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ELECTRICITY LAW DEVELOPMENTS – September 4, 2007

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:

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New developments since the June 2007 issue of Electricity Law Developments are **in bold**.

I. FERC PROCEEDINGS

**A. Investigation Concerning PJM's Market Monitoring Unit
Docket Nos. EL07-56 and EL07-58**

Numerous groups have protested a Settlement Offer filed August 2, 2007 by PJM Interconnection L.L.C. ("PJM) to end the investigations concerning its Market Monitoring Unit. The proceedings involve complaints of the Organization of PJM States ("OPSI") and several electric cooperatives arising out of charges by Joseph Bowring that PJM has been undermining the independence of its market monitoring unit ("MMU"). Bowring has charged that PJM has deprived the MMU of adequate resources, lured away its employees, exercised editorial control over MMU reports and interfered with MMU data systems. The complaints request that FERC issue a declaration that PJM has violated its tariff and that PJM should be required to return MMU staffing and resources to the *status quo ante*.

ELCON, the PJM industrial group and numerous others filed interventions urging that FERC investigate these serious charges. FERC granted fast-track processing and submitted detailed data demands both to PJM and Bowring requiring that each provide information to enable the Commission to investigate the accusations. Allegheny Elec. Coop. v. PJM, 119 FERC ¶ 61,165 (May 18, 2007). PJM hired outside counsel to conduct an "independent investigation" of these charges. FERC noted in its May 18 decision that the Commission's investigation would proceed notwithstanding PJM's own internal investigation, but that the report of PJM's investigation would be entered in the public docket.

Both Bowring and PJM filed responses to FERC's data demands in June 2007. Bowring's counsel subsequently filed comments noting that the documents do not so much indicate disagreement as to what factually occurred as they reflect PJM's refusal to recognize the independence of the market monitor.

PJM'S Settlement Offer

PJM's August 2 Settlement Offer provides for establishment of an external MMU, modeled in large part on the MISO structure. PJM maintains that an external MMU will eliminate complaints that PJM management could interfere with the MMU. PJM proposes that Bowring be retained as MMU and that the PJM Board would not be able to replace him without FERC approval. The MMU will have control over its own data systems. The MMU will give PJM 10 days notice before it files a report with FERC but, while PJM can comment on the proposed report, PJM would not be able to screen, alter or delay the MMU's findings. In addition, the MMU would establish a Market Monitoring Advisory Panel to review the annual state of the market report. The Advisory Panel will consist of a PJM employee, an OPSI economist and an independent economist selected by the Panel members. The MMU would have its own budget and if it believed it was under funded by PJM, the MMU could bring its concerns to the Commission. Procedures would also be adopted to prevent PJM from raiding MMU employees. PJM then provides a side-by-side chart designed to show that the proposal would address each and every concern about MMU independence raised in the complaints.

On August 22, 2007, ELCON submitted comments expressing several concerns with the Settlement Offer:

- PJM's Settlement Offer purports to resolve the proceeding and to obviate the need for further FERC proceedings. Given the nature of the charges and the need for the Commission to send a message to RTO's about the independence and integrity of MMUs, it is critical that the Commission issue a final decision evaluating the RTO's conduct vis-à-vis the MMU. The Settlement Offer should not enable PJM to hide its conduct behind a curtain;**

transparency is important to the credibility of the RTO structure and the organized markets.

- For similar reasons, PJM should be required to file the report of the “independent investigation” that it commissioned to examine Bowring’s charges. PJM should not be allowed to short-circuit the investigation or to suppress the conclusions that its outside counsel would otherwise file on the public record.
- PJM should not be allowed to avoid the requirements that FERC may impose by rule on all RTOs with respect to MMU independence in the ANPR. Whatever structural changes and safeguards the Commission adopts at the close of this proceeding with respect to RTOs generally should apply *a fortiori* to PJM in light of evidence that the RTO has stripped the MMU of needed resources and attempted to undermine its independence.
- With respect to the specifics of PJM’s settlement proposal, it appears that the “two tier” proposal advanced by PJM falls far short of the more muscular MMU structure adopted by California ISO. Under the CAISO approach, much greater authority is given to an external three-person advisory panel. ELCON’s specific concerns with the PJM MMU Proposal include:
 - The MMU will interface on a day-to-day basis with a Market Monitoring Liaison (PJM employee) identified by PJM. The MMU must obtain any data and information it needs through this Liaison. There is a potential for mischief if the PJM employee restricts the data and information from the MMU.
 - PJM’s proposed Market Monitoring Advisory Panel is made up of three people -- one of whom is an employee of PJM. This gives PJM far too much oversight. While the settlement says that this proposal is “similar to an advisory panel used by the California ISO...,” PJM’s proposal actually is significantly different. There are no CAISO employees on CAISO’s advisory panel. All three individuals on the CAISO advisory panel are part-time, independent economists.
 - The MMU should report directly to the Board and be assured of retaining current personnel and budgeting.

Other problems cited by ELCON include lack of participation in lower committees and working groups which effectively cuts off access by MMU to PJM staff and members, and no role in tariff administration when the market monitor is supposed to enforce the rules.

From a procedural perspective, this proceeding illustrates the importance of a liberal intervention policy. The outcome here will have nationwide implications for RTO-MMU relationships. The structures that other RTOs and ISOs have adopted with respect to MMUs (notably CAISO) provide a useful model to test the adequacy of PJM's Settlement Offer. (See section D below regarding a statement sent by ELCON and other associations to FERC criticizing the Commission's a recent statement discouraging interventions by member organizations in proceedings.)

PJM's market monitor Joseph Bowring submitted comments stating that he was encouraged that PJM was attempting to address some of the concerns he had raised, but that the settlement proposal "is ultimately not acceptable because it does not adequately protect the purpose, principles, functions and essential features of the MMU." With revision, he indicated that the settlement offer could be a starting point for negotiations. Bowring did not oppose making the MMU an external entity; however, he was critical of the settlement's failure to ensure MMU independence. In particular, he took issue with PJM's exclusive oversight and administration of the retention agreement and with its review of all MMU periodic reports. Additionally, Bowring expressed concern with provisions that limit the MMU's access to data and other necessary resources and with provisions that prohibit the MMU from interacting with PJM committee members during the market rule development process.

The Allegheny Energy group (the "Joint Complainants") urged FERC to reject the settlement proposal and to proceed with the hearing process, particularly discovery. "Without a full understanding of what went wrong, it may not be possible to determine the appropriate structural reform going forward." They characterized the proposal as

unreasonable and unworkable, and were particularly critical of the fact that PJM “continu[es] to gloss over the distinction between an independent market monitor and one that is merely external.”

The Organization of PJM States, Inc. (OPSI) also filed comments strongly opposing the proposed settlement. The evidence in the record, they asserted, “clearly establishes issues of material fact that must be resolved by the Commission before PJM’s proposal may be addressed on its merits.” The settlement offer “does not constitute sound policy, does not resolve the issues identified in OPSI’s complaint, fails to address PJM’s historic tariff violations and creates unacceptable risk that PJM could continue to hamper activities of the PJM market monitor.”

In a related development, FERC issued an ANOPR addressing “Wholesale Competition in Regions with Organized Markets,” 119 FERC ¶ 61,306 (June 22, 2007) (Docket RM07-19, AD07-7). The ANOPR has as one of its principal topics solicitation of comments on the optimal structure of MMUs and how to assure their independence. (See section B below).

B. FERC ANOPR on Reforms to the Organized Markets
Docket Nos. RM07-19, AD07-7

On June 22, 2007, FERC announced an Advanced Notice of Proposed Rulemaking (ANOPR) to initiate certain reforms of the organized markets. “Wholesale Competition in Regions with Organized Markets,” 119 FERC ¶ 61,306. The reforms address four of the concerns or problem areas that ELCON and other consumer interests have identified with organized markets such as PJM: (1) demand response, (2) long-term contracting, (3)

market monitoring, and (4) RTO governance. Some of FERC's proposals are outlined below:

(1) Demand Response and Pricing During Power Shortages

- **Require RTOs and ISOs to allow demand resources to provide certain ancillary services in their markets unless not permitted by state law, modify tariffs to let demand resources provide spinning and supplemental reserves without being required to sell into the energy market.**
- **Modify RTO and ISO tariffs to eliminate certain charges for purchasing less energy in real time than in the day ahead market during a system emergency.**
- **Amend market rules to permit an entity that aggregates the demand responses of individual retail consumers to bid the aggregate demand reduction directly into an RTO or ISO energy market, unless not permitted by state law.**
- **Modify market power mitigation rules so that pricing during an emergency can elicit more demand response.**

(2) Long-Term Power Contracting

- **Require RTOs and ISOs to post information that would facilitate long-term contracts.**
- **Require or encourage efforts by RTOs and ISOs to develop standardized forward products.**
- **Dedicate a portion of the ISO's or RTO's website for market participants to post long-term buy/sell offers.**

(3) Market Monitoring Policies and Information Sharing

- **Remove the market monitoring unit from RTO/ISO operations.**
- **Require that the MMU advise the Commission and other stakeholders of any design flaws and report to the Commission any tariff violations it believes may have been committed by the RTO or ISO.**
- **Regular conference calls among the market monitor, interested state commission and FERC staff.**
- **Release of offer and bid data, with a lag period. Release would mask market participants' identities.**

- **Subject to certain limitations, state regulatory commissions within an RTO or ISO may request and receive information from the RTO's or ISO's market monitoring unit.**
- **Develop a pro forma tariff provision to address all sections relating to market monitoring.**

(4) Responsiveness of RTOs and ISOs

- **Provide RTO and ISO customers with direct access to the board of directors.**

ELCON plans to submit comments commending FERC for recognizing the need for reforms to improve the operation of the organized markets and expressing the hope for a rapid and bold outcome. In particular, ELCON hopes that this proceeding will be used by the Commission to begin a process by which FERC reconsiders its current mix of regulation and competition in the organized markets to ensure that customers are not exploited by a flawed market design and that they receive the benefits they deserve from restructured markets. Among some of the comments ELCON contemplates are:

Demand Response

ELCON strongly supports the ANOPR's attempts to expand the role of incentive-based demand response in the organized markets. ELCON supports or recommends the following proposals on demand response:

- **Each ISO or RTO should have an obligation to purchase on a non-discriminatory basis demand resources in markets for ancillary services. Demand resources should be eligible to provide any ancillary service currently required in the OATT. The demand resources would be expected to meet reasonable size, telemetry, metering and bidding requirements. The protocols should not be based on the limitations of generators but rather on a source neutral basis that reflects system reliability needs.**

- **ISO or RTO protocols for purchasing demand response for ancillary services should be standardized to accommodate sales from industrial end users with DR capable facilities in multiple ISOs or RTOs.**
- **Sellers of demand response should have the opportunity to bid demand response as operating reserves without the obligation to sell into the energy market.**
- **Deviations charges to buyers who take less energy in the real-time energy market than purchased in the day-ahead market should be eliminated. Each ISO or RTO that imposes such charges should implement other cost-based rate mechanisms for the recovery of prudent uplift costs.**
- **ISO/RTO market rules should permit aggregators of retail customers (ARCs) to bid demand reduction on behalf of retail customers. The market rules should be non-discriminatory with respect to bids from ARCs or non-aggregated bidders. Practices, rules and procedures for the acquisition of demand response should be standardized across ISOs and RTOs to promote participation.**
- **Demand response should be compensated on the same basis as generation for the same services. If generators are given the option of higher of LMP or opportunity costs, demand should be eligible for the same or comparable pricing scheme. Demand response participants should also receive incentive payments to be able to provide energy whether it is called or not.**
- **Demand response participants should not be required to purchase energy as a precondition to a demand reduction bid unless required by contract or tariff. So-called generator offsets are unnecessary as long as non-participating loads receive net benefits.**
- **ELCON urges great caution with regard to modifications to market mitigation rules to allow scarcity pricing. Any proposal to raise (not eliminate) market-wide caps in emergency situations must only be considered after end-use customer loads are adequately hedged from spot market price volatility and other pre-conditions are met. This requires the establishment of a liquid forward market. Even after such conditions are met, it is preferable that a “proof of concept” be established in a carefully designed pilot test. Raising bid caps for demand bids only may not be practical until other reforms to the market have succeeded. ELCON opposes the proposal for an administratively-determined demand curve for operating reserves because it will reduce market transparency and oversight, and may be too complex to survive intact during adjudication.**

Long-term Power Contracts

ELCON applauds the Commission for recognizing that it is important that wholesale sellers and buyers have adequate opportunities to sell and buy power through

long-term power contracts and to be able to choose a portfolio of short-term, intermediate-term, and long-term power supplies. However, the proposals in the ANOPR will not get us there. The organized markets are unwittingly structured as suppliers' markets and fundamental changes to the Day-Two market paradigm will be necessary to establish a robust forward market capable of delivery net benefits to consumers.

Market Monitoring Principles

ELCON believes that the debate between an “internal” or “external” MMU is misplaced. In their present forms we believe that neither can be independent. We advocate a two-tiered MMU structure with the “top-tier” consisting of a small panel of part-time market experts reporting to the board. The “lower-tier” would be internal to the ISO or RTO and generally report to the board. ELCON supports other reforms proposed in the ANOPR related to MMUs.

ISO/RTO Governance

ELCON supports a requirement that each ISO or RTO have a balanced “hybrid” board consisting of a majority of independent members and a minority of members representing stakeholder interests. The stakeholder members should be evenly split between supplier and consumer interests.

Comments are due September 14, 2007.

C. **Order No. 688-A, Order On Rehearing Implementing PURPA Sec. 210(m)
Docket No. RM06-10**

On June 22, 2007, FERC issued its long-awaited order on rehearing of its Final Rule for implementing PURPA Section 210(m). Order No. 688-A, 119 FERC ¶61,305. This rule fulfills Congress' mandate in EAct 2005 to grant utilities waivers from the PURPA QF purchase obligation if certain conditions described in the statute are met. **The Final Rule (Order No. 688¹) was only slightly modified by this order.** The Final Rule represented a compromise between utility and QF interests. FERC found that the section 210(m)(1)(A) of the statute did not require a showing of competitive markets as a prerequisite to relieving utilities from purchases obligations in the four Day 2 markets. However, in a change from the NOPR favorable to QF interests, FERC recognized several showings related to operational characteristics or transmission constraints that QFs above 20 MW could rely on to rebut a presumption of access to markets. QFs below 20 MW are rebuttably presumed not to have access to markets. Additionally, the Final Rule was favorable to ELCON and QF interests by requiring a "facility-specific" determination of access and by requiring that utilities provide information on transmission constraints and congestion that would not otherwise be available to QFs. *Id.*, at para. 104.

ELCON filed a short rehearing request, but the Cogeneration Association of California and CIBO submitted more extensive rehearing requests. The utilities also sought rehearing, complaining in particular about informational requirements. In general Order No. 688-A reaffirms Order No.688.

In a key passage in the rehearing Order, FERC explains: "Congress could have stated a broad general finding to be made by the Commission such as 'workably

¹ 117 FERC ¶61,078 (October 20, 2006).

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.

Perhaps the most important change is that where there is credible evidence in a complaint that OATT is being violated, access to transmission will not be presumed.

In the Rehearing Order, FERC finds:

Section 210(m)(1)(A) - Organized Markets.

FERC rejects AF&PA and CCC’s 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.

FERC finds that on the basis of EQR reports long-term contracts do exist in the Day 2 markets. RTOs have no incentive to favor one set of suppliers over others in providing transmission access. FERC finds that the existence of a spot market as an alternate source for power reduces the costs to buyers and sellers of long-term bilateral supply commitments. FERC stresses 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 time sales.”

Such language is not contained in (A)(ii) which only requires access to markets. Order No. 688-A, 119 FERC ¶ 61,305 at para. 24. Even if Day 2 long-term markets are nascent, Congress in (A)(ii) only required that the Commission finds that they exist, not that they be robust. *Id.*, at para. 26, 28.

Without much rationale, FERC finds 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. FERC does mention that it is trying to improve the quality of the markets and opportunities for long-term contracting.

Section 210(m)(1)(B) - CAISO and SPP

Here Congress required termination of purchase obligations if a QF has nondiscriminatory access to (i) transmission provided by an RTO and (ii) “competitive wholesale markets providing a meaningful opportunity to sell long-term and short-term capacity to buyers other than the interconnecting utility.”

As in the final rule, FERC finds that CAISO and SPP have only been found to satisfy the first prong, and “the issue of whether ‘competitive wholesale market’ exist will be an issue in the proceeding and the burden will be on the applicant to make the required demonstration.”

Section 210(m)(1)(C)

The Commission reaffirms that ERCOT offers a market of comparable quality to the Day 2 and Day 1 markets.

Rebuttable Presumption of Access to Markets Under (A)(B) and (C)

(i) Operational Characteristics/Transmission Constraints

FERC reaffirms that the presumptions of access may be rebutted where a particular QF has operational characteristics that effectively prevent its participation in a market or lacks access to a mechanism to schedule transmission service or make advance sales on a consistent basis. Order 688-A, 119 FERC ¶ 61,305 at para. 66. Further, utilities will be required to submit information on transmission constraints, levels of congestion and interconnections to enable the QF to have access to relevant information. *Id.*, at para. 67.

In a change from Order 688, on rehearing the Commission provides that while the complaint process is the preferred mechanism to adjudicate transmission disputes, especially since the Commission has only 90 days to act under 210(m), “where there are pending complaints raising credible issues concerning a transmission provider’s implementation or administration of its OATT, the Commission will also consider that fact...when evaluating whether a QF does in fact have nondiscriminatory access to that market. FERC rejected CAC’s comment that OATT does not guarantee physical transmission rights; the Commission regards financial transmission rights as supplementary.

(ii) Small Size

The Commission adheres to the presumption in the final rule that QFs with a net capacity of 20 MW or larger have access to markets, rejecting CIBO’s proposal for an 80 MW cut-off. FERC acknowledges that Congress utilized an 80 MW cut-off for the definition of large power producer, but maintains that a presumption regarding access to transmission involves a different inquiry. FERC notes that most QFs above 20 MW have access to transmission lines. FERC stresses that these presumptions are rebuttable; some QFs above 20 MW will not have access to transmission and conversely some utilities may

be able in individual cases to overcome the presumption that a particular QF below 20 MW lacks access.

(iii) Information Requirements

The Commission denies EEI's request that utilities within an ISO/RTO footprint be relieved of providing the information on transmission availability required for QFs to overcome the presumption of transmission access. In response to our comments, the Commission indicates that the information provided should be equivalent to the information required related to transmission access in the Unisource Energy proceeding, 109 FERC ¶ 61,047 (excluding market monitoring requirements).

(iv) Obligation to Sell (implementing section 210(m)(5))

FERC reaffirms the statement made in the final rule (responsive to our comments) that "lifting the obligation from a particular utility to purchase electric energy from a QF did not relieve such utility of its obligation to sell backup, standby and supplemental power." *Id.*, at para. 123. Competing retail suppliers implies two or more sellers. *Id.*, at para.125. But FERC imposes no requirement that rates for replacement power are reasonable since FERC has no jurisdiction over retail rates. *Id.*, at para.127.

**D. AEP Granted Relief from QF Purchase Obligations under PURPA
Docket No. QM07-4-000**

On July 18, 2007, FERC granted AEP a waiver from the mandatory PURPA purchase obligation. 120 FERC ¶ 61,052. The waiver applies to AEP's eight operating companies in the Midwest (so-called "AEP East"). It does not apply to AEP Texas, Public Service Co. of Oklahoma or SWEPCO.

Following FERC's October 2006 issuance of Order 688 implementing new PURPA section 210(m) and outlining the criteria and procedures by which utilities in organized markets could apply for relief from QF purchase obligations, AEP had filed a petition with FERC on April 18, 2007 for relief from the mandatory PURPA purchase obligations on a service-territory basis for AEP East.

On May 15, 2007, ELCON had filed an intervention urging FERC to issue its rehearing order on Order 688 before acting on AEP's petition for relief of QF purchase obligations. To do otherwise, ELCON argued, would be disruptive and wasteful of FERC's and the QF's resources since the rehearing order could impact the procedures and criteria for evaluating AEP's request.

AF&PA also protested AEP's request, arguing that AEP had not met the statutory burden of a factual showing that meaningful competition exists in its footprint and the QFs have nondiscriminatory access. On May 31, AEP filed a response asserting that neither ELCON nor AEP had standing in the proceeding.

FERC granted AEP the waiver on the basis of AEP's membership in PJM and the "rebuttable presumption" in FERC's rules that PJM provides QFs larger than 20 MW net capacity nondiscriminatory access to independently administered, auction-based day ahead and real-time wholesale markets for the sale of electric energy. FERC noted that none of the affected QFs identified by AEP protested the utility's petition for the waiver

The order denied ELCON's motion to intervene because ELCON did not present "case-specific" arguments or state that any ELCON member was, in fact, affected by AEP's petition. FERC went further to chastise "all membership organizations that going forward, when seeking to intervene in case-specific adjudications such as this one, they are

expected to confine their comments to specific factual and legal argument raised in the individual proceeding.” FERC stated that it will not allow such proceedings to be used to re-litigate generic matters. Although FERC's exact intent in including this admonishment is unknown, the impact of this language would significantly restrict both and state and national membership organizations such as ELCON from participating in individual cases that may, in the future, establish precedent.

In response, several organizations – ELCON, American Public Power Association, National Rural Electric Cooperative Association, and the Electric Power Supply Association, and several state industrial groups among them – sent a joint letter to FERC Commissioners and staff on July 31 concerning the intervention rights of member organizations in FERC proceedings. In the letter, the groups expressed “substantial concern” about FERC’s statement “as it suggests an effort by the Commission to discourage the scope of intervention by membership organizations and associations.” They criticize the Commission for arbitrarily and capriciously singling out a specific class of intervenor, despite that the Commission’s intervention rules permit intervention by membership organizations and individual stakeholders. In particular, ELCON noted:

the Commission’s frequent use of adjudicatory proceedings to announce and implement new policy, policy changes or policy refinements requires that the Commission grant broad intervention rights. FERC frequently announces important new rules in adjudications and then applies the results reached in those adjudications prospectively thereafter as FERC policy. ... [W]ithout the intervention of national membership organizations FERC could inadvertently issue a sweeping decision apparently logical in the facts of a specific case without being advised that the issue is under consideration in other regions where markets, reliability or local regulations require a different solution.

E. Revision of Rules for Power Marketers
Docket No. RM04-7-000

FERC issued on June 21, 2007 a new rule, Order 697, revising the regulations governing the market-based rates for wholesale sales of electric energy, capacity and ancillary services. 119 FERC ¶ 61,295 (2007). The Final Rule represents further fine-tuning of the market power analysis required in order for a seller to be authorized to sell at market-based rates.

Beginning in 1988, FERC had developed a four-prong test to determine whether a seller was eligible for market-based rate (“MBR”) authority, including an assessment of a seller’s (or seller’s affiliates’) market power in generation, market power in transmission, ability to erect barriers to entry, and evidence of affiliate abuse or reciprocal dealing.

In April 2004, FERC revised its test and looked at two indicative generation market power screens. Then, in May of 2006, FERC issued a NOPR proposing once again to modify MBR authorizations.

Highlights of the Final Rule include:

Categories of sellers:

FERC distinguishes between two categories of sellers. Category 1 power marketers are those that own 500 MW or less generation per region and that do not own transmission and are not affiliated with anyone that owns transmission in the same region as the seller’s generation assets. Category 2 sellers are all others. Category 1 power marketers are excused from filing updated market power analyses. Rather FERC will track whether Category 1 sellers have acquired market power through change in status filings and Section 203 filings applicable when jurisdictional facilities are transferred. Category 2

sellers will continue to provide triennial market power analyses, but the analysis will utilize a new regional approach to market power based on six “regions”: Northeast (ISO-NE, NYISO, PJM); Southeast (NERC Regions SERC and FRCC); Central (MISO, NERC Region MRO); Southwest Power Pool; Southwest; Northwest. Category 1 sellers must identify themselves at the time specified in the schedule for updated regional market power analysis. For example, Northeast transmission operators must file during December 2007; all others including independent power marketers that sold into the Northeast should file during June 2008.

Market power analysis

The Commission will continue to assess market power through two “horizontal” market power screens designed to assess market power in generation. These screens are the seasonal market power screen (pegged to exceeding a 20% share and based on an average of daily native load peaks per season) and a pivotal supplier screen (seller’s capacity needed to meet peak load). To date these screens have tripped a handful of transmission-owning utilities, but not independent power marketers. FERC clarifies the terms for mitigation where a utility fails to meet the tests (for example requirement that power be sold at incremental costs plus ten percent, or that certain long term embedded cost contracts be filed for approval.)

The Commission has made several changes in assessing horizontal market power of interest to independent power marketers:

- (i) The default geographic market is either the ISO/RTO area for organized markets or the seller’s “balancing authority area” for non-ISO/RTO areas *unless* the Commission finds that there is a sub-market within the region in which case a sub-market within the RTO may be selected. It is possible that creation of sub-markets could increase the number of sellers found to have market power.**

- (ii) Previously in determining market power, the Commission exempted generation built after July 9, 1996 on the theory that there has been competition in “new generation” since that date. This exemption for post July 1996 generation has now been removed, so all sellers must provide a horizontal market power analysis for the generation they own or control including generation built after July 1996.**
- (iii) The owner of a facility is presumed to have control of the facility unless such control has been transferred to another party by virtue of a contractual agreement. Thus a power marketer filing an initial application for market-based rates or a change in status report can identify the party that it believes has control of the generation facility. A “letter of concurrence” must also be obtained from other affected parties so FERC can make a determination who has control. FERC also notes in some instances it may be reasonable to allocate capacity based on ownership percentages.**

Traditional utilities will be found to lack vertical market power so long as they comply with open access tariffs but a finding of violation of an OATT can lead to loss of market-based rate authority as well as disgorgement of profits or other penalties. No power sales are allowed between a franchised public utility with captive customers and any power marketer affiliate offering market-based rates without Commission approval. Code of conduct requirements are codified.

The change in status filings that all sellers are obliged to make (within 30 days after the change in status occurs), will continue to require sellers to advise FERC when they acquire more than a net increase of 100MW generation or ownership or acquire ownership or control of transmission facilities or affiliate with transmission providers. FERC will not require that sellers report a change in ownership or control of natural gas and oil supplies, or affiliation with an entity that owns or control such fuels supplies. However, a change of status must be filed where the seller first affiliates with an entity that owns or controls inputs to power production including gas storage, distribution or transportation, sites for new generation, or coal supplies or coal transportation facilities.

EEI sought rehearing or clarification as to four issues: (1) the final rule’s constraint on public utilities with captive customers and their market-regulated power sales affiliates sharing field and maintenance employees and their supervisors if the employees or supervisors control generation; (2) the final rule’s requirement for market-regulated affiliates to sell non-power goods and services to utilities with captive customers at or below market prices, unless otherwise authorized by the Commission, as that may apply to centralized service companies; (3) the final rule’s mitigation provisions as those may apply in the context of existing mitigation regimes approved by the Commission for regional transmission organization (“RTO”) and independent system operator (“ISO”) markets; and (4) the final rule’s impacts on the ability of companies to engage effectively in long-term contracts.

Among the numerous other rehearing requests was a request by a group of Industrial Customers (of the Coalition of Midwest Transmission Customers, PJM Industrial Customer Coalition, NEPOOL Industrial Customer Coalition, Industrial Energy Users – Ohio, Industrial Energy Consumers of PA, Southeast Electricity Consumers Association, West Virginia Energy Users Group, and the Southwest Industrial Customer Coalition). This group asserts that Order 697 errs by failing to acknowledge the argument that the existence of a competitive market -- and not just a seller’s lack of market power -- is a prerequisite to the use of market-based rate authority. They further argue that FERC errs by continuing to find that market-based rates are just and reasonable without first determining that competitive markets actually exist. In particular, Industrial Customers argue that the Commission must either: (1) explain why the case law underlying MBRA no longer requires the prerequisite showing of competitive

markets based on empirical proof, or (2) undertake the task of analyzing whether current wholesale electricity pricing mechanisms amount to a "competitive market." The primary question that the Commission must answer before it can declare MBRA to be just and reasonable, and the key question the Commission failed to answer in Order 697, "is what constitutes a truly competitive market and whether there are any in the country sufficient to enable use of MBRA." They outlined what they consider "definite criteria," in the identification of a competitive market, including "barriers to entry or exit, demand elasticity, ease of product deliverability, transparent market information, unconcentrated generation asset ownership, correct market design, and absence of market power."

APPA and TAPS agreed that FERC erroneously assumes long-term markets are inherently competitive. NRECA suggested FERC require utilities to submit separate analyses of horizontal market power for short-term and long-term markets. "[T]he Commission cannot assume that the lack of market power in short-term energy implies a concomitant lack of market power in providing long-term capacity in a transmission-constrained area."

The NYISO expressed concern that FERC intends the default mitigation measure to impose a revenue cap in LMP markets, which would distort responses to market price signals and would not work with uniform clearing-price auctions.

Southern challenged FERC's use of market power screens at all. Under the FPA, they argue, FERC has the burden of proof in and section 206 proceeding. That a seller must rebut the presumption of market power where that seller fails the screen test is an unlawful shift of the burden of proof.

F. FERC Issues New Policy Statement on Mergers
Docket Nos: PL07-1, RM07-15, RM07-21-000

On July 19, 2007, FERC issued a Policy Statement and two NOPRs designed to provide greater clarity and guidance on its merger and corporate review policies while ensuring ratepayer protection against unauthorized cross-subsidies of utility and non-utility affiliates.

In the Supplemental Policy Statement (120 FERC ¶61,060, Docket No. PL07-1), the Commission provides guidance regarding future implementation of FPA section 203. The guidance reportedly is based on the Commission's experience since amending its FPA section 203 regulations and enacting new regulations under the PUHCA 2005, and discussion at two technical conferences held in December 2006 and March 2007. Among the issues discussed in the Supplemental Policy Statement are:

- Safe harbor transactions that are unlikely to raise cross-subsidization issues.
- Deference to state-adopted protections, such as ring-fencing measures. Ring-fencing is a means of separating and protecting the financial assets and ratings of a regulated utility from the business risks of other companies in a holding company.
- Broader blanket authorizations considered on a case-by-case basis and a proposal for certain generic blanket authority addressed in a concurrent NOPR discussed below.
- Guidance regarding disposition of "control" jurisdictional facilities.
- The Appendix A merger analysis, used to help identify instances of market power. The Commission will continue to analyze mergers by focusing on a company's ability and incentive to exercise market power.

In the first NOPR, the Commission proposes to codify cross-subsidy pricing restrictions on power and non-power goods and services transactions between franchised public utilities with captive customers and their market-regulated power sales affiliates or non-utility affiliates. (120 FERC ¶61,061, Docket No. RM07-15).

The other NOPR seeks comment on a proposal to grant an additional limited blanket authorization for certain dispositions of jurisdictional facilities (120 FERC ¶61,062, Docket No. RM07-21). Under section 203 (a) (1) of the FPA, a public utility, without prior Commission authorization, may dispose of less than 10 percent of its voting securities to a public utility holding company only if, after the disposition, the holding company and any associate company will own, in the aggregate, less than 10 percent of the public utility. The Commission believes that the disposition of such limited voting interests (less than 10 percent) with the proposed “in aggregate” restriction and the existing reporting requirements applicable to holding companies will not harm competition or captive customers and will accommodate additional investment and market liquidity in the electric industry.

G. FERC Rejects PJM Proposal to Exclude Day-Ahead Customers from ELRP Docket No. ER07-508

FERC issued an order on June 15, 2007 rejecting PJM's attempt to eliminate participation by Day-Ahead LMP-based contract customers in the RTO's Day-Ahead Economic Load Response Program. Gerdau Ameristeel Corporation initiated the protest of this proposal and the company received the active support ELCON, PJMICC, Steel Manufacturers Association and AISI. The effect of FERC's rejection is moderate because it only provides for continuation of the program until its anticipated expiration at the end of this year. The program will end if PJM does not file an application to renew it.

At issue is the use of non-market based incentives in the program that are intended to "enhance the ability and opportunity for reduction of consumption when PJM LMPs are

high." When the LMP is lower than \$75 per MWh, load offering demand response receives the LMP price net of generation and transmission charges. When the market price is above \$75 per MWh, the load is paid the full LMP without the reduction for the energy commodity. The cost of the full LMP payment (the "incentive") is socialized among the LSEs within the zone of the load that offers the load reduction. PJM's market monitor filed testimony questioning the integrity of the incentive program.

According to PJM's filing in early 2007, the proposed revisions to its economic load response rules were needed "to address the problem of entities engaging in activity using PJM's demand-response market access which does not provide the demand-response benefits that PJM's economic load-response program was designed to produce." The existing rules allow participants in the program to buy and sell in the same day-ahead market upon which the retail LMP rate is indexed, but prohibit such activity in the real-time market. According to PJM, entities with day-ahead LMP-based contracts are able to game the system by submitting demand reduction bids in the day-ahead market when LMP is above \$75/MWh in order to receive the economic-load response incentive irrespective of whether they intend to consume energy for that period.

Gerdau filed a protest in February 2007, citing, among other concerns, two issues of particular importance to ELCON members: first, PJM's proposed revisions fail to treat demand response symmetrically with generation; and second, PJM's assertion that a majority of stakeholders approved the plan does not paint an accurate picture of stakeholder support.

On April 3, 2007, FERC notified PJM that its filing was deficient and directed PJM to supply additional information, including:

- An explanation of how PJM measures demand reduction benefits.

- An explanation of how bidding behavior of Day-Ahead LMP customers “negat[es] any real demand response from such customers”.
- An analysis of the effects of eliminating Day-Ahead LMP customers from the ELRP program and impacts on the market.
- Details of specific actions taken by customers that PJM considers gaming and an explanation of how the bidding behavior is similar to paying subsidies for wash trading.

PJM responded April 18, 2007, explaining that its position is:

...when a Day-Ahead LMP customer curtails its consumption as a result of a payment under the ELRP program, these load reductions do not produce net benefits to the PJM market. These load reductions result in non-efficient prices with negative impacts on the market. ... LMP customers ... already face the appropriate price signals. Allowing such customers to participate and receive the ELRP incentive results in economically irrational demand response because it provides an out of market subsidy. ...

While economically irrational response may result in less load on the system, such activity distorts efficient price signals and, therefore, undermines efficient market activity and investment.

FERC disagreed with PJM’s rationale for excluding one set of customers from the program:

We find that PJM has not provided sufficient support to terminate the incentive program at this time for one set of customers that made financial arrangements based on the expectation that this program would continue.

As the parties argue, they had a reasonable expectation under the tariff to make arrangements for demand response at least up until December 31, and relied on that fact in expending time and resources to negotiate new agreements. PJM has not sufficiently justified terminating the program early for only this one set of customers, the Day-ahead LMP customers.

PJM conceded in its answer to the deficiency letter that its proposal was not based on the failure of customers to perform under the program. PJM has acknowledged that Day-ahead LMP customer demand bids do reduce consumption, and therefore assist in taking energy off the system at peak periods.

119 FERC ¶ 61,280 at para 27-29.

The need for any such an incentive might be questionable in a fully functioning market. However, PJM’s current market design necessitates out of market incentives and

socialized cost recovery if price responsive load is to have a place in the market. As PJM has explained, during a heat wave last summer payments to loads for load reductions worth \$5 million provided \$650 million in total energy cost savings. PJM's current market design has no mechanism to internalize these savings. The New York ISO and ISO New England have similar economic demand response programs.

**H. NYISO Report on Implementation of ICAP Demand Curve
Docket No. ER03-647-009**

On July 17, 2007, the NYISO submitted a report discussing the implementation of its ICAP demand curves and withholding under the demand curve program. On January 16, 2007, the NYISO had submitted a compliance report on the implementation of its Installed Capacity Demand Curves. On May 18, FERC accepted the report, but asked the NYISO to provide further information and analysis. 119 FERC ¶ 61,162 (2007).

In this most recent report, the NYISO states that capacity prices remain stable on a statewide basis and that the performance of the ICAP markets generally does not raise concerns about significant physical or economic withholding. In New York City, the ISO reports observation of "certain bidding behavior that has kept prices at the Commission-approved cap" for certain owners of generation divested from ConEd prior to the formation of the NYISO, but indicates that this is consistent with expectations under FERC-approved mitigation measures. Overall, capacity offered and purchased throughout the state "has consistently exceeded the minimum capacity requirements, and prices have been below the costs of entry reflected on the ICAP Demand Curves."

Regarding generation investment, the NYISO states that it is "difficult to reach any conclusions regarding the effects of the ICAP Demand Curves on investment in new

generation in New York mainly because, over the past several years, New York has had capacity available in excess of the minimum requirements to maintain reliability. On the other hand, the behavior of key market variables suggests that the system is geared to providing the signals necessary to provide appropriate incentives to new investment.”

I. FERC Uses New Enforcement Authority in Connection with Market Manipulation
Docket Nos IN07-26-000, IN06-3-002

FERC for the first time used its new enforcement authority to prosecute market manipulation. On July 26, 2007 the Commission issued show cause orders that made preliminary findings of market manipulation and proposed civil penalties totaling \$458 million in two investigations involving traders’ unlawful actions in natural gas markets.

The first case involves a Connecticut-based hedge fund, Amaranth LLC, and two traders. This case involves intentional manipulation of the settlement price of a NYMEX Natural Gas Futures Contract on three dates in 2006 by selling an extraordinary amount of these contracts during the last 30 minutes of trading before these future contracts expired, with the purpose and effect of driving down the settlement price. That settlement price is explicitly used to determine the price for a substantial volume of FERC-jurisdictional physical natural gas transactions. Investigators in the Commission’s Office of Enforcement found that Amaranth had previously taken positions in various financial derivatives that were several times larger, and whose values increased, as a direct result of the fall in the settlement price of the natural gas futures contract. Thus, for every dollar lost on its sales of the futures contracts, Amaranth would gain several dollars on its derivative financial positions.

In the second case, the Commission found that Energy Transfer Partners, LP (ETP), a Texas-based owner of pipeline assets and a natural gas trading affiliate, violated FERC's Market Behavior Rule, the anti-manipulation rule then in effect, when it artificially lowered the price for prompt month gas at the Houston Ship Channel to the benefit of its physical and financial positions. By lowering the price, ETP suppressed the Inside FERC Houston Ship Channel index, published by Platts, on which the pricing of many physical natural gas contracts and financial derivatives are based. The investigation also found that ETP suppressed the price of daily gas at Waha, and violated the Natural Gas Policy Act (NGPA) by unduly preferring affiliated shippers and unduly discriminating against non-affiliated shippers on its Oasis Pipeline for interstate gas transportation system from Waha, in West Texas, to Katy, near Houston. The investigation uncovered voice recordings that show senior managers at ETP were aware of the situation and directed the company's manipulative strategy to suppress fixed-price gas at the Houston Ship Channel.

The CFTC is reportedly conducting similar investigations of the two companies for violations of its statutes. The two federal agencies cooperated in the two investigations through their Memorandum of Understanding, though their individual actions fall under separate statutes.

II. COURT PROCEEDINGS

A. Door Once Again Opened to Possibility of Refunds in Pacific Northwest

On August 24, 2007, the Ninth Circuit told FERC that it must once again take up the issue of whether or not to order refunds from Pacific Northwest power suppliers possibly involved in the western energy crisis of 2000-2001. Port of Seattle, Washington v.

FERC, et al. (No. 03-74139), 2007 U.S. App. LEXIS 20217 (2007). The court did not conclude that refunds are appropriate, but found that FERC should have considered evidence of intentional market manipulation in California that affected short-term power prices on Pacific Northwest spot markets.

The decision arises out of a petition for review of FERC's June 25, 2003 rejection of requests to order refunds for short-term power sales in the Pacific Northwest between December 2000 and June 2001. 103 FERC ¶61,354, Docket No. EL02-60. In the June 25 Order, FERC had determined that the volume of transactions that would be subject to retroactive refunds and the Commission's lack of jurisdiction over a large number of Northwest sellers party to the transactions that took place from December 2000 through June 2001 would make it all but impossible to achieve an equitable outcome. In particular, governmental entities would be eligible to receive refunds for purchases made during the energy crisis, but would not have to provide refunds for high-priced sales they had made. FERC also expressed concern that providing refunds would amount to rewarding utilities for relying on the spot market at a time when it sought to encourage long-term contracting. And finally, FERC worried that providing refunds would undermine regulatory credibility by rewriting the rules "on which buyers and sellers in the Pacific Northwest reasonable relied." Various California state agencies and Pacific Northwest cities challenged FERC's decision.

The Court found that FERC's failure to consider or examine evidence of market manipulation in California that came to light in the spring of 2003 (but after a hearing on the matter of retroactive refunds in the Northwest had ended) and its failure to consider the relationship of manipulation in California with the Pacific Northwest was arbitrary and

capricious. “Even assuming all of these transactions occurred in the California spot market, the fact that Pacific Northwest sellers were apparently involved in Enron’s manipulation indicates that FERC must at least consider the possibility that the Pacific Northwest spot market was not, as the ALJ found, functional and competitive.” The Court also rejected FERC’s attempt to distinguish between sales into California and sales into the Pacific Northwest, pointing out that elsewhere in similar proceedings (e.g., EL00-95), FERC had not limited refunds to energy ultimately consumed within California.

The Court remanded the case to FERC for further consideration. In particular, FERC was directed to take into detailed account new evidence of market manipulation “in any future orders regarding the award of denial of refunds in the Pacific Northwest proceeding.” Additionally, the Court recommended FERC engage in additional fact-finding “if the record evidence of market-manipulation is not sufficient to enable FERC to make a reasoned decision.”

B. D.C. Circuit Upholds FERC’s Ability to Prevent Market Manipulation

On June 22, 2007, the U.S. Court of Appeals for the District of Columbia Circuit rejected a challenge to the Federal Energy Regulatory Commission's ability to set rules to prevent market manipulation in wholesale power markets. Colorado Office of Consumer Counsel, et. al., v. FERC, Case No. 04-1238, 490 F.3d 954 (2007), reh’g den. 2007 U.S. App. LEXIS 19939 (2007) and 2007 U.S. App. LEXIS 19940 (2007) . In a very brief decision, the Court found that the Federal Power Act gives the Commission the discretion to investigate and resolve issues surrounding market-based rates. It upheld rules the Commission issued in 2003 to prevent manipulative practices in wholesale power sales and

effectively dismissed arguments that the Commission could not authorize market-based rates.

Earlier the same week, on June 18, the U.S. Supreme Court declined to hear further challenges to a 2004 Ninth Circuit decision upholding FERC's market-based rate regime. California v. FERC, Case No. 02-73093, 383 F.3d 1006 (2004), cert. den. 2007 U.S. LEXIS 7865 and U.S. LEXIS 7866 (June 18, 2007). In that case, California (then) Attorney General Bill Lockyer, together with a number of California agencies, had challenged FERC's ability to authorize and administer market-based energy tariffs, and charged FERC with failing properly to administer the tariffs when it declined to order several California providers to provide refunds following a failure to include transaction-specific data in quarterly reports. California's current Attorney General then asked the Supreme Court to rule that FERC's MBR program violates the FPA. The Ninth Circuit ruling was also challenged by a group of power wholesalers who asked the high court to limit FERC's ability to order refunds in cases where reporting requirements under the MBR program are not met.

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