

FERC Adopts New Rules for Market-Based Rate Authorization

June 27, 2007

On June 21, the Federal Energy Regulatory Commission (FERC) issued a [Final Rule](#) (Order No. 697) that codifies FERC's requirements for market-based rate (MBR) authorization. Order No. 697 completes a rulemaking process initiated in 2004 and adopts, with modifications, the regulations proposed in the May 19, 2006 [Notice of Proposed Rulemaking](#). Among other things, Order No. 697: (1) codifies the existing market power analysis for MBR authorization, with some adjustments to the methodology; (2) clarifies the scope of the mitigation applicable to sellers that lose MBR authority; (3) codifies and clarifies the affiliate restrictions contained in the model code of conduct developed through FERC's precedent; and (4) modifies the current requirements for triennial updates and requires MBR sellers to make certain compliance filings. Order No. 697 reaffirms the validity of FERC's MBR program in light of the Ninth Circuit's decisions in [Lockyer](#) and [Snohomish](#). Order No. 697 will take effect 60 days after publication in the *Federal Register*.

Horizontal Market Power

FERC will continue to rely on the current pivotal supplier analysis (based on the annual peak demand) and market share analysis (applied on a seasonal basis) as indicative screens for a seller's market power with respect to generation owned or controlled through contract. Order No. 697's main changes to the existing methodology include: (i) eliminating the exemption for generation facilities built after July of 1996; (ii) adjusting upward the proxy for native load used in the market share analysis; (iii) allowing sellers to use seasonal instead of nameplate capacity; and (iv) allowing sellers to deduct short term sales to franchised utilities when the power is used to meet native load. Sellers that fail the indicative screens may submit a market power analysis based on the Delivered Price Test or propose mitigation.

FERC will use a seller's balancing authority area (instead of the seller's control area) or certain Independent System Operators (ISOs) or Regional Transmission Organization (RTOs) as the default geographic markets for the market power analysis. However, when FERC makes a finding that a submarket exists within an ISO/RTO, the submarket is the default market for the market power analysis.

FERC declined to adopt a presumption that energy management agreements confer control over generation. However, Order No. 697 requires sellers to make an affirmative statement as to whether contractual arrangements result in the transfer of control of generation assets to another entity.

Vertical Market Power

Order No. 697 combines into a single analysis of vertical market power the review of a seller's ability to exercise market power in transmission and its ability to erect barriers to entry in the market. For sellers that own transmission facilities, or are affiliated with transmission owners, FERC will continue to find that having an Open Access Transmission Tariff (OATT) on file with FERC sufficiently mitigates market power in transmission. However, OATT violations with a nexus to the MBR authority of the transmission owner or its affiliates may result in revocation of the MBR authorization of both the transmission owner and its affiliates. Order No. 697 creates a rebuttable presumption that loss of MBR authority by the transmission owner results in a loss of MBR authority for each of the transmission owner's affiliates but only in the same market.

Order No. 697 requires MBR sellers to disclose their ownership, control, or affiliation with the following inputs to electric power production: (i) intrastate natural gas transportation, storage, or distribution facilities; (ii) sites to generation capacity development; and (iii) sources of coal supplies and transportation of coal supplies. However, Order No. 697 adopts a rebuttable presumption that those affiliations do not allow a seller to raise barriers to entry. FERC also clarified that ownership

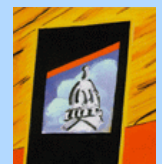
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or control of natural gas and oil supply, interstate natural gas transportation and storage, or oil transportation does not raise market power concerns.

Mitigation

FERC will continue to use the existing default cost-based mitigation for sellers that have market power and have not proposed alternative mitigation. FERC initiated a separate proceeding to determine whether cost-based rates under the WSPP Agreement are just and reasonable as an alternative mitigation method for sellers that have market power. Order No. 697 clarifies that mitigated sellers are not subject to a “must offer” obligation and may retain MBR authority in markets where they have not been found to have market power. Moreover, Order No. 697 clarifies that mitigated sellers may offer selective discounts from their cost-based mitigated rates and may, under certain circumstances, make MBR sales at the metered boundary between the balancing authority area in which they are found to have market power and the balancing authority area in which they retain MBR authority.

Affiliate Issues

Order No. 697 codifies in FERC’s regulations the general prohibition against power sales between a franchised public utility with captive customers and its affiliates as well as the affiliate restrictions previously contained in the model code of conduct developed through FERC’s precedent. Specifically, the regulations incorporate, with certain revisions, the existing model restrictions with respect to separation of functions, information sharing, sales of non-power goods and services, and brokering of power. Consistent with FERC’s Standards of Conduct rules, Order No. 697 adopts an exception to the separation of function requirement for support employees, field and maintenance employees, and senior officers and directors. A new “no conduit” rule prohibits the franchised public utility and its affiliates from using anyone, including shared officers or directors and energy or asset managers, as a conduit to circumvent the information sharing restrictions.

Waivers

FERC will continue to grant MBR sellers the existing waivers of certain accounting requirements. The loss of a seller’s MBR authority will result in the revocation of the waivers for the seller as well as its MBR affiliates in the same market, effective 60 days from the order revoking the waivers. Affiliated power marketers may retain the waivers if they have no physical assets and no cost-based rates on file and are prohibited from selling in the mitigated balancing authority area. FERC will also continue to grant MBR sellers blanket approval for future issuance of securities and assumption of liabilities. Loss of MBR status will result in revocation of the blanket authorization for the mitigated seller and any affiliates making sales in the mitigated market.

Ancillary Services Sales

FERC will retain its policy on sales of ancillary services at MBR within certain organized markets (CAISO, ISO-NE, NYISO, and PJM). MBR sales of ancillary services outside of those markets continue to be subject to the substantive conditions set forth by FERC in Avista. However, Order No. 697 eliminates the requirement that sellers establish and maintain an Internet-based site similar to OASIS for posting and transacting ancillary services sales. Sellers continue to report ancillary services sales in their Electric Quarterly Reports.

Triennial Updates

Order No. 697 adopts a new Regional Market Power Update Schedule for the submission of triennial updates. Under this schedule, updates will be filed for six regions in accordance with staggered deadlines. The first cycle will begin in December 2007 with submissions by transmission operators in the Northeast and will close in December 2010 with the filing by sellers that do not operate transmission in the Northwest. Companies that own or control electric facilities in more than one of the six regions would file triennial reviews for each market. As a result of the staggered deadlines, a seller located in the Pacific Northwest with a triennial update currently due in the fall would not have to file until 2010. However, a transmission operator in the Northeast that recently filed a triennial update may have to submit a new

analysis as early as December 2007. FERC will continue to use its “snapshot in time” approach based on historical data for its market power analysis.

Certain sellers that own or control no more than 500 MW of generation in a region, and have no affiliation with transmission facilities or a franchised public utility in the same region, are exempt from the requirement of filing a triennial update. However, those sellers are still required to make a filing, at the time the triennial update for their region is due, to show that they meet the criteria for the exemption and to disclose all generation assets owned or controlled by the seller or its affiliates. The new rules on triennial updates do not apply to filings due before the effective date of Order No. 697.

Tariff Amendments

Order No. 697 requires MBR sellers to make certain tariff amendments at the time of the filing of their first change in status, triennial update, or tariff revision following the effective date of Order No. 697. These amendments include: (i) a standard provision requiring compliance with FERC’s MBR regulations; (ii) a provision identifying all applicable limitations on MBR authority, exemptions (including affiliate sales), waivers, and blanket authorizations; (iii) standard provisions regarding mitigated sales and sales of ancillary services (to the extent applicable); (iv) elimination of any existing provisions on sale or reassignment of transmission capacity and FTRs. In addition, sellers must submit with their initial application and each subsequent notice of change in status or triennial update appendices that disclose certain affiliates.

Changes in Status

Order No. 697 clarifies that change in status notifications with respect to changes in ownership or control of inputs to electric power production are required for new ownership or affiliation with intrastate natural gas transportation, storage, or distribution facilities, sites for new generation development, sources of coal supplies, and the transportation of coal supplies. The order also clarifies that for power sales contracts with future delivery, a change in status must be filed within 30 days after the physical delivery has begun.

For Additional Information

Van Ness Feldman regularly assists energy companies in obtaining market-based rate authorization and advises clients on market power issues and continuing compliance with FERC’s market-based requirements. For assistance in evaluating the implications of the new rules adopted in Order No. 697, please contact Peg Moore, Doug Smith, Gary Bachman, Vincenzo Franco, or any other member of our Electricity practice at (202) 298-1800.

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