



# AFFILIATE TRANSACTION AND MARKET- BASED RATE POLICIES CRITICAL COMPONENTS OF THE NEW MARKET DESIGN

The Eleventh Annual FERC Briefing  
EXNET/Bruder, Gentile & Marcoux, L.L.P.  
The Next Generation of Issues for Utility Management  
March 15, 2005

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## *Old Market Features*

- ✦ Command & Control
- ✦ Local integrated utility typically sole provider
- ✦ “Cost plus” rate regulation – emphasis on curbing high profits not achieving low prices
- ✦ Least cost planning
- ✦ Cost-based power pools
- ✦ Beauty in beholder’s eye
  - ✦ Old markets were dinosaurs, non-dynamic, inefficient, without customer choice, or
  - ✦ Old markets lacked instability and volatility and provided reliable service at predictable, reasonable prices; not the hare but the tortoise who won the race every time

## *New Generation Market; Affiliate Transactions*

- ☀ Affiliate power sale not tainted by affiliate abuse concerns if
  - ☀ There are no captive wholesale customers, and
  - ☀ Retail customers protected by retail choice, or if
  - ☀ Transaction only involves unregulated affiliates
- ☀ Otherwise, affiliate transactions under a cloud
- ☀ Three Cases: *Edgar*, 55 FERC ¶ 61,382; *Mountainview*, 106 FERC ¶ 61,183; and *Allegheny*, 108 FERC ¶ 61,082

## *Affiliate Transactions Under a Cloud*

- ✦ *Edgar* 1991, inter-affiliate market-based rate rejected
  - ✦ Utility failed to demonstrate either
    - ✦ absence of affiliate abuse and competitiveness of rate, or
    - ✦ cost justification
- ✦ *Mountainview* 2004
  - ✦ Resuscitates and broadens *Edgar*
  - ✦ Departs from prior policies routinely permitting cost-based affiliate power sales

## *Affiliate Transactions Under a Cloud, cont.*

- ✦ *Mountainview* proclaims new policy: *Edgar* affiliate abuse tests apply whether affiliate transactions are at cost or market
- ✦ *Mountainview* objectives:
  - ✦ Protection of production markets
  - ✦ Afford unaffiliated producers opportunity to sell
- ✦ *Mountainview* recognition:
  - ✦ Robust generation market with numerous, independent participants is consumer's best friend; achieves long-term consumer benefits
  - ✦ Lower price for affiliate purchase only a short-term benefit

## *Allegheny Ground Rules*

- ✦ *Allegheny 2004*, adopts RFP/auction to protect against affiliate abuse through
  - ✦ Provision of equal opportunity to unaffiliated suppliers
  - ✦ Protection against affiliate favoritism
- ✦ *Allegheny RFP characteristics*
  - ✦ *Transparency*: competitive solicitation must be open and fair
  - ✦ *Precise product definition*: parties must understand the product being sold
  - ✦ *Standard evaluation criteria*: must apply equally to all bids and bidders
  - ✦ *Independent third party*: to design solicitation, administer bidding, and evaluate bids

## *Allegheny Hearings*

- ✦ RFPs not always required
- ✦ Hearing likely required if RFP not conducted
- ✦ Implied requirement to show cause why RFP not conducted
- ✦ Hearing also required if RFP procedures not fully followed
- ✦ Purpose – purge affiliated transactions of discrimination against non-affiliated suppliers

## *Limitations on Affiliate Policies*

- ✦ Uncertain impact on exchange agreements among holding company subsidiaries; old agreements probably grandfathered
- ✦ Potential conflict between *Allegheny* policy and SEC integration requirement
- ✦ Inter-affiliate joint planning at risk
- ✦ Whether same rules should apply to
  - ✦ Transactions between and among regulated affiliates
  - ✦ Transactions between regulated and non-regulated affiliates

## *The OGE Case And Asset Transactions*

- ★ *Oklahoma Gas & Electric ("OGE")*, 105 FERC ¶ 61,297
  - ★ Lonely petunia in the onion patch – a transaction between non-affiliates in a discussion of affiliated transactions
  - ★ Integrity of production markets underscores both *OGE* and affiliate transaction policy
  - ★ *OGE* reflects FERC bias against integrated utility purchase of IPPs located in utility service area
  - ★ Conversion of IPP to utility directly-owned or affiliate-owned generation weakens production market through
    - ★ Increase in market concentration
    - ★ Elimination of competitor from market place
    - ★ Integrated utility incentive to acquire still other competitors

## *The OGE Case And Asset Transactions, cont.*

- ✦ In purchasing IPP generator, OGE
  - ✦ Claimed no market concentration change and/or mitigation since
    - ✦ Transmission enhancement would increase import capability
    - ✦ Purchases under other expiring IPP contracts would terminate
  - ✦ FERC rejected OGE position
    - ✦ Found no causal relationship between OGE purchase and either transmission enhancement or other terminating IPP contracts
    - ✦ Ordered hearing
    - ✦ Eventually approved purchase subject to more stringent mitigation



## *The OGE Case And Asset Transactions, cont.*

- ★ FERC has allowed several acquisitions similar to *OGE*
  - ★ Distinction is existence of long-term power purchase contract between utility and acquired IPP
  - ★ Thus acquisition arguably does not affect market concentration
  - ★ Acquisition equivalent to contract buy-out

## *The Ameren Case And Affiliate Asset Transactions*

- ★ Like *OGE*, *Ameren*, 108 FERC ¶ 61,081 concerns acquisition by regulated utility of generator
- ★ Unlike *OGE*, regulated utility and selling utility were affiliates
- ★ Pre-*Ameren* FERC merger policy did not consider affiliate issues except that
  - ★ Inter-affiliate asset transfer presumed not to change market concentration and raise competition concerns
  - ★ Without rate or regulatory concerns, inter-affiliate transactions routinely approved



## *The Ameren Case And Affiliate Asset Transactions*

- ✦ *Ameren* establishes new policy for asset transactions between regulated utility and unregulated affiliates
- ✦ FERC found that regulated utility acquisition of affiliated non-regulated generation
  - ✦ Creates safety net for non-regulated affiliates with unprofitable generation projects
  - ✦ Same safety net not available to IPPs
  - ✦ Transaction also potentially detrimental to regulated utility consumers

## *The Ameren Case And Affiliate Asset Transactions*

- ★ Due to concerns, FERC initiated hearing and
  - ★ Held that *Edgar* affiliate abuse criteria would apply to all future asset transactions between a regulated utility and its non-regulated affiliates
  - ★ Described *Allegheny* RFP rules as the most effective demonstration of absence of affiliate abuse

## *Entergy-Perryville, A FERC Jurisdictional Gap*

- ✦ *Perryville*, 109 FERC ¶ 61,019, another non-affiliate asset transaction with implications for affiliate transaction policies
- ✦ In *Ameren*, FERC rejected Applicants' contention that step-up transformers inadequate to support FERC Section 203 jurisdiction
- ✦ In *Perryville*, Entergy purchased generator without step-up transformer, which is
  - ✦ Classified as "transmission"
  - ✦ Without significant investment but often more than \$50,000 jurisdictional minimum
  - ✦ Jurisdictional tail that wags non-jurisdictional dog

## *Entergy-Perryville, A FERC Jurisdictional Gap, cont.*

- ✦ Used to assert jurisdiction, but
- ✦ Ignored in FERC public interest analysis
- ✦ Entergy claimed no FERC jurisdiction since only non-jurisdictional generation facilities acquired
  - ✦ FERC agreed it lacked jurisdiction
  - ✦ Major jurisdictional gap created for market power purposes
    - ✦ FERC recourse is its market-based rate (“MBR”) authority
    - ✦ Notice obligation to FERC of a Perryville-type transaction
    - ✦ FERC could revoke MBR authority if permissible market concentration levels exceeded

## *Entergy-Perryville, A FERC Jurisdictional Gap, cont.*

- ✦ Jurisdictional gap also created for *Ameren*-type asset transactions between regulated and unregulated affiliates
- ✦ FERC market power remedies irrelevant to affiliated asset transaction since affiliated generation already treated as under single utility ownership
- ✦ FERC did not rely on seller's books, records and rate schedules ("BRR") to assert jurisdiction. Perhaps BRR inadequate as jurisdictional base or inapposite if acquisition is only of seller's asset and not seller itself

## *Market-Based Rates (MBR)*

- ✦ *Entergy, AEP* and *Southern* orders revamp MBR test
- ✦ Discard "hub and spoke" analysis for failure to show market power
- ✦ Adopt interim Pivotal Supplier Assessment (PSA) and Wholesale Market Share Assessment (WMSA) tests
- ✦ Post July 9, 1996 capacity additions continue automatic eligibility for MBR authority except FERC determines whether combination of old and new generation can create market power

## *MBR Authority, Relevant Geographic Markets*

- ✦ Equate geographic markets with utility control area unless Applicant
  - ✦ Located in RTO that has sufficient market structure, *i.e.*,
    - ✦ A single energy market with single control commitment and dispatch, and
    - ✦ FERC-approved market monitoring and mitigation
- ✦ PJM, New England, New York, California and apparently MISO Day 2 are approved MBR markets
- ✦ Rehearing on MISO Day 2 Market pending
- ✦ Non-RTO Applicant can also attempt *ad hoc* proof that market broader than local control area appropriate

## PSA and WMSA Characteristics

- ✦ PSA and WMSA aimed at capacity available to serve wholesale market
  - ✦ Purport to eliminate retail load and capacity needed to serve retail load
  - ✦ Include all uncommitted capacity
    - ✦ Either located within the market or
    - ✦ Importable into the market on simultaneous import basis
    - ✦ Whether owned or controlled by Applicant or Applicant's affiliates
- ✦ PSA applied in peak month of the year

## PSA and WMSA Characteristics, cont.

- ☀ PSA measures ability to serve market without Applicant's capacity
- ☀ WMSA determines if Applicant has 20% or more of available capacity
- ☀ WMSA test applied seasonally

## *PSA and WMSA Tests – Who Passes?*

- ★ Applicants likely to pass both tests if relevant market is
  - ★ Not within control area maintained by the Applicant or its affiliate
  - ★ Within RTO approved by FERC as a market for MBR purposes
- ★ Applicants who do maintain control areas outside of approved MBR RTOs are likely to
  - ★ Pass the PSA screen
  - ★ Fail the WMSA screen
- ★ New FERC MBR criteria create significant incentives for RTO formation and membership

## *PSA and WMSA Screens -- Consequences of Failure*

- ✦ PSA and WMSA screens “indicative”
- ✦ Failure of either screen
  - ✦ Does not result in market power finding
  - ✦ Does trigger hearing to determine if Applicant has market power
  - ✦ Unclear if Applicant failing a screen could avoid hearing through reliance on alternative evidence
- ✦ MBR authority continued during hearing, subject to refund
- ✦ For triennial renewal applicants with pre-existing MBR authority, FERC has burden of proof to show Applicant has market power

## *Finding of Market Power*

- ★ If Applicant has market power, Applicant may
  - ★ Lose MBR authority in its own market but retain MBR authority in other markets
  - ★ Propose mitigation plan
- ★ FERC default mitigation plan:
  - ★ Sales for one week or less priced at Applicant's incremental cost plus 10%
  - ★ Sales for more than one week but less than one year priced "up to" embedded costs of unit or units expected to make sale, and
  - ★ Sales of power for a year or longer priced on an embedded cost basis

## *Finding of Market Power, cont.*

- ✦ Mitigation proposal
  - ✦ Need not be deferred until end of proceeding
  - ✦ Can be offered as part of initial MBR filing or when FERC initiates hearing
- ✦ Forego MBR authority
  - ✦ Applicant at any time may forego MBR authority
    - ✦ Only in its own market
    - ✦ Also in other markets

## *Other MBR Requirements*

- ☀ Applicant must also:
  - ☀ Demonstrate absence of vertical market power
  - ☀ Demonstrate absence of affiliate abuse or reciprocal dealing
  - ☀ Adopt FERC market behavior rules
  - ☀ Report MBR sales on FERC's EQR (Electronic Quarterly Report) system
- ☀ Market behavior rules trigger refund obligation if utility engages in anticompetitive or abusive practices



## *Other New Market Features*

- ✦ Retail choice in many jurisdictions
- ✦ Major shift of jurisdiction to FERC over unbundled transmission service for ultimate consumers and over much larger sales volume
- ✦ Restructuring of many utilities
- ✦ Reliance on market-based rates
- ✦ RTO adoption of
  - ✦ Financially-based congestion management



## *Other New Market Features*

- ✦ Hourly and Day-ahead markets
- ✦ Bid-based dispatch
- ✦ Region-wide transmission tariffs
- ✦ Inter-RTO coordination agreements

## *The Markets: The Old Versus The New*

### OLD

Stability

Reliance on planning

Encourage base load generation investment

Monopoly power

Regulation controls profit not prices

Physical congestion management

### NEW

Volatility

Reliance on market

Encourage capital recoveries in short term

Premium on deconcentrated markets; market monitoring as a back-stop

Competition controls prices not profits

Financial congestion management



## *The Markets: The Old Versus The New, cont.*

Market fragmentation

Limited customer choice

State regulation

Vertical integration; suppliers control transmission

Trickle down decision making – utilities/regulators control consumers

Market consolidation

Broader customer choice

Bigger FERC regulatory role

Disaggregation; common carrier transmission

Trickle up decision making – consumers exercise control through market mechanisms