that CWIP-related price squeeze or double whammy allegations may arise, the utility must address such matters in its initial filing. The burden is initially on the utility to substantiate its CWIP-based rate and to refute price squeeze or double whammy effects. With respect to double whammy issues the utility may shift the burden by providing “a positive demonstration that the customers’ demand was a significant factor” contributing to the utility’s expansion of facilities or offer “other justification.” Additionally, the interim rule permits intervenors to seek preliminary relief from price squeeze or double whammy at the suspension stage. However, such extraordinary relief requires “a concrete, substantial showing . . . [of] imminent, irreparable harm if CWIP is allowed.”<sup>91</sup> The Commission reserved the right to grant relief on a case-by-case basis. In sum, despite the D.C. Circuit’s remand, the FERC has instituted its 50% CWIP rule.

### *I. Generic Rate of Return*

In *Generic Determination of Rate of Return on Common Equity for Public Utilities*,<sup>92</sup> the Commission denied four requests for rehearing of Order No. 420,<sup>93</sup> which set the first benchmark rate of return on common equity applicable to rate filings made by public utilities in July 1985, and established procedures for updating the benchmark through January 1986.

In Order No. 420, the Commission determined that the average cost of common equity during the “base year” ending June 30, 1984, was 15.31%. The quarterly indexing procedure adopted to update this cost estimate and produce benchmark rates of return yielded a figure of 14.46% as the first benchmark rate applicable to rate filings in July 1985. The indexing procedure was based on fixed adjustment factors and changes in median dividend yield for a broad-based sample of 100 electric utilities. The cost of common equity was comprised of two components: the market required rate of return and flotation costs.

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89. A “double whammy” occurs when wholesale customers must pay for CWIP on a plant even though such customers cease being wholesale customers prior to the time a plant is constructed.

90. See Order No. 448, F.E.R.C. Stats. & Regs. ¶ 30,689 (1986).

91. F.E.R.C. Stats. & Regs. at 30,145.

92. Order No. 420-A, 32 F.E.R.C. ¶ 61,257 (1985).

93. F.E.R.C. Stats. & Regs. ¶ 30,644 (1985).

In determining the first component, the Commission relied on the discounted cash flow (DCF) method.<sup>94</sup> Flotation costs were based on the industry average annual flotation costs for the near term future.

The FERC rejected proposals by two petitioners which would incorporate some return on dividends based upon their quarterly payment and thus increase the cost of common equity. In rejecting this proposal, the FERC noted that it set the benchmark as a nominal rate of return, rejecting the proposal that the allowed rate of return be an "effective" rate of return which would result from reinvestment of dividends. It also rejected a proposal by one petitioner to adopt a continuous compounding form of the DCF mode, with no adjustment to the dividend rate. The FERC noted that this proposal would assume that earnings retained earn a zero return.

The FERC also rejected arguments that it should increase the return on common equity by providing (1) a return on flotation costs and (2) recovery of past flotation costs. In its rejection, the Commission noted that the purpose of allowing flotation costs is to compensate for average annual flotation costs and that past flotation costs were recovered in previous proceedings.

The Commission refused to alter Order No. 420 wholesale services with special contract provisions which reduce the risk below the industry-average level, noting that section 37.6 of its regulations allows case-by-case consideration where a utility's risk differs significantly from the average risk of jurisdictional utilities.

Finally, the Commission rejected a request that the Commission involve itself more directly in the annual proceedings, such as through a public hearing. The Commission expressed reluctance to change the procedural aspects of its rules during the initial two-year advisory period, noted the importance of maintaining a streamlined ratemaking process, and indicated that a public hearing could be instituted *sua sponte* or on motion.

### *J. Multi-Class Rates*

In *Cities of Riverside and Colton v. FERC*,<sup>95</sup> the court affirmed the FERC use of a multi-class rate design.

On January 15, 1979, Southern California Edison (Edison) filed with the Commission a proposed rate increase pursuant to Section 205 of the Federal Power Act,<sup>96</sup> seeking to increase its rates charged to nine of its wholesale customers. Under this proposed rate increase the customers would be given an option to be served under Rate Schedule R (Resale) or Rate Schedule TOU-R (Time of Use Resale). Although the presiding administrative law judge rejected Edison's proposal, the FERC accepted it.<sup>97</sup>

In its compliance filing Edison established two alternatives. One alternative placed all wholesale customers in a single wholesale class. The second alternative divided the customers into two classes—Rate Schedule R and Rate Schedule TOU-R. Each alternative produced on 10.09% test year rate of re-

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94. See 32 F.E.R.C. at 61,607.

95. 765 F.2d 1434 (9th Cir. 1985).

96. 16 U.S.C. § 824d (1982).

97. See Southern Cal. Edison Co., Opinion No. 145, 20 F.E.R.C. ¶ 61,301 (1982).

turn; however, the rates of return Edison would receive from individual customers varied. The Commission rejected these compliance filings on the ground that neither of the presented alternatives complied with the Commission's directive that Edison demonstrate that its rate design produced the same approximate earned rate of return from each customer.<sup>98</sup>

The Cities sought rehearing of the Commission's rejection order, claiming that the Commission improperly reversed Opinion No. 145 by requiring that wholesale customers be divided into several classes. The Cities' petition was denied, and Riverside and Colton filed petitions for review of the rejection order. Subsequently, Edison submitted a revised compliance filing, which was withdrawn before consideration. This was later revised and resubmitted. The Revised Second Compliance Filing grouped the rate Schedule R customers into three classes and minimized the variation in rates of return to .26%.

Anaheim and Vernon agreed with the Revised Second Compliance Filing, while the Cities filed comments urging the Commission to return to a single-class rate. In July 1984, the Commission issued its Letter Order accepting the Revised Second Compliance Filing.<sup>99</sup>

On review, the court upheld the FERC opinion. It determined that not only must the revenues from each class of customers match costs of service, but that any disparity created by a rate scheme must be minimal.

#### K. Annualization

In *Delmarva Power and Light Co. v. FERC*,<sup>100</sup> the court decided that the FERC was inconsistent in declining to adopt a *per se* rule against annualization but relying upon criteria to prove annualization inappropriate which was tantamount to a *per se* rule.

Delmarva Power and Light Co. (Delmarva) filed a revised tariff increasing wholesale electric rates in two phases: Phase I rates were intended to take into account the addition of a new generating unit, Indian River No. 4 (IR4), which was expected to begin commercial operation approximately September 1, 1980.<sup>101</sup>

In structuring its rate proposal, Delmarva selected 1980 as the test year, with the knowledge that IR4 would be in service for not more than 4 months during that year. However, Delmarva annualized the cost of IR4 for calendar year 1980.

The FERC refused to reject Delmarva's filing or grant summary judgment on the annualization issue, deciding that there is no *per se* rule against annualization. After a hearing on the issue, the presiding administrative law judge ruled that Delmarva's proposed annualization should be accepted if Delmarva could prove that all other test year estimates, which were not annualized, were not affected by the new generating plant. He stated that annuali-

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98. See Order Rejecting Compliance Filing, 25 F.E.R.C. ¶ 61,324 (1983).

99. 28 F.E.R.C. ¶ 61,206 (1984).

100. 770 F.2d 1131 (D.C. Cir. 1985).

101. The Phase II rates, which are not at issue in this appeal, were intended to include the addition to plant in service, Delmarva's 7.41% share of Salem Generation Station Unit No. 2, a new nuclear facility then scheduled to begin operation in late 1980.

zation would be permissible if there were no revenue, load, or sales growth to be annualized. He concluded, however, that Delmarva did not meet the burden. The FERC upheld this decision.

The court decided that the burden of proof imposed by the FERC was improper in that it required a utility to have flawless, rather than merely reasonable, projections. The court noted that the decision embodied a generalized suspicion that the possibility of understated systemwide revenues exists when selective annualization is employed, and concluded that the FERC criteria for determining the appropriateness of selective annualization is itself tantamount to a *per se* rule against selective annualization.

## VII. EFFECTIVE DATE OF SECTION 206 RATE

In *Electrical District No. 1 v. FERC*,<sup>102</sup> the court determined that a rate established by the FERC pursuant to section 206 of the Federal Power Act is "fix[ed]" pursuant to section 206(a) only after the Commission accepts a compliance filing. Here, the FERC approved a rate increase for Arizona Public Service Company (APS) pursuant to section 206 of the Federal Power Act because the company's contract with wholesale customers precluded a unilateral rate increase pursuant to section 205. Following the issuance of the initial order on March 2, 1982, which directed APS to make a compliance filing within 45 days, the parties sought a rehearing of the order, and APS requested and was granted an extension of time of 45 days following the order on rehearing to submit a compliance filing. APS made its compliance filing on November 12, 1982, and revised it November 17, 1982. The Office of Electric Power Regulation, under delegated authority, accepted the filing and made the rates effective as of February 7, 1983.

APS appealed the effective date to the FERC, which decided to make the rates effective as of March 2, 1982. On appeal, the court noted that the primary purpose of the Federal Power Act is to protect wholesale customers and stated that wholesale customers cannot plan their activities until they know the precise cost of their electricity. The court found that such precise cost could not be determined until after the compliance filing and remanded to the FERC for appropriate proceedings.

## VIII. CO-GENERATION

In two major co-generation cases, the FERC determined the interpretation of "qualifying facility" for purposes of PURPA and the rate-setting treatment when sales of electricity are made by a qualifying facility to a utility participating in interstate power pooling.

In *Alcon (Puerto Rico), Inc.*,<sup>103</sup> the Commission rejected Alcon's application to certify a cogeneration facility, located at Alcon's pharmaceutical plant in Puerto Rico, as a "qualifying facility" (QF) for purposes of PURPA. The Commission narrowly interpreted "qualifying facility" and held that where the

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102. 774 F.2d 490 (D.C. Cir. 1985).

103. 32 F.E.R.C. ¶ 61,247 (1985).

consumption and production facilities of a cogeneration plant are separately owned, only the production facilities qualify as a QF. Without certification as a QF, a power consumer cannot invoke PURPA to compel back-up power from an electric utility.

In *Alcon*, the pharmaceutical company sought to add a cogenerating facility to its manufacturing plant in Puerto Rico. Alcon intended to consume all power generated from the facility. O'Brien Energy Products, Inc. was to construct, install and own the cogeneration equipment and then lease the facilities to Alcon. Additionally, Alcon had an option to buy the equipment from O'Brien at the end of five years. This arrangement permitted O'Brien to finance the cogeneration facilities for Alcon while taking advantage of tax incentives incident to such financing agreements. A critical element of the cogeneration plan, however, was Alcon's certification as a QF so that, pursuant to PURPA, Alcon could compel the local electric utility, Puerto Rico Electric Power Authority (PREPA) to supply necessary back-up power. FERC's ruling meant that O'Brien, the owner of the project, was the QF. Thus, only O'Brien, who did not need power, could compel back-up sales. The Commission found that the lease and option to buy did not pass ownership to Alcon. Further, the Commission rejected Alcon's argument that the energy consuming facility (its pharmaceutical plant) and the producing cogenerating equipment should be treated as one unit. Instead, FERC held that the cogeneration facility is limited strictly to the production equipment.

Reaching beyond the facts presented in *Alcon*, the Commission further stated, in dicta, that should O'Brien resell back-up electricity obtained from PREPA to Alcon, then O'Brien "would be an electric utility . . . and would cease to be a qualifying cogeneration facility."<sup>104</sup>

Since third-party financing of cogeneration projects has been extensive, FERC's failure to guarantee QF status to the party needing the power is likely to have a deleterious effect on cogeneration projects. A request for rehearing has been filed in *Alcon*.

In *Middle South Services, Inc.*,<sup>105</sup> the FERC held that state regulatory commissions may set rates when sales of electricity are made by a QF to an electric utility participating in an interstate pooling agreement. Specifically, the Commission addressed the determination of costs of electricity purchased by affiliates of Middle South Utilities (MSU).<sup>106</sup>

Analyzing section 210 of PURPA, the Commission found that Congress intended to encourage cogeneration and to allow state regulatory authorities to implement cogeneration. Thus, the FERC held that state avoided cost decisions would not interfere with FERC's jurisdiction. In fact, the FERC held that state commission avoided cost determinations, even though potentially affecting intra-pool costs and thus wholesale rates, were permissible and appropriate

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104. *Id.* at 61,579.

105. Opinion No. 246, 33 F.E.R.C. ¶ 61,408 (1985) [hereinafter Opinion No. 246]; *reh'g granted in part and denied in part*, 34 F.E.R.C. ¶ 61,342 (1986) [hereinafter Opinion No. 246-A].

106. MSU is a holding company and power pool consisting of four operating companies. The operating companies pool power and allocate costs pursuant to a system agreement. Under the agreement, the MSU Operating Committee determines whether electricity purchased from a non-affiliated source will be treated as a purchase of capacity and, if so, how that purchased capacity will affect intra-pool billing.

under both PURPA and the Federal Power Act. Thus, FERC ordered MSU to amend its system agreement to recognize state commission avoided capacity determinations.

The FERC did rule, however, that in the absence of a state commission avoided capacity determination MSU could determine whether negotiated purchases would avoid company capacity costs within the system. Moreover, the Commission agreed that MSU could determine intra-system allocation of qualifying facility purchases and capacity, as it does with any purchase of power from non-affiliates. Finally, the Commission ruled that intra-system resale rates for energy purchased from qualifying facilities "shall be the actual cost" of the company purchasing the power from the Qualifying Facilities.

### IX. INTERLOCKING DIRECTORATES

In *Donald B. Riefler*,<sup>107</sup> the Commission authorized Mr. Riefler to hold concurrently the positions of director of the Niagara Mohawk Power Corporation (Niagara Mohawk), a public utility, and various board positions on a bank holding company and its subsidiaries on the condition that he refrain from involvement in any decisions regarding the financing of the utility.

The bank holding company and two of its subsidiaries were engaged in the "placement" of commercial paper of public utilities. One of these subsidiaries had numerous business relations with Niagara Mohawk, serving as investment manager and as a continuing source of credit. At least one wholly-owned, second-tier subsidiary of this subsidiary had underwritten and marketed Niagara Mohawk securities in the Eurobond market.

The application for interlocking positions within this complex and intertwined corporate structure raised three issues: (1) Commission jurisdiction over bank commercial paper activities; (2) jurisdiction over interlocks based upon the underwriting activities of the second-tier subsidiaries; and (3) jurisdiction over the foreign underwriting activities of a subsidiary of an interlocked bank.

As a preliminary matter, the Commission noted that section 305(b) prohibits interlocking unless the Commission finds that neither public nor private interests will be adversely affected. In accordance with its holding in *Margaret M. Stapleton*,<sup>108</sup> the Commission attributed the underwriting authority of the subsidiaries to the parent companies, thus expanding the scope of its jurisdictional analysis to include the proposed interlocks between the utility and the parent banks.

With respect to the first issue, the Commission noted that section 305(b) prohibits any person from simultaneously holding the position of officer or director of a public utility and the same position on any bank authorized to underwrite or market securities of a public utility but found that the private placement of third party commercial paper by banks is neither "underwriting" nor "marketing" of securities and thus is not jurisdictional. Moreover, the Commission found the potential for abuse created by interlocks between public utilities and banks authorized to place third party commercial paper to be

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107. 32 F.E.R.C. ¶ 61,375 (1985).

108. 27 F.E.R.C. ¶ 61,286 (1984).

remote.

Next, the Commission considered the question of undue influence that was presented by the underwriting activities of the second-tier subsidiaries. Citing *William T. Coleman, Jr.*,<sup>109</sup> the Commission noted the traditional basis for imputing the activities of an underwriter to a non-underwriter is the control which the non-underwriter can or cannot exercise over the underwriter. Because, as a general rule, affiliates do not control their parents, the Commission held that it did not have jurisdiction over the proposed interlocks between the subsidiaries that did not exercise control over the second-tier banks underwriting Niagara's securities.

Finally, the Commission considered the issue of jurisdiction over the second-tier subsidiaries underwriting Niagara's securities on the Eurobond market. The bank at issue, a subsidiary of a bank within which the petitioner held a board position, underwrote notes guaranteed by a bank established under French law. The Commission concluded that protection of domestic consumer interests justified jurisdiction over an interlock between a public utility and a financial institution which has a subsidiary underwriting utility securities in a foreign market, such as the one at issue.

The Commission found that the condition imposed on the application was warranted in light of the need to mitigate the potential for abuse that was presented by the close business ties between the utility and the various bank subsidiaries. Citing *Thomas Madison McDaniel, Jr.*,<sup>110</sup> and *Robert F. Gilkeson*,<sup>111</sup> the FERC reserved its right to require a further showing that neither public nor private interests would be adversely affected by the petitioner's continued holding of the interlocking positions.

J. Cathy Lichtenberg, *Chairman*  
Carmen L. Gentile, *Vice-Chairman*

George F. Bruder  
Stuart K. Gardiner  
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Michael Kessler

Brian J. McManus  
James K. Mitchell  
Robert A. Nelson, Jr.  
Arnold H. Quint  
Michael E. Small  
William H. Smith, Jr.

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109. 19 F.E.R.C. ¶ 61,270 (1982).

110. 24 F.E.R.C. ¶ 61,026 (1983).

111. 22 F.E.R.C. ¶ 61,226 (1983).

