

UTILITY/AFFILIATE POWER SALES: HAS THE DEATH KNELL SOUNDED?

Energy Bar Association
Southern Chapter
April 25, 2005



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The Edgar Standards

- Boston Edison proposed to purchase energy from Edgar Electric, an affiliate, at rates set based on comparison to the market.
 - 15 contracts negotiated by BECO over 3 years;
 - an RFP resulting in 48 proposals from QFs;
 - 34 QF/IPP contracts signed in Massachusetts;
 - 2 IPPs whose rates were approved by FERC.
- FERC rejected the rates without prejudice, stating that there was not a clear showing of a lack of potential for affiliate abuse. *Boston Edison Company Re: Edgar Electric Energy Company*, 55 FERC ¶ 61,382 (1991).

FERC's "Edgar" Standards for Utility Purchases from Affiliates

- A utility may demonstrate that there is head-to-head competition, where:
 - the solicitation or negotiation was designed and implemented without undue preference;
 - the analysis did not favor the affiliate, in particular regarding non-price terms;
 - the affiliate was selected based on a reasonable combination of price and non-price factors.
- A utility may demonstrate that the price is reasonable based on the prices that non-affiliated buyers were paid for similar services, provided that the other buyers are in the relevant market and were not subject to market power.
- A utility may demonstrate benchmark evidence of prices, terms and conditions of sales by non-affiliated sellers to the utility or others in the relevant market at the same period of time and for similar services.

FERC's Rationale for Rejecting the Edgar Filing

- FERC must be certain that the buyer has chosen the least-cost option, taking into account both price and non-price terms.
- Transactions must be "above suspicion"; not only must there be no affiliate abuse – there must be no **potential** for affiliate abuse.
- FERC was concerned that the utility has an incentive to favor its affiliate even if it is not the least cost supplier, because that would benefit its shareholders.
- Consequently, evidence of a competitive marketplace with sufficient supply options and no barriers to competition through the control of transmission was not sufficient to show that the price is reasonable.

Reasons for Rejection of Edgar's Prices

- The company had inadequate documentation of the cost of the Edgar contract and the alternatives.
- It failed to include non-price factors in the rankings of alternatives or to show how it calculated the scores of potential alternative suppliers.
- Data on benchmark sales were not shown to reflect similar services in the relevant market.
- The company did not demonstrate that all relevant contemporaneous purchases were included in the comparison.

Mountainview – The FERC Broadens the Edgar Decision

- Southern California Edison proposed to purchase power from Mountainview, a to-be-acquired affiliate, at cost-based rates that gave Mountainview incentives to control discretionary costs and maintain high availability and a low heat rate.
- The FERC accepted the agreement, but required Mountainview to modify the rates in several respects to ensure that the charges reflect its actual costs, rather than fixed rates that are based on cost estimates; and to conform in all respects to the requirements placed on utilities selling power at cost-based rates.
- The FERC also held that in the future it would require all affiliate long-term power sales agreements, at cost-based or market-based rates, to be subject to the *Edgar* standards. *Southern California Edison Company*, 106 FERC ¶ 61,184 (2004).

Mountainview – The FERC Broadens the Edgar Decision continued

- The Commission stated that it was concerned that undue preferences to affiliates could cause long-term harm to the wholesale market by discouraging non-affiliates from adding supply.
- The Commission also held that restricting SCE's resale of the output of Mountainview to spot market sales at the marginal cost of each unit would address concerns that SCE could depress market prices by bidding Mountainview into the market at below cost.

FERC's Objectives in Mountainview

- FERC was faced with a sharp decline in the number of planned generators that were being completed. Construction had been suspended.
- FERC also saw a trend toward the purchase of independent generators by utilities. Mountainview had three owners before SCE proposed to purchase it.
- Post-Enron, FERC also was concerned about the ability of large owners of generation to affect the market through bidding strategies. It concluded that this could be avoided by broadening the number of owners of generation and restricting the bidding practices of the large owners.
- FERC wanted to protect and encourage production markets, having concluded that a robust generation market with numerous participants achieves long-term consumer benefits.

Allegheny Energy Supply – the FERC Establishes New Standards

- AE Supply was selected to supply a portion of Potomac Edison's standard offer service obligations.
- The contract was awarded pursuant to a public RFP that was designed through a proceeding at the Maryland PSC; provided for all bidders to be pre-qualified using publicly available criteria; was monitored by an independent consultant; and the results of which were approved by the Maryland PSC.
- The FERC held that the RFP met the *Edgar* standards. It also provided guidance on the standards it will use to evaluate future RFPs to ensure that affiliates do not receive undue preference.

The Allegheny Energy Supply Standards for RFPs

- **Transparency:** The solicitation must be an open and fair competition in which all parties have equal access to information. The utility should use a public solicitation, not one in which selected parties are invited to bid.
- **Definition:** Products sought must be precisely defined and nondiscriminatory.
- **Evaluation:** Criteria for evaluation must be standardized, publicized and applied equally. The utility should specify the importance of each evaluation criterion. A third party should negotiate with short-listed bidders if an affiliate is involved.
- **Oversight:** An independent third party should design the solicitation, administer bidding and evaluate bids prior to the company's selection.

Conectiv Energy Supply – A “Reductio ad Absurdum”?

- Delmarva Power & Light notified suppliers that it would seek bids for service to its retail load and published the RFP on its web site. It pre-qualified bidders so that they competed only on price terms; non-price terms were non-negotiable. It awarded the contract to CESI, an affiliate, which had the lowest price of the 7 bidders.
- Delmarva did not use an independent third party to design the solicitation, administer bidding or evaluate the bids, but it used the same process that the Commission had approved in the *Allegheny* case.
- FERC held that since an independent third party had not been involved, the RFP did not meet the “oversight” criterion. It cited the inability to determine whether CESI received preferential treatment at any stage of the proceeding, such as the pre-qualification process, and it set the matter for hearing.
Conectiv Energy Supply, Inc., 109 FERC ¶ 61,385 (2004).

Conectiv Energy Supply – A “Reductio ad Absurdum”? continued

- Commissioner Kelliher dissented, stating that the Commission should have approved the contract since the Commission had approved the RFP process in *Allegheny* and no protests had been filed. He stated that the *Allegheny* criteria should be guidelines rather than a bright line test.
- It seems unlikely that the Commission will achieve any additional protection of competition as a result of setting the case for hearing. The proceeding is now in settlement negotiations.

Wisconsin Public Service – A Meaningless Exercise?

- WPSC filed a renegotiated power sales agreement with its affiliated utility, Upper Peninsula Power Company. UPPCO is in a transmission-constrained area and had not received any responses to three previous RFPs other than responses from WPSC.
- WPSC proposed to charge UPPCO the average price WPSC charges under its market-based rate authority to non-affiliated wholesale long-term power purchasers in the region, which resulted in a reduction in the rates that otherwise would be charged to UPPCO.
- The Commission held that another RFP was not necessary, given the past history. However, it set the matter for hearing, stating that the rates had not been shown to be just and reasonable. *WPSC*, 109 FERC ¶ 61,319 (2004).

The WPSC Decision – Matters Set For Hearing

- Whether the price was set based on a sufficiently large sample of contracts to ensure a lack of affiliate abuse.
- Whether power purchase agreements between WPSC and other wholesale customers allow comparable variations in annual power nominations.
- Whether a similarly situated customer would be permitted to terminate an unfavorable power supply contract.
- Whether the new agreement is likely to reduce UPPCO's costs after the end of the superseded agreement.
- Whether an automatic renewal clause is appropriate in an affiliate transaction.
- Whether UPPCO's wholesale power customers are likely to be put at a competitive disadvantage given their formula rate pass-through of these costs and the transmission constraints.

Lesson Learned # 1: State Commission Oversight May Not Be Relevant

- The Massachusetts (Edgar), California (Mountainview), Maryland (Allegheny) and Virginia (CESI) commissions approved the RFP processes, were closely involved and/or filed interventions in support.
- The FERC has shown no inclination to defer to state commission involvement or determinations, even where the sale is solely for the purpose of supplying retail customers.
- The FERC has on several occasions rejected restrictions by state commissions on sales of power by marketing affiliates to their utilities, asserting that the matter is subject to its exclusive jurisdiction.
- The FERC evidently has concluded that the need to oversee the wholesale markets overrides any incentive to grant deference to state commissions with respect to the oversight of power purchases by utilities.

Lesson Learned #2: It's a "Lower of Cost or Market" Environment

- The *Edgar* decision applied market evaluation criteria to a market-based price: head-to-head competition, comparability to similar transactions in the relevant market and benchmark evidence.
- The *Mountainview* decision required cost-based contracts to be subject to the market evaluation standards, and *Allegheny* expanded the evaluation criteria.
- Utilities that make power purchases from affiliates at cost are also subject to market-based evaluations. Consequently, they are subject to "lower of cost or market" limits on prices.
- In WPSC/UPPCO, FERC was evidently concerned about affiliate abuse resulting from lowering the price charged by one regulated utility to another.

Lesson Learned # 3:

FERC Will Set All for Hearing All Affiliate Transactions that Do Not Result from RFPs that Meet the *Allegheny* Criteria

- Commissioner Kelliher correctly pointed out in *CES* that the FERC was using *Allegheny* as a “bright line” instead of as guideline. Doing so wastes resources; the FERC should have known that it would not achieve a lower price as a result of setting the case for hearing.
- FERC set the WPSC/UPPCO case for hearing even though the price was below cost and there obviously was no competitive market in the UPPCO region. The contract could not have an adverse impact on other suppliers in the market or competition in general – the asserted reasons for expanding the FERC’s oversight of such transactions.
- It is almost certain that the Commission will also set for hearing all cases that attempt to justify rates based on the other criteria set out in *Edgar* – comparisons to the prices paid by other purchasers and benchmark data.

Lesson Learned # 4: FERC's Decisions May Have Additional Implications

- FERC has now applied its criteria to a transaction between two affiliated regulated utilities. Will it apply them to all transactions between holding company affiliates?
 - Sales between holding company affiliates of temporarily unneeded "lumpy" new generation.
 - Sales of jointly planned new generation by a utility service company to its operating companies.
- FERC has not discussed (or evidently considered) the implications for utilities subject to the Public Utility Holding Company Act:
 - Sales at cost.
 - Requirement of integrated operation.

Lesson Learned # 5: FERC Has a Strong Bias Against Affiliate Transactions

- FERC's decisions could be interpreted as an almost paranoid concern about affiliate abuse; or a fundamental intention to force the industry to give a greater market share to independent generators. Either interpretation leads to the same result.
- FERC's concern with opening up the market can be seen elsewhere:
 - *Oklahoma Gas & Electric*, where FERC held that a purchase of an IPP whose long-term power sales contract was expiring resulted in an adverse effect on competition in the absence of mitigation;
 - *Ameren*, in which FERC expanded the *Edgar* criteria to evaluations of utility acquisitions of their marketing affiliates' generation and encouraged use of the *Allegheny* RFP criteria.
 - *Entergy-Perryville*, where the FERC conceded that it had no jurisdiction over a sale of a generator without a step-up transformer, but held that it would evaluate changes in market share in the utility's market-based rate filing.

Lesson Learned # 5:

FERC Has a Strong Bias Against Affiliate Transactions continued

- Entergy Services, where the Commission trial staff filed testimony stating that Entergy had unfairly favored its affiliate's bid in response to an RFP.
- FERC has expressed concern with "recent trends" in the markets toward the re-integration of generation into traditional utilities. It intends to revise its affiliate transaction criteria in the pending market-based rate rulemaking, RM04-7-000.