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# MAY THE FERC RELY ON MARKETS TO SET ELECTRIC RATES?

Gerald Norlander\*

## I. INTRODUCTION

In the aftermath of spectacular failures of electricity markets it previously approved, the Federal Energy Regulatory Commission (FERC) accelerated its pursuit of a deregulatory agenda for the electric utilities and services under its jurisdiction. The essence of this approach is to supplant traditional agency rate setting with market mechanisms to determine wholesale electricity and bulk transmission rates.<sup>1</sup> Seeking to lessen its role as rate dispute umpire and administrative rate setter, the FERC is attempting to restructure the industries it regulates and redefine itself to achieve an agency "vision" of "[d]ependable, affordable energy *through sustained competitive markets*."<sup>2</sup> An explicit goal is to "[f]oster [n]ationwide [c]ompetitive [e]nergy [m]arkets as a [s]ubstitute for [t]raditional [r]egulation."<sup>3</sup> Notwithstanding the FERC's forceful efforts to implement the new "vision" and goals, are markets a lawful substitute for rate regulation? I conclude they are not.

The current initiative to implement the FERC vision is a 612 page July 31, 2002 Notice of Proposed Rulemaking to create agency structured markets with a "Standard Market Design" for setting rates (*SMD NOPR*).<sup>4</sup> If adopted, the rule would establish markets managed by new entities, denominated by the FERC as "Independent Transmission Providers" (ITPs). These "independent" private utilities would be approved by the FERC to be controllers of the bulk power transmission grids, and rate-setters. The *SMD NOPR* would require transmission-owning utilities to transfer control of their facilities to ITPs.<sup>5</sup> Each

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1. "Until just under ten years ago, virtually all sales were made at traditional cost-of-service rates or via cost-based formulas. Since then, the Commission has allowed sellers to sell at 'market-based rates' . . . . In brief, the Commission requires that sellers demonstrate that they do not 'dominate' (have undue market power) in generation, do not dominate transmission, and cannot impose barriers to entry." Peter Fox-Penner, et al., *Competition in Wholesale Electric Power Markets*, 23 ENERGY L.J. 281 (2002).

2. *FERC Strategic Plan FY 2002 - FY 2007*, 1 (emphasis added), available at <http://www.ferc.gov/About/mission/SP-09-18-02.pdf> (last visited Feb. 22, 2003).

3. *FERC Strategic Plan FY 2002 - FY 2007*, at 2, Goal 2 (emphasis added). Objective 2.1 is to "[a]dvance [c]ompetitive [m]arket [i]nstitutions [a]cross the [e]ntire [c]ountry," and Objective 2.2 is to "[e]stablish [b]alanced, [s]elf-[e]nforcing [m]arket [r]ules." *Id.* (emphasis added).

4. Notice of Proposed Rulemaking, *Remedying Undue Discrimination Through Open Access Transmission Service and Standard Electricity Market Design*, [1998-2002 Proposed Regs.] F.E.R.C. Stats & Regs. ¶ 32,563, 67 Fed. Reg. 55,451 (proposed Aug. 29, 2002) (to be codified at 18 C.F.R. pt. 35) [hereinafter *SMD NOPR*].

5. "We also propose that no later than September 30, 2004, or such date as the Commission may

deviates from the process prescribed by statute for remedying undue discrimination and fixing by the agency of non-discriminatory, reasonable rates under Section 206 of the FPA.

## II. KEY FEATURES OF THE FERC *SMD NOPR*

The FERC issued an evolutionary series of generic orders to foster the creation and operation of private day-ahead and real-time electricity spot markets to perform the rate-setting function. In 1996, in *Order 888*,<sup>9</sup> the FERC inspired utilities voluntarily to form transmission grid and market operating entities, the "Independent System Operators" (ISOs), which were new private utilities formed by transmission owners and other industry "stakeholders." Five ISOs were approved including single-state ISOs in California and New York. Next, in *Order 2000*,<sup>10</sup> the FERC sought voluntary participation across state lines to form "Regional Transmission Organizations" (RTOs) to manage the bulk power grid and establish larger interstate regional markets. In the 2002 *SMD NOPR*, the FERC abandons the voluntary approach and proposes to mandate the creation and utilization of ITPs.<sup>11</sup> The *SMD NOPR* suggests a "Pro Forma Standard Market Design Tariff" containing rules for six ITP spot markets for various components of electric service: three day-ahead markets and three real-time markets. The proposed component markets are for (1) Energy, (2) Regulation service, and (3) Operating reserves.

The new Standard Market Design contains a number of design features of spot markets now operated by PJM Interconnection (PJM) and New York Independent System Operator (NYISO). The ITP utilities running the spot markets would not be required to set just and reasonable rates. The FERC would issue market based rate orders, as is current practice, allowing sellers to dispense with filing their rates and notice of rate changes upon a demonstration that certain FERC criteria are met. Thus, the actual rates demanded by sellers would not be filed in advance with the FERC. Advance notice of proposed changes in rate schedules would not be filed subject to FERC review and possible refund, nor would the proponent of a rate change bear the burden of demonstrating the new rates are just and reasonable. The proposed spot market rules prohibit contemporaneous public disclosure of the rates demanded by each seller. A "locational market price" (LMP) is established. It is based on what the market will bear at a given time and location, and may have extreme variations at times

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9. Order No. 888, *Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities and Recovery of Stranded Costs by Public Utilities and Transmitting Utilities and Recovery of Stranded Costs by Public Utilities*, F.E.R.C. Stats. & Regs. [Regs. Preambles Jan. 1991-June 1996] ¶ 31,036 (1996), 61 Fed. Reg. 21,540 (1996) (codified at C.F.R. pts. 35 & 385) [hereinafter *Order 888*].

10. Order No. 2000, *Regional Transmission Organizations*, F.E.R.C. Stats. & Regs. ¶ 31,089 (1999), 65 Fed. Reg. 809 (2000) (codified at C.F.R. pt. 35) [hereinafter *Order 2000*].

11. The proposed regulations include a new Subpart G to 18 CFR pt. 35 entitled "Procedures and Requirements Regarding Non-Discriminatory Open Access Transmission Services and Standard Market Design." *SMD NOPR*, *supra* note 4, at 34,409. Section 35.35(b)(1) defines an "Independent Transmission Provider" as "any public utility . . . that administers the day-ahead and real-time energy and ancillary services markets in connection with its provision of transmission services pursuant to the pro forma tariff [prescribed by FERC in the *SMD NOPR*] and that is independent . . ." *Id.*

ITP would create and manage six markets (hence the "Standard Market Design") to set variable rates for components of wholesale electricity and transmission service. These agency-fostered bazaars would use "spot" markets to set rates only for day-ahead and real time balancing purposes. Generators and energy marketing utilities would obtain "market-based rate" orders from the FERC. These orders would allow rates to be determined by the ITP markets, so that the tariffs and rate schedules filed by the utilities would not disclose the actual rates demanded or charged.<sup>6</sup> The spot market rates would be complemented by rates set privately in unfiled bilateral, off-spot market contracts.<sup>7</sup>

This article addresses whether the FERC has power under existing law to use markets for setting rates. It does not address the merits or wisdom of the spot market rules, or other controversial proposals contained in the *SMD NOPR* proposal (such as assertion of FERC jurisdiction over the transmission component of previously bundled state-regulated retail rates).<sup>8</sup> Basic features of the *SMD NOPR* are highlighted to illustrate the agency's emphasis on creating private markets and using market mechanisms to set rates, and to distinguish the proposed rules from rate filing and rate fixing requirements of the Federal Power Act of 1935 (FPA). Several Supreme Court decisions involving federal regulatory agency efforts to rely upon markets to set rates are examined. The FERC's legal justifications for market based rates, and the lower court opinions upon which they are based, are also reviewed.

The article concludes that if the issue of the FERC's market based electricity rate initiatives were squarely presented in litigation, the court would likely apply the clear language of the FPA, and its longstanding judicial interpretations, to bar the FERC from using market prices to set rates. In particular, the FERC market based rate making initiative conflicts with the statutory duty of FERC jurisdictional utilities publicly to file schedules of reasonable rates demanded and charged under Section 205 of the FPA, and

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establish, only Independent Transmission Providers would operate Commission-jurisdictional facilities." *Id.* at 55,469 (emphasis added). In *Atlantic City Elec. Co. v. FERC*, 295 F.3d 1 (D.C. Cir. 2002), however, the District of Columbia Circuit Court of Appeals held that FERC approval is not required for a utility seeking to withdraw from the PJM transmission organization. Thus, the utility was free to withdraw from the Independent System Operator (ISO) and file new rates under the traditional FPA regimen, subject to all the FPA procedures and FERC review of its new rates.

6. "[M]any of the regulations which customarily apply to traditional public utilities have been waived or relaxed for power marketers. For example . . . they are permitted to charge market-based rates . . . . Power marketers need not file their accounting records . . . . Power marketers need not file their accounting records with the Commission . . . ." *How to Get Market-Based Rate Approval*, FERC Power Marketer Information, available at <http://www.ferc.gov/Electric/pwrmt/Prnhw.htm> (last visited Feb. 22, 2003).

7. "Central to the Standard Market Design concept is its reliance on bilateral contracts entered into between buyers and sellers. The resource adequacy requirement strongly encourages such long-term contracts. The short-term spot markets . . . are intended to complement bilateral procurement . . . . We expect that market participants will strike an appropriate balance between bilateral contracts and spot market transactions." *SMD NOPR*, *supra* note 4, at 34,282.

8. For a detailed critique of the merits of the *SMD NOPR* proposals, see generally *Comments of the Colorado Office of Consumer Counsel, New Mexico and Rhode Island Attorneys General, Utah Committee of Consumer Service, Public Utility Law Project, and National Consumer Law Center Under*, 67 Fed. Reg. 55,452 (Nov. 15, 2002), available at <http://www.tellus.org/general/news/fercnopr.pdf> (last visited Feb. 22, 2003).

