

# TRANSMISSION PRICING UNDER THE FEDERAL POWER ACT: APPLYING A MARKET SCREEN

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The electric utility world (*i.e.*, regulators, executives, independent power entrepreneurs, and consumers) has, for the past several months, been trying to adjust to the Energy Policy Act.<sup>1</sup> That legislation, which passed on the last day of the 102d Congress, made important changes in the way the federal government regulates the industry. In particular, Congress charged the Federal Energy Regulatory Commission (FERC or Commission) with more responsibilities over both access to and pricing of transmission.

At last fall's mid-year meeting of the Federal Energy Bar Association, then-Deputy Secretary of Energy Stuntz said that she "would nominate the . . . [pricing] provisions especially for an award" for legislative ambiguity.<sup>2</sup> Congress did introduce new rate making concepts into the area of transmission regulation. Moreover, the Commission recognizes that the Energy Policy Act, whether by design or happenstance, presents the agency with the opportunity to engage in innovative rate making for transmission services. In her recent testimony before the House Energy and Power Subcommittee, the FERC Chair declared:

It is time for the Commission to explore new pricing concepts in order to develop a long-term policy that makes sense in an evolving, competitive industry. There has been considerable debate about the Commission's current approach to transmission pricing. . . . [I]t is important to recognize that we are in transition, that our current pricing scheme may have some limitations, and that we need to move to a longer-range policy.<sup>3</sup>

To begin grappling with these issues, including the impact of the Energy Policy Act amendments, the Chair announced that the Commission will convene at least one technical conference, if not several, on transmission pricing.<sup>4</sup>

Nevertheless, students of the relevant section of the Energy Policy Act will find buried within its complexity the following admonition: "[Transmission] rates, charges, terms, and conditions shall promote the economically effi-

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1. Pub. L. No. 102-486, 106 Stat. 2776 (1992) [hereinafter Energy Policy Act].

2. *Federal Energy Bar Explores Role Of Competition And Regulation In Post Order-No. 636 Era Under The Influence Of The National Energy Policy Act Of 1992 And Policies Anticipated Under The Clinton Administration*, FOSTER NATURAL GAS REPORT No. 1903, Nov. 19, 1992 at 1.

3. Testimony of Elizabeth Anne Moler, Chair of the Federal Energy Commission, before the Subcommittee on Energy and Power, Committee on Energy and Commerce, House of Representatives at 3-4 (March 4, 1993).

4. *Id.* at 4.

cient transmission and generation of electricity . . . ."<sup>5</sup> That language, on its face, requires the FERC to promote "economic efficiency."

Senator Malcolm Wallop, the ranking Republican on the Senate Energy and Natural Resources Committee and Republican Floor Manager of the Energy Bill, explained during the floor debate on the Conference Report how the Commission should achieve that goal:

I would encourage the FERC at the earliest moment to begin to employ a "market screen" test, not unlike that which the Antitrust Division of the U.S. Department of Justice spoke about. . . . Where effective competition exists, there remains no valid public policy reason for the federal government to intervene in privately negotiated activities.<sup>6</sup>

The transmission pricing provisions of the new Energy Policy Act apply, by their terms, only to orders requiring mandatory transmission services. The statutory language remains silent about pricing in actions the Commission might take when it regulates or reviews transmission rates under other sections of the Federal Power Act (FPA). Nevertheless, the colloquy on the Senate floor between Senator Wallop and the Chairman of the Committee on Energy and Natural Resources, Senator Johnston, during the debate on final passage suggests that the Commission would do well to apply the same scheme to transmission rate making in general.<sup>7</sup>

This article attempts to explain the "market screen." The concept has sound legal foundations and works in practice. It comes from and thrives in antitrust law. In essence, the market screen requires the Commission to rely on effective competition, where that exists, to set rates. If a buyer can show that in meeting its needs it had three possibilities to choose from, it has satisfied the market screen. In most situations, using the market screen would entail examining the overall bulk power market. There, the "choices" would comprise transmission, plus two generation alternates (self-generation and purchase within the buyer's grid). In other less frequent instances, the buyer would show that it could obtain transmission from any of three utilities.

Applying the market screen will have some practical benefits as well. It will make the FERC's job of administering its new responsibilities under the transmission pricing provisions of the FPA, in particular, and regulating transmission rates, in general, easier. The market screen allows the Commission to apply a bright line test in instances where parties have met the "three choice" requirement. This lessens the need for the Commission in every case to interpret the transmission ratemaking concepts of the Energy Policy Act.

Most important, allowing the rates parties freely negotiate to go into effect will benefit society, including the transmission provider, independent power entrepreneurs and customers. The benefit to customers will enure to both those consuming the electricity and those of the selling utility. It will give utilities incentives to offer transmission, making possible transactions that

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5. Energy Policy Act, § 722, 106 Stat. 2776 (amending § 212(a) of the Federal Power Act, 16 U.S.C. § 824k(a) (1988)).

6. 138 CONG. REC. S17,616 (daily ed. Oct. 8, 1992) (statement of Sen. Wallop).

7. 138 CONG. REC. S17,613 (daily ed. Oct. 8, 1992) (statement of Sen. Johnston, "I see no reason why these new pricing principles should not be applied by the FERC to other transmission orders.").

use less expensive electricity. This helps both those needing transmission to compete with traditional utilities and the consumers of the electricity.

The market screen also benefits consumers of the selling utility. Because the transmission seller must apply the money it earns from transmission as credits toward core customers' bills, the market screen will keep rates down. Moreover, since the market sets the rates for transmission, the transmission customer pays the full value of the facilities it uses. Therefore, by definition, regulators need not worry that the customers of the seller will subsidize transmission for third parties.

Finally, extending market pricing to transmission marks another step on the path the Commission has taken to open the gas<sup>8</sup> and oil pipeline<sup>9</sup> industries and the electric generation<sup>10</sup> sector to competition.

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8. In the gas industry, the effort began with "open access" in Order No. 436, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, 50 Fed. Reg. 42,408 (1985), [1982-1985 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,665, (codified as amended in scattered sections of 18 C.F.R. pts. 2, 157, 282, 375, and 381) (final rule and statement of policy), *reh'g granted in part and denied in part*, Order No. 436-A, 50 Fed. Reg. 52,217 (1985), [1982-1985 Regs. Preamble] F.E.R.C. Stats. & Regs. ¶ 30,675, *reh'g granted in part*, Order No. 436-B, 51 Fed. Reg. 6,398 (1986), F.E.R.C. Stats. & Regs. ¶ 30,688, *reh'g denied*, Order No. 436-C, 51 Fed. Reg. 11,566 (1986), 34 F.E.R.C. ¶ 61,404, *reh'g denied*, Order No. 436-D, 51 Fed. Reg. 11,569 (1986), 34 F.E.R.C. ¶ 61,405, *reconsideration denied*, Order No. 436-E, 51 Fed. Reg. 1,156 (1986), 34 F.E.R.C. ¶ 61,403; *vacated and remanded*, *Associated Gas Distrib. v. FERC*, 824 F.2d 981 (D.C. Cir. 1987), *cert. denied sub nom*, *Interstate Natural Gas Ass'n of America v. FERC*, 485 U.S. 1006, 108 S.Ct. 1468, 99 L.Ed.2d 698 (1988), *readopted on an interim basis*, Order No. 500, 52 Fed. Reg. 30,344, [1986-1990 Regs. Preambles] III F.E.R.C. Stats. & Regs. ¶ 30,761, (1987), *extension granted*, Order No. 500-A, 52 Fed. Reg. 39,507, (1987), F.E.R.C. Stats. & Regs. ¶ 30,770, *modified*, Order No. 500-B, 52 Fed. Reg. 39,630 (1987), F.E.R.C. Stats. & Regs. ¶ 30,772, *modified further*, Order No. 500-C, 52 Fed. Reg. 48,986 (1987), F.E.R.C. Stats. & Regs. ¶ 30,786, *modified further*, Order No. 500-D, 53 Fed. Reg. 8,439 (1988), F.E.R.C. Stats. & Regs. ¶ 30,800, *reh'g denied*, Order No. 500-E, 53 Fed. Reg. 16,859 (1988), 43 F.E.R.C. ¶ 61,234, *modified further*, Order No. 500-F, 53 Fed. Reg. 50,924 (1988), F.E.R.C. Stats. & Regs. ¶ 30,841, *reh'g denied*, Order No. 500-G, 54 Fed. Reg. 7,400 (1989), 46 F.E.R.C. ¶ 61,148, *remanded*, *American Gas Ass'n v. FERC*, 888 F.2d 136 (D.C. Cir. 1989), *readopted*, Order No. 500-H, 54 Fed. Reg. 52,344 (1989), [1986-1990 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,867 (Final Rule) *rehearing granted in part and denied in part*, Order No. 500-I deed title [1986-1990 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,880, 55 Fed. Reg. 6,605 (1990), *aff'd in part and remanded in part*, *American Gas Ass'n v. FERC*, 912 F.2d 1496 (D.C. Cir. 1990); *cert. denied sub nom*, *Wilcox v. FERC*, 111 S.Ct. 957 (1991), (codified at 18 C.F.R. § 284.8(b), [hereinafter Order No. 436]. In the eyes of many it culminated with the "unbundling" of Order No. 636, *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation, and Regulation of Natural Gas Pipelines After Wellhead Decontrol*, 57 Fed. Reg. 13,267, III F.E.R.C. Stats. & Regs. Preambles ¶ 30,939, *order on rehearing*, Order No. 636-A, 57 Fed. Reg. 36,128, III F.E.R.C. Stats. & Regs. Preambles ¶ 30,950, *order on rehearing*, Order No. 636-B, 57 Fed. Reg. 57,911, 61 F.E.R.C. ¶ 61,272 (1992). In addition, then-Chairman Allday of the Commission appointed Commissioner Terzic to lead a task force to examine the criteria to use in determining whether to allow market rates for gas pipelines.

9. In a landmark case, the Commission adopted "light-handed" regulation for competitive markets. *Buckeye Pipe Line Co. L.P.*, 53 F.E.R.C. ¶ 61,473 (1990), *reh'g denied*, 55 F.E.R.C. ¶ 61,084 (1991). The Commission also held a technical conference on April 30, 1992, to consider whether market pricing should apply generically to the oil pipeline industry.

10. See, e.g., *Entergy Serv., Inc.*, 58 F.E.R.C. ¶ 61,234, *order on rehearing*, 60 F.E.R.C. ¶ 61,168 (1992), *appeal filed*, *Cajun Elec. Power Coop., Inc. v. FERC*, Nos. 1461, *et al.*, (D.C. Cir. filed Sept. 24, 1992).

## I. INTRODUCTION: TRANSMISSION PRICE REGULATION FROM THERE TO HERE

President George Bush signed the Energy Policy Act at a ceremony near Lafayette, Louisiana, on October 24, 1992. His signature culminated years of effort to enact comprehensive energy legislation. The law contains 30 titles, covering a broad spectrum of subjects ranging from energy efficiency and integrated resource planning to licensing of nuclear plants and storage of spent fuel. Of interest here, the provisions of Title VII represent the most far-reaching overhaul of electric utility regulation since the federal government first asserted jurisdiction over the industry in the Public Utility Act of 1935.<sup>11</sup>

Those who subscribe to the Biblical adage, "[T]here is nothing new under the sun,"<sup>12</sup> will savor some similarities between the Public Utility Act and the Energy Policy Act. Congress passed the Public Utility Act, which contemporaries also called the Wheeler<sup>13</sup>-Rayburn<sup>14</sup> Act, as part of the New Deal in response to the economic collapse of the Great Depression. The law comprised two titles: (1) the Public Utility Holding Company Act (PUHCA),<sup>15</sup> restricting utility holding company activity; and (2) the FPA,<sup>16</sup> authorizing Federal Power Commission regulation of electric utility rates and practices. Victory came at the end of the legislative session and after a long and bitter debate.<sup>17</sup>

The electricity title of the new statute, which Congress passed in the wake of the Persian Gulf War, encompasses two subtitles: (1) reform of PUHCA allowing relaxed regulation of wholesale electric generating subsidiaries of utility holding companies; and (2) amendments to the FPA granting the FERC<sup>18</sup> authority over certain electric utility rates and practices, namely those pertaining to transmission service. Suspense, including a successful early filibuster in the Senate,<sup>19</sup> skillful parliamentary maneuvering in reviving the bill<sup>20</sup> and cloture to limit debate on the last day,<sup>21</sup> attended the enactment of the Energy Policy Act.

Aside from these parallels, the Energy Policy Act points in a different direction from its progenitor legislation. Congress tried "something else" in the area of transmission pricing. In fact, the entire portion on transmission pricing, section 722, represents a departure from previous law and regulatory

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11. Pub. L. No. 74-333, 49 Stat. 803 (1935).

12. *Ecclesiastes* 1:9.

13. Sen. Burton K. Wheeler (D. Mont.), served 1923-1947, Chairman of the Committee on Interstate Commerce.

14. Rep. Sam Rayburn (D. Tex.), served 1913-1961, Chairman of the Committee on Interstate and Foreign Commerce.

15. 15 U.S.C. §§ 79-79z-6 (1988).

16. 16 U.S.C. §§ 824-824k (1988).

17. For a detailed description of those dramatic events see KENNETH S. DAVIS, *FDR: THE NEW DEAL YEARS: 1933-1937* at 529-37 (1986).

18. Congress designated the Federal Energy Regulatory Commission as the successor agency to the Federal Power Commission in the Department of Energy Organization Act, 42 U.S.C. §§ 7171-78 (1988).

19. 137 CONG. REC. S15,754-61 (daily ed. Nov. 1, 1991).

20. 138 CONG. REC. S944-46 (daily ed. Feb. 5, 1992).

21. 138 CONG. REC. S17,635-36 (daily ed. Oct. 8, 1992).

practice. The specific subject of the discussion here, the “economically efficient” language, originated in the Conference Committee and had no counterpart in either the Senate or House Bills. The House Bill, H.R. 776, contained a different scheme for transmission pricing. The Senate Bill, S. 2166, retained existing law on transmission.<sup>22</sup> Therefore, the reader can fully appreciate the innovation this represents only by knowing the backdrop against which the Conference Committee wrote the language of section 722. That requires an excursion into: the law at the time, the House Bill’s transmission pricing provisions and the Conference changes.

#### A. *The Tried And True Method*

Until Congress amended the FPA as part of the omnibus energy legislation it passed during the Carter Administration, the statute did not authorize the Commission to order wheeling (transmission of power over one utility’s lines from other suppliers to other customers). That omission resulted from a deliberate decision. Originally, both the Senate and House versions of the Public Utility Act contained provisions which would have required utilities to wheel upon reasonable request.<sup>23</sup> In the end, Congress decided to leave wheeling to the “voluntary action” of electric utilities.<sup>24</sup>

The FPA subjected those transmission agreements utilities negotiated to the Commission’s rate review. Section 201 states that the FPA applies to “the transmission of electric energy in interstate commerce.”<sup>25</sup> The Supreme Court ultimately defined “transmission” (as opposed to distribution) to encompass power that commingled with electricity flowing out of state.<sup>26</sup> For the most part, utilities in the United States transmit power over an interconnected grid. As a practical matter, regulation of transmission agreements or tariffs falls within exclusive federal authority.

The rate provision of the FPA, section 205(a), states, “All rates and charges made . . . for or in connection with the transmission . . . of electric energy subject to the jurisdiction of the Commission and all rules pertaining to such rates or charges shall be just and reasonable . . . .”<sup>27</sup> As section 205 refers to rates for all jurisdictional service, the Commission applied to transmission pricing the same principles as it did to wholesale sales (the other area of FERC regulation), the “just and reasonable” standard.

That term has existed since the very early days of federal railroad rate regulation.<sup>28</sup> The courts have enshrined in law, perhaps to a greater extent than the economists have in rate making lore, the criteria to apply in arriving

22. The Senate version of the electricity title involved reform of the Public Utility Holding Company Act, without transmission access.

23. S. 1725, 74th Cong., 1st Sess. § 202(a) (1935); H.R. 5423, 74th Cong., 1st Sess. § 203(b) (1935).

24. S. REP. NO. 621, 74th Cong., 1st Sess. 19 (1935); H.R. REP. NO. 1318 74th Cong., 1st Sess. 27 (1935).

25. 16 U.S.C. § 824.

26. *FPC v. Florida Power & Light Co.*, 404 U.S. 453 (1972), *reh’g denied*, 405 U.S. 948 (1972).

27. 16 U.S.C. § 824d(a).

28. *Farmers Union Central Exchange, Inc. v. FERC*, 734 F.2d 1486, 1504-1506 (D.C. Cir. 1984), *cert. denied sub nom.*, *Williams Pipe Line Co. v. Farmers Union Central Exchange, Inc.*, 469 U.S. 1034 (1984).

at a decision whether in individual cases rates meet the just and reasonable requirement. In a series of cases, the Court of Appeals for the District of Columbia Circuit held that at least as a starting point, if not a presumption, "just and reasonable" equates with "embedded cost" (system average cost) rates.<sup>29</sup>

As Commissioner Trabandt explained, in transmission ratemaking the Commission traditionally has required a utility operating "an integrated system . . . to charge a system-wide rate to its customers. The company must show that the lines serving [the customer] stand apart from the company's otherwise integrated transmission system in order to assign the costs to the particular customer."<sup>30</sup> The Commission has, however, permitted a utility that constructs a line or provides ancillary services for a particular customer only, and no one else, (such as to make the connection to the grid) to bill that entity the full cost of the exclusive service.<sup>31</sup>

In essence, embedded-cost rate making entails calculating the cost of the selling utility's grid, both the old and new facilities, and charging each customer the average. If a company operates its transmission, as most do, on an integrated basis, the embedded-cost rate will include an average of the entire system. As a typical utility uses its transmission grid primarily to deliver electricity to its power sales customers, embedded-cost pricing means that transmission and sales customers share in the cost of the entire transmission system. To the extent the transmission customer fails to pay its freight, the sales customers pick up the difference.

On the other hand, marginal-cost and, in the case where the utility needs to add to the grid to serve the new customer, incremental-cost rate making allow the utility to divide its system costs and bill each purchaser of electricity or transmission for the part of the system serving that buyer. The utility charges in the order of patronage, old customers for older facilities and new customers for newer facilities. Under that method, each of the customers pays for what it uses or what its demand level, by accident of order, required the utility to add to the system.<sup>32</sup>

The Public Utility Regulatory Policies Act (PURPA)<sup>33</sup> added sections 211 and 212 to the FPA. Section 211 gave the Commission the authority to order wheeling in limited circumstances.<sup>34</sup> The section on pricing of wheeling services stated:

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29. See, e.g., *Electricity Consumers Resource Council v. FERC*, 747 F.2d 1511 (D.C. Cir. 1984) (rejecting marginal cost as the basis for rates because of a lack of record support); *Farmers Union*, 734 F.2d at 1502 ("the most useful and reliable starting point for rate regulation is an inquiry into costs").

30. *Ohio Edison Company*, 58 F.E.R.C. ¶ 61,315 at 62,009 (1992) (Commissioner Trabandt, concurring).

31. *Pennsylvania Electric Co., order on reh'g*, 60 F.E.R.C. ¶ 61,034 at 61,128 n.42 (1992).

32. Economic wisdom holds that marginal cost pricing (whether short-run, using existing facilities, or long-run, involving replacements) offers the best mechanism for allocating society's resources. Firms use more of existing facilities or add capacity only if those customers pay for the facilities they tax. The customers pay only if that represents the most efficient course for them. See, e.g., ALFRED E. KAHN, *THE ECONOMICS OF REGULATION PRINCIPLES AND INSTITUTIONS* 70-71 (1991).

33. 16 U.S.C. §§ 2601-2645 (1988).

34. 16 U.S.C. § 824j.

No order [requiring wheeling] may be issued under . . . this title unless the applicant for such order demonstrates that [it] is ready, willing, and able to reimburse the party subject to such order for . . . (2) in the case of an order [requiring wheeling] . . . (A) the reasonable costs of transmission services, including the costs of any enlargement of transmission facilities, and (B) a reasonable rate of return on such costs, as appropriate, as determined by the Commission.<sup>35</sup>

Nobody knows how these pricing provisions operate in practice. The Commission never applied them, for it never issued a wheeling order under those amendments to the FPA. Therefore, embedded-cost rates remained the rule, until the regulatory shifts that culminated in passage of the Energy Policy Act began to gather steam.

### B. *The Change Begins*

The movement away from embedded-cost rates for transmission services began because a majority of the Commission increasingly showed an inclination to order wheeling and transmission access under provisions of the original FPA. This phenomenon appeared most prominently in merger cases, as an exercise of the Commission's authority to condition approval under section 203.<sup>36</sup>

Overall, the push for transmission access served as a means to help achieve what some considered to be the goal of supplanting utility-owned generating plants with independent power facilities as the primary source for the nation's electricity.<sup>37</sup> Some saw this notion emerging in an articulated fashion from the deliberations of the Commission's Transmission Task Force. Although the Task Force Report did not endorse the policy, a segment of its audience, namely, Commissioner Trabandt, found that idea embodied in the last chapter.<sup>38</sup>

In advance of the Transmission Task Force issuing its report, the first hint of at least the possibility that the Commission would depart from embedded cost to accept a different rate making approach appeared in the order approving the merger in *Utah Power & Light Company, PacifiCorp, PC/UP&L Merging Corp (Utah)*.<sup>39</sup> The Commission imposed an obligation on the surviving company to honor requests for wheeling or other transmission service, even to the extent of constructing new lines. The order required that the company sell the service at "cost-based rates."<sup>40</sup> Footnote 163 breached a hairline crack in the wall:

"Cost-based" is not intended to suggest rates that are limited to embedded cost. . . . Where additional capacity is needed to meet a request, rates may be designed to specifically assign the cost of that capacity addition to the party requesting service. We do not preclude the possibility that such costs will subse-

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35. 16 U.S.C. § 824k(b).

36. 16 U.S.C. § 824b.

37. Others, such as supporters of the growth of independent power, viewed this as the natural outcome of competition between the two types of electric generation.

38. *The Transmission Task Force's Report to the Commission*, ELECTRICITY TRANSMISSION: REALITIES, THEORY AND POLICIES 167-190 (1989).

39. 45 F.E.R.C. ¶ 61,095 at 61,294-95.

40. *Utah Power & Light Company*, 45 F.E.R.C. ¶ 61,095 at 61,291 (1988).

quently be allocated to other beneficiaries of the additional capacity.<sup>41</sup>

Before the Commission could apply this cryptic statement to the Utah Power & Light Company-PacifiCorp merger, events moved rapidly.

The next merger case, *Northeast Utilities Service Company (NU I)*,<sup>42</sup> involved the parent of Northeast Utilities (NU) acquiring the bankrupt Public Service Company of New Hampshire. The Commission approved the merger and the majority imposed *Utah*-style conditions. As in *Utah*, the Commission had to deal with a situation in which the utility could not, for legitimate reasons, construct new lines to meet a request for transmission. The solution, however, differed.

In the *Utah* case, the Commission held that if (after an initial period) the company could not accommodate a particular request for transmission, it need not reduce service to its native load customers (those for which the utility had an obligation under law or contract to supply their requirements for electricity). Rather, the company would reduce sales to third-party, off-system customers to make room for the transmission service. At least the parties knew the ground rules.

In *NU I* the Commission majority failed to provide even that much certainty. The majority, instead, established a mechanism for any disappointed transmission customer to trigger a "technical conference."<sup>43</sup> At the conference, "the complainant, NU, all affected state commissions and affected customers [would recommend] . . . the most efficient and equitable allocation of existing transmission capacity on the NU system."<sup>44</sup> (After discussion at the Commission meeting, however, the majority agreed to keep the *Utah* assurance that native load will not lose service.<sup>45</sup>) The order approving the merger left for a later stage of the proceeding questions regarding incremental pricing for new construction.<sup>46</sup> Commissioners Trabandt and Terzic proposed an alternative. They would have dealt with the allocation question in a straightforward way, by recognizing its true nature as a pricing issue. They recommended these principles:

2. Economy purchases [from other utilities] that benefit the native load will have a preference. . . .
3. If a . . . request for transmission . . . will cause the merged company to forgo an economy purchase that would result in a lower rate for native load, the complainant will pay NU as part of the transmission rate the 'opportunity cost'. . . for economy purchases as the difference between the cost to NU of substitute power . . . and the price of the economy purchase it must forgo. . . .
4. Off-system sales will come ahead of a transmission request, to the extent the sales reduce native load rates, except if the complainant requesting wheeling agrees to pay NU . . . the portion of the proceeds from the sale NU would have credited to its native load customers. NU must provide legal documentation of the lost sale, such as an affidavit or a contract.
5. NU will make available any remaining capacity to the complainant for third-

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41. *Id.*

42. 56 F.E.R.C. ¶ 61,269 (1991).

43. *Id.* at 62,024.

44. *Id.*

45. *Id.* at 62,059-60 (Commissioner Trabandt, dissenting in part).

46. *Id.* at 62,028-32.



party wheeling.<sup>47</sup>

Parties reacted to the decision in *NU I* with many objections on rehearing. In response, in *Northeast Utilities Service Co. (NU II)*,<sup>48</sup> as well as in a companion case, *Northeast Utilities Service Co. (NU III)*,<sup>49</sup> the Commission embraced three new transmission pricing principles. In particular, the agency allowed NU to depart from traditional Commission practice of embedded-cost rates.

*NU II* adopted three goals for pricing firm transmission: (1) “[n]ative load customers of the utility providing transmission service should be held harmless”; (2) “transmission customers should be charged the lowest reasonable cost-based rate. . .”; and (3) “[transmission] pricing should prevent the collection of monopoly rents by the transmission owner and promote efficient transmission decisions.”<sup>50</sup> The Commission stated that it would balance the three goals on a case-by-case basis in ruling on proposed rates.<sup>51</sup> Under the new pricing regime, the utility could also charge transmission customers incremental rates for system upgrade or expansion, if the new activity cost more than the average for facilities on the system.

The more novel feature in these cases involved allowing NU, as part of the “hold harmless” principle, to recover so-called opportunity costs, or the extra expense the utility incurs because of the third-party customer’s presence.<sup>52</sup> The transmission customer occupying the grid prevents the company from lowering native load rates. The transmission seller cannot use its grid to buy cheaper power or sell excess electricity. Similarly, utilities may also incur ancillary costs in providing transmission that may result in higher native load rates. The Commission claimed it began to tackle both problems. *NU II* held out to utilities the hope that they might collect opportunity costs from their firm customers (when the utility must provide service).<sup>53</sup>

In *NU III* the Commission said it wanted to expand the possibilities for utilities to collect opportunity costs. There, the Commission decided that companies could charge opportunity costs even in the non-firm (where the utility has the discretion to curtail) context.<sup>54</sup> The Commission held, “that ‘properly implemented, a lost opportunity charge applied to increase the quality of non-firm service can be just and reasonable.’”<sup>55</sup> The Commission also agreed that, in concept, utilities may recover from transmission customers the increased ancillary costs those transactions create. Section III of *NU III* discussed that issue with regard to “out of rate charges.”<sup>56</sup> This levy represents the increased costs resulting from the New England Power Pool having to run

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47. *Id.* at 62,059.

48. 58 F.E.R.C. ¶ 61,070 (1992).

49. 58 F.E.R.C. ¶ 61,069 (1992).

50. 58 F.E.R.C. ¶ 61,070 at 61,203.

51. *Id.*

52. *Id.* at 61,200-04.

53. *Id.* at 61,203-04.

54. 58 F.E.R.C. ¶ 61,069 at 61,165.

55. *Id.* at 61,179 (footnote omitted).

56. *Id.* at 61,181-82.

more expensive plants when the transmission customer occupies the grid and blocks access to the lowest cost facility.

This, in summary form, represented the Commission's institutional thinking on transmission pricing regulation at the time Congress deliberated the Energy Policy Act. In some situations, utilities might collect incremental costs for upgrade or expansion of the grid. In other instances, the Commission might allow sellers to recover opportunity costs for existing capacity. What a utility could charge depended on a case-by-case balance among the three transmission pricing goals: holding native load harmless; lowest reasonable price to the transmission customer; and efficiency in transmission usage.<sup>57</sup>

### C. Congress Steps In And Erects The Market Screen

S. 2166, which passed the Senate before the House took up the energy legislation, kept silent on transmission.<sup>58</sup> The House, however, passed provisions on that subject in section 723 of H.R. 776.<sup>59</sup> First, the House required the Commission to order wheeling in specified cases (such as mergers and requests for market-based negotiated rates) as well as after a proceeding adjudicating a specific application for a wheeling order.<sup>60</sup> Second, H.R. 776 contained pricing principles which slightly differed from those the Commission promulgated in the *NU* series. In particular, the House required rates not to be "unjust, unreasonable, unduly discriminatory or preferential."<sup>61</sup>

Section 723(a), which proposed to add section 212(b)(2) to the FPA, provided:

Rates, charges, terms, and conditions applicable to transmission service . . . to the extent practicable, based on the facts and circumstances present at the time, shall be designed to —

- (A) compensate native load customers for legitimate and verifiable economic costs of providing the transmission service,
- (B) provide the lowest reasonable transmission rates for the transmission service, and
- (C) prevent the collection of monopoly rents by the transmitting utility and promote the efficient transmission and generation of electricity. Such rates, charges, terms, and conditions shall account for any benefits to the transmission system of providing the transmission service, and a reasonable balance among subparagraphs (A), (B), and (C).<sup>62</sup>

The House Report explained these provisions in two terse sentences: "The transmitting utility is entitled to payment of the cost of providing such service, plus a reasonable rate of return. The FERC may require the enlargement of existing facilities on a shared basis."<sup>63</sup> Nevertheless, by comparing

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57. Whether that regulatory scheme has worked in practice remains a matter of dispute. See *Western Massachusetts Electric Co.*, 61 F.E.R.C. ¶ 61,182 (1992) and dissents of Commissioners Trabandt and Moler.

58. S. 2166, 102d Cong., 2d Sess. (1992).

59. H.R. 776, § 723, 102d Cong., 2d Sess. (1992).

60. *Id.*

61. *Id.*

62. *Id.*

63. H.R. REP. NO. 474, 102nd Cong., 2nd Sess., pt.1, at 140 (1992).

section 723 with the *NU II* principles, one notices that the House made two changes.

First, instead of the "hold harmless" language of *NU II*, H.R. 776 allowed utilities to collect "legitimate" and "verifiable" "economic" costs of transmission. Second, with the "shall account for" language, the House required a "system benefits" test. Under that provision, the Commission must reduce the rate to the transmission customer to the extent that its patronage creates conditions, such as power flows, that allow the native load to experience savings.

The Conference Committee revamped the House provisions on transmission. The Conferees removed all mention of the Commission ordering transmission in cases involving mergers or market rates. Wheeling orders even upon direct application became discretionary. The pricing provisions changed as well. Senator Johnston's offer, which on pricing became the Senate's initial offer to the House Conferees, contained the following language:

Any order under this Act [involving transmission] shall require the transmitting utility . . . to provide . . . services at rates and charges which permit the recovery . . . of all legitimate and verifiable costs incurred in connection with providing the . . . services, including, but not limited to:

- (1) the appropriate share of the costs (including a reasonable rate of return on investment) of existing facilities and of any enlargement, advancement or alteration of facilities, necessary for the provision of the ordered services;
- (2) any increased costs resulting from curtailment, displacement, or redispatch or other alteration of the transmitting utility's use of its generation or transmission system caused by the provision of the ordered services;
- (3) any reasonably ascertainable uncompensated economic burden to the transmitting utility or its existing customers caused by non-recovery of the costs of generation, transmission and distribution facilities that, but for the provision of the ordered service, were reasonably attributable to the recipient of the electric energy to be transmitted; and
- (4) the costs of necessary associated services. Such rates shall not be unjust, unreasonable, unduly discriminatory or preferential.<sup>64</sup>

The Senate offer made pre-eminent the goal of native load protection. In addition, the new language spelled out that customers might, in appropriate circumstances, have to pay for existing as well as new facilities. Subsection (2) stated that utilities may bill transmission customers for the extra generation costs tying up the grid may cause opportunity costs and out of rate charges. Subsection (3) permitted the utilities to recover "stranded investment" costs. Customers changing from purchasing electricity to purchasing transmission would have to pay for the facilities that the utility had dedicated to them and which now stood idle.

At one of the public Conference Committee meetings dealing with these provisions, several House conferees argued in favor of discarding the entire transmission section and leaving the traditional "just and reasonable" requirement untouched.<sup>65</sup> The discussion never became a formal proposal. In any

64. TRANSMISSION OFFER BY SENATOR JOHNSTON, CONFERENCE COMMITTEE ON H.R. 776, Sept. 9, 1992 at 4-5.

65. Author's notes of Conference Committee meeting of Sept. 30, 1992.

event, the transmission pricing provision changed again before the Conference Committee adopted section 722 in what became its final form.

As enacted, section 722 amended section 212(a) of the FPA as follows:

An order under section 211 shall require the transmitting utility . . . to provide . . . services at rates, terms, and conditions which permit the recovery by such utility of all costs incurred in connection with the transmission services and necessary associated [ancillary] services, including, but not limited to, the appropriate share, if any, of legitimate, verifiable and economic costs, including taking into account any benefits to the transmission system of providing the transmission service, and the costs of any enlargement of transmission facilities. Such rates . . . shall promote the economically efficient transmission and generation of electricity and shall be just and reasonable. Rates . . . shall ensure that, to the maximum extent practicable, costs incurred in providing the wholesale transmission services, and properly allocable to the provision of such services are recovered from the applicant . . . and not from [the] utility's existing wholesale, retail, and transmission customers.<sup>66</sup>

The Energy Policy Act departed from the House's scheme and from the *NU II* principles in several respects. The "lowest reasonable price" criterion and the case-by-case balancing fell by the wayside. The term "monopoly rent" vanished and the "efficiency" of transmission criterion became "economically efficient transmission and generation." "Legitimate and verifiable economic costs" became "legitimate, verifiable and economic costs."

The Energy Policy Act requires the Commission to "ensure" that the transmission customer pays the full cost of the service it receives "to the maximum extent practicable." The House Bill said that the Commission might exercise its discretion in a particular case to insulate the utility's existing native load customers from absorbing in their rates the higher generation costs that a transmission customer might bring about. Now, the Commission must act to "ensure" that "to the maximum extent practicable" the transmission customer bore them.

Finally, section 722 places the rate scheme within the rubric of the "just and reasonable" standard. This language declares section 722 ratemaking "just and reasonable." That gives the Commission further legal support for a new transmission pricing scheme.

In short, the language in the Energy Policy Act more rigorously articulated the new transmission pricing concept. The *NU II* principles list holding native load harmless as only one factor for the Commission to consider. Those principles, at best, assigned native load protection equal weight with low transmission prices. The Energy Policy Act removes the goal of lowest reasonable transmission prices. In that way, the new law places native load protection on firmer footing than did *NU II*.

Where does the market screen fit in? Senator Wallop, in his floor statement, urged the Commission to adopt the market screen to fulfill the agency's statutory obligation to promote "economically efficient" transmission and generation.<sup>67</sup> In addition, in a lengthier section-by-section analysis, he said:

The provision in the Conference Report that requires 'rates shall promote the

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66. Energy Policy Act § 722.

67. See *supra* text accompanying note 6.

economically efficient transmission and generation of electricity . . .’ needs explanation. In a recent *United Illuminating* case [60 F.E.R.C. ¶ 61,214 (1992)] the FERC overrode the competitive process that had led a utility and a supplier to negotiate rates not based on costs. The Department of Justice joined in petitioning for rehearing, arguing that the FERC should adopt existing judicial precedents of market efficiency when dealing with market-based rates. The FERC on rehearing dodged the issue . . . Adding the modifier ‘economically’ to the word ‘efficient’ calls to the FERC’s attention that the science of economics has developed sophisticated doctrine of market efficiency. The FERC should draw on that knowledge in its cases and needs to identify situations where FERC can reasonably withdraw from transaction-by-transaction review.<sup>68</sup>

Finally, in a floor colloquy, responding to Senator Lott’s question about the meaning of “economically efficient,” Senator Wallop said, as follows:

The purpose of this language is to encourage negotiated rates, where appropriate. In cases where the relevant market — the market for delivered power — is competitive, the negotiated or market price will reflect the true value of the use of facilities and promote the economically efficient allocation of resources. In such cases, a market-based rate shall be deemed to meet all the requirements of section 212(a).<sup>69</sup>

While not directly extending the reach of section 212 beyond wheeling orders under section 211, Congress encouraged the Commission to apply the same pricing concepts to transmission pricing cases, under whatever section they arose. The colloquy between Senators Johnston and Wallop contains the following exchange:

Mr. WALLOP: Do the pricing provisions of new F[ederal] P[ower] A[ct] section 212(a) apply only to FERC-ordered transmission pursuant to section 211, or do they also apply to the pricing of transmission pursuant to other authorities under the FPA?

Mr. JOHNSTON: The conference report does not exclude their application beyond section 211. As a matter of policy, I see no reason why these new pricing principles should not be applied by FERC to other transmission orders. It would make good policy sense to do so.<sup>70</sup>

## II. THE MARKET SCREEN IN ANTITRUST

### A. *The Framework*

The preceding discussion illustrates that Congress intended the Commission to allow competition, in the individual cases in which it occurred, to set transmission prices. If a transmission customer faced a sufficient number of alternate suppliers so that buyer could freely negotiate the terms of the deal with the seller, the Commission should yield to the parties. This represents sound economics.

It also follows along the path the Commission has set in other industries. In the gas industry, the Commission has vigorously pressed to give customers maximum choice, to the point of requiring pipelines to separate their sales, transportation and storage functions. In the oil pipeline area, the Commission

68. 138 CONG. REC. S17,619 (daily ed. Oct. 8, 1992) (statement of Sen. Wallop).

69. 138 CONG. REC. S17,647 (daily ed. Oct. 8, 1992) (statement of Sen. Wallop).

70. 138 CONG. REC. S17,613 (daily ed. Oct. 8, 1992) (statements of Sen. Wallop and Sen. Johnston).

has allowed the forces of competition to determine the price in competitive markets, and last year the Commissioners convened a technical conference to consider whether to apply that policy more broadly. More recently, the Commission issued for public comment a staff proposal that calls for even less intrusive regulation, as a result of the Energy Policy Act becoming law.<sup>71</sup> Even in the electric utility area, the Commission has allowed market-based rates for transactions involving sales of electricity.<sup>72</sup>

The market screen holds that parties can have the benefit of their bargain if the buyer had three choices. This rule conforms with the notion underlying the Energy Policy Act: competition will improve the electric industry. Because electricity forms an integral raw material in the production of goods and provision of services, a more efficient electric industry will help the economy expand as well.

### *B. The Concept*

Using antitrust as a model for transmission pricing regulation proceeds from a sound policy premise. Some among those who follow both antitrust and energy law recognize that the terms "market power" and "dominance," phrases the Commission has increasingly used in recent rate cases, actually come from merger cases.<sup>73</sup> When enforcement authorities determine whether a merger does (or tends to) lessen competition, they analyze the degree of competition in the market at the time of the merger and after the merger were to take effect. More to the point, antitrust agencies and courts want to know whether the new firm will contribute to making the market a monopoly. If it does, that firm has "market power" or enjoys "dominance." A seller with market power can engage in price exploitation, free of restraints from rivals for the business.

This consideration, guarding against price gouging by monopolists, underlies the FPA. The D.C. Circuit held with regard to the Interstate Commerce Act, the prototype for the FPA, "[i]t is of course elementary that market failure and the control of monopoly power are central rationales for the imposition of rate regulation."<sup>74</sup> The Supreme Court also attributed to Congress a similar rationale for granting the Federal Power Commission its charge to regulate public utilities.<sup>75</sup>

The just and reasonable standard embodies that purpose. Therefore, in *Duquesne Light Co. v. Barasch*,<sup>76</sup> which represents the latest in a chain of

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71. Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992, Docket No. RM 93-11-00 (March 18, 1993).

72. See *supra* notes 8-10.

73. See *United Illuminating Co.*, 60 F.E.R.C. ¶ 61,214 at 61,735-4-5 (Commissioner Trabandt, concurring).

74. *Farmers Union*, 734 F.2d at 1508, (citing Stephen Breyer, *REGULATION AND ITS REFORM* at 15-16 (1982)).

75. *Atlantic Refining Co. v. Public Service Commission*, 360 U.S. 378, 388 (1959) (Congress passed the rate provisions of the Natural Gas Act, legally the functional equivalent of those in the Federal Power Act, to "afford consumers a complete, permanent and effective bond of protection from excessive rates and charges.").

76. 488 U.S. 299 (1989).

doctrine begun in *FPC v. Hope Natural Gas Co.*,<sup>77</sup> the Supreme Court defined the concept as a balance between confiscatory and exploitative rates. In most cases, commissions use cost plus rate of return to establish the balance. When parties ask the Commission to depart from cost-based rates, the agency may approve if it finds that market-based pricing similarly restrains exploitation. In order to assure against price exploitation the Commission must, as the Court in *Farmers Union*<sup>78</sup> required, find that: in fact, the rates emerged from what the court called workable competition; the rates fall below a just and reasonable ceiling; and the agency will monitor later developments.

Antitrust and the Commission's rate regulation under the FPA converge. The requirement that negotiated rates emerge from workable (or sufficient) competition assures that the seller did not overcharge the buyer. Market power in merger law assures that the surviving firm will not have the potential to overcharge buyers. Understanding how antitrust law proceeds to translate that goal into practical decisions forms a useful predicate for the FERC's transmission rate policy.

### C. *The Practical Benefits*

For reasons of administrative practicality as well, the market screen makes sense. Each of the pricing provisions of the Energy Policy Act has the potential for creating lengthy litigation at the Commission, perhaps also in courts reviewing Commission decisions. In contrast, a market screen will obviate the need for the Commission to apply the statute where competition exists.

For example, section 212(a) of the FPA,<sup>79</sup> as amended, now requires the Commission to decide what constitutes "legitimate" costs, to define "verifiable" and to classify "economic." If a utility spends money to reinforce its system at the same time it expands, the Commission will have to draw the line between what the utility could "legitimately" allocate to the transmission customer for that service and the money the utility spends that bears no relation to the expansion. With an integrated grid the line of demarcation may be difficult for the decision makers to find. The requirement for "legitimate" costs also gives parties the potential to litigate the necessity of particular expenditures.

Under "verifiable," the Commission must determine how far to delve into the utility's books. Should the utility produce bills, or will projections suffice? Also, how detailed an examination will the Commission make into the papers the transmission utility brings as proof of its expenses? As for "economic" costs, since Congress nowhere defined the term, the Commission must first decipher its meaning. What kinds of expenses for transmission expansion fall inside or outside the rubric "economic" costs? Does, perhaps the statute mean "economic" in the sense of least cost? If so, how should the Commission

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77. 320 U.S. 591, 603 (1944).

78. 734 F.2d at 1507-09.

79. 16 U.S.C. § 824k(a).

make its findings? Given the experience among the states that apply least cost planning, ascertaining "economic" costs could consume much time and effort.

In addition, the "system benefits" language grants the Commission discretion to lower the rate to the extent that the new transmission customer changed the flow on the grid to allow the utility to put the system to better use than otherwise. Parties in the *NU II* case urged the Commission to adopt that as part of the transmission pricing principles; the Commission declined.<sup>80</sup>

Commissioner Trabandt's dissent in *Ohio Edison*<sup>81</sup> showed the mischief the "system benefits" test could possibly cause. He wrote with regard to the hearing the Commission ordered in that case (which involved the method of charging a customer for a transmission line the utility specifically built early to serve a municipal agency):

[T]he burden will fall on [the utility] to show that only [the transmission customer], and not any of its other customers, profits from the upgrades. I believe that power flows present such complexity that [the utility] will experience considerable difficulty proving that all the "benefits" inure to [the transmission customer].<sup>82</sup>

Commissioner Trabandt added: "[L]itigating . . . loop flows presents a technically complicated undertaking. It involves tracing invisible electrons on a system of wires. In addition, when utilities belong to a pool, power . . . flows constantly and continuously over the entire interconnected transmission grid, whenever one [utility] sends electricity over the wires."<sup>83</sup> The Commissioner concluded:

The entire integrated grid serves as a conduit for all the electricity traversing its wires. Therefore, under the standard [the municipal agency] requests, every transmission customer will lay on retail customers part of the cost of upgrading the system. *NU [II]* will never apply in a real case.

Even if I am wrong, a hearing on the system "benefit" issue will tie everyone up in knots. Every time a utility wants to charge an individual customer for an individual upgrade, the customer will argue that "system benefits" call for a reduction. (If the Commission applies this standard across the board, in extreme cases, the transmission customer will gain free access to the grid as a reward for all the "benefits" its transaction provides.) In short, the engineering or the number of cases may overwhelm any attempt to depart from embedded cost rates.<sup>84</sup>

The Commission's experience on the gas side regarding incremental pricing for expansion also shows how complicated the allocation of costs, such as fuel, between existing customers and new ones can be.<sup>85</sup>

80. 58 F.E.R.C. ¶ 61,069 at 61,165, 61,170.

81. 58 F.E.R.C. ¶ 61,315 (1992).

82. *Id.* at 62,010.

83. *Id.* (quoting *New York State Elec. & Gas Corp.*, 47 F.E.R.C. ¶ 61,185 at 61,619-20 (1989)(Commissioner Trabandt, concurring)).

84. *Id.*

85. *See, e.g.*, *Algonquin Gas Transmission Co.*, 61 F.E.R.C. ¶ 61,273 (1992); *Great Lakes Gas Transportation Limited Partnership*, 59 F.E.R.C. ¶ 61,234 (1992), *reh'g denied*, 62 F.E.R.C. ¶ 61,102 (1993). Unlike with electric utilities operating an integrated grid, gas companies build facilities for discrete customers. Therefore, on the gas side, when it certifies construction, the Commission wants to allow companies to expand, as long as the risk lies with the pipeline.



In their colloquy on the Conference Report, the respective floor managers of the Bill, Senator Johnston and Senator Wallop, agreed that “system benefits” mean “[a]ctual benefits to the transmission system . . . namely documented operational cost savings.”<sup>86</sup> Similarly, Senator Wallop, in his colloquy with Senator Lott defined “system benefits” as “reduced line loss” from the additional transaction.<sup>87</sup> Nevertheless, deciding the issue in a concrete case still entails difficult litigation on a highly technical subject.

Finally, the question how the utility recovers opportunity costs and expansion costs remains murky. The beginning of section 722 requires the Commission to allow the utility to recover “all the costs incurred” in providing the service. The section then goes on to describe recovering “an appropriate share, if any, [of the costs of existing grid], taking into account any benefits to the system of providing the transmission service, and the costs of any enlargement[s].”<sup>88</sup> Does the “all the costs” language dictate the “appropriate share?” Does “and the cost of enlargement” stand alone or does the phrase “appropriate share, if any” encompass that as well?

Moreover, the language requiring the Commission to “ensure” that a customer for service under a wheeling order will pay its own way contains the modifier “to the extent practicable.” Since here the Conference Committee inserted a requirement that neither the Senate nor the House had included, and rejected the balancing the House had passed, no record exists as to what this language intends to accomplish. One asks, then, to what extent does the language “to the maximum extent practicable” allow something less than full protection? That same issue, in the guise of whether to allow a utility to collect opportunity costs or expansion costs as an addition to embedded costs, or only if higher than embedded cost, became the subject of controversy at the Commission, in the industry, and now the court of appeals.<sup>89</sup>

The better argument holds the “all the costs” language predominates, since the rest of section 722 does not expressly limit that command. Under that theory, the modifier to the protection against cross-subsidy allows an escape if the Commission finds full protection infeasible, but not if it finds that undesirable. Nevertheless, the statute fails to provide a direct answer.

For all these reasons, adopting a market screen would simplify matters for the Commission. It would avoid these contentious issues because the contract the parties operating in a competitive atmosphere agreed to would govern.<sup>90</sup> As we next see, the market screen, which allows negotiated rates to go into effect if the buyer had three suppliers to choose from, stands on firm legal ground and provides a workable alternative to applying the regulatory provisions of section 212(a), as amended.

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86. 138 CONG. REC. S17,613 (daily ed. Oct. 8, 1992) (statement of Sen. Johnston).

87. 138 CONG. REC. S1,647 (statement of Senator Wallop).

88. Pub. L. No. 102-408 § 722.

89. *Pennsylvania Electric Co.*, 58 F.E.R.C. ¶ 61,278 (1992), *reh'g denied*, 60 F.E.R.C. ¶ 61,034 (1992), *appeal pending*, No. 92-1408 (D.C. Cir. filed Sept. 11, 1992).

90. Certain issues still remain, however. State commissions must decide the proper division of revenue between the native load and the transmission utility's shareholders.

### III. MESHING ANTITRUST WITH TRANSMISSION RATE MAKING

#### A. From The Antitrust Experience

##### 1. Defining Competition

The Energy Policy Act seeks to extend competition in the electric utility industry. Competition and monopoly, the opposite poles of economic activity, have formed the central theme of antitrust law since its inception. Therefore, electric utility regulation could profit well from borrowing antitrust concepts and adapting them to new pricing provisions in the FPA.

We must first establish the definition of "competition." The term, in the Sherman Act<sup>91</sup> and Clayton Act<sup>92</sup> context, means something different from what the economics textbooks consider that state of affairs to be. Robert H. Bork, then Professor of Law at Yale Law School (later Judge of the U.S. Court of Appeals for the D.C. Circuit) explained the idea in his classic work on antitrust:

Both economics and law generally [seek to guide] through the concepts of "competition" and "monopoly." But the two disciplines mean quite different things by those terms, and when the differences go unremarked — or worse, various common-speech terms are inserted without notice — debate grows more and more heated and less and less illuminating. The economist's models of competition and monopoly are descriptive[;] [t]he lawyer's . . . normative. There is a wide gap in practical consequences. The economist builds a pure model in order to clarify thought; such models are indispensable starting places for policy analysis, but they are not prescriptions for policy. They leave out too much. A determined attempt to remake the American economy into a replica of the textbook model of competition would have roughly the same effect on national wealth as several dozen strategically placed nuclear explosions. To say that is not to denigrate the models but to warn against their misuse.<sup>93</sup>

In fact, economics professors,<sup>94</sup> for purposes of teaching the subject, describe perfect competition as a situation in which the prices of goods fall to the lowest competitive level. Sellers lose all their patronage to rivals if they raise prices and cannot stay in business if they lower them. Under that model, buyers must have every willing supplier available; the market excludes no one willing to participate in it.

The law, on the other hand, adopts a more practical course. Rather than aim for unattainable certainty, the law uses educated approximation to set standards. The problem arises primarily in the merger area, where adjudication depends on the competitive nature of the market and the degree of efficiency a particular merger may bring. Nevertheless, "there is no . . . clear, reliable, and general theory of the ways in which [mergers] may create [a certain type of] efficiency. It follows, therefore, that antitrust analysis, if it is to be successful, must proceed primarily by elimination."<sup>95</sup> Therefore, antitrust

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91. 15 U.S.C. §§ 1-7 (1988).

92. 15 U.S.C. §§ 12-27 (1988).

93. ROBERT H. BORK, *THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF* 91-92 (quoted in *Western Systems Power Pool*, 55 F.E.R.C. ¶ 61,099 at 61,333 (1991) (Commissioner Trabandt, dissenting)).

94. *E.g.*, PAUL A. SAMUELSON, *ECONOMICS* 43, 482 (9th Ed. 1973).

95. BORK, *supra* note 93, at 122.

enforcers (for example the Department of Justice and Federal Trade Commission Merger Guidelines) adopt “rules about allowable percentages that reflect the probable balance. . . .”<sup>96</sup>

## 2. The Market Analysis In Merger Cases

The law, then, favors taking a wide cut rather than aiming for a policy of impractical exactitude. The next issue becomes: from whose point of view does the analysis of legal or harmful activity proceed? Antitrust law has traditionally taken the correct path (even if courts sometimes ignore it). Merger law, as antitrust generally, stems from the idea that society must “protect[ . . . ] competition, not competitors.”<sup>97</sup> The law restrains mergers that harm competition. It allows those that do not, even if competitors suffer.

Furthermore, the Supreme Court held that “merger[s] [must be] functionally viewed, in the context of [the] particular industry,”<sup>98</sup> and with information “unique” to the case at hand.<sup>99</sup> Because the law concerns itself with competition, rather than competitors, adjudicators must concentrate on buyers’ choices, not sellers’ opportunities.

In a later case, the Court held that decision makers must make a “careful selection of the market area in which the seller operates, and to which the purchaser can practicably turn for supplies.”<sup>100</sup> In short:

The central issue is where does a potential buyer look for potential suppliers of the service — what is the geographical area in which the buyer has, or in the absence of monopoly would have, a real choice as to price and alternative facilities? This depends on the facts of the market place, taking into account [various] economic factors . . . .<sup>101</sup>

As a corollary, in contrast to classroom economics, which, as we saw earlier, requires totally free entry for competition to exist, the antitrust laws examine the competitive results. Therefore, as long as the seller cannot block the purchaser from exercising choice, it has no market power, even if one particular rival cannot participate in the market. The law condemns the power to exclude if it has the potential to give a firm the power to control prices. Eliminating one competitor while leaving a sufficient number to transact business hardly reaches the level of controlling the price the buyer will pay. As Professor Hay wrote, “The power to exclude competition must be read as the power to exclude competition generally, as opposed to the power to exclude a single competitor.”<sup>102</sup>

Finally, proper analysis must proceed from the experience of buyers of the product. The Court in *United States v. General Dynamics Corp. (General Dynamics)*<sup>103</sup> warned against playing a numbers game that confuses means

96. BORK, *supra* note 93, at 128.

97. *Brown Shoe Co. v. United States*, 370 U.S. 294, 320 (1962) (emphasis deleted).

98. *Id.* at 321-22.

99. *Id.* at 322 n.38.

100. *Tampa Electric Co. v. Nashville Coal Co.*, 365 U.S. 320, 327 (1961).

101. *United States v. Grinnell Corp.*, 384 U.S. 563, 589 (1966) (Fortas and Stewart, J.J., dissenting).

102. George Hay, *Market Power in Antitrust*, 60 ANTITRUST L.J. 807, 820 n.50 (1992).

103. 415 U.S. 486 (1974).

with ends:

[W]hile [a] statistical showing . . . would . . . suffice[] to support a finding of "undue concentration" in the absence of other considerations, the question before us is whether [the trial court] was justified in finding that other pertinent factors affecting the . . . industry and the business of the appellee mandated a conclusion that no substantial lessening of competition occurred or was threatened by the acquisition. . . .<sup>104</sup>

In *General Dynamics*, the Court held that long-term contracts kept a significant amount of coal away from potential buyers, leaving a wrong impression about the competitive consequences of a merger. Rather than evaluate the total supplies of the companies, the Court looked at uncommitted supplies. As a result, the Court overcame the fact that the merger created a company with a high market share and found the combination acceptable, even though the Department of Justice, using conventional analysis, had not.

Similarly, in *United States v. Baker Hughes, Inc.*,<sup>105</sup> the Court of Appeals for the District of Columbia Circuit rejected the Justice Department's argument that ease of entry formed the only defense to an otherwise objectionable merger. The court cited cases in which other mitigating factors tipped the balance and held that the small size of the product market and the few firms that historically competed made the usual statistics misleading.

In addition, the court of appeals endorsed the "sophisticated buyer" defense as one factor to consider in the market analysis under the antitrust laws. The court recited that:

the district court considered . . . the sophistication of [the product's] consumers. [Drilling rigs] currently cost hundreds of thousands of dollars . . . . These products are hardly trinkets sold to small consumers who may possess imperfect information and limited bargaining power. [In this particular market] buyers closely examine available options and typically insist on receiving multiple, confidential bids for each order. . . . This sophistication, the court found, was likely to promote competition even in a highly concentrated market. . . . These findings [besides the ease of entry] provide considerable support for the district court's conclusion that the defendants successfully rebutted the government's prima facie case.<sup>106</sup>

Some of the lower courts have accepted the "sophisticated buyer" defense in merger cases. The court in *United States v. Archer-Daniels-Midland Co.* found, "[t]he existence of large, powerful buyers of a product mitigates against the ability of sellers to raise prices."<sup>107</sup> The district court in *United States v. Country Lake Foods, Inc.* ruled that a merger between milk suppliers in a market that showed three distributors controlling 90% of the retail sales did not harm competition because these buyers could protect themselves against monopoly conduct.<sup>108</sup>

Other courts have, however, rejected the "sophisticated buyer" defense

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104. *Id.* at 497-498.

105. 908 F.2d 981 (D.C. Cir. 1990).

106. *Id.* at 986-987 (citations omitted).

107. 781 F. Supp. 1400, 1416 (C.D. Iowa 1991).

108. 754 F. Supp. 669, 679 (D. Minn. 1990).

on evidentiary and other grounds.<sup>109</sup> The Department of Justice and the Federal Trade Commission similarly do not recognize a “big buyer” defense but do include the structure of the buying side of the market in which the merging companies operate as among the factors to consider.<sup>110</sup> Even if one rejects the “sophisticated buyer” defense, the customers have a role to play in evaluating market power in the merger context.

In a variation on the “sophisticated buyer” theme, district courts have taken customer opinion into account in their analysis of whether a merger will harm competition. If the allegedly injured parties support the merger, the transaction must, in practice, not have the anti-competitive consequences that the statistics suggest. In *FTC v. Great Lakes Chemical Corp.*, the court supported its ruling in favor of allowing a merger on evidence that the customers wanted that result.<sup>111</sup> The court called the customer support a “key factor” in the analysis.<sup>112</sup> The court quoted a Supreme Court case on standing under the Clayton Act to the effect that the antitrust laws protect the “‘people of the United States as individuals,’ especially consumers.”<sup>113</sup>

From that premise, it takes but a short and sensible step to reach the conclusion that if the supposed victims acquiesced in the merger, so should the United States Government. In a more serious vein, the participants know the consequences of a merger on the market better than people studying the situation from afar. As we will see in the next section, however, the FERC rejected that line of reasoning as a matter of principle.

### 3. The Market Test In Monopolization Cases

Before turning from the legal analysis of the market screen in antitrust, the reader must bear with one final word on antitrust, regarding the “essential facilities” doctrine. Some proponents of embedded-cost ratemaking, the opposite of the market screen, argue that transmission constitutes an “essential facility,” necessitating close regulation, including embedded-cost ratemaking.<sup>114</sup> In *Utah*, the Commission found that the Utah Power & Light transmission system, standing alone, met the four tests for an “essential facility.”<sup>115</sup> The Commission found: (1) a monopolist controlled it; (2) competitors could not economically duplicate it; (3) Utah Power & Light Company denied use to competitors; and (4) “it [wa]s feasible” for Utah Power & Light Company to allow competitors access.<sup>116</sup>

Three points dispose of the argument. First, as the facts of some Com-

109. *E.g.*, *U.S. v. United Tote, Inc.*, 768 F. Supp. 1064 (D. Del. 1991); *U.S. v. Ivaco*, 704 F. Supp. 1409, 1427-1429 (W.D. Mich. 1989).

110. Paul T. Denis, *Market Power In Antitrust Merger Analysis: Refining The Collusion Hypothesis*, 60 ANTITRUST L.J. 829, 834-835 (1992); Mary Lou Steptoe, *The Power Buyer Defense in Merger Cases*, 61 ANTITRUST L.J. 493 (1993).

111. 528 F. Supp 84, 94-96 (N.D. Ill. 1981).

112. *Id.* at 94.

113. *Id.* (citing *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 486 n.10 (1976)).

114. *Cf.*, *e.g.*, American Public Power Association, A CRITICAL LOOK AT THE FEDERAL ENERGY REGULATORY COMMISSION'S MARKET-PRICING POLICIES FOR WHOLESALE POWER 5 (1992).

115. 45 F.E.R.C. ¶ 61,095 at 61,287 (1988).

116. *Id.*

mission cases in the next section show, other markets look different from that of *Utah*. Buyers do face choices among many transmission suppliers. In those instances, applying the market screen makes sense. Authorities make bad policy if they base it on sweeping generalizations. In any event, the legislative history of the Energy Policy Act suggests that the Commission should make case-by-case determinations, as good policy dictates, a logical way to proceed.

Second, noted antitrust authorities have denied the doctrine a special role in antitrust law. The "essential facilities" cases rest on the premise that owners of these properties must make them accessible to all comers on "reasonable terms." Judge Stephen Breyer of the First Circuit argued that applying the doctrine blindly leads policy makers astray.<sup>117</sup> He gave as an example the mousetrap spring business consisting of one company. Under a strict reading of the "essential facilities" case law, a court would require that firm to make the spring available to all at reasonable rates. Such a requirement would create bad public policy if the spring maker came to its position as a result of having been efficient. He said, "Thus, the 'bottleneck' doctrine, the essential facilities doctrine, is at heart not an 'antitrust' doctrine, but a 'public utilities' doctrine . . . . It is a *regulatory* doctrine stemming from regulatory concepts of public service on fair terms."<sup>118</sup> Therefore, even if one agrees with the legal concept, "essential facilities" cases amount to nothing more than conventional monopolization cases that require market power analysis.<sup>119</sup>

Third, recent decisions show that the doctrine has developed more subtly than what may appear from the surface. Calling a facility "essential" does not preclude the usual antitrust market scrutiny. Rather, the label describes the conclusion a court reaches after performing such an analysis. For example, the Ninth Circuit only last year in *City of Anaheim v. Southern California Edison Co.*,<sup>120</sup> issued a major ruling on "essential facilities" in the context of an electric utility's transmission system. The City of Anaheim and other municipalities (the City) sued their wholesale utility under the Sherman Act. Among other things, the City charged that Southern California Edison (Edison) denied access to an essential facility, the Pacific Intertie, a transmission line connecting California with the Northwest. The district court ruled in favor of Edison.

The court of appeals affirmed. It held that Edison justified its action because the utility had a good business reason for using the line itself. In addition, the court reviewed the district court's finding that the City had at its disposal other means to gain access to inexpensive electricity. The district court held that the Pacific Intertie fell outside the category of an "essential facility." The court of appeals affirmed. The appellate court's holding applied the usual traditional analysis:

In short there was no dearth of available power. Nor, as a matter of fact, did inability to obtain Pacific Northwest Power preclude the Cit[y] from obtaining power at reasonable rates . . . . In short, the fact that the Cit[y] could achieve

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117. Stephen Breyer, *Luncheon Address*, 57 ANTITRUST L.J. 774 (1989).

118. *Id.* at 775 (emphasis added).

119. See *Consul, Ltd. v. Transco Energy Co.*, 805 F.2d 490, 494 n.11 (4th Cir. 1986).

120. 955 F.2d 1373 (9th Cir. 1992).

savings at the expense of Edison and its other customers is not enough to turn the Pacific Intertie into an essential facility. That being so, the district court did not err.<sup>121</sup>

The Eighth Circuit held similarly in the *City of Malden v. Union Electric Co.*<sup>122</sup> A jury had found that the city had other choices for transmission service. In fact, the court of appeals recited that the defendants showed five alternate paths to the outside.<sup>123</sup> In addition, the defendants showed<sup>124</sup> that one of those competitors offered to link its lines with the city, but the city declined. The trial judge had also instructed the jury that an essential facility analysis depended on finding and examining the relevant market.

The court of appeals sustained the jury findings and the trial judge's instructions. The court held<sup>125</sup> that the essential facilities doctrine operated to help fact finders decide whether the owner possessed monopoly power in a given market.

Even if one applies the "essential facilities" doctrine to transmission, the Commission may still adopt the market screen. In "essential facilities" cases, the fact finder analyzes the relevant product and geographic markets to determine whether the owner has the potential to cause competitive harm to its customers. The market screen works in transmission pricing cases because the owning utility sometimes operates in a competitive market. As we see later, that happens more often than one might expect, given the rhetoric on the issue.

#### 4. The Economic Theory Behind The Market Screen

Current antitrust economics examines the general structure of the market, equates market power with monopoly power and makes a measurement from the standpoint of the purchaser. In his article, Professor Hay observes that "[t]he concept of market power [lies] at the core of antitrust" and antitrust policy is aimed primarily at preventing firms from "achieving, retaining, or abusing market power."<sup>126</sup> He concludes from these premises that:

If we accept the notion that the point of antitrust is promoting consumer welfare, then it is clear why the concept of market power holds such a prominent role in antitrust analysis. If the structure of the market is such that there is little potential for consumers to be harmed, we need not be especially concerned with how firms behave because the presence of effective competition will provide a powerful antidote to any effort to exploit consumers.<sup>127</sup>

Several policies flow from these postulates. First, because antitrust concerns itself with harm to the consumer, the measure of market power must come from the buyer's vantage point. Furthermore, the law should condemn only that activity which allows firms "profitably to maintain prices signifi-

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121. *Id.* at 1381.

122. 887 F.2d 157 (8th Cir. 1989).

123. *Id.* at 161-162.

124. *Id.*

125. *Id.* at 163.

126. Hay, *supra* note 102, at 807.

127. Hay, *supra* note 102, at 808 (footnote omitted).

cantly above the competitive level for an sustained period of time.”<sup>128</sup> Similarly, if a firm earns well but does so because consumers willingly pay, the authorities should not disturb the situation. Professor Hay uses as an example a highly profitable restaurant in Washington, D.C., whose success comes “despite vigorous competition.”<sup>129</sup>

In short, market power only exists if one can prove harm to consumer welfare. If the structure of the market permits rivals to limit a firm’s ability to raise prices significantly and for the long term, the Commission should not intervene. If the buyers have sufficient choices, no single seller can possess market power. This rationale underlies the market screen. As, however, I show in the later discussion on how the market screen works, the Commission has not followed that line of reasoning in several cases where a buyer showed tht multiple sellers competed in the market.<sup>130</sup>

### *B. Into The Energy Arena*

Transmission pricing cases come before the Commission in two distinct business situations. In the first type of case, the transmission service forms part of a larger transaction. There, the buyer sets out to obtain electricity, with or without transmission. In the second type, the buyer shops only for transmission service. The customer must use the transmission grid and look for a seller to provide a route. If the Commission were to adopt a market screen for transmission pricing, it would apply the mechanism in both cases. Conceptually, the market screen works the same way whatever the transaction involves. The mechanics of the analysis, however, differ. The Commission, or decision maker, determines whether the buyer faced sufficient choices. If so, the ultimate agreement with the seller resulted from free negotiations and would, therefore, be acceptable.

The Commission, in effect, determines whether the buyer could have turned down the seller if the seller tried to use its position as owner of the grid to impose a price. The Commission would examine the number of possibilities the buyer faced and would take into account customer support. If the Commission determines the buyer had a sufficient range from which to pick, the rates would go into effect.

Defining “sufficient choices,” or “sufficient competition” contains an element of imprecision. Nevertheless, as the earlier section on the antitrust experience showed, the law, unlike academic economics, must make these practical adjustments. As Judge Bork pointed out in his antitrust treatise, undertaking a complete study of the industry and the market in each case, along the lines of a doctoral thesis, amounts to a wasted effort.<sup>131</sup> In the endless complexity of adjudication, the decision maker loses any marginal gain. As he put it with regard to adjudicating the effects of mergers:

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128. Hay, *supra* note 102, at 814.

129. Hay, *supra* note 102, at 815.

130. For the competing views on this question within the Commission, see Nevada Sun-Peak Limited, 54 F.E.R.C. ¶ 61,264 (1991); Terra Comfort Corp., 52 F.E.R.C. ¶ 61,241 (1990).

131. BORK, *supra* note 93, at 114.



The application of th[e] technique [of judging whether to allow mergers by discounting monopolistic possibilities rather than calculating benefits] to particular situations will not be error free. But that is not a fatal objection. No system of law is error free. The legal system makes mistakes in perceiving reality in the decision of every kind of case, from torts and contract disputes to homicide prosecutions. To demand perfection is to demand the abolition of law.<sup>132</sup>

In merger law, courts have traditionally used market shares as a tool with which to make the rough cut. The Commission itself has done so in at least one merger case.<sup>133</sup> As the previous section explains, antitrust courts have become more sophisticated and consider other facts as well. In some manner, however, the antitrust law tries to measure the change in consumer choice a merger will bring. That concept, in a different guise, serves as a useful broad brush for the FPA's market screen as well.

The undertaking aims to find out how many sellers the buyer could have chosen from to meet its needs. A seller cannot hold the buyer at its mercy if the buyer can take its business elsewhere. The old Sherman Act standard allowed mergers for market shares up to about two thirds, which still allowed one firm to hold a preponderant position. The Clayton Act applied a stricter prohibition. As Judge Bork wrote, even under that test, a one-third market share should pass.

He reasoned, that with that degree of concentration, even if all other firms in the market merged, the buyer would still face three realistic choices. In his view, the degree of competition increases substantially even with two firms of equal size; three makes the prospect even greater. Therefore he considered three competitors to be a number more than adequate to allow effective competition to exist.<sup>134</sup>

The Commission has used the fact that a buyer had access to three sources of electricity as a reason to allow "flexible pricing" for power sales. In *Pacific Gas & Electric Co.*,<sup>135</sup> the parties sought approval for an agreement which, among other things, allowed negotiated rates for "co-ordination services." This aspect of the contract came into play when the buyer had all the power it needed, but wanted power at a lower price. Within the limits of a ceiling, which exceeded the seller's costs plus a reasonable return, the parties wanted to transact without case-by-case Commission approval of the rates.

The Commission agreed to the arrangement, with one condition: the rates would apply only if the buyer could choose from among three alternate sources. As the order held:

The Commission believes that there exists a natural limit for the price that PG&E could charge . . . [It] is the potential for Turlock to shop the bulk power market to acquire energy from alternat[e] sources. . . . [PG&E's] rates . . . could be effectively limited by the price of an alternat[e] supply source because PG&E would be forced to match or beat th[at] price . . . to get Turlock's business. However, this limit can only be ensured with the following modification: PG&E may charge flexible prices . . . [only if] Turlock has at least one potential alterna-

132. BORK, *supra* note 93, at 123.

133. *NU I*, 56 F.E.R.C. ¶ 61,269 at 62,006-07.

134. BORK, *supra* note 93, at 221-222.

135. 42 F.E.R.C. ¶ 61,406, *order on reh'g.*, 43 F.E.R.C. ¶ 61,403 (1988).

tive source of supply (other than its own resources and long-term purchases). . . .<sup>136</sup>

Notice that the standard there permitted as one alternate a potential source, while the market screen theory requires three actual choices.

For the market screen in transmission pricing, which also seeks to measure effective competition, three choices for the buyer would suffice to allow negotiated rates to go into effect. The Commission must first identify the market involved. In most cases, those in which the buyer buys transmission service as part of a purchase of electricity, the bulk power market constitutes the correct locale to examine. As Commissioner Trabandt wrote:

On the whole, I would use bulk power as the relevant market, with the necessary transmission capacity for delivering the power as an essential and integral element of that market. The standard for judgment whether to define a broad or narrow market lies not in whether "transactions take place between buyers and sellers of transmission . . . ." Rather, what can buyers reasonably substitute? For example, if they freely switch among fruit juice, fruit punch, soda and bottled water, the market becomes soft drinks, rather than one particular variety.

The same holds true here. Utilities do not buy transmission for its own sake. Rather, it serves as a means for acquiring and delivering electricity. Generally, utilities have three ways to obtain power: (1) generating the power themselves; (2) buying from someone located on their own grid; and (3) using transmission to purchase supplies from outside the area.<sup>137</sup>

For transactions involving only transmission, the choices boil down to those transmission lines the buyer could have used.

Commissioner Trabandt's opinion in *United Illuminating Co.*<sup>138</sup> declared that in rare cases, the Commission should be able to override a showing that the buyer faced three choices:

Admittedly, one may claim that the winning seller skewed the market, in which case workable competition did not occur. I agree we must deal with that situation, but not in the way the majority chooses. A seller can skew competition not only by using a transmission network to exclude competitors but also (to borrow one of the examples from Hay's article) by blowing up a rival's plant. Yet, in the case of violence the Commission would require some evidence and I assume would put the burden on the opponent of the market rates to prove that the seller engaged in that type of mayhem. So, too, with transmission, I would require evidence and put the burden on the party opposing the rates.<sup>139</sup>

The concurrence went on:

Even so, I think the burden would be heavy. The fact that a seller owns transmission falls short. The party would have to show that (1) a competitor absolutely necessary to create adequate workable competition uniquely required the territory encompassing the transmission grid and could not locate elsewhere (I think not many developers, especially those building gas fired plants, can make that claim); (2) that the competitor requested transmission; and (3) that the seller refused. I would also require a showing that the excluded competitor would have won the business otherwise. I would keep open the safety valve for overturning

136. 42 F.E.R.C. ¶ 61,406 at 62,197 (emphasis added; footnote omitted).

137. *NU I*, 56 F.E.R.C. ¶ 61,269 at 62,068 (citation omitted).

138. 60 F.E.R.C. ¶ 61,124 (1992).

139. *Id.* at 61,735-6.

the result of what otherwise looks like competition, but I think it would rarely come into play.<sup>140</sup>

With the advent of the Commission's expanded authority to order transmission access under section 211 of the FPA, the need for this exception evaporates. A wheeling order solves the problem.

Two cases, one for each category, illustrate how the market screen works. The first, involving the Western Systems Power Pool (WSPP),<sup>141</sup> allowed pool members to negotiate transmission rates. The Commission, with Commissioner Trabandt dissenting, rejected the scheme when the participants applied for permanent status. Had the majority kept the power pool arrangement at market-based rates, the Commission would have afforded utilities a greater incentive to offer transmission access on a voluntary basis.

The second, which the utility has taken to the court of appeals, dealt with a negotiated rate for wheeling service the Pennsylvania Electric Company provided for a facility selling power to a New York utility.<sup>142</sup> Here, again, the majority of the Commission, with Commissioner Trabandt dissenting, rejected the rates. Had the dissent prevailed, retail customers in Pennsylvania would have saved money through lower rates.

WSPP allowed members to purchase from each other transmission for one year or less. The transmission enabled the buyers to obtain power to supplement their existing needs. The parties could negotiate the rates. As the Commission acknowledged, the pool amounted to an "experiment to test whether flexible pricing for . . . transmission services would increase efficiency and competition in the bulk power market."<sup>143</sup> Eventually, forty members serving sixty million people joined.<sup>144</sup> The pool members supported their request for negotiated transmission rates with the following evidence in the record.

**WSPP's Response to Interventions and Protests pointed out:**

All of the members have . . . other ways to satisfy their . . . needs. . . . For example, many of the members belong to traditional power pools, such as the Inland Power Pool, the Northwest Power Pool, the Intercompany Power Pool, the California Power Pool and the Southwest Power Pool. Moreover, . . . a great number of bilateral contracts between members . . . exist [outside of] WSPP . . . . Also, the obligations among a number of the members for various services are governed by license terms or conditions imposed by regulatory agencies separate from contracts; for example, Pacifi[C]orp [via the merger conditions FERC imposed] . . . the conditions on the . . . licenses for the [Arizona Public Service Company consortium's] Palo Verde and [Southern California Edison's] San Onofre nuclear plants, and P[acific] G[as] & E[lectric]'s Stanislaus Commitments.<sup>145</sup>

Exhibits D.1 and D.2 attached to the report of SDG, WSPP's consultant, also showed the extent of interconnections (in number and megawatts) as well

140. *Id.*

141. 55 F.E.R.C. ¶ 61,099, *reh'g. denied in part*, 55 F.E.R.C. ¶ 61,495 (1991).

142. 58 F.E.R.C. ¶ 61,278 (1992).

143. 55 F.E.R.C. ¶ 61,099 at 61,300 (footnote omitted).

144. *Id.* at 61,333 (Commissioner Trabandt, dissenting).

145. WSPP Response to Interventions and Protests 7-8.

as “real-time access to primary markets” for WSPP’s members. Exhibit D.3, listed the degree of transmission dependence WSPP members experienced.

In the category “captive,” SDG listed five municipal utilities: Anaheim and Riverside (within the grid of Southern California Edison (SOCAL)) and Modesto Irrigation District (Modesto), Northern California Power Agency (NCPA), and Sacramento Municipal Utility District (SMUD) (dependent on PG&E). Of those, all but Anaheim could reach more than one supplier and even that customer had possible access to four markets. “That [meant] that if each [could] actually use the transmission system of its surrounding utility, the municipality [had] alternate sources to WSPP to satisfy [any] ‘market power’ concerns.”<sup>146</sup>

Of those five, two, Modesto and SMUD, were able to use PG&E’s transmission to “escape” their “captivity.” The Commission had approved a transmission agreement between PG&E and Modesto<sup>147</sup> and approved with modifications a contract between PG&E and SMUD.<sup>148</sup> Both guaranteed access to the outside.

Anaheim and Riverside, SOCAL’s captive customers, fell into the same category as NCPA. Neither made agreements akin to Modesto’s or SMUD’s. Nevertheless, NCPA had not shown that PG&E engaged in anti-competitive conduct at the time of the WSPP experiment. Moreover, the data showed no instance of SOCAL refusing a transmission request from either of these customers. As an interesting aside, WSPP offered transmission access principles more generous than these utilities usually proffered if the Commission had allowed the pool to attain permanent status.<sup>149</sup> Those principles represented a far-reaching undertaking.

The majority held that even in the face of this evidence that buyers had a plethora of choices, WSPP had failed to show adequate competition existed. In addition, because the transmission principles fell short of promoting open-access tariffs, the Commission rejected them as well. The pool remained, but with cost-based rates. The majority erred for several reasons. The WSPP transmission principles fell by the wayside. In addition, the Commission stifled a working marketplace. To my knowledge, members have used WSPP with much less regularity than before.

The other case worthy of mention involved a transmission contract between Pennsylvania Electric Company (Penelec) and a customer, Penntech Papers, Inc. (Penntech).<sup>150</sup> The Commission permitted this customer to own a transmission line connecting the facility to the purchaser of its electricity. Moreover, the Penelec transmission contract arose from Penntech selling its electricity to Niagara Mohawk, a New York utility. As Commissioner Tra-bandt’s dissent argued,<sup>151</sup> Penntech and Penelec pointed out in their petitions for rehearing that the qualifying facility could have connected directly with

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146. 55 F.E.R.C. ¶61,099 at 61,336.

147. Pacific Gas & Electric Co., 44 F.E.R.C. ¶ 61,010 (1988).

148. Pacific Gas & Electric Co., 53 F.E.R.C. ¶ 61,145 (1990).

149. 55 F.E.R.C. ¶ 61,099 at 61,308-311.

150. Penntech Papers, Inc., 48 F.E.R.C. ¶ 61,120 (1989).

151. 60 F.E.R.C. ¶ 61,034 at 61,129-7 to 129-8.

Niagara Mohawk, without having to use Penelec's system at all.<sup>152</sup>

On this record, the Commission could easily have found sufficient or workable competition. Penntech could have either: (1) built a line itself directly to New York; or, (2) built its own line to connect with Penelec; or (3) used the existing Penelec grid. Penntech actively considered each of these three possibilities. Penntech stated that it and Penelec conducted "extensive negotiations" before reaching an agreement.<sup>153</sup>

Commissioner Trabant concluded that the Commission should have accepted the contract.<sup>154</sup> In contracting with Penelec, the customer picked the least costly of the three choices. Penelec faced competition for Penntech's business, and the resulting contract emerged from competition. Considerations of alleged "windfalls" should become irrelevant in a competitive context, just as policy makers ignore the rate of return in competitively negotiated power sales. As with power sales at market rates, the agreement benefits everyone. Here, especially, the benefit would have flowed to retail rate payers.

Under traditional Commission policy, utilities making sales to third parties use the revenue to reduce the rates of their core customers, whose rates pay for the facilities.<sup>155</sup> So, the Commission, despite unanimous support for the contract among the interested parties, namely, Penntech, Penelec and, on behalf of the retail customers, the Pennsylvania Public Utility Commission, overrode the deal negotiated by the buyer and seller. The retail rate payers in Pennsylvania lost.

The market screen test would allow these contracts to go into effect. The Commission should have accepted the transaction. Penntech obtained the least cost deal, Penelec earned money, and the state commission saw retail rates reduced. From a societal point of view as well, here we have the most economically efficient outcome.

#### IV. CONCLUSION

The market screen works in transmission pricing as it does in antitrust law. Conventional wisdom may consider transmission a monopoly, but in individual cases, the opposite holds true. Customers can sometimes choose. In cases involving purchases of electricity, as in *WSPP*, or *Nevada Sun-Peak Limited Partnership*,<sup>156</sup> transmission owners face competition from outside the transmission business. Buyers can meet their needs by generating their own electricity, or purchasing from sellers connected to the buyer's own grid. If the parties negotiate a deal involving transmission, the Commission could validly apply the market screen. The parties will have met the "three choices" test in the same manner as if the three transmission utilities served the area.

Moreover, in more instances than most people imagine, two or more transmission utilities serve an area. A number of random cases come to mind.

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152. Penntech pet. 1-2; Penelec pet. 5-6.

153. Penntech pet. 2.

154. 60 F.E.R.C. ¶ 61,304 at 61,129-8.

155. *See, e.g., Id.* at 61,129-4-5 (Commissioner Trabant, dissenting).

156. 54 F.E.R.C. ¶ 61,171 (1991).

We saw in *Malden* that the court found that the city could meet its needs from six utilities. Also, the evidence showed a plethora of choices available to the vast majority of WSPP's members.<sup>157</sup> In addition, the record in *Terra Comfort Corp.*<sup>158</sup> showed that the buyer there could have picked from among the grids of seven interconnecting utilities with which it had agreements for transmission rights.<sup>159</sup>

In another example, the buyer in *TECO Power Services Corp., et al. (TECO)*<sup>160</sup> could have obtained transmission from two utilities, in addition to the seller (which needed to build a line to connect with the purchaser).<sup>161</sup> A similar showing elsewhere (free from the affiliate problems in *TECO*) satisfies the market screen test.

The Commission has taken a different approach to defining a competitive market. In electric rate cases, the majority considers a market competitive only if every possible entrant can participate. The issue has most often arisen in cases in which parties request market-based rates. For those situations involving a utility that owns transmission,<sup>162</sup> the majority requires an open-access tariff on file as a condition for market-based rates.

For example, as many suppliers as a buyer in *WSPP* had to choose from, "if somebody . . . can conjure a potential, unrequited seller hiding behind a rock"<sup>163</sup> the Commission, as it did in *WSPP*, will ignore the prices the parties negotiated in favor of cost-based rates. Even if the seller granted all requests for transmission service, the parties have failed to make their case. A seller of less expensive power than the winning supplier *might* have appeared, had the utility announced open access to its lines.<sup>164</sup>

If the majority were to depart from the current practice of the market-based rate cases, the Commission would have to examine each set of facts on its own, rather than rely on generalizations. Some have claimed that in order to do so, the Commission must conduct lengthy and complex adjudication. As this article shows, however, the market screen calls for something less than a full-blown antitrust case lasting many years. Nevertheless, adjudicating transmission cases will require more specific findings. That will take more work than a generic one-size-fits-all approach.

Congress, in the Energy Policy Act, has decided to bring the forces of competition to bear on the electric utility industry. Competition forms the basis of our economy; indeed, under our system, the government properly relies on regulation only as a last resort. At the core of competition lies the concept of buyer's choice. In the electric transmission area, as in any other,

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157. See *supra* text accompanying notes 137-139.

158. 52 F.E.R.C. ¶ 61,241 (1990).

159. Exhibit D-1 p. 8.

160. 52 F.E.R.C. ¶ 61,191 (1990).

161. *Id.* at 61,702 (Commissioner Trabant, concurring) (citing a map of Florida's transmission grid).

162. In a seemingly inconsistent manner, if the seller owns or controls no transmission, the Commission ignores the fact that another participant in the bid may have blocked a seller more efficient than the winner. There, the Commission allows the market rates to go into effect without ado. See, e.g., Commonwealth Atlantic Limited Partnership, 51 F.E.R.C. ¶ 61,368 (1990).

163. 55 F.E.R.C. ¶ 61,495 at 61,341 (Commissioner Trabant, dissenting).

164. 52 F.E.R.C. ¶ 61,241 at 61,842.

where effective competition exists, the Commission should take advantage of it.

Previously, some have argued that the legal requirements of the FPA did not match that reality. Now, the new law has removed those doubts and the Commission should go forward. Implementing the market screen brings many societal benefits. We will see more efficient transmission and generation. Utilities will have greater incentives to offer access voluntarily. Consumers will experience lower retail rates. All those involved will gain from simplified administration of the Act. This makes any extra effort to examine the facts in individual cases well worth the Commission's while.