

REGULATORY COMMISSIONS AND THE DEVELOPMENT OF COMPETITIVE WHOLESALE ELECTRIC MARKETS.

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Before the California Public Utilities Commission

Thursday, August 4th, 1994

EXECUTIVE SUMMARY

The passage of the Energy Policy Act in 1992 ushered in a new competitive era in the U.S. electricity industry. The task ahead for both state and federal regulators is to make the regulatory changes that are a necessary part of these changes in the industry in a coherent fashion.

- There is no way to achieve coherence in transmission policy without formal cooperation between federal and state regulators. The Commission should take steps to begin this collaborative process, in order to address issues of transmission pricing, unbundling of services, siting, access, and planning.
- Who should bear the risks of a transition to a more competitive industry? This is clearly a question of policy, and should be treated as such. As a matter of policy, the jurisdiction which is responsible for creating stranded assets should be the one which deals with its consequences. I applaud the California and Michigan commissions for dealing with this issue explicitly as part of their proposals. The FERC has done the same in its recent NOPR, but has left unclear the issue of possible preemption of state jurisdiction.
- The failure of Congress to codify the *Pike County* doctrine has created a number of regulatory difficulties which make retail competition more attractive, IRP less attractive, and potentially diminishes the richness of wholesale markets.

The FERC and the state commissions must exercise statesmanship on these issues, rather than continuing to engage in bureaucratic turf battles.

* These opinions are exclusively my own.

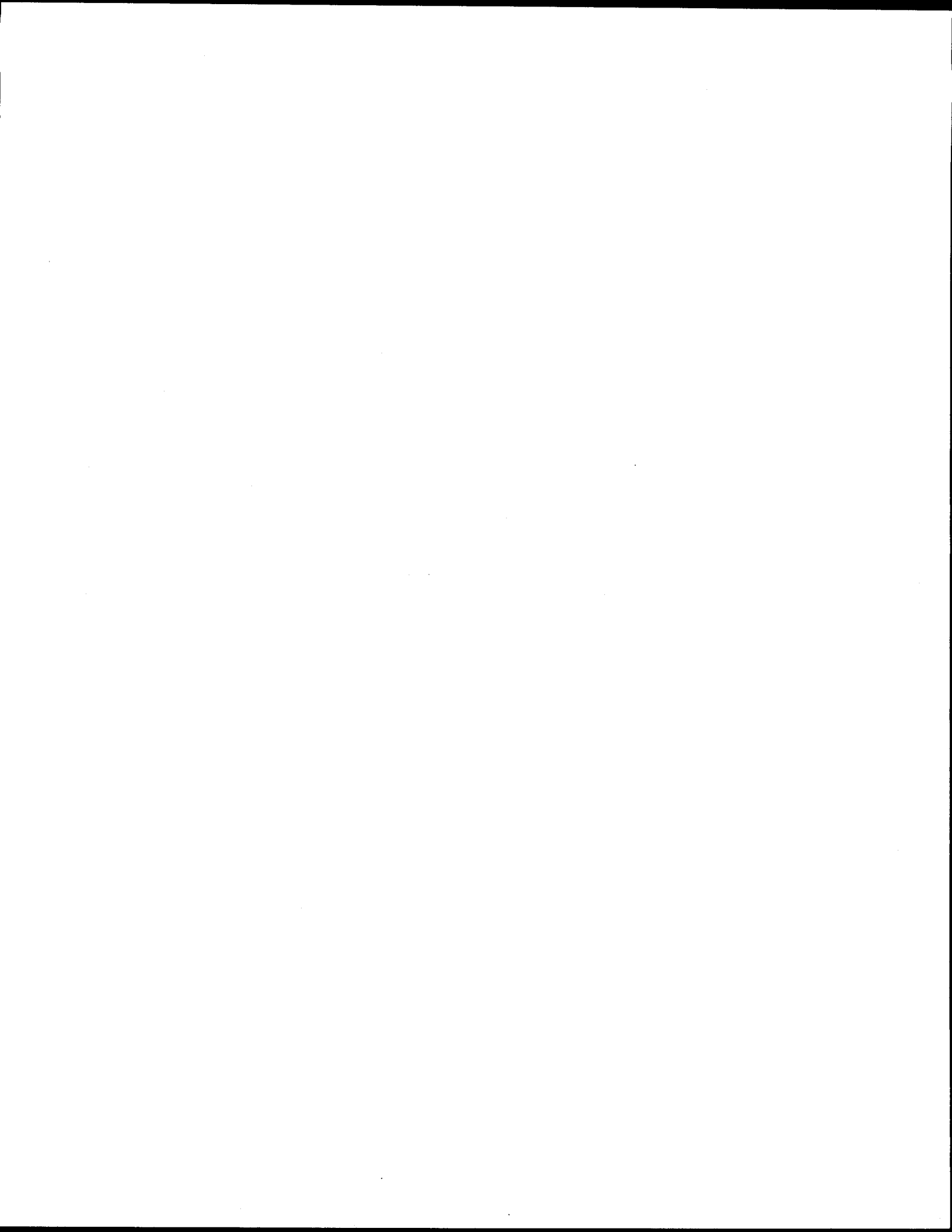


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Mr. President and members of the Commission, thank you for the opportunity to testify on regulation of the electricity industry as it moves toward competition. I would like to congratulate the Commission on choosing to hold proceedings on such a timely subject. Your retail competition proposal has contributed mightily to the discussion and debate over the future of the electricity industry and its regulation. The enormous changes taking place in the electricity industry merit a great deal of attention. We are certainly devoting a great deal of effort to studying the subject at the Harvard Electricity Policy Group at the Kennedy School of Government at Harvard University, where I serve as Executive Director. Prior to joining Harvard I served as Commissioner of the Public Utility Commission of Ohio and Chair of the Electricity Committee of National Association of Regulatory Utility Commissioners (NARUC). I am also at present Principal Consultant to the firm RCG/Hagler, Bailly. My comments today, of course, reflect my own opinions, and do not necessarily represent the views of RCG/Hagler, Bailly, NARUC or the Harvard Electricity Policy Group.

The passage of the EAct facilitated and expedited the pre-existing trend toward a new competitive era in the electricity industry. The development of a competitive wholesale market is well under way. Competition is also a reality in many retail markets, and some state Public Utility Commissions (PUCs), like the Michigan commission and here in California, are proposing to implement plans for retail open access. Even without retail wheeling, large industrial customers, local governments, and others are already seeking to use other competitive means to reduce the price of electricity through procurement of power through alternative sources to the local franchise utility by such means as moving production lines, self-generation, cogeneration, or municipalization. Competition in electricity is already present and is certain to intensify in the future.

The task ahead for both the state commissions and the FERC is to develop coherent policies which will smooth the transition from the traditional vertically-integrated monopolies to the emerging competitive industry. While the trend is clear, there are major impediments in the way of the transition to and perhaps even to the evolution of a fully competitive electricity industry.

It can be stated unequivocally that transmission policy can never achieve coherence or predictability without coordinating federal and state policies and practices. The current jurisdictional allocation and practice is simply incapable of providing coherence. The FERC has jurisdiction over wholesale pricing and access to transmission facilities. On the other hand, the FERC has no authority over the planning and siting of, and retail access to, transmission facilities. These are domains over which the PUC or other agencies in state government have exclusive jurisdiction. While the pricing of retail transmission services has been done by the state commissions for over a century, proposed unbundling of those services has led to more controversy over whether states have had the jurisdiction they have been exercising for so long. Furthermore, in exercising their respective jurisdictions, the FERC and the PUCs take remarkably different approaches. The FERC approaches transmission as a discrete service providing the incremental use of existing facilities for which the residual revenue responsibility has been assured by native load, primarily retail ratepayers. PUCs, on the other hand, approach transmission issues as part of unbundled electric service for which retail customers bear all prudently invested costs. Any revenue garnered from non-retail use of facilities (e.g. wholesale wheeling) serves to offset retail rates. This structure leads to a fragmented, highly contentious, and often unpredictable approach to regulatory decisions affecting transmission services.

A clear example of the consequences of the fragmented approach occurs when the FERC mandates access to transmission facilities and its order falls into the "black hole" in the EPAct, namely the interface between the FERC's access powers and state siting authority. The EPAct says that, on request, FERC can mandate under §211 that a utility provide access to any eligible party that seeks it, but if the party from whom access is sought can show to FERC's satisfaction that it cannot provide that access with existing facilities, it then has a good faith obligation to go to the state siting authority and get that line sited. The state, even without any parochialism or NIMBY perspective, is then faced with a real dilemma. The state's siting decisionmakers have historically made two decisions when they sited and certified a line. First, they have decided there is a need for that facility and that the facility ought to be built. Even if you consider this decision to be preempted by the FERC access order, there still remains a whole other set of issues that states have to examine, including environmental issues, aesthetic issues, and public health concerns relating to the siting of transmission lines. States need to balance these issues against the need for the facility.

The second decision is whether the transmission facility should be included in the retail rate base, thereby placing retail customers in the position of guaranteeing the residual revenue requirements to the utility for that facility. These issues -- how to site and how to pay for transmission -- present two very different decisions. On the one hand, there is a very compelling argument for the FERC to be able to order access once it has established there is a need for it. But, on the other hand, does that mean that the state then ought to make retail customers bear the residual revenue responsibility if FERC happens to use a pricing scheme that doesn't fully compensate the utility? Can the utility assume it can come to the retail customers to pay for it whether or not the state finds that the retail customers need this facility?

The traditional duality in state siting decisions may need to be decoupled by separating access orders from the question of who pays. Decoupling could well mean that a utility might be ordered by the FERC to build a line, without knowing whether it would be compensated for the facility. If I were managing a utility I'd be very concerned about being subject to an access order when I have no idea whether I am going to be adequately compensated for it. From the state regulator's perspective, even if you believe the line is needed, or are willing to accept that proposition as inherent in FERC's access order, if you do not believe there is a retail need for the facility, why in the world would you ever want to impose the residual revenue responsibility for it on retail customers? Even without an access order, states can force this issue, although none have yet done so by doing load flow studies and disallowing from rate base that proportion of transmission investment which is used for non-jurisdictional transactions. As long as the scope of federal and state jurisdiction remains uncertain in this area, and recovery of investment is made less certain, underinvestment in transmission facilities, which could eventually reduce the vitality of a competitive bulk power market, seems a probable result.

In terms of transmission siting, cooperation between the states is needed as well as cooperation between state and federal regulators. Some form of regional regulation should be encouraged, since transmission planning and siting is a regional rather than simply a local issue. Regional Transmission Groups (RTGs) can provide some of the benefits of regional planning, but it must be remembered that RTGs are self-regulating institutions and they cannot either replace or determine the decisions made by government regulators. Persuasive evidence of this is the fact that no RTG has emerged which professes to decide important transmission pricing issues. There is not enough unity of interest on difficult jurisdictional issues for the RTGs to be an effective decision-

making process in those areas where governmental authority is required.

A second example of jurisdictional conflicts occurs in the context of transmission pricing. On the one hand, the FERC has jurisdiction over wholesale sales of electricity in interstate commerce under section 201(b) of the Federal Power Act (FPA). The FERC examines transmission pricing in discrete terms, as one of many unbundled services a utility may provide. On the other hand, PUCs deal almost exclusively with vertically integrated utility services. PUCs typically use bundled pricing by throwing transmission into retail rates and treating it like any other utility asset in the rate base. Without ever thinking about it, what states have done is to impose on the retail ratepayer the residual revenue responsibility by essentially guaranteeing the utility recovery of the cost of its transmission investment. If the present system continues, states may well start to ask questions such as: if Ontario Hydro sells a thousand megawatts to New York State and an average 40% of that transaction crosses the transmission system in the rate base paid for by Ohio ratepayers and drops not a single penny of revenue to offset Ohio's revenue responsibility, why should Ohio's ratepayers continue to pay for 100% of the cost of that facility?

The introduction of retail wheeling complicates the jurisdictional equation even further. Today, a hotly debated topic growing out of this proceeding is whether state or federal regulators have jurisdictional authority over retail transmission. Traditionally, the state PUCs had authority over retail transmission since they set "bundled" rates for service to ultimate consumers which included charges for both transmission and distribution services. The PUCs interpret the "savings clause" of the EPAct as an express reservation of this pre-existing authority to the states. On the other hand, some commentators believe that attempts by states to mandate access to transmission facilities for retail wheeling is preempted by the EPAct. These proponents of federal preemption regard the savings clause of the EPAct as a reservation to the states of authority over only intrastate transmissions. However, considering that virtually all transmission facilities are connected to an interstate grid, why would Congress include a savings clause which reserves no power to the states? Any interpretation such as this runs counter to numerous provisions of statutory interpretation.

If the states are preempted from mandating access for retail wheeling, what effect will this produce? Ironically, it may well be that a utility has far more to lose than to gain if state authority over retail transmission is preempted. The immediate result of preemption would be to remove retail transmission from the rate base, since presumably the state PUCs lacked the jurisdiction to put it there in the first place.¹ In order to recover revenues for retail transmission services, the utility would have to file at the FERC and would likely suffer through highly contested proceedings. It is unclear whether such a proceeding would result in retail ratepayers continuing to bear residual revenue responsibility, thereby subjecting the utility to the potential risk of not being able to recover its revenue requirements for transmission facilities, a circumstance made more likely by the FERC's traditional pricing methodology based on embedded costs.

In the longer term, a state PUC is likely to look at the utility as having vertically disaggregated itself for ratemaking purposes. As a result the PUC is likely to require the utility to acquire power supply at least cost on the open market since the utility has chosen to disaggregate itself rather than operate as a vertically integrated utility. Accordingly, the utility that was successful in avoiding state regulation of retail transmission by federal preemption now has converted the value

¹ *Will Mich. Retail Wheeling Suit Lead to Unbundling?*, THE ELECTRICITY DAILY, June 8, 1994.

of its generating assets from book to market value, a potentially disastrous result for a high cost utility.

It makes little sense to price unbundled retail transmission services differently than unbundled wholesale services. That is one of the arguments advanced by proponents of federal preemption of all transmission services. On the other hand, the centerpiece of transmission pricing for the entire history of the industry has been the assumption of the residual revenue responsibility by native-load, predominantly retail, customers. To alter that arrangement, and the case for change is compelling, without careful coordination between federal and state regulators would necessarily complicate and discourage investment in transmission pricing, particularly given FERC's historic commitment to average, embedded cost pricing. Unbundling by preemption is almost certain to yield chaotic economics in transmission for years and seems almost certain to make the siting of new facilities, already a difficult task, a virtual impossibility. That is the case when preemption is easily done; it is by no means clear that it is easily done in the area of transmission pricing given the interrelationships of pricing and access itself, and the terms and conditions thereof.

The failure to codify the *Pike County* doctrine² has produced three critical results: 1) it increases the attractiveness of retail wheeling proposals as a way of disciplining retail rates; 2) it makes IRP less meaningful, since the state's power to enforce IRP is unclear for most utilities and absent in the context of a registered holding company;³ and 3) it diminishes diversity of regulation on the purchasing side of the market which in turn retards the growth of a viable competitive wholesale market.⁴

It is readily apparent that on these issues of transmission access and siting, transmission pricing, there is a compelling need for collaboration and cooperation between the FERC and the PUCs. There is, however, no need to legislate at present if regulators themselves take the initiative to find ways to collaborate. Absent collaboration, the problems inherent in the transition to competition will multiply quickly and legislation may become the only solution. As the current jurisdictional system now stands, neither federal nor state regulators have sufficient jurisdiction of their own to formulate and carry out coherent policies which ease the transition toward a competitive marketplace. Since 1981, the FERC has consistently refused to collaborate meaningfully with the states on matters of substance. The FERC has treated state regulators as parties rather than peers in comity and has hidden behind *ex parte* rules to avoid serious discussions. It has never utilized the Joint Board provision in the FPA, nor ever conducted any type of alternative joint proceeding other

²*Pike County Light & Power Co. v. Pennsylvania Public Utility Commission*, 465 A.2d 735 (Pa. Cmwlth. 1983), in which it was held that while a state could not second-guess a FERC-approved tariff, it could decide, when more than one rate was available, whether the purchasing utility was prudent in the selection of the tariff it chose. In short, the doctrine sets forth the right of a state commission to determine the prudence of the wholesale purchasing activity of retail utilities subject to its jurisdiction.

³It is one of the great ironies of EPAct that it requires PUCs to consider the implementation of IRP but fails to vest commissions with the authority to make IRP determinations binding.

⁴Another irony worth noting is that retail wheeling deprives FERC of jurisdiction over a generator which might otherwise be engaged in a sale for resale. Hence, while some have argued that states lose transmission jurisdiction when retail rates are unbundled, it appears that states may gain more jurisdiction over generation in a retail access regime.

than formalized discussion sessions. The new membership of the current Commission, however, offers the real possibility of putting substantive cooperation and collaboration ahead of bureaucratic turf protection. The Commissioners should be encouraged to take the statesmanlike approach.

In this respect, I would like to propose ways in which the federal and state agencies might be encouraged to work together. First, there is built in to the FPA a heretofore unused joint mechanism to handle difficult jurisdictional problems. This mechanism, or, if it is deficient, some other cooperative mechanism, should be explored and taken advantage of. Second, protocols or mutual deferrals can be used whereby the FERC maintains the jurisdictional authority to review state decisions but defers to the judgement of the PUCs in the absence of bad faith or abuse of power. This was the compromise reached in the FERC's *Consolidated Edison* decision.⁵ Other types of deferrals could be established. States might agree, for example, to allow a FERC §211 access order to be determinative of the "need" to site a line, in exchange for FERC agreeing to defer to comprehensive state transmission planning in lieu of separate and redundant §211 access proceedings. Similarly, RTGs could be greatly enhanced if FERC and the states in a given region convened Joint Boards, or other collaborative mechanisms, to contemplate RTG regional pools or other regional actions in order to remake needed governmental decisions that are, at least in part, subject to multiple jurisdiction (e.g., an IPP selling directly to an end user; siting a new transmission facility made necessary by a §211 access order; or a utility merger). Joint activity in such areas as transmission pricing terms and conditions as well as determinations on the recovery of stranded assets would be far preferable to prescriptive legislation of bureaucratic turf. Third, a measure of comity should be developed between the FERC and the PUCs. State PUCs should be treated not as mere parties before the FERC, but should be given deference similar to that given to prior state decisions by federal courts. States should also work with each other to a greater extent on issues like transmission siting and planning.

Finally, the decision-making process itself should be reformed. Most of the decisions made by regulatory agencies are legislative in nature -- prospective decisions like ratemaking and tariff filing -- and therefore administrative decision-making should be less judicialized.⁶ To accomplish this objective, *ex parte* rules should be relaxed to allow the FERC and the PUCs to consult informally on important technical matters of mutual decision-making interest and develop a coherent approach for the regulation of a rapidly changing industry. Furthermore, sunshine laws should be read in ways that maximize the opportunity for federal and state regulators to meet privately in order to coordinate or reach compromises on important policy issues. This would also avoid sending premature and misleading signals to investors, utilities, and consumer groups. Of course, these observations are equally true with regard to intra-PUC communications and inter-PUC communications as they are with regard to FERC-PUC communications.

A related federal-state issue in the electricity industry which needs to be addressed is whether the utilities should be allowed to recover stranded assets, and who should decide that question. Good arguments can be made on both sides of the issue. Those who advocate that no recovery should be allowed for stranded assets point out that structural change in the electricity industry was

⁵ Consolidated Edison of New York, 15 F.E.R.C. 61,174 (1981).

⁶ See Brown, Ashley *The Overjudicialization of Regulatory Decisionmaking*, Natural Resources and Environment, Fall 1990.

foreseeable and investors knowingly took risks and that these risks are reflected in the allowed rates of return. On the other hand, those who advocate partial or complete recovery of stranded assets declare that the investments were undertaken on the behalf of ratepayers, were declared to be prudent, and that the swiftness and the magnitude of the regulatory changes was unforeseeable, and the results asymmetrical.

Whatever you think of the arguments on both sides of the issue, the ultimate question in this debate is who is going to bear the risks of competition -- the investors or the consumers. Clearly, who bears the risk of competition is fundamentally a policy decision and the question should be treated as such. Sound public policy, however, dictates that to whatever extent government action caused actions to be stranded, that some level of government be responsible for bearing the consequences produced by the decision. In short, if state policy causes investments to be stranded than state governments should decide the question of who pays for stranded assets. The same principle holds true for federal actions. A regulatory regime should not be created where one level of government makes the decisions and another is forced to deal with the consequences. Accountability requires jurisdictional symmetry.

In conclusion, the jurisdictional mechanisms that regulate and provide policy guidance for the industry are neither reflective of nor very useful for the emerging structure of the industry. The debate over the EPAct in 1992 made it clear that regulatory federalism is not an easy area for Congress to legislate. It is clear, however, that further Congressional action may not even be necessary or desirable if the regulatory community gets its own house in order for dialogue, collaboration, and coordination. The FERC and the PUCs are charged with the responsibility of producing durable policy guidelines that investors, consumers, and other can rely on without a lengthy and protracted dispute over jurisdiction and turf. This nation deserves statesmanship rather than bureaucratic turf battles. This commission would do well to initiate and foster such a collaborative approach.