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ELECTRICITY LAW DEVELOPMENTS – June 3, 2008

Prepared for ELCON

This report summarizes recent developments in FERC proceedings in which ELCON has been active and other matters of interest to industrial consumers. Inside this issue:

New developments since the May 2008 issue of Electricity Law Developments are in bold. The next scheduled issue will appear in early September 2008.

I. REGULATORY PROCEEDINGS

A. FERC Denies New Harquahala Appeal of NERC Registration (FERC Docket No. RC08-4)

On May 16, 2008, FERC upheld NERC's determination that New Harquahala's 26-mile tie line could have a destabilizing impact on the grid if it were to fail and therefore the generator is required to be registered in the NERC Compliance Registry also as a Transmission Owner (TO) and a Transmission Operator (TOP).

On February 4, 2008, generator New Harquahala ("Harquahala") appealed a NERC/WECC requirement that it be registered in the NERC Compliance Registry as a TO and a TOP because of tie line or radial ownership. Harquahala agreed that it was subject to registration as a generator, but had argued that what is owned and operated is a minor piece of the transmission system that is not integrated with the grid and, in and of itself, bears no risk to reliability. Thus there is no reliability gap or material impact on interconnection; the facility should only be registered as a generator. WECC had argued that because the generator's interconnection to the grid is part of a larger transmission system that is important to bulk power reliability the generator should be registered as a TO or TOP.

On March 5, 2008, ELCON intervened in support of Harquahala. ELCON noted that Harquahala's minor tie line interconnections facilities (which are similar to those of many ELCON members) do not have the potential materially to impact bulk power system reliability. ELCON pointed out that the inconsistent and unreasonable application of NERC and WECC are allowed to inconsistently and unreasonably apply reliability registration criterion to Harquahala will cause it to incur costs exceeding $1 million annually in order to employ the five NERC-certified transmission officers that TO/TOP registration would require. ELCON also pointed out that this case is another example of NERC overreaching and urges the Commission to exercise increased vigilance over the ongoing implementation of the *Statement of Compliance Registry Criteria*.

Among the twenty-three other intervenors and commenters who had joined the proceeding, the Electric Power Supply Association ("EPSA") also urged that NERC's arguments would result in all generators being treated either as TOs or TOPs because "every generator has interconnection facilities connection the generator to the transmission grid." Just as ELCON noted that many of its members were in a situation similar to Harquahala, EPSA warned that the issue would "keep coming up if NERC continues to register generators as TOs and TOPs."

The Cogeneration Association of California ("CAC") asked FERC to clarify how the facts of this case should properly be considered because "[m]any of the facts specific to Harquahala are also common to other generators." CAC argued that Harquahala already had to comply with reliability standards as a Generator Owner, and the a better solution to fill any gaps where transmission reliability standards are not applicable to generators is to adopt those standards for generators, rather than register generators are TO/TOP. CAC also points out that, because the Harquahala generator lead line is solely used to deliver net generation from Harquahala to the utilities, it cannot properly be considered "an integrated transmission element" as required by NERC's *Statement of Registration Criteria*.

On March 20, 2008, NERC filed an answer to the numerous arguments raised by intervenors. NERC argued that its *Statement of Compliance Registry Criteria* is being consistently applied across region and defended its application of the term "integrated transmission element" as applicable to generators who are simply "connected" to the bulk power system. NERC reasserted that a gap in reliability would occur if Harquahala were registered only as a generator because it would not, for instance, be obligated to comply with vegetation management standards application to TOs and TOPs.

Harquahala owns and operates a 1,092 MW generating facility located in Northwestern Arizona. Harquahala's generating facility is interconnected to the Hassayampa substation through Harquahala's 26 mile, 500 kV sole-use transmission line and a 500 kV switchyard. The Hassayampa and Palo Verde substations serve as a common bus that connects over 10,000 MW to the grid in southwest Arizona, including the Palo Verde nuclear units. This generation hub is critical to the reliability of the power grid in the southwest and makes up a large portion of the power needed to serve load in the southwest including Phoenix and Southern California.

In its decision and again in its FERC pleadings, NERC cited a number of events occurring at Harquahala and nearby facilities that highlight the reliability impact which can result from fault incidents and "highlight the need for proper protection, communication during emergencies, and adherence to explicit communication standards during switching operations." The Commission agreed with NERC that "if Harquahala is only registered as a generator owner and generator operator, and not a transmission owner and transmission operator, it will not be required to have its staff trained and NERC-certified to operate these facilities in an emergency or to coordinate protection for its transmission line and switchyard with other transmission operators and the Regional Entity." "Similarly configured generating facilities with transmission lines connected to Hassayampa have been involved in events that resulted in not only the loss of the generator tied to the faulted transmission line but the additional loss of generators connected by other transmission lines to Hassayampa, including the loss of one or more Palo Verde nuclear

units.”

Harquahala had expressed concern that it would physically be unable to comply with all of the reliability standards applicable to transmission owners and operators. NERC indicated that this could be addressed after registration, and committed to work with Harquahala and WECC to develop a list of applicable requirements within the reliability standards for the facility. FERC ordered Harquahala and NERC to negotiate within 60 days which of the reliability standards would apply. NERC is then to submit a compliance filing outlining the results. If the entities are unable to come to agreement, FERC will then resolve the dispute based on the language of the reliability standards and the reliability risks posed by Harquahala’s facilities.

B. NERC Proposes Changes to Compliance Registry Criteria

On April 29, 2008, NERC issued a revised draft of its Statement of Compliance Registry Criteria (“Registry Criteria”) and is once again seeking public comment on the proposed changes. The Registry Criteria are intended to define the parameters that regional reliability councils and NERC will use to select candidates for registration in the NERC Compliance Registry. Once registered, an entity is legally obligated to comply with NERC reliability standards. Among those that have been identified as potentially required to register are entities that own or operate behind the meter generation. Additionally, NERC staff has not precluded the possibility that “large loads” (with or without generation) may be registered in the future.

ELCON has advocated limiting registration to entities that are utilities or that have “utility-like” functions and has urges against registration of end-users except where it can

be factually demonstrated that an end user facility has a material impact on bulk power system reliability.

The proposed changes to the Registry Criteria seek to clarify that non-asset-owning LSEs are exempt from registration if (1) they are distribution providers and (2) their otherwise applicable compliance responsibilities have been assigned under written agreement to another entity such as a joint action agency.

ELCON submitted comments to NERC recommending that the ERO adopt a factual basis test to determine "material impact." ELCON agrees that any entity that has a material impact on the bulk power system should be included on the Compliance Registry. ELCON asserts that while NERC alone is responsible for identifying and registering those entities that do in fact have a material impact on the bulk power system, it may delegate to the Regional Entities certain registration functions provided clear and detailed registration criteria – developed by NERC- have been established and are followed. Finally, ELCON strongly urged that there must be consistency between regions and across the continent regarding the registry. If the regions are allowed to create their own individual criteria and registries, it will be very costly and time consuming for entities operating in more than one region to comply with varying criteria.

In particular, ELCON indicated concern with the several of the proposed revisions that lack clarity and, in ELCON's view, leave too much discretion to the Regional Entities. For example, NERC states that it will include in its compliance registry "each entity that NERC concludes *can* materially impact the reliability of the bulk power system." ELCON recommended that the sentence be changed to state: "NERC will include in its compliance registry each entity that NERC *has factually demonstrated has a* material impact on the

reliability of the bulk power system." While it is possible that certain entities have the ability to take unilateral actions that may materially impact reliability, the burden of proof should be on NERC to identify *in a factual manner* the material impact of any such entity. ELCON also asked the ERO to clarify that the fact that an organization is *identified* as a potential registrant does not mean it must register unless or until NERC has factually demonstrated the material impact that entity has on bulk power reliability. ELCON took particular issue with the proposal that the Regional Entities be tasked with determining which entities may be "reasonably deemed material to the reliability of the bulk power system." ELCON asked NERC to develop a material impact test and to clarify that Regional Entities will be required to follow detailed NERC criteria. Registration should not be based on the Regional Entity's "deeming" an entity to have a material impact. Additionally, ELCON pointed out that radial transmission facilities connecting generators to the bulk power system may not have a material impact on the reliability of the bulk power system, and recommended that NERC consider circumstances such as this when developing a material impact test.

Comments were due May 30. NERC's Organization Registration & Certification Subcommittee will meet on June 10 to review the comments and recommendations. The draft Registry Criteria are available at:

http://www.nerc.com/~comply/compliance_registry_criteria.html.

C. Commenters Applaud FERC's Proposal to Simplify Standards of Conduct, but Offer Numerous Suggestions (Docket No. RM07-1)

On March 21, 2008, FERC issued a NOPR proposing to simplify and refine its standards of conduct for transmission providers. Previously, in January 2007, FERC had

put forth a proposal to revise its Order No. 2004, which had established the rules of conduct for electricity transmission providers and certain elements of which had been rejected by a federal appeals court, but determined that the proposal was too complex and too costly to implement effectively.

In the March NOPR, FERC indicated that to the extent practicable, it wished to retain a single set of standards for both the electricity and natural gas sectors. The new NOPR is based on three principal components: a return to a system of functional separation of transmission personnel from marketing personnel (thus abandoning the January 2007 proposed approach based on corporate division separation); a "no conduit" rule which would prohibit the sharing of most transmission system information with marketing or energy affiliates; and a "transparency rule" to assist FERC in its oversight. The revised rules would carry over existing exceptions to marketing functions, and would allow communications between transmission and marketing function employees of certain information such as information about generation needed to dispatch and operate the transmission system and information necessary for integrated resource planning. The NOPR also recognizes that restrictions on the flow of information may impede certain executives from performing their jobs and so provides that supervisors are not transmission function or marketing function employees if they spend a *de mimimis* amount of time engaged in such activities.

FERC received comments from a wide variety of industry participants and regulators, most enthusiastic about the proposed revisions, but most also requesting clarifications and further refinement.

NARUC was concerned that FERC needed more tools to monitor compliance with the standards. "If clear auditing and reporting standards are not specified, then compliance is very difficult, if not impossible to enforce. EEI also requested more clarity, particularly since violators could face penalties of up to $1 million per day. TAPS also expressed concern that under the proposed revisions, violations are automatically sanctionable, although the NOPR "does not attempt to define the full scope of prohibited conduct."

EPSA was pleased with the return to rules that regulate individual employees according to their functions rather than their position in the corporate organization. The proposal "makes sense and is practical." "It should be easier for market participants to follow and therefore will achieve the goals of the standards of conduct." EPSA, EEI and others however, asked FERC to clarify what it means to be personally engaged in marketing or transmission functions. EEI suggested FERC re-implement Order 889 day-to-day standards under which a person was considered a marketing function employee or a transmission function employee only if he or she engaged in those activities on a daily basis. EEI also suggested that FERC create a safe harbor for supervisors approve or provide guidance on transactions that cannot simply be delegated to lower-level employees. A safe harbor for supervisors would also be consistent with compliance obligations under Sarbanes-Oxley.

The FTC encouraged FERC to focus on developing structural solutions rather than expending efforts on behavioral rules. "Behavioral rules against transmission discrimination are not the only available way to unbundled transmission from other stages of production. Indeed, FERC has approved elements of structural unbundling in both the

natural gas and electric sectors." The FTC pointed out that transmission facility owners not controlled by RTOs or ISOs have an incentive to provide information to their affiliates and FERC's existing rules and proposed changes do not address all of the ways that information can be passed along to affiliates. Even where the behavior is covered by the standards, it may be difficult to detect and document violations. The FTC urged FERC to consider taking further steps to induce the structural unbundling of transmission.

> **After more than a decade of efforts to develop effective, workable behavioral rules against transmission discrimination, FERC may wish to weigh the possibility that accounting separation and accompanying behavioral rules (i.e. functional separation) are insufficient to meet that objective – particularly in the electric power sector, where transmission arrangements can be vulnerable to subtle discrimination that is difficult to detect and document. FERC's Order No. 2000 developed the basis for the conclusion that behavioral rules are not fully effective. That order established structural unbundling of transmission under the control of RTOs and ISOs. Structural unbundling of transmission not already under the control of RTOs and ISOs would reduce the potential for discrimination on these transmission systems. The FTC encourages FERC to undertake an evaluation of the benefits and costs of such additional structural unbundling.**

The FTC stated that its experience in crafting remedies to prevent anticompetitive conduct (taken together with materials supporting FERC Order No. 2000) indicate that structural unbundling can be a more attractive alternative -- or at least a valuable complement – to behavioral rules.

The Large Public Power Council ("LPPC") suggested that one potential trouble spot in the NOPR is FERC attempt to create a separate category of integrated resource planning and competitive employment procurement employees. Resource planners "must know the availability, price and other relative terms and conditions of each option" in order to make decisions such as whether to build new transmission or generation or to seek

long-term supplies. LPPC therefore suggested that long-term supply procurement for native load should not be viewed as a marketing function.

APPA urged the Commission to consider the need for comparability requirements to apply to exchanges of information between a transmission provider and power supply planning employees so that network system transmission customers are able to integrate their loads and resources on a least cost basis. APPA also suggested that FERC clarify whether those who trade physical transmission rights are subject to the standards of conduct. They noted that firm transmission capacity is a scarce commodity, and although FERC requires firm capacity to be provided on a first come first served basis, there is an incentive to facilitate preferential sales because firm capacity can be resold at higher prices than the transmission provider itself could charge initially for the service.

TAPS and others echoed the concern about firm capacity, noting that the problem is aggravated by FERC's decision in Order No. 890 to eliminate price caps on resales of transmission capacity by transmission providers and their affiliates. TAPS also pointed out a number of other potential gaps in the rules, such as not including sales to bundled retail load of competitive offers of ancillary services as "marketing functions."

Regarding transparency, the Public Utility Commission of Ohio suggested that each transmission owner be required to post information about its compliance program on its web site, including training programs, compliance objectives, and chief compliance officer. They also suggested that civil penalties for violations be collected at the shareholders' expense and not passed on to ratepayers.

D. FERC Announces Reforms to Enforcement Policy
<u>(FERC Docket Nos. PL08-3, PL08-2, RM08-8, and RM05-30-002)</u>

On May 15, FERC announced a number of reforms designed to strengthen its enforcement program. The reforms include a revised and expanded policy statement on enforcement; an interpretative order that expands the areas in which FERC will allow the no-action letter process; a Notice of Proposed Rulemaking clarifying rules for off-the-record contacts and separation of functions in the context of enforcement investigations; and a final rule that outlines the rights of entities against whom staff from FERC's Office of Enforcement seeks an order to show cause.

<u>Revised Policy Statement (PL08-3-000)</u>

FERC's new policy statement on enforcement reflects the experience FERC has gained in administering the enhanced enforcement tools Congress granted under the Energy Policy Act of 2005 and responds to requests from regulated entities for more transparency in the process.

The revised policy statement builds on provisions in the original policy statement issued in October 2005 by providing further guidance on factors FERC considers in its enforcement decisions. It also details the FERC investigative process works, including the considerations that staff of the Office of Enforcement take into account when determining whether to open an investigation and, once opened, whether to close it without further action or to recommend sanctions. Where FERC determines further action is warranted, the options will be settlement or show cause proceedings. The toolbox of remedies includes, among others, disgorgement of profits, implementation of a compliance program, and penalties. The policy statement also sets forth factors considered in determining whether, and how much of, a penalty is appropriate. FERC declined to establish a penalty matrix,

as some had suggested. The agency stated that it needs to be able to fashion "each remedy and sanction to the particular circumstances of the specific case" before it.

As part of this effort to open up the process, FERC also has directed Enforcement staff to release annual statistical reports summarizing enforcement activities concerning both investigations and audits for the preceding year, to be issued at the close of each fiscal year. Additionally, FERC said that it will hold workshops to discuss what constitutes an effective vigorous compliance program.

Commissioner Moeller stated in a concurrence that FERC should also indicate its enforcement priorities. "While all violations of our rules and regulations are serious and subject to enforcement, given limited resources, we should identify and prioritize the types of violations that are most harmful."

Rights of Regulated Entities to Submit Arguments to FERC after Staff Recommends Issuance of a Show Cause Order (RM08-10-000)

Order No. 711 amends FERC's regulations to clarify the rights of an entity when Enforcement staff intends to seek an Order to Show Cause. The rule essentially codifies current FERC practice. In all but extraordinary circumstances, an entity will be notified in advance when Enforcement staff intends to seek an Order to Show Cause. The subject will have 30 days to respond, and the response will be presented to the Commission together with Enforcement staff's memorandum requesting an Order to Show Cause, both of which will be non-public documents.

No-Action Letter Process for Obtaining Guidance (PL08-2-000)

FERC issued an interpretive order expanding the scope of issues for which FERC will permit requests for no-action letters, the process through which regulated entities seek

a determination on whether staff would recommend enforcement action if particular transactions, practices or situations are pursued. This process now will include everything within the area of energy markets jurisdiction except for issues relating to the licensing of hydroelectric projects, certification of natural gas pipelines, operation of LNG terminals and enforcement of mandatory reliability standards. FERC also announced it will establish an Internet-based compliance "help desk" as another way to obtain staff guidance, to go along with current mechanisms for obtaining formal and informal guidance through petitions for declaratory order, general counsel opinion letters, accounting interpretations, the enforcement hotline and other informal communication with FERC staff.

Ex Parte Contacts and Separation of Functions (RM08-8-000)

FERC announced a NOPR proposing revisions to FERC regulations to clarify the application of rules governing off-the-record contacts and separation of functions in the context of non-public investigations. The NOPR proposes to ensure that the rules limiting contact with Commissioners and decisional staff apply in the same manner to outside parties as it does to litigation staff, and proposes to clarify the rule on intervention to specify that intervention is not available as of right in proceedings arising from non-public investigations. The rule would permit investigative staff to confer with Commissioners and outside persons off the record until a show cause order is issued or a civil proceeding is initiated. Additionally, intervention will not be permitted as a right in proceedings arising from enforcement investigations, although they may be permitted under "appropriate circumstances, such as where a third party wished to determine the impact of a sanction or other resolution upon its own interest."

Comments on the NOPR will be due 60 days after publication in the *Federal Register*.

II. COURT PROCEEDINGS

A. Challenge to FERC's PURPA Sec. 210(m) Implementation Rules (U.S. Court of Appeals for the D.C. Circuit, Case No. 07-1328)

On August 16, 2007, the AF&PA filed a petition for review in the D.C. Circuit challenging FERC's new rules implementing PURPA Section 210(m) establishing the procedures and conditions under which a utility may seek relief from PURPA mandatory QF purchase obligations. (Order Nos. 688, 117 FERC ¶61,078 (October 20, 2006) and 688A, 119 FERC ¶61,305, (June 22, 2007).)

The rules in question represent FERC's fulfillment of Congress' mandate in EPAct 2005 to grant utilities waivers from the PURPA QF purchase obligation if certain conditions described in the statute are met. On rehearing, FERC rejected the argument that Congress intended that there be a meaningfully competitive market prior to terminating a QF's purchase obligation and that such markets that do exist are predominantly for resale and very short-term. In a key passage, FERC asserted: "Congress could have stated a broad general finding to be made by the Commission such as 'workably competitive markets.' Instead Congress tailored subparagraphs (A) and (B) to establish criteria specific to each market design…". Order No. 688-A at para. 47. "While it is true that EPACT 2005 did not repeal PURPA or the Commission's obligations to encourage QF development, enactment of section 210(m) of PURPA clearly changes the rights of QFs under PURPA. The Commission has no discretion other than to terminate the purchase requirement if it finds that a QF has nondiscriminatory access… It would be inappropriate for the

Commission to ignore this mandate… in a way that undermines the specific standards of relief that Congress chose to establish in the statute." Id., at para. 48.

FERC stressed most heavily the different standard that Congress applied in Section 210(m)(1)(B)(ii) which requires a finding of access to "competitive wholesale markets that provide a meaningful opportunity to sell capacity, including long-term and short-term sales, and electric energy including long-term, short-term and real tie sales." Such language is not contained in (A)(ii) which only requires access to markets. Order No. 688-A, at para. 24. Even if Day 2 long-term markets are nascent, Congress in (A)(ii) only required that the Commission find that they exist, not that they be robust. Id., at paras. 26, 28. Without much rationale, FERC also found that the one-year term used for EQR reports is sufficient to meet the statutory requirement that there be "wholesale markets for long-term sales of capacity and energy" within the meaning of section 210(m)(1)(A)(ii). Id., at para. 27.

AF&PA filed their petitioner's brief on May 15, 2008. The brief focuses on analysis of the statutory language. It closely tracks the legal arguments made in AF&PA's rulemaking comments that FERC's reading of 210(m) with respect to the Day 2 markets is inconsistent with the plain language of the statute that all markets must be competitive and is untenable when viewed in the context of the other parts of 210(m), including the standards for utility relief in (m)(3) and for QF relief in (m)(4). AF&PA argues that FERC's reading of the statute is nonsensical -- Congress could not have intended for meaningless, noncompetitive markets to meet the statutory definition:

> **The Commission's interpretation makes nonsense out of key pieces of the Statute. If meaningless, noncompetitive markets are enough to meet the requirement of §210(m)(1)(A)(ii), then §210(m)(1)(C) – which requires markets "of *comparable competitive quality* as the markets described in paragraph (A) [which the Commission believes may be meaningless and noncompetitive] and**

> **(B) [which must be "competitive" and feature a "meaningful opportunity to sell"] – is incoherent. If meaningless, noncompetitive markets are enough under §210(m)(1)(A)(ii), then §210(m)(3) -- requiring utilities seeking relief from the Mandatory Purchase Obligation to "set forth the *factual basis* upon which relief is requested and describe why the conditions set forth in subparagraphs (A), (B) of (C) of paragraph (1) of this subsection have been met" – is likewise deprived of significance, since under the Commission's interpretation of the term "markets" there is no factual basis upon which a QF could demonstrate that the markets required under (A) do not exist. Under the Commission's interpretation§210(m)(4), which again requires a "factual basis" for concluding that the requirement of (A)(ii) is met, suffers the same incongruous fate.**

On May 30, 2008, ELCON filed a brief as *amicus curiae* in support of AF&PA. ELCON's arguments focus on two issues relating to long-term contracting: FERC failed to properly apply the statutory criteria and failed to properly address comments specifying the nature of the long-term contracting needed to support the special operating characteristics of QFs.

First, ELCON asserts that FERC erred as a matter of law in concluding that the mere existence of the so-called "Day 2 markets" and, on rehearing, its reference to evidence of some bilateral contracting in those markets, satisfies the statutory standard of *non-discriminatory access* to *long-term* contract opportunities. The Day 2 markets are in their infancy. FERC itself recognized in two contemporaneous rulemakings that the absence of a forward market is in fact one of the principal problems confronting the nascent wholesale markets.

Second, ELCON argues that FERC erred in defining "long-term" contracts for purposes of section 210(m) as those with a duration as short as one year, based merely on selective reference to inapposite FERC precedent. FERC failed to grapple with comments by ELCON and others establishing that contracts of on the order of five years duration are

important to support investment in and construction of cogeneration facilities and other QFs, particularly in view of their special characteristics for dispatch of electricity. In the absence of a statutory definition or legislative history, FERC should be guided by the purpose of section 210(m), which was not to remove incentives to QFs -- important as they are to the electricity grid and achievement of improved energy efficiency -- but rather to establish conditions whereby the deregulated wholesale markets can properly serve as a reasonable substitute for the mandatory purchase obligations of PURPA that otherwise would apply.

Oral argument has not yet been scheduled but is anticipated to be this fall, as final briefs are due in early September.

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