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REGULATORY ALERT BULLETIN¹

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ORDER NO. 697-A

MARKET BASED RATES FOR POWER

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On April 21, 2008, the Federal Energy Regulatory Commission (“Commission”) issued Order No. 697-A, the Order on Rehearing and Clarification of its Final Rule, issued June 21, 2007, amending its regulations governing market-based rate authorizations for wholesale sales of electric energy, capacity, and ancillary services by public utilities.²

For the most part, Order No. 697-A largely affirms Order No. 697. This Regulatory Alert Bulletin focuses on the extent to which the Commission granted rehearing or clarification of the Final Rule.

Order No. 697-A will become effective 30 days after its publication in the Federal Register.

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² *Market-Based Rates for Wholesale Sales of Electric Energy, Capacity and Ancillary Services by Public Utilities*, Order No. 697, 72 Fed. Reg. 39,904 (Jul. 20, 2007), FERC Stats. & Regs. ¶ 31,252 (2007) (“Order No. 697”). See also *Market-Based Rates for Wholesale Sales of Electric Energy, Capacity and Ancillary Services by Public Utilities*, 121 FERC ¶ 61,260 (2007) (“Clarification Order”).

I. Introduction

- The Commission largely affirms determinations made in Order No. 697 concerning its horizontal market power analysis including:
 - The use of the 20 percent threshold for the indicative wholesale market share screen and the Delivered Price Test (“DPT”);
 - The use of a 2,500 point Hirschman-Herfindahl Index (“HHI”) as a threshold under the DPT; and
 - The use of average peak native load as the native load proxy for the indicative wholesale market share screen and DPT analysis. Order No. 697-A at P 4.
- Where the Commission has made a specific finding that there is a submarket within an RTO/ISO, that submarket should be considered the default geographic market. Order No. 697-A at P 4.
- There is a rebuttable presumption that existing Commission-approved RTO/ISO mitigation is sufficient to address market power concerns in RTO/ISO markets, but a separate section 206 proceeding may be instituted by the Commission, based on evidence submitted by intervenors, to investigate whether existing RTO/ISO mitigation continues to be just and reasonable. Order No. 697-A at P 5.
- In addition to use of historical data and a “snapshot in time approach,” applicants may submit sensitivity studies, on a case-by-case basis, that present clear and compelling evidence that changes in a market should be included in the market power analysis in a specific case. Order No. 697-A at P 6.
- The use of simultaneous total transfer capability (“TTC”) in the simultaneous transmission import limit (“SIL”) studies must properly account for all firm transmission reservations, transmission reliability margin (“TRM”), and capacity benefit margin (“CBM”). Order No. 697-A at P 7.
- The Commission affirms its determinations concerning the vertical market power analysis. Sellers are not required to report on financial transmission rights (“FTRs”) as part of that analysis. Order No. 697-A at P 8.
- The Commission codifies in its regulations, at 18 C.F.R. § 35.36, a definition of “affiliate” for purposes of Order No. 697 based on the definition adopted in the Affiliate Transactions Final Rule.³ The Commission also reiterates a number of clarifications made in the Affiliate Transactions Final Rule regarding “captive customers,” the purpose of the definition, and its focus on “cost-based regulation.” Order No. 697-A at P 9.

³ *Cross-Subsidization Restrictions on Affiliate Transactions*, Order No. 707, 73 Fed. Reg. 11013 (Feb. 29, 2008), FERC Stats. & Regs. ¶ 31,264 (Feb. 21, 2008) (“Affiliate Transactions Final Rule”).

- The new affiliate restriction regulations in Order No. 697 supersede codes of conduct approved prior to the effective date of Order No. 697. The Commission also provides clarification on employees not subject to the independent functioning requirement. The Commission grants rehearing regarding the adoption of a two-way information sharing restriction in 18 C.F.R. § 35.39(d), finding that a one way restriction is sufficient. Order No. 697-A at P 10.
- The Commission affirms most of its determination concerning mitigation. It retains the Commission’s default mitigation and declines to impose a general “must-offer” requirement. Order No. 697-A at P 11.
- The Commission modifies its policy with respect to mitigation of long-term transactions (one year or more) by allowing a mitigated seller to demonstrate on a case-by-case basis that it does not have market power for a specific long-term contract. Order No. 697-A at P 11.
- The Commission is revising its required tariff language to remove the “intent element” for market-based sales by mitigated sellers at the metered boundary between the balancing authority area in which the seller was found, or presumed, to have market power and a balancing authority area in which the seller has market-based rate authority. Order No. 697-A at P 12.
- The Commission affirms its decision in Order No. 697 to exempt “Category 1” sellers from submitting automatic updates to market power analyses, but emphasizes that the Commission can require an updated market power analysis at any time. Order No. 697-A at P 13.
- The Commission also provides clarifications on other aspects of the Final Rule such as the implementation process adopted in Order No. 697 and the change in status reporting requirement. Order No. 697-A at P 14.

II. Discussion

A. Horizontal Market Power

1. DPT Criteria

- In Order No. 697, the Commission upheld its use of the DPT for making definitive determinations of seller market power. In response to questions regarding what counts as “available economic capacity” in such an analysis, the Commission clarifies in Order No. 697-A that the DPT analysis does not include capacity committed to native load or otherwise unavailable on a long-term firm basis. Order No. 697-A at P 48.

2. Native Load Deduction

- In Order No. 697, the Commission established that a seller is considered to be pivotal “if the sum of the competing suppliers’ economic capacity is less than the load level (plus a reserve requirement that is no higher than State and Regional Reliability Council

operating requirements for reliability) for the relevant period.” On rehearing, the Commission clarifies that the DPT analysis “should be performed using available economic capacity to account for the sellers’ and competing suppliers’ native load commitments,” and that “native load in the relevant market (sellers’ and competing suppliers’) should be subtracted from the total load in each season/load period.” Order No 697-A at P 67.

3. Relevant Geographic Market

- The Commission grants PSEG’s request that Northern PSEG not be a separate market in PJM, but affirms its other findings regarding submarkets, including its finding that PJM-East is a submarket within PJM. Order No. 697-A at P 90.
- For sellers seeking market-based rate authority who rely on RTO/ISO market monitoring and mitigation, there is a rebuttable presumption that “the existing mitigation is sufficient to address any market power concerns.” Intervenors are free to challenge this presumption, but the challenging party bears the burden of demonstrating that the RTO/ISO mitigation is insufficient. Order No. 697-A at P 111.
- If the Commission does find RTO/ISO mitigation measures insufficient, the Commission will consider instituting a separate section 206 proceeding to investigate whether existing mitigation continues to be just and reasonable. Order No. 697-A at P 114.

4. Use of Historical Data

- Historical data must be used for both the indicative screens and the DPT, but applicants and intervenors may submit sensitivity analyses on case-by-case basis. Order No. 697-A at PP 116, 124, 130.

5. Transmission Imports

- “[T]he use of simultaneous TTC in the SIL study must properly account for all firm transmission reservations, transmission reliability margin, and capacity benefit margin.” Third party transmission reservations should not be double-counted. Applicants should not assume that such reserved transmission will become available as unused transmission capacity. Additionally, applicants are not required to address short-term (less than one month) transmission reservations in the market power screens. Order No. 697-A at PP 142, 144.
- Applicants are permitted, but not required, to submit additional transmission sensitivity studies, including a more thorough import study, as part of the DPT. Order No. 697-A at P 146.

6. Further Guidance Regarding Control and Commitment of Capacity

- The Commission provides guidance regarding the information to be provided for the generation asset control portion of the application. The seller “should specifically state whether a contractual arrangement transfers control and should identify the party or

parties it believes control(s) the generation facility. In doing so, the seller should make its representation in light of [the Commission's] discussion in Order No. 697 and cite to that order as the basis for which it has made its determination." Order No. 697-A at P 150.

B. Vertical Market Power

1. Treatment of FTRs

- Sellers are not required to report on FTRs as part of the vertical market power analysis. Although FTRs may impact a seller's incentive to exercise market power, there are adequate protections in place that limit the seller's ability to do so. Order No. 697-A at P 165.

2. Other Barriers to Entry

- The term "inputs to electric power production" does not encompass every instance of a seller entering into a coal supply contract with a vendor in the ordinary course of business. Rather, the term encompasses *physical* coal sources and ownership of or control over *who may access* transportation of coal via barges and railcar trains. Thus, the Commission will revise its definition of "inputs to electric power production" as follows: "intrastate natural gas transportation, intrastate natural gas storage or distribution facilities; sites for new generation capacity development; physical coal supply sources and ownership of or control over who may access transportation of coal supplies." Order No. 697-A at P 176.

C. Affiliate Abuse

1. General Affiliate Terms and Conditions

a. Affiliate Definition

- The term "affiliate" for purposes of market power analyses and the affiliate restrictions adopted in 18 C.F.R. § 35.39 is re-defined to be the same as used in the Affiliate Transactions Final Rule and codified in 18 C.F.R. § 35.43(a)(1). Order No. 697-A at P 182.

b. Definition of Captive Customers

- Rather than requiring sellers to explain why wholesale customers are not captive, a seller must demonstrate that the wholesale customers are adequately insulated against affiliate abuse. The definition of "captive customer" is revised to be consistent with the definition adopted in the Affiliate Transactions Final Rule. Thus, for market power analyses, "captive customers" are "any wholesale or retail electric energy customers served by a franchised public utility under cost-based regulation." Order No. 697-A at PP 201-202.

c. Public Utility Holding Company Act of 2005 as a “Commission Rule or Order” Permitting At-Cost Pricing

- For centralized service companies, “Order No. 667 constitutes a ‘Commission rule or order’ generally authorizing use of at-cost pricing by centralized service companies to their franchised public utilities with captive customers, absent complainant evidence that such at-cost pricing exceeds the market price.” Order No. 697-A at PP 216, 218. Thus non-power goods and services provided by centralized service companies to affiliates may, subject to certain conditions, occur at cost, rather than at the lesser of cost or market.

2. Power Sales Restrictions

a. Sales Between Two Affiliates Requiring Prior Commission Approval

- “[A]dditional authorization is not required for power sales between two affiliated franchised public utilities, one with captive customers and one without captive customers.” However, the Commission may, upon its own motion or upon complaint, examine power sales between two such affiliated franchised public utilities. Order No. 697-A at P 228.

b. Affiliate Restrictions’ Applicability to Franchised Public Utilities and Commission Jurisdictional Market-Regulated Power Sales Affiliates

- The Commission’s market-based rate regulations do not apply to entities that are not “public utilities” under section 201(e) of the Federal Power Act (“FPA”), which would include entities that sell exclusively within the Electric Reliability Council of Texas. However, sales by such an entity to an affiliated public utility are subject to the Commission’s affiliate sales restrictions. Order No. 697-A at P 231-232.

3. Market-Based Rate Affiliate Restrictions

a. Two-Way Information Sharing Restriction

- The Commission grants rehearing and reverses Order No. 697’s determination that restricted two-way information sharing between a public utility with captive customers and its market-regulated power sales affiliate. A one-way information sharing restriction, under which the public utility is prohibited from sharing information with its market-regulated power sales affiliate, provides sufficient protection and is consistent with the Commission’s Standards of Conduct. Order No. 697-A at P 241.

b. Affiliate Restrictions’ Precedence Over Pre-Existing Codes of Conduct

- The new affiliate restrictions set forth in Order No. 697 supersede codes of conduct previously approved by the Commission. In the event of a conflict between a seller’s code of conduct and Order No. 697, the regulations promulgated under Order No. 697

govern. However, if the Commission imposed a more restrictive code on the seller, those limitations are still in effect. Order No. 697-A at PP 245-246.

c. Treatment of “Field & Maintenance” Employees and Shared Operation and Maintenance Staff in Affiliate Restrictions

- “[F]ield and maintenance employees” include technical and engineering personnel engaged in generation-related activities, provided that such employees do not: (1) buy or sell energy; (2) make economic dispatch decisions; (3) determine (as opposed to implement) outage schedules; or (4) engage in power marketing activities. Additionally, although operational employees may generally not be shared, companies may share employees and supervisors who have the authority to curtail or stop the operation of generation facilities solely for operational reasons, as long as such employees are not involved in the marketing or sale of electricity from the facilities, do not make economic dispatch decisions, and do not determine the timing of scheduled outages for facilities. Order No. 697-A at PP 251, 253.

d. Risk Management Employees Under the No-Conduit Rule

- Risk management employees may be shared under the affiliate restrictions, as long as such employees are not acting as marketing function employees. Such employees, however, are subject to the “no-conduit rule”. Order No. 697-A at P 256.

D. Mitigation

1. Cost-Based Rate Methodology

a. Sales of One Year or Greater (Long-Term Sales)

- The Commission grants rehearing in part and modifies its policy with regard to mitigation of long-term sales. Sellers will be permitted to demonstrate, on a case-by-case basis, that they do not have market power with respect to long-term contracts. Specifically, any seller who fails the market-based rate test or submits to mitigation (a “mitigated seller”), may file with the Commission under FPA section 205 for contract-specific market-based rates. Order No. 697-A at PP 279-281.
- The Commission does not set out a generic “safe-harbor” with regard to long-term contracts. Rather, a mitigated seller will need to demonstrate that it does not have market power with respect to a specific contract. The mitigated seller must show that the buyer had access to viable alternatives, including entry of third-party generation into the market. The Commission declines to state the specific information that must be provided with an application, but notes that “mitigated sellers who identify a specific buyer for a proposed contract will be better able to provide the Commission with an understanding of the viable and comparable alternatives that the particular buyer may have.” The Commission will deny market-based rate authority for a long-term contract if the mitigated seller cannot meet the evidentiary burden. Order No. 697-A at PP 281-283.

2. Protecting Markets With Mitigated Sellers

a. Must Offer

- In Order No. 697, the Commission declined to impose a “must-offer” requirement for mitigated sellers, stating that there was insufficient evidence to support the imposition of a generic “must-offer” requirement. On rehearing, the Commission clarifies that it has not pre-judged the circumstances in which a “must-offer” requirement might be imposed on a particular seller. Additionally, the Commission has not made a determination of which party bears the burden of proof that a “must-offer” requirement should be imposed – the seller or the challenging party. Order No. 697-A at PP 294, 305-306.

b. Tariff Language

- The Commission revises the required tariff language regarding market-based sales at the metered boundary to conform with the Clarification Order’s use of the term “mitigated market.” As noted in the Clarification Order, a “balancing authority area in which a seller is found, or presumed, to have market power” is a more appropriate term for describing a seller’s mitigation area. Order No. 697-A at P 333.
- The Commission eliminates the intent element from the required tariff language regarding border sales. Order No. 697-A at P 334.
- When using the term “metered boundary” with respect to mitigation, the Commission means that mitigation applies to sales made at the metered boundary, without regard to which “side” of the boundary the sale occurs. This approach is adopted as “a concession to mitigated sellers that wish to make sales that may technically take place in a balancing authority area where they do not have market-based rate authority.” Order No. 697-A at P 337.

E. Implementation Process

1. Category 1 and 2 Sellers

a. Establishment of Category 1 and 2 Sellers

- The Commission modifies the approach to analyzing the indicative screens (such as those that might be submitted with a regularly-scheduled market power analysis update). If a Commission-identified submarket is under analysis, the Commission will consider whether there is any indication that any sellers in that submarket, including Category 1 sellers, have market power. Category 1 sellers with generation assets will not be required to submit updated market power analyses. Rather, the Commission will perform its own analysis of Category 1 sellers, using publicly-available information, when it is performing evaluations of Category 2 sellers. Order No. 697-A at P 355.

2. Clarifications on Implementation Process

- In the Clarification Order, the Commission explained that the market shares calculated for the wholesale market screen and for the DPT analysis should be based on the four seasons, rather than on the four quarters of the calendar year. Additionally, the study period runs from December of one year through November of the following year. Order No. 697-A at P 373.
- As explained in the Clarification Order, transmission-owning utilities with market-based rate authority and their affiliates (if the affiliates also have market-based rate authority) are the entities required to make the first filings of updated market power analyses in each region. Order No. 697-A at P 374.
- Category 2 sellers may request exemption from the need to submit an updated market power analysis at least 120 days prior to the first day of the month in which the seller's next analysis is due. Order No. 697-A at P 375.
- If an unaffiliated power marketer has made no sales at any time since it obtained market-based rate authorization, it should make a filing explaining why it meets the criteria for Category 1 during the next filing period, *i.e.*, June 1-30, 2008. Once a seller is determined to be in Category 1, it is not required to file an updated market power analysis, or evidence of Category 1 status, for the other regions in which it makes sales. This condition continues as long as the seller continues to meet the criteria for a Category 1 seller. Order No. 697-A at P 376.
- The transmission facilities to be included in the asset appendix (submitted with an updated analysis or change in status filing) are those assets the ownership or control of which would require the entity to have an OATT on file with the Commission. This applies even if the OATT requirement has been waived. Order No. 697-A at P 378.
- Applicants may combine assets of a common size into one line item for the purposes of the appendix. For example, 12 individual 500 kV lines can be identified as a single line item. However, this must be specifically called out on the appendix, *i.e.*, identified as "Combined 500 kV lines," or similar mechanism. However, the combined approach may only be used if the assets are controlled by the same entity. Finally, both tables, the Market-Based Rate Authority and Generation Assets table, and the Electric Transmission Assets and/or Natural Gas Interstate Pipelines and/or Gas Storage Facilities, must be submitted, even if only to indicate that the seller does not hold such assets. Order No. 697-A at PP 379-381.

3. Market-Based Rate Tariff Clarifications

- If a seller's market-based rate authority is not subject to any limitations, or any exemptions, waivers, or blanket authorizations, the seller should state so in the "Limitations and Exemptions" section of its market-based rate tariff, if only by stating "N/A". If such limitations or exemptions do apply, the seller should include a cite to the specific Commission order granting such limitations or exemptions. Order No. 697-A at PP 383-384.

- If a seller seeks an exemption, waiver or blanket authorization, the seller should include proposed tariff sheets including the docket number of its filing. The Commission is in the process of creating a website that will allow a new applicant for market-based rate authority to retrieve a docket number prior to making the filing. This will eliminate the need to substitute pages on compliance merely to add the docket number. Order No. 697-A at P 385.
- The Commission revises slightly its required tariff language for sellers authorized to make sales of ancillary services as a third party provider (rather than to an ISO/RTO). Order No. 697-A at P 387.
- If a seller wishes to make sales of ancillary services at market-based rates in one or more of the RTOs/ISOs listed at Appendix C, the seller may file revised tariff sheets including the standard ancillary service language, but need not seek separate authorization from the Commission under FPA section 205. Order No. 697-A at P 387.
- Seller-specific terms and conditions that may be included in the market-based rate tariff are “those provisions that are commonly found in power sales agreements, such as creditworthiness, force majeure, dispute resolution, billing, and payment provisions.” All provisions previously included in a seller’s market-based rate tariff, but now included in the Commission’s regulations, should be removed from each seller’s market-based rate tariff. This includes items addressing codes of conduct, affiliate sales, market behavior rules, and the change in status reporting requirement. Order No. 697-A at P 388.
- All of the requirements of Order No. 697 became applicable on September 18, 2007. Thus, provisions of market-based rate tariffs inconsistent with the Final Rule were ineffective as of that date. Although market-based rate sellers were not given a specific date by which to submit a revised market-based rate tariff, sellers filing tariff sheets solely to comply with Order No. 697 should use September 18, 2007 as the effective date. Any deviations from the Order No. 697 tariff should have a proposed effective date. Order No. 697-A at P 389.
- If a seller was granted a waiver regarding affiliate restrictions prior to Order No. 697, and the seller still qualifies for the waiver, the waiver remains effective. Order No. 697-A at P 390.
- A seller should indicate in its market-based rate tariff whether it is a Category 1 or a Category 2 seller. The Commission will make a finding regarding the seller’s category, and if appropriate, order tariff revisions to reflect the correct category. Any seller whose category has been determined, but has not included such information in its tariff, should make such a revision in its next related filing. Order No. 697-A at PP 391-393.

F. Miscellaneous

1. Third Party Providers of Ancillary Services

- In Order No. 697, the Commission eliminated certain posting and reporting requirements with regard to sales of ancillary services by third parties, finding that the electric

quarterly reports (“EQRs”) provided sufficient means to monitor such sales. On rehearing, the Commission clarifies that the elimination of the posting and reporting requirements applies to third-party sales of Regulation Service, Energy Imbalance Service, Spinning Reserves, and Supplemental Reserves, as well as Dynamic Capacity and Energy Service (a combination of Regulation Service and Energy Imbalance Service). Order No. 697-A at P 521.

G. Clarification of the Commission’s Regulations

- The Commission is modifying certain of its regulations to reflect the changes made throughout Order No. 697-A. Order No. 697-A at P 527.
 - Section 35.39(b) restricts sales between a franchised public utility with captive customers and a market-regulated power sales affiliate unless the seller first receives Commission authorization for the transaction under FPA section 205. The Commission is revising the language to add the phrase “or capacity” to the term “wholesale sales of electric energy.” Order No. 697-A at P 528.
 - The Commission clarifies that a change in status also includes long-term firm capacity purchases that result in net increases of 100 MW or more. Accordingly, 18 C.F.R. § 35.42(a)(1) is revised so that a change in status includes, but is not limited to, ownership or control of generation capacity and long-term firm purchases of generation capacity that result in net increases of 100 MW or more. Sellers may not have been on notice that this was the Commission’s intent, and will therefore not be held responsible for failure to report such changes in status prior to the effective date of Order No. 697-A. Order No. 697-A at P 529-31.
 - The Commission is revising the definition of captive customers. The definition of captive customers in 18 C.F.R. § 35.36(a)(6) will be revised to “mean any wholesale or retail electric energy customers served by a franchised public utility under cost-based regulation, to be consistent with the discussion in the Affiliate Transactions Final Rule and the definition of captive customers adopted in that rule at 18 CFR 35.42(a)(2).” Order No. 697-A at P 532.
 - The Commission is adding a definition for affiliate. “The definition of affiliate as that term is used in the Affiliate Transactions Final Rule will be codified at paragraph 35.36(a)(9).” Order No. 697-A at P 532.
 - The Commission is revising 18 C.F.R. § 35.39(d)(1) to reflect the determination to adopt a one-way information sharing restriction. Order No. 697-A at P 533.
 - The Commission is revising the definition of inputs to electric power production to clarify the types of coal supply that are intended to be included in the definition. Order No. 697-A at P 533.