National Regulatory Research Institute

DT: April 2, 2008

TO: State Commissioners and Staff

FR: David Magnus Boonin, NRRI, Director of Electricity Policy and Research
Scott Hempling, NRRI, Executive Director

RE: FERC NOPR on Wholesale Competition in Regions with Organized Markets – Ideas for Comments

On February 22, 2008, FERC issued a Notice of Proposed Rulemaking (NOPR) entitled *Wholesale Competition in Regions with Organized Electric Markets*, Docket Nos. RM07-19-000 and AD07-7-000, 122 FERC para. 61,167 (2008). FERC intends the NOPR to make wholesale markets more competitive. The NOPR focuses on wholesale markets administered by regional transmission organizations. Comments are due by April 21, 2008. NRRI has developed a list of questions that state commissions may wish to consider in preparing their responses to the NOPR.

In summary, this NOPR proposes:

1. Actions to have Demand-Side Resources treated comparably to supply resources, including issues such as:

    - Requiring that DSR resources be allowed to be bid as ancillary services
    - Removing deviation charges when a DSR uses less than its reserved day-ahead quantities
    - Allowing for the aggregation of DSR resources by third parties
    - Proposing various pricing paradigms that could be used during periods of operating reserve shortages

2. Actions to increase the use of long-term power contracts by making these transactions more transparent. The Commission proposes to require RTOs to set aside part of their websites to allow parties interested in buying or selling power to post information.

3. Actions to further the independence of Market Monitoring Units, including requiring RTOs to share certain information with state commissions.

4. Actions to increase the availability of offer and bid data.

5. Actions to increase the responsiveness of RTOs to stakeholders, including: inclusiveness, fairness in balancing diverse interests, representation of minority positions, and ongoing responsiveness.

The purpose of this memorandum is not to support or oppose aspects of the NOPR, but rather to identify issues not treated by the NOPR that fall within its scope. The attached Appendix lists potential issues we believe warrant FERC consideration. Common to many of our comments below are three general questions.

1. Since Congress passed the Federal Power Act to protect consumers,[1] and since consumers are retail consumers, are FERC's proposals sufficiently guided by and informed by that purpose?

2. Does the absence of full demand response activities render wholesale markets insufficiently competitive, and if so, does that fact mean that market-based rates are unlawful? What evidence is necessary to answer this question? Does FERC know? Does anyone know?

3. Given FERC's premise that wholesale markets are here to stay, what actions should state commissions be taking to make them work for retail markets? Does the NOPR create a sufficiently clear path for states to assess the costs and benefits of those actions?

We encourage state commissions to consider these questions, and the comments below, in preparing their responses to FERC. Please contact **David Boonin** at **215-985-4114** or **dboonin@nrri.org** with any questions.

[1] *See Public Systems v. FERC*, 606 F.2d 973, 979, n.27 (D.C. Cir. 1979).

Appendix

Below are listed issues that state commissions may wish to consider in preparing their responses to FERC's NOPR on Wholesale Competition in Regions with Organized Markets.

I. DSR

The NOPR proposes several reforms to reduce barriers to demand response in organized energy markets. These reforms require that demand response be treated by the RTO comparably to other resources. FERC raises issues about ancillary services, charges associated with reducing demand below purchases made on the day-ahead market, aggregation of DSR, and pricing during periods of operating reserve shortages. In commenting on this topic, states may wish to consider the following issues, some posed as questions:

1. The Federal Power Act requires that rates be just and reasonable. The courts have said that when rates are not cost-based, the Commission must ensure that effective market forces protect the consumer. Is the Commission saying that absent effective demand response, market forces are ineffective? If so, is the upshot that market-based rates in such markets are inherently unlawful?

2. What, if any, is FERC's legal obligation to act consistently with the retail pricing structures that states have implemented?

3. The NOPR lists several potential methods for pricing during periods of operating reserve shortages and asks for comments and alternative proposals. In responding to FERC's requests, states may want to ask FERC to verify, rather than assume, the following:

    a. That the pricing approach will produce lawful rates, i.e., rates that are just and reasonable.

    b. That the approach is more likely to create better balance between supply and demand resources than some other approach.

    c. The approach's effect on and through retail ratepayers, as discussed in our comments regarding responsiveness in Part XX below.

II. Long-term power contracts

By increasing transparency and efficiency in long-term power contracting, FERC seeks to stimulate and facilitate wholesale market activity in long-term wholesale contracts, in part by proposing to require RTO posting of offers. Section 2 of the proposed rule, section 38.25(g)(2), thus requires that an RTO dedicate a portion of its website for market participants to post offers to buy or sell power on a long-term basis.

FERC should consider other approaches to facilitate long-term power contracts, such as establishing a library of contract provisions that frequently appear in contracts already approved by FERC, to assist parties new to this environment. This library could include, for example, several models of previously approved pricing or contract renewal provisions. One possible approach is that RTOs, with FERC oversight, should create these libraries.

III. Market monitoring units

The proposed rule, at section 38.25(g)(3)(ii)(C), requires the MMU to provide reports to the FERC Enforcement Staff but not to state commissions. These MMU reports identify instances in which a market participant's or the Commission-approved ISO's or RTO's behavior may require investigation. In regard to retail regulator access, state commissions may want to consider the following issues:

1. Retail regulators with a responsibility to protect retail customers should not be excluded from the receipt of available information that shines light on the operation of a market on which their retail customer depend.

2. Retail regulators need access to information about market imperfections if they are to have confidence in the wholesale market's ability to produce efficient and fair results for retail customers.

3. How can issues of confidentiality be addressed to allow state regulators access to information similar to that provided by the MMU to the FERC concerning market irregularities?

4. Our view of responsiveness (addressed in Section V) requires that state commissions have the same access to reports that an MMU provides to FERC and its board, including behavior that may require investigation by FERC.

IV. Offers and bids

The NOPR at Section 4 of the proposed rules sets forth a proposal under which RTOs would make offer and bid information publicly available. Offer and bid data can

include critical information that enables retail regulators to make resource decisions or assess the effect of proposed wholesale rules on retail customers. Section 4 of the proposed rule requires an RTO to release offer and bid data within three months, while allowing the RTO to mask the identities of the participants. This proposal raises several questions about what information needs to be released and in what format:

1. State regulators need bid and offer data that differs from the data provided to the market as a whole. State regulators, for example, might need more current information to perform program monitoring activities than the three-month lag proposed elsewhere in this NOPR. A regulator might require data to perform a prudence assessment that differs from the data other stakeholders may require for merchant analysis.

2. Offer and bid data reports must be in a format that allows state commissions to provide reasonable resource analysis assessments of both increments and decrements. The data should be in a common, electronically manipulable format that is user-friendly.

3. FERC should require the provision of the full scope of the bid and offer data for each hour.

4. The data must identify key characteristics or constraints that accompany a bid, such as must run, cycling, spinning reserves, startup or ramp-up constraints, or maximum usage.

5. FERC should require that the initial filing include at least three and preferably five years of offer and bid data, since the market is not homogenous from year to year.

6. Concerning the NOPR's use of a three-month lag for data provision, state commissions should ask the FERC: Are there technical reasons that limit RTOs from providing this data on something more akin to a day-behind basis? State commissions might need more current data to track how well a DSR program is working or to respond to public inquires about price spikes or supply shortages.

7. In addition to historical bid and offer data, FERC should require RTOs to publish future estimates of supply curves and market clearing prices.

    a. RTOs should present the projected price and supply curve as hourly forecasts and distribution curves.

    b. The RTOs should base their projections on hypothetical resource models and potential resources that are actually under development. If based upon actual projects under development, RTOs should develop and use screening tools that identify the

resource by level of development (e.g., level of financial commitment, regulatory approval, or design work completed necessarily prior to listing a resource).

c. RTOs should use a reasonable range of demand forecasts to create a set of cases of forecasted supply curves and market clearing prices.

d. RTOs should include sensitivity analysis for other key assumptions (e.g., fossil fuel prices, new carbon emission rules, interest rates or new technology deployment). They should show the internal consistency of each sensitivity case (e.g., not assuming robust demand and high fossil fuel prices simultaneously).

e. Stakeholders, including state commissions, should have significant input into the RTO's development of a reasonable set of scenarios that provide meaningful guidance about the likely effect of additional resources on market clearing prices.

V. Responsiveness of RTOs and ISOs to stakeholders and customers

In addressing responsiveness, the NOPR uses terms like inclusiveness, fairness, balancing diverse interests, minority positions, and ongoing responsiveness. Missing from the NOPR is an affirmative statement that responsiveness requires RTOs' and the FERC's responsiveness to retail consumers. In public utility regulation, the reason for responsiveness is to serve the public interest—to carry out commissions' obligation to consumers, meaning retail consumers. FERC cannot assume that what is good for the wholesale market is necessarily good for the retail market and its customers, without taking into account the specifics of affected retail markets. Nor can FERC assume that a wholesale market practice is inappropriate merely because it does not "fit" with the current retail ratemaking paradigm. It is best, therefore, for both federal and state regulators to keep at the forefront the effects of policies on retail customers. Regulators must therefore acknowledge and address the unavoidable interactions between wholesale and retail markets, and between wholesale prices and retail rate design.

In responding to the NOPR, state commissions may want to consider these issues:

1. FERC orders on wholesale market modifications should contain a detailed assessment of the likely effect of the modifications on retail customers. FERC should require that RTOs file supporting information on how the RTO sees its proposed modifications affecting retail customers. Such assessments might contain the following features:

   a. An examination of how the proposed wholesale market modification interacts with different retail market structures. For

example, assume two retail market structures, both within the same RTO region. In one, the market is vertically integrated with most resources owned by the local distribution utility. In this case, changes in the market clearing price would likely affect retail ratepayers only to the extent they go to the wholesale market for their marginal or economic needs. In the second retail market structure, assume the utility has divested all its generation, has no long-term contracts, and thus is purchasing all its needs from the wholesale market at the hourly spot or day ahead clearing price. Now assume the RTO has proposed a new DSR program aimed at driving down the market price during periods when a change in demand has the greatest effect on price. Would this DSR program have a greater impact on retail ratepayers in the second market than in the first market (vertically integrated)? FERC should require RTOs to quantify this differing effect.

b. Differentials exist in customer size, mobility, shopping opportunities, and rate design; for example, in certain states retail rates reflect wholesale market pricing, and in others they do not. For example, some retail customers may see real-time pricing for generation that tracks the wholesale price each hour. Other retail customers may see only the change in the hourly wholesale price of electricity indirectly through some annual average price. Now assume that an RTO proposed a tariff change that would greatly increase the price of electricity during periods where demand strained the available supply. Will those customers with retail rates that reflect the new wholesale pricing paradigm be more able to adjust and save compared to customers facing a retail rate which is a blended or averaged rate? FERC should require RTOs to quantify this differing effect on retail customers.

c. An assessment of how changes in revenue requirements will affect each rate class. Changes to the wholesale market can affect the total cost paid by all retail customers, and may affect one set of customers while leaving others unaffected. For example, a modification proposed by RTOs, such as a capacity charge or a rule that made DSR only available to large customers, could affect customer classes differently.

d. The RTO's filing and FERC's order should identify the risks and uncertainties the proposal introduces to the retail market and how state commission, RTO, or FERC actions can mitigate them. Assume that an RTO's proposal increases the volatility of the wholesale price under certain conditions. What physical or financial hedges might a state regulator wish to consider to help

mitigate potential economic dislocations associated with the increase in price volatility?

2. FERC should consider establishing a process by which to assess the costs and benefits of making states' retail rate policies consistent with wholesale market modifications. Consider these options. FERC, RTO, or both should seek advice from retail regulators on necessary retail tariff modifications for their retail customers to take advantage of the wholesale modifications, while mitigating risks or costs arising from the wholesale market modification. This advisory process should be both formal and informal.