UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

101 FERC ¶ 61,104

Before Commissioners: Pat Wood, III, Chairman;
William L. Massey, Linda Breathitt,
and Nora Mead Brownell.

Promoting Wholesale Competition
Through Open Access Non-Discriminatory
Transmission Services by Public Utilities — Docket No. RM95-8-006

Recovery of Stranded Costs by
Public Utilities and Transmitting Utilities — Docket No. RM94-7-007

ORDER ON REMAND

(Issued October 31, 2002)

1. This case is before the Commission on remand from the United States Court of Appeals for the District of Columbia Circuit.[1] The court has instructed the Commission to: (1) explain its treatment of energy costs in the stranded cost marketing option in Order No. 888,[2] and (2) establish a reasonable cap on contract extensions made through existing customers' right of

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[1]Transmission Access Policy Study Group, et al. v. FERC, 225 F.3d 667 (D.C. Cir. 2000) (TAPS), aff'd sub nom. New York v. FERC, 122 S. Ct. 1012 (2002).

[2]Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities and Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, Order No. 888, 61 Fed. Reg. 21,540 (May 10, 1996), FERC Stats. & Regs. ¶ 31,036 (1996), order on reh'g, Order No. 888-A, 62 Fed. Reg. 12,274 (March 14, 1997), FERC Stats. & Regs. ¶ 31,048 (1997), order on reh'g, Order No. 888-B, 81 FERC ¶ 61,248 (1997), order on reh'g, Order No. 888-C, 82 FERC ¶ 61,046 (1998), aff'd in part, remanded in part sub nom. Transmission Access Policy Study Group, et al. v. FERC, 225 F.3d 667 (D.C. Cir. 2000), aff'd sub nom. New York v. FERC, 122 S. Ct. 1012 (2002).

first refusal. This order explains why permitting customers to buy and resell stranded power does not produce a windfall for those customers and reaffirms the Commission's policy that there should be no limit on contract extensions made through the right of first refusal. This order benefits customers because it provides regulatory certainty without disrupting market operations.

Background

2. Order No. 888 required all public utilities that own, control or operate facilities used for transmitting electric energy in interstate commerce to: (1) file open access non-discriminatory transmission tariffs containing certain minimum, non-price terms and conditions, and (2) functionally unbundle wholesale power generation services from transmission services.[3] It also allowed public utilities and transmitting utilities to seek recovery of legitimate, prudent and verifiable stranded costs associated with providing open access.[4]

3. Order Nos. 888-A, 888-B and 888-C responded to various requests for rehearing and clarification of the policies articulated in Order No. 888. At the conclusion of the rehearing process, a group of petitioners challenged on appeal provisions of Order No. 888 that "range from the hypertechnical to arguments that FERC lacks authority to order open access transmission at all."[5] The court upheld Order No. 888, but remanded two specific issues to the Commission for further consideration. We will address those issues in this order.

Discussion

A. Treatment of Energy Costs in the Market Option

4. In Order No. 888, the Commission adopted the following formula for calculating a departing generation customer's stranded cost obligation (SCO), on a present value basis, under a revenues lost approach:

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[3] See Order No. 888 at 31,635-36.

[4] See id. at 31,636.

[5] Transmission Access Policy Study Group, 225 F.3d at 681.

SCO = (RSE - CMVE) x L

where:

RSE = Revenue Stream Estimate – average annual revenues from the departing generation customer over the three years prior to the customer's departure (with the variable cost component of the revenues clearly identified), less the average transmission-related revenues that the host utility would have recovered from the departing generation customer over the same three years under its new wholesale transmission tariff.[6]

CMVE = Competitive Market Value Estimate – determined in one of two ways, at the customer's option: Option (1) - the utility's estimate of the average annual revenues (over the reasonable expectation period "L" discussed below) that it can receive by selling the released capacity and associated energy, based on a market analysis performed by the utility; or Option (2) - the average annual cost to the customer of replacement capacity and associated energy, based on the customer's contractual commitment with its new supplier(s).

L = Length of Obligation (reasonable expectation period) – refers to the period of time the utility could reasonably have expected to continue to serve the departing generation customer.

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[6] In the case of a retail-turned-wholesale customer, subtraction of distribution system-related costs may also be appropriate.

In addition, application of the formula and collection of the resulting stranded costs were made subject to a number of other conditions.[7]

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[7]See Order No. 888 at 31,839-40.

5. The Commission recognized that utilities may have an incentive to minimize their estimates of the competitive market value (CMVE) of the released capacity and associated energy and thereby inflate their stranded costs.[8] To address this problem, the Commission provided customers with the option to market the released capacity and associated energy if they believe the utility's CMVE estimate is too low. If this "marketing option" is chosen, the customer would buy the released capacity from the utility at the utility's market value estimate. The associated energy would be purchased at the utility's average system variable cost. The customer would then resell the released capacity and energy and keep the resulting revenues. Thus, a customer that believes a utility has understated CMVE can purchase the utility's capacity and associated energy at the understated amount and resell it at the actual (presumably higher) market price, keeping the difference for itself.[9]

6. On appeal, the investor-owned utilities argued that under the Commission's approach, whenever a utility's average cost of generating energy is less than the actual market value of that energy, the utility will not receive the full market value of the capacity and energy generated by its assets.[10] The investor-owned utilities argued that allowing customers to pay average variable cost for the associated energy is inconsistent with Order No. 888's definition of the CMVE, which equals the market value of both the generation capacity and associated energy. They submitted that customers could receive a windfall by exercising the market option (although they will pay average variable cost for the associated energy, they will be able to resell it at the presumably higher market price), while the utilities will be unable to recover the full market value of the power because they will be forced to sell the associated energy at cost.

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[8]See id. at 31,840-42.

[9]See id. at 31,842.

[10]See Brief of Investor Owned Utility Petitioners at 45, Transmission Access Policy Study Group, et al. v. FERC, 225 F.3d 667 (D.C. Cir. 2000) (No. 97-1715).

7. The court determined that the Commission had not properly addressed the investor-owned utilities' concerns. It found that the Commission's policy of allowing customers to purchase at cost the energy associated with released capacity gives customers an incentive to exercise the market option even when a utility has appropriately estimated CMVE because a customer can buy the energy at cost and resell it at the presumably higher market price. The court found that the Commission failed to explain whether it intended this result, and, if it did, the justification for permitting customers to receive a windfall while undercompensating utilities. It ruled that this constituted a failure of reasoned decisionmaking, vacated the relevant portion of Order No. 888, and remanded the issue to the Commission for further consideration.[11]

[11] See Transmission Access Policy Study Group, 225 F.3d at 715-16.

8. In response, we clarify that the Commission did not intend for the marketing option to provide customers with an incentive to exercise that option even when a utility has appropriately estimated CMVE and therefore to receive a windfall while undercompensating utilities. The marketing option was intended to protect a departing customer from a low utility estimate of CMVE, which would result in a higher stranded cost charge to the customer.[12] It was not, however, intended that a customer's exercise of the option would make the utility worse off than if the associated energy costs were calculated on a market value basis.[13]

9. We further note that, to our knowledge, the scenario posited by the investor-owned utilities (i.e., exercise of the marketing option to give the customer a windfall at the utility's expense) has not arisen. Indeed, we are not aware of any case in which a departing customer has exercised the marketing option, much less done so to receive a windfall at the expense of the utility. Because the policy underlying Order No. 888 is to provide utilities with the opportunity to recover their legitimate, prudent and verifiable stranded costs associated with providing open access, we did not intend that the marketing option, if exercised, would be used

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[12] See Order No. 888 at 31,840-42; Order No. 888-A at 30,432.

[13] As the Commission explained in Order No. 888-A, allowing a customer that chooses the marketing option to pay the average system variable costs for the associated energy was designed to give the customer an opportunity to buy the associated energy at the price that it would pay had it remained a customer of the utility (i.e., average system variable costs). In designing this option, the Commission expected that customers would use this option if they believed that the utility's CMVE estimate was too low. The Commission did not expect that a customer would use the option as a means to receive a windfall. See Order No. 888-A at 30,433.

to undercompensate a utility. Should allegations in that regard be brought to the Commission's attention, we will address them on a case-by-case basis.

B. Limit on Contract Extensions Made Through Right of First Refusal

10. Order No. 888 provided all firm transmission customers with the right to continue to take transmission service from their existing transmission provider upon expiration of their contracts or at the time their contracts become subject to renewal or rollover.[14] The right of first refusal allows a transmission customer with a one-year or longer contract to match the rate offered by another potential transmission customer (up to the transmission provider's maximum filed rate), and accept a contract term at least as long as the competing transmission customer offers.[15] Thus, if not enough capacity is available to accommodate all requests for service, the right of first refusal gives the existing customer who had been using the capacity on a long-term, firm basis the option of keeping the capacity.[16]

11. In response to requests for clarification of the limits on the right of first refusal, the Commission affirmed in Order No. 888-A its decision to grant a reservation priority to existing firm transmission customers served under one-year or longer contracts.[17] It refused to modify the requirement that customers seeking to exercise their right of first refusal must agree to a contract term at least as long as that sought in a competing bid for transmission service. The Commission explained that without such a requirement "utilities could be forced to enter into shorter-term arrangements that could be detrimental from both an operational standpoint (system planning) and a financial standpoint."[18] Further, the Commission declined to specify the mechanics by which the right of first refusal mechanism should be exercised, and stated that it intended to address such issues case by case when disputes arose.[19]

12. Order No. 888-B addressed several requests for further clarification. In response to arguments about the rate a transmission customer must pay when it exercises its right of first

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[14] See Order No. 888 at 31,665.

[15] See id.

[16] See id.; Order No. 888-A at 30,195.

[17] See Order No. 888-A at 30,197.

[18] Id. at 30,197-98.

[19] See id. at 30,198.

refusal, the Commission reiterated that the right of first refusal is meant to act as a tie-breaker between substantially similar requests. Therefore, the Commission clarified that the existing transmission customer exercising its right of first refusal will be required to match the term of service requested by another customer and may be required to pay the transmission provider's maximum rate. The rate must, however, be for substantially similar service of equal or greater duration.[20]

[20]The Commission also clarified that the transmission customer will not be required to pay the highest rate that the transmission provider is collecting from any customer. See Order No. 888-B at 62,085.

13. Prior to the time Order No. 888 and its progeny established the right of first refusal with respect to electric energy transmission contracts, Order No. 636 established a similar right with respect to natural gas transportation contracts.[21] Order No. 636-A capped extensions of transportation contracts through the right of first refusal at twenty years.[22] On appeal, the Court of Appeals for the District of Columbia had found that the Commission had justified the right of first refusal mechanism for natural gas contracts, but remanded the twenty-year limit on

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[21] Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations, Order No. 636, 57 Fed. Reg. 13,267 (Apr. 16, 1992), FERC Stats. & Regs. ¶ 30,939 at 30,448-49 (1992).

[22] Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations, Order No. 636-A, 57 Fed. Reg. 36,128 (Aug. 12, 1992), FERC Stats. & Regs. ¶ 30,950 at 30,631 (1992).

contract extensions for further consideration.[23] New data, and several arguments on rehearing, persuaded the Commission to reestablish the cap at five years on remand in Order No. 636-C.[24] The five-year cap was subsequently appealed and again remanded to the Commission.[25] The Commission will act on this remand in a concurrent order.

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[23]See United Distribution Companies v. FERC, 88 F.3d 1105, 1140-41 (D.C. Cir. 1996), cert. denied, 520 U.S. 1224 (1997).

[24]See Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations, Order No. 636-C, 78 FERC ¶ 61,186 at 61,772-75 (1997), reh'g denied in relevant part, Order No. 636-D, 83 FERC ¶ 61,210 at 61,925-26 (1998). On the same day the Commission issued Order No. 636-C, however, the Commission issued Order No. 888-A, which contained no limit on extensions of electric energy transmission contracts via a comparable right of first refusal.

[25]See Interstate Natural Gas Association of America v. FERC, 285 F.3d 18, 51-53 (D.C. Cir. 2002) ("Pick 20 years, and get reversed for failing to explain the length; pick five, and get reversed for failing to explain the brevity.").

14. On appeal of Order No. 888, petitioners argued that the Commission's policy regarding extensions of transmission contracts under the right of first refusal constituted a failure of reasoned decisionmaking for the same reasons that United Distribution Companies v. FERC remanded the issue of extending natural gas transportation contracts. First, they argued that the Commission's regulatory scheme has been interpreted to protect existing customers against abandonment. If a utility wants to terminate service to an existing wholesale customer, petitioners asserted that it must first obtain the Commission's authorization, even if the customer's contract has expired. Second, petitioners argued that absent a limit on the service term to which transmission customers would have to subscribe, those customers could fall victim to the exercise of transmission market power.[26] The Commission conceded error in light of United Distribution Companies v. FERC, and the Court of Appeals remanded the issue so that the Commission could provide a reasonable cap on contract extensions.[27]

15. We reaffirm that there is no need to have a cap on the term of an agreement that an existing customer would have to match. The Commission requires existing customers to match the term of competing requests for service so that utilities will not be forced to enter into shorter-term agreements. As the Commission explained in Order No. 888-A, such shorter-term agreements could be detrimental from both an operational standpoint (system planning) and a financial standpoint.[28] Transmission Access Policy Study Group petitioners were concerned, however, that protecting transmitting utilities from entering into short-term arrangements this way might subject customers to the exercise of market power and force them into longer-term contracts than the market would produce:

> [W]hen demand for monopoly transmission capacity exceeds the capacity requirements of a new customer and an existing customer whose contract is expiring, the existing customer could be forced to match any contract term offered by a competing bidder –

[26] See Brief of Petitioners on Terms and Conditions of Transmission Service and Other Miscellaneous Issues at 26, Transmission Access Policy Study Group v. FERC, 225 F.3d 667 (2000) (No. 97-1715) [hereinafter Terms & Conditions Brief].

[27] See Transmission Access Policy Study Group v. FERC, 225 F.3d 667, 735 (D.C. Cir. 2000).

[28] See Order No. 888-A at 30,197-98.

however long. This could give the transmitting utility undue bargaining leverage and threaten service continuity.[29]

[29]Terms & Conditions Brief at 25.

16. The Commission has determined that there is no need to have a cap on the term of an agreement that an existing customer would have to match.[30] The primary rationale presented for such a cap is that transmission providers can exercise market power such that existing customers would be forced to enter into longer-term contracts than they would otherwise have chosen. The Commission, however, has in place regulatory controls that are sufficient to constrain transmission providers from exercising market power to pressure existing transmission customers into longer contracts than they desire, without the need for any term-matching cap.[31]

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[30] Accord Regulation of Short-Term Natural Gas Transportation Services, and Regulation of Interstate Natural Gas Transportation Services, 100 FERC ¶ ___ (being issued concurrently).

[31] See Process Gas Consumers Group v. FERC, 292 F.3d 831, 836-38 (D.C. Cir. 2002). The Commission has stated in a proposed rulemaking that in other circumstances transmission providers may be able to exercise market power and has, accordingly, proposed remedies. See Remedying Undue Discrimination Through Open Access Transmission Service and Standard Electricity Market Design, 67 Fed. Reg. 55,452 (Aug. 29, 2002), FERC Stats. & Regs. ¶ 32,563 (2002).

17. Transmission providers are limited to charging rates that are just and reasonable and must sell all available transmission capacity to transmission customers willing to pay the maximum tariff rate. Moreover, transmission providers are obligated, at the request of a transmission customer, to expand transmission capacity and make that capacity available at cost-based rates.[32] Thus, a transmission provider has no legal ability to withhold existing capacity and, in the context of the right of first refusal, could exert market power only by violating Order No. 888 and its open access transmission tariff. With respect to a transmission provider's affiliates, Commission regulations prohibit a transmission provider from favoring or colluding with its own affiliates to manipulate the market through sham bids.[33] Moreover, even if a transmission provider chose not to build new capacity or chose to collude with an affiliate to force an existing customer into a longer term, transmission customers can initiate a complaint proceeding before the Commission. All of these regulatory constraints adequately limit a transmission provider's ability to induce longer-term contracts.[34]

18. We believe that our existing policy furthers the development and function of competitive wholesale markets, and that sufficient regulatory safeguards are in place to protect against any exercises of market power that may occur with respect to the right of first refusal. We therefore conclude that our existing policy of not imposing a limit on the length of contract extensions an existing transmission customer must match under a right of first refusal is just and reasonable.

The Commission finds:

(A) The Commission hereby clarifies its intention as to the marketing option, as discussed in the body of this order.

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[32] See Order No. 888-A at 30,516, 30,526-27.

[33] See 18 C.F.R. § 37.4 (2002).

[34] See Process Gas Consumers Group, 292 F.3d at 837.

(B) The Commission hereby upholds its existing policy of not imposing a limit on the length of contract extensions an existing transmission customer must match under a right of first refusal, as discussed in the body of this order.

By the Commission.

(S E A L)

Linwood A. Watson, Jr.,
Deputy Secretary.