



Primer on Market-Based Rate Applications

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Introduction

In 2007, the Federal Energy Regulatory Commission (FERC) issued Order No. 697, which governs applications for market-based rate (MBR) authority for wholesale sales of electric energy, capacity, and ancillary services. In Order No. 697, FERC codified the standards for MBR authority and streamlined the administration of the MBR program. This Order is significant to public utilities, independent power producers (IPPs), power marketers, and other entities that seek to pursue wholesale power sales at market-based rates instead of regulated cost-based rates, because the Order: (1) codifies existing market power analyses for MBR applications, with certain adjustments to FERC's preexisting methodologies; (2) clarifies the scope of mitigation available to applicants who lose MBR authority; and (3) modifies the requirements for triennial updates and requires MBR applicants to make certain compliance filings. This primer, by explaining the requirements and procedures established by Order No. 697, is intended to assist all parties interested in seeking MBR authority.

History of FERC's market-based rate authority

Since FERC began granting MBR authority to public utilities in the 1980s, there have been three major changes in FERC's orders governing the analytical methods required for MBR applications.

On November 20, 2001, FERC announced a new generation market power screen for MBR applications on an interim basis. This Supply Margin Assessment (SMA) screen replaced FERC's previous "hub-and-spoke" analysis. After the introduction of wholesale competition, electricity markets changed and expanded, and new participants in addition to the traditional vertically integrated public utilities entered wholesale markets. The SMA screen built on and improved the existing hub-and-spoke analysis in two ways. First, the SMA considered transmission constraints in determining the relevant geographic market; and second, the SMA established a threshold based on whether an applicant was pivotal in the market, i.e., whether an applicant was effectively a "must-run" supplier that was needed to meet peak load in a given control area.

On April 14, 2004, FERC replaced the SMA screen with two "indicative screens" for assessing generation market power, and it modified the mitigation it had announced in its 2001 SMA Order. In its April 2004 Order, FERC adopted both a "pivotal supplier" test and a "market share analysis" test, because together these can provide a reasonable indication of whether an applicant has unilateral and/or coordinated market power. FERC further recognized that utilities have obligations to serve native load, and accordingly, it used an applicant's "uncommitted capacity" as the basis for the pivotal supplier test and the market share test. If an applicant fails one or more of the indicative screens, there is a rebuttable presumption of generation market power, and a more thorough analysis using the Delivered Price Test (DPT) is needed if the applicant chooses not to proceed directly to mitigation. FERC specified that the DPT analysis should be performed for ten different seasons and load conditions, and the DPT analysis should use "economic capacity" and "available economic capacity" to account for the applicant's and competing suppliers' native load commitments.

Concurrently with its April 2004 Order, FERC initiated a generic rulemaking docket to perform a comprehensive review of the appropriate analyses to be used in granting MBR authority, addressing issues of generation market power, transmission market power, other barriers to entry, affiliate abuse, and reciprocal dealing. This rulemaking culminated in Order No. 697, issued on June 21, 2007, which established FERC's final rules for granting authority to public utilities to make wholesale sales of electric energy, capacity, and ancillary services at market-based rates. In Order No. 697, FERC clarified and codified the rigorous up-front analyses needed to support an application for MBR authority. This is the Order that governs all MBR applications today.

Summary of Order No. 697

Order No. 697 sets forth FERC's basis in considering applications for MBR authority. FERC examines whether the applicant has horizontal market power or vertical market power (including transmission market power and other barriers to entry), examines issues around affiliate abuse, and considers mitigation measures, if applicable.

Horizontal market power analysis under Order No. 697

To evaluate horizontal market power, FERC applies two indicative screens: the market share screen and the pivotal supplier screen. If an applicant passes both screens, there is a rebuttable presumption that the applicant does not have significant horizontal market power. On the other hand, if an applicant fails either screen, the applicant proceeds to perform a Delivered Price Test (DPT) using the pivotal supplier approach, market shares, and the Herfindahl-Hirschman Index (HHI) of market concentration. The procedures are similar in principle to those adopted in FERC's April 2004 Order, with certain technical modifications in the implementation of the indicative screens and DPT analysis. An applicant passes the market share screen if its market share is less than 20%, and it passes the pivotal supplier screen if demand can be met without any contribution of supply by the applicant or its affiliates. For the HHI analysis under the DPT model, FERC adopts a HHI threshold of 2,500 as a measure of market concentration that gives rise to market power concerns.

In Order No. 697, FERC continues to define the default relevant geographic market as the balancing authority area where the generation owned or controlled by the seller is physically located, plus each of the balancing authority areas directly interconnected to it (so-called first-tier markets). FERC also continues to define RTOs or ISOs in which a seller is located as default relevant geographic markets, as long as the RTOs/ISOs have sufficient market structure and a single energy market, without requiring the seller to consider the first-tier markets to such RTOs/ISOs as being part of the default relevant geographic markets. If FERC finds that a submarket exists within an ISO/RTO, however, the submarket is the default market for the market power analysis.

Vertical market power analysis under Order No. 697

In evaluating vertical market power, FERC has specified that any concerns regarding the adequacy of the Open Access Transmission Tariff (OATT) should be addressed in an OATT proceeding and not in an MBR proceeding. When an applicant or any of its affiliates owns, operates, or controls transmission facilities, FERC has concluded that a FERC-approved OATT will adequately mitigate transmission market power. FERC will revoke an entity's MBR authority in response to an OATT violation only upon a finding of a nexus between the specific facts relating to the OATT violation and the entity's MBR authority.

In evaluating other barriers to entry, FERC considers two categories of inputs to electric power products: (1) natural gas supply, interstate natural gas transportation and storage, oil supply, and oil transportation and (2) intrastate natural gas transportation, storage and distribution; generation sites; and sources of

coal supplies and the transportation of coal supplies such as barges and rail cars. For the first category of potential barriers to entry, FERC does not require a descriptive or affirmative statement. For the second category, FERC adopts a rebuttable presumption that the applicant cannot erect barriers to entry with regard to ownership or control of these inputs.

Affiliate abuse analysis under Order No. 697

FERC no longer considers affiliate abuse to be a separate “prong” of MBR analysis. Instead, FERC regulations explicitly require any seller with MBR authority to comply with regulatory restrictions against affiliate abuse. FERC regulations expressly prohibit power sales between a franchised public utility with captive customers and any market-regulated power sales affiliates, absent FERC authorization for such transactions. FERC requirements in this area also include what FERC has previously called its MBR “code of conduct.”

Mitigation under Order No. 697

If FERC has concerns about a MBR applicant’s ability to exercise market power, it allows the applicant to propose cost-based mitigation methods. At the same time, FERC has also specified a set of default mitigation measures in the event that an applicant does not propose its own mitigation measures. Specifically, for sales of one week or less, FERC adopts incremental cost plus a 10% “adder” as its default mitigation. For sales of more than one week but less than one year, FERC adopts as default mitigation an embedded cost “up to” rate that reflects the costs of the unit(s) expected to provide the service. FERC grants applicants some flexibility in selecting the particular units that form the basis of this “up to” rate, but FERC conducts its own analysis to validate the seller’s analysis. For sales of one year or greater, FERC requires mitigated sellers to price long-term sales on an embedded cost-of-service basis and to file each such contract with FERC for review and approval prior to the commencement of service. FERC will consider, on a case-by-case basis, alternative mitigation proposals that are not cost-based.

When a supplier is authorized to sell under an “up to” cost-based rate, the supplier has an incentive to discount its sales price when the market price is lower than its cost-based ceiling rate. FERC allows discounting from the default cost-based mitigated rates for short- and midterm sales and permits selective discounting by mitigated sellers, provided that the sellers do not use such discounting to unduly discriminate or give undue preference.

Impact of Order No. 697

Order No. 697 has had a significant impact on MBR applications for market participants such as public utilities, independent power producers, and power marketers. FERC has established two categories of sellers with MBR authority: Category 1 sellers and Category 2 sellers.

Category 1 sellers are wholesale power producers and power marketers that own or control 500 MW or less of generation in aggregate per region. They do not own or control transmission facilities other than those that are necessary to connect the generation facility to the grid. These sellers are not affiliated with either the transmission owner, the transmission operator, or the local public utility in the same region as the seller’s generation assets. Category 1 sellers do not raise any other vertical market power issues, and they are not required to file regularly scheduled updated market power analyses.

All sellers that do not meet the criteria of Category 1 sellers are Category 2 sellers. They are required to file (triennial) updated market power analyses on a schedule set by FERC for six different regions: the Northeast, Southeast, Central, Southwest Power Pool, Southwest, and Northwest. FERC set this schedule so that, for each region, the transmission-owning utilities, who have the information necessary

to perform simultaneous import limit (SIL) studies, would file six months in advance of all other sellers in the same region, thus, ensuring data consistency and availability.

Order No. 697 also adopts several changes that may have a significant impact on an applicant's market power analysis. For example, FERC allows the applicant to use either nameplate capacity or seasonal capacity. For energy-limited resources, such as hydroelectric and wind capacity, FERC allows applicants to provide an analysis based on historical capacity factors. These changes can be particularly significant for public utilities that have large portions of hydro capacity in their generation portfolios.

Another change brought about by Order No. 697 involves the way in which a native load "proxy" is computed for the native load deduction allowed in some of the screens and tests. In the market share indicative screen, FERC changed the native load proxy from the minimum native load peak demand for the season to the average of the daily native load peak demands for the season. This makes computation of the market share indicative screen more consistent with the native load proxy used in the pivotal supplier indicative screen. For public utilities with native load to serve, the resulting increase in the native load proxy makes it more likely that the applicant will pass the market share test.

Overall, by codifying the standards for MBR authority and streamlining the administration of the MBR program, Order No. 697 provides a clearly defined framework for future MBR applications and triennial reviews.

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