American Public Power Association

2301 M Street, N.W.
Washington, D.C. 20037
202-467-2900; fax: 202-467-2910
www.APPAnet.org

Restructuring and Open Access Reconsidered

Comments of
Alan H. Richardson
President & CEO
American Public Power Association

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Good morning and Happy New Year. Thank you for the opportunity to offer a few opening comments at this roundtable workshop.

We are two weeks into the New Year, and I'd like to preface my comments by observing a few anniversaries that we will be celebrating in 2005.

This year marks the 125th anniversary of the institution of public power. The first publicly owned electric utilities were founded in Wabash, IN and Butler, MO in early 1880 to provide arc lighting in their village squares. As electricity quickly went from a phenomenon to a necessity over the next several years, thousands of communities created their own municipally owned electric utilities, in many cases because the market wasn't meeting their needs quickly or cheaply enough. The number of public power systems reached its apex in 1923 with a total of over 3500. Thereafter, the numbers declined as hundreds of smaller public power systems and smaller IOUs were acquired by the ever-expanding utility holding companies controlled by Samuel Insull and other industry leaders. The vast majority of those that survived until the utility holding companies were brought under control continue to serve their communities today.

Another institutional anniversary is the creation of APPA sixty-five years ago. Today, APPA is the national voice representing the interests of nearly 2000 publicly owned, locally controlled electric utilities. Collectively, public power systems provide electricity to over 14 percent of the nation's ultimate retail customers. We own about 10 percent of the nation's installed generation capacity. Doing the math, it is obvious that we are net purchasers of wholesale power and equally obvious why we have a very keen interest in properly functioning wholesale markets that meet our needs.

Public power systems range in size from quite large, like the Los Angeles Department of Water and Power with 1.4 million metered customers, to Radium City, Kansas with 23. Some are vertically integrated, some are distribution-only companies. All were created to serve their communities and all share the characteristics of public ownership and public service orientation.

There is one other institutional anniversary this year, and it is the one in which we are participating today – the 5th anniversary of the American Antitrust Institute's electricity conference. Let me compliment and congratulate AAI and its leaders, Bert Foer and Diana Moss, on this anniversary. In just a few years, AAI has gone from a gleam in Bert's eye to a truly impressive and highly respected organization dedicated to fostering (and forcing if necessary) consideration of antitrust concerns across a broad array of industries including, of course, the electric utility industry.

There are some legal anniversaries that need to be mentioned as well. Seventy years ago, Congress enacted a momentous piece of legislation – the Public Utilities Act. Title I was the Public Utility Holding Company Act while Title II was the Federal Power Act. Both statutes remain on the books, although the Securities and Exchange Commission, which has pleaded for PUHCA repeal for at least two decades, now acts as though it has been repealed despite the lack of Congressional action.

These statutes and the principles underlying them have served the public well over the last seven decades. The remarks about the failures of regulation that have been so prevalent over the last few years as we engaged in debates over the promised benefits of deregulation and restructuring are gradually being displaced by the growing realization of how horrendously complex (and easily corrupted) the restructuring process has turned out to be. Indeed, the process of deregulation is proving to be more dysfunctional than the process of regulation. The "just and

reasonable" wholesale rate requirement embodied in the Federal Power Act continues to be the law of the land and a critically important piece of the framework constructed to protect electric consumers from the abuses of market power. The Act's prohibition against "undue discrimination" has been the foundation on which open access to transmission facilities has been built.

That brings me nicely to the last anniversary I'll mention this morning, the 10th anniversary of FERC's NOPR that eventually produced Order No. 888. Now, with a decade of experience under our belt, it is very appropriate that we revisit open access, a phrase that I will interpret broadly for the purpose of these comments to include all aspects of industry restructuring. APPA has just concluded a similar revisitation and our views are expressed in a White Paper entitled "Restructuring at the Crossroads: FERC Electric Policy Reconsidered." This document is available on our Web site, www.APPAnet.org. Many of my comments reflect what we said in that paper.

Our journey toward restructuring has been both fascinating and frustrating. We've put on a lot of miles. Unfortunately, we haven't made much progress toward the goals we embraced at the outset. When the process began, our goals were lower rates, better service and greater innovation through markets and competition. New transmission organizations that would provide non-discriminatory access, eliminate rate pancaking, and engage in regional planning (and possibly construction) of transmission facilities were a means to these ends. For the most part, public power systems were enthusiastic supporters of these new transmission organizations. And while we were perhaps more skeptical (and I believe more realistic) about the likelihood of successfully restructuring this industry all the way down to retail choice, we did look forward to the benefits of displacing regulation with competition where that could occur without losing focus on the real beneficiaries of the process – the end use consumer. Sadly, from our perspective at least, we have yet to see these predictions come true or the new institutions perform the functions initially envisioned.

The RTO and ISO institutions that have been sanctioned by FERC to date are quite different from the ones we initially envisioned, and all suffer from serious flaws. Common problems include spiraling costs, unaccountable governance, and most important, service offerings that do not meet transmission customer and end-user needs.

Public power systems are load serving entities with the sole mission of meeting the electric service needs of their customers and communities as cheaply and reliably as possible. Most depend to some extent on the wholesale power market to serve their retail load. Long-term assured access to transmission at stable and predictable rates is essential to meet this mission. Existing RTOs and ISOs are not only not helping us meet our mission, they are impeding our ability to do so. This disconnect has caused disillusionment among many of APPA's members that were once strong supporters of FERC"s restructuring efforts.

In the RTO world of today, APPA members are being forced to exchange their physical firm long-term transmission rights (often hard-won through litigation) for Financial Transmission Rights -- FTRs -- that are inadequate in quantity and term. An RTO's idea of a "long-term" FTR is 1 – 5 years, while a public power's idea of "long-term" is measured in decades. The ability of public power systems to plan for and procure long-term generation resources to serve load is being adversely impacted. Credit rating agencies, which have liked our business model and consistently given us high ratings despite the financial meltdown of others in our industry, have taken note of this problem, and that, too, concerns us.

Not only do public power systems need long-term assured access, they need reasonable stability in transmission pricing. Access to the transmission system in RTO regions is being rationed by price under the Locational Marginal Pricing (LMP) construct. Rate pancaking, one of the ills that was to have been eliminated through regional transmission organizations, has been replaced by LMP differentials that often have the same (if not worse) economic effect.

We do need a more robust transmission grid. However, the LMP/FTR system taken alone does not ensure the construction of adequate transmission infrastructure. At best, it shows which source and sink pairings create congestion with the hope that this information will be sufficient encouragement for the "market" to develop economically efficient solutions. The market has not leapt into the breach. For the most part, merchant transmission companies have not formed. And incumbent transmission owners have reasons of their own for not being eager to take on the task of building new transmission facilities, from avoiding bad publicity to protecting the profitability of their own generation facilities.

Complicating this problem is the fact that some RTO transmission-planning regimes have focused on the artificial distinction between new transmission needed for "reliability" and that needed for "economic" purposes. Where new transmission is deemed necessary solely for economic reasons, construction is being left to the "market" with less than optimal results. Rather than such a bright-line distinction, it seems to me that we should instead be trying to determine whether our transmission structure is adequate to meet society's needs at a reasonable cost. Indeed, there really isn't such a bright-line distinction. As Professor Paul Joskow noted in a recent analysis of PJM transmission additions, "'economic' transmission investments can also often confer 'reliability' benefits as well. Thus, in my view, at the very least, reliability and economic transmission investments are interdependent. At worst, the distinction between them is analytically arbitrary."

These developments are leading to the perverse result that many of my members are not looking to the wholesale power market but are instead either renewing power supply contracts with their existing IOU suppliers, or building their own generation as close to their own loads as possible – all to reduce transmission-related risk and uncertainty. These decisions may not produce the most economically efficient generation resource results, but they are being driven towards these outcomes by the RTO/LMP market construct. What is not developing is a well-functioning wholesale power market with many healthy competitors.

Worse yet, we are paying dearly for the privilege of living in this frustratingly complex RTO environment. RTO administrative costs have spiraled upward with little apparent accountability for or appreciation of the impact of these costs on electric consumers. This problem is further aggravated for the mostly small public power systems within the RTO footprints who must add staff, hardware and software simply to cope with these new markets, protocols and requirements.

The other shoe on FERC's policy foot is its market-based rate regime. FERC's market-based rate policy until now has assumed that competitive markets (supplemented in RTO regions by RTO market monitoring and mitigation regimes) will produce just and reasonable rates for wholesale power supplies. In many real-world instances, in the organized markets and elsewhere, this has proven not to be the case.

Prices for generation charged in the organized markets are often substantially above those that would result if cost of service regulation were used. It is clear that many suppliers in these markets are not bidding their marginal costs, as the theory underpinning centralized single price clearing markets posits, but instead are charging what they think the market will bear. What the

market will bear often does not pass the Federal Power Act's "just and reasonable" smell test, especially in periods of high demand. Moreover, the price volatility of these short-term markets does not match up well to the steady stream of long-term revenue that investors in new generation facilities now like to see.

Sale of power at market- based rates is a privilege, not a right. To obtain FERC permission to sell wholesale power at market-based rates, the seller must demonstrate that it does not possess, or has mitigated its market power. There is, as well, a continuing obligation on the Commission's part to ensure that market-based rates remain just and reasonable. If that continuing obligation was not clear previously, it was made crystal clear last fall by the 9th Circuit Court of Appeals decision in *State of California, ex rel. Bill Lockyer v. FERC.*

FERC's assumption that the entire footprint of an RTO constitutes the relevant geographic market, and that the RTO's mitigation regime is sufficient to counteract any generation market power a seller may have needs to be examined carefully, as does the actual performance of market monitors, who are the first line of defense in ensuring that market based rates continue to be just and reasonable. FERC is increasingly relying on market monitors, who are either employees of or contractors to the RTOs, to examine evidence to assess whether the wholesale energy and transmission prices reflect those that would be expected of competitive markets. But the recent decision of the United States Court of Appeals for the District of Columbia Circuit in *Electric Power Supply Association v. FERC* calls this continued reliance into question. As Commissioner Kelliher has noted, it may not be appropriate (or legal) for FERC to delegate determination of "just and reasonable" rates to market monitors.

APPA has recently commissioned an assessment of RTO and RTO-sponsored empirical studies on how restructured wholesale power markets in the mid-Atlantic and Northeastern United States are performing. The preliminary results are not comforting. The analysis is not yet final, but at this point it suggests there is good cause to be concerned over abuses of market power, strategic behavior on the part of suppliers intended to raise prices, and the lack of competitive market forces to constrain anticompetitive behavior of market participants.

Anecdotally, many of my members are facing serious threats to their viability because of lack of availability of long-term firm transmission and increasing generation consolidation. They get few if any viable bids from suppliers in response to their RFPs, can't obtain transmission to reach alternative sources of power, and are faced with dramatic price increases from local suppliers with market power. Little wonder, then, that we look with alarm at further consolidation within the industry, such as the recently announced giga-merger of Exelon and PSEG, which will produce a company controlling more than 50,000 MW of generation. Industry observers assume this marriage will be blessed by FERC because any possible anticompetitive problems will obviously be mitigated simply by membership of the merged utility in PJM. That assumption must be validated.

I started by noting that this is the 10th anniversary of the FERC NOPR that produced Order No. 888. The Open Access Transmission Tariffs ("OATTs") required by Order No. 888 to ensure transmission access on a non-discriminatory basis are behavioral remedies intended to address the exercise of transmission market power. To work, they require substantial and continuing policing by FERC. Some police work is occurring, and some bad guys are being caught. We learned at the end of last year, for example, that random audits by the FERC's Office of Market Oversight and Investigations found that both Arizona Public Service and Tucson Electric Power had failed to make timely data postings and had provided favorable treatment to their merchant power subsidiaries. The existence of these anticompetitive practices should come as no shock. Utilities

have been using their transmission assets to disadvantage competitors for decades. What is important is to find out the extent to which companies continue to play these games. It seems likely that APS and TEP are not isolated instances. And in fact Chairman Wood recently suggested that we may see additional violations uncovered as a result of other random audits. However, even these two examples suggest there is a need to refine and improve Order No. 888.

FERC, unfortunately, issued Order No. 888, then quickly shifted its focus to RTO activities. Unless a transmission customer called the hotline or filed a complaint, FERC generally assumed all was well with OATT administration. FERC should undertake a comprehensive look at ways its OATT regime could be improved through clearer rules or changes to improve efficiency. We were pleased to see Commissioner Kelliher suggest this course last summer and that this topic was at the top of the agenda for FERC's December 7, 2004 technical conference on transmission market power issues.

A lot has happened in ten years. While things have not turned out as APPA and its members had hoped, at least we seem to be taking account of the lessons learned, and the debates on how to move forward are shifting away from blind faith in markets to consideration of actual facts on the ground. This is apparent, for example, in an article authored by three individuals affiliated with the Carnegie Mellon Electricity Industry Center and published in the October 2004 issue of *The Electricity Journal* entitled "Rethinking Electricity Deregulation." They first take a careful look at the hard knocks of deregulation and steps taken to address the many problems that have arisen. They conclude that designing a competitive market to remedy the problems already encountered is a difficult task, and while it might be accomplished "the costs of doing so might make full deregulation unattractive."

The proposition that public sentiment will trump economic theory, especially misguided theory, every time also appears to be affecting current thinking about restructuring. The Cato Institute's paper, "Rethinking Electricity Restructuring" released on November 30, 2004, is a startling example of this. The paper states that "electric utility restructuring was a political answer to the problem of high rates" while the academic underpinnings were based on economic theories about how market solutions could make the wholesale and retail electric markets more efficient. Now the politics have shifted -- again. The authors acknowledge that while "restructuring has delivered some of its promised benefits, most Americans associate markets in electricity with bad outcomes…." These bad outcomes leave the industry stuck in "open-access limbo."

The Cato paper suggests that the industry could move out of limbo and forward to full and complete deregulation, its preferred choice ideologically, or "backwards to a world of vertical integrated and incentivised rate regulation." Acknowledging political realities, Cato endorses the "second-best solution… accept the regulatory oversight of electric power companies … in return for management of the transmission commons through vertical integration."

We start this year with a new Congress, a new Secretary of Energy and possibly changes in personnel at FERC. We have the benefit of a decade of experience from which we can measure the successes and failures of restructuring against the successes and failures of regulation. All of this sets the stage for 2005, which promises to be a fascinating and perhaps even a watershed year. It sets the stage as well for today's workshop. I look forward with great interest to the discussion.