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Recent Developments Regarding Qualifying Facilities and FERC Chairman Wellinghoff's Statements About Avoided Cost Rates

Qualifying Facilities ("QFs") and the law that established QFs, the Public Utility Regulatory Policies Act of 1978 ("PURPA"), have been at the center of two recent significant developments that may affect the relationship between QFs and the utilities to which they sell their electric output. The first issue concerns the possibility posed by the FERC Chairman that certain generators require compensation for the extra "value" they provide, and the second issue pertains to the ownership of Renewable Energy Certificates ("RECs") attributable to energy produced by QFs. This article provides a concise summary of the issues for the benefit of interested parties that may be impacted by the outcome of these developments.

Compensating Generators for Greater "Value"

At a March 21, 2012 webinar hosted by the American Council on Renewable Energy on the topic of waste energy recovery from industrial processes, Federal Energy Regulatory Commission ("FERC") Chairman Wellinghoff announced a new initiative pertaining to avoided cost rates under PURPA. The Chairman stated that he has directed FERC lawyers and policy experts to research whether the avoided cost rates utilities pay to QFs should include additional compensation to distributed generation because it offers more value to consumers than centralized generation.

Although the focus of the Chairman's remarks concerned distributed generation, he also spoke more broadly regarding a larger issue concerning compensating resources for added value. For example, he stated that FERC's Order No. 755, issued October 20, 2011, requires certain technologies—such as flywheels, storage devices and demand response resources—to be paid more than conventional generation to provide frequency response because they offer more value. Frequency response is used by Independent Transmission Operators and Regional Transmission Organizations to balance supply and demand on the transmission systems they control. The Chairman explained that certain resources are more valuable because they can provide this service nearly instantaneously, whereas traditional generators require more time to ramp up and down. The more valuable resources should therefore be compensated in a manner that reflects that value, the Chairman maintained.

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Similarly, the Chairman stated that distributed generation, including facilities that recycle the waste and heat of generation, offer extra value that deserves extra remuneration. Distributed generation is generally perceived to offer additional efficiency benefits over centralized generation, such as the avoidance of line losses and a reduction in the need for new transmission lines. The Chairman believes that such resources should therefore be provided extra compensation under PURPA.

The Chairman explained that his initiative is in its very early stages and that he did not yet know whether providing the extra compensation would be consistent with PURPA, which states that a utility is not required to pay more than the utility's avoided costs for purchases of energy and capacity from QFs. He also stated that certain laws may need to be modified before the compensation mechanism could be implemented.

Extrapolating from the Chairman's comments and the recent Order No. 755, there appears to be a trend at FERC towards identifying and incentivizing resources that are able to provide certain services in a superior manner. This trend could encompass many factors, including efficiency, enhanced reliability, availability, response time, proximity and other desirable traits. In the event the Chairman's initiative results in revisions in law designed to reward QFs for certain characteristics, it might also open the discussion of QF compensation to other QFs that can point to any "extra value" benefits that they provide.

Who Owns the RECs?

Today, most contracts between QFs and utilities specifically designate the owner of RECs and other "green attributes" that exist now or that may exist in the future. Many older contracts, however, simply did not contemplate the development of renewable portfolio standards and accompanying assets like RECs. Such contracts are therefore silent regarding the ownership of RECs. Adding to the complexity of the matter, QFs and their sales of energy at wholesale to utilities is generally governed by federal law, whereas RECs are state-created assets. In 2003, FERC made the first effort to address this issue in *American Ref-Fuel Co., et al.*, 105 FERC 61,004 (2003) (hereinafter "*American Ref-Fuel Co.*") by granting a Petition for Declaratory Order regarding the ownership of RECs. Although FERC provided guidance in *American Ref-Fuel Co.*, many aspects of REC ownership remain unsettled, as further discussed below. Two QFs recently solicited further guidance from FERC regarding the ownership of RECs by filing Petitions for Enforcement of PURPA. The Petitions allege the Public Service Commission of West Virginia ("WV PSC") violated PURPA by issuing a decision finding that RECs attributable to QFs are owned by the utility purchasers.

The first Petition was filed on February 24, 2012 in Docket No. EL12-36-000 by Morgantown Energy Associates ("MEA"), the owner and manger of a 50 MW qualifying cogeneration facility. The second Petition was filed on March 15, 2012 in Docket No. EL12-48-000 by the City of New Martinsville, West Virginia (the "City"). The City owns a hydroelectric QF consisting of two 18.7 MW generating station units. Both Petitioners are parties to long-term contracts executed in the 1980s pursuant to which they sell their respective QFs' electricity and capacity to utilities at the utilities' avoided cost rate. In 2009, the West Virginia legislature enacted a Renewable Portfolio Standards Act ("WV RPS Act") establishing renewable energy requirements and creating a REC program within the state. The City has certified its QF under the WV RPS Act in order to produce eligible RECs within the state. MEA has certified its QF to sell RECs under other states' RPS programs, but has decided not to certify under the WV RPS Act.

On November 22, 2011, the WV PSC issued a declaratory ruling ("Ruling") finding that a utility, Monongahela Power Co. ("Mon Power"), and an affiliate, Potomac Edison Co. ("PE"), own the RECs attributable to purchases Mon Power made from three QFs, including MEA and the City. The Ruling was based on three findings: "(i) consistent with the [WV RPS] Act, the utility that is obligated to purchase PURPA generation (which also qualifies as eligible generation under the [WV RPS] Act) should own the credits that exist for the purpose of measuring utility compliance with the portfolio standard, (ii) Mon Power and PE's ownership of the credits is based on their ownership of the qualifying energy as it is generated, and (iii) under the circumstances of the case in which the [WV RPS] Act and the [contracts] do not contain provisions that specify credit ownership by the utility or the QF, it is appropriate to consider equity and fairness and the impact of our decision on utility rates."

In their Petitions, MEA and the City claim that the WV PSC Ruling violates PURPA by (i) finding that the "mere existence of a PURPA contract, at an avoided cost rate, constitutes compensation for RECs," despite agreement among the parties that the contract is silent with respect to RECs; and (ii) by discriminating against Petitioners on the basis of their QF status as compared to the treatment of other generation sources that are eligible to generate RECs. Because MEA chose not to certify under the WV RPS Act, it also argues that the Ruling violates PURPA by authorizing the WV PSC or Mon Power to make a management decision for MEA by deeming it certified under the WV RPS Act contrary to MEA's own management decision. Mon Power and PE filed a joint Protest, and the WV PSC filed a separate Protest to the Petitions (collectively, "Protesters"). Chief among the Protesters' counterarguments is that the ownership of state-created RECs is a matter to be decided under state law, not PURPA, and that the WV RPS Act grants ownership to purchasing utilities in West Virginia.

Petitioners and Protesters both point to FERC's prior decision in *American Ref-Fuel Co.* to support their respective positions. In *American Ref-Fuel Co.*, FERC decided a Petition for Declaratory Order filed by various QFs seeking a declaration that avoided cost contracts entered into pursuant to PURPA do not convey RECs to the purchasing utility absent any express contractual provisions to the contrary. In response, FERC declared that "the Commission's avoided cost regulations did not contemplate the existence of RECs and that the avoided cost rates for capacity and energy sold under contracts entered into pursuant to PURPA do not convey the RECs, in the absence of an express contractual provision." MEA and the City point to this conclusion to support their argument that the RECs are not part of the sale of energy and capacity under PURPA contracts, nor does the avoided cost rate include payment for RECs. But FERC also declared in *American Ref-Fuel Co.* that "RECs are created by the States. They exist outside the confines of PURPA. PURPA thus does not address the ownership of RECs. And the contracts for sales of QF capacity and energy, entered into pursuant to PURPA, likewise do not control the ownership of the RECs (absent an express provision in the contract). States, in creating RECs, have the power to determine who owns the REC in the initial instance, and how they may be sold or traded; it is not an issue controlled by PURPA." The Protesters point to this language to argue that FERC has declared that, absent relevant contractual provisions, the ownership of RECs is solely within the jurisdiction of the states that created the RECs. Notably, following the decision in *American Ref-Fuel Co.*, at least 17 states have addressed the issue of REC ownership and the majority has determined that the RECs are owned by the utility.

The outcome of these proceedings could have significant impacts. Mon Power and PE state that it would cost their ratepayers approximately US$50 million to replace the RECs that they obtained from MEA, the City and the third QF at issue in the Ruling. On the other side, Petitioners state that a finding that the avoided cost includes payment for RECs would be akin to penalizing QFs millions of dollars, would be a disincentive to the development of eligible QFs, and would shift the burden associated with the environmental benefits of PURPA and RPS programs from the general consuming public to the QFs. It will be interesting to see if FERC provides any new guidance regarding the ownership of RECs in its decision whether to initiate an enforcement action. The City's proceeding is open for comments until 5:00 pm EST on March 29, 2012.

Conclusion

As laws and technologies evolve, new policy matters emerge that could affect the PURPA landscape in the future. We continue to follow these developments and invite you to contact us if you would like to discuss these matters.

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