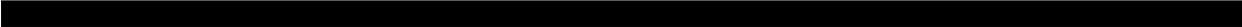




Restructuring at the Crossroads

FERC Electric Policy Reconsidered



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American Public Power Association

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Executive Summary

It is time to take stock of the Federal Energy Regulatory Commission’s (“FERC”) electric restructuring policies. APPA believes substantial “mid-course corrections” to FERC’s policies are needed to fix existing Regional Transmission Organizations (“RTOs”) and to encourage non-RTO alternatives in those regions where RTOs are not likely to form.

To protect electric consumers, as the Federal Power Act (“FPA”) requires, FERC should reorient its policies to make sure electric consumers in fact—not just in economic theory—benefit from electric restructuring.

FERC should:

- Ensure appropriate investment in transmission and generation infrastructure;
- Recognize and respect regional industry differences and preferences;
- Encourage cost-effective and not overly complex regional solutions;
- Support rational long-term generation resource arrangements that are in turn supported by long-term transmission service provided at just and reasonable rates;
- Foster well-functioning wholesale electric markets; and
- Ensure that public utility sellers of power at market-based rates charge “just and reasonable” prices.

APPA members in RTO regions report substantial, across-the-board problems with spiraling RTO costs, unaccountable RTO governance, and ever-increasing provision of RTO services through questionable market mechanisms. These APPA members are unable to obtain or even retain long-term firm transmission service at just and reasonable rates. This is impairing their ability to enter into the long-term generation resource arrangements they need to provide reliable and affordable electric service to their end-use customers.

Because of regional differences and the largely negative experience of APPA members now served by RTOs, many APPA members in non-RTO regions oppose RTO expansion to their own regions. These APPA members believe there are more cost-effective means to provide open access transmission service and to promote market efficiency, including: joint development of regional Open Access Same-time Information

Systems; regional provision of market monitoring; and development of inclusive regional transmission planning and expansion processes. Joint ownership of transmission facilities by all load-serving utilities in a region can also address many of the transmission access issues RTOs were intended to address. FERC should also deal with residual discrimination in the provision of transmission service by clarifying and more vigorously enforcing its Order No. 888 open access transmission regime.

Finally, FERC must address generation market power through a “bottom up” review and update of its market-based rate policy, for both RTO and non-RTO regions. The ability of public utility sellers to charge market-based rates is a privilege conferred under the FPA, not a right. Where regional wholesale generation markets are not competitive, FERC must adopt enforceable protective conditions on the market-based rate authorizations of specific public utility sellers, to ensure that rates remain just and reasonable.

Restructuring at the Crossroads:

FERC Electric Policy Reconsidered

Introduction

It has been twelve years since Congress passed the Energy Policy Act of 1992. It has been more than eight years since the Federal Energy Regulatory Commission (“FERC”) issued Order No. 888, which first encouraged the development of Independent System Operators (“ISOs”). It has been five years since FERC issued Order No. 2000 (its rule governing the voluntary formation of “Regional Transmission Organizations” (“RTOs”)), and more than two years since it launched its now-moribund “Standard Market Design” (“SMD”) initiative. During that time, FERC’s policy emphasis has changed from ensuring non-discriminatory transmission access to advocacy of RTO-run wholesale electric markets.

Electric restructuring has turned out to be a more complex, difficult and uncertain undertaking than most people imagined when FERC issued Order No. 888. The Western market debacle of 2000–2001, the spectacular flame-out of Enron and the subsequent revelation of its cynical and duplicitous business practices, the massive Northeast-Midwest blackout of August 14, 2003, the increasing and often unstable cost of natural gas used to fuel most new electric generation, the related run-up in long-term power supply prices (often without regard to actual production costs), the ever-increasing costs of RTOs in those regions where they exist, the severe financial distress of so many competitive electric generators/marketers, and the resulting entrance of financial institutions and lenders into the generation and power trading sectors, all illustrate the phenomenon of unintended consequences.

There are currently five up-and-running FERC-jurisdictional ISOs.¹ With the possible exception of the Southwest Power Pool (“SPP”) region, it is

¹ The five are ISO New England (“ISO NE”), the New York ISO (“NYISO”), the PJM Interconnection (“PJM”), the Midwest ISO (“MISO”), and the California ISO (“CAISO”). The ERCOT ISO in Texas is not FERC-jurisdictional, and hence is not included in this discussion. While these five entities are organized as ISOs, and FERC has only finally approved four of them as Order No. 2000-compliant RTOs, we will use the term RTOs to refer to all five, both for simplicity’s sake and because this is common industry usage.

not likely that RTOs will form in the rest of the country in the foreseeable future. The American Public Power Association (“APPA”) believes that RTOs are not the only—and in many regions not the best—structure for providing non-discriminatory transmission access. Thus, regional diversity must be acknowledged, and more pragmatic and flexible federal transmission policies implemented to deal with the reality “on the ground.”

It is time to take stock of FERC’s electric restructuring policies—some of which APPA and its members initially endorsed—and to make badly needed “mid-course corrections” to fix existing RTOs and to encourage non-RTO alternatives in those regions where they are not likely to form. A “bottom up” evaluation is needed to ensure the long-term adequacy of both generation and transmission facilities, in both RTO and non-RTO regions.

Few would say that FERC’s policies have been an unqualified success; many APPA members view them as a failure. APPA fears that a continuation of the “RTO or nothing” approach and inadequate supervision of existing RTOs will harm consumers and threaten the adequacy of our Nation’s electric system.

FERC is charged under the Federal Power Act (“FPA”) with ensuring that rates, terms and conditions of service for wholesale electric power and transmission service are “just and reasonable” and not “unduly discriminatory.” FERC needs to examine whether its policies satisfy these statutory requirements and benefit *electric consumers*—not the independent power producing sector, the existing RTOs/ISOs, investor-owned utilities (“IOUs”) and their shareholders, or financial institutions.

In this paper, APPA outlines fundamental policies intended to ensure that electric consumers in fact—not just in economic theory—benefit from FERC’s initiatives. It suggests that FERC reorient its policies to:

- Ensure appropriate investment in long-lived transmission and generation infrastructure;
- Recognize and respect regional differences and preferences in the industry;
- Encourage cost-effective and not overly complex regional solutions that both fulfill FERC’s statutory obligations and meet the needs of a region’s diverse stakeholders;

- Support rational long-term resource arrangements—arrangements that are in turn supported by long-term transmission service obtainable with acceptable risk and at just and reasonable rates;
- Foster well-functioning wholesale electric markets that provide load-serving utilities with cost-effective supply alternatives; and
- Ensure that sellers of short-term and long-term power supplies charge market-based rates only if the resulting prices are “just and reasonable.”

The Public Power Perspective

Public power utilities were created by state or local governments to serve the public interest. They are not-for-profit entities controlled locally by the people they serve. Their purpose and obligation is to provide reliable and low-cost electric power to their retail and wholesale requirements customers, consistent with good environmental stewardship, and to do so consistently year after year.

Rather than focusing on improving transmission availability through long-term planning and timely investments in transmission facilities, RTOs have morphed into vehicles for implementing centralized markets for day-ahead and real-time power and ancillary services, and the use of Locational Marginal Pricing (“LMP”) to deal with transmission congestion.

APPA was an important part of the coalition that convinced Congress in 1992 to start the process of opening the transmission network to promote wholesale competition. It was an early and strong supporter of FERC’s non-discriminatory open access transmission policies. APPA also supported the formation of properly structured, cost-effective RTOs, with their promise of independent and non-discriminatory transmission service provided under Open Access Transmission Tariffs (“OATTs”), regional non-pancaked transmission rates, and regional collaborative transmission planning and construction processes. APPA did so because it thought these RTO goals would benefit consumers.

APPA’s early optimism, however, has dimmed, as FERC’s RTO policies have increasingly lost sight of these shared goals. Rather than focusing on improving transmission availability through long-term planning and timely investments in transmission facilities, RTOs have morphed into vehicles for implementing centralized markets for day-ahead and real-time power and ancillary services, and the use of Locational Marginal Pricing (“LMP”) to deal with transmission congestion.

Moreover, APPA has viewed with increasing alarm the business strategies that some of our early allies in the open access transmission debates, as well as many of our competitors and wholesale power suppliers, have adopted to take pecuniary advantage of FERC's policies. "Competition," "restructuring," and creation of a multitude of "markets" for their own sake seem to have become the way to higher profits, not the means to lower costs and improve services to consumers.

New markets and protocols have been implemented without a clear understanding of whether these measures would in fact provide real benefits to electric consumers—benefits commensurate with the costs and risks that FERC and the industry have asked consumers to bear—or whether they lead to exorbitant profits for some and unstable prices for all. These increased costs and risks have made it more difficult for public power systems to serve their own customers with reasonably priced and reliable power. They have also resulted in substantially higher power prices in long-term bilateral markets, prices that seem to bear little relationship to sellers' actual costs.

The Public Power Business Model: Sticking to the Basics

Because they are locally owned and controlled, the interests of public power systems are necessarily aligned with the long-term interests of their respective customers and communities. Public power utilities embrace their obligation to serve their local communities, and have pursued vertical integration (accomplished in a variety of ways) as the most efficient and effective means to do so.

Some systems, particularly the larger ones, are fully integrated. They own and operate the facilities necessary to provide electric service to retail customers. Many others are "virtually" vertically integrated—they have contract and tariff arrangements under which they buy transmission service from others and join together through municipal joint action agencies to own or procure generation. Still others are distribution utilities that purchase full requirements-type energy and transmission service from larger utilities. Collectively, public power systems are net buyers of wholesale power. A wholesale power market that works is thus critically important to them.

Public power systems have long planning horizons and a low tolerance for risk and price volatility. In order to serve their customers reliably and economically, they are required to make long-term investments and contractual commitments. Public power systems look for policies that respect long-term contractual arrangements and keep the cost of capital low by reducing the risk incurred as a result of such commitments.

This “stick to the basics” business model has served public power and its customers well during the past few years, as was very apparent during the California energy crisis. Public power entities in California and throughout the country avoided making business decisions like those that triggered the credit deterioration and ratings downgrades affecting the independent

Public power entities continue to believe that their way of serving the public works well. Federal policies should support their ability to continue to provide such service.

power sector and many IOUs.² Ironically, those public power utilities that have suffered the most financially in recent years got caught up in regional market blow-ups not of their making, or entered into transactions with counterparties that later proved to be bad credit risks, unscrupulous, or both, necessitating in some cases painful rate increases.³

Public power entities continue to believe that their way of serving the public works well. Federal policies should support their ability to continue to provide such service. By reorienting

FERC’s policies to support long-term planning and investment in transmission and generation facilities, public power systems can continue to provide the high-quality electric service that our consumer-owners have come to expect.

² See, e.g., “Public Finance Report Card: Public Power,” Standard & Poor’s, published September 13, 2004, at 1 (“Since our last report card, published Jan. 21, 2004, the sector has continued to experience overall credit stability, and even slight improvement, with 10 upgrades and two downgrades. This is in contrast with the experience of the investor-owned and merchant sectors, which, despite seeing a moderation in the pace and severity of downgrades, have 40% of ratings carrying negative outlooks.”). According to Standard & Poor’s, only five out of 246 public power systems rated were below investment grade (and of these, four were California irrigation districts holding contracts with Pacific Gas and Electric Company). *Id.*

³ See, e.g., “Assessing Wholesale Market Risk in Pacific Northwest Public Power Ratings,” Standard & Poor’s, published August 26, 2004, at 1 (“...[T]he Pacific Northwest contributed a significant fraction of the public power rating downgrades in these years. The vast majority of these actions can be traced directly to the increased risks of wholesale power markets that defined the western U.S. power crisis.”).

Public Power Views on Federal Restructuring Policies

Federal Transmission Policy Must Accommodate Regional Diversity

As previously noted, the country has five up-and-running FERC-jurisdictional RTOs. It does not appear likely that RTOs will form in the rest of the country (with the possible exception of the SPP region). Even if it were politically possible to export the current RTO model to those regions that do not have

Even if it were politically possible to export the current RTO model to those regions that do not have RTOs now (which it is not), the experience to date of those APPA members located in RTO regions does not support such a course.

RTOs now (which it is not), the experience to date of those APPA members located in RTO regions does not support such a course. In fact, given the considerable differences that exist in the various regions of the country, it should not be assumed that RTOs are the only, or even the preferred, mechanism available to ensure competitive wholesale power markets.

APPA members located in RTO regions report substantial, across-the-board problems with spiraling RTO costs, unaccountable governance, lack of understanding of transmission customer and end-user needs and less-than-satisfactory service options. They see more and more RTO services being provided through questionable market mechanisms, and RTO resistance to any questioning of the economic theories underpinning these actions.

The remaining non-RTO regions are very different both from each other and from the regions where RTOs have already been created. Some regions have a history of using contractual arrangements and regional institutions or practices to capture many of the benefits claimed for RTOs at less risk and cost, and have shown a willingness to pursue alternatives to enhance transmission access and the efficiency of existing markets. Other differences include the prevalence of jointly owned generation and transmission, the radial nature of transmission systems connecting remote generation to loads, the predominance of hydropower in the generation mix, differences in population density, the extent to which open region-wide planning processes are used, the existence of a framework for enforcement of reliability standards by contract, the extent to which a standard form of contracting is used for bilateral transactions, the existence of active wholesale market hubs accessible to many market participants, the presence or absence of a few large dominant IOU transmission providers, existence of

substantial transmission constraints, and the relative importance of point-to-point transmission versus network service.

APPA therefore believes that regional diversity in the provision of transmission service must be acknowledged, and a pragmatic and flexible federal transmission policy implemented to deal with the reality “on the ground.” In both cases, however, the same principles should govern policymaking: fostering the development of cost-effective transmission and generation infrastructure; supporting long-term power supply and transmission arrangements at just and reasonable rates, including the capacity rights to deliver power supplies to loads; developing cost-effective and responsive regional solutions that meet regional needs; promoting market transparency; and preventing the exercise of generation market power. The ultimate goal should be supporting delivery of reliable, low-cost electric power to consumers.

Needed “Mid-Course Corrections” in Those Regions with Existing RTOs

APPA members in RTO regions report substantial problems that impair their ability to provide reasonably priced and reliable long-term service to their own electric consumers. This is not to say that all RTOs are without value and should simply be dismantled. They have eliminated pancaked transmission rates (allowing transactions to take place over a broader geographic area, provided that the necessary transmission infrastructure is available) and developed transparent spot markets in which APPA members can purchase needed incremental power and lay off excess short-term power. But APPA is alarmed and dismayed by the level of discontent among its members regarding RTO performance, and the common concerns many members express across multiple RTO regions. Clearly, corrective actions are needed. The concerns of APPA members in RTO regions include:

APPA members in RTO regions report substantial problems that impair their ability to provide reasonably priced and reliable long-term service to their own electric consumers.

Load-Serving Utilities Must Be Able to Retain/Obtain Long-Term “Firm” Transmission at Known and Reasonable Rates

Under the LMP regimes all five RTOs use (or intend to implement), transmission congestion is included in the price of transmission service and is set by reference to nodal power supply prices in the RTO’s day-ahead market at the relevant points of generation and delivery. The primary tool provided to transmission customers to offset such congestion charges is the “Financial Transmission Right” (“FTR”).

An FTR provides under certain circumstances a revenue stream to the holder, which can be used to offset the congestion charges a holder incurs as a transmission customer.

These rights, however, are limited in number, transmission path and direction because they are tied to the physical capability of the transmission system under specified conditions. Thus, in many cases there are insufficient FTRs available even to hedge existing firm transmission service arrangements. As a result, many APPA members have FTR portfolios that are insufficient to hedge fully their current power supply and transmission arrangements, due to the “proration” of FTRs.

This has happened despite the assurances FERC provided in its April 2003 White Paper, where it said it would “ensure that existing customers retain their existing transmission rights and retain rights for future load growth.”⁴ In fact, FERC has failed to protect fully the existing transmission rights of utilities with an obligation to serve in its new RTO markets. Major generation investments and power purchases have been made for the benefit of consumers in reliance on transmission owned or contracted for on a long-term basis. It is essential that the existing transmission rights of load-serving utilities arising out of ownership of transmission, existing contracts (including “grandfathered” contracts) or service agreements entered into under an individual FERC-regulated transmission provider’s OATT, be preserved under any market design approved by FERC. The holders of such rights should be granted the right to elect to continue to use their physical transmission rights to meet their service obligations at the prices specified in those contracts or agreements, or if they wish, to convert to equivalent tradable rights or FTRs that will hold them harmless under any new wholesale market design.

The use of FTRs also creates additional levels of complexity and uncertainty, as well as opportunities for gaming. These problems threaten the economics of public power systems’ current power supply arrangements, many of which are very long term in nature.

Moreover, because FTRs are generally shorter term in duration, they do not address public power entities’ long-term needs, including load growth. APPA members are deeply concerned about their inability to hedge fully their transmission congestion costs, and thus to assure their

⁴ Federal Energy Regulatory Commission, “White Paper—Wholesale Market Platform,” issued April 28, 2003, in Docket No. RM01-12-000, *mimeo.* at 5.

APPA members are deeply concerned about their inability to hedge fully their transmission congestion costs, and thus to assure their ability to obtain transmission service at a known and reasonable rate over a long time horizon (often measured in decades, not years).

ability to obtain transmission service at a known and reasonable rate over a long time horizon (often measured in decades, not years).

The LMP/FTR system has deprived them of their ability to plan with any certainty for new long-term generation resources that would require transmission service, *e.g.*, development of or participation in a new generation resource (including environmentally desirable resources such as wind generation), or execution of long-term power supply contracts with suppliers that require the buyer to assume the risk of transmission service.

Under an LMP congestion pricing regime, the “all-in” price of any new resource is subject to price fluctuations, not only due to increases in fuel prices, fixed transmission costs, and other such “traditional” factors, but due to congestion caused by shifts in transmission system usage and prices in the RTO’s spot power markets (which can be extremely volatile). This is

true *even when the utility is not purchasing power in that market*. If suppliers agree to assume this additional price risk at all, they do so only in return for hefty premiums that come out of electric consumers’ pockets. This increased uncertainty and risk could lead to lower credit ratings and increased capital costs when public power systems commit to new long-term arrangements and the accompanying financing.⁵ Since many public power systems are physically or virtually vertically integrated and all retain the obligation to serve their loads, they see this as an extremely serious shortcoming in FERC’s preferred RTO model.

Such a short-term focused regime is not good for the industry in the long run: not good for utilities that need long-term power supplies; not good for generation project developers that need long-term commitments to support their projects; not good for financial institutions lending the

⁵ A Special Comment by Moody’s Investors Service issued in September 2004, entitled “Credit Issues Resurface as New Electric Generation Projects by Public Power Utilities Take Center Stage,” cites several factors that could contribute to increased credit risk for public power utilities building new generation facilities. Prominent among them are transmission and pricing practices: “Moody’s believes there is potential risk in the short-term marginal pricing model being used in various regional energy markets in the U.S. Without long-term contracts for transmission rights and price certainty for the transmission of energy from new generation facilities, cost recovery in the long term may not be assured.” *Id.* at 4.

The Achilles heel of the LMP/FTR system is that it, taken alone, does not ensure construction of adequate transmission infrastructure.

money for such projects (who will not lend in the future without long-term commitments); not good for the economy; and certainly not good for electric consumers.

Wall Street has made it abundantly clear that financial institutions will not again lend to generation project developers without assurances that such developers have long-term commitments of some sort to support their projects.⁶ RTO features that impair the ability of utilities to make such commitments must therefore be revisited and revamped. Physical transmission rights may be required to support commitments to build or buy from long-lived generation resources requiring substantial advance commitments. When LMP-based congestion pricing is used, it is imperative that FTRs of a term sufficient to hedge long-term supply and transmission arrangements be provided to those entering into such commitments.

There Must Be Meaningful Mechanisms to Get Adequate Transmission Infrastructure Built in a Timely Fashion

The Achilles heel of the LMP/FTR system described above is that it, taken alone, does not ensure construction of adequate transmission infrastructure. It does nothing to ensure that entities serving load in a region have access to a robust transmission system, and hence competing power supply options. All the LMP/FTR system does is show which source/sink pairings create transmission congestion. While the theory is that this information will be sufficient for “the market” to spring into action, developing economically efficient solutions to such congestion, the reality can be much different.⁷

⁶ See, e.g., Transcript of FERC Technical Conference in Docket No. PL04-2-000, February 2, 2004, at 8 (Statement of Lehman Brothers representative regarding the strength of long-term contracts as evidence of creditworthiness); Project Finance News Wire, August 2004 issue at 5–13 (report of proceedings of a Chadbourne and Parke conference on the distressed generation project market and the changed environment for merchant generation, at which a representative of Standard & Poor’s stated: “The basic problem is we have in the power business a commodity business that requires large amounts of capital. It is a particularly tough commodity that we all know cannot be stored. The transmission and regulatory issues and lumpiness of capital are particularly tough. That means long-term credit is absolutely paramount.”).

⁷ David Bodek and Swami Ventakaraman, “Makeover for California’s Power Markets,” *Standard & Poor’s Utilities & Perspectives*, July 5, 2004, Vol. 13, No. 27, at 5 (authors question whether CAISO’s MD02 market redesign will in fact spur new transmission investment: “If MD02’s ultimate aim is to ensure that

RTOs themselves do not have the ability to construct transmission facilities, so they must rely on their member transmission owners (“TOs”). These TOs have in some cases challenged their RTO’s ability to require them to build. They have many reasons of their own to be unenthusiastic about constructing the transmission facilities needed to alleviate congestion, including pricing structures that impact the cost of serving their own loads, and, in some instances, protecting their own generation from wholesale competition.⁸

Rather than pigeon-holing new transmission facilities as needed for either reliability or economic purposes, the focus should be on how much transmission is required both to keep the lights on and to keep rates to consumers at just and reasonable levels.

Some RTO transmission-planning regimes separately identify those transmission facilities needed for “reliability” purposes and those needed for “economic” purposes. “Reliability” is defined such that so long as sufficient generation (no matter how high the price) is available to keep the lights on, new transmission facilities are not deemed to be needed. This means that all additional transmission facilities are deemed to be “economic” in nature. Labeling specific transmission facilities upgrades as “economic” can in turn lead to controversies as to who should pay for their construction.

Rather than pigeon-holing new transmission facilities as needed for either reliability or economic purposes, the focus should be on how much transmission is required both to keep the lights on and to keep rates to consumers at just and reasonable levels. Instead of leaving most transmission construction to the vagaries of the “market,”⁹

(footnote continued from previous page)

sufficient generation and transmission are built in California, what seems to be lacking is a formal mechanism to plough back ‘congestion revenues’ earned under the nodal pricing scheme back into the system as new generation or transmission. In its absence, it would require a regulatory fiat to build assets at the right location. Many stakeholders argue that if a regulatory fiat is to be used, there may be no need for nodal pricing and CRRs in the first place.”).

⁸ To be sure, the process for siting and constructing transmission facilities can be both daunting and uncertain. The necessary approvals must be obtained from state or local authorities, and landowners and residents located near a proposed line corridor often vigorously oppose such approvals or demand expensive alterations (including undergrounding). Siting of interstate facilities continues to be a contentious issue in some regions.

⁹ APPA notes that PJM, as instructed by FERC in its orders in Docket Nos. RT01-2-000, *et seq.*, has modified its transmission planning regime to add a new procedure to enable the construction of new transmission facilities

an RTO must develop a rigorous regional transmission planning and construction process that ensures the region has a robust (but not gold-plated) transmission system.¹⁰ Each affected RTO region should have the flexibility to develop through a collaborative process an associated transmission facilities cost-allocation method that works best for its stakeholders and for electric consumers.

Transmission construction has also been relegated to second-place status in a number of RTOs, because “economic” transmission facilities

The value that a more robust transmission infrastructure will bring to electric consumers—access to additional sources of generation, support for generation fuel diversity, and stronger reliability—must be recognized in the RTO planning and construction process.

must “compete” with generation projects and demand-side management mechanisms in RTO planning processes. But adding individual generation units in load pockets or at weak points on the transmission system, in lieu of constructing needed transmission facilities, often only creates a new generator with local market power, lower fuel efficiency, and only minimal benefits to consumers. Few merchant generators (entities without an obligation to serve) would build such new units (at least without a long-term commitment for the power) if they thought they could not charge prices to electric consumers that reflect the value their location confers. The value that a more robust transmission infrastructure will bring to electric consumers—access to additional sources of generation, support for generation fuel diversity, and stronger reliability—must be recognized in the RTO planning and construction process.

An important way to address TOs’ reluctance to construct needed new transmission facilities would be to encourage joint participation by other utilities serving load in regional transmission systems and in new transmission construction projects. IOU TOs in RTO regions still are the primary (if not exclusive) owners and builders of transmission facilities in their respective service territories. IOUs have told FERC that they need substantial transmission rate incentives to construct new transmission

(footnote continued from previous page)

needed for “economic” purposes, if no market solution is forthcoming in a specified time window.

¹⁰ It is not economically or politically feasible to construct a transmission grid sufficient to support all potential commercial demands of all market participants, regardless of the associated transmission construction costs. Hence, the regional planning process must balance the competing interests of the various market participants, and support the construction of those transmission facilities found to benefit the region because they are cost-effective.

facilities, due to the risks involved.¹¹ Yet such IOUs have often overlooked potential partners in transmission construction projects right in their own back yards—public power systems that could join with them in financing, constructing, and jointly owning transmission facilities, both existing and new. Such joint projects could reduce the financial burden and spread the perceived transmission-investment risks for the incumbent IOUs. Public power participation could also assist in siting and permitting of new transmission facilities, by sending the signal to communities that all of the local utilities (including those that are publicly owned and not-for-profit) concur in the need for the project.¹²

Such a regime will not work, however, if all that contributing public power systems receive in return is an inadequate allocation of FTRs. Investment in the transmission system must carry with it future long-term certainty of transmission service at a just and reasonable cost and, for contributing public power systems, rights that reflect their long-term contributions to the fixed costs of the underlying system as well as their investment in new facilities.

For RTO regions, a timely and effective transmission planning and construction regime is absolutely essential, especially if an LMP/FTR regime is to remain in place.

For RTO regions, a timely and effective transmission planning and construction regime is absolutely essential, especially if an LMP/FTR regime is to remain in place. Without it, an LMP/FTR scheme will merely “price” ever-escalating transmission congestion and leave intact the illusory promise that the “market” will build new transmission, increasing the resulting price of electric service to consumers. While some progress is being made in certain RTOs towards reinforcement of inadequate transmission infrastructure, timely construction of needed new regional transmission projects necessary to

¹¹ APPA does not concede this point, given that transmission facilities are generally certificated prior to construction and the associated costs (including a rate of return) are recovered in regulated rates. APPA does, however, agree that certainty of cost recovery during the initial phases of a transmission facilities construction project (planning, permitting, siting and initial construction) is an issue of legitimate concern for TOs, and that in appropriate instances, extraordinary measures may be needed to address these issues.

¹² An alternative joint transmission ownership model is that of the American Transmission Company (“ATC”) in Wisconsin. Numerous load-serving entities in the state, including IOUs, municipal systems, and cooperatives, own shares in ATC, which in turn owns the higher voltage transmission facilities in the state. ATC is responsible for planning and constructing new transmission facilities.

APPA members are increasingly alarmed by the spiraling development and operational costs of RTOs.

ensure a strong regional transmission system must be made a top priority for all RTOs.

RTOs Must Be Accountable for Their Costs

APPA members are also increasingly alarmed by the spiraling development and operational costs of RTOs.¹³ It seems that personnel, administrative, hardware and software costs are running out of control, without sufficient appreciation of the impact of these costs on electric consumers. Development of complex “Day Two” LMP markets over large geographic regions spawns huge software budgets.¹⁴

Worse yet, RTO members, including APPA members, must ramp up their own internal operations, adding staff, hardware and software, simply to cope with these new markets, protocols and requirements.¹⁵ Public power systems have

¹³ The Public Power Council (“PPC”) has estimated that since 2000, total U.S. RTO operating expenses have increased by 143 percent, and are growing at an annualized rate of 20 percent per year, largely due to lack of cost control and increases in operational size and scope. In 2004, PPC estimates that \$1.04 billion will be spent funding the operation of the five FERC-jurisdictional ISOs and the ERCOT ISO. “Comparative Analysis of RTO/ISO Operating Costs, August 17, 2004,” Public Power Council, available at: <http://www.ppcpdx.org/ComparativeAnalysisTWO.FINAL.pdf>. See also, Final Report, “Study of Costs, Benefits and Alternatives to Grid West,” prepared for Snohomish County Public Utility District by Henwood Energy Services, dated October 15, 2004, at ES-1.

¹⁴ On October 6, 2004, FERC released a report by its Staff comparing the Day One costs of four RTOs (excluding the California, New York and New England ISOs and including the not-yet-operational SPP). According to Staff, initial establishment of a Day One RTO should, after taking into account “lessons learned,” cost approximately \$50–70 million—about half the actual cost of the most expensive RTO analyzed—with annual revenue requirements of between \$50 and \$70 million. But Day One RTO costs are only the tip of the iceberg. FERC has made it quite clear that it expects all RTOs to develop full Day Two markets, which FERC’s own Staff calculates to be a much more expensive proposition (in the neighborhood of \$100 to \$250 million in initial investment costs, with annual operating expenses in the range of \$125 million to \$240 million). “Staff Report on Cost Ranges for the Development and Operation of a Day One Regional Transmission Organization,” Docket No. PL04-16-000, prepared by the Staff of the Federal Energy Regulatory Commission, October 2004, and available at: <http://www.ferc.gov/EventCalendar/Files/20041006145934-rto-cost-report.pdf>.

¹⁵ For example, FERC conditionally approved treatment as a “regulatory asset” the \$24 million in internal costs that Dominion is spending to join PJM and an

to dedicate scarce personnel resources to unraveling incomprehensible (and often erroneous) billings and settlement statements received from their RTOs.¹⁶ Corrected statements can come months, if not years, after the period in question, disturbing accounting periods that have already been closed and upsetting the economics of deals already done. Outside counsel and consultants must be retained at considerable expense, simply to keep track of RTO collaborative processes and tariff modifications.¹⁷

Even APPA members not participating in RTOs are finding that RTO cost adders are being layered on top of their existing transmission service agreements with TOs that do participate in RTOs. These costs can be substantial.¹⁸ Difficult “seams” issues can also arise, when RTO operating protocols do not conform to the uniform operating practices used by neighboring control areas within the region that have not established RTOs.

APPA members are also concerned that RTO market mitigation and monitoring regimes are insufficient to prevent the exercise of generation market power and thus to assure just and reasonable power prices. The theory underpinning LMP markets calls for sellers into the RTO’s

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additional \$14.4 million (plus carrying charges) that Dominion spent on the defunct Alliance RTO proposal. Dominion also expects to incur \$241 million in PJM administrative charges on behalf of its retail customers during the first five years of membership. *See, PJM Interconnection, L.L.C. and Virginia Electric and Power Co.*, 109 FERC ¶ 61,012 at P 47, n. 46, issued October 5, 2004, available at: <http://www.ferc.gov/EventCalendar/Files/20041005132245-ER04-829-000.pdf>.

¹⁶ For example, the CAISO has over 100 charge types, which greatly add to the complexity and costs of administering billings and settlements. *See*, CAISO Settlement Charge Matrix 17.xls, Effective: Trade Date 10/1/2004.

¹⁷ *See*, Letter dated September 9, 2004, from Marc S. Gerken, President and CEO of AMP-Ohio, Inc., to FERC Chairman Pat Wood, available at: http://ferris.ferc.gov/0/idmws/file_list.asp?document_id=4238777 (describing increased costs AMP-Ohio has incurred due to implementation of RTOs, including payment of \$5.9 million annually in RTO administrative costs); Letter Response of FERC Chairman Pat Wood to Marc S. Gerken, dated October 14, 2004, and filed in FERC Docket No. RM04-12-000 (Document Accession No. 20041022-0037).

¹⁸ For example, the Los Angeles Department of Water and Power estimates that it is being charged approximately \$12 million per year in CAISO-related pass-through charges for service under its existing transmission agreements within the CAISO control area.

organized markets to bid their marginal costs of production. In fact, bids into the market at times can be quite inconsistent with that theory, instead being based on a more practical consideration of what the market will bear. APPA members believe that the resulting prices, even with market price mitigation schemes in place, are often substantially higher than marginal costs would produce. The resulting higher prices not only affect buyers in the RTO's organized markets (and in longer term bilateral markets), but all transmission customers, because these prices are used to derive the LMPs that are then used to price transmission congestion.

These costs might be easier to bear if RTOs were generating overall savings to APPA members located in RTOs and their electric consumers. APPA members, however, are not seeing such savings. This results from a number of factors, including the implementation of the LMP/FTR regime

The bottom line is that RTOs have not resulted in rate reductions to the electric consumers APPA members serve, and the associated costs keep rising.

for pricing congestion, which renders their current bilateral long-term contract arrangements more difficult and expensive. It is also difficult or impossible to avoid participating in the RTO's spot markets, if only to clear supply/demand imbalances, which exposes APPA members to the volatile pricing in those markets. Of course, some price increases in the last few years have been due to factors beyond any RTO's control, *e.g.*, increases in fuel prices for natural gas, coal and rail transportation. But the bottom line is that RTOs have not resulted in rate reductions to the electric consumers APPA members serve, and the associated costs keep rising. The very fact that RTOs must employ extensive mitigation measures and overall price caps in their markets calls into question the existence of effective wholesale competition. All in all, it is not a pretty picture.

RTOs must review their operations with both a fine-tooth comb and a consumer orientation. What RTO functions actually benefit consumers, and can they be carried out in a more cost-effective manner? Do the costs of creating markets for every last possible product exceed the benefits that would accrue to end-use consumers from creating those markets? Would it be better to allow certain products to be contracted for bilaterally or to maintain cost-based pricing for those products, especially if the associated market power concerns are so severe that elaborate mitigation and monitoring schemes would be required? These are the types of questions that an entity with accountability to customers would ask. RTOs must address all of these subjects to rein in their costs, and FERC must make RTOs accountable for their costs to their customers and electric consumers. The Commission's September 16, 2004, Notice of Inquiry in Docket No. RM04-12-000 is a tentative first step in this direction, but

much more needs to be done. The Commission needs to view RTOs for what they are—regional monopolies that it must vigorously regulate, not regional extensions of the Commission itself. The FPA does not exempt from regulation public utilities simply because they are RTOs.

RTO Governance Must Be Made Accountable To Electric Consumers' Interests

Four of the five current RTOs have independent and, in some cases, self-perpetuating boards. FERC's reason for requiring independent boards was a good one: to avoid RTO governance structures that could be "captured" by one or a few industry sectors, leading to bias in RTO operations and transmission service provision. But APPA members' experience with independent RTO boards shows that there is a significant downside as well.

First, independent RTO boards can lack direct accountability to the industry participants in the RTO's region and to the electric consumers the RTO ultimately serves. APPA members have seen RTO boards vote to take actions that a very substantial majority of industry stakeholders in their own regions vehemently opposed. When such events occur

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repeatedly, there is a loss of confidence in—and "buy in" to—RTO actions by industry participants. This can be very damaging for the RTO itself in the long run. RTOs will only be able to operate effectively if they are accountable and have the respect of all industry participants that must deal with the RTO. That respect has to be gained and maintained through RTO board and management accountability.

Second, some independent boards seem to rely to a very significant degree upon RTO management and staff (who can also be inexperienced). This can lead to insufficient oversight (in the cost area discussed above, for example). Recent corporate governance scandals in this and other industries point out the need to avoid boards that are too dependent on management and staff, without independent knowledge of what is happening "on the ground," both within their own RTO organization and in the RTO's region.

This lack of RTO accountability to customers and stakeholders creates the widely held view that RTOs have only one dominant stakeholder—FERC. This perception is damaging to the credibility of both FERC and the respective RTOs. To allay this problem, FERC and the RTOs must take steps to promote an atmosphere of mutual respect and constructive relations between RTOs and the industry participants that must deal

with them. RTO management and boards cannot be subservient to industry participants, but they should not be able to simply ignore them. FERC must also take steps to vigorously regulate RTOs as the regional monopolies they have become, to ensure that they meet their responsibilities to industry participants and electric consumers.

RTO Regions Should Make Sense from a Commercial and Reliability Perspective

FERC should reject choices by TOs to join RTOs when such choices are likely to increase costs to public power systems and other market participants or decrease reliability in the region. Many APPA members have been dismayed by the “crazy quilt” geographic configurations FERC has

Rather than joining the RTO that makes the most sense from a market and reliability perspective, some FERC-jurisdictional TOs have insisted on joining those RTOs that fit best with their own corporate goals and philosophies, creating jagged RTO-to-RTO “seams.”

approved for their RTOs. Rather than joining the RTO that makes the most sense from a market and reliability perspective, some FERC-jurisdictional TOs have insisted on joining those RTOs that fit best with their own corporate goals and philosophies, creating jagged RTO-to-RTO “seams.” These seams raise the costs of affected RTOs and market participants, as they have to make additional business judgments and investments to compensate for less-than-optimal regional configurations.

Worse yet, such decisions can have a “ripple effect.” For example, some IOU transmission providers are now proposing to reform the borders of their current Regional Reliability Councils to better fit with the RTO membership decisions their various subsidiaries have made. Reliability concerns should trump the corporate interests of individual RTO members, not vice versa.

The Bottom Line: RTOs Should Be a Boon to Electric Consumers, Not a Drag on Them

For residential electric consumers, RTOs are a pocketbook issue, although the vast majority of them do not realize it. For industrial and commercial customers, RTO policy is a vital economic issue that could make the difference between being profitable (thus staying in business), and shutting down operations or leaving the community. Reliable, reasonably priced electric service is a national economic development and jobs issue. APPA members in RTO regions are deeply concerned about RTO cost and service issues because they directly impact the economies of their local communities.

It is time to reorient RTOs towards their original mission: providing adequate, reliable and reasonably priced regional transmission service to bring cost savings to consumers.

Somewhere along the RTO-development road, the original business purposes of RTOs that FERC envisioned (to provide non-discriminatory transmission service, eliminate transmission rate pancaking, and provide a vehicle for joint planning and construction of transmission facilities—all for the benefit of electric consumers) morphed into a different mission and agenda. Today, the “business” of RTOs appears to be to develop markets for every possible product, whether or not such markets are necessary, competitive and cost-effective, and to serve the needs and desires of regulators and preferred classes of stakeholders, rather than electric consumers. It is time to reorient RTOs towards their original mission: providing adequate, reliable and reasonably priced regional transmission service to bring cost savings to consumers.

Ways to Advance Transmission Policy Goals in Regions Without RTOs

Because of regional differences, and the largely negative experiences of their counterparts in RTO regions, many APPA members oppose the expansion of RTOs to their own regions. The problems created by the formation of RTOs have proven to be more significant than first anticipated and the benefits have proven to be more elusive. These APPA members believe there are more cost-effective means to provide open access transmission and promote market efficiency in their regions.

FERC should abandon its “RTO-or nothing” approach to transmission policy. Regional initiatives that enhance the efficiency of markets with minimal added cost and risk should be encouraged and supported, not discarded as inconsistent with FERC’s SMD template. Regional differences are real and have to be respected. Solutions tailored to the needs of each region should be pursued that meet the goals set forth in the Introduction to this WHITE PAPER.

FERC must also fully appreciate the deep and abiding concerns that public power systems, especially those in the West, have about electric restructuring and RTO formation in the wake of the meltdown of Western power markets in 2000. Many public power systems are skeptical that FERC has the ability or the will to move quickly and effectively to address abuses of market power, and protect consumers from paying unjust and unreasonable rates (or even to make them whole later). Until these past problems are meaningfully resolved,

and FERC shows that it will in the future act aggressively to fulfill its FPA responsibilities, it will be very difficult to “move past the past.” Many public power systems in the West feel like they have lived in a restructuring Petri dish for the past several years, and they have little appetite for new experiments.

Regional Practices and Institutions that Meet the Needs of Particular Regions Should Be Encouraged

In some regions without RTOs, cost-effective improvements have been made to facilitate the reservation and scheduling of transmission and to encourage a more active secondary market. For example, under public power leadership, twenty public power and investor-owned entities in the West have jointly developed the westTTrans.net Open Access Same-time Information System (“OASIS”) site. Prospective transmission customers can submit one electronic query to this OASIS for transmission service over multiple transmission systems. Innovations such as these enjoy widespread support, not only among non-jurisdictional utilities but also among many merchants and IOUs doing business in the region. Market monitoring is another function that entities are exploring for provision on

a regional basis, even without an RTO. If such practical, least-cost initiatives can replicate benefits that an RTO is supposed to provide at substantially less cost than a “traditional” RTO, then these outcomes may well be superior for that region. Rather than condemning such regional efforts as “inferior” to the outcomes under a full-fledged RTO regime, these efforts should be fostered, and similar efforts in other areas encouraged.

Many APPA members believe that emphasis on regional transmission planning and expansion, without the complications introduced by RTOs, is a preferable strategy for making cost-effective improvements in the adequacy and reliability of transmission.

Open Regional Transmission Planning Is Critical And Can Be Accomplished Without an RTO

Many APPA members believe that emphasis on regional transmission planning and expansion, without the complications introduced by RTOs, is a preferable strategy for making cost-effective improvements in the adequacy and reliability of transmission. In non-RTO regions, APPA members (as well as many jurisdictional utilities) retain the obligation to serve, which provides a strong incentive to plan for and invest in transmission necessary to meet their needs. This planning must be inclusive and meet the needs of all utilities serving load on a comparable basis.

The Western Interconnection provides an example of an approach to transmission planning that pre-dates RTOs, transcends RTO boundaries

and encourages participation by jurisdictional and non-jurisdictional entities alike. Four sub-regional planning efforts,¹⁹ each with participation by both jurisdictional and non-jurisdictional entities, have been established to address the transmission expansion needs of the Interconnection. Recently, the bylaws of the Western Electricity Coordinating Council (“WECC”) have been amended to permit it to coordinate planning efforts within the entire interconnection. In addition, the Western Governors’ Association has sponsored an assessment of transmission needs, and the member Governors, along with several federal agencies, have executed an interstate siting memorandum of understanding.²⁰

The longer term goal must be an inclusive regional transmission planning and construction process, in which all affected wholesale market participants and state authorities participate. In the absence of an RTO, a regional platform or forum must carry out this function, as WECC is now undertaking for the West. These regional planning processes should be tailored to the needs, preferences and characteristics of each region, so that those in the region have confidence in both the process and its results.

If the responsibility for building and owning the transmission grid is spread more broadly among entities serving loads in a region, then joint transmission planning will likely be facilitated, simply because there are more participants at the planning table.

Joint Ownership of Generation and Transmission Reduces the Need for RTOs and Should Be Encouraged

Joint ownership of transmission addresses many of the issues that RTOs were intended to address. Proportional ownership is an effective means to mitigate the transmission market power of incumbent FERC-jurisdictional utilities where this is a pressing policy concern. If the responsibility for building and owning the transmission grid is spread more broadly among entities serving loads in a region, then joint transmission planning will likely be facilitated, simply because there are more participants at the planning table. If “network integration transmission service” (“network”) customers are encouraged to “buy in” to their load ratio share of the transmission system, transmission usage and ownership will be more closely aligned, and the historical frictions between transmission-dependent utilities and

¹⁹ These groups include the Southwest Transmission Expansion Planning Group, the Southwest Arizona Transmission Study Group, the Northwest Transmission Assessment Committee, and the Rocky Mountain Area Transmission Study.

²⁰ To underscore the importance of regional differences, federal land ownership is a greater barrier to interstate transmission projects in the West than is rejection of a project by an individual state siting authority.

their TOs can be overcome. Joint ownership would also better promote the policy goal of adequate transmission infrastructure to support long-term power supplies needed to assure adequate and reasonably priced electric service to all consumers, regardless of what type of load-serving utility supplies them.

Joint generation ownership also helps limit market power.²¹ If, for example, five different owners hold an interest in a major generating facility and have transmission rights terminating at a commercially significant market hub, the market power of each party at that hub is reduced. A party wishing to reserve long-term transmission capacity then has the option of dealing with five counterparties, rather than being required to live with whatever FTRs it can obtain from an RTO. If coupled with a regional OASIS in which all the interest holders participate (such as the westTrans.net OASIS), and a regional transmission planning regime, such a decentralized system could provide many of the benefits of RTOs, at much less cost.

Another advantage of a joint-ownership model compared to the RTO model is that it preserves the link between the obligation to serve and the responsibility to invest. When a retail service provider has the responsibility for securing sufficient resources to serve its load, it also takes on the responsibility for assuring that the resources can be delivered. Fulfilling this responsibility could involve participation in a transmission system expansion or entering into a transmission contract with a term that matches the resource commitment.

There are many examples in RTO and non-RTO regions of joint transmission expansion efforts and groups established to jointly own transmission facilities on behalf of several smaller retail service providers.²²

²¹ APPA notes that public power joint generation projects in the West have a long history of success, *e.g.*, the Intermountain Power Project. Public power systems are joint owners of over 20,000 MW of coal, hydro-electric, nuclear and gas-fired power capacity throughout the United States. Our co-owners include over 40 different investor-owned utilities, cooperatives, and independent power producers, as well as numerous other public power systems. Specific examples include the Palo Verde (AZ), Millstone 2 (CT), and Crystal River 3 (FL) nuclear plants, the Rodemacher 2 (LA) and Trimble County 1 (KY) coal plants, and the McClain (OK) and South Fond du Lac (WI) gas-fired plants.

²² Joint ownership of specific transmission lines by public power utilities and other parties is widespread in the western United States. In addition, public

In addition, some entities are discussing “buy in” to existing regional transmission networks. Such responsible and innovative approaches to securing adequate transfer capability should be supported and encouraged as viable alternatives to RTOs.

FERC Enjoys Significant Authority to Address Remaining Discrimination under the Current Order No. 888 OATT Regime

Under Order No. 888’s OATT regime, FERC-jurisdictional TOs are obligated to provide transmission service on a non-discriminatory basis. There are undoubtedly some instances where residual discrimination still exists. Such discrimination can be addressed effectively, without the complications that RTOs introduce, by focusing on clarifying and enforcing open access rules.

FERC should undertake a comprehensive look at ways its open access regime could be improved through clearer rules or changes to improve efficiency.

With its shift in emphasis away from the Order No. 888 OATT regime in favor of RTO activities, FERC has relegated improvements to its open access rules to case-by-case adjudication. FERC should undertake a comprehensive look at ways its open access regime could be improved through clearer rules or changes to improve efficiency.²³ For example, lack of clarity or specificity with respect to calculation and posting of Available Transmission Capacity (“ATC”) has led to concerns by some APPA members about manipulation of ATC calculations. To date, FERC has chosen to address these issues primarily on a case-by-case basis, rather than making and enforcing rule changes to assure that calculations are auditable and transparent. Similarly, protocols for processing transmission reservation queues and procedures regarding the exercise of rollover rights could use a fresh look.

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power utilities jointly own transmission networks in states such as Georgia, Michigan, Indiana, and Minnesota. In Vermont, the bulk transmission system is jointly owned by municipal, cooperative, and investor-owned utilities through Vermont Electric Transmission Company. In Wisconsin, public power systems are permitted to invest up to their load ratio share in ATC. See n. 12 above.

²³ FERC Commissioner Joseph Kelliher has suggested that FERC consider strengthening its Order No. 888 transmission rule, and that it review claims of discrimination under that regime. “With RTO Development Stalled, FERC Should Beef Up Order 888, Kelliher Suggests,” *Inside FERC*, August 23, 2004, at 1; “Kelliher: Eliminate Flaws in Open-Access Rule,” *Electric Power Daily*, September 29, 2004, at 3.

FERC Should Address the Concerns Of Network Service Customers

The OATTs of FERC jurisdictional TOs require them to plan for the transmission needs of their network customers. Some OATT network customers, however, believe that their loads and resources have not been treated equitably or “comparably” to those of their TOs in transmission planning and facilities construction. While network customers pay their load ratio share of transmission system costs, they can be put on the “margin” by their FERC-jurisdictional TOs when it comes to transmission planning. Some have been told they must pay the full cost of all additional transmission facilities needed to connect their new resources or to serve their increased loads, even when they believe that the TO’s own loads would very likely benefit from such facilities as well. The joint transmission planning that network customers had hoped would come with the Order No. 888 OATT has not materialized. Similarly, generation developers have had difficulty gaining access to the transmission system in some regions, and in having their generation projects designated as network resources.

FERC could do much to assure adequate transmission infrastructure development in non-RTO regions of the country merely by vigorously enforcing the joint planning and transmission construction obligations FERC-jurisdictional TOs have under their own existing OATTs.

FERC could do much to assure adequate transmission infrastructure development in non-RTO regions of the country merely by vigorously enforcing the joint planning and transmission construction obligations FERC-jurisdictional TOs have under their own existing OATTs. In so doing, FERC could promote the concept of joint participation in transmission systems and construction projects by both TOs and their network service customers on a proportional basis, to reduce the capital outlays required by FERC-jurisdictional TOs, and to make transmission ownership more broadly

available to load-serving utilities in these regions. Such joint participation in transmission system and facilities ownership is a logical extension of FERC’s current transmission system cost-allocation method, under which network service customers already pay their load ratio share of their TO’s fixed transmission system costs, day after day, year after year.

Generation Market Power Must Be Addressed Through a New Market-Based Rate Policy

Many small APPA members are facing very serious threats to their viability because of lack of availability of long-term firm transmission and increasing generation consolidation.

Many small APPA members are facing very serious threats to their viability because of lack of availability of long-term firm transmission and increasing generation consolidation. These systems get few if any bids from suppliers, are often unable to obtain transmission to reach alternative sources of power, and are faced with dramatic increases from local suppliers with significant market power.

APPA member experience demonstrates that merely imposing “global” generic conditions (such as RTO participation) on market-based rate authorizations may have substantial unintended consequences, require years to put in place, and may or may not address the underlying problems (*e.g.*, generation market dominance compounded by a dearth of long-term firm transmission capacity to obtain access to competitive suppliers). Lack of competitive conditions must be addressed through a new market-based rate policy that ensures just and reasonable wholesale rates at all times.²⁴

FERC’s RTO policy, as well as its market-based rate policy, assumes that competitive markets (supplemented in RTO regions by RTO market monitoring and mitigation regimes) will produce just and reasonable rates. In many real-world instances, this has proven not to be the case. On a purely practical level, if the prices for power in “competitive” markets (either RTO-run or bilateral) exceed for sustained periods the costs for power that would have resulted under a traditional cost-of-service regime, this disparity will eventually bring calls for a return to traditional cost-of-service regulation for electric generation. For these reasons, FERC must undertake a “bottom up” review and update of its market-based rate policy, as it applies both in RTO and non-RTO regions.

However, this “bottom up” review must not become a pretext to delay FERC actions needed to address generation and transmission market power problems on a local or company-specific basis. Public power utilities participate in many different local and regional energy markets, most of which are flawed at best. Where these wholesale markets are not competitive,

²⁴ *State of California, ex rel. Bill Lockyer v. FERC*, 383 F.3d 1006 (9th Cir. 2004) (rehearing and rehearing en banc sought October 25, 2004) (FERC has continuing obligation under its market-based rate regime to ensure that rates remain just and reasonable).

FERC must adopt enforceable protective conditions on the market-based rate authorizations of specific public utility sellers. Such conditions should include the imposition of cost-based rates and conditions circumscribing the conduct of individual market participants, if such conditions are needed to ensure that wholesale rates are just and reasonable and not unduly discriminatory or preferential. Reliance on cost-based rates ensures that wholesale rates will remain within a zone of reasonableness. Alternative conditions can also be crafted, but above all, conditions must be targeted at the specific market power problems identified in the local area or region, be achievable within a reasonable period of time, and be enforceable by both FERC and the affected entities.

The ability of FERC-regulated public utilities to sell power at market-based rates under the FPA is a privilege, not a right.

The ability of FERC-regulated public utilities to sell power at market-based rates under the FPA is a privilege, not a right. It is not FERC's mission to ensure that its market-based rate regime benefits the sellers (and the financial institutions that have lent money to them). Instead, FERC's market-based rate policies must benefit consumers and their communities by ensuring they are charged only "just and reasonable" rates, as Congress intended when it enacted the FPA.

Conclusion

APPA and its members are not advocating the dismantling of each of the FERC-jurisdictional RTOs now in place. Nor are they advocating the formation of additional RTOs. Rather, they seek to reform the existing RTOs, so that they operate to benefit electric consumers (rather than particular industry participants), and employ market mechanisms only as a means to an end (serving electric consumers), and not an end in themselves. In regions without RTOs, APPA and its members urge policymakers to recognize important regional differences and to support initiatives that promise to deliver substantial regional benefits in areas such as transmission planning and construction, market monitoring, and OASIS administration. FERC should also take steps in regions without RTOs to clarify and enforce open access transmission rules to ensure that FERC-jurisdictional transmission providers are indeed carrying out their obligations to transmission customers. Finally, FERC must revamp its market-based rate policy to ensure that electric consumers in both RTO and non-RTO regions pay only just and reasonable rates for electric generation.



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