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ELECTRICITY LAW DEVELOPMENTS – November 4, 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:

- **RPM Buyers request oral argument and seek rehearing of FERC's order upholding PJM transitional capacity auctions (p.2)**
- **FERC issues final rule addressing competition in organized wholesale markets (p.5)**
- **EPSA asks Commission to redefine "control" in connection with dispositions of jurisdictional facilities and other market power analyses (p.9)**
- **FERC orders equal treatment of all generation under MISO's resource adequacy plan and reverses previous approval of netting of behind-the-meter and demand resources (p.18)**
- **In two separate orders, FERC declines to grant intervention as a matter of right to state regulators or other interested parties in enforcement proceedings (p. 20)**
- **FERC streamlines Standards of Conduct rules for transmission providers in new Final Rule (p.24)**
- **Oral argument for PURPA implementation case is scheduled for Nov. 13.**

New developments since the October 2008 issue of Electricity Law Developments are in bold.

I. REGULATORY PROCEEDINGS

A. RPM Buyers Seek Rehearing of FERC's Order Rejecting Protest of PJM Transitional Capacity Auction Prices (Docket Nos. EL08-67, ER05-1410)

FERC's September 19, 2008 order dismissing the RPM Buyers' complaint¹ protesting the results of PJM's Reliability Pricing Model ("RPM") transitional capacity auctions appears to be far from the last word on the matter. In a pair of filings on October 20, RPM Buyers signaled their preparation to seek judicial review of the Commission's ruling first seeking rehearing of FERC's order to bring the transition auction results into line with the objectives of those auctions, and second, in an unusual move, asking the Commission to hold oral arguments on the rehearing request so that "the record [may] reflect that the Commission gave the parties every reasonable opportunity to present their arguments and respond to questions, without confining them to the limits of written presentations."

RPM was developed through a lengthy series of Commission proceedings and a settlement process after PJM's original capacity program was found to be unjust and unreasonable.² RPM provides for base auctions to be conducted every year to procure capacity three years in advance of the year in which the capacity will be provided. The RPM design involves a downward-sloping demand curve that establishes the amount of capacity PJM's LSE customers are required to purchase, and the price for that capacity, in each capacity zone. Capacity prices are expected to be somewhat higher in transmission-constrained zones. LSEs that are able to fully supply their own capacity can choose not to participate in the auctions, and

¹ 124 FERC ¶61,276.

² Subsequent to the Commission's approval of RPM, several parties, including some of the RPM Buyers, petitioned for review of those orders. That appeal is currently pending before the DC Circuit. *Pub. Serv. Elec. & Gas Co. v. FERC*, No. 07-1336, *et al.* (D.C. Cir. filed Aug. 23, 2007).

instead opt for a long-term fixed resource requirement. The program included a four-year transition period with an accelerated schedule for a series of transition auctions for capacity delivery years through 2011 and a phase-in of the more than twenty anticipated “Locational Delivery Areas.” RPM also includes measures to mitigate the exercise of market power, including bid caps designed to replicate a seller’s avoidable costs. The most recent auction, the May 2008 auction for the 2011-2012 delivery year, was the first to procure capacity under a full three-year forward commitment.

After FERC declined to grant an earlier request by RPM Buyers’ to review the RPM mechanism, the group filed a formal protest in May 2008 alleging that the transition period rates resulting from the first four RPM base auctions resulted in unwarranted windfalls for incumbent suppliers with no commensurate benefits to customers or the system, which translates into unjust and unreasonable rates for customers. In particular, RPM Buyers asserted that, during the transition period, “[t]he absence of price discipline provided by new capacity resources and the ability of existing resources to withhold some capacity within the RPM rules combined to produce capacity prices in the transition period that are not comparable to those that would be produced in a competitive market or determined under cost-based regulation.” RPM Buyers also complained that when the RPM settlement was filed with FERC, the Commission limited parties’ ability to challenge aspects of the settlement by only permitting the creation of a limited factual record and by requiring allegations of specific instances of market manipulation before addressing the potential for that problem.

The Commission rejected RPM Buyers’ complaint, finding that “for the transition auctions, no party violated PJM’s tariff and the prices determined during the auctions were in accord with the tariff provisions governing the auctions.” FERC further did “not

find a sufficient basis to re-run the past auctions or change the prices that resulted from those [the transition] auctions,” explaining:

The prices and obligations set in those auctions became set as of the date of the auctions, and PJM and the capacity resource providers had every right to rely on those prices and obligations in making their decisions, including any capacity commitments and investment decisions. RPM Buyers have not established that any such investments were not, in fact, made. But even if resource providers had not yet made new investments in plant and equipment as a result of those auctions, each supplier of necessity would have had to forgo other opportunities to use its generating capacity, as a result of its commitment to serve PJM at the rates established in the auction. Indeed, capacity resource providers that participated in the transitional auctions gave up the opportunity to use their capacity to make bilateral sales of capacity or to participate in other RTO capacity markets.

In the rehearing request, RPM Buyers point out that the Commission failed to address the central question raised in their complaint – whether the RPM transition auctions produced just and reasonable capacity charges that customers must now pay through May 2011. They assert that FERC “ignored the mountain of facts demonstrating the transition auctions’ failure and instead answered a question that the RPM Buyers never asked, concluding gratuitously that no party violated existing tariff provisions.” The base auctions were intended to mitigate large cost shifts and rate effects and “to enable parties to understand and make adjustments to the new market,” and “allow market participants to realign their contractual obligations to meet the new capacity market.” Instead, RPM Buyers argue, the transition auctions produced erratic, inflated, illogical price signals that did little to enhance local reliability, permit informed forecasting, or smooth the progression to a rational, competitive capacity mechanism.

RPM Buyers argue that relief applicable only to future auctions will do nothing to correct the deficiencies peculiar to the unique transition period auctions. Under the

Commission’s ruling, customers are stuck paying the unjust and unreasonable prices brought about by those deficiencies. With respect to supplier reliance on transition auction prices, RPM Buyers assert that there is no evidence in the record of any such reliance, and that the timing of transition auctions make material reliance unlikely.

In the request for oral argument, RPM Buyers point out to the Commission that “[v]irtually every entity responsible for protecting customer interests in PJM vociferously objects to the transition auction results, and that various members of Congress are also among the protestors of the RPM transition auctions. They also remind the Commission that the RPM mechanism is currently the subject of a pending petition for review and state that judicial review of the transition auction prices will be sought if FERC fails carefully to examine the auction results and hear views on all sides of the issue.

B. EPSA Proposal to Further Expand Unfettered Investment in Utilities by Raising the Threshold for Passive Investors to Twenty Percent (Docket No. EL08-87)

Couched as a “request for guidance”³ regarding the Commission’s policy for determining “control” or “affiliation” in connection with applications and compliance filings under Sections 203 and 205 of the Federal Power Act, on September 2, 2008 EPSA filed a petition seeking blanket authorization for passive investors in energy infrastructure, including hedge funds and pension funds, to hold up to 20% of a publicly-traded electric utility company as long as they certify that the investment is not made for the purpose of controlling the company.

³ The petition is filed under Commission Rule 207(a)(5), 18 CFR § 385.207(a)(5), for an “action which is in the discretion of the Commission...”. The Transmission Access Policy Group suggests it should have been filed under Rule 207(a)(4), 18 CFR § 385.207(a)(4) as a request for a “rule of general applicability.”

In particular, EPSA requested that FERC make the following generic determinations:

- 1. Investors owning less than 20% of a publicly-held company's voting securities will not be deemed to "control" the company or raise concerns of "affiliation" for the purposes of Sections 203 or 205 approval as long as the investor files Schedule 13G with the SEC certifying that such investment is not for the purpose of controlling the company.⁴**
- 2. A finding of "no control" in the Section 203 proceeding will apply equally to a Section 205 proceeding.**
- 3. Investments by upstream owners of a publicly-held company in entities not otherwise related to the publicly-held company will not be deemed to be within the knowledge and control of the publicly-held company's subsidiaries with MBR authorization and thus will not trigger an obligation on the part of the MBR seller to (a) file a notice of change in status with respect to those investments, or (b) include generation or inputs owned or controlled by the other entities in future market power analyses.**

EPSA argues that these "clarifications" are necessary to facilitate needed investment in energy infrastructure and to address certain market-based rate compliance issues faced by competitive power suppliers. Reading between the lines, EPSA's filing appears to be motivated, at least in part, by FERC's delay (beyond the usual 6-8 weeks) in taking action on Section 203 applications for significant increased investments in Mirant and TransAlta.⁵

A number of parties intervened by the September 30, 2008 deadline. Harbinger, the prospective investor in several recent filings, urged FERC to conclude that: (1) minority

⁴ EPSA notes that Schedule 13G is available to "Passive Investors" and "Qualified Institutional Investors." Although the 20% limit only applies to "Passive Investors" who wish to file Schedule 13G with the SEC, EPSA suggest applying the 20% limit also to Qualified Institutional Investors for the purposes of FPA Section 203 approval.

⁵ EPSA lists six recent 203 filings by hedge funds and other investment entities as an indication of the need for a generic ruling. Two of the listed transactions have already received FERC approval and at least two others involve issues that require case-specific attention by the Commission. The acquirer in three of the transactions is Harbinger Capital Partners Master Fund I, Ltd. and Harbinger Capital Partners II, L.P. ("Harbinger"); in two other transactions, the acquirer is LS Power Development, LLC and Luminus Management, LLC; and the final transactions involves Horizon Asset Management.

shareholders should not be presumed to be able to exercise control where a holding company's by-laws provide for majority or super-majority vote to effectuate changes; (2) binding investor commitments not to direct sales of power should substantiate a finding of no control; and (3) generating entities should not be required to assume affiliation with each other when they share an upstream investor but are not in fact under common control.

Several utilities, as well as EEI and other organizations representing their interests also intervened in support of EPSA's petition. Among other arguments, they pointed to the difficulties for publicly held companies of tracking open market, often transitory, transactions.

Weighing in against the petition, APPA, NRECA and TAPS have challenged EPSA's request as an impermissible collateral attack on prior Commission orders. They argued EPSA does not present any evidence that investment is chilled by the Commission's current policy or that current policies and rules impose an undue compliance burden. They state that the number of hedge funds and investment entities that recently have filed Section 203 applications in fact shows that financial institutions are continuing to invest in the power sector and that this increase investment confirms the need for Commission monitoring of public utilities and possible affiliate relationships among them.

EPSA's petition comes fast on the heels of the conclusion of FERC's proceedings to fully implement the flexibility granted in EAct 2005. In fact, in its 2007 issuance of the Section 203 Supplemental Policy Statement, FERC rejected the request of a coalition of investment banking affiliates, self-styled the "Financial Institutions Energy Group," for virtually the identical relief now sought by EPSA. Then, FERC stated that it would

consider eligibility to file a Schedule 13G passive investor with the SEC as part of an indication that an entity will not be able to assert control over a public utility, but would not accept it as a definitive statement regarding control.⁶ Furthermore, “control” for SEC Schedule 13G purposes is defined as “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through ownership of voting securities, by contract or otherwise.” 17 CFR § 240.12b-2. This is not the same as FERC’s very broad interpretation of “control” which includes the ability to affect sales of power from the plant or otherwise impact the ability of capacity to reach the market. Likewise, in its recent Change in Status proceeding, FERC declined to raise the threshold above 10 percent, and in company-specific proceedings where authority above 10 percent is requested, FERC has imposed detailed reporting and other limitations.

⁶ See FPA Section 203 Supplemental Policy Statement, 120 FERC ¶61,060 (July 20, 2007) at P.41. Additionally, in connection with the pending Harbinger Section 203 application to acquire outstanding stock of Mirant, FERC on June 26 sent the applicant a request for further information which included the following discussion of the Commission’s consideration of Schedule 13G as evidence of lack of control:

In previous orders the filing of Schedule 13G with the SEC was only one of several factors that the Commission depended upon in determining that the proposed acquisitions of securities would not have an adverse effect on competition, rates, regulation and cross-subsidization. While the combination of factors that was relied upon differed among the *Investment Firm Orders*, in each case, in addition to the Schedule 13G filings, the Commission also relied upon a number of additional factors such as: (1) the functional separation and informational barriers between investing groups within each entity; (2) internal policies and controls designed to prevent such groups from aggregating their respective securities holdings in order to exercise control; (3) responsibilities of the entities regarding control as an advisor and fiduciary, as well as investment policies and restrictions disclosed to the entities’ clients; (4) rules of self-regulating organizations, such as the New York Stock Exchange, to which the entities belong; (5) pledges to notify to Commission of any changes in intent with respect to controlling the relevant utility; and (6) quarterly reporting requirements of the entities’ holdings of public utility securities.

June 26, 2008 letter to Harbinger Capital Partners Master Fund I, Ltd. and Harbinger Capital Partners Special Situations Fund, L.P., Docket No. EC08-59-000 (internal cites omitted). As one of many follow-up questions, FERC asked the applicant to explain how the filing of a Schedule 13G provides, in and of itself, the basis for the Commission to conclude that the proposed transaction will not result in any adverse effect on competition, rates, regulation and cross-subsidization.

As EPSA was not an active proponent of increased investment authority in these proceedings, EPSA's petition now could be viewed as an attempt to break a logjam in specific Section 203 proceedings of interest to its members. However, the current liquidity crisis could lead FERC to revisit issues that it thought it had just resolved.

FERC has not yet issued a ruling in this proceeding.

C. Final Rule on Competition in the Organized Wholesale Power Markets (FERC Docket Nos. RM07-19 and AD07-7)

On October 17, 2008, the Federal Energy Regulatory Commission issued a final rule in its proceeding on competition in the wholesale electricity markets.⁷ The final rule closely tracks the narrow approach of the proposed rule, rather than the broader assessment that was suggested by the advance notice of proposed rulemaking in this proceeding. In particular, the final rule addresses: participation of demand response providers in the markets; long-term power contracting; the role of market monitors; and RTO and ISO responsiveness to stakeholders within the markets.

FERC rejected calls for pro forma tariff language that would establish a uniform nationwide approach. Instead, the final rule's directives are to be implemented in individual proceedings in each RTO and ISO, which are directed to make compliance filings with FERC within six months after publication of the final rule.

Demand Response

The final rule addresses four issues relating to demand response: demand response access to ancillary services markets; elimination of deviation charges for voluntary

⁷ Order No. 719, 125 FERC ¶61,071 (October 17, 2008).

reduction of demand during system emergencies; access to RTO and ISO markets by aggregations of retail customers (“ARCs”) providing demand response; and implementation by RTOs and ISOs of scarcity pricing mechanisms. FERC stated that its policy with respect to participation of demand response is not to give preferential treatment to demand response, but to remove barriers to participation by demand response so that these resources are assured treatment comparable to traditional supply side resources.

- *Demand Response Access to Ancillary Services Markets*

The final rule directs RTOs and ISOs to accept bids in markets for ancillary services from technically capable demand response resources “on a basis comparable to any other resources,” provided that the demand resources are able to meet the RTO’s or ISO’s requirements with respect to response time, size, telemetry, metering and so forth, and, where applicable, provided the laws or regulations of the relevant electric retail regulatory authority permit retail customers to participate. The final rule applies to specified competitively-bid ancillary services (or their functional equivalent specified in the RTO or ISO tariff), including energy imbalance, spinning reserves, supplemental reserves, reactive supply and voltage control, and regulation and frequency response.

However, the final rule does not require RTOs and ISOs to create new competitively-bid ancillary services markets. FERC also declined to iterate a standardized set of technical requirements for demand response participation in ancillary services markets, or to establish a uniform approach to “comparable treatment,” instead leaving it up to each RTO or ISO to draw up appropriate requirements in conjunction with its stakeholders. In this regard, the final rule ordered that demand response resources be

allowed to specify limits on duration, frequency and amount of their services, similar to limits generators may specify on price, quantity, startup and no-loads costs and minimum downtime between starts. FERC also directed RTOs and ISOs to work with stakeholders to develop mechanisms to assess the technical feasibility and value to the market of smaller demand resources providing ancillary services to the market, including how and whether they can provide operating reserves, and to develop adequate customer baselines to aid in evaluation of compensation for demand resources and in the measurement of load reduction.

- *Elimination of Deviation Charges During System Emergencies*

The final rule requires all RTO and ISO tariffs to be modified so as to eliminate deviation charges to buyers that take less energy than planned in the real-time market during periods when the RTO or ISO declares an operating reserve shortage or makes a generic request for load reduction to avoid a such shortage. RTOs and ISOs may impose the deviation charges on virtual purchasers during the same period they are eliminated for physical purchasers only if they are able to convince the Commission that such charges are appropriate under the particular circumstances of the RTO's or ISO's market design.

FERC explicitly declined to extend its reforms beyond system emergencies.

- *Demand Response Bids by Retail Aggregators*

The final rule sets forth guidelines for aggregation of retail customers (ARC) into larger pools of demand resources the participation of these resources in the RTO and ISO markets, where permitted by the laws or regulations of the relevant electric retail regulatory authority):

- **An ARC demand response bid must meet the same requirements as bids from other entities and must be treated comparably to other bids from other entities.**
- **An ARC bid can be on behalf of a single retail customer or multiple customers, and except for where retail customer participation is prohibited by law, there is no prohibition on who may be an ARC.**
- **RTOs and ISOs may impose certain requirements, such as RTO/ISO membership and creditworthiness requirements, on an ARC if such requirements are imposed on other bidders.**
- **The RTOs and ISOs may establish mechanisms to avoid double payment for the same demand response resource.**

FERC declined to issue pro forma market rules or specific technical requirements for ARCs, preferring to leave it up to each organized market to establish requirements that fit the particular market design.

- ***Scarcity Pricing During Periods of Operating Reserve Shortages***

In the notice of proposed rulemaking, FERC had observed that certain existing RTO and ISO market rules governing periods of operating reserve shortages may not produce price signals that accurately reflect the value of energy in an emergency and therefore may harm reliability, inhibit demand response and deter new entry of needed generation resources. The final rule orders the RTOs and ISOs to establish market rules that “allow the market-clearing price during periods of operating reserve shortage to reach a level that rebalances supply and demand so as to maintain reliability while providing sufficient provisions for mitigating market power. In either revising their rules or showing that their existing rules are adequate, the RTOs and ISOs are to show that they:

- **improve reliability by reducing demand and increasing generation during periods of operating reserve shortage;**
- **make it more worthwhile for customers to invest in demand response technologies;**
- **encourage existing generation and demand resources to continue to be**

- relied upon during an operating reserve shortage;
- encourage entry of new generation and demand resources;
- ensure that the principle of comparability in treatment of and compensation to all resources is not discarded during periods of operating reserve shortage; and
- ensure market power is mitigated and gaming behavior is deterred during periods of operating reserve shortages including, but not limited to, showing how demand resources discipline bidding behavior to competitive levels.

In order to address concerns of customer reaction to sudden price increases and to allow for planning for reductions in demand during system emergencies, RTOs and ISOs will be allowed to phase in the emergency pricing methods over a period of up to a few years. But phase-ins are not required, and if elected, may not be protracted and must be justified as part of the RTOs or ISO's overall proposal to change its pricing rules.

Commissioner Kelly dissented in part, criticizing the final rule's approach to scarcity pricing in the following statement:

I continue to be troubled by the Final Rule's directive to each RTO or ISO with an organized energy market to make a compliance filing to propose any necessary reforms to allow for scarcity pricing in times of emergency by modifying market power mitigation rules, such as raising energy supply bids caps and demand bid caps. While the Final Rule makes substantial efforts to address market power associated with scarcity pricing and to ensure that there is an adequate record regarding any scarcity pricing proposal, this does not alleviate my fundamental concerns regarding the very real impacts on customers associated with such scarcity pricing proposals. I continue to believe that, absent the necessary demand response infrastructure to give consumers the ability to respond to higher prices, it is not responsible to allow energy supply bid caps and demand bid caps to rise without regard to the impacts on consumers.

Long-Term Power Contracting

Despite numerous comments to the contrary, FERC found no fundamental problem with long-term contracting for electric power either inside or outside of organized markets. Rather, FERC stated that "interest among buyers and sellers in engaging in long-term contracting fluctuates depending upon the balance of resources and demand in the market

for power” and that higher prices in recent years is a result of market factors such as changes in supply and demand and increasing fuel costs. FERC’s conclusions may have been based in part on its determination that, for purposes of this rule, long-term contracts are broadly defined as those with terms of one year or longer. Without making specific references to any particular concern, FERC noted it will continue to explore other “structural issues” that were raised in comments and at technical conferences but which were “found not to be ripe for inclusion” in this rulemaking.

Accordingly, the final rule simply adopts the proposal that each RTO and ISO must dedicate a portion of its web site for market participants to post offers to buy or sell power on a long-term basis. Additionally, FERC encouraged the RTOs and ISOs to work with stakeholders to facilitate long-term power contracting.

Market Monitoring Policies

In an attempt to increase the independence of the RTO and ISO Market Monitoring Units (“MMUs”) and to improve transparency and performance of the MMU function, the final rule: (1) requires the MMU to report to the RTO or ISO board, rather than to management; (2) requires the RTO or ISO to provide the MMU with data access, resources and personnel; (3) more clearly defines expanded functions of the MMU, including clarification of the MMU’s role in market mitigation; (4) removes the MMU from tariff administration; (5) establishes ethics standards for MMUs and their employees; and (6) enhances information sharing by the MMU.

FERC declined to mandate a specific structural relationship between the MMU and its RTO or ISO. In particular, while observing that “the hybrid structure can provide

many benefits,” FERC concluded that a hybrid MMU would not necessarily be more or less independent than an internal or an external MMU.

- *Oversight and Access to Data*

To foster independence and remove the MMU from reporting to ISO or RTO management, the final rule directs the MMU to report to the RTO or ISO board of directors and excludes management representatives on the board from oversight functions (with an exception for reporting to management for administrative purposes). RTOs and ISOs, for their part, must provide their MMUs with access to market data, resources, and personnel sufficient to carry out their functions. Additionally, the MMU shall have full access to the RTO or ISO databases and exclusive control over any MMU-created data. RTOs and ISOs may not alter reports generated to MMUs or dictate conclusions reached by MMUs.

- *Expanded Functions*

To further their market-monitoring role, the final rule specifies that MMUs are to be responsible for: (1) evaluating market rules, tariff provisions and market design elements for their effectiveness, and proposing recommended changes; (2) reviewing and reporting (at least on a quarterly basis) on the performance of the wholesale markets; and (3) referring suspected wrongdoing by, or need for investigation of, market participants or the RTO or ISO to FERC.

FERC declined to adopt a fourth proposed function -- daily monitoring of the wholesale market -- reasoning that this was already included in the function of reviewing and reporting on market performance. FERC also agreed with comments that the MMU’s

role in recommending proposed tariff changes and rules is an advisory role, and that the MMU should not be involved in implementing such changes.

- *Mitigation Activities*

In response to numerous comments, the final rule departs somewhat from the proposal. Under the final rule, if an RTO or ISO employs a hybrid MMU structure, it may authorize its internal MMU to conduct mitigation. However, if an RTO or ISO chooses to permit its internal market monitor to conduct mitigation, “it must assign its external marketer monitor the responsibility, and give it adequate tools, to monitor the quality and appropriateness of that mitigation.” Further, an RTO or ISO may allow its MMU, regardless of whether it uses a hybrid structure, to conduct retrospective mitigation, and the MMU “may provide the inputs required by the RTO or ISO to conduct prospective mitigation, including determining reference levels, identifying system constraints, cost calculations and the like.”

- *Ethics Standards for MMUs and their Employees*

Each RTO and ISO must include in its tariff a specified set of minimum ethics standards, including provisions addressing affiliation with market participants, participation in the market; compensation for expert witness testimony or other commercial services to the RTO or ISO; acceptance of gifts or other transactions with market participants, and acceptance of employment with market participants.

- *Information Sharing by the MMU*

The final rule aims to enhance the dissemination of information in several aspects:

- In addition to annual reports, MMUs must now report quarterly on aggregate market performance (market trends and performance of the wholesale market) to FERC staff, staff of interested state

commission, the management of the board of directors of the RTOs and ISOs, and market participants.

- State commissions may make tailored requests for information from the MMUs, so long as the request is limited to information regarding general market trends and the performance of the wholesale market. State commissions may also petition FERC for release of otherwise proscribed information.
- The lag time for release of offer and bid data by the RTO or ISO is reduced from six months to three months.
- Regular conferences are required among the MMU and staffs of FERC, the RTO or ISO, and interested state commissions, state attorneys general, and market participants

Responsiveness to Customers and Stakeholders

In response to comments in this and other proceedings that RTO and ISO boards of directors are inaccessible to customers and certain categories of market participants, the final rule takes modest steps to make RTOs and ISOs more responsive to stakeholders. Each RTO and ISO board of directors is required to implement practices and procedures to directly receive concerns and recommendations from stakeholders, and to take responsive action. The criteria for assessment of such procedures are: inclusiveness (i.e., whether any customer or other stakeholder is permitted to communicate its views to the board of directors); fairness in balancing diverse interests, including whether there are procedures in place to ensure that issues are not dominated by a single stakeholder category; representation of minority positions; and ongoing responsiveness, including mechanisms to provide feedback to ensure that information exchange and communication continue over time.

The final rule also instructs the RTOs and ISOs to post a mission statement or the organizational charter on the organization's web site. In the final rule, however, FERC rejected calls for RTOs or ISOs to adopt a particular board structure such as a "hybrid"

board or board advisory committee (although FERC described the latter as “a particularly strong mechanism for enhancing responsiveness”), concluding that that “a one-size-fits-all approach is not appropriate, given the different needs of each region.” In the event that an RTO or ISO wants to pursue a hybrid board, it must show that the criteria of Order No. 2000 are satisfied, including a showing “that no one class would be allowed to veto a decision reached by the rest of the board and that no two classes could force through a decision that is opposed by the rest of the board.”

D. FERC Grants Rehearing on Issue of Treatment of Behind-the-Meter Generation under MISO’s Resource Adequacy Plan (Docket No. ER08-394-001)

In the category of “be careful what you ask for,” in a recent order on rehearing regarding the Midwest ISO’s (“MISO”) resource adequacy plan, FERC granted a request to revisit the issue of comparable treatment of internal and external resources and determined that MISO’s proposal to net behind-the-meter generation against forecast load requirements is unjust and unreasonable.⁸

Under the plan that FERC had approved in March of 2008,⁹ MISO will establish a planning reserve margin for each LSE based on a “loss of load” study, and will calculate the resource adequacy requirement for LSEs based on various factors such as generator forced outage rates generator planned outages, forecast performances of “load modifying resources” (“LMRs”) such as behind-the-meter generation¹⁰ and demand resources, and

⁸ 125 FERC ¶61,061 (October 20, 2008).

⁹ 122 FERC ¶61,283 (March 26, 2008).

¹⁰ Behind-the-meter generation is generating resources located within load that do not participate directly in the transmission provider’s energy markets, that have load located behind a customer meter, and have an obligation to be available during system emergencies.

transmission congestion. The resource adequacy requirement for LSEs with behind-the-meter generation would be based on the forecast LSE requirement net of demand resources and behind-the-meter generation. In practical terms, this means that an LSE with 80 MW of generation and load would have to obtain approximately 12MW of additional resources to meet its resource adequacy requirement while an LSE with 80 MW of behind-the-meter generation would not be required to secure any planning reserves. Dairyland Power Cooperative and Reliant Energy separately objected to MISO's proposed treatment of behind-the-meter generation because it is based on the assumption that locating generation 'behind the meter' eliminates the need for an LSE to secure Planning Reserves associated with that generation.

On rehearing, FERC agreed with Dairyland's assertion that "[r]eliability does not honor metering boundaries, control area or balancing area boundaries, or geographical boundaries. Setting Planning Reserves requirements based on the location of generation vis-à-vis a meter will result in a less than desired outcome that shifts responsibility for reserves to other LSEs and creates inequitable consequences." Thus, behind-the-meter and demand resources will be accorded comparable treatment with other resources in terms of the planning reserves each is required to obtain, which may amount to some additional costs for LMRs.

In the same rehearing order, FERC also addressed potentially disparate treatment of demand resources with respect to penalties for failing to reduce demand under the Emergency Demand Response program ("EDR") and the resource adequacy plan. For LMRs that have also registered as EDRs and have offered demand reductions under the requirements of both programs, failure to reduce demand would be assessed under both

programs separately. FERC ordered MISO to revise the penalty provisions so as to avoid duplicative penalties.

E. Commission Denies Intervention as of Right in Enforcement Proceedings

In two separate actions, the Commission has recently denied requests by state utility regulators to participate in Commission enforcement proceedings. On October 16, 2008, FERC issued a Final Rule on *Ex Parte* Communications and Separation of Functions¹¹ in which the Commission declined generally to grant intervention as of right to state regulators in non-public investigations. Ten days earlier, the Commission denied a specific request by several interested state regulators to participate in enforcement proceedings against Edison Mission Energy.¹²

**Final Rule on Ex Parte Communications and Separation of Functions
(Docket No. RM08-8)**

On May 15, 2008, FERC issued a NOPR proposing revisions to the rules governing *ex parte* communications and separation of functions as they apply to non-public enforcement proceedings (“Part 1b investigations”). Numerous parties, including ELCON, filed comments on the NOPR. On October 16, 2008 FERC issued a Final Rule adopting without change the revisions proposed in the NOPR.

By regulation, information obtained by staff during the course of a Part 1b investigation is considered non-public until such time as the Commission determines that disclosure is appropriate, or until disclosure occurs during an adjudicatory proceeding or pursuant to a FOIA request. Part 1b investigations therefore differ from other types of investigations carried out by

¹¹ 125 FERC ¶61,063 (2008).

¹² *In re Edison Mission Energy*, 125 FERC ¶61,020 (2008).

the Commission, such as investigations into the justness and reasonableness of the rates in a particular market. Investigations that are not carried out under Part 1b generally are announced publicly, and include public comment and the maintenance of a public record in the same manner as adjudicatory proceedings.

The Final Rule clarifies that intervention is not available as a matter of right in proceedings arising from non-public investigations. Reasoning that the revised rule is necessary to prevent intervening parties from complicating or delaying an enforcement proceeding or sidetracking it from its purpose, the Final Rule amends the Rules of Practice and Procedure before FERC to state that “No person, including entities listed in paragraphs (a)(1) and (a)(2) of this section, may intervene as a matter of right in a proceeding arising from an investigation pursuant to Part 1b of this chapter.” 18 C.F.R. § 385.214(a)(4). The Commission has stated that it expects “intervention to be permitted only in unusual situations.” 125 FERC ¶ 61,063 p. 16.

The Commission’s proposed rule limiting intervention generated substantial negative commentary from state regulators and NARUC. NARUC stated that to the extent the proposed revisions seek to “eliminate a State Commission’s ability to join as a party to such proceedings via filing a notice, it is poor policy and inefficient – as well as inconsistent with the special role both Congress and Courts have accorded FERC’s State colleagues.” Moreover, they argue, Section 308 of the FPA authorizes FERC to admit a state commission as a party to any proceeding in which the state is interested. 16 U.S.C. § 825g(a). The section contains no qualifiers regarding the type of proceedings in which a State may intervene. “States are not just another stakeholder,” NARUC argues. “They, like the FERC, are public servants charged with

overseeing the operations of regulated entities in the public interest.... Affected states should be parties as a matter of right in all FERC enforcement cases.”

In the Final Rule, FERC disputed NARUC’s argument that Section 308 of the FPA authorizes intervention as a matter of right. Section 308 of the FPA provides that “[i]n any proceeding before it, the Commission, in accordance with such rules and regulations as it may prescribe, *may admit* as a party any interested States, State Commission”

Pointing to the phrase “may admit” the Commission found that “the FPA leaves the Commission with discretion to prescribe appropriate rules and to admit parties when it is ‘in the public interest.’ By using ‘may’ instead of ‘shall,’ it is clear that section 308 establishes no right of intervention.” 125 FERC ¶ 61,063 p. 14. FERC pointed to case law to support its position, arguing that courts have determined that the Commission has considerable discretion over the exercise of its enforcement powers. *See, e.g., Heckler v. Chaney*, 470 U.S. 821, 831 (1985) (agency decisions regarding conduct of enforcement actions are presumptively unreviewable by the courts).

The Final Rule also revises the regulations limiting contact between decisional staff (including Commissioners) and FERC investigation staff once a “show cause” order has been issued as a result of a Part 1b investigation. Commission investigative staff will continue to have unrestricted access to FERC Commissioners and other FERC staff until a “show cause” order is issued.

A collection of industry sponsored groups, including the Edison Electric Institute and the Electric Power Supply Association, filed comments arguing that the target of the investigation should have the same communications opportunities as investigative staff; otherwise, the target “is at a distinct disadvantage in making its case to decisional

employees.” FERC found that the comments were outside the scope of the rulemaking, because the policies to which the industry objected were contained in the Commission’s Revised Policy on Enforcement not the NOPR. The NOPR “proposed only to revise the rules on separation of functions and off-the-record communications to clarify that both outside person and Commission investigative staff will be able to communicate with decisional staff during the same time periods, specifically while an investigation is pending until the point at which the Commission initiates an enforcement proceeding.” 125 FERC ¶ 61,063 p. 18.

FERC Denies Motions to Intervene in Edison Mission Energy Enforcement Proceeding (Docket No. IN08-3-001)

FERC also considered its policy on intervention in Part 1b proceedings in an October 6 Order denying motions to intervene in *In re Edison Mission*. 125 FERC ¶ 61,020. The Order was issued prior to the Final Rule on Ex Parte Contacts and Separation of Functions issued on October 16, 2008 but relied on identical reasoning.

The motions to intervene were filed in response to a Commission Order issued on May 19, 2008 approving a Consent Agreement in settlement of a Part 1b investigation into the activities of certain Edison Mission entities. The Edison Mission entities, which participated in the PJM interconnection, owned and operated generation units that were designated as capacity resources pursuant to the PJM tariff. The investigation focused on whether the entities had violated a statute, rule, or regulation administered by FERC by engaging in a “high offer strategy.” A “high offer strategy” involves offering capacity resource generation units in the day-ahead market at prices near the PJM bid cap, which results in those resources being taken in the PJM real-time market, rather than the PJM day-ahead market. The Stipulation and Consent Agreement requires Edison Mission to

pay a \$7,000,000 civil penalty for violating its duty of candor to the Commission, and to implement a compliance plan at an estimated cost of \$2,000,000. The Agreement contains no stipulation with respect to the high offer strategy and no penalty associated with it. However, the Agreement does contain a stipulation that Edison Mission voluntarily discontinued use of the strategy in April 2006 and commits not to engage in that strategy in the future.

A number of motions to intervene were filed by interested parties, including state utility regulators and consumer advocates of the states in which PJM operates, and industrial coalitions including PJMICC and ELCON. The movants argued that intervention should be permitted based on the potential impact of the settlement on other entities that participate in the PJM interconnection. Movants noted that they lacked the opportunity to intervene previously, given that the existence of the investigation was not revealed until the Commission issued the May 19 Order.

In an October 7, 2008 order, FERC denied all motions to intervene. The Commission asserted that “no entity has a right to participate in an investigative proceeding initiated under Part 1b.” 125 FERC ¶ 61,020 p. 11. The Commission added that “[w]hile it is true that the Commission has left open the possibility that intervention in enforcement matters may be appropriate in limited circumstances, those circumstances are not present here.” *Id.* at 12.

F. FERC Issues Final Rule on Standards of Conduct (Docket No. RM07-1)

On October 16, 2008, FERC concluded a long-running process to create new Standards of Conduct for Transmission Providers in the gas and electric industries. New

standards for gas transmission providers were necessitated by a 2006 District of Columbia Circuit decision¹³ remanding to FERC its 2003 Order governing the behavior of natural gas pipeline employees.¹⁴ Although FERC faced no such mandate with respect to the rules it applied to electric transmission providers, industry participants had complained that the rules were unwieldy to implement and imposed excessive costs of compliance.

The 2003 standards had marked a significant departure from prior Commission practice, and proved highly unpopular within the industry. Among other initiatives, the 2003 standards expanded application to all “energy affiliates” - broadly defined - of transmission providers, required regulated entities to create independent corporate bodies for transmission employees and marketing employees, and severely limited communications between transmission and marketing entities. In 2006, the District of Columbia Circuit held that FERC had failed to adequately justify application of the more onerous restrictions to gas transmission providers and remanded the matter back to the Commission. The recent Final Order is the culmination of the rulemaking process initiated in response to the District of Columbia’s decision.

The new Standards of Conduct outlined in Order No. 717¹⁵ return to the pre-2003 approach of allowing separation based on function without requiring separate corporate entities. The new standards are based on three core rules: an independent functioning rule; a no conduit rule; and a transparency rule.

The independent functioning rule mandates that a transmission provider’s transmission employees must function independently from marketing employees. It no

¹³ *Nat’l Fuel Gas Supply Corporation v. FERC*, 468 F.3d 831 (D.C. Cir. 2006).

¹⁴ Order No. 2004, 105 FERC ¶61,248 (2003).

¹⁵ Order No. 717, 125 FERC ¶61,064 (2008).

longer defines transmission and marketing employees based on the corporate group in which they work, but rather looks at whether the employee is actively engaged in marketing energy or power or providing transmission service on a day-to-day basis. Supervisors of marketing function employees or of transmission function employees are not themselves automatically deemed to be transmission function or marketing function unless they are actively engaged in such activities on a daily basis. The rule further clarifies that “transmission functions” does not include long-term planning activities, and that “marketing functions” does not include power purchases. Additionally, certain restrictions on communications between employees in the two functions are lifted to address reliability concerns.

The no conduit rule prevents a transmission provider from “using anyone as a conduit for the disclosure of non-public transmission function information to its marketing function employees.” In the NOPR, FERC had proposed imposing a prohibition on marketing-function employees from receiving non-public transmission function information from any source, but abandoned this requirement as a result of numerous comments pointing out the practical difficulties of enforcing such a rule.

Finally, while most of the Commission’s existing posting requirements remain in effect, the transparency rule adds the requirement that a transmission provider immediately to post on its web site or OASIS any non-public information that is inadvertently disclosed to marketing function employees. FERC had also considered imposing a blanket requirement to post all waivers and exercises of discretion under a transmission provider’s tariff. However in the Final Rule, FERC determined that such requirements go beyond what is needed to alert customers and others to possible acts of

undue discrimination or preferences in favor of an affiliate, and are duplicative of other existing posting requirements. Therefore, FERC elected to impose the posting requirement only with respect to waivers and exercises of discretion vis-à-vis a transmission provider's affiliate and which is not already permitted under the transmission provider's tariff. Additional recording requirements apply to all waivers and exercises of discretion.

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)

In August 2007, the AF&PA filed a petition for review in the D.C. Circuit challenging FERC's final rule implementing PURPA Section 210(m), which establishes 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).) In particular, AF&PA challenge FERC's rejection of the notion that a QF had to have nondiscriminatory access to a *meaningfully competitive market* in order for a utility's QF purchase obligation to be terminated. In a key passage in the rehearing order, 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. 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. 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). Order No. 688-A at paras. 24-28.

AF&PA asserted 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.

The primary argument of FERC's brief is based on strict statutory construction and deference to administrative agency interpretation of the statute. FERC asserts that, under the statute: (a) the Commission is not required to examine the competitive quality of the wholesale markets in the context of RTO markets because the word "competitive" is absent from the text of the statute; and (b) the test for whether a QF has nondiscriminatory access to a market is satisfied in the context of Day 2 markets because bilateral long-term contracts exist in these markets and QFs *have access* to buyers and sellers for long-term contracting purposes in all Day 2 regions because these markets operate under OATTs.

In its August 13 reply brief, AF&PA argues that FERC has missed the point -- that the failure to examine the competitive quality of the market in question not only is a misreading of the PURPA rules but also amounts to a deprivation of the procedural rights granted to QFs under the statute. A QF can have nondiscriminatory access under a utility's OATT; however if the market is not competitive, such access is meaningless. While FERC essentially argues that Congress presumed the Day 2 markets to be competitive, AF&PA assert that this is not necessarily the case, and that at any rate, FERC must on a case-by-case basis evaluate each application for relief in terms both of nondiscriminatory access *and* competitive quality of the market.

The briefing on burden of proof highlights the different positions of the litigants. According to FERC, if the QF is able to rebut the presumption that the RTO's OATT affords it nondiscriminatory access, the mandatory purchase obligation will continue. AF&PA replies that, to the contrary, under the statute it is up to the specific utility to furnish the factual demonstration

that the statutory requirements are met; Congress did not place the burden on the QFs to show that the requirements are not met.

In May 2008, ELCON filed a brief as *amicus curiae* in support of AF&PA. ELCON's arguments focused on two issues relating to long-term contracting. First, ELCON asserted that FERC erred as a matter of law in concluding that the mere existence of the so-called "Day 2 markets" where there is any evidence of long-term contracting activity satisfies the statutory standard of *non-discriminatory access to long-term* contract opportunities. Second, ELCON argued 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. In the absence of a statutory definition for "long-term contracts" 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 would otherwise apply.

FERC's brief urged the Court to ignore ELCON's arguments as issues not properly before the Court because AF&PA did not challenge the definition of "long term". However, FERC again justifies its selection of a one-year duration based on its treatment of power sales with a contract for more than one year as long-term for reporting purposes and under OATTs.

Oral argument has been scheduled for the morning of November 13, 2008, before Judges Garland, Brown and Williams.

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