FERC Imposes New Constraints on Utility Procurement

To prevent undue preference to utility affiliates, FERC is calling for open competitive solicitations that meet the Edgar standard. A New Jersey procurement auction offers a paradigm for fast-track FERC approval.

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I. Introduction

In February and July of this year, the Federal Energy Regulatory Commission issued decisions on a number of affiliate transactions. FERC is expanding the scope of its review and subjecting all future ones to the standard set by *Edgar*.[1] Business is not as usual. Utilities that wish to enter into power purchase contracts with affiliates or wish to buy assets from them face brand new constraints. These constraints require utilities to rethink their procurement processes and to consider open competitive solicitations that level the playing field for affiliates and non-affiliates and squarely meet the *Edgar* standard.

FERC's goal is to expand the role of competitive markets, foreclosing neither existing merchant generators, new entrants, or non-affiliated suppliers. In the Commissioners' words, "[t]he public interest requires policies that do not harm the development of vibrant, fully competitive generation markets."[2] FERC is prodding utilities with supply resource needs to rely on market-based mechanisms for procurement, and is discouraging them from direct awarding of contracts to affiliates.[3] FERC has pledged to undertake a thorough review of all future affiliate transactions to assure that independent suppliers are not denied equal competitive

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opportunities.[4] It has, however, pointed out one sure way to achieve fast-track review and approval of an affiliate transaction: The transaction in question must be the result of an open and transparent competitive solicitation process conducted by an independent third party.[5]

This article reviews FERC's new affiliate policy and presents a case study illustrating how to design a competitive solicitation to meet the *Edgar* standard.

II. Recent Case History

The first expansion of scope of FERC review came in *Mountainview*.[6] In this case, FERC ordered that the *Edgar*[7] standard be applied to *all future* affiliate power transactions of duration of one year or greater, whether filed as cost-based tariffs or market-based tariffs. The *Edgar* standard – designed to assure that the utility does not choose to enter into a high-cost transaction with an affiliate when less-costly options are available from non-affiliated suppliers – had only previously applied to market-based tariffs. In extending it to cost-based transactions, FERC recognized that supply conditions in several parts of the country are such that cost-based tariffs may be higher than market-based tariffs; in these situations, FERC wants to assure that customers pay no more than market value.

The second expansion of the scope of FERC review came in *Ameren*.[8] That decision calls for extension of the *Edgar* standard to apply to Section 203 transfers of FERC-jurisdictional assets from a generator to an affiliated regulated utility. FERC had been concerned in previous cases—see for example *Cinergy*[9]—that the regulated utility might serve as a ''safety net'' for merchant generators who could sell their assets back to the utility at book costs, to be recovered by the latter's cost-based rates, in the event market conditions turn unfavorable and the merchant cannot recover those costs from market rates.[10] Hence, whether it is the buyer in a power purchase agreement (PPA) or the buyer of a generating plant, the utility must now in all cases provide evidence sufficient to meet the *Edgar* standard that there has been no abusive self-dealing.

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While one may view FERC's action as overlapping with the role of the state public utility commissions whose purview includes prudence reviews of utility expenditures, FERC implies that its role is different and is necessary in addition to state review. FERC notes that prudence reviews by state commissions occur after the fact, and that FERC review occurs before the transaction is consummated.[11] While state commissions have the opportunity *ex post* to assure that above-market costs from affiliate transactions (if any) are not passed on to ratepayers, FERC has the opportunity to review them *ex ante* and prevent any harm to market competition. In *Ameren*, FERC determined:

> While effective state regulatory review can prevent excessive rates to the retail customers of the acquiring utility, it is not a remedy for the anticompetitive effects of affiliate preference, which harm all customers. The possibility of eventual regulatory review does not prevent the exercise of affiliate preference before the transaction occurs. We are also not convinced that such eventual regulatory review of rates is an effective remedy for anticompetitive effects that arise at the time affiliate preference occurs. Ultimately, all customers are harmed because competition is undermined.[12]

FERC cites decreased efficiency, increased market power, and increased entry barriers as three areas of potential harm to competition that could ensue if affiliate transactions are not screened and determined to be free from competitive distortion in the first place.[13]

In *Ameren*, FERC further spells out new constraints on utilities in their supply planning, if that includes the possibility of an affiliate transaction. In order to meet its competition objectives, utilities are now encouraged by FERC to include open, transparent

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