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Writer's Direct Dial: (202) 974-1550

March 17, 2003

FILED ELECTRONICALLY

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

Re: Proposed Pricing Policy for Efficient Operation and Expansion of Transmission Grid – Docket No. PL03-1-000

Dear Secretary Salas:

On March 13, 2003, the Electricity Consumers Resource Council (ELCON), American Iron and Steel Institute (AISI), American Chemistry Council (ACC), and PJM Industrial Customer Coalition (PJMICC) (collectively "Industrial Consumers") filed comments in Docket No. PL03-1-000, Proposed Pricing Policy for Efficient Operation and Expansion of Transmission Grid.

Enclosed for filing in Docket No. PL03-1-000 is an amended version of the comments filed on March 13, 2003. The original filing did not include the Coalition of Midwest Transmission Customers (CMTC) as a joint intervenor.

Please contact the undersigned at (202) 974-1550 should you have any questions regarding this amended filing.

Respectfully submitted,

/s/ Sara D. Schotland

Sara D. Schotland

Enclosure

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Proposed Pricing Policy for Efficient Operation and Expansion of Transmission Grid	)	**Docket No. PL03-1-000**

AMENDED COMMENTS OF THE
ELECTRICITY CONSUMERS RESOURCE COUNCIL,
AMERICAN IRON AND STEEL INSTITUTE,
AMERICAN CHEMISTRY COUNCIL,
COALITION OF MIDWEST TRANSMISSION CUSTOMERS
AND
PJM INDUSTRIAL CUSTOMER COALITION

The Electricity Consumers Resource Council (ELCON), American Iron and Steel Institute (AISI), American Chemistry Council (ACC), Coalition of Midwest Transmission Customers (CMTC), and PJM Industrial Customer Coalition (PJMICC) (collectively "Industrial Consumers") offer the following comments on FERC's policy to create rate incentives that reward RTO and ITC formation and grid investment.

FERC proposes to reward transmission owners for joining RTOs and turning their assets over for RTO operation. (i) Any entity that transfers operational control of transmission facilities to a Commission-approved RTO will qualify for an adder of 50 basis points on its ROE; (ii) ITCs that participate in RTOs and meet an independent ownership requirement will qualify for an additional incentive equal to 150 basis points applied to the book value of facilities at the

time of the divestiture: and (iii) a generic ROE-based incentive equal to 100 basis points would apply to new transmission facilities found appropriate during an RTO planning process.

INTRODUCTION

Industrial Consumers strongly support what we believe are the three overarching objectives of the proposed pricing policy: (1) the formation of large, independent RTOs in all regions of the country, (2) a fair demonstration of the efficacy of Independent Transmission Companies (ITCs) as a viable business model for transmission, and (3) an adequate and reliable transmission infrastructure. We continue to applaud the Commission's diligence in pursuing these important objectives. But the proposed pricing policy puts us in a quandary because, while the objectives of the policy are unquestionably meritorious, the "incentive" mechanisms in the proposal violate D.C. Circuit decisions on incentive ratemaking[1] and may establish a precedent for the manner in which risks are shared between utilities and their ratepayers in the future.

We do not rule out the application of incentive mechanisms as a useful regulatory policy tool if appropriately crafted. However, Industrial Consumers believe that the proposal falls short because no criteria are specified to ensure that the incentives are applied on a just and reasonable basis. Missing are: (i) appropriate quantitative and qualitative benchmarks for measuring risk against performance; (ii) guidelines for ensuring that net benefits to customers exceed costs plus the incentive premium; (iii) guidelines for ensuring that efficient investment tradeoffs are made among competing technologies (i.e., generation and demand response

[1] See, e.g., Farmers Union Central Exchange Inc. v. FERC, 734 F.2d 1486 (D.C. Cir. 1984), cert. denied sub nom., 469 U.S. 1034 (1984); City of Charlottesville v. FERC, 661 F.2d 945 (D.C. Cir. 1981).

solutions to congestion); and (iv) a screening process for preventing windfall profits to free-riders.

As proposed, the incentives are a tax on transmission services. And like any tax, once implemented, it is hard to get rid of and there is constant pressure to increase it. Industrial Consumers are concerned that the incentives are not tied to specific criteria. Additionally, there is concern that this will spark a campaign for other incentives, which may or may not be tied to anticipated or realized ratepayer benefits.

EXECUTIVE SUMMARY

Insufficient investment in transmission does not result from deficiencies in FERC pricing. Rather the problem of under-investment reflects:

- Reluctance of vertically integrated utilities to relieve congestion that favors their generation. Incentives, such as FERC proposes, will harm consumers without being sufficient to incent vertically integrated utilities to relieve congestion. The return earned in transmission rates pales when compared to generation profits attributable to congestion.
- Uncertainty in the regulatory climate.

Industrial Consumers strongly favor improving the transmission system. But transmission owners are monopolists and "incentives" beyond cost of service for new monopoly transmission investments fail on several counts. (i) Cost-of-service regulation should provide adequate economic incentives because utilities are allowed to recover prudently incurred costs and earn a virtually guaranteed rate of return with almost no downside risk. There is no need to embellish any monopoly transmission owner's potential earnings as long as this guarantee applies. (ii) Incentives cannot make a monopolist behave as a real competitor unless the monopolist is allowed to fail. (iii) Traditional cost-of-service regulation is not lacking workable

incentive mechanisms. In fact, under cost-of-service, regulators often establish bandwidths around allowed returns that reward exceptional behavior or exceptional risk and penalize the opposite.

Those who want to construct new transmission must first demonstrate that such risk exists. We must keep in mind that investment in transmission is essentially low-risk. A Goldman Sachs analyst has stated that a return in the historical 11-12 percent range usually is adequate to stimulate appropriate investment dollars.[2] Only if and when transmission owners and transmission investors can first demonstrate a higher degree of risk would a higher rate of return be acceptable.

Fitch, financial analysts, prepared a report in 2001 on the newly formed American Transmission Company, a transmission-only company not affiliated with any one utility. That report states that ATC's "costs are recouped through an annual revenue requirement passed through rates to 'network' customers" and that those network customers guarantee 95 percent of ATC's annual revenues, rain or shine, regardless of load. This analysis is yet another illustration that investment in transmission is intrinsically low risk.

Industrial Consumers offer three points in these comments. First, FERC may be vulnerable to judicial challenge that the incentives that it has proposed violate the just and reasonable standard, in view of the lack of empirical evidence to support the level of incentives. We discuss extensive D.C. Circuit case law that imposes constraints on incentive ratemaking by the Commission and requires demonstration that the incentives are carefully calibrated and will

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[2] Testimony of Managing Director Thomas Lane, July 27, 2001, before House Energy and Commerce Committee, Subcommittee on Energy and Air Quality.

not result in a windfall.[3] For example, in Farmers Union, the D.C. Circuit held that unsupported predictions of increased investment in oil pipelines were not sufficient to justify the challenged incentive rates. There must be an attempt to "verify the accuracy of [the Commission's] prediction that granting…incentives will spur increased investment."[4] The increase should not be inflated beyond what is needed to incent the regulated utility.[5] Finally, if any incentives are offered with respect to new construction, utilities should not be allowed to "double dip" and claim stranded costs for such facilities. If incentives are justified on the basis of putative risk, utilities should bear the risk that the facilities might become stranded.

Second, FERC has existing statutory authority to require utilities to join RTOs or ITPs as FERC has itself recognized in its SMD NOPR. Having found that residual discrimination exists post Order No. 888 and post Order No. 2000, FERC has already recognized that it has the statutory authority under Sections 205 and 206 to order utilities to join RTOs or unbundle transmission from generation.

Third, FERC has existing statutory authority to order utilities to expand transmission as necessary to mitigate market power in the context of approvals to charge market-based rates. FERC should review applications for approval or extension of market-based rate authority to assure that transmission constraints do not reflect exercise of market power. Where transmission constraints reflect market power and where expansion is reasonably feasible, transmission owners must undertake compensated expansions of the transmission grid.

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3 See Farmers Union Central Exchange Inc., 734 F.2d at 1503.

4 Id. (quoting City of Charlottesville, 661 F.2d at 955 (D.C. Cir. 1981) (Wald, J., concurring)).

5 See City of Charlottesville, 661 F.2d at 950.

A. FERC's Proposed Transmission Pricing Policy May Be Vulnerable As Inconsistent With The Just and Reasonable Standard

1. Case Law On Incentive Pricing

In City of Charlottesville v. FERC, 661 F.2d 945 (D.C. Cir. 1981), the D.C. Circuit struck down the Commission's consolidated tax policy for gas pipelines that gave shareholders, rather than ratepayers, the benefits of consolidated tax savings that come from production losses. The court insisted that a stricter standard of review would apply to Commission ratemaking endeavors that seek to encourage certain behaviors through increased rates to consumers: "[If] the Commission contemplates increasing rates for the purpose of encouraging exploration and development…it must see to it that the increase is in fact needed and is no more than is needed for the purpose. Further than this we think the Commission cannot go without additional authority from Congress." Id. at 950 (emphasis added) (quoting City of Detroit v. FPC, 230 F.2d 810 (D.C. Cir. 1955)).

The D.C. Circuit also held in City of Charlottesville that the Commission must demonstrate that the incentive is effective in achieving the desired outcome. The D.C. Circuit found that the tax savings were not being used to expand exploration, but were being put to general corporate purposes.

In Farmers Union Central Exchange Inc. v. FERC, 734 F.2d 1486 (D.C. Cir. 1984), cert. denied sub nom., 469 U.S. 1034 (1984), the Commission remanded to FERC a generic ratemaking methodology for oil pipelines. The methodology applied price caps designed only to prevent "egregious price exploitation" and relied upon market forces to assure proper rate levels. Among FERC's justifications for setting the maximum rates at "such high levels" (id. at

1503) was the need to stimulate additional oil pipeline capacity. While the court acknowledged that non-cost factors such as the need to stimulate new supplies can be used to establish rates, there are limits to such incentives: "However, in this case FERC failed to forecast or otherwise estimate the dimensions of the need for additional capacity, and did not even attempt to calibrate the relationship between increased rates and the attraction of new capital." Id. (emphasis added). The opinion sums up several cases that establish that incentive rates must be justified with findings that the particular incentive increment will result in the intended outcome:

> In the absence of such a reasoned inquiry, we cannot countenance FERC's approval of oil pipeline rates which, by FERC's own admission, ensure "creamy returns" to the carriers, 21 FERC at 61,650, and are "far more generous than those [rates] that [FERC] or other regulators give elsewhere," *id.* at 61,646. In a similar context, this court explained:
>
> > If the Commission contemplates increasing rates for the purpose of encouraging exploration and development . . . it must see to it that the increase is in fact needed, and is no more than is needed, for the purpose. Further than this we think the Commission cannot go without additional authority from Congress.
>
> *City of Detroit v. FPC*, 230 F.2d 810, 817 (D.C. Cir. 1955), *cert. denied sub nom. Panhandle Eastern Pipe Line Co. v. City of Detroit*, 352 U.S. 829, 1 L. Ed. 2d 48, 77 S. Ct. 34 (1956); *see San Antonio v. United States*, 203 U.S. App. D.C. 249, 631 F.2d 831, 851-52 (D.C. Cir. 1980) (ICC action, adding seven percent above costs in setting rates, is arbitrary and capricious because it lacks "adequate justification for [the] choice of a particular increment above fully allocated costs"), *rev'd on other grounds sub nom. Burlington Northern, Inc. v. United States*, 459 U.S. 1229, 103 S. Ct. 1238, 75 L. Ed. 2d 471 (1983); *Public Service Commission v. FERC*, 589 F.2d at 553-54 (citing cases). In the *Williams* proceeding, FERC "made no attempt at all to verify the accuracy of its prediction that granting pipeline [rate] incentives will spur increased investment." *City of Charlottesville v. FERC*, 213 U.S. App. D.C. 33, 661 F.2d 945, 955 (D.C. Cir. 1981) (Wald, J., concurring). Indeed, FERC here failed to make its prediction with any specificity beyond the bald statement that "everybody agrees that the nation needs and will need more pipeline plant." 21 FERC at 61,614.

Id. (emphasis added). The conclusion of the opinion reiterated the importance of carefully calibrated incentive rate mechanisms: "Departures from cost-based rates must be made, if at all, only when the non-cost factors are clearly identified and the substitute or supplemental ratemaking methods ensure that the resulting rate levels are justified by those factors." Id. at 1530.

In Public Service Commission v. FERC, 589 F.2d 542 (D.C. Cir. 1978), the court remanded an order of the FPC that provided an "optional certificate program" for natural gas producers that was designed to increase exploration and development of new gas sources. The court was particularly concerned that the incentive was not coordinated with the Commission's main ratemaking procedure and might result in "double counting," billing consumers twice for high cost projects. The court stated that if additional incentives were needed to increase gas production beyond the national ratemaking mechanism, then incentive programs like the optional certificate would have to be justified, especially when such an incentive might result in a rate that includes "sunk costs of a period before the onset of the program":

> Where, as here, an agency has established national rates on an average cost basis, and individual exceptions escalating the price above the national rate are established in the interest of increasing supply, there must be a connection between such increased funding and the increased exploration and development of new gas sources alleged to result. This principle has been stated in a number of ways: that there must be a "Quid pro quo" for the extra funding; that there must be an "inquiry into the incremental increase in gas supply" attributable to the program; and that there must be "symmetry" between the funding and increase in production. In the Supreme Court's words, the program must provide increased funding "while assuring that such increase would not be levied upon consumers unless accompanied by increased supplies of gas." Mobil Oil Corp. v. FPC, 417 U.S. 283, 318, 94 S. Ct. 2328, 2350, 41 L. Ed. 2d 72 (1974)….
>
> In its programs to provide incentive for new expenditures the FPC has long been concerned with avoiding payment for expenditures "sunk" before the announcement of the incentive, i.e., with avoiding a windfall for old expenditures… Here, in its novel extension of total project costs as a basis for

> rates to include sunk costs of a period before the onset of the program, the Commission has failed to give "'reasoned consideration' to the shaping of its order in an effort to protect consumers from paying substantially more than necessary to bring forth the needed supplies."

Id. at 552-54 (emphasis added) (footnotes omitted). The court also noted that the Commission seemed to be capitulating to any demand of gas producers in order to achieve higher production levels.[6]

Industrial Consumers believe that the Proposed Pricing Policy is equally vulnerable to judicial challenge on the basis that there is no record developed that the hoped-for incentives will result from the over-generous pricing policy.

2. FERC'S 1992 Policy Statement on Incentive Regulation

In 1992, FERC established general guidelines for the Commission's consideration of incentive rate proposals on a case-by-case basis.[7] The price cap structure for incentive rates anticipated by the 1992 Policy Statement is different than the incentives being employed in the current Proposed Pricing Policy. However, general concepts from the 1992 Policy Statement are useful to evaluate the current proposal. The Commission's 1992 Policy Statement focused on requiring quantification of benefits to consumers from proposed incentive rates. The 1992 Policy Statement determined that there should be an "absolute upper limit on the risk to

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[6] The court stated:

> The FPC created the optional certification program as an exception to national ratemaking to give greater security and higher rates to producers as an incentive for increased exploration and development. In 1974 we gave the FPC broad latitude to develop appropriate standards for the program. Since 1974, we have not seen expanded or refined analysis by the FPC of how to make the program work. Instead, if anything, the FPC retreated from its earlier attempts at analytically justifying its standards, and essentially lapsed into "kid glove" acquiescence to the desires of natural gas producers.

Id. at 562-63 (emphasis added).

[7] Incentive Ratemaking for Interstate Natural Gas Pipelines, Oil Pipelines, and Electric Utilities, 61 FERC ¶ 61,168 (1992) ("1992 Policy Statement").

consumers that the incentive rates would be higher than rates they would have paid under traditional regulation." Id. at 61,587. FERC historically has been concerned with ensuring incentives are beneficial to consumers:

> The Commission remains convinced that benefits to consumers must be quantifiable even though the task is admittedly a difficult one. All proposals must include a quantified estimate of the consumer benefits compared to cost-of-service regulation (i.e., a comparison of projected cost-of-service rates to prospective rates under the proposed incentive rate mechanism), and a realistic estimate of the program's prospects for success and the risks of failure.[8]

In his concurrence to the 1992 Notice of Proposed Policy Statement on Incentive Regulation, Commissioner Charles A. Trabandt summarized the "take-home" message from the City of Charlottesville decision:

> …[W]e cannot just decide to give companies undefined "incentives," such as tying rates to some external index. Rather, after overcoming the hurdle that we need incentive ratemaking at all, the Commission must show how that the mechanism we choose gives companies enough, but not too much, money and, in fact, will bring about cost reductions. I also think that we will have to introduce a rigorous monitoring program to make sure that a particular form of incentive does more than degenerate into windfalls for the pipeline.

Notice of Proposed Policy Statement on Incentive Regulation, 58 FERC ¶ 61,287, at 61,911 (1992).

FERC's pre-existing incentive rate policy provides "[i]ncentive ratemaking must simultaneously protect customers' interests and offer potential rewards to the utility for good performance."[9] "[I]ncentive regulation should be designed to penalize utilities that fail to achieve these efficiencies – opportunities for reward should be offset by a symmetric downside

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[8] Id. at 61,590 (footnote omitted).

[9] 1992 Policy Statement at 61,589.

risk."[10] Industrial Consumers agree incentives must have both a downside and upside to protect consumers and assure that utilities offer quality service.

B. FERC Has Adequate Legal Authority To Order Utilities to Join RTOs

FERC has the authority to order utilities to join RTOs or ITPs to mitigate market power under Sections 205 and Section 206 of the FPA. The D.C. Circuit has insisted on FERC's duty to address undue discrimination. Gulf States Utilities Co. v. FPC, 411 U.S. 747, 758-59, reh'g denied, 412 U.S. 944 (1973). See also City of Huntingburg v. FPC, 498 F.2d 778, 783-84 (D.C. Cir. 1974) (finding that the Commission has a duty to consider the potential anticompetitive effects of a proposed interconnection agreement). The Federal Power Act fairly bristles with concern for undue discrimination. See Associated Gas Distributors v. FERC, 824 F.2d 981, 998 (D.C. Cir. 1987), cert. denied, 485 U.S. 1006 (1988).

The D.C. Circuit upheld FERC's broad view of its plenary authority to initiate rulemakings to remedy undue discrimination under the FPA in Transmission Access Policy Study Group v. FERC, 225 F.3d 667 (2000), aff'd sub nom., New York v. FERC, 535 U.S. 1 (2002). The FPA does not expressly grant FERC the authority to implement open access by rule (as opposed to the case-by-case approach of Section 211), but FERC correctly derived such authority by virtue of its Section 206 authority. FERC has similar authority to order by rule operational unbundling via RTOs based on its record findings.

In the SMD NOPR, FERC found that residual discrimination required utilities to join RTOs or ITPs. The SMD NOPR painstakingly recites the numerous opportunities for

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[10] Id. at 61,590.

discrimination under the *status quo*. These include, for example, skewed determination of available transfer capacity (ATC); discretionary use of transmission loading relief (TLRs); set aside of transmission transfer capability for reliability (CBM—capacity benefit margin); transmission curtailment preference for bundled retail load. See SMD NOPR, Appendix C. FERC has found that Order No. 888 and Order No. 2000 have not served to eradicate discrimination in transmission:

> The Commission's goal in Order Nos. 888 and 2000 was to harness the benefits of competition for the nation's electricity customers by assuring adequate and reliable supplies of electricity at a just and reasonable price. As discussed above in the Need for Reform section (Section III), the current rules and regulations have prevented the full attainment of that objective.

SMD NOPR ¶ 107.

In the SMD NOPR, FERC recognized:

> . . . [T]he Commission's regulatory authority "clearly carries with it the responsibility to consider, in appropriate circumstances, the anticompetitive effects of regulated aspects of interstate utility operations pursuant to [Federal Power Act sections] 202 and 203, and under like directives contained in [Federal Power Act sections] 205, 206, and 207." The Commission's authority to remedy undue discrimination and anticompetitive effects is broad.

Id. ¶ 101 (footnotes omitted).

Under New York v. FERC, FERC is *required* to remedy such discrimination: "Were FERC to investigate this alleged discrimination and make findings concerning undue discrimination in the retail electricity market, § 206 of the FPA would require FERC to provide a remedy for that discrimination." 535 U.S. at 27. FERC's finding that RTOs and ITPs are necessary to eradicate discrimination is strengthened by the fact that FERC first tried to mitigate discrimination through functional unbundling (Order No. 888) and voluntary RTOs (Order No. 2000). FERC proceeded incrementally and found that the incentive of transmission-owning utilities and the potential for exercise of market power remained.

FERC was correct in its assertion of jurisdictional authority in the SMD NOPR and has no need to bribe utilities to join RTOs.

C. FERC May Order Transmission Expansion As A Remedy To Market Power

As noted above, vertically integrated utilities can withhold transmission expansion (i) to increase the value of their generation resources; (ii) to deny competitors access to the grid; or (iii) to gain congestion rents especially in load pockets.

Pursuant to FERC's mandate under Section 205 of the FPA to assure just and reasonable rates and FERC's mandate under Section 206 to redress undue discrimination, FERC could require transmission owners to show due diligence/reasonable efforts to expand transmission availability as a condition of market-based rate authority.

In addition or alternatively, FERC could require that RTOs address market power by ordering compensated transmission expansion where it is feasible to relieve congestion through expansion. In the SMD NOPR, FERC recognized that transmission congestion may reflect exercise of market power. The problem that FERC has correctly identified is not addressed by the market power mitigation proposal in the SMD NOPR, and as a result, the mitigation proposal should be expanded. Where market power is found to exist due to constrained transmission facilities, the RTO or the ITP could be charged with requiring a demonstration of best efforts/due diligence by transmission owners to relieve the constraint.

1. FERC Recognized in the Market-Based Rates Investigation Docket (EL01-118-000) That Sec. 206 Gives FERC Authority To Revoke Market-Based Rates If Market Power Is Exercised

FERC recognized in its order establishing the Market-Based Rates Investigation docket (EL01-118-000) that it has a statutory obligation to assure that rates charged by power

marketers and other utilities with market-based rate authority are just and reasonable and do not reflect exercise of market power:

> We have a responsibility under the FPA to monitor wholesale markets to ensure that jurisdictional rates in the markets remain within a zone of reasonableness. <u>Our responsibility is to ensure that sellers not charge unjust and unreasonable wholesale rates, and that the market structures and market rules governing public utility sellers nationwide, and affecting the wholesale rates of such public utility sellers, do not result in, or have the potential to result in, wholesale rates that are unjust, unreasonable, unduly discriminatory, or preferential. We have become increasingly concerned about the potential that public utilities with market-based rate authorization might, under certain circumstances, exercise market power or engage in anticompetitive behavior that could result in unjust or unreasonable rates</u>.[11]

The Market-Based Rates Investigation docket focused on physical and economic withholding of generation. FERC would impose refunds or the sanction of revocation of market-based rate authority if case-by-case review indicates that the utility has engaged in prohibited behavior. The same logic would apply if, on a case-by-case basis, FERC finds that a given utility in an exercise of market power has failed to provide reasonable transmission access to competitors through unreasonable refusal to expand facilities. Transmission is the paradigmatic essential facility and deliberate under-building can result in withholding and discrimination against competitors. The same statutory authority and objectives would justify a similar utility-specific review of whether transmission-owning utilities have exercised market power by unreasonably failing to expand transmission.

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[11] <u>Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations</u>, 97 FERC ¶ 61,220, at 61,976 (2001) (emphasis added).

2. Adequate Mitigation Of Market Power Is An Essential Precondition Of FERC's Market-Based Rate Authorization

As a precondition to obtaining approval to charge market-based rates, the seller and its affiliates must show that they lack generation and transmission market power or mitigate any market power that they may have. The major concern of the Commission was whether the seller or its affiliates could limit competition and thereby drive up prices. If the seller or its affiliates owned or controlled transmission facilities it could, by denying access or imposing discriminatory terms or conditions on transmission service, foreclose other generators from competing. In Heartland Energy Services, Inc., 68 FERC ¶ 61,223 (1994), the Commission applied its comparability standard to an affiliated electric power marketer seeking blanket authorization to sell electricity at market-based rates. The Commission explained that for all future cases involving blanket approval of market-based rates "an offer of comparable transmission services will be required before the Commission will be able to find that transmission market power has been adequately mitigated." In the context of an affiliated power marketer, this has meant that all of its affiliated utilities must have a comparable transmission tariff on file. Post Order No. 888, the open access requirement in power marketer approval dockets is a superfluous condition given that FERC rule imposed open access on all transmission owners.

Open access is insufficient to mitigate market power where transmission is constrained. To assure that mitigation of transmission market power is meaningful, on a case-by-case basis, FERC must adjudicate that utilities have exercised best efforts/due diligence to relieve transmission constraints and that utilities have not deliberately exercised market power by unreasonably refusing to expand.

3. Order No. 888 Requires Transmission-Owning Utilities To Expand Transmission Facilities To Meet Firm Commitments To Avoid Exercises Of Market Power; It Is A Logical Extension To Impose The Duty To Expand To Non-Firm Commitments Where Necessary To Avoid A Given Utility's Exercise Of Market Power

FERC recently addressed the circumstances under which a transmission owner can be required to build new transmission in NEPOOL, 100 FERC ¶ 61,259 (September 6, 2002). In this order, FERC explained why the Order No. 888 obligation to build additional facilities does not apply in unique circumstances of Cross Sound Cable merchant transmission project. What is significant, however, is the discussion comparing merchant transmission facilities with vertically integrated transmission owners who may exercise market power when they refuse to expand transmission facilities.[12] The OATT imposes a duty to expand

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[12] The Commission explained:

> NEPOOL explains that the pro-forma open access tariff of Order No. 888 was the response to the Commission's conclusion that "the key to competitive bulk power markets is opening up transmission services." The Commission found that vertically integrated utilities -- "monopoly suppliers to their native load" -- exercised market power through the control of transmission. Because open access places vertically integrated utilities' generation at risk, the Commission reasoned, the "utilities have an incentive to deny access by . . . offering transmission services inferior to those used by the transmission owner."
>
> ...
>
> NEPOOL contends that it is evident that the obligation to expand was not directed to merchant transmission owners. First, the predicate for the obligation to expand long predates the existence of merchant transmission. Indeed, the Commission's finding of undue discrimination -- to which the obligation to expand is addressed --was directed at traditional vertically integrated utilities... Unlike a traditional utility, CSC LLC has no generation, no service territory, no native load, no obligation to serve or concomitant right to recover a revenue requirement, and finally, no right of condemnation associated with any transmission expansion. Unlike a traditional utility whose obligation to expand to serve wholesale transmission customers is comparable to its obligation to expand as necessary to serve native load, CSC LLC has no obligation to native load. Accordingly, NEPOOL contends that the principles of comparability do not warrant an obligation by CSC LLC to expand to serve wholesale transmission customers.
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> Second, NEPOOL states that the open access tariff was intended to mitigate monopoly utilities' potential exercise of market power. CSC LLC is not a monopoly and has no ability to exercise market power as an owner of CSC. Further, NEPOOL argues, the reason the Commission authorized CSC LLC to sell CSC transmission rights at negotiated rates, rather than regulated rates, was

transmission for firm transmission customers on the conventional IOU subject to compensation. See Order No. 888 final rule, 61 Fed. Reg. 20,540 (1996), Tariff provisions §§ 13.5, 15.4 and 27. The OATT establishes the principle that a duty to build facilities may be necessary to redress market power, although the OATT is limited to "firm" transactions.

4. Expansion of Transmission Facilities Could Be Ordered Under The Market Power Mitigation Features of the SMD NOPR

The SMD NOPR at Paragraph 434 provides that the Market Monitor's work "must be integrated into the regional planning process. The market monitor's analysis of the markets will identify load pockets and can help provide direction for needed investment in generation, including distributed generation, demand response capability and transmission infrastructure to improve the competitive structure of markets." (Emphasis added.)

Despite the recognition that transmission infrastructure may bear on market power, the market power mitigation provisions of the NOPR are limited to measures related to generation market power such as must run units and bid caps. While these measures are much needed to address other incidents of market power, the SMD NOPR does not go far enough to address market power caused by transmission constraints that vertically owned utilities have no incentive to resolve. FERC can and should utilize its Section 206 authority to put teeth into the requirement that RTOs and ITPs require implementation of *compensated* transmission enhancements where necessary to mitigate market power.

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because CSC LLC was not in a position to exercise market power. Even if all CSC capacity were to be withheld (which would not be allowed under the OASIS posting requirements from the Commission's June 2000 Order), that would not denigrate the competitive status quo ante. As a result, NEPOOL contends, there is no purpose served in directing an obligation to expand to the CSC.

5. The Essential Facilities Doctrine Provides Support

A recent decision, Covad Communications v. BellSouth Corp., 299 F.3d 1272 (11th Cir. 2002), is instructive. Covad is a seller of high-speed Digital Subscriber Line (DSL) internet service (dial-up Internet access). BellSouth is a regional telephone service and telecommunications provider that also sells DSL service. Covad and BellSouth entered into an "interconnection agreement" to allow Covad to provide DSL service to consumers over BellSouth's existing telephone lines. To bring its services to consumers in BellSouth's region, Covad must have dependable, timely, and affordable access to the local telephone network controlled by BellSouth. The local telephone network facilities controlled by BellSouth cannot practicably be duplicated. Thus, to operate feasibly, Covad must be able to "interconnect" its DSL network with BellSouth's local telephone network, which means, at its most basic, that Covad needs to be able to connect its wires to the BellSouth wires that make up the local telephone network.

Covad's complaint alleged that BellSouth frustrated its competitor's access to the essential facility it controlled by denying Covad access on the basis that space was inadequate. The court denied BellSouth's motion to dismiss on the basis that Covad stated sufficient facts to state a claim under the Sherman Act. The court observed:

> Covad complains that BellSouth denied Covad the use of an "essential facility," namely its network of telephone lines. Although, as Covad recognizes, the antitrust laws in general do not require that firms (including monopolies) affirmatively help their competitors to succeed, there is a narrow exception to this general rule when a monopolist improperly withholds access to an "essential facility" without which a competitor cannot enter or compete in a market. *See*, *e.g.*, *Consolidated Gas Co. of Fla., Inc.*

Id. at 61,925. With respect to merchant transmission power, FERC issued a notice on November 26, 2002 in Docket RM01-12-000, inviting comment on whether merchant transmission should have an obligation to expand.

> *v. City Gas Co. of Fla.*, 880 F.2d 297, 301 (11th Cir. 1989) (hereinafter, "Consolidated Gas I").

Id. at 1284. The court found that monopoly leveraging could occur if BellSouth, which at present has no monopoly in the high-speed internet market, "used its monopoly in the communications market by refusal to deal with or provide essential facilities to competitors in the high-speed internet market." Id. at 1284. Monopoly leveraging can violate the Sherman Act, § 2.[13] BellSouth argued that the Essential Facilities Doctrine imposes no duty on the monopolists to build. The court found that Covad's allegations were sufficient to state a claim whether or not it could ultimately prove a violation.

Industrial Consumers do not argue that in every instance a transmission monopolist's refusal to upgrade transmission facilities is inevitably an example of monopoly leveraging or a violation of the Sherman Act. However, significant delay or denial of access to essential facilities on reasonable terms raises serious competitive concerns and justifies FERC scrutiny to assure itself that the conduct is not anticompetitive and an abuse of market power.

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[13] The court explained the Essential Facilities Doctrine as follows:

> The withholding of access to an essential facility without which a competitor cannot enter or compete in a market is a violation of the antitrust laws. *See Consolidated Gas I*, 880 F.2d at 301. Under the well-established "essential facilities" doctrine, an inference of anticompetitive intent in violation of Section 2 arises upon a showing of four elements: (1) control of the essential facility by a monopolist; (2) a competitor's inability practically or reasonably to duplicate the essential facility; (3) the denial of the use of the facility to a competitor; and (4) the feasibility of providing the facility. *See MCI Communications Corp. v. AT&T*, 708 F.2d 1081, 1132-33 (7th Cir. 1983). By exercising its control over an essential facility (sometimes called a "bottleneck") to withhold access to that facility, a monopolist can exclude competition. For example, in *Consolidated Gas I*, we found that a massive system of natural gas pipes controlled by the defendant was an essential facility. Control over that bottleneck, the gas pipelines, enabled the defendant to exercise its power in the market to exclude competition. *See Consolidated Gas I*, 880 F.2d at 301. "Thus, the antitrust laws have imposed on firms controlling an essential facility the obligation to make the facility available on non-discriminatory terms." *MCI*, 708 F.2d at 1132.

Id. at 1285.

CONCLUSION

Industrial Consumers urge FERC to rely on its existing statutory authority to compel utilities to functionally separate generation and transmission and alleviate transmission constraints, in lieu of allowing incentives that may prove to be windfalls to utilities. We caution that on judicial review, the incentive pricing that it proposes may be invalidated under the precedent of the D.C. Circuit and the Commission.

DESCRIPTION OF INTERVENORS

The Electricity Consumers Resource Council (ELCON) is an association of industrial consumers of electricity organized to promote the development of coordinated and rational federal and state policies that will assure an adequate, reliable, and efficient electricity supply for all users at competitive rates. ELCON member companies produce a wide range of products from virtually every segment of the manufacturing community. The member companies of ELCON consume approximately five percent of all electricity in the United States.

The American Iron and Steel Institute (AISI) is the principal trade association of the North American steel industry. Its member companies account for about seventy percent of the raw steel production in the United States. The steel industry is one of the most energy-intensive sectors in the United States; the cost of electricity for AISI members may constitute as much as twenty percent of the manufacturing cost of a steel mill product.

The American Chemistry Council (ACC) represents the leading companies engaged in the business of chemistry. The business of chemistry is a $450 billion enterprise and

a key element of the nation's economy. It is the nation's largest exporter, accounting for ten cents out of every dollar in U.S. exports.

The Coalition of Midwest Transmission Customers (CMTC) is an ad hoc coalition of large industrial end-users of electricity. All CMTC members operate one or more manufacturing facilities in the Midwest and purchase electric delivery service or bundled electric service from at least one of the transmission owners encompassed by the Midwest ISO or the companies comprising the formerly proposed Alliance RTO. CMTC members consume more than 3 billion kilowatt-hours of energy annually.

The PJM Industrial Customer Coalition (PJMICC) is an ad hoc coalition of 38 large commercial and industrial consumers of electricity. PJMICC members operate manufacturing and institutional facilities throughout Delaware, New Jersey, Maryland, and Pennsylvania, as well as in West Virginia and Virginia, which are served by PJM West. PJMICC member companies consume more than 7.7 billion kilowatt-hours of electricity annually.

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Dated: March 17, 2003