

# Cleary, Gottlieb, Steen & Hamilton

2000 pennsylvania avenue, n.w.  
washington, d.c. 20006-1801  
(202) 974-1500

facsimile  
(202) 974-1999

one liberty plaza  
new york, ny 10006

41, avenue de friedland  
75008 paris

rue de la loi 57  
1040 brussels

city place house  
55 basinghall street  
london ec2v 5eh

main tower  
neue mainzer strasse 52  
60311 frankfurt am main

j. eugene marans  
daniel b. silver  
richard dec. hinds  
senior counsel

piazza di spagna 15  
00187 rome

via fatebenefratelli 26  
20121 milan

paveletskaya square 2/3  
115054 moscow

bank of china tower  
one garden road  
hong kong

shin kasumigaseki building  
3-2, kasumigaseki 3-chome  
chiyoda-ku, tokyo 100-0013

donald l. morgan  
kenneth l. bachman, jr.  
sara d. schotland  
john s. magney  
mark leddy  
john c. murphy, jr.  
david m. becker  
george s. cary  
janet l. weller  
mitchell s. dupler  
linda j. soldo  
john t. byam  
matthew d. slater  
michael r. lazerwitz  
michael a. mazzuchi  
robert w. cook  
mark w. nelson  
robin m. bergen  
derek m. bush

resident partners

w. richard bidstrup  
scott n. benedict  
linda s. matlack  
keven a. griffin  
mitchell l. rabinowitz

counsel

joyce e. mccarty  
karen a. kerr  
scott r. goodwin  
senior attorneys

matthew i. bachrack  
craig a. benson  
lee f. berger  
brent e. binge  
david l. bosco  
kiersten l. boyce  
brian byrne  
jeremy j. calsyn  
kerri j. chase  
janie a. chuang  
farah f. cook  
sean d. corey  
alyson j. dais  
jacob o. davison  
tanya n. dunne  
christoph t. feddersen\*  
william s. fultz  
darian m. futrell  
morgan a. harris  
chandra w. holloway  
christine a. hopkinson\*  
megan a. irmler\*  
melissa m. johns

steven j. kaiser  
michael j. kehoe  
sarah g. koss\*  
elke k. kulas  
john r. loatman  
mutheu maitha  
paul d. marquardt  
patricia m. mcdermott  
dipali b. mehta  
pamela a. meisel  
adam j. miller\*  
andrew k. niebler  
helen m. pataki\*  
laura p. pavlovic  
suzanne b. perry  
tamara d. schmidt  
mark d. shaffer  
julie a. southfield  
joshua b. sterling  
petia vretenarova  
diana m. weed\*  
mark j. woodward

\*admitted only to a bar other than that of  
the district of columbia. working under the  
supervision of principals of the washington office.

June 9, 2004

Honorable Magalie Roman Salas, Secretary  
Federal Energy Regulatory Commission  
888 First Street, NE  
Washington, D.C. 20426

**VIA ELECTRONIC FILING**

**RE: Rulemaking on Market-Based Rates for Public Utilities  
Docket No. RM04-7-000**

**Errata and Amended Comments of the Electricity Consumers Resource  
Council**

Dear Secretary Salas:

On June 8, 2004, the Electricity Consumers Resource Council (ELCON) filed comments in connection with the June 9, 2004 Technical Conference on Market Based Rates. The introduction of those comments erroneously implies that the comments were submitted in connection with a presentation to be made during the June 9 conference. Rather, the comments were intended to be submitted for the written record only.

Enclosed with this letter are the Amended Comments of the Electricity Consumers Resource Council for filing with the Commission in the above-referenced proceeding.

We sincerely apologize for any confusion in this matter and we appreciate your understanding.

Very truly yours,

CLEARY GOTTLIEB STEEN & HAMILTON

By: Sara D. Schotland  
Counsel to the Electricity Consumers Resource Council

Enclosure

**UNITED STATES OF AMERICA  
BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION**

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**Market-Based Rates  
for Public Utilities**  
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**Docket No. RM04-7-000**

**AMENDED COMMENTS OF THE ELECTRICITY CONSUMERS  
RESOURCE COUNCIL**

The Electricity Consumers Resource Council (ELCON) appreciates the opportunity to submit comments in connection with FERC's rulemaking proceeding on market-based rates for public utilities and the revised market power analysis tests announced in its April 14, 2004 Order in Docket No. ER96-2495-016 (*AEP Power Marketing, Inc.*).

There are two points ELCON wishes to make. First, FERC has a statutory duty to require mitigation of market power as a precondition to allowing market-based rates. Second, FERC's interim test is a very good start that FERC should implement right away and not let the better be the enemy of the good.

**Description of ELCON**

ELCON is an association of industrial consumers of electricity organized to promote the development of coordinated and rational federal and state policies that will assure an adequate, reliable, and efficient electricity supply for all users at competitive rates. ELCON member companies produce a wide range of products from virtually every segment of the

manufacturing community. The member companies of ELCON consume approximately five percent of all electricity in the United States.

### **Notices And Communications**

The following persons are designated by ELCON to receive service and communications on their behalf with regard to these proceedings:

Dr. John Anderson  
Executive Director  
Electricity Consumers Resource Council  
1333 H Street, N.W.  
The West Tower 8<sup>th</sup> Floor  
Washington, D.C. 20005

Sara D. Schotland, Esq.  
Cleary, Gottlieb, Steen & Hamilton  
2000 Pennsylvania Avenue, N.W.  
Suite 9000  
Washington, D.C. 20006

### **Comments**

(i) **FERC's Authority To Approve Market-Based Rates Is Conditioned On Mitigation Of Market Power**

FERC's authority to approve market-based rates is conditioned on the mitigation of market power. In interpreting Section 205 of the Federal Power Act, the courts have stated that the overriding purpose of prohibiting unjust and unreasonable rates and charges is "to protect consumers from exorbitant prices and unfair business practices."<sup>1</sup> "[T]he prevailing price in the marketplace cannot be the final measure of 'just and reasonable' rates mandated by the Act."<sup>2</sup>

Courts have stated that to be "just and reasonable," rates must fall within a "zone of reasonableness" where they are neither "less than compensatory" to producers nor "excessive"

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<sup>1</sup> Public Systems v. FERC, 606 F.2d 973, 979, n.27 (D.C. Cir. 1979).

<sup>2</sup> FPC v. Texaco, Inc., 417 U.S. 380, 397 (1974).

to consumers.<sup>3</sup> When the inquiry is on whether the rate is reasonable to a producer, the underlying focus of concern is on the question of whether it is high enough to both maintain the producer's credit and attract capital. [W]hen the inquiry is whether a given rate is just and reasonable to the consumer, the underlying concern is whether it is low enough so that exploitation by the [regulated business] is prevented.<sup>4</sup>

Rates must fall within a “zone of reasonableness” which is “bounded at one end by the investor interest against confiscation and at the other by the consumer interest against exorbitant rates.”<sup>5</sup>

When the Commission authorizes market-based rates, it is under a continuing duty to ensure that the relevant market remains sufficiently competitive to prevent unjust and unreasonable prices.<sup>6</sup> Where markets are not sufficiently competitive to keep prices at reasonable levels, the Commission must exercise its ratemaking and refund powers to protect consumers.

FERC has the flexibility to allow market-based rates if it is assured that the result is just and reasonable rates, e.g., because market power does not exist or has been mitigated. In Farmers Union, the court rejected the Commission's reliance on a cost-based cap for oil transportation rates, because the cap was set at a level designed merely to prevent “egregious exploitation and gross abuse” rather than to ensure a just and reasonable rate. Although premised on an assumption that competition would keep prices in the “zone of reasonableness,” the Commission made no findings that competition for oil transportation services was in fact

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<sup>3</sup> Farmers Union Central Exchange v. FERC, 734 F.2d 1486 (D.C. Cir. 1984), cert denied, 469 U.S. 1034 (1984).

<sup>4</sup> Id.

<sup>5</sup> Jersey Central Power & Light v. FERC, 810 F.2d 1168 (D.C. Cir. 1987).

sufficient to do so. The Commission did not look at market share or otherwise assess the number of competitors available to provide transportation service.

Similarly, in Tejas Power, the court rejected a gas inventory charge (“GIC”) that deviated from the cost-based model then in place for natural gas pipeline regulation. The court held that the Commission had erred in accepting the rate as part of a larger settlement package, having “made no prior finding that [the pipeline] lacked significant market power vis-à-vis the [customers].”<sup>7</sup> “[I]n a competitive market, where neither buyer nor seller has significant market power, it is rational to assume that the terms of their voluntary exchange are reasonable, and specifically to infer that the price is close to marginal cost, such that the seller makes only a normal return on its investment.”<sup>8</sup>

In Elizabethtown Gas Co. v. FERC,<sup>9</sup> the D.C. Circuit upheld a market-based rate for the sale of natural gas, indicating that “when there is a competitive market the FERC may rely upon market-based prices in lieu of cost-of-service regulation to assure a “just and reasonable” result.”

And in Louisiana Energy and Power Authority v. FERC, the courts rejected plaintiff’s challenge to FERC’s approval of an application by CLECO to charge market based rates because FERC had determined that CLECO lacked market power. The decision cites with

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<sup>6</sup> Process Gas Consumers v. FERC, 177 F.3d 995 (D.C. Cir. 1999) (“FERC must remain attuned to the status of the affected market vis-à-vis monopoly and competition.”).

<sup>7</sup> Tejas Power v. FERC, 908 F.2d 998 (D.C. Cir. 1990).

<sup>8</sup> Id. at 1004.

<sup>9</sup> 10 F.3d 866 (D.C. Cir. 1993).

approval the continuing authority of Elizabethtown for the proposition that *where markets are competitive*, FERC can authorize market based rates.<sup>10</sup>

So application of a well-conceived market power screen is not an optional frill, it is a practical necessity to meet the statutory predicate for authorizing market-based rates.

(ii) **Implementation Of The New Screen**

Under the new test, the first step is to determine whether the applicant is a pivotal supplier or has seasonal market power. If so, the applicant can provide FERC with a more sophisticated delivered price analysis to rebut the inference of market power. Even if there is market power, mitigation methods are encouraged.

With the new SMA screens, FERC is better able to fulfill its mandate under the FPA. While the ultimate objective is to ensure just and reasonable rates in all wholesale power markets, the objective in the interim is to set up a mechanism that prevents market abuses. FERC's SMA test is quite flexible and provides market-based rate applicants "with a number of procedural options, several types of generation dominance tests, and the option of proposing mitigation tailored to the particular circumstances of the applicant." 2004 SMA order at P35. FERC has stated that the new screens are indicative rather than determinative. The Commission should be mindful of the risk of targeting participants who in fact may not be able to exercise market power, but who for one reason or another are caught by the screens. This is where there is a need for flexibility. We commend this test and encourage FERC to apply it imaginatively and flexibly. We urge the Commission to implement the new interim screens without delay.

ELCON would like to caution the Commission about one important behavioral aspect of market-based rate approval: it is often asserted that market-based rates are inevitably

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<sup>10</sup> 141 F.3d 364 (D.C. Cir. 1998).

higher than cost-of-service (i.e., the average embedded costs of the resource base). This is troubling to ELCON because it may undermine public support for FERC policies and market restructuring in general. While rates based on cost-of-service could be lower than the competitive marginal cost market-based rate in the same market, this should not always be the case, particularly in the long run. As ELCON has previously pointed out, and as economists and the courts agree, social welfare is maximized when the marginal cost of purchasing any commodity is equivalent to the marginal cost of producing it – which should ideally be the competitive market price.<sup>11</sup> If FERC gets the markets right, market-based rates in a competitive market should be the same or lower than cost-of-service rates. If market prices over a long period of time remain well above what the cost-of-service rates would be, this may be a signal that there is a failure in the market that merits a closer look.

### **Conclusion**

The new interim screens are an improvement upon the prior tests and are a reasonable compromise as FERC continues to work toward the development of more effective means of market oversight. We commend FERC on the test and encourage its implementation.

Respectfully submitted,

/s/ SARA D. SCHOTLAND  
Sara D. Schotland  
CLEARY, GOTTLIEB, STEEN &  
HAMILTON  
2000 Pennsylvania Avenue, N.W.  
Washington, D.C. 20006-1801  
202-974-1500

Dated: June 9, 2004

Counsel for ELCON

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<sup>11</sup> See, e.g., Town of Norwood v. FERC, 962 F.2d 20 (D.C. Cir. 1992).