

**UNITED STATES OF AMERICA  
BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION**

<b>INVESTIGATION OF TERMS AND )</b>	
<b>CONDITIONS OF PUBLIC )</b>	<b>Docket Nos. EL01-118-000</b>
<b>UTILITY MARKET-BASED )</b>	<b>and</b>
<b>RATE AUTHORIZATIONS )</b>	<b>EL01-118-001</b>

**REQUEST FOR REHEARING ON BEHALF OF COLORADO OFFICE  
OF CONSUMER COUNSEL, RHODE ISLAND ATTORNEY GENERAL,  
NEW MEXICO ATTORNEY GENERAL, UTAH COMMITTEE OF  
CONSUMER SERVICE, PUBLIC UTILITY LAW PROJECT OF NEW  
YORK, INC, NATIONAL CONSUMER LAW CENTER,  
AND PUBLIC CITIZEN, INC.**

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ATTORNEY GENERAL, UTAH COMMITTEE OF CONSUMER  
SERVICE, PUBLIC UTILITY LAW PROJECT OF NEW YORK, INC,  
NATIONAL CONSUMER LAW CENTER, AND PUBLIC CITIZEN, INC.**

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Pursuant to Rule 713 of the Rules of Practice and Procedure of the Federal Energy Regulatory Commission (“Commission” or “FERC”), 18 C.F.R. § 385.713 (2003), Ken Salazar, the Attorney General of the State of Colorado, in his capacity as Attorney for the Colorado Office of Consumer Counsel; Patricia Madrid, in her capacity as Attorney General of the State of New Mexico; the Utah Committee of Consumer Services; the Public Utility Law Project of New York, Inc.; the National Consumer Law Center, Inc., on behalf of its low-income clients; and Public Citizen, Inc. (collectively, “Consumer Advocates”) jointly submit this Request for Rehearing of the Commission’s November 17, 2003 Final *Order Amending Market-Based Rate Tariffs and Authorizations* (“*Order Amending Tariffs*”) in these Dockets, and for clarification with respect to a missing finding.<sup>1</sup>

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<sup>1</sup> *Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorizations, Order Amending Market-Based Rate Tariffs and Authorizations*, Docket Nos. EL01-118-000, and EL01-118-001 105 FERC § 61,218 (Nov. 17, 2003). Party status was granted to the Consumer Advocates in the Final Order. *Id.*, at p. 5, para. 10, as listed at p. 7, fn. 15.

The history of the proceeding, recounted at paragraphs 1 - 10 of the *Order Amending Tariffs*, summarizes the evolution of the Commission’s decision to create new “Market Behavior Rules,” which are sub-regulatory guidelines intended to discourage manipulation and “market abuse” in the establishment of market rates for electricity services under the Commission’s jurisdiction.<sup>2</sup> Petitioners seek rehearing because the *Order Amending Tariffs* fails to establish prospective rates, as required by section 206 of the Federal Power Act, which are just and reasonable and not unduly discriminatory or preferential.

**I. SPECIFICATION OF ERROR:**

**BECAUSE OF THE MISSING SECTION 206 FINDING, THE COMMISSION SHOULD GRANT THE REQUEST FOR CLARIFICATION, OR, ALTERNATIVELY, GRANT REHEARING.**

The Commission has undertaken in this proceeding an investigation under Section 206 of the Federal Power Act (“FPA”)<sup>3</sup> regarding the justness and reasonableness of so-called “market-based” rates, *viz.*, rates the Commission has authorized utilities to establish among themselves, without reference to objective cost or other standards, and to put into effect without Commission review and not subject to refund.

The Consumer Advocates strongly agree with and support the Commission’s finding (at p.2) that sellers’ existing “market-based” tariffs or authorizations are “unjust and unreasonable” as they now stand. Indeed, there does not appear to be either a shred of evidence or even economic theory, much less statutory authority or legal precedent, to support the justness or reasonableness of current “market-based” rates. Under Section 206, the Commission must next determine the “just and reasonable rate, charge, classification” etc. to be thereafter “observed and

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<sup>2</sup> *Id.*, para. 1, 2.

<sup>3</sup> 16 U.S.C. § 824e (2000).

in force, and shall fix the same by order.”<sup>4</sup> The Commission has not met this legal requirement. Rather, it has “adopted” certain behavioral rules for sellers, as though this were a rulemaking proceeding instead of an investigation under section 206. Indeed, the order states that the Commission finds “that our Market Behavior Rules, as modified in Appendix A to this order, are just and reasonable....”<sup>5</sup>

The Federal Power Act contains no provisions requiring sellers’ “*behavior*” to be “just and reasonable” -- indeed, what could this remarkable concept mean? Rather, the Act requires that “*all rates and charges made, demanded, or received*”<sup>6</sup> by sellers must be “just and reasonable.” Accordingly, the Commission’s order does not comport with the legal requirements of the statute. Adopting behavior rules or principles does not “fix” a rate within the meaning of the statute, “which requires the rate itself to be specified.” *Electrical Dist. No. 1 v. FERC*, 774 F.2d 490, 492-493 (D.C. Cir. 1984). Consumer Advocates therefore request clarification as to whether the Commission intended to find that the “market-based” tariffs and authorizations, which it has determined to be unjust and unreasonable without inclusion of the behavioral rules, will be “just and reasonable” if sellers include the Market Behavior Rules in their tariffs?

If the Commission does not intend to, and does not make, this required legal finding under Section 206, Consumer Advocates specify such failure to meet the statutory requirements as error on the Commission’s part and seek rehearing on this point.

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<sup>4</sup> 16 U.S.C. § 824e(a) (2000).

<sup>5</sup> *Id.*, para. 3.

<sup>6</sup> 16 U.S.C. § 824(a) (2000).

## II. SPECIFICATION OF ERROR:

### **THE COMMISSION ERRED BY FAILING TO ADDRESS CONSUMER ADVOCATE'S CONTENTION THAT IT HAS NO AUTHORITY UNDER THE FEDERAL POWER ACT TO FIND "MARKET-BASED" RATES AND TARIFFS TO BE JUST AND REASONABLE OR TO OTHERWISE ASSERT A STATUTORY BASIS FOR ALLOWING SUCH RATES.**

The Commission in its *Order Amending Tariffs* fails to address the threshold issue raised by the Consumer Advocates in their August 18, 2003 comments, *viz*, that the Commission lacks any statutory basis under the Federal Power Act ("FPA") to erect and oversee a market rate regimen for setting rates for electric service under Commission jurisdiction. The Commission failed to address Consumer Advocates' contention that key elements of the Commission's market rate initiative are clearly inconsistent with FPA requirements. The Federal Power Act does not mention or define "competitive markets." However, the FPA clearly requires the Commission to review wholesale electric rates, require them to be noticed and subject to refund, with interest, pending such Commission review, and to ensure that such rates are not only just and reasonable, but that they are also not unduly discriminatory or prejudicial. The Commission erred by failing to state any statutory basis for ignoring these duties under the statute in favor of instigating a "competitive market regime" apparently more to its liking.

In its *Order Amending Tariffs* the Commission now recognizes that electric "market-based rates" it previously approved are illegal.<sup>7</sup> The *Final Order* does not, however, fix new rates or require utilities with unjust and unreasonable "market-based rate" tariffs to file new just and reasonable rates in accordance with the requirements of the FPA. Instead, the *Final Order* perpetuates the "market-based rates" regimen, and requires those who have market-based rate dispensations to incorporate into their tariffs six new "Market Behavior Rules."<sup>8</sup>

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<sup>7</sup> The Commission determined that "sellers' existing tariffs and authorizations, without clearly-delineated rules of the road to govern market participant conduct, are unjust and unreasonable." *Final Order*, para.. 3. "We find market-based tariffs and authorizations that do not include such standards are unjust and unreasonable." *Id.*, para. 11. Under the Federal Power Act, "any such rate or charge that is not just and reasonable is hereby declared to be unlawful." 16 U.S.C. § 824a (2000).

<sup>8</sup> These "Rules of the Road" address (1) unit operations, (2) market manipulation, (3) communications, (4) reporting, (5) record retention, and (6) related tariff matters. They are contained in Appendix A to the *Final Order*.

As argued below, the Supreme Court looks with disfavor on federal regulatory agencies seeking to introduce markets and competition in lieu of rate setting without express congressional authorization. The Federal Power Act provides no such authorization, nor does any other statute that governs the Commission's powers. Accordingly, Consumer Advocates cite as legal error the Commission's failure to address the arguments raised regarding its lack of statutory authorization to leave ratemaking to "the market" and the Commission's failure to assert any statutory basis for finding the market-based rates and tariffs under investigation to be "just and reasonable" on a prospective basis.

**The Commission's *Order Amending Tariffs* Perpetuates A  
"Market-Based Rate" Regimen Inconsistent With The Federal  
Power Act**

In their prior comments, Consumer Advocates argued that the Commission lacks any legal authority to dispense with the filing of rates demanded and charged by wholesale sellers. There is no statutory basis for FERC to approve "market-based rates" for electricity.<sup>9</sup> The Commission completely ignored the issue of its legal authority in its discussion of parties' comments in the *Order Amending Tariffs*. This issue is properly raised because a federal regulatory agency's powers are only conferred by statute and must always be grounded in statutory language:

As a federal agency, FERC is a 'creature of statute,' having 'no constitutional or common law existence or authority, but *only* those authorities conferred upon it by Congress.' Thus, if there is no statute conferring authority, FERC has none. . . .<sup>9</sup> *Louisiana Public Service Comm'n. v. FCC*, 476 U.S. 355, 374 (1986) (recognizing that 'an agency literally has no power to act . . . unless and until Congress confers power upon it'). In the absence of statutory authorization for its act, an agency's 'action is plainly contrary to law and cannot stand.'<sup>10</sup>

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<sup>9</sup> Consumer Advocates' August 18, 2003 Comments included a detailed analysis of the Commission's lack of any authority to grant market-based rate authorizations, and in support cited Norlander, *May the FERC Rely on Markets to Set Electric Rates?*, 24 *Energy Law Journal* 65 (2003).

<sup>10</sup> *Atlantic City Elec. Co. v. FERC*, 295 F.3d 1 (D.C. Cir. 2002) (citations omitted).

Consumer Advocates again invite the Commission's attention to the legal authority issue. No language in the FPA supports market-based rates as authorized by the Commission. Bills that would have allowed a market rate regimen have failed in Congress. The General Accounting Office has observed that the FERC lacks the statutory and institutional means to transform itself from a rate-setting agency to a market overseer.<sup>11</sup> Circuit court cases typically relied upon by the Commission never directly adjudicated whether the electric market regimen devised by the Commission satisfies the filing, transparency, and review provisions of the FPA.<sup>12</sup> The Supreme Court has said that the statute requires rates to be filed and "not even a court can authorize commerce in the [electricity] commodity on other terms." *Montana-Dakota CO. v. Northwestern Pub. Serv. Co.*, 341 U.S. 246, 251-252 (1951). As a result of its adherence to the language of statutes and the filed rate doctrine, the Supreme Court has not looked favorably upon federal agency efforts to deregulate without legislative action. *MCI v. AT&T Co.*, 512 U.S. 218 (1994) (Invalidating FCC effort to introduce competition by relaxing rate filing requirements); *Maislin Industries, U.S., Inc. v. Primary Steel*, 497 U.S. 116 (1990) (Invalidating relaxation of statutory rate regulation requirements); *FPC v. Texaco, Inc.*, 417 U.S. 380 (1974) ("Congress could not have presumed that 'just and reasonable' rates could conclusively be determined by reference to market price....").

The Commission belatedly concedes in its *Order Amending Tariffs* that all the market rates it previously authorized are not just and reasonable. The "bond" of the statute, that no rate will be demanded or charged that is not just and reasonable, has been broken. "The purpose of the ... Act was to underwrite just and reasonable rates to the consumers .... *The Act was so framed as to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges.*" *Atlantic Rfg. Co. v. Pub. Serv. Comm'n*, 360 U.S. 378 (1959)

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<sup>11</sup> *Energy Markets: Concerted Actions Needed by FERC to Confront Challenges That Impede Effective Oversight*, GAO-02-656, Table 4, 69 (June 2002), available at <http://www.gao.gov/new.items/do2656.pdf>

<sup>12</sup> *Elizabethtown Gas Co. v. FERC*, 10 F.3d 866, 870 - 871 (D.C. Cir. 1993) (Court did not reach issue whether market rates are consistent with reporting and filing requirements of the statute); *Louisiana Energy and Power Auth. V. FERC*, 141 F.3d 364, 366 n. 2 (D.C. Cir. 1998) ("LEPA did not challenge FERC's general policy of permitting market-based rates in the absence of market power"); *Grand Council of the Crees v. FERC*, 198 F.3d 950 (D.C. Dir. 2000) (plaintiffs lacked standing to attack order granting market-based rates).

(*emphasis added*).<sup>13</sup> The statute achieves that end not by directing the Commission to create or watch over markets and sellers’ “behavior,” but by requiring utilities to publicly file rate schedules and contracts, subject to federal agency review for reasonableness, before the rates take effect. “Market-based rates” as approved by the Commission cannot satisfy this requirement, and the new “rules of the road” for “market behavior” do not cure this defect. Instead, the “Market Behavior Rules” will continue to allow unfiled rates to be charged no matter what the price and no matter how often the rates are changed.

The “Market Behavior Rules,” when superimposed upon “market-based rates” the Commission has found to be unjust and unreasonable are not a valid substitute for the filing and fixing of all wholesale electric rates under Sections 205 and 206 of the Federal Power Act. The “market-based rate” tariffs approved by the Commission do not “fix” or specify any particular “rate” as is required by the FPA for the protection of consumers. *Electrical Dist. No. 1 v. FERC*, 774 F.2d 490, 492-493 (D.C. Cir. 1984) (“predictability is the whole purpose of the well established ‘filed rate’ doctrine, which ‘forbids a regulated entity to charge rates for its services other than those properly filed with the appropriate federal regulatory authority’”). Rather, under the Commission’s regimen, “market-based rates” are demanded by the utilities and changed by them without filing the rate schedules, without any notice of changes from previously demanded rates, and without an opportunity for FERC review before they become effective. The Commission recognizes in its *Order Amending Tariffs* that the market regimen has not produced just and reasonable rates. In an effort to salvage the market experiment, the *Order Amending Tariffs* would require utilities to impose upon themselves, through inclusion in their tariffs, limited obligations not to manipulate market rates. This is unlikely to cure the market manipulation problem, as demonstrated in Part II below, but the larger issue is that the Commission’s market regimen cannot square with the statute as it is written. The Supreme Court

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<sup>13</sup> While the cited case is a natural gas proceeding, the rate making provisions of the Natural Gas Act and the Federal Power Act are almost identical with respect to the just and reasonable rates requirement, and precedents under those statutes are cited and followed interchangeably. *Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571, 577 fn. 7 (1981).

held in *MCI Telecommunications Corp. v. American Tel. & Tel. Co.*, 512 U.S. 218, 231 n.4 (1994), that a federal agency is bound “not only by the ultimate purposes Congress has selected, but by the means it has deemed appropriate, and prescribed, for the pursuit of those purposes.” The requirement that utilities file all rates and contracts under FPA Section 205 is the “means” prescribed by Congress for protecting consumers from “unjust and unreasonable” or discriminating rates for wholesale power. *MCI*, 512 U.S. at 234 (“For better or worse, the Act establishes a rate-regulation, filed tariff system . . .”). FERC’s devout belief that the new “Market Behavior Rules” will ensure “just and reasonable” wholesale rates is not a sufficient justification for ignoring the statutory filing requirements and is not a basis for the agency to abdicate its statutory oversight duty to correct unreasonable rates by fixing new ones that are reasonable.

The Consumer Advocates’ legal arguments apparently were brushed aside as a minority viewpoint, when the Commission stated that “[t]he vast majority of the comments we received in response supported the Commission’s overall objectives in this proceeding, *i.e.*, the need to establish clear guidelines applicable to market-based rate sellers’ conduct in the wholesale markets.”<sup>14</sup> The Commission failed even to acknowledge Consumer Advocates’ contention that the Commission lacks any statutory authority to adopt the market regimen favored by the agency, and that key elements of the Commission’s market rate initiative are wholly inconsistent with and repugnant to the Federal Power Act’s longstanding consumer-protection requirements. Accordingly, Consumer Advocates specify as error the Commission’s failure to state a statutory basis upon which to make its apparent legal finding that existing “market-based” rate tariffs and authorizations which include the new behavioral “rules” are just and reasonable, and not unduly discriminatory or preferential.

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<sup>14</sup> *Id.*, para. 3.

### III. SPECIFICATION OF ERROR:

#### **THE “MARKET BEHAVIOR RULES” FAIL TO ASSURE JUST AND REASONABLE RATES, AND WILL NOT PREVENT OR REMEDY THE EXERCISE OF MARKET POWER OR MARKET MANIPULATION.**

The purpose of this proceeding, according to the *Order Amending Tariffs*, “is to determine how and to what extent market-based rate seller conduct in the wholesale markets should be monitored by the Commission, and, when necessary, how and to what extent this conduct should be remedied.”<sup>15</sup> The *Order Amending Tariffs* adopts several rules to address “seller conduct,” and finds that “market-based rate tariffs and authorizations that do not include such standards are unjust and unreasonable.”<sup>16</sup> Consumer Advocates request rehearing because incorporation of these subjective and elusive standards into existing utility tariffs is not authorized by the FPA, and will not cure the defects that made the market-based rates unjust and unreasonable in the first place. Even assuming that the Commission has the authority to equate “competitive” rates with “just and reasonable” rates, which Consumer Advocates contend it does not, the Commission failed to address in its *Order Amending Tariffs* Consumer Advocates’ comments questioning the efficacy of the specific proposed “Market Behavior Rules” to achieve “competitive” rates. First, the Market Behavior Rules would not be published rules of the agency with the force of law, but rather, conditions included by utilities in their voluntarily filed market rate tariffs. Moreover, the Market Behavioral Rules are far too general, vague and subjective to be useful, making it impossible for FERC staff actually to implement them in a manner that would detect and rectify most incidents of market power abuse in wholesale electric markets. The basic effectiveness of the rules in monitoring and mitigating market power would be almost completely dependent on the Commission’s unstated future interpretation of the *intent* of sellers or the extremely vague term “legitimate business purpose.” Broad segments of electricity sales would not be covered because there are no market rules for bilateral sales at

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<sup>15</sup> *Order Amending Tariffs*, para. 11.

<sup>16</sup> *Id.*

market-based rates, and broad categories of behavior, including capacity withholding and strategic bidding, are not addressed by the rules.

Furthermore, the Commission dropped any consideration of establishing structural rules or structural market models for application to wholesale power markets in order to minimize the possibility of the exercise of market power occurring, contrary to Consumer Advocates' explicit recommendations in our initial comments of January 4, 2002 in this docket as to the need for capacity as well as energy markets as part of any formal RTO ISO power markets. Consumer Advocates' requests for rehearing on these specified errors are explained in greater detail below.

**A. The Commission Fails to Specify or Define A “Zone of Reasonableness” for Rates In Its Market-Based Rate Regimen.**

The Commission begins its discussion of Market Behavior Rule 2 on page 10 of the *Order Amending Tariffs* by stating again that “our reliance on competitive markets to establish just and reasonable rates requires that we have the tools necessary to ensure that prices created in these markets continue to fall within a just and reasonable zone.” *Id.* This quote is very revealing. It shows, as we have argued in previous Comments to the Commission in this docket, that, at best, competitive markets are only a means to the end of just and reasonable rates. That goal has not changed, since the Federal Power Act’s rate regulatory provisions have not changed during the time period during which the Commission has allowed deregulated generation markets to exist, beginning in about 1992.<sup>17</sup> Furthermore, it is extremely important to note yet again, as we pointed out in our January 4, 2002 Comments, the Commission has not given any clear definition of what it means by a “just and reasonable” zone, or a “zone of reasonableness” as the courts describe it, which we take as synonymous, within the context of “market-based” rates. Yet, such a zone must be quantified, at least approximately. A “zone” is a range in common sense English, in this case a range of prices. What anchors this range of prices that the Commission discusses to a price that would be “just and reasonable” under the Federal Power

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<sup>17</sup> Legislative efforts to grant FERC authority to allow market rates and to supervise markets have consistently failed to gain passage in Congress.

Act? The Commission does not say, and has never provided this crucial connection in any orders of which we are aware. Yet, the lower courts that clearly rooted such a range or zone as being very closely tied to traditional cost-of-service based rates for power in wholesale markets.

We request rehearing on the issue of how to define what the “zone of reasonableness” is in a market-based rate regime, so that this goal of Market Behavior Rule 2 is clear. If the Commission has no definition of the “zone of reasonableness” in a deregulated market context, then it can never hope to carry out “effective market monitoring and enforcement,” as it proposes on page 10 of the *Order Amending Tariffs*.

The basic concept that is relevant here, as we described in our January 4, 2002 Comments, is that this zone of reasonableness exists where rates are neither “less than compensatory” to investors nor “excessive” to customers.<sup>18</sup> As we said then, range “certainly sounds like a result obtained by setting a fair return on equity (“ROE”) in the process of traditional cost-of-service ratemaking.” (p. 8 of our January 4, 2002 Comments). By leaving undefined the key goal of its ratemaking scheme and the key term that describes it, the “just and reasonable zone,” the Commission ensures that Final Rule 2 will be completely ineffectual, because it cannot know how to achieve the goal of this rule if this concept remains undefined. As we shall see, much of the Commission’s discussion of its Market Behavior Rule 2 regarding market manipulation simply amounts to “we will know it [market manipulation] when we see it.” This is not a sufficient level of clarity or certainty for a very important federal agency rule, under a statute that demands fixing schedules of reasonable rates in advance of their being charged.

On page 10 of the *Order Amending Tariffs*, the Commission states that in order to carry out effective market monitoring and enforcement it proposes to prohibit activities that “adversely affect competitive outcomes.” This statement again indicates that the Commission equates competitive market outcomes with just and reasonable rates. Yet, equating these two radically different concepts is not valid.<sup>19</sup> As we have described at length in our previous comments in

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<sup>18</sup> See footnote number 3 on page 8 in our January 4, 2002 Comments in this docket.

<sup>19</sup> “[W]e should also stress that in our view the prevailing price in the marketplace cannot be the final measure of ‘just and reasonable’ rates mandated by the Act.” *FPC V. Texaco*, 417 U.S. 380, 397 (1974).

this docket, the prices produced in a competitive generation market could be far above a just and reasonable rate, as the federal courts have defined “just and reasonable.” Competitive market prices could, in fact, be far above a zone of reasonableness because they could be far above traditional cost-of-service rates in some parts of the US. (For example, see pages 5-6 of our August 18, 2003 Comments.) Indeed, it would only be a happy coincidence if competitive wholesale market prices for generation fell within a zone of reasonableness with respect to the traditional cost-of-service rate for such power. The Commission fails to address, however, the standard one would compare competitive market prices *to* in making the necessary judgments as to whether or not they were just and reasonable.<sup>20</sup> Would one compare such prices to average cost-of-service rates in a region? Would one compare competitive market prices to the cost-of-service rates for each power plant in the region as a strict interpretation of the Federal Power Act might dictate? All these critical questions must be answered if the Commission is to depart from the longstanding legal tradition of determining the zone of reasonable based on a wholesale seller’s costs of the service provided. As the courts have found, “the necessity for an anchor to ‘hold the terms “just and reasonable” to some recognizable meaning’ is plain, for the words themselves have no intrinsic meaning applicable alike to all situations.” *City of Chicago v. FPC*, 458 F.2d 731, 750 (D.C. Cir. 1971). The Commission erred in failing to define what it means by “zone of reasonableness,” and just and reasonable rates for electric generating units in the context of competitive markets as these terms are used in Market Behavior Rule 2.

The Commission asserts in its *Order Amending Tariffs* that the behavioral rules that it has adopted are: “clearly defined so that they do not create uncertainty, disrupt competitive commodity markets or simply prove ineffective.”<sup>21</sup> Applying these criteria to the Market Behavior Rules issued in the Commission’s order, we demonstrate below that the rules clearly violate all the criteria above that the Commission itself has used to determine their adequacy.

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<sup>20</sup> “At the very least, the order is so ambiguous that it falls short of that standard of clarity that administrative orders must exhibit.” *FPC v. Texaco*, 417 U.S. 380, 396 (1974).

<sup>21</sup> *Order Amending Tariffs*, para. 12, p. 5 .

**B. Seller Withholding of Capacity, and Seller Conduct in Bilateral Contract Markets, Are Effectively Exempted From the “Unit Operation” Rule Because Sellers Are Not Required to Bid or Supply Services, and Because There Are No Other “Commission-Approved Rules and Regulations” Applicable to Unit Operation by Sellers In Bilateral Markets.**

**1. “Market Behavior Rule 1” Does Not Address Capacity Withholding.**

Consumer Advocates request rehearing on the issue of the need to establish anti-capacity withholding rules for all power markets whenever that capacity is counted as part of a regional reliability requirement. Petitioners in their formal Comments of August 18, 2003, objected to “Market Behavior Rule 1”<sup>22</sup> as proposed, stating: “This rule must be greatly amplified and clarified to be satisfactory.”<sup>23</sup> This rule is completely dependent on the existence of some other, unspecified, “Commission-approved rules and regulations of the applicable power market.”<sup>24</sup> At best it is vague due to the cross-reference to unspecified rules of private markets. If there really were other Commission “rules and regulations” bearing on unit operation, it is difficult to perceive what this provision would add. There are, however, no Commission rules or regulations addressing unit operation, and “Market Behavior Rule” 1 by its own terms “does not require Seller to bid or supply electric energy or other electricity products...”<sup>25</sup> The RTOs or ISOs -- themselves private utilities -- may have Commission-approved tariffs containing their private “rules and regulations” for the other utilities who participate in the RTO or ISO. Essentially Market Rule 1 requires utilities participating in RTOs or ISOs to include in their tariff a provision that they will follow the rules contained in the tariff of the RTO or ISO. Thus, Market Rule 1 will not be an official “rule” of the Commission published in the Code of Federal

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<sup>22</sup> “**Unit Operation:** Seller will operate and schedule generating facilities, undertake maintenance, declare outages, and commit or otherwise bid supply in a manner that complies with the Commission-approved rules and regulations of the applicable power market. Compliance with this Market Behavior Rule 1 does not require Seller to bid or supply electric energy or other electricity products unless such a requirement is a part of a separate Commission-approved tariff or requirement applicable to Seller.” *Market Rule 1, Final Order, Appendix A.*

<sup>23</sup> [citation]

<sup>24</sup> *Market Rule 1, supra.*

<sup>25</sup> *Id.* The rule suggests it might require a Seller to bid or supply electric energy or other electricity products if “such requirement is a part of a separate Commission-approved tariff or requirement applicable to Seller.” *Id.* Again, this only adds to the vagueness and circularity of the rule.

Regulations, violation of which could lead to penalties under the Federal Power Act, but would be merely a private utility tariff provision.

In Petitioners' prior formal Comments we implicitly urged that the Commission to adopt an anti-capacity withholding rule for all wholesale electricity markets. If this is not done, then generation owners can use the well-known technique of capacity withholding to amplify their ability to exercise market power. The Commission explicitly accepts the premise that market power can be exercised through capacity withholding. Yet, inexplicably, the Commission has now stated that it will not issue such an anti-withholding rule applicable to all market-based rate tariffs. The Commission should re-consider this decision and should remove the second sentence of this final rule. The Commission should issue anti-capacity withholding rules for all generation markets, whenever the relevant capacity is being counted against a distribution utility's system reliability requirements by NERC, or by the relevant regional reliability council, or by the relevant state public utility commission.

The new second sentence of Market Behavior Rule 1 seems to respond to one of Consumer Advocates' original comments seeking a prohibition against capacity withholding.<sup>26</sup> The Commission acknowledges that Consumer Advocates want Proposed Rule 1 to be interpreted as an anti-capacity withholding rule in all power markets. In response, the Commission totally rejected Consumer Advocates' position, by adding the new second sentence to Rule 1 which makes it clear that Final Rule 1 will not be interpreted as an anti-withholding rule. Consumer Advocates ask the Commission to reconsider its amendment to Proposed Rule 1, by eliminating the new second sentence. The Commission should make clear that if a particular power plant (or power contract) is being counted on by a retail supplier (load serving entity) as part of a state or federally mandated required capacity reserve margin, then the owner of the plant does have an obligation to make its power available to one or more types of regional power

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<sup>26</sup> "Finally ... Colorado Consumer Counsel, et al.) Interprets Market Behavior Rule 1 as a prohibition against capacity withholding and seeks clarification regarding the application of such a rule to hydroelectric generation in those parts of the country where hydro power is used primarily for peak shaving." *Final Order*, para. 17, p. 7-8.

markets whenever the plant is able to operate. The Commission has ignored this critical point in drafting the final Market Behavior Rule 1.

For the Commission not to include such an anti-withholding requirement in Rule 1 clearly endangers generation system reliability, and would clearly allow capacity withholding to be used as a tool to exercise market power by making the supply of capacity relative to demand much tighter. Allowing capacity withholding to occur when that capacity is required to meet regional reliability rules would be extremely dangerous to the preservation of system reliability in most parts of the nation. It would also undermine the credibility of all of the Commission's other rules designed to prevent market manipulation. The only effective alternative to amending Rule 1 in the manner we suggest is for the Commission to interpret its phrase "legitimate business purpose" in Final Rule 2 to mean that capacity withholding in any wholesale market, including bilateral contract markets, is not a legitimate business purpose by definition, whenever the relevant capacity is being credited against a state or federally mandated capacity reserve requirement. If the Commission intends to rely on Market Behavior Rule 2 rather than Market Behavior Rule 1 to forbid capacity withholding in these circumstances, it should explicitly so state.

## **2. "Market Behavior Rule 1" Fails to Address Seller Behavior in Bilateral Markets.**

Another glaring flaw in "Market Behavior Rule 1" is that a major segment of energy sales by sellers with market-based rate authorizations will not be reached by this standard. This is because in granting market-based rate authority, the Commission has relaxed statutory filing and review requirements that should apply to all bilateral contracts and sales, and because the administratively deregulated bilateral contract markets for power (including informal bilateral spot markets) typically have no rules and regulations, as we pointed out in our prior Comments. The Commission intends for the bilateral contract market for power to be covered by these final behavioral rules. Indeed, the Commission has urged that a majority of wholesale generation be acquired in bilateral markets, in contrast to the formal day-ahead spot markets operated by RTOs

or ISOs. Therefore, by the Commission's own estimation, "Market Behavior Rule 1" will not apply to the majority of the power sold in the power markets by sellers who have been granted market-based rate authorizations. This substantially vitiates effectiveness of the rule. This means that Rule 1 cannot ensure that prices for most wholesale purchases, namely for those made in the bilateral contract markets, are just and reasonable. Unless the rule is modified to apply to all wholesale power markets, including bilateral contracts, it will be ineffectual.

The Commission makes it clear in paragraph 20 of the Final Order that this rule will not apply to any bilateral power sales arrangements to which the seller might be a party. This is consistent with the idea that Rule 1 only applies when Commission-approved rules and regulations exist for the relevant power market, since there are no relevant rules for the bilateral power markets. This implies that what the Commission considers as a requirement for just and reasonable outcomes in the RTO or ISO formal power markets is not a requirement to ensure just and reasonable outcomes for all other market-based power sales arrangements where there are even fewer or no Commission-approved rules and regulations governing those markets in order to protect consumers. The *Order Amending Tariffs* does not justify this apparent inconsistency in logic, especially, as we noted above, since most power should or does pass only through the bilateral contract market. The way to eliminate this logical inconsistency is not to water down "Market Behavior Rule 1", so that it adds nothing substantive to the content of any rules and regulations that do exist for markets, but for the Commission to issue comprehensive rules governing unit operations that would apply to the bilateral contract market as well. Market Behavior Rule 1 leaves an enormous loophole in its overall protections against generation unit owners and power marketers operating the plants whose output they control in a way that can make the possibility of market manipulation much higher than it would be with strong unit operation behavioral rules that would apply to the bilateral markets as well as to formal RTO and ISO markets. Final Rule 1 could also result in disrupting power markets by allowing different rules to govern different parts of the overall market, something the Commission has always

opposed, particularly at those times when the Commission has argued for establishing RTOs in all regions of the US.

Thus, the Commission should address and answer the question as to how a rule such as Rule 1 could only be necessary in markets where there are many other RTO and ISO rules, but not be necessary in markets where there are no such rules at all. The Commission never addresses how the public interest will be protected by “Market Behavior Rule 1” in those other, less formal markets in which the Commission has granted dispensation from the normal rate filing and review requirements of the FPA. It was the clear intent of the Commission in establishing this docket in the first place to protect ratepayers against market manipulation within all the power markets it had administratively deregulated. Thus, Rule 1 will simply be ineffective in achieving the Commission’s original goal, which was to amend all market-based rate tariffs or authorizations by adding behavioral rules to prevent market manipulation, etc. Since under section 206 the Commission must determine the rates to replace rates that it has found to be “unjust and unreasonable,” the Commission must clarify the effect of Rule 1 on market-based rate authorizations for bilateral contracts. If the Rule 1 simply means: “if a given market has rules already in place, then just follow those rules,” Consumer Advocates believe it to be meaningless. If Rule 1 means something more than this, we request that the Commission clarify its meaning and make the additional content of Final Rule 1 applicable to all market-based tariffs and authorizations.

### **3. “Market Behavior Rule 2” Will Not Curb Manipulation of Rates Because It Fails to Define Actions Having a “Legitimate Business Purpose.”**

The most important phase in “Market Behavior Rule 2” is the term “legitimate business purpose.”<sup>27</sup> This provides a safe harbor from the Commission’s apparent prohibition of a wide

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<sup>27</sup> **Market Manipulation:** Actions or transactions that are *without a legitimate business purpose* and that are intended to or foreseeably could manipulate market prices, market conditions, or market rules for electric energy or electricity products are prohibited. Actions or transactions undertaken by Seller that are explicitly contemplated in Commission-approved rules and regulations of an applicable power market (such as virtual supply or load bidding) or taken at the direction of an ISO or RTO are not in violation of this Market Behavior Rule.” *Market Behavior Rule 2, Final Order, Appendix A*. In subparts a - d, the rule proscribes certain specific conduct, including “wash

range of behaviors in the wholesale generation markets, in addition to the prohibited behaviors that are explicitly banned in the rule's four subparts a. – d. Because it is the linchpin within this rule, as many intervenors in this docket have stated, the term “legitimate business purpose” must be clearly and precisely defined. Yet, the Commission has consciously chosen not to do so anywhere in its *Order Amending Tariffs*, but instead will: “on a case-by-case basis ... determine whether the motives ascribed to transactions by sellers are legitimate or not legitimate.”<sup>28</sup>

Consumer Advocates cite as error the Commission's incorporation of subjective tests, based on the motive and intent of utilities, to evaluate rates, rather than evaluating the reasonableness of the rates utilities demand or charge. One searches the Federal Power Act in vain in for any language permitting rates for electricity to be raised by any amount so long as the utility has a legitimate business purpose. However, even if the Commission had a statutory basis for evaluating rates on the basis of the seller's motive, Consumer Advocates seek rehearing of its decision not to define and explicitly list the behaviors considered to be consistent with legitimate business purposes for generation owners (or generation traders or bilateral contract holders). A comprehensive list should be included in the rule identifying what kinds of wholesale generation bidding strategies would be considered consistent with having a “legitimate business purpose.” Once a complete list is included in “Market Behavior Rule 2”, Petitioners and other parties should have the opportunity to comment further on the adequacy and relevance of this list. If the Commission never states what kinds of behaviors or bidding strategies are considered legal, it cannot know which behaviors or strategies are illegal. These strategies will have to be enumerated and described very precisely anyway if the Commission's staff is ever to know how to monitor the wholesale markets for the existence of market power.

In paragraphs 27 though 29 of the *Order Amending Tariffs*, the Commission acknowledges that many parties have protested that the key phrase “without a legitimate business purpose” is fatally vague and unclear, because the Commission has refused to define this phrase.

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trades,” submitting false information to transmission providers, creating “artificial congestion,” and “collusion with another party” to manipulate rates.

<sup>28</sup> *Final Order*, p. 14, fn. 25.

Consumer Advocates agree, and request rehearing on this issue. We do not believe that such a critical Commission rule, such as Market Behavior Rule 2, which would ultimately prove to be the Commission's main defense against the exercise of market power in generation markets, can rest on such an unclear and undefined phrase. As other parties have stated, there are no clear guidelines in this industry for what "legitimate" business purposes are. That may have been part of the reason why Enron was allowed to get away with causing so much damage to power markets in previous years. Deregulated wholesale power markets are a recent experiment, and one that has not been sanctioned as permissible under the Federal Power Act, as we discuss at the outset of this rehearing. Thus, given the historical manner in which the Commission has incrementally allowed more and more power to be sold at market prices over the last decade, without ever establishing clear rules for market behavior, the Commission cannot continue to prospectively authorize market-based rate authority without clearly delineating such behavior. The Commission cannot claim to rely on "recognized principles or accepted rules and standards" as a definition of "legitimate business purposes," by quoting Webster's Dictionary on page 11 of the *Order Amending Tariffs* when the Commission is the regulatory body that oversees wholesale generation sales and purchases and would have to establish and enforce such standards. It is, after all, not Mr. Webster that has been entrusted with administration of the Federal Power Act and the protection of wholesale consumers.

What reasons does the Commission itself give for not defining the key phrase "legitimate business purposes"? The main reason is a desire not to be precluded in the future from providing remedies "for market abuses whose precise form and nature cannot be envisioned today." (p. 13 of *Order Amending Tariffs*). But this makes no sense; the Commission can always define legitimate business purposes today, and yet leave its list open-ended to allow it to determine that additional unanticipated market behaviors are not justifiable. Not knowing a complete list today should not preclude the Commission from not making any list of legitimate business purposes at all. Having no list will surely make this rule totally ineffectual, and any Commission decisions

based on such a vague standard will surely be appealed to the courts by parties attempting to manipulate power markets.

In paragraph 37 of the *Order Amending Tariffs*, the Commission uses further language when discussing legitimate business purposes that raises new problems. The order states: “we clarify that transactions with economic substance, in which a seller offers or provides service to a willing buyer and where value is exchanged for value, are not prohibited by our rule.” *Id.*, p.14. In our opinion, this is a perfect example of a lack of clarity in the *Order Amending Tariffs*. Obviously, the term “economic substance” is vague and has no electric industry-specific meaning. It is not a technical term. Similarly, the word “value” is equally vague. Perhaps “value being exchanged for value” could be an instance of criminal or other illegal behavior, where the spoils of such behavior are shared by the two parties doing business with each other. Such a business relationship would, presumably, not meet the Commission’s intended standard of “legitimate” business purpose, but the use of the term “value” in the statement intended to clarify “legitimate” just serves to make the issue more unclear and confused. Having announced a new standard, there is no shortcut available to the Commission to avoid listing and explaining “legitimate business purposes” that are directly relevant to rate setting behavior in electric generation markets.

In contrast, in footnote #19 on page 10 of the June 26, 2003 Order in this docket, the Commission stated that “engaging in manipulation, for example, in order to maximize profits, is not a legitimate business purpose.” However, if maximizing profits is not a legitimate business purpose, we do not know what such purposes would be. Here, of course, another problem is that the Commission has also not defined the key term “manipulation.” For example, is strategic bidding to raise market prices above competitive levels without colluding, and without withholding capacity, market manipulation? Consumer advocates think that strategic bidding qualifies as manipulation, though the Commission appears not to. Yet, strategic bidding is, probably, the most common mechanism used by generation owners to exercise market power in wholesale electricity markets, as we have described at length in our three sets of comments in

this docket. Consumer Advocates request clarification as to whether or not strategic bidding is a form of market manipulation under the Commission's rules, and rehearing if it is not.

The Commission further justifies use of the term "legitimate business purpose" in Rule 2 in paragraph 37, by saying that "sellers acting in a pro-competitive manner will have the opportunity to show that their actions were not designed to distort prices..." (p. 14 of the Order). If the intent is to actually allow sellers to defend their actions every time the Commission identifies a market price that appears not to be just and reasonable, the Commission will never be able to keep up with the market monitoring process and needs throughout the US. This aspect of how the Commission intends to carry out its Market Behavior Rules institutionally is completely unworkable. This is another reason why the Market Behavior Rules need to have much more clarity, so that endless discussions with sellers are not necessary to enforce the Market Behavior Rules. Finally, the Commission's use of the terms "pro-competitive" and "anti-competitive" in attempting to clarify what legitimate business purposes are also fails to assist this critical process, since the Commission never bothers to define either of these two terms. This is probably because the Commission has never described what it considers to be a competitive wholesale electricity market structure, and it certainly does not do so in this *Order Amending Tariffs*. Thus, it is completely unclear how the Commission would define a competitive price, even if such a price could be assumed to be just and reasonable, which Consumer Advocates contend it cannot. The Commission erred by failing to define "competitive market price" and we request rehearing on this point.

It seems to us as Consumer Advocates that it is naïve, to say the least, for the Commission to believe it will be able to discuss all suspicious market transactions with sellers to determine when market manipulations have occurred. Our analysis of how market power occurs in wholesale electric markets indicates that market manipulations are a constant feature of markets and occur incessantly. Whether or not these types of market manipulations generally or always lead to excess profits is a factual matter that we will not prejudge. But FERC staff would never have the time or ability to engage in all these discussions about intent with market

participants if Rule 2 continues to put so much weight on intent and specifying the legitimate business purpose behind each transaction. This is particularly true because the Commission is in the process of establishing thousands of sub-markets for electric generation throughout the US, each of which will set a formal market price every five minutes, or so. This implies that Market Behavior Rule 2 is simply unworkable, due, literally, to the incredibly large volume of work that it would create. Yet, despite the vast number of cases it would have to deal with, at footnote 25 on page 14 of the *Order Amending Tariffs*, the order states that “the Commission is well equipped, on a case-by-case basis [emphasis added], to determine whether the motives ascribed to transactions by sellers are legitimate or not legitimate.” *Id.* Consumer Advocates believes that this is factual error.

Also, because the precise language of final Rule 2 says that transactions are prohibited that “are intended to or foreseeably could manipulate market prices,” there will be endless disputes with market participants over motives and intent unless the Commission establishes clear rules to protect buyers from the exercise of market power. One legal point that the Commission must clarify is that neither intent nor “foreseeability” are appropriate criteria for deeming a transaction to be unjust and unreasonable. The Federal Power Act simply requires the outcome of each market transaction (if market mechanisms are legal at all) to be just and reasonable rates. Intent does not matter under the statute. Yet the Commission explicitly states that it is adopting “an intent standard” on page 22 of the *Order Amending Tariffs* in connection with final Rule 2.b., and on page 25 with respect to final Rule 2.c. We request a rehearing with respect to all these key definitional issues in order to give final Rule 2 the required clarity and precision to make it workable if it is to be the Commission’s first line of defense against the existence of market power in all generation markets, including bilateral contract markets. We also request a rehearing of the complete wording of final Rule 2 in order to remove all the language dealing with intent from the rule, because intent is irrelevant to the just and reasonable standard under the Federal Power Act. Rule 2 should focus solely on the outcome or result of the rate setting mechanism.

**4. “Market Behavior Rule 2.c”: Forbidding “Artificial Congestion” Fails to Specify How the Exercise of Market Power Will be Monitored and Mitigated.**

“Market Behavior Rule 2.c” prohibits “transactions in which an entity first creates artificial congestion and then purports to relieve such artificial congestion (unless Seller exercised due diligence to prevent such an occurrence)... *Id.* The Commission fails, however, to specify how market power will be monitored, and mitigated or eliminated when any level of congestion exists in a transmission grid. The Commission should not just include in this sub-rule language dealing with the intentional creation of additional congestion. Perversely under this rule, any price gouging rate may now be demanded at a time of congestion, no matter how unreasonable, if the congestion is not “artificially” created.

The Commission referenced Consumer Advocates’ objection, recognizing the problem of “how market power, during periods of congestion, will be constrained,”<sup>29</sup> but then never dealt with or resolved this issue in its discussion of Rule 2.c, or for that matter, anywhere else in the *Order Amending Tariffs*. Thus, the Commission erred by failing to address the issue raised by Consumer Advocates on this point.

The Commission has previously issued several orders which address to some extent the control of market power in certain load pockets where formal spot markets exist but, to Consumer Advocates’ knowledge, the Commission has never systematically addressed how deregulated market prices for bilateral or informal spot markets can be purged of market power when a significant level of transmission congestion exists. The Commission could do so by re-framing and broadening rule 2.c. to include all levels of transmission congestion wherever it exists. Otherwise, the existence of congestion within a power market will always make the exercise of market power easier than when no congestion exists, no matter what kind of power market is considered (i.e., bilateral or a formal RTO or ISO spot market). This problem of

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<sup>29</sup> “Colorado Consumer Counsel, et al. argue that, in addition to the prohibition set forth in the proposed rule, the Commission should also address how all gradations of congestion will be managed in a wholesale market context and how market power, during periods of congestion, will be constrained.” Final Order, para. 71, p. 24.

market power -- and hence clearly unreasonable rates – exists whether the congestion is created intentionally or not. Is it a legitimate business purpose to exploit the presence of congestion no matter what its cause, to raise generation prices above competitive levels? The Commission must address this question. By only dealing with cases involving the intentional creation of congestion, the Commission errs by ignoring the more prevalent circumstances in which congestion can generally lead to market manipulation and unreasonable rates.

The Commission would prohibit the creation of artificial transmission congestion, because the rate received for relieving such congestion would not likely be just and reasonable. However, again, if the existence of transmission congestion (even if not intentionally created) facilitates the exercise of market power via the exercise of multilateral strategic bidding, the Commission cannot find market-based rates to be just and reasonable unless it takes action to cure this problem as well. If, upon rehearing, the Commission adopts our recommendation to prohibit multilateral strategic bidding whether in the presence of transmission congestion or not, this problem would be addressed.

##### **5. “Market Behavior Rule 2.d” Fails to Address Behaviors Other than Overt Collusion Which Raise Market Prices Above Competitive Levels.**

“Market Behavior Rule” 2.d prohibits “collusion with another party for the purpose of manipulating market prices, market conditions, or market rules for electric energy or electricity products.”<sup>30</sup> Thus, sub-rule 2.d. only prohibits overt collusion among parties for the purpose of manipulating market prices. It does not address Consumer Advocates’ contentions, made repeatedly in prior filings,<sup>31</sup> that other key types of behaviors, such as strategic bidding, can raise

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<sup>30</sup> *Market Behavior Rule 2.d.*

<sup>31</sup> A clear description of how multilateral strategic bidding leads to the exercise of market power is provided in Petitioners’ January 4, 2002 Comments on pages 32-35. Petitioners cited game theory analysis demonstrating that parties engaging in strategic bidding in repetitive uniform price auctions, without overt collusion, can drive prices above competitive levels. Petitioners also cited an economics laboratory research experiment finding prices can be driven 50% above competitive levels, through strategic bidding of the sellers, without overt collusion. Mount, et al., Testing the Performance of Uniform Price and Discriminative Auctions, (Revised Draft, July 16, 2001.) <http://www.pserc.wisc.edu> under documents/publications.2001 publications, item 2001 01-18. This experience supports the theoretical analysis showing that the spot markets that pass conventional market power screens can be gamed without collusion.

market prices well above competitive levels. The *Order Amending Tariffs* does not address the question whether such non-collusive strategic bidding, demanding rates well above the marginal cost bidding presumed by the economic rationale advanced for the formal spot markets, is a legitimate business purpose. Yet, aside from the use of capacity withholding as discussed above, the use of multilateral strategic bidding is likely to be the predominant means for generation owners to exercise market power and market manipulation. Petitioners assume that outright collusive bidding to drive prices up in electricity markets is, in fact, rare. Based on game theory analysis and evidence, overt collusion is totally unnecessary to achieve market clearing prices far above competitive levels, particularly at times of congestion. Petitioners' three previous sets of comments in this docket contain detailed discussions of how multilateral strategic bidding can lead to rates above a competitive level, and above cost-of-service based levels.

On page 28 of the final Order, the Commission states the “we are prohibiting market manipulation undertaken collectively.” Unfortunately, the actual final Rule 2.d. language does not, in general, do so. The Commission is only prohibiting collective action to manipulate market prices through collusion; it is not prohibiting collective action to manipulate market prices through multilateral strategic bidding, as Consumer Advocates have previously urged the Commission to do in this docket. Again, Consumer Advocates request rehearing on this key issue, because, again, the just and reasonable standard for generation rates in the Federal Power Act does not rely on intention. Whether or not a particular unjust and unreasonable wholesale generation rate is caused by collusion or by multilateral strategic bidding based on the mutual self-interest of the bidders, but where no explicit communication between them has occurred (constituting collusion), the result is the same. Under the statute, the rate is just as unlawful either way.

**6. “Market Behavior Rule 2.e” Should Not Have Been Eliminated Because It Addressed Non-Collusive Withholding of Capacity and Bidding Behavior Which Results in Unreasonable Rates.**

Initially, the Commission proposed “Market Behavior Rule 2.e”, which would have prohibited “bidding the output of or misrepresenting the operational capabilities of generation facilities in a manner which raises market prices by withholding available supply from the market.”<sup>32</sup> Unfortunately, in the *Order Amending Tariffs*, the Commission has abandoned this proposed rule. A rule of this nature might have addressed the strategic bidding behavior of generation owners who bid in a way that results in making all or part of their output either unavailable or so expensive that other high priced units are called to operate, which results in spot market rates set at a level higher than would have obtained had sellers demanded rates for all their output at competitive levels. Consumer Advocates request that the Commission add a prohibition on the use of multilateral strategic bidding to its prohibition on collusion either by reviving rule 2.e or amending 2.d, to address cases when strategic bidding leads to the economic withholding of capacity, as well as when capacity ends up operating, but where the bids for this capacity are significantly above a competitive market outcome. Part of the reason for this request is that the intent of the generation owners in manipulating the market prices is not the real issue. The Federal Power Act requires that all rates demanded or charged must be just and reasonable, no matter what the intent of generation owners might be. If rates in the wholesale markets are not just and reasonable, it does not matter why this is so, or if any seller worked alone or in concert with others to obtain an unjust or unreasonable rate. The statute provides that rates that are not just and reasonable are unlawful.

Finally, we are very concerned that in its final Rule the Commission decided to drop Proposed Rule 2.e. from further consideration, and not adopt it, because it was seen as redundant with other rules adopted. We are not convinced that it is redundant, because capacity withholding is no longer explicitly mentioned in any one of the final Rules. It is especially

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<sup>32</sup> *Final Order*, para. 93, p. 29.

unclear how the other rules will explicitly prohibit capacity withholding in wholesale bilateral contract markets, which constitute the majority of the wholesale market transactions (in megawatts). In contrast, this proposed rule would have provided critical protection from the withholding of generation capacity from use in serving load when needed for economic or reliability purposes. Thus, we find that the Commission erred in dropping this sub-rule from its Market Behavior Rules and request rehearing. As we have discussed above, there are other Market Behavior Rules that could be modified in order to incorporate an adequate anti-capacity withholding rule if the Commission chose to address the question in another rule. However, the Commission has so far not done so, and Consumer Advocates believe that it must.

#### **7. The “Market Behavior Rules” May Be Economically Breached Because Statutory Penalties Will Not Apply to Violations.**

The Market Behavior Rules adopted in the *Order Amending Tariffs* are intended by the Commission to be “rules of the road,” but they are not being adopted as rules of the Federal Energy Regulatory Commission. No new FERC rule applicable to utilities under the Commission’s jurisdiction is to be added to the Code of Federal Regulations as part of the agency’s official rules. Carefully parsed, the *Order Amending Tariffs* imposes only a duty upon utilities to incorporate the “Market Behavior Rules” into their own tariffs, prospectively.<sup>33</sup> As a result, once the text of the rules is incorporated into its tariffs, a utility’s violation of these “rules of the road” will not constitute a violation of the FPA, will not be a violation of any official FERC regulations, and will not violate requirements of the *Order Amending Tariffs*. The statutory penalties for such violations, therefore, will not apply to manipulation of market rates.<sup>34</sup>

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<sup>33</sup> Carefully parsed, the *Final Order* does not actually order the utilities to follow the new rules. See the ordering provision “B” at p. of the *Final Order*, at p. 63 directing the utilities to “include the Market Behavior Rules” in their next -filed tariffs.

<sup>34</sup> “(a) Statutory violations. Any person who willfully and knowingly does or causes or suffers to be done any act, matter, or thing in this chapter prohibited or declared to be unlawful, or who willfully and knowingly omits or fails to do any act, matter, or thing in this chapter required to be done, or willfully and knowingly causes or suffers such omission or failure, shall, upon conviction thereof, be punished by a fine of not more than \$5,000 or by imprisonment for not more than two years, or both.

(b) Rules violations. Any person who willfully and knowingly violates any rule, regulation, restriction, condition, or order made or imposed by the Commission under authority of this chapter, or any rule or regulation imposed by the

Rather, a breach of the new “rules of the road” will be treated merely as a tariff violation, a breach of the utility’s own rules.

Any violation of these Market Behavior Rules will constitute a *tariff violation*. Seller will be subject to disgorgement of unjust profits associated with the tariff violation, from the date on which the tariff violation occurred. Seller may also be subject to suspension or revocation of its authority to sell at market-based rates or other appropriate non-monetary remedies.<sup>35</sup>

Although an apprehended wrongdoer might be required, under the tariff, to disgorge “unjust profits associated with the tariff violation,” there would be no requirement that a market manipulating seller who inflates rates paid to himself and to other sellers must “make the market whole.”<sup>36</sup> This latest effort to salvage an alternative regulatory paradigm, built upon a crumbling foundation of hopelessly flawed spot markets with increasingly complex and expensive to administer “rules of the road,” is doomed. The new “rules of the road” will not deter market manipulation when it is profitable to take the risk. The ultimate penalty is to revoke market rate activity and require the seller to file just and reasonable cost-based rates, as before.

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Secretary of the Army under authority of subchapter I of this chapter shall, in addition to any other penalties provided by law, be punished upon conviction thereof by a fine of not exceeding \$500 for each and every day during which such offense occurs.” *16 U.S.C. Sec. 825o. - Penalties for violations.*

<sup>35</sup> *Final Order, Appendix A (Emphasis added).*

<sup>36</sup> “I would not limit the monetary penalty for tariff violations to disgorgement of unjust profits. Market manipulation can raise the market prices paid by all market participants and collected by all sellers. In such a case, the appropriate remedy may be that the manipulating seller makes the market whole.” *Order Amending Tariffs, Concurring Opinion* (Commissioner Massey).

#### IV. CONCLUSION

For all of the policy and legal reasons stated above, existing “market-based” tariffs and authorizations that include the Commission’s new “Market Behavior Rules” issued in its *Order Amending Tariffs* in this docket will not result in wholesale electric generation rates that are just and reasonable as required by the Federal Power Act. The Commission has never defined what “just and reasonable” means in a market context. Furthermore, the Commission cannot properly assume, as it appears to have done, that competitive market outcomes for electric generation will yield just and reasonable rates. Further, these Market Behavior Rules do not meet the Commission’s own criteria for adequacy in controlling market “behavior.” The *Order Amending Tariffs* proposes new behavior rules that are fatally unclear and subjective, and are often based on determinations of intent to manipulate the power markets. Instead, any Market Behavior Rules to be applied to market-based authorizations in this docket should be based solely on determining whether or not the outcome of the rate setting process will lead to just and reasonable rates. “Intent” is not an element of just and reasonable rates under the FPA. Finally, we have demonstrated that the Federal Power Act does not allow the Commission to establish any type of market mechanism that is inconsistent with the constraint that all wholesale generation rates must be filed rates subject to all the relevant consumer protection provisions of the Federal Power Act, including refunds with interest if such rates go into effect before they have been reviewed by the Commission. In order to be lawful under the Federal Power Act, any wholesale rates produced by market mechanisms must also fall within a zone of reasonableness with respect to cost-of-service based rates for the output of each generating unit, and the Commission’s market monitoring and enforcement mechanisms and methodologies must ensure that this happens. The Commission failed to fix new reasonable rates as required under Section 206, and the “Market Behavior Rules” proposed for market-rate tariffs and authorizations in the *Order Amending Tariffs* do not achieve lawful rates under the Federal Power Act.

December 16, 2003

Respectfully submitted,

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New Mexico

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Colorado

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Utah

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PULP

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NCLC

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Public Citizen

**CERTIFICATE OF SERVICE**

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in this proceeding.

Dated at Santa Fe this 17<sup>th</sup> day of December, 2003.

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Jeff Taylor