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FERC Imposes New Constraints on Utility Procurement

To prevent undue preference to utility affiliates, FERC is calling for open competitive solicitations that meet the Edgar standard. A New Jersey procurement auction offers a paradigm for fast-track FERC approval.

Kurt Strunk and Kushal Patel

I. Introduction

In February and July of this year, the Federal Energy Regulatory Commission issued decisions on a number of affiliate transactions. FERC is expanding the scope of its review and subjecting all future ones to the standard set by Edgar.1 Business is not as usual. Utilities that wish to enter into power purchase contracts with affiliates or wish to buy assets from them face brand new constraints. These constraints require utilities to rethink their procurement processes and to consider open competitive solicitations that level the playing field for affiliates and non-affiliates and squarely meet the Edgar standard.

FERC’s goal is to expand the role of competitive markets, foreclosing neither existing merchant generators, new entrants, or non-affiliated suppliers. In the Commissioners’ words, “[t]he public interest requires policies that do not harm the development of vibrant, fully competitive generation markets.”2 FERC is prodding utilities with supply resource needs to rely on market-based mechanisms for procurement, and is discouraging them from direct awarding of contracts to affiliates.3 FERC has pledged to undertake a thorough review of all future affiliate transactions to assure that independent suppliers are not denied equal competitive

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opportunities.\textsuperscript{4} It has, however, pointed out one sure way to achieve fast-track review and approval of an affiliate transaction: The transaction in question must be the result of an open and transparent competitive solicitation process conducted by an independent third party.\textsuperscript{5}

This article reviews FERC’s new affiliate policy and presents a case study illustrating how to design a competitive solicitation to meet the Edgar standard.

II. Recent Case History

The first expansion of scope of FERC review came in Mountainview.\textsuperscript{6} In this case, FERC ordered that the Edgar standard be applied to all future affiliate power transactions of duration of one year or greater, whether filed as cost-based tariffs or market-based tariffs. The Edgar standard – designed to assure that the utility does not choose to enter into a high-cost transaction with an affiliate when less-costly options are available from non-affiliated suppliers – had only previously applied to market-based tariffs. In extending it to cost-based transactions, FERC recognized that supply conditions in several parts of the country are such that cost-based tariffs may be higher than market-based tariffs; in these situations, FERC wants to assure that customers pay no more than market value.

The second expansion of the scope of FERC review came in Ameren.\textsuperscript{8} That decision calls for extension of the Edgar standard to apply to Section 203 transfers of FERC-jurisdictional assets from a generator to an affiliated regulated utility. FERC had been concerned in previous cases—see for example Cinergy\textsuperscript{9}—that the regulated utility might serve as a “safety net” for merchant generators who could sell their assets back to the utility at book costs, to be recovered by the latter’s cost-based rates, in the event market conditions turn unfavorable and the merchant cannot recover those costs from market rates.\textsuperscript{10} Hence, whether it is the buyer in a power purchase agreement (PPA) or the buyer of a generating plant, the utility must now in all cases provide evidence sufficient to meet the Edgar standard that there has been no abusive self-dealing.

While one may view FERC’s action as overlapping with the role of the state public utility commissions whose purview includes prudence reviews of utility expenditures, FERC implies that its role is different and is necessary in addition to state review. FERC notes that prudence reviews by state commissions occur after the fact, and that FERC review occurs before the transaction is consummated.\textsuperscript{11} While state commissions have the opportunity ex post to assure that above-market costs from affiliate transactions (if any) are not passed on to ratepayers, FERC has the opportunity to review them ex ante and prevent any harm to market competition. In Ameren, FERC determined:

\begin{quote}
FERC implies that its role is different and is necessary in addition to state review.
\end{quote}

While effective state regulatory review can prevent excessive rates to the retail customers of the acquiring utility, it is not a remedy for the anticompetitive effects of affiliate preference, which harm all customers. The possibility of eventual regulatory review does not prevent the exercise of affiliate preference before the transaction occurs. We are also not convinced that such eventual regulatory review of rates is an effective remedy for anticompetitive effects that arise at the time affiliate preference occurs. Ultimately, all customers are harmed because competition is undermined.\textsuperscript{12}

FERC cites decreased efficiency, increased market power, and increased entry barriers as three areas of potential harm to competition that could ensue if affiliate transactions are not screened and determined to be free from competitive distortion in the first place.\textsuperscript{13}

In Ameren, FERC further spells out new constraints on utilities in their supply planning, if that includes the possibility of an affiliate transaction. In order to meet its competition objectives, utilities are now encouraged by FERC to include open, transparent
competitive solicitations in their supply planning processes to assure that customers are getting the least-cost supply resources available in the market. To avoid all suspicion of affiliate preference, FERC recommends that the solicitations be conducted by an independent third party.\textsuperscript{14} \textit{Ameren} spells out the guiding principles for such solicitations, and just falls short of making such solicitations mandatory.

\subsection{A. Edgar}

Given FERC’s reliance on the \textit{Edgar} standard for all future affiliate transactions, a brief review of that standard is warranted here. In \textit{Edgar}, FERC sought to assure that the buyer, Boston Edison, had chosen the lowest-cost supplier from the options available in the market, taking into account both price and non-price terms—i.e., that it had not given unjust preference to its affiliate, Edgar Electric Energy.\textsuperscript{15} To meet the standard set in \textit{Edgar}, an applicant must show that customers of the regulated entity will not experience higher costs as a result of unjustified preference whereby the regulated entity selects an inferior offer from an affiliate over a superior offer from a non-affiliate.

Under \textit{Edgar}, there are three principal ways that the seller may demonstrate that the transaction is free from such abuse. The first would be “evidence of direct head-to-head competition between [the seller] and competing unaffiliated suppliers either in a formal solicitation or in an informal negotiation process.”\textsuperscript{16} This head-to-head competition should assure that the transaction is disciplined by the competitive market. When a head-to-head competitive process is relied upon, the \textit{Edgar} standard requires the applicant to demonstrate that: (a) the competitive process was not designed and implemented in a way that provided the affiliate an undue competitive advantage; and (b) the evaluation did not unduly favor the offer from the affiliate, with a particular emphasis on the evaluation of non-price factors.

\textbf{In Edgar, FERC sought to assure that the buyer, had chosen the lowest-cost supplier from the options available.}

an undue competitive advantage; and (b) the evaluation did not unduly favor the offer from the affiliate, with a particular emphasis on the evaluation of non-price factors.

The second type of evidence permissible under \textit{Edgar} is “the prices that non-affiliated buyers were willing to pay for similar services” from the generation project in question.

A third type is “benchmark evidence which shows the prices, and terms and conditions of sales made by nonaffiliated sellers.” When an applicant elects to submit a benchmark analysis, it must base that analysis on an appropriate group of comparable transactions. \textit{Edgar} sets the following criteria for the comparison group of transactions:

1. They must occur in the relevant market;
2. They must be contemporaneous with the instant transaction;
3. They must involve services similar and comparable to those involved in the instant transaction;
4. The applicant must demonstrate that the instant transaction is as favorable to the buyer as the comparison group transactions, considering both in their entirety—i.e., both their price and non-price terms;
5. The applicant must clearly and fully explain all assumptions used to evaluate both; and
6. The comparison group transactions must not incorporate the effect of the exercise of market power by a party to the instant transaction.

\section*{III. Implications of the New Requirements}

The most important aspect of the new FERC policy for utilities is FERC’s recommendation to issue solicitations before executing a transaction with an affiliate, to assure that the transaction is the least-cost option for the utility and does not harm the competitive process.\textsuperscript{17} While all three types of evidence permissible under \textit{Edgar} may still be used by applicants seeking to demonstrate the reasonableness of an affiliate transaction, FERC’s 2004 policy
clearly articulates a strong preference for head-to-head competition and underscores its value in assuring that a transaction is above suspicion and does not distort or repress competition. FERC offers four principles that should guide future solicitations:

A. Transparency: the competitive solicitation process should be open and fair.

B. Definition: the product or products sought through the competitive solicitation should be precisely defined.

C. Evaluation: evaluation criteria should be standardized and applied equally to all bids and bidders.

D. Oversight: an independent third party should design the solicitation, administer bidding, and evaluate bids prior to the company’s selection.

Head-to-head competition is viewed as most compelling because it leaves no doubt that the utility considered all available options and chose the least-cost one. When independently monitored and evaluated, head-to-head competition between affiliates and non-affiliates directly and unambiguously determines the market price for a given service or product and allows observers to understand and appraise the results.

IV. Possible Solicitation Scenarios

The proper application of FERC’s new guidelines to future solicitations will of course depend on the market environment the utility faces. Indeed, the guidelines leave a utility considerable room to design its own solicitation. Whether utilities will be able to implement them easily depends on their operating environment. The guidelines call for well-defined products: In some markets, a utility may be able to define the product more precisely; in other markets it may be more difficult.

In the case of non-standard products, extreme care must be taken at the solicitation design stage.

On the one hand, certain power products lend themselves to standardization. If a utility’s need can be met through a standard product with standard terms and conditions that apply to any winning bidder, there can be no dispute about differences in non-price terms between the offers of affiliated and non-affiliated suppliers. (Care will of course still need to be taken to assure that the choice of commercial terms for the standard contract does not provide unjustified preference to the affiliate.) A standard product can be put to bid in an open and transparent solicitation in which price is unambiguously the determining factor in the selection of winning bidders. Hence, with standard products, the FERC criterion of evaluation transparency is easily met.

On the other hand, a standard product is not always going to be involved. A utility operating in certain circumstances may wish to solicit bids on a PPA that is asset-backed, either tied to the construction of a new facility or backed by an existing plant. Alternatively, the utility may wish to acquire assets directly through the solicitation. FERC has explicitly anticipated these possibilities.

When the solicitation design and evaluation must take into consideration differing qualities and values of several assets, the goals of product uniformity, evaluation objectivity and transparency are more difficult to achieve. In this case, a utility may face substantial challenges with respect to product design and bid evaluation. These need not be insuperable. Decades of industry experience with IPP contract solicitations in the U.S. and internationally provide solutions to many of them. In the case of non-standard products, however, extreme care must be taken at the solicitation design stage.

V. Example of a Compliant Solicitation

The auctions for Basic Generation Service (BGS) contracts in New Jersey – designed with the assistance of our firm, NERA, and
operated by NERA – provide an excellent example of the open, transparent process that FERC is looking for in upcoming solicitations. As it observed in approving an affiliate BGS contract:

*The BGS competitive bid process described by Applicants alleviates the Commission’s concerns regarding affiliate abuse.* (102 FERC ¶ 61, 097, Order Granting Authorization To Make Affiliate Sales, Docket No. ER03-304-000, January 30, 2003.) *(Emphasis added.)*

The approach to product design and solicitation design taken by the electricity distribution companies (EDCs) in New Jersey, described below, demonstrates how a solicitation can meet FERC’s competition objectives and comply with the *Edgar* standard.

**A. Background**

The solicitation in New Jersey followed a statewide restructuring initiative taken on by the legislature, the utilities, and the Board of Public Utilities (BPU). New Jersey implemented retail choice in August 1998, adopting a four-year transition period. During the first three years (Aug. 1, 1999 through July 31, 2002), the New Jersey EDCs supplied default service to customers who elected not to switch to a competitive retailer or who returned to the utility. Default service was termed Basic Generation Service (BGS) in the legislation. In the fourth year – Aug. 1, 2002 through July 31, 2003 – the EDCs jointly proposed an auction in which suppliers would compete to provide BGS, while the customers would continue to pay pre-established rates or rates determined by pre-established rate-making processes. After the transition period, the EDCs elected to seek BPU approval to continue with BGS auctions and to use the resulting auction price as the unbundled generation rate. In each year since the transition period ended, the BPU has approved the proposed auctions and the auction results.

An essential goal of the post-transition auction process was to provide full-requirements BGS to customers at a cost consistent with market conditions. A second important goal was to further the development of markets in New Jersey by providing an opportunity for new entrants to compete in the auction by aggregating supplies at wholesale and providing a full-requirements, price-risk-managed service to retail customers. The BGS auctions have indeed stimulated markets in New Jersey and PJM and have provided competitively priced generation service to default customers.

There have been three BGS auctions to date – held in February of 2002, 2003, and 2004 – through which the EDCs procured over 17,000 MW of electric supply to serve BGS load in single, statewide processes. The management of each auction was assigned to an independent “Auction Manager.” Each year, the New Jersey BPU has approved the EDCs’ proposed auction process, which allows for input from all stakeholders and involves considerable regulatory oversight. In addition, the BPU staff and their consultants oversee the auction and provide input to the BPU prior to the approval of the auction results.

The transaction solicited in the first-year auction (fourth year of the transition period) was the supply of a “tranche” of an EDC’s full-requirements default service load served at a fixed $/MWh price. A tranche is a specific fraction of the utility’s default service load in every hour of the year; it can be thought of as a vertical slice of the EDC’s load curve or a “slice of system” product. In the second year of the auction, participants bid on tranches of the small customers’ loads at a fixed price, but the EDCs elected to define a separate product for large customers that incorporated hourly energy prices from the PJM wholesale market. Suppliers of the large customer product bid a fixed capacity price...
and were paid that fixed capacity price, the hourly PJM energy price, and compensation for transmission and ancillary services.

For the fixed-price product, the EDCs have established annual auctions for contracts of three-year duration. On a going forward basis, this means one-third of each EDC’s small customer load bid is out during each auction and exposure to the price from any single auction is reduced relative to bidding out all load at once. For the large customers, BGS contracts have one-year duration during which the prices for capacity and ancillary services are fixed, but the energy prices fluctuate in accordance with the PJM spot market and the transmission price tracks the PJM open-access transmission tariffs (OATT).

The type of auction used in New Jersey is a “Simultaneous Descending Clock Auction” or “clock auction.” In each round, suppliers bid for the right to provide a product (i.e., a tranche of load for a given EDC) at the prevailing auction price. The form of the bid is a quantity – i.e., the share of a given EDC’s load the bidder is willing to supply – at the prevailing auction price. If, at a given price, all current round bids aggregate to more than 100 percent of an EDC’s load, the price in that market will “tick” down in the following round. Bidders can revise their offerings for a product when its price falls by reducing the tranches of load they are ready to serve or by switching their offer from one EDC to another. Prices tick down and bidders reduce the number of tranches they wish to offer until the total number of tranches bid equals the number of tranches needed. The bidders that hold the final bids when the auction closes are the winning suppliers.

An examination of the BGS auctions in terms of each of FERC’s four guiding principles demonstrates how the auction reflects best practice in solicitation design and compliance with the Edgar standard.

Guiding Principle 1: Transparency

FERC calls for a competitive solicitation process that is open and fair. FERC defines transparency as the free flow of information: “[n]o party, particularly the affiliate, should have an informational advantage in any part of the solicitation process.” We also consider transparency in evaluation and the selection of winning bidders to be an important factor. FERC addresses this aspect of transparency in another guiding principle, “evaluation.” Hence, the guiding principles should not be viewed as independent, but must be considered collectively.

The New Jersey BGS Auction maintains transparency – free information flow – through the use of a publicly viewable Web site, managed by the independent Auction Manager, that contains all relevant information, including hourly load data for each EDC, the auction rules, and the Supplier Master Agreements. It can be viewed by any interested party and thereby guarantees fair and equal access to the largest universe of potential bidders. It provides an overview of the BGS auction, results from previous auctions, guidelines, and information necessary for bidders to participate effectively.

All communication between interested parties and the utilities is funneled through the Auction Manager and is posted every week on the Web site for public viewing under the rubric “frequently asked questions.” When the Auction Manager relays questions to the EDCs, the name of the bidder asking the question remains anonymous. The fact that there is no direct communication between bidders and the EDCs, and that the EDCs respond to all questions on an anonymous basis assures the integrity of the process. In addition to the BGS Auction Web site, telephone communication with the Auction Manager
Manager is permitted and potential bidders are encouraged to attend bidder information sessions. These take place on three occasions prior to the auction and are open to any interested party. At the sessions, the Auction Manager makes presentations and distributes information packets consisting of, for example, the auction rules, a BGS Auction Web site description, and other important bidder information. The live session includes an opportunity for in-depth questions and answers. All material and information provided to the attendees of the sessions is subsequently made available on the BGS Auction Web site. These communication practices fulfill FERC’s goal that the solicitation be well promoted and that the rules be clearly presented to all bidders.

In addition, in order to “enhance the fairness and transparency of the entire process,” the BGS auction allows for public comment on the auction design vis-à-vis the BPU regulatory process. The process allows all interested parties to participate, on equal terms, as intervenors in the proceeding before the New Jersey BPU and thereby voice any issues, concerns, or comments on the auction design and process. The BPU then is the final authority on deciding whether the auction itself is or is not approved and whether changes to the design or process are required.

Finally, the auction prohibits post-bid negotiation, in order to ensure fair and equal treatment of all winning bidders.

**Guiding Principle 2: Definition**

FERC also states “[t]he product or products sought through the RFP should be defined in a manner that is clear and nondiscriminatory. The RFP should state all relevant aspects of the product or products sought.” The BGS auction provides for a clear and explicit product definition, which consists of full requirements power for a “slice” or “tranche” of each utility’s load.

The exact product is manifest to all bidders in the form of the BGS Supplier Master Agreement, which is posted on the BGS Auction Web site, and spells out in contractual detail the product terms and conditions for all potential bidders, with no room for ambiguity. The use of a standard agreement for all suppliers allows any potential bidder to play on a level playing field with any other bidder, affiliate or not, and assures no bias in the auction process. A standard supplier agreement also vastly simplifies the selection of winning bidders, permitting decisions to be made on price terms alone, since all other relevant terms are defined to be the same.

**Guiding Principle 3: Evaluation**

FERC says, “[t]o fulfill the evaluation principle, RFPs should clearly specify the price and non-price criteria under which the bids are evaluated.” The BGS auction is designed to select those bidders who are willing to supply BGS at the lowest cost to customers. It reveals a clear unambiguous price for each product, so the evaluation is transparent and easy to follow. Evaluation of non-price criteria is also not an issue because the standardized contract means that all bidders, affiliate or not, will be supplying the product under the same non-price terms.

In addition, the BGS auction provides for a pre-auction bidder qualification process, to assure that all potential bidders meet certain stipulated minimum requirements. This assures that all bidders are positioned to take on the responsibilities of being a BGS supplier. The pre-qualification process is important to the fairness of the process and evaluation because it assures that all price bids considered in the auction are from suppliers who are qualified to be counterparties to the BGS Supplier Agreement.

Note that after pre-qualification, certain confidential information about the auction is available only to registered...
bidders, the Auction Manager, BPU Staff, and its consultants. The EDCs themselves are restricted from viewing certain information that could conceivably be used to render preferential treatment to an affiliate. Hence, the Auction Manager filters all information to assure a fair process.

Guiding Principle 4: Oversight
FERC’s fourth principle calls for: “[a]n independent third party [to] ensure meaningful participation by nonaffiliates and eliminate characteristics that improperly give an advantage to the affiliate.” As we have already noted, the BGS auction is administered and overseen by an independent third party, the Auction Manager, who assures that no abuse of an affiliate relationship occurs and that all potential bidders receive fair and equal treatment. The Auction Manager has oversight authority, has no financial interest in the bidders (including the affiliates of the EDCs), and is not paid on the basis of the outcome of the auction. The Auction Manager ensures that the guidelines and rules of the auctions are followed in an unbiased manner. By controlling the flow of information from potential bidders to the utilities, the Auction Manager can deny the EDCs prior access to any information that might give an unfair advantage to their affiliates, unambiguously preserving the integrity and fairness of the auction process. The Auction Manager fulfils FERC’s requirement for independent oversight and evaluation.

VI. Applications to Asset-Specific Transactions

While the New Jersey auctions provide an excellent example of a solicitation that complies with Edgar, this type of solicitation will not fit all utilities. There are unique circumstances – such as the existence of well-developed spot and forward markets and an appropriate regulatory regime – that make non-asset-backed, full-requirements auctions possible in New Jersey. Utilities elsewhere will need to design procurement processes that take into account local market conditions and the prevailing regulatory framework. They too can design solicitations that meet the Edgar standards, but the nature of the transaction may be different.

In the context of a solicitation for an asset-specific product, many solicitation design criteria used in the BGS auctions could be preserved. For example, the use of a public Web site is an effective means of providing information to interested parties on a non-discriminatory basis. Further, the use of an independent third party for bid evaluation remains a necessary means of complying with the FERC requirements.

The key areas that will differ for asset-specific transactions are product design and evaluation. The product design will require considerable forethought to assure that the type of capacity sought includes all resources that might provide a competitive source of power for the utility. Similarly, choices with respect to how the contract allocates risks (availability, fuel price, transmission, residual value, force majeure, etc.) will be scrutinized and must be defensible and unbiased.

When evaluating assets with distinct characteristics, the design of an objective evaluation process is critical. It is certainly feasible to have an evaluation that compares different types of supply resources in a single solicitation, as FERC anticipates. Such an evaluation can be transparent and well-documented. The best approach to evaluating very different bids in a single solicitation is to quantify (monetize) all factors that are reasonably subject to quantification. The most significant factors are generally susceptible to quantification. For example, one can quantify, in a common measure of cost, any difference in
availabilities or dispatch restrictions, or for that matter different dispatch costs. A system planning model can be used to compare the bids in present value or levelized per-kWh cost terms. For factors that are not quantifiable, the utility may elect to set minimum threshold requirements, much like the bidder qualification process in the BGS auctions.

While more complicated than solicitations for standard products, asset-specific solicitations can be designed to meet FERC’s competition requirements and the Edgar standard. In order to assure a successful outcome for the utility, while ensuring a fair competitive process, careful analysis and forethought in solicitation design are in every case imperative.

Endnotes:

5. 108 FERC ¶ 61,082, at 5–6.
10. 102 FERC ¶ 61,128, at 61,345, at 9.
11. 108 FERC ¶ 61,081, at 22.
17. 108 FERC ¶ 61,081, at 24 and 102 FERC ¶ 61,128 at 61,345, at 6–7.
18. The small customer load is procured via a separate auction from the large customer load. There is no switching between small-customer and large-customer products.
20. Id.
21. 108 FERC ¶ 61,082, at 8.
22. Id.

In order to assure a successful outcome for the utility, careful analysis and forethought in solicitation design are in every case imperative.