

# FERC and the States: A Marriage of Necessity?

## I. Introduction

As is increasingly the case, the federal government and the states are finding that today's problems can best be solved by working closely together. This seems almost intuitive for issues such as homeland security, health care, and the environment to name a few. Energy issues demand the same kind of partnership.

With the electric power industry continuing its progression toward a hybrid model of competition and regulation, the need for the Federal Energy Regulatory Commission and the states to work closely

together to benefit the ultimate customer is becoming more important. The question is how?

The nation's shareholder-owned electric companies—whose electricity transactions continue to be scrutinized by both the Commission and the states—are advocating a partnership based on the time-honored principles of cooperation and understanding. It is the only way both sides can achieve their common goal of providing the nation's consumers with an affordable, reliable power supply.

The underlying framework for the electric utility industry was established by Congress in 1935 with the adoption of the Federal Power Act,<sup>1</sup> which gave the Commission exclusive jurisdiction over rates for the transmission of electric energy in interstate commerce, and the sale of electric energy at wholesale in interstate commerce. The states retain authority over rates for retail sales of electric energy and facilities used in the local distribution of electricity.

Experience following the evolution of energy legislation in Congress over the past several years suggests that, even if new electricity legislation were to be enacted, Congress is unlikely to substantially change this allocation

of regulatory authority, at least in the near future. And as long as the underlying framework is retained by Congress, the courts are also unlikely to allow any significant change in federal and state jurisdiction. This means federal jurisdiction prevails in some instances, states prevail in others, and many matters could be reviewed by both state and federal agencies.

For example, when Enron and several states challenged FERC's Order No. 888 (the Open Access rules), the Supreme Court closely analyzed the jurisdictional provisions of Section 201 of the Federal Power Act. It reaffirmed FERC's authority over interstate transmission, and at the same time rejected Enron's argument that FERC was required to assert jurisdiction over retail transmission. In doing so, the Court noted the potential conflict of the FPA's jurisdictional provisions, stating:

It is obvious that a federal order claiming jurisdiction over *all* retail transmission would have even greater implications for the States' regulation of retail sales – a state regulatory power recognized by the same statutory provision that authorizes FERC's transmission jurisdiction.<sup>2</sup>

On the other hand, when the FPA is clear as to jurisdiction, the

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**Edward Comer** is Vice President and General Counsel at the Edison Electric Institute (EEI) in Washington, DC, with responsibility for all legal issues affecting EEI and its members. Among other activities there, he negotiated on behalf of EEI to achieve agreement with public power to jointly support legislation to remove federal tax impediments to greater competition in and infrastructure improvements for the electric business. Prior to joining EEI in 1981, he spent several years in private practice at Terris and Sunderland in Washington, DC. He holds a law degree from the University of Pennsylvania Law School.

Supreme Court has had no trouble enforcing it, as it did recently when it reaffirmed the "filed rate doctrine" in the context of costs allocated in a FERC tariff. This doctrine "requires 'that interstate power rates filed with FERC or fixed by FERC must be given binding effect by state utility commissions determining interstate rates.'"<sup>3</sup>

Efforts to use "conditioning" authority to expand FERC control over matters within state authority are likely to have mixed success, at best. The *California Independent System Operator* decision issued by the United States Court of Appeals for the District of Columbia Circuit found that FERC lacks authority to require that the corporate governance of the California ISO be independent of the state government as a "practice" related to rates. This limits the Commission's authority to use its conditioning powers to expand its jurisdiction. The decision reaffirmed that "FERC is a 'creature of statute,' having 'no constitutional or common law existence or authority, but *only* those authorities conferred upon it by Congress.'"<sup>4</sup> In that case, FERC could not force the ISO or the state to change governance.

Interstate transmission issues are primarily a FERC responsibility. Retail sales and distribution issues are state responsibilities. These overlap when wholesale transactions and generating asset transfers affect state-regulated service.

With no simple, bright lines, and with increasing instances of

overlap, greater cooperation and understanding is indeed the only sensible approach for the Commission and the states.

## II. Need for Expanded FERC Role in Transmission Siting

This is especially the case with respect to the nation's increasingly stressed transmission network.

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Investment in the nation's grid is critical for the development of the nation's competitive electricity markets. Today, that investment is falling short. Factors contributing to this drop include:

- Uncertainty over who owns and controls the transmission lines,
- Questions as to who will pay for new transmission,
- Increasingly complex grid management, as a number of organizations—some established and some newly emerging—begin to interact, and
- Concerns for many investors who are wondering if their money will be recoverable under state retail rate caps.

This drop in transmission investment, coupled with the higher demand for power and wholesale transactions, has begun pushing the capacity of transmission lines to their limits in some high-density population areas. Although there has been an increase in transmission investment in the last three years, it is still not enough to handle the significant growth in the use of transmission. For the nation's electricity markets to deliver their full potential, the country must have a robust transmission network. For this to happen, the Commission needs to work closely and cooperatively with state authorities.

Regional transmission organizations (RTOs) can play an important part in planning and expanding transmission systems to meet the needs of regional electricity markets. But the authority to approve siting of new lines rests in the states. Some states have the authority to take into account regional benefits of such facilities; others do not. In either case, there will usually be substantial opposition to facilities which are clearly needed.

Going forward, it is clear that states and often local governments will need to be firmly convinced as to the need for controversial new facilities. The success of these efforts will clearly be enhanced if there is close coordination between local, regional, and federal entities over all aspects of planning and operating these facilities.

Recognizing that some states lack the authority or ability to site even needed facilities, EEI has advocated

national energy legislation that contains a provision for the Commission to have limited backstop transmission siting authority to help site transmission lines in "interstate congestion areas" designated by the Department of Energy (DOE) if states have been unable to agree or move forward.

EEI has also urged that the federal permitting process for transmission facilities located on federal lands or requiring federal environmental permits be reformed and simplified by designating the U.S. Department of Energy as the lead agency to coordinate and set deadlines for that process. To facilitate siting further, deadlines and funding for the designation of transmission corridors that may be used for future transmission facilities across federal lands also need to be established, and steps need to be taken to protect those corridors from incompatible uses. But these efforts will work best when there is full communication and coordination between state and federal decision makers.

### III. Role of Regional State Committees

The regional state committees (RSCs) that are rapidly gaining momentum in conjunction with the formation of RTOs can help facilitate this coordination and cooperation between the Commission and the states. The Organization of Midwest Independent System Operator States (OMS), the first RSC, has been proactive since its inception in June 2003. Its three

major functions are to advise MISO, advise FERC, and be a resource to the states.

Similarly, the Southwest Power Pool (SPP) RSC, which had its first meeting in April, is already working actively on two key issues: a multi-state cost-benefit analysis and the policies concerning transmission upgrade and expansion cost allocation for the SPP. Finally, the New England Governors' Conference has filed a

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comprehensive plan for the New England RSC—NE-RSC—with FERC.

In response to industry and state concerns, the Commission has advocated the formation of RSCs to provide a more active role for the states in regional policy and planning decisions. But right now, the role of the RSC is still evolving.

On behalf of its members, EEI has advocated a number of principles for the formation and the role of RSCs. Among them are that RSCs should:

- Consider individual state needs, but act in the best interest of its region,

- Facilitate the necessary state regulatory approvals for parties seeking to build new transmission facilities that cross state boundaries,
- Support timely recovery of costs associated with the formation and operation of RTOs and ISOs, and
- Minimize regulatory uncertainty and assist in a timely transition to regional wholesale electricity markets.

It is important to note that in gaining these functions, RSCs should not become an additional level of regulation. Although some RSCs seek to pre-approve RTO filings at FERC, or even seek authority to tell RTOs what they may file, the law is clear that interstate bulk power market issues are a federal responsibility and that state commissions should cooperate extensively in the development of regional markets, but cannot usurp the transmission owners' authority to file their rates without prior review.<sup>5</sup>

### IV. Developing Effective Retail Bidding Processes

As indicated above, the Federal Power Act gives the states substantial authority to regulate retail electric service, to oversee procurement of new generation resources, and to establish the conditions and criteria the states believe necessary to assure adequate service with just and reasonable terms and conditions.

A number of states and utilities are now working together to develop guidelines for the compe-

titive procurement of electricity. These combine the Commission's goals for competitive wholesale markets, with the states' needs for an affordable power supply for their retail customers. The state-driven efforts are focusing on an open price discovery process that offers the potential for securing "like-type" resources at the lowest possible price and that helps assure the fairness of the solicitation process. They also significantly reduce the risk that a utility procurement decision will later be determined to be imprudent. These procurement processes also help deal with new uncertainties about the optimal timing of purchases and, particularly with retail access, uncertainty about the size of loads utilities will remain obligated to serve.

At the same time, in many regions the drop in wholesale electricity prices, a waning economy, and a significant retrenchment of the industry have led to the number of power plant sellers far exceeding the potential buyers. As a result, buying a merchant plant within their service territory can become the least-cost option for some electric utilities.

In late July the Commission presented four guidelines for competitive energy solicitations in both rate and asset transfer situations.<sup>6</sup> The Commission's guidelines focus on transparency, clear product definition, clear evaluation criteria, and independent oversight. While EEI had recommended that FERC hold a joint workshop with the states to discuss best practices for competitive solicitations, FERC instead proceeded

directly to issue these guidelines in individual cases in a process that many complain provided no opportunity for states or the public to comment on a draft of the guidelines. As of this writing in early fall, it is not clear whether state commission involvement is sufficient to constitute "independent oversight," but we believe it should.

Many of the principles in FERC's guidelines are reasonable. The

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process must be clear and unbiased. The products being procured should be clearly defined, including quality, time, price, and quantity. Non-price factors should be considered, including fuel diversity, reliability, and the creditworthiness of the supplier. In addition, utilities should be compensated for any extra risks and costs required, including impacts of long-term contracts on the balance sheet and credit rating of purchasers.

Finally, we must be vigilant and be sure that competitive procurement not only results in good prices for consumers, but also provides the long-term market

stability that will yield investment. As of this writing in early fall, it remains to be seen how FERC's guidelines will work and whether they are compatible with good state approaches. We hope that FERC's guidelines will be flexible enough to work well with the variety of good requirements set by state commissions.

## V. Conflicts over Market Power

Recent decisions by the Commission in the pursuit of its goals to stimulate competition in the country's emerging wholesale electricity markets have led to conflicts with the states and their regulated utilities. In particular, several of the Commission's recent market power rulings have called into question decisions made by states to serve their retail customers. At the same time, the rulings have challenged the corporate flexibility of utilities to fulfill their state commissions' mandates.

Since 1996, when it issued its Order 888 requiring transmission providers to offer non-discriminatory access to transmission services through an Open Access Transmission Tariff, the Commission has been aggressively developing a regulatory framework to mitigate the potential of a power supplier to exert market power—the ability to profit by raising rates in a given market above competitive levels.

The Commission announced in April 2004 an interim set of screens and tests to replace the "hub-and-spoke" analysis it had

long used to judge whether a power generator had the capability to exert horizontal market power. The new methodology adopts “pivotal supplier” and “market share” preliminary screens, and a more intensive delivered price test. The Commission has also announced a rulemaking to review its approach to addressing all aspects of market power—not only this horizontal market power issues, but also an applicant’s ability to exercise vertical market power through control over transmission facilities, the even-handedness of the applicant’s business transactions with affiliated companies vis-à-vis others, and its ability to erect barriers to entry.

Although many have serious concerns about the accuracy of parts of the Commission’s new screens and tests for generation market power, the Commission has been applying them since August in the context of approving use of market-based rates by individual companies. As a result, many companies—especially vertically integrated utilities outside RTOs—are expected to fail the initial screen because of deficiencies in the screen, not because they are likely to have actual market power.

These concerns were highlighted by a recent situation involving Oklahoma Gas & Electric Company (OG&E). With its state’s backing, OG&E sought Commission approval to buy an independent power plant within its control area because this was the best option to serve its growing retail base. At the time, OG&E was

committed to joining the Southwest Power Pool RTO, which was close to receiving final approval. Nevertheless, the Commission found OG&E’s purchase would create market power because it disregarded OG&E’s native load commitments in its analysis and imposed new hurdles to a company committed to forming a new RTO.



FERC gave its approval only after OG&E agreed to make a number of concessions that would limit its potential to exert market power. This order leaves the impression that the Commission will discourage the acquisition of state-approved, relatively low-cost generating plants to meet the increasing needs of native load customers.

We hope the Commission will clarify many of the ambiguities in its application of the current market power test as it reviews individual applications and in the rulemaking process. It is essential, however, that the Commission switch to a screen that more accurately assesses the ability of a supplier to exercise market power.

Cooperation and understanding. They are the essential ingredients behind every successful partnership. Joint workshops with the industry, state regulators, and Commission members to discuss best practices may be a good way to start building both. EEI is up to the task of helping to stimulate these dialogues. With a common goal to guide everyone—affordable, reliable power with greater regulatory certainty—it could be a match made in heaven.

#### Endnotes:

1. Federal Power Act (16 U.S.C. 791-828c; Chapter 285, June 10, 1920; 41 Stat. 1063).
2. *New York v. FERC*, 535 U.S. 1 at 27–28, 122 S.Ct. 1012 at 1028 (Mar. 4, 2002).
3. *Entergy Louisiana Inc. v. Louisiana Public Service Commission*, 539 U.S. 39 at 47, 123 S.Ct. 2050 at 2056 (June 2, 2003) citing the Court’s earlier Nantahala decision 476 U.S. 953 at 962, 106 S.Ct. 2349.
4. *California Independent System Operator Corp. v. FERC*, 372 F.3d 395 at 398, D.C.Cir. (June 22, 2004), citing the court’s earlier decision in *Atlantic City Electric Co. v. FERC*, 235 F.3d 1, 8 (2002), emphasis in the original text.
5. *Commonwealth of Mass., Dept. of Public Utilities v. FERC*, 729 F. 2d 886 1st Cir. (Mar. 15, 1984).
6. *Allegheny Energy Supply Co., LLC, Order Granting Authorization to Make Affiliate Sales*, 108 FERC ¶ 61,082 (July 29, 2004); *Ameren Energy Generating Co. and Union Electric Co., d/b/a AmerenUE, Opinion and Order Affirming Initial Decision In Part, Denying Requests for Rehearing and Announcing New Guidelines for Evaluating Section 203 Affiliate Transactions*, 108 FERC ¶ 61,081 (July 28, 2004).