

FERC's Unclear Guidance On Horizontal Market Power

Law360, New York (April 10, 2013, 5:05 PM ET) -- The Federal Energy Regulatory Commission recently declined to authorize under Section 203 of the Federal Power Act (FPA) a proposed transaction pursuant to which MACH Gen LLC would sell, and Saddle Mountain Power LLC would buy, all outstanding equity interests of New Harquahala Generating Company LLC.[1]

Since the proposed transaction, absent mitigation, failed FERC's screens for horizontal market power by a wide margin, applicants proposed to transfer control over a generating plant owned by New Harquahala to Twin Eagle Resource Management LLC, an independent third party, pursuant to an energy management agreement (EMA).

FERC determined that the EMA did not transfer "unlimited discretion and control"[2] of the Harquahala facility to Twin Eagle, and, therefore, the proposed mitigation was insufficient to address the market power concerns raised by the proposed transaction.

The Proposed Transaction

MACH Gen is a holding company that owns 100 percent of the interests in three electric generating companies, including New Harquahala. MACH Gen is owned by financial institutions. The Harquahala facility is a natural gas-fired, combined-cycle electric generating plant with a summer rating of approximately 1,054 megawatts. The Harquahala facility is located in the balancing authority area of Arizona Public Service Company (APS BAA).

Saddle Mountain, a wholly owned subsidiary of Wayzata Opportunities Fund II LP (WOF II), was formed to acquire the equity interests of New Harquahala. Wayzata Investment Partners LLC is the investment manager of WOF II.

Wayzata also is the fund manager for Wayzata Opportunities Fund LLC (WOF I). WOF I and WOF II each own a 50-percent interest in Sundevil Power Holdings LLC, which owns two of the four generating units (combined summer rating of approximately 1,167 MW) at the Gila River natural gas-fired electric generating facility in Gila Bend, Ariz. The Gila River facility interconnects with the transmission grid in the APS BAA.

Applicants recognized that absent any horizontal market power mitigation measures, the proposed transaction would result in the failure of FERC's screens for horizontal market power due to the large percentage of generation capacity that New Harquahala and its affiliates would own and control in the APS BAA.

Under the economic capacity analysis, the relevant market would be highly concentrated, and the changes in the Herfindahl-Hirschman Index (HHI) resulting from the proposed transaction would be above FERC's threshold for seven of 10 seasons or load periods.

Under the available economic capacity analysis, the proposed transaction also would result in HHI changes exceeding 1,000 for seven of 10 seasons or load periods. Hence, mitigation would be necessary to eliminate the possibility that New Harquahala and its affiliates would have market power following the proposed transaction.

The Proposed Mitigation of Horizontal Market Power

Applicants' proposed mitigation included the following:

- New Harquahala would relinquish control of all available capacity and of the authority to dispatch the Harquahala facility to Twin Eagle on a rolling 12-month basis.
- Twin Eagle's responsibilities to New Harquahala, as provided in the EMA, would include the economic dispatch, marketing and execution of short-term transactions for capacity and related energy products, scheduling transmission, administering settlement and payment for its transactions, procuring fuel and scheduling and tagging power.
- Twin Eagle would create a daily marketing plan based on the available capacity at the Harquahala facility (as communicated by the operations and maintenance operator), the generation cost for the day at various output levels and Western Electricity Coordinating Council protocols. New Harquahala would have the right to audit the daily marketing plans only 30 days after the close of the most recent calendar quarter, by which time all of the information would have been disclosed in electric quarterly reports filed with FERC.
- New Harquahala would have limited rights to terminate the EMA only under the following circumstances: upon insolvency or default; where either party undergoes a change in control or a change in status that might affect its ability to make sales at market-based rates; if FERC determines that mitigation is no longer necessary; or upon 60 days' prior written notice if New Harquahala has elected a successor energy manager, which is approved by FERC.

Applicants explained that certain parameters were set forth in the EMA to guide Twin Eagle's operation of and sales from the Harquahala facility to avoid uneconomic dispatch. Specifically, under the EMA, New Harquahala would establish the Harquahala facility's operating limits, dispatch and efficiency curves and operating costs, all of which are factors within the dispatch model and energy management plan, an attachment to the EMA.

In addition, New Harquahala would be responsible for operation and maintenance of the Harquahala facility. Finally, New Harquahala retained the right to enter into long-term agreements for energy or capacity from the Harquahala facility that would commence at least one year after the date of execution of such agreements and that would be subject to prior FERC approval.

The FERC Order

Applicants' ability to exercise market power was of particular concern to FERC because the Harquahala facility and the Gila River facility (the two facilities that would be commonly-owned and controlled by Wayzata in the APS BAA) operate using similar generation technology (combined-cycle, natural gas-fired turbines).

Under competitive conditions, each facility would have a similar dispatch cost and could be available at a similar point on the supply curve. FERC highlighted three reasons why, in its judgment, New Harquahala's proposed transfer of control via the EMA was insufficient to address the market power concerns raised by the proposed transaction.

First, under the EMA, Twin Eagle would have to follow a detailed, proscribed methodology for dispatching the Harquahala facility, from which methodology it would have little discretion to deviate. Under the EMA, New Harquahala would establish the operating limits, dispatch and efficiency curves and operating costs of the Harquahala facility.

Thus, New Harquahala, its parent, Saddle Mountain, and its affiliates under common control of Wayzata, including Sundevil, would have advance knowledge of the short-term marketing strategy for the generation output of the Harquahala facility.

Sundevil, which already owns and controls 1,167 MW of capacity at the Gila River facility, would have access to information that would allow it to make anti-competitive sales from that facility.

For example, Sundevil could choose to withhold output from that facility or dispatch energy from its capacity at the Gila River facility at a higher price than would result from a competitive process to maximize its overall profits. Notably, as FERC found, such a withholding strategy would not require any overt cooperation between Sundevil and Twin Eagle.

Second, New Harquahala would be responsible for operation and maintenance of the Harquahala facility.

Third, New Harquahala would retain the right to enter into long-term contracts for sales from the Harquahala facility. According to FERC, “Applicants cannot credibly argue that the Harquahala facility will be under someone else’s control when New Harquahala reserves the right to control the facility itself for purposes of marketing it for long-term sales.”[3]

FERC declined to authorize the proposed transaction without prejudice to applicants making a new filing that proposes mitigation that would be sufficient to remedy the identified failures of FERC’s market power screens.

Some Further Guidance and More Questions

FERC has provided little guidance on when an entity has control of capacity pursuant to an energy management or comparable agreement such that the capacity could be attributed to that entity for purposes of determining whether to grant that entity the necessary authorizations under the FPA to provide jurisdictional services or whether to authorize a proposed transfer of facilities subject to FERC jurisdiction.

FERC has never authorized a proposed transaction pursuant to FPA Section 203, where the ability to exercise market power has been mitigated through the transfer of control over generation facilities pursuant to such an agreement.

In its notice of proposed rule-making regarding market-based rates (MBR),[4] FERC considered whether, in the interest of providing greater certainty and clarity regarding the determination of control for the purpose of authorizing MBRs, it should make generic findings or create generic presumptions regarding what constitutes control.

In particular, it sought comment on whether any of the following functions should merit a finding or presumption of control and, if so, on what basis: directing plant outages, fuel procurement, plant operations, energy and capacity sales, and/or credit and liquidity decisions.

In Order No. 697,5 FERC declined to adopt a presumption of control regarding energy management and comparable agreements or the above-described functions listed in the NOPR. FERC concluded:

[E]nergy management and comparable agreements do not necessarily convey unlimited discretion and control away from the entity that owns the plant. In this regard ... it is the totality of the circumstances that will determine which entity controls a specific asset.[6]

Accordingly, Order No. 697 provides little guidance regarding when an entity has control of capacity for purposes of determining whether to permit the entity to charge MBRs. As FERC noted, it will provide such guidance on a case-by-case basis.[7]

Likewise, FERC has provided little guidance regarding when the transfer of control will be sufficient in an FPA Section 203 proceeding to mitigate the failure of FERC's horizontal market power screens. In MACH Gen, FERC provides some limited guidance in this regard.

First, as in the case of MBRs, FERC determines on "the totality of the circumstances" whether there has been a transfer of control.

Second, in order for the proposed mitigation to address the potential adverse impact the transaction will have on competition, there must be a transfer of "unlimited discretion and control." This would appear to establish a very high standard that will be applicable at least with respect to the transfer of control in FPA Section 203 proceedings.

Finally, the proposed mitigation will not be sufficient to the extent that the entity establishes and, thus, has knowledge of, the operating limits, dispatch and efficiency curves and operating costs of the relevant facility; operates and maintains the facility; and has the right to enter into long-term (for more than one year) sales contracts.

However, MACH Gen lacks certainty and clarity in other respects and raises more questions. First, FERC does not indicate whether the retention of any one of the above-listed responsibilities or right would result in a denial of an FPA Section 203 application for failure to transfer "unlimited discretion and control." [8]

Second, FERC was concerned because New Harquahala, its parent Saddle Mountain and its affiliates under common control of Wayzata, including Sundevil, would have access to "relevant information to which no other market participant [would] have, namely, advance knowledge of the short-term marketing strategy of the generation output of the Harquahala facility." [9]

Henceforth, FERC apparently will consider both whether the entity has the ability to control the output of the facility and, if not, whether it nonetheless will have access to relevant nonpublic information that would enable it to engage in anti-competitive sales even without any overt cooperation between parties.

Finally, FERC seems to suggest that what constitutes a change of control for mitigation purposes under FPA Section 203 may differ from what would suffice in an FPA Section 205 proceeding. In distinguishing MACH Gen from Acadia Power Partners LLC, [10] FERC stated, "that proceeding involved a change in status filing pursuant to Order No. 652, and analyzed the EMA in the context of affiliate sales rather than its effect on competition." [11]

Parties such as MACH Gen, for which transferring control to an independent third party may be the only practicable manner in which to mitigate horizontal market power, [12] apparently will have to await further guidance from FERC, provided on a case-by-case basis, on what it will deem to be the transfer of "unlimited discretion and control."

In the meantime, entities seeking to mitigate horizontal market power through the transfer of control to an independent third party will have to give careful thought to the functions they can continue to perform or the rights they can retain, if any, and even if not, the extent to which they may have access to nonpublic information that could permit them to engage in anti-competitive sales to maximize their overall profits.

To view the FERC order denying the proposed transactions, click [here](#).

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[1] MACH Gen, LLC, 142 FERC ¶ 61,178 (2013). MACH Gen, Saddle Mountain, and New Harquahala are collectively referred to herein as Applicants.

[2] *Id.* at P 29.

[3] *Id.* at P 32.

[4] Market-Based Rates for Wholesale Sales of Elec. Energy, Capacity & Ancillary Servs. by Pub. Utils., 71 FR 33102 (Jun. 7, 2006), FERC Stats. & Regs. ¶ 32,602 (2006) (NOPR).

[5] Market-Based Rates for Wholesale Sales of Elec. Energy, Capacity & Ancillary Servs. by Pub. Utils., Order No. 697, FERC Stats. & Regs. ¶ 31,252 (2007) (Order No. 697), clarified, 121 FERC ¶ 61,260 (2007), order on reh'g, Order No. 697-A, FERC Stats. & Regs. ¶ 31,268, clarified, 124 FERC ¶ 61,055, order on reh'g, Order No. 697-B, FERC Stats. & Regs. ¶ 31,285 (2008), order on reh'g, Order No. 697-C, FERC Stats. & Regs. ¶ 31,291 (2009), order on reh'g, Order No. 697-D, FERC Stats. & Regs. ¶ 31,305 (2010), aff'd sub nom. *Mont. Consumer Counsel v. FERC*, 659 F.3d 910 (9th Cir. 2011), cert. denied sub nom. *Pub. Citizen, Inc. v. FERC*, 133 S. Ct. 26 (2012).

[6] Order No. 697 at P 197.

[7] Order No. 697 at P 197.

[8] Likewise, in *Westar Energy, Inc.*, 115 FERC ¶ 61,228, at P 76 (2006), to which the FERC cites, it found that there was not a transfer of control for FPA section 203 purposes because the entity retained:

The sole right and responsibility to, among other things: (1) establish all marketing plans for Power, Fuel or Ancillary Services and approve or disapprove of any deviations from such Marketing Plans that may be recommended by the Energy Manager ... from time to time; (2) establish short-term and long-term fuel and energy trading strategies; (3) establish Risk Management Policies and Strategies; (4) approve all short-and long-term fuel and power transactions; (5) determine the amount of otherwise non-contracted power available from the facility at any time; and (6) determine the amount of fuel to be supplied to the facility.

In addition, the entity would operate the facility. Again, it is not clear whether the retention of any one or more of these functions, as the FERC notes, among others, would defeat the transfer of unlimited discretion and control sufficient for the mitigation of horizontal market power in an FPA section 203 proceeding.

[9] MACH Gen at P 31.

[10] 115 FERC ¶ 61,228 (2006).

[11] MACH Gen Order at P 29 n.36.

[12] The FERC has indicated that horizontal market power mitigation measures include, but are not limited to, joining or forming a Regional Transmission Organization, implementation of an independent coordinator of transmission arrangement, generation divestiture, virtual generation divestiture, and proposals to build new transmission to provide greater access to third party suppliers. E.g., Duke Energy Corp., 139 FERC ¶ 61,194 at P 4 (2012).

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