

## MEMORANDUM

February 27, 2008

To: WSPP Members

From: Arnie Podgorsky  
Matthew SegersRe: FERC Order Regarding WSPP Cost Caps

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This memorandum summarizes the determinations of the Federal Energy Regulatory Commission (“FERC” or “Commission”) in its February 21, 2008 order issued in Docket Nos. ER91-195-000 and EL07-69-000 (“Cost Cap Order”).<sup>1</sup> The Commission’s order, in our view, assumes an understanding of the WSPP cost cap methodology, and perhaps some of you are not familiar with it. This memorandum sets out some history and methodology.

The Commission determined that it is not just and reasonable to allow a Seller (capitalized terms are defined in the WSPP Agreement) to use the WSPP Inc. (“WSPP”) “up to” demand charge as a ceiling rate in markets where the seller does not have market-based rate authority, unless the seller cost-justifies use of the “up to” demand charge based on its own fixed capacity carrying costs.

**A. The Original WSPP Agreement**

The Commission’s initial acceptance of the WSPP Agreement on a nonexperimental basis in 1991,<sup>2</sup> included provision for flexible cost-based pricing for energy (coordination) sales.

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<sup>1</sup> See *W. Sys. Power Pool*, 122 FERC ¶ 61,139 (2008).

<sup>2</sup> *W. Sys. Power Pool*, 55 FERC ¶ 61,099, *order on reh’g*, 55 FERC ¶ 61,495 (1992) (Initial Order), *aff’d in relevant part and remanded in part sub nom. Environmental Action and Consumer Federation of America v. FERC*, 996 F.2d 401 (D.C. Cir. 1992), *order on remand*, 66 FERC ¶ 61,201 (1994) (*Environmental Action*). Prior to 1991, the WSPP Agreement was used for three years on an experimental basis. See *W. Sys. Power Pool*, 50 FERC ¶ 61,339 (1990) (extending the initial two-year period for an additional year).

In accepting the WSPP Agreement, the Commission rejected WSPP's proposed system of price caps based on the highest costs of WSPP participants, and instead developed a methodology consisting of an individual seller's forecasted Incremental Costs (e.g., fuel, transmission, ancillary services, and possibly other components) plus an "up to" demand charge based on the weighted average costs of a sub-set of the original parties to the WSPP Agreement. The Commission calculated the "up to" demand charge by creating a hypothetical "average" electric utility company based upon data from the jurisdictional utilities then participating in the WSPP.<sup>3</sup> The Commission utilized jurisdictional utilities because they were the only WSPP members for which the necessary data (FERC Form No. 1) was available. Peak demand for these utilities (for 1989) was totaled and, for each utility, the percentage contributed to that total was calculated.

The Commission then estimated the cost of the plant that was most likely to be used to make a coordination sale for each utility (a stacking analysis). These estimates reflected surplus capacity available for sale after supplying native loads (using 1989 load resource data and peak loads). These estimated costs were adjusted downward to determine what amount of that surplus would be "marketable" (i.e. expensive peaking units were eliminated). The result was the investment cost per kW of the plant most likely to be available to supply a WSPP sale. The Commission noted that the cost of the plant most likely to make a coordination sale reflected generation station averages taken from the FERC Form No. 1.

Because the plant would be available to supply only a given percentage of the utility's contribution to the total 1989 peak demand, the Commission multiplied the investment cost by that same percentage to arrive at a weighted cost of generation for all utilities. Stated differently, this arithmetic product was the weighted average investment cost for plants most likely to make a WSPP sale.

The Commission next calculated the cost of service for this "average" plant. The Commission assumed an annual fixed (carrying) cost for plant of 20 percent, and that the plant would be available 80 percent of the time (this latter calculation built in the cost of reserves). The Commission then added transmission cost, which was calculated with each utility's investment in transmission weighted against the utility's contribution to peak demand (again using the 20 percent figure for the annual fixed carrying costs).

The U.S. Court of Appeals for the District of Columbia Circuit upheld the Commission's rejection of WSPP's proposal to cap prices at the costs of the highest-cost WSPP member, and accepted the Commission's ceiling based on the costs of a sub-set of the original parties to the WSPP Agreement.<sup>4</sup>

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<sup>3</sup> See *Initial Order* at 61,325.

<sup>4</sup> See, generally, *Environmental Action*.

## B. Order No. 697

The recent Order No. 697<sup>5</sup> established a market power analysis methodology to determine whether a seller should be granted a market-based rate tariff.. On the basis of this Order, the Commission has found that numerous sellers failed the Commission’s horizontal market power screens. Such screen failures create a rebuttable presumption of market power. Some sellers that were found or presumed to have market power may have proposed to mitigate the alleged market power by making sales under the WSPP Agreement, utilizing the WSPP cost-caps. This may have brought WSPP’s caps, once again, to the Commission’s attention.

## C. Recent Commission Activity

By order issued on June 21, 2007,<sup>6</sup> the Commission initiated an investigation under section 206 of the Federal Power Act (“FPA”) into the justness and reasonableness of the WSPP cost-based ceiling rates for coordination energy sales by public utility sellers that are found to have, or are presumed to have, market power.<sup>7</sup> The Commission initiated this investigation based on its stated concern that the evolution and use of the WSPP Agreement ceiling rate have resulted in circumstances in which the WSPP rate may no longer be just and reasonable for sellers that are found to have market power (or are presumed to have market power) in a particular market.<sup>8</sup> The Commission also sought comment on whether it should set a just and reasonable “up to” rate based on: (1) individual sellers’ costs; (2) a new agreement-wide up-to rate based on the costs of a representative group of WSPP sellers (including how such an agreement-wide rate should be calculated); or (3) or a different methodology.<sup>9</sup>

By response on July 20, 2007, and among other arguments, WSPP presented the results of an updated cost analysis using the same methodology the Commission established in the 1991 orders to set the WSPP-wide cost caps. The updated presentation included a larger group of public utility members. In this analysis, WSPP looked at the costs of the same kinds of members (generation-owning jurisdictional public utilities) that submitted the necessary information in the FERC Form 1 (for 2006).<sup>10</sup> As in the Commission’s 1991 analysis, WSPP’s updated analysis used a 20 percent fixed charge rate and reflected reserves. WSPP argued that the updated cost analysis demonstrated that the existing WSPP cost caps continue to be cost justified.

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<sup>5</sup> *Mkt.-Based Rates For Wholesale Sales Of Elec. Energy, Capacity And Ancillary Servs. By Pub. Utils.*, Order No. 697, III FERC Stats. & Regs., Regs. Preambles ¶ 31,252, *order on clarification*, 121 FERC ¶ 61,260 (2007).

<sup>6</sup> *See W. Sys. Power Pool*, 119 FERC ¶ 61,302, at P 9 (2007) (“June 21 Order”).

<sup>7</sup> *See id.* at P 9.

<sup>8</sup> *See id.* at P 7.

<sup>9</sup> *See supra* note 7.

<sup>10</sup> There were 36 companies in this analysis.

In the Cost Cap Order, the Commission explained that the WSPP cost-based ceiling rate consisted of the seller's Incremental Cost plus the "up to" demand charge, and determined that, because the "up to" demand charge is not based upon a seller's specific costs, its use by a seller may be unjust and unreasonable in markets where the seller does not have market-based rate authority to the extent that such seller is only able to cost justify a demand charge lower than that contained in the WSPP Agreement.<sup>11</sup> The Commission stated that, while the WSPP rate is technically a cost-based ceiling rate, it nevertheless has some of the flexibility of a market-based rate to the extent an individual seller is allowed to negotiate a rate above its own, individualized, cost-justified demand charge, albeit subject to a ceiling.<sup>12</sup> The Commission further reasoned that such a seller may be able to exercise market power with respect to such transactions.<sup>13</sup> The Commission applied this finding to sellers under the WSPP Agreement that do not have market-based rate authority, as well as to sellers that lose or relinquish market-based rate authority and seek to use the WSPP Agreement ceiling rate as a means of mitigating their market power.<sup>14</sup>

The Commission thus directed all sellers under the WSPP Agreement that lack market-based rate authorization, or that have lost or relinquished their market-based rate authority in some or all markets (including those sellers currently using the WSPP Agreement as mitigation), that wished to continue transacting under the WSPP Agreement, to make a filing by April 21, 2008 providing cost justification to demonstrate that use of the WSPP Agreement "up to" demand charge is just and reasonable for that particular seller.<sup>15</sup> If a seller provides cost support demonstrating that the "up to" demand charge under the WSPP Agreement does not exceed the demand charge that the seller could cost-justify based on its own fixed costs, that seller would be permitted to continue to use the WSPP Agreement cap.<sup>16</sup> Otherwise, that seller would be required to file a separate stand-alone rate schedule that is cost-justified based on its own costs.<sup>17</sup> In the latter case, the seller could propose to use the non-rate terms and conditions of the WSPP Agreement, but would have to include those provisions as part of its stand-alone rate schedule.<sup>18</sup>

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<sup>11</sup> See Cost Cap Order at P 21.

<sup>12</sup> See *id.*

<sup>13</sup> See *id.*

<sup>14</sup> See *id.* The Commission did agree with WSPP F that it was not necessary to update the demand charge as it applies to sellers that have market-based rate authority. See *id.* at P 24.

<sup>15</sup> See *id.* at P 22.

<sup>16</sup> See *id.*

<sup>17</sup> See *id.*

<sup>18</sup> See *id.*

WSPP made several arguments that its cost caps were consistent with other FERC reliance on regional costs. For example, that the Commission has continued to allow reliance on regional costs such as use in Southwest Power Pool, Inc. (“SPP”) of a proxy rate for reactive power based on one new generating unit. The Commission rejected the argument on several grounds including the limited nature of the reactive power market and the regulated nature of SPP.<sup>19</sup>

The Commission also rejected WSPP’s argument that the Commission has accepted setting hourly charges for certain RTO markets based on a marginal or single unit, rather than on an individual unit, basis.<sup>20</sup> The Commission contrasted the locational marginal pricing in these markets against the WSPP Agreement, which allows for an “up to” cap that is not location-specific, but can apply to sales across the entire Eastern and Western Interconnections.<sup>21</sup> The Commission also noted, in effect, that the WSPP “up to” cap amount was static, whereas the marginal unit that sets each locational marginal price in the RTOs is selected every five minutes.<sup>22</sup> Finally, the Commission noted that the RTOs employ Commission-approved market monitoring and mitigation purportedly to ensure just and reasonable prices in the organized markets.<sup>23</sup>

The Commission also rejected WSPP concerns that requiring individual rates will decrease efficiency, discourage membership, decrease liquidity, and increase administrative complexities.<sup>24</sup> However, the Commission stated that its action should not discourage WSPP membership or increase administrative complexities significantly, given the limited scope of sellers affected by the determination and the continuation of the WSPP Agreement non-rate terms and conditions without revision.<sup>25</sup> Moreover, while recognizing that there will be some additional burden on utilities that must now support their individual rates, the Commission reasoned that the burden will be moderate, and was necessary to prevent unjust and unreasonable rates by sellers that lack market-based rate authority.<sup>26</sup> The Commission also reiterated that sellers that do not have (or lose) market-based rate authorization may continue to make sales

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<sup>19</sup> See *id.* at PP 26-29.

<sup>20</sup> See *id.* at P 29.

<sup>21</sup> See *id.*

<sup>22</sup> See *id.*

<sup>23</sup> See *id.* at P 30.

<sup>24</sup> See *id.* at P 31.

<sup>25</sup> See *id.*

<sup>26</sup> See *id.*

under the WSPP Agreement using the “up to” demand charge, provided they submit specific cost justification to demonstrate that use of the “up to” demand charge was just and reasonable.<sup>27</sup>

### **Conclusion**

As explained above, the Commission’s Cost Cap Order prohibits sellers that do not have market-based rate authority from use of the WSPP Agreement’s “up to” demand charge as a ceiling rate unless the respective sellers can cost-justify the use of the “up to” demand charge based on their own fixed costs.

Pursuant to FPA section 313, 16 U.S.C. § 825l(a), any party wishing to seek rehearing of any aspect of the Cost Cap Order must submit their rehearing request to the Commission no later than March 24, 2008. We will address with the WSPP Administrative Committee whether, and under what theories, WSPP may seek rehearing.

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<sup>27</sup> *See id.*