"Transmission Competition": No Longer an Oxymoron

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Readers of a certain age learned as infants that "transmission is a natural monopoly." If so, then "transmission competition" is an oxymoron, right? Wrong, said FERC. In Order 1000, FERC directed incumbent transmission owners to delete the contract clauses they wrote to block their competitors. Several still-resistant owners then challenged FERC's deletion directive on Mobile-Sierra grounds. Two appellate courts just upheld FERC. Is the path finally clear for true transmission competition? No. First, some history.

A Half-Century of Struggle

It's been nearly 50 years since Congress authorized the Nuclear Regulatory Commission to require nuclear plant operators to offer nondiscriminatory transmission access to their competitors.[1] It's been nearly 30 years since FERC first found that a regional merger would be anticompetitive unless conditioned on nondiscriminatory transmission access.[2] It's been almost 25 years since the Energy Policy Act of 1992 authorized FERC to order nondiscriminatory transmission access directly (albeit in only narrowly defined circumstances). It's been 20 years since FERC's landmark Orders 888 and 889 found that transmission "haves" routinely and unduly discriminated against "have-nots," and therefore required every investor-owned utility to file "open access transmission tariffs."[3] It's been 16 years since FERC found, in Order 2000, that regional transmission organizations can reduce discrimination.[4] It's been nearly 10 years since FERC held, in its Order 890, that the 100-page tariff required of the transmission "haves" was insufficient to prevent discrimination in access and pricing.[5] And it's been five years since FERC found, in Order 1000, that even with Orders 888, 889, 890 and 2000, transmission "haves" still could discriminate—unless there was a regional planning process in which buyers could describe their needs and competitive transmission providers could offer solutions.[6]

But Order 1000 also found that all these Orders—888, 889, 890, 2000 and even 1000—were insufficient to ensure competition because of one large fly in the ointment: the incumbents' "right of first refusal." So Order 1000 ordered its removal. Still unwilling to accommodate competition, transmission incumbents fought back in three separate court cases—all losers. In baseball, three strikes and you're out. In utility regulation, not necessarily. Let's see why.

The ROFR Wall Comes Down

For newcomers to our field: A regional transmission organization (RTO) is a nonprofit organization, voluntarily formed by transmission owners but run by a board that is legally independent of those owners (and of all other market participants). The "region" covered by an RTO (sometimes called its "footprint") is defined by the service territories of the transmission

owners that formed or joined the RTO. Within its region, the RTO is the legal provider of transmission service, controlling both operations and planning.

The RTO has control of operations and planning because each transmission owner signed standard contracts granting that control. Under those contracts, each transmission owner retains ownership of its facilities but must carry out directives issued by the RTO. Those RTO directives can include orders to build or expand transmission facilities, when and where the RTO deems it necessary.

The RTO contracts were drafted largely by the transmission owners, since it was their decision to form the RTOs. Like any rational actor, they drafted language to serve their interests. Transmission is a source of profit and, because of its natural monopoly features, a potential source of market power. ("Market power" is the ability to charge prices above competitive levels, for a sustained period of time, without an unacceptable loss of sales.) To keep those benefits to themselves, the initial transmission owners wrote into the contracts a "right of first refusal" (to industry insiders, a ROFR): If the RTO identified a need for a new transmission facility within an owner's service territory, the right to build and own the facility would lie with that owner, even if competitors were willing and able to do the job. (The ROFR applied only to facilities needed for "regional" purposes, as opposed to more "local" facilities.)

FERC initially approved these provisions. But by 2011 FERC realized that while transmission was a natural monopoly service, there could be competition to provide that service. Allowing the incumbent an automatic right to build, when others might do it better, faster and less expensively, was inconsistent with the Federal Power Act's consumer protection purpose. So in Order 1000, FERC held that the ROFR violated the statutory prohibition against "practices" that are "unjust and reasonable" and/or "unduly discriminatory or preferential." The transmission owners had to delete the ROFR from the contracts.

FERC's goal was twofold: to "make it possible for non-incumbent developers to compete and propose more efficient or cost-effective [regional] transmission solutions," and "to eliminate practices that have the potential to undermine the identification and evaluation of more efficient or cost-effective alternatives to regional transmission needs." FERC's reasoning was straightforward: "[I]t is not in the economic self-interest of public utility transmission providers to expand the grid to permit access to competing sources of supply," or "to permit new entrants to develop transmission facilities, even if proposals submitted by new entrants would result in a more efficient or cost-effective solution to the region's needs." Indeed, why would a prospective entrant even offer a proposal, if the ROFR-armed incumbent could just copy it and carry it out? The ROFR thus both prevented competition and it reduced the flow of innovative ideas. As the D.C. Circuit said, upholding FERC: "Not only would non-incumbents be unlikely to recoup the full benefits of their proposal, but they would not even be able to recoup the costs of identifying the need and making a proposal that would address it."[7]

Mobile-Sierra Protection: Unavailable for Anti-Competitive Clauses

The incumbents had one more shot. Order 1000 invited them to argue, in subsequent submissions, that eliminating the ROFR violated the Mobile-Sierra doctrine. A judicial interpretation of the Federal Power Act, *Mobile-Sierra* limits FERC's authority to modify FERC-jurisdictional contracts without the contracting parties' consent. That limitation takes the form of a rebuttable presumption: When "sophisticated parties" freely negotiate a contract at arm's length, FERC must presume that the contract terms are "just and reasonable" and therefore lawful. The presumption can be rebutted (i.e., FERC can declare the contract unlawful) only if its terms cause "serious harm" to the public (or as the Supreme Court once stated, only in circumstances of "unequivocal public necessity").[8]

So the transmission owners argued *Mobile-Sierra*. In three separate court cases, they accused FERC of eliminating the ROFR without finding "serious harm." They lost. The D.C. Circuit upheld FERC's two key findings. First, the ROFR was not "the product of adversarial negotiations between sophisticated parties pursuing independent interests." (According to FERC, the "negotiations" were not arm's length; they were "among parties with the same interest, namely, protecting themselves from competition in transmission development.") Second, Mobile-Sierra contract protection "does not extend to anti-competitive measures"; specifically, "disincentives for nonincumbents to identify and commit resources to cost-effective solutions to transmission needs."[9]

That brings us to the Seventh Circuit opinion, bluntly presented by the venerable Judge Posner. "No one likes to be competed against. ... [Incumbents] don't want to have to bid down the prices at which they will build new facilities in order to remain competitive. ... [C]ontract rights are not sacred, especially when they curtail competition." Yes, Mobile-Sierra deference is due parties who are "sophisticated"; and yes, the incumbents were sophisticated—"sophisticated enough to understand the benefits of a contract that would give each party protection against competition in the creation of new facilities." Judge Posner concluded: "[A] contract in which the parties are seeking to protect themselves from competition from third parties (cartels are the classic example of such contracts)" does not deserve Mobile-Sierra deference.[10]

Legal Uncertainty: The States, Again

Two emphatic unanimous opinions. Has the path to transmission competition now been cleared? No. What the transmission incumbents lost at FERC, they could seek from the states. FERC has the power to delete anti-competitive language from FERC-jurisdictional contracts. FERC does not have the power to delete anti-competitive language from state statutes.

Crafting this next sentence took me only two minutes: "No transmission facility may be constructed and owned within a service territory except by a public utility obligated to serve retail customers in such service territory." By enacting these 26 words, a state would protect its in-state transmission monopolies from competition. The cost-increasing effects would fall on its own citizens (industrial, commercial and residential consumers), but also on customers

throughout the region (because we are talking about regional facilities). If each state does the same thing, each state guarding its own utilities against competition from other states' utilities, the states will have, once again, formed a circular firing squad.[11]

A state law conflicting directly with FERC's policies would raise judicial eyebrows. How far, we don't know. The preemption analysis that felled New Jersey's and Maryland's actions (specifically, their financial support of chosen generators bidding into regional markets)[12] would not apply. Those states had entered FERC's domain, by effectively setting FERC-jurisdictional prices. Here, states would argue they are remaining within their own domain, by deciding who can own the facilities that serve their residents.

Let's hope that in this season of patriotism, we remember our Pledge of Allegiance: "one nation under all, indivisible."

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[1] *See* Pub. L. 91-560, 84 Stat. 1472 (1970) (adding Section 105(c) to the Atomic Energy Act of 1954, requiring the NRC to conduct antitrust reviews of nuclear plant applicants and authorizing NRC to condition operating licenses to prevent anti-competitive conduct, including withholding access to an electricity source then viewed as "too cheap to meter"). The NRC imposed such conditions in *Consumers Power Co.*, 6 N.R.C. 887, 1036-44 (1977); *Toledo Edison Co. & Cleveland Elec. Illuminating Co.*, 10 N.R.C. 265, 327-34 (1979); and *Alabama Power Co.*, 13 N.R.C. 1027, 1061 (1981).

[2] *Utah Power & Light & PacifiCorp*, 45 F.E.R.C. para. 61,095 (1988).

[3] *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities, Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, Order No. 888, 75 F.E.R.C. para. 61,080 (1996).

[4] *Regional Transmission Organizations*, Order No. 2000, 89 FERC 61,285 (1999).

[5] *Preventing Undue Discrimination and Preference in Transmission Service*, Order No. 890, F.E.R.C. Stats. & Regs. para. 31,241, 72 Fed. Reg. para. 12,266 (2007).

[6] *Transmission Planning and Cost Allocation by Transmission Owning and Operating Public Utilities*, Order No. 1000, 136 FERC para. 61,051 (2011).

[7] *South Carolina Public Service Authority v. FERC*, No. 12-1232 (D.C. Cir. Aug. 15, 2014).

[8] The doctrine is named after a pair of Supreme Court opinions issued in 1956—the same year Don Larsen pitched baseball's only World Series perfect game (on Oct. 8, 1956—the date on my driver's license). See *United Gas Pipe Line Co. v. Mobile Gas Corp.*, 350 U.S. 332 (1956), and *FPC v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956). See also *Permian Basin Area Rate Cases*, 390 U.S. 747, 822 (1968) ("Setting aside a contract rate requires a finding of

unequivocal public necessity"). The doctrine was restated, with more clarity, in *Morgan Stanley Capital Group, Inc. v. Pub. Util. Dist. No. 1 of Snohomish County*, 554 U.S. 527 (2008).

[9] *Oklahoma Gas & Electric Co. v. FERC*, No. 14-1281, slip opinion at 10 (D.C. Cir. July 1, 2016).

[10] *MISO Transmission Owners v. FERC*, No. 14-2153 (Apr. 6, 2016). In a separate case, affiliates of FirstEnergy, Public Service Electric & Gas, Exelon, and PPL Corp. also challenged FERC's decision. The D.C. Circuit dismissed that challenge for lack of jurisdiction, finding that the petitioners had failed to preserve their arguments before FERC. *American Transmission Systems, Inc., et al. v. Federal Energy Regulatory Commission*, Nos. 14-1085 and 14-1136 (D.C. Cir. July 1, 2016).

[11] For other examples, see these essays: “FPA "Power Grab": On Whose Foot is the Shoe?” and “Maryland's Supreme Court Loss: A Win for Consumers, Competition and States.”

[12] *See* “Maryland's Supreme Court Loss: A Win for Consumers, Competition and States.”