UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Market-Based Rates for Wholesale Sales of Electric Energy, Capacity and Ancillary Services	Docket No. RM04-7-000

REPLY COMMENTS OF
AMERICAN PUBLIC POWER ASSOCIATION AND
TRANSMISSION ACCESS POLICY STUDY GROUP

The American Public Power Association ("APPA") and the Transmission Access Policy Study Group ("TAPS") appreciate the opportunity to submit reply comments in these important proceedings on the standards and process by which the Commission judges public utility sellers' eligibility for market-based rate ("MBR") authority. APPA and TAPS, which submitted Initial Comments in this proceeding on August 7, 2006 ("APPA/TAPS Initial Comments"), limit their reply comments to common positions taken by a number of parties.

EXECUTIVE SUMMARY

- The Commission must not adopt the skewed point of view advanced primarily by dominant, vertically integrated public utilities that MBR authority is their FPA-given right and that market power is not a concern in wholesale markets. As the Commission has correctly concluded, MBR authority is a privilege, not a right. Market power remains endemic in many geographic areas. Part I below.

- The Commission has the authority, responsibility and justification to impose a must-offer obligation as a condition to authorizing sales by sellers with market power. It should reject a narrow view of its authority. Part II below.

- The Market Share Screen remains a useful tool in MBR reviews, and the Commission should remain unpersuaded by claims that the Screen should be abandoned. Part III below.

- The Commission should proceed cautiously with any reliance on price indices to set mitigated prices, especially given its obligations to justify departures from cost-based and company-specific rates. Part IV below.

- Captive wholesale customers will not benefit from selective discounting from high ceiling rates; instead, they require non-discriminatory cost-based rates to protect them from market power. Part V below.
- The FPA requirement that the Commission provide initial and ongoing review of requests for MBR authorization demands that the Commission eliminate the exemption from MBR review for new generation units built after July 1996. Part VI below.
- The clear public benefits of the Commission's proposal for regional MBR reviews far outweigh any added burden on a handful of national companies. Part VII below.

While these Reply Comments focus on more widely advanced positions, APPA/TAPS also urge the Commission to reject out-of-hand extreme positions taken by isolated parties. For example, Southern Company (and apparently only Southern) continues to advocate the use of Total Transfer Capability ("TTC") as the measure of transmission capability for conducting the Initial Screens and the Delivered Price Test ("DPT"), Southern at 28-31,[1] even though in the April 14 Order and July 8 Rehearing Order the Commission correctly rejected TTC, because it "is a measure of the maximum transfer capacity of a transmission line, but it does not reflect reliability and operational limits on the line that reduce the amount of generation that could be simultaneously imported into an applicant's control area."[2] Another positional outlier is Reliant's call (Comments at 6-7)[3] for elimination of MBR reviews for sellers into markets with Commission-approved market power monitoring and mitigation and to instead rely exclusively on ISO/RTO market monitors, a regulatory scheme that would represent a

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[1] Initial Comments of Southern Company Services, Inc., filed Aug. 7, 2006 ("Southern Company" or "Southern").

[2] *AEP Power Mktg. Inc.*, 108 F.E.R.C. ¶ 61,026, P 46 (2004) ("July 8 Rehearing Order"); *see also AEP Power Mktg. Inc.*, 107 F.E.R.C. ¶ 61,018, P 81 (2004) ("April 14 Order").

[3] Comments of Reliant Energy, Inc., filed Aug. 7, 2006 ("Reliant").

clear abdication of the Commission's responsibilities.[4] The Commission should similarly reject Progress Energy's implication (Comments at 9, 15)[5] that cost-based rates for wholesale customers would wrongly deprive retail customers of revenues, thus resulting in a "rate class war" that pits retail ratepayers against wholesale ratepayers.[6] The Commission is not called upon to decide a struggle between wholesale and retail ratepayers, but to set a just and reasonable wholesale rate, which a Commission-approved cost-based rate surely is. The Commission's exclusive authority over wholesale rates does not require setting those rates at levels that subsidize retail customers.[7]

COMMENTS

I. THE COMMISSION MUST NOT LOSE PERSPECTIVE

A. MBR Authority is a Privilege

"The authorization to sell power at market-based rates . . . – as opposed to traditional, cost-based rates – is a privilege, and granted if, and only if, the Commission determines that an applicant's use of such rates will be just and reasonable." *Enron Power Mktg., Inc.*, 106 F.E.R.C. ¶ 61,024, P 13 (2004); *see also* July 8 Rehearing Order at P 25. While the Commission's statement could not be more clear, the comments of a number of public utilities, especially several vertically integrated utilities (or their representatives) that remain dominant in their home control or service areas, reflect an

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[4] *California ex rel. Lockyer v. FERC*, 383 F.3d 1006, 1013 (9th Cir. 2004) (Commission reliance on market-based rates requires ongoing assessment of seller market power).

[5] Comments of Progress Energy, Inc., filed Aug. 7, 2006 ("Progress Energy").

[6] Progress Energy's comments assume that the retail utility is even obligated to pass profits through to retail customers.

[7] *Nantahala Power & Light Co. v. Thornburgh*, 476 U.S. 953, 967-73 (1986); *Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, 487 U.S. 354, 369-77 (1988); *Midwest ISO Transmission Owners v. FERC*, 373 F.3d 1361, 1372 (D.C. Cir. 2004).

expectation that MBR authority is an FPA-granted legal right and that cost-based rates, as a remedy to market power, represents a deprivation of that right. The Commission must not adopt this skewed view of rate regulation under the FPA.

The comments of the Edison Electric Institute ("EEI") contain numerous examples of this point of view. EEI claims that continued use of the Market Share Screen will cause MBR authority "to be *unjustly* denied to the majority of vertically integrated utilities for wholesale sales within their control areas." EEI at 6 (emphasis added). EEI continues that the Market Share Screen "has been the major contributing factor in the *exclusion* of the majority of non-RTO vertically integrated utilities from participating through market-based rates in competitive wholesale markets." EEI at 9 (emphasis added). Later, EEI claims it would be "discriminatory" to prohibit a seller with market power from selling at market-based rates outside of its control area. EEI at 33. All of these statements reflect a sense of entitlement, contrary to the principle that MBR authority is a privilege.

EEI is not alone in holding the "MBR authority as entitlement" perspective. MidAmerican Energy Company ("MEC") and PacifiCorp oppose a cost-based, must-offer obligation on grounds that it would provide buyers with "guaranteed access to below-market rates."[8] This statement is in fact, most revealing, as it implies that public utilities are entitled to charge market-based rates that exceed their costs, even where the higher "market" price is determined in a market distorted by the seller's own market power. This view is wrong on at least two counts. First, customers purchasing under

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[8] MEC/PacifiCorp Comments at 22 filed Aug. 7, 2006; see also Progress Energy Comments at 14.

cost-based rates do not receive a windfall compared to a competitively set market-based rate, nor does denial of MBR authority leave the seller any worse off than it would have been in a truly competitive market, because a competitively set market-based rate and a cost-based rate should both provide the seller the opportunity to recover its costs (including a normal rate of return).[9] Second, if the denial of MBR authority causes a seller to forgo profits earned as a result of its market power,[10] such profits would be unjust and unreasonable and not lawful in any event. In other words, such rates would be excessive and exploitative.[11]

A sense of entitlement also underlies Southern's view that "no rebuttable presumption should attach to any screen 'failure' because doing so unfairly shifts the burden of proof to the applicant." Southern at 4. Southern seems to forget that the burden of demonstrating eligibility for MBR authority is *always* on the applicant. July 8 Rehearing Order at P 29. There is nothing "unfair" about requiring a seller to prove that it does not have or has mitigated market power, such that the prerequisites for MBR authority are satisfied. Because departures from cost-based rates must be justified,[12] the

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[9] Steven Stoft, POWER SYSTEM ECONOMICS: Designing Markets for Electricity 58-59 (2002); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) ("just and reasonable" rates should generate "enough revenue not only for operating expenses but also for the capital costs of the business"); *Farmers Union Cent. Exch. v. FERC*, 734 F.2d 1486, 1502 (D.C. Cir. 1984) (rates should fall within a "'zone of reasonableness,' where rates are neither 'less than compensatory' nor 'excessive').

[10] Similarly, the Commission should reject Progress Energy's suggestion (Comments at 14-15) that cost-based rates prevent a utility from fulfilling a commitment to retail customers to minimize costs. If the wholesale rate is just and reasonable, which a cost-based rate presumptively is, the retail customers do not have a legal basis to complain. Indeed, the Commission should not accept the proposition that one group of ratepayers should benefit from the supra-competitive rates paid by another set. Wholesale customers should not be retail customers' cash cows, and vice versa.

[11] *Farmers Union*, 734 F.2d at 1502 ("Rates that permit exploitation, abuse, overreaching or gouging are *by themselves* not 'just and reasonable.'") (emphasis in original).

[12] *Farmers Union*, 734 F.2d at 1502.

Commission should appropriately place the burden on sellers to demonstrate that they should enjoy the privilege of MBR authority.

B. Market Power Exists

Another example of some commenters' skewed perspective is their denial of any market power problem to be addressed. Several argue that, by refusing to sell in their home control/service areas, they are simply selling output in the broader market where it will receive the best price. Southern at 58-59.[13] However, this argument ignores the market power that the seller possesses at home. Captive customers have few or no supply alternatives in the home market and are constrained from accessing purchase opportunities in the broader market. Competing sellers are unable to reach customers within the dominant seller's constrained control/service area. Where the dominant seller sells its output outside its home market under these circumstances, it reduces output in the home market, which is not addressed simply by prohibiting the seller from selling at unmitigated prices.[14]

This market power problem is real and can be traced to the continued dominance of certain vertically integrated sellers. The Order 888 OATT accomplished many of the Commission's policy objectives, but a tariff alone does not change the underlying structural conditions created by market dominance and transmission constraints. So while opponents of the must-offer obligation minimize the need for it by stating that

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[13] Indeed, a TAPS member reported that at NARUC's November 15, 2005 annual convention, a representative from the Southern Company indicated publicly that if Southern was not permitted to use market-based rates within its control area, it would not sell at cost-based rates, but would sell its MWs outside the control area at market-based rates.

[14] *See* EEI at 32-33 ("As long as a mitigated supplier is not selling power at unmitigated rates into the geographic market in which the supplier's sales are mitigated, the supplier cannot exercise market power in that market.").

"sellers who own transmission are required to offer open-access service to wholesale customers, thereby allowing customers to seek suppliers outside the control area," MEC/PacifiCorp at 20, the reality is that even with such tariffs, embedded loads often cannot economically reach alternative suppliers.[15]

Nor should the Commission limit its response to market power only to instances of its actual exercise. *See* Duke at 16 ("we are unaware of any credible evidence (anecdotal or otherwise) suggesting that any form of generations market power has been exercised by . . . utilities [failing the Market Share Screen]").[16] The Commission's assessment of seller MBR eligibility is not a search for the guilty with rewards for the innocent. Rather, the Commission considers whether a seller and its affiliates have market power or have mitigated it, not whether it has been exercised.[17] Where such market power exists without mitigation, the Commission is not authorized to approve MBR authority.[18]

II. THE COMMISSION HAS THE AUTHORITY, RESPONSIBILITY AND JUSTIFICATION TO IMPOSE A MUST-OFFER OBLIGATION ON SELLERS WITH MARKET POWER

APPA and TAPS's Initial Comments (36-43) demonstrated that the Commission has the authority, responsibility and justification to impose a must-offer obligation on sellers with market power. Such an obligation is needed to protect customers captive to

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[15] The December 7, 2004 testimony of Anne Kimber in this docket illustrates that on the MEC system, loads of less than a single MW were unable to obtain alternative power supplies, despite MEC's Order 888 tariff. *See* APPA/TAPS Initial Comments at 73-74.

[16] Comments of Duke Energy Corporation, filed Aug. 7, 2006 ("Duke").

[17] *AEP Power Mktg. Inc.*, 107 F.E.R.C. ¶ 61,018 at P 40.

[18] Sellers caught exercising market power should be separately pursued. *See* APPA/TAPS Initial Comment at 21-26.

the seller's transmission system from unmitigated market power, particularly in the form of physical withholding. Arguments advanced opposing such a must-offer obligation are readily answered:

- A number of public utilities claim that the Commission does not have the authority under sections 205 and 206 either "to require sales of power into mitigated markets nor to prohibit sales of power outside of them." EEI at 35; MEC/PacifiCorp at 18; Progress Energy at 13-14. They further claim that they are under no duty to sell, EEI at 36,[19] and that any such obligation should only be imposed based upon the facts of a particular case, Southern at 60. These comments ignore that the Commission would impose the must-offer obligation as a condition to a public utility's jurisdictional MBR sales authorization, which the Commission's ample conditioning authority fully supports. *See* APPA/TAPS Initial Comments at 37-40. The factual justification for the condition lies in the seller's using the assets that provide it with market power to make jurisdictional MBR sales, which sales cannot be deemed just, reasonable and not unduly discriminatory if the seller can withhold (physically or economically) the output of such assets from customers who have no other economic choices. *See* APPA/TAPS Initial Comments at 38-40. The Commission's finding that a seller seeking MBR authority has market power, because it fails either the Initial Screens or the DPT, is proof that customers captive to the seller's transmission system lack meaningful alternatives. The Commission would be further justified in imposing the must-offer requirement because, as the Commission has observed, the absence of alternatives can give rise to an obligation to serve. *See* APPA/TAPS Initial Comments at 39-40.

- EEI and Southern, among others, claim that the requirements of FPA section 202(b) have not been met, including a showing that a customer lacks alternatives. EEI at 35-36, Southern at 60. While the Commission should not rule out relying on its section 202(b) authority in appropriate cases, it need not rely upon this provision because sections 205 and 206 provide it with ample authority to require cost-based sales in response to seller market power as a condition on MBR authority, as described above.

- EEI and Progress Energy, among others, claim that a must-offer obligation will unfairly provide certain wholesale customers with preferential access to cost-based power supply that they can then use for arbitrage, for example, by purchasing cost-based power when it is below market prices. EEI at 33, Progress Energy at 14, 16. However, a purchaser's comparison of market-based to cost-based rates will be meaningless without any real ability to import the power priced on a market basis and if there are no or few competitors in the home control area. Further, APPA/TAPS

[19] EEI claims (at 36, especially note 38) that *United States v. Reliant Energy Services Co.*, 420 F.Supp.2d 1043, 1059 (N.D. Cal. 2006) stands for the proposition that there is no duty to sell, but the case simply begs the question whether such a duty exists.

proposed a way to deal with arbitrage concerns: limit the must-offer obligation to LSEs using that power to serve loads in the seller's home control area or transmission service territory (*see* APPA/TAPS Initial Comments at 41).

- Progress Energy and Southern also posit that a wholesale customer able to take advantage of the must-offer obligation might forgo building capital intensive baseload generation and instead rely upon capacity made available by the mitigated seller. Progress Energy at 16, Southern at 62-63. However, the Commission itself has noted that not all load-serving entities are in a position to build their own generation. *AEP Power Marketing, Inc.*, 107 F.E.R.C. ¶ 61,018 at P 155. Furthermore, the must-offer obligation would not, by its own terms, impose an obligation to build on the seller, *see* APPA/TAPS Initial Comments at 41, so an LSE that relied exclusively on must-offer sales would be taking risks that capacity to support such sales might no longer be available. Nor should an LSE be faulted for purchasing power pursuant to the must-offer obligation, if such supply is the most economic, available alternative. So long as the rate is cost-compensatory and therefore just and reasonable, the seller is not disadvantaged by making the sale.

- Another claim is that a must-offer obligation will somehow distort or impede competition. EEI at 37, Progress Energy at 16, MEC/PacifiCorp at 22. This claim turns market power analysis and mitigation on its head. The limited must-offer obligation is tailored to remedy market power that the seller has been found to possess. Moreover, it is the seller's own constrained transmission system that keeps wholesale customers captive and prevents new entry that might dilute the seller's market power. In any event, "[t]he legal duty of the Commission to prevent unjust and unreasonable rates and undue discrimination or preference in the sale of wholesale power or interstate transmission by jurisdictional sellers is absolute; the Commission does not have the discretion to ignore them."[20] By contrast, reliance upon market-based pricing to ensure just and reasonable rates is a policy choice that the FPA does not mandate.[21]

- Finally, EEI and Progress Energy suggest that the Commission could impose the must-offer requirement using its anti-market manipulation authority. EEI at 36, Progress Energy at 17. While it should certainly not hesitate to require cost-based sales as a remedy for market manipulation in appropriate cases, the Commission itself has said that, as part of the MBR screening process, "market power is a structural issue to be remedied, not by behavioral prohibitions, but by processes to identify and,

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[20] JOSEPH T. KELLIHER, *Market Manipulation, Market Power, and the Authority of the Federal Energy Regulatory Commission*, 26 ENERGY L.J. 1, 3-4 (2005) (footnote omitted).

[21] "[T]he just and reasonable standard does not compel the Commission to use any single pricing formula." *Mobil Oil Exploration & Producing Southeast Inc. v. United Distribution Co.*, 498 U.S. 211, 224 (1991); *see also FPC v. Texaco, Inc.*, 417 U.S. 380, 394 (1974).

where necessary, mitigate market power that a tariff applicant may possess or acquire."[22]

III. THE COMMISSION SHOULD RETAIN THE MARKET SHARE SCREEN

In comments submitted at the outset of this rulemaking, EEI and a number of its vertically integrated members launched an attack on the Market Share Screen, urging that it be replaced by a so-called "Historical Contestable Load Analysis" or "HCLA." APPA/TAPS and the Federal Trade Commission, among others, showed that the HCLA was flawed and should not be adopted.[23] APPA and TAPS were thus heartened when the May 19, 2006 proposed rule did not adopt the HCLA as an alternative means of assessing seller market power.[24] In response to the NOPR, EEI and others are no longer advocating the HCLA as such, but they have resurrected arguments used to support the HCLA in their renewed effort to get rid of the Market Share Screen. The Commission should again reject these attacks.

The similarities between EEI's current effort and its former one can be seen by comparing present and past arguments. In its August 7, 2006 Initial Comments, EEI stated that "the major design flaw inherent in the Market Share Screen is that the screen ignores the relationship of total market supply to market demand in assessing whether an

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[22] *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorization*, 115 F.E.R.C. ¶ 61,053, P 19 (2006).

[23] March 14, 2005 Comments of the American Public Power Association and the Transmission Access Policy Study Group, Docket No. RM04-7-000, at 10-20, *available at* http://elibrary.ferc.gov/search/fercadvsearch.asp ("e-Library") Accession No. 20050314-5178; January 18, 2006 Comments of the Federal Trade Commission ("FTC"), Docket No. RM04-7-000, *available at* e-Library Accession No. 20060118-5037.

[24] *Market-Based Rates for Wholesale Sales of Electric Energy Capacity and Ancillary Services*, Notice of Proposed Rulemaking, 71 Fed. Reg. 33,102 (June 7, 2006), IV F.E.R.C. Stat. & Regs. ¶ 32,602 (proposed to be codified at 18 C.F.R. pt. 35) ("NOPR").

applicant has the potential to exercise market power in that market." EEI at 6. In almost identical language, EEI stated back in March 2005 that "the Market Share Screen does not take into account the relative size of total market demand to total uncommitted generation capacity in assessing whether the applicant can exercise generation market power."[25] Both now and then, EEI complained that the Market Share Screen's 20% threshold meant that the amount of competing supply needed to pass the screen exceeded the vertically integrated seller's capacity multiple times and that the Commission needed to focus more closely on whether competitors' excess supply sufficed to provide purchasers with supply alternatives to the applicant. Commenting on EEI's March 2005 arguments, the FTC observed that EEI's approach "has some intuitive appeal because it includes elements that wholesale customers are likely to consider when evaluating prospects to obtain wholesale supply," FTC at 4-5, but it nevertheless concluded:

> The basic problem with the proposal, however, is that historical contestable load analysis is not a reliable test of market power. The historical contestable load proposal fails to include a number of potentially important considerations in its framework for assessing horizontal market power, and the elements that it does include are not considered in an economically sound manner.

FTC at 5 (footnote omitted).

Rather than burden these Reply Comments by repeating APPA/TAPS's and the FTC's prior demonstrations of flaws in EEI's position, APPA/TAPS respectfully refer the Commission to those earlier filings made in this docket,[26] including these main points:

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[25] March 14, 2005 Post Technical Conference Comments of the Edison Electric Institute and the Alliance of Energy Suppliers on Market-Based Rates for Public Utilities, Docket No. RM04-7, at 7, available ate-Library Accession No. 20050314-5076.

[26] *See* note 23 above.

- EEI's approach is an effort to turn the Commission's focus away from the applicant's own supply and towards everyone else's, even though the point of the MBR analysis is to determine whether the *applicant* has the ability and incentive to exercise market power.
- EEI's approach ignores differences among the ability of potential suppliers to sell specific products, particularly the often superior position of vertically integrated applicants to provide the kind of long-term products, such as load following services that transmission-dependent LSEs need. For example, an IPP with a single 500 MW plant is not similarly situated to a vertically integrated utility with a fleet of generation units when it comes to serving an LSE's relatively small 25 MW load if the IPP is looking for an "anchor tenant" for its facility and is unwilling or unable to arrange for the kinds of back-up supply that would allow it to "firm up" a load following sale to the LSE.

EEI and others also claim that the 20% threshold results in too many vertically integrated utilities' failing the Market Share Screen.[27] Duke, for example, proposes (at 20) to increase the Market Share Screen threshold to 35%.[28] These attacks on the 20% market share are truly an illustration of the old saying, "if you can't raise the bridge, lower the river," thus allowing all ships to pass unimpeded. It is entirely appropriate for the Commission to examine more closely whether applicants that have a market share of 20% possess market power, given that even the 20% threshold can be excessive and mask the ability of a seller to exercise market power, particularly in the electric power industry with its numerous structural limitations.[29] The fact that sellers with less than 20% market

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[27] EEI at 7-10. Duke at 16, Southern at 13. EEI also says (at 9) that the Market Share Screen "has been the major contributing factor in the exclusion of the majority of non-RTO vertically integrated utilities from participating through market-based rates in competitive wholesale markets," This view assumes that these sellers have an entitlement to MBR authority in the first place. As shown above, they do not.

[28] Southern also hauls out the over-used "false positive" warning, Southern at 14, but cites not one example of a case producing a false positive.

[29] *See* APPA/TAPS Initial Comments at 16-18.

share can have market power also strongly argues against Duke's proposal for a 35% threshold.[30]

EEI also claims that the ability of an MBR applicant to rebut the market power presumption by submitting a DPT is "a generally futile exercise," because the Commission uses the 20% market share threshold as part of the DPT. EEI at 9. EEI ignores that the Commission also examines HHI and pivotal supplier results,[31] and uses its judgment to determine whether these results, including market shares, support granting or denying MBR authority.[32] EEI's argument therefore discounts the Commission's ability to make such judgments.

IV. THE COMMISSION MUST PROCEED CAUTIOUSLY WITH ANY RELIANCE ON PRICE INDICES

A number of commenters suggest that the Commission rely on price indices in lieu of cost-based rates as mitigation for sellers found to possess market power. EEI at 26-27, Duke at 13-14, MEC/PacifiCorp at 12-14. While APPA/TAPS do not categorically oppose the use of price indices, they urge caution, because numerous factors could cause the price index relied upon not to reflect a just and reasonable rate. Commission reliance on a price index would be a departure from a cost-based rate which would demand both justification as well as substantial evidence that the proxy bears a

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[30] *Id.*

[31] However, as APPA/TAPS urged in their Initial Comments (at 77-79), the HHI threshold under the DPT should be 1800, not 2500.

[32] *See, e.g.*, *Acadia Power Partners, LLC*, 113 F.E.R.C. ¶ 61,073 (2005); *Kansas City Power & Light Co.*, 113 F.E.R.C. ¶ 61,074 (2005).

reasonable relationship to the rate that would have been set in a truly competitive market for the seller's area.[33]

One important factor is whether the rate proxy reflects competitive, transparent and liquid conditions similar to those that would exist in the seller's market if that market were truly competitive and the seller lacked market power. A thinly traded market, such as a thinly traded RTO hub or commercially developed price index based upon a few or opaque data points, or one separated by transmission constraints, can create volatility or arbitrage possibilities that would leave consumers worse-off compared to a mitigated rate based upon costs. Nor are solid, appropriate price proxies available for all products for which some form of mitigated rate is required. RTO-administered real-time or day-ahead markets would not generally provide acceptable proxies for price-mitigation in markets for weekly, monthly or annual sales. Commercial indices may also not exist for all such products (especially more tailored products such as load-following service).

APPA and TAPS members' experiences with prices based upon market indices illustrate potential pitfalls with this approach. For example, in a region such as the Southeast where no real liquid trading hubs exist, contracting parties have had to resort to a "basket" of indices, which have needed occasional updating because some indices dry up. Due to the fact that the markets reflected in the indices are not necessarily comparable to the market in which products are actually sold, arbitrage opportunities arise. Furthermore, transmission constraints can cause uncertainty and volatility due to differences between even a fairly robust market, such as PJM, and a more thinly traded

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[33] *Farmers Union*, 734 F.2d at 1502, 1530; *Permian Basin Area Rate Cases*, 390 U.S. 747, 768-69 (1968).

one, such as Duke. This volatility and uncertainty create risks that discourage parties from trading in the products so priced.

The Commission should also reject the claim that "use of price indexes would eliminate any incentive for mitigated sellers to focus their sales efforts in unmitigated regions," and would, in turn, "eliminate any reason for the Commission to impose a must-offer requirement." MEC/PacifiCorp at 14. A dominant seller's incentive not to sell to customers captive to its transmission system goes beyond the availability of a higher price elsewhere. Even where the seller could sell at the market price proxy inside or outside the mitigated market, a desire to competitively disadvantage competing LSEs within its service territory could provide incentives to physically withhold. The must-offer obligation remains necessary, even if the power sold is priced using an index.

V. CAPTIVE CUSTOMERS WILL NOT BENEFIT FROM SELECTIVE DISCOUNTING

Commenters supporting a seller's ability to discount on a case-by-case basis from an "up to" rate fail to address a crucial issue: the absence of incentives for a seller with market power to offer discounts to customers whose only viable power supply option is the seller itself. For example, Duke states that "selective discounting allows a utility to meet competition where necessary to retain and attract business." Duke at 10. It continues by claiming that "[e]ven in control area markets that are highly concentrated, under many load conditions, the incumbent utility can face stiff competition for wholesale sales from other control area generators as well as from imports." *Id.* at 10-11. However, Duke provides no evidence either that local, competing generation exists or that transmission capability supports significant imports. Were competition as robust as Duke posits, the seller likely would qualify for MBR authority in the first instance.

The fact that it does not strongly indicates that selective discounting would effectively mean no discounts for captive loads. To avoid discrimination against those who have no economic power supply alternatives, the seller should be required to offer to them any discounts off the cost-based mitigated rate that it offers to others.[34] *See* APPA/TAPS Initial Comments at 44-48.[35]

Other commenters discuss factors that they claim support discounting but that in reality justify adjustments to seller-specific cost-based rates because of differences in actual costs of service. For example, Progress Energy (at 12) cites a customer's capacity factor or credit rating, while MEC/PacifiCorp (at 16) cites fuel costs. While these factors reflect changes in a seller's cost of service, they do not justify straightforward "meet-the-competition" discounts, and should be reflected in the seller's cost-based rate rather than through selective discounting.

VI. THE COMMISSION SHOULD SUBJECT ALL PUBLIC UTILITIES TO MBR REVIEW

Several commenters oppose the NOPR's correct proposal to eliminate the existing exemption from MBR review for generation built after July 1996. PPL at 19-20, Mirant at 9-11, EPSA at 12-17.[36] As shown below, the basis for their opposition finds no support in fact or law. The Commission should stand by its proposal.

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[34] In effect, the Commission would condition such discounting with a form of most favored nation clause similar to those the Commission has often approved. *See, e.g., Garden Banks Gas Pipeline, LLC*, 113 F.E.R.C. ¶ 61,132 P 15 and n.18 (2005).

[35] Where a purchaser has genuine access to alternative suppliers, the Commission might allow discounting of an "up to" rate, but such a rate would not be appropriate for the kinds of customers to whom the must-offer obligation should apply.

[36] Comments of the PPL Companies, filed Aug. 7, 2006 ("PPL"); Comments of Mirant Corporation, filed Aug. 7, 2006 ("Mirant"); and Rulemaking Comments of the Electric Power Supply Association, filed Aug. 7, 2006 ("EPSA").

Proponents of the exemption question the Commission's observation that over time the retirement of older generation will mean that all plants would qualify for the exemption, thus eliminating MBR review. EPSA at 15. But even if such a day is some years away (or never comes at all), the FPA currently requires that the Commission examine whether applicants for MBR authority possess market power. In *Lockyer*, the 9th Circuit held that such reviews are critical to the lawfulness of the Commission's reliance on market-based rates. *Lockyer*, 383 F.3d at 1013. Thus, continuation of the exemption would violate the statutory underpinning of MBR authority.

Some commenters further claim that loss of the exemption will discourage new entry. Mirant at 11, PPL at 19-20, EPSA at 13. However, these commenters provide no evidence that increased filing burdens on new entrants would raise costs to an extent that outweighs the benefit of seeking MBR authority. Mirant claims that its out-of-pocket costs would increase by approximately $80,000 if several of its plants were subject to MBR review, Mirant at 11, but that cost is paltry compared to the over $3.4 billion in generation revenues reported by Mirant in 2005,[37] doubtless in no small part due to its MBR sales.[38]

Besides supposed adverse effects on entry associated with complying with the FPA's filing requirements, exemption proponents essentially argue that the Commission should allow them to exercise market power as an entry incentive, especially in areas where capacity is short. PPL, for example, concedes that a new plant could be pivotal in

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[37] Mirant, 2005 Annual Report, at 105, *available at* http://www.mirant.com/investor_relations/pdfs/annual_report_web.pdf.

[38] Further, companies with multiple plants in a single region will need to prepare only one competitive analysis for those plants under the proposed regional triennial reviews. NOPR P 154.

such areas, PPL at 19, which means that the plant could name its own price – *i.e.*, exercise market power – because the lights would not stay on without its output. However, PPL also says loss of the exemption will chill such entry. *Id.* Similarly, Mirant and EPSA state:

> There is no incentive for a competitive supplier to build new generation in a region if its sales will be mitigated at some level of cost-based rates, especially if the Commission retains the incremental cost plus 10 percent cap for sales of less than one week. The inability of competitive supplier to get market-based rates in these regions will perpetuate the continued market power of the host utility.

Mirant at 12, EPSA at 13-14. These claims wrongly assume that a generator would earn all of its revenues through hourly or daily sales where the incremental cost plus 10% cap would apply, even though the Commission has repeatedly told generators that they should look to long-term contracts to recover their costs.[39] Under the Commission's default mitigation, such contracts would be priced on an embedded cost basis, NOPR P 22, thus providing the generator a just and reasonable opportunity to recover its costs.

In any event, the proposition that the Commission should allow new entrants to exercise market power as an entry incentive finds no support in the FPA. The Commission cannot authorize market-based rates if a seller has, or has not mitigated, market power. *AEP Power Mktg.*, 107 F.E.R.C. ¶ 61,018 at P 40; *Lockyer*, 383 F.3d at 1013. However, as shown by the foregoing statements, exemption proponents are essentially asking for such authority. The premise underlying their position – that they need to exercise market power during at least some hours to recover their costs – calls

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[39] *Midwest Indep. Transmission Sys. Operator, Inc.*, 102 F.E.R.C. ¶ 61,280, P 47 (2003); *Midwest Indep. Transmission Sys. Operator, Inc.*, 109 F.E.R.C. ¶ 61,157, P 303 (2004).

into question the legality of the Commission's market-based rate program. In principle, a just and reasonable rate should permit a seller to recover its costs, including a normal rate of return, regardless of whether that rate is cost-based or market-based (assuming a competitive market).[40] However, exemption proponents argue that they need a rate, unrestrained by competition or costs, to enter or remain in a market. If so, the Commission needs a new regulatory approach.

Exemption proponents do cite the potential for new entry as the answer to market power concerns, Mirant at 11, PPL at 20, but provide no evidence that such entry is actual or probable rather than merely theoretically possible. In fact, citing "necessary environmental, safety, and zoning approvals," the Department of Justice Antitrust Division recently concluded that "entry through the construction of new generation or transmission capacity would not be timely, likely, and sufficient to deter or counteract an anticompetitive price increase" associated with the proposed (though now defunct) merger of Public Service Enterprise Group and Exelon Corp.[41] By contrast, exemption proponents make no showing that entry will be timely, likely, and sufficient to make market power review of new generation unnecessary. The Commission should thus discontinue the current exemption.

VII. THE COMMISSION SHOULD ADOPT REGIONAL MBR REVIEWS

EEI, EPSA and Mirant, among other, attack the NOPR's sensible proposal to conduct MBR triennial reviews on a rotating, regional basis to improve the quality and

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[40] *See* Part I.A above.

[41] Competitive Impact Statement of United States, at 11-12, *United States v. Exelon Corp. and Pub. Serv. Enter. Group Inc.*, No.1:06CV01138, (D.C. Aug. 10, 2006), *available at* http://www.usdoj.gov/atr/cases/f217700/217717.pdf.

quantity of the data relied upon for MBR determinations and to provide the Commission with a more comprehensive picture of competitive conditions in regional markets.[42] EEI at 23, EPSA at 39-40, Mirant at 2-6. They chiefly cite the claimed increased burden on a handful of companies with assets in a number of regional markets. The Commission should not sacrifice improvements to its MBR program, including the resulting greater confidence in the Commission's determinations, to the interests of a few companies. While these companies claim that they would be involved in nearly perpetual MBR reviews, they overlook the fact that company-by-company reviews subject market participants in any particular region to a nearly continuous parade of MBR filings. Moreover, any increased financial cost to the companies associated with regional reviews is outweighed by both these companies' profits from MBR sales and the billions of dollars in MBR payments made by consumers each year.[43]

Mirant advances a number of other concerns regarding regional reviews, all of which are easily dismissed:

- It claims that sellers will be scrambling to hire a limited number of consultants and that the ones hired will be reluctant to pass along the efficiency benefits of regional reviews to their clients. Mirant at 4. This claim is ironic coming from a company that supposedly supports competition. One should expect that the market will respond to any increased demand for consulting services and that competition will force efficiency gains to be passed along to consultants' clients. As for concerns associated with a group of sellers jointly hiring a consultant to produce an analysis of the overall market,[44] competent antitrust counsel should be able to ensure that such joint representation does not result in improper information sharing. Indeed, there is

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[42] APPA/TAPS discussed the benefits of regional reviews at 30-33 of their Initial Comments.

[43] Mirant also ignores the simplifying assumptions that can significantly lessen the burden of the filings. *See* NOPR P 71. Nor is it clear that the companies will incur significantly increased costs, since specific reviews involving a company will focus on a single region rather than on every region in which the company sells.

[44] Sellers will still need to address on an individualized basis whether they have market power. *See* NOPR P 154 ("The Commission proposes to continue to make findings on an individual seller basis").

no reason for such arrangements to result in the sharing of competitively sensitive information among applicants given the availability of protective orders and the limitations on the improper use of sensitive information.

- Mirant claims (at 5) that company-by-company reviews allow reliance upon other companies' data, especially transmission data prepared by transmission owners. In fact, such data sharing should be enhanced by regional reviews, particularly if the Commission adopts APPA/TAPS's proposal that ISO/RTOs provide market participants with transmission data in advance of regional reviews. *See* APPA/TAPS Initial Comments at 30.

- Mirant (at 5-6) also claims that more frequent but less comprehensive MBR reviews will give the Commission a better handle on regional market developments than triennial reviews. However, the more robust data and opportunities to reconcile conflicting data and study results associated with a regional review process lead to the opposite conclusion. The piecemeal approach favored by Mirant is inferior.

CONCLUSION

The Commission should adopt a final rule that reflects the comments of APPA and TAPS, both as set forth above and in their Initial Comments.

Respectfully submitted,

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