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BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Commission's)
Investigation into the Value of)
Continued Participation in Regional) Case No. 09-90-EL-COI
Transmission Organizations.)

COMMENTS OF INDUSTRIAL ENERGY USERS-OHIO

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COMMENTS OF INDUSTRIAL ENERGY USERS-OHIO

On March 4, 2009, the Public Utilities Commission of Ohio ("PUCO" or "Commission") issued an entry ("Entry") seeking comments on regional transmission organizations ("RTOs"). The Entry indicated the comments would be considered by Ohio's federal energy advocate in the preparation of a report, pursuant to Section 4928.34, Revised Code, on whether continued participation by the State's electric utilities in RTOs is in the interest of Ohio's consumers. Pursuant to the Entry, the Industrial Energy Users-Ohio ("IEU-Ohio") submits its comments for the Commission's and federal energy advocate's consideration.¹

EXECUTIVE SUMMARY

The Ohio Legislature, through the enactment of Amended Substitute Senate Bill 221 ("Am. Sub. SB 221"), tasked the Commission and the federal energy advocate with undertaking an analysis and providing a report on whether continued participation of Ohio utilities in RTOs is in the interest of Ohio's consumers. The Commission appears

¹ IEU-Ohio is authorized to state that the PJM Industrial Customer Coalition ("PJMICC") and the Coalition of Midwest Transmission Customers ("CMTCC") have reviewed and support these Comments. PJMICC is an ad hoc association of large industrial and commercial customers that have facilities in the PJM Interconnection ("PJM") region. CMTCC is an ad hoc association of large industrial and commercial customers that have facilities in the Midwest Independent Transmission System Operator ("MISO") region.

to have taken a myopic view of what analysis is appropriate and a broader perspective is needed.

Utility regulation was introduced as a result of legislative determinations that competition within and between suppliers within a business sector affected with the public interest was not in the public interest. But the installment of government as the entry, exit, service quality, financial integrity and economic regulator of public utilities did not change the public interest objective; regulation was selected as the means of promoting and protecting the public interest in, among other things, “just and reasonable rates”. Regulation was not the public interest objective. And, with specific regard to regulation of the economic relationship between utilities and their customers, regulation seeks to mimic the results of effective competition.

Designing and implementing laws, regulations and policies that properly balance the interests of utilities and the public is not an easy or static responsibility but is the core mission of public utility regulation at all levels of government. In the more detailed discussion that follows, IEU-Ohio demonstrates that the design and implementation functions associated with the relatively new regulatory institutions known currently as RTOs are presently incapable of serving the public interest in “just and reasonable rates”.

The unacceptable condition briefly described above is not the result of competitive forces but the result of choices made and remade by regulators at the state and federal level who transformed what was a good concept (functional unbundling of competitive and non-competitive services and products) to test the opportunity to enable effective competition in the electric industry into a dysfunctional assembly of tasks,

commercial and regulatory islands that have steadfastly avoided any responsibility for considering impacts on ultimate customers and have willingly contributed to creation of an illusion that dynamically efficient markets have sprung into existence and are working in the public interest. In the end, RTOs – the agents of regulation – have contributed to significant reliability failures and have built commercial platforms that have permitted “market participants” to manipulate commerce for the purpose of transferring massive amounts of wealth from consumers to producers, including some producers who manufactured false information.

It is IEU-Ohio’s position that without major reforms it is not in the public’s or customers’ interest to continue to permit: (1) Participation in RTOs as such participation may relate to “Day 2” market structures; and, (2) Electric distribution utilities (“EDUs”) to pass on the cost of RTO participation to Ohio retail customers until they make an affirmative demonstration that the direct customer benefits of the RTO selections (made by the EDUs or their affiliates) exceed the costs.

The origin of RTOs can be traced to the Federal Energy Regulatory Commission (“FERC”) issuing Order 888 in 1996. FERC determined it was statutorily obligated to remedy undue discrimination in access to and use of utility transmission systems. Order 888 required utilities to functionally separate the operation of their transmission systems, and to provide third parties with open access to use their transmission systems. Utilities in tight power pools (at that time New York Power Pool, New England Power Pool and the Pennsylvania-New Jersey-Maryland Interconnection) were required to form independent system operators (“ISO”) and have these independent entities assume operation of regional transmission facilities in order to comply with Order 888.

FERC also rationalized Order 888 on the expectation that its action would provide approximately \$3.8 to \$5.4 billion per year of cost savings to customers.

FERC subsequently issued Order 2000, which required jurisdictional utilities to file proposals for joining an RTO or to explain why such actions were not feasible. At the time, it appeared that FERC was moving aggressively to require fully-functional RTOs to be in place nationally by December 2001. Although all Ohio utilities were initially considering participation in the Midwest Independent Transmission System Operator ("Midwest ISO" or "MISO"), at the eleventh hour American Electric Power Company ("AEP") and FirstEnergy Corp. ("FirstEnergy") decided to withdraw and pursue the formation of the Alliance RTO. Several years of protracted proceedings at FERC subsequently followed, with many parties opposed to the prospect of two RTOs intertwined in a geographic configuration that made little physical or electrical sense. FERC ultimately declared the Alliance RTO unfit for duty and directed would-be participants to join another RTO. Ohio utilities split in their decisions to become either a member of PJM Interconnection ("PJM") or MISO. FERC approved the RTO elections based upon a condition that PJM and MISO implement a single common market. However, while today the two RTOs engage in interregional coordination, plans for a single common market have been abandoned.

Soon after FERC first directed utilities to form ISOs, some parties urged FERC to take a broader range of actions to facilitate restructuring of the industry for the purpose of enabling effective competition. They argued that it was impossible to distinguish the functions necessary to maintain real-time reliability of the grid with the rules for the operation of commercial markets. They urged FERC to require ISOs to operate

centralized markets with responsibility for dispatching generation suppliers to meet demand. FERC found these arguments persuasive and Order 2000 required RTOs to provide market mechanisms to manage transmission congestion. Over time, management of transmission congestion based upon the use of a security constrained dispatch and economic settlements calculated based on locational marginal prices ("LMP") became the *de facto* FERC standard. As they have evolved under FERC's oversight, the RTO markets have two key attributes: (1) The ability of generators and wholesale suppliers to sell electricity at "market-based" rates; and (2) The use of a single-clearing or uniform clearing price auction to establish the spot market price.

In 2002, FERC attempted to coordinate and standardize the formation of organized wholesale electricity throughout the United States (and indirectly portions of Canada) by issuing a proposal known as standard market design ("SMD"). FERC's SMD proposal prompted a strong political backlash from Congress and others. FERC retreated and subsequently withdrew its SMD proposal. However, and notwithstanding its hasty retreat from SMD, FERC encouraged existing RTOs to expand the number of organized markets (more services and products) and required significant changes to the structure of existing markets.

Over the last fifteen years, FERC has made determinations that market forces could better serve the public interest than traditional rate regulation, and that customers would see lower prices, better service and innovation as a result of RTO-run energy markets. However, FERC's determinations have not been based upon empirical findings or supported by quantitative evidence. Instead, FERC has used a faith-based regulatory approach to its responsibility to ensure "just and reasonable rates" It has

repeatedly substituted a potential means of serving the public interest (competition) as the public interest objective which it is obligated to achieve. FERC's regulatory choices are substantially similar to the *laissez faire* approach to our Nation's regulation of financial institutions over the last decade, an approach that has pushed us into a global financial crisis.²

In the absence of empirical analysis by FERC, others have stepped forward to fill the void and attempt to answer the question of whether RTO markets are providing consumers benefits. Several studies paint a very disturbing picture of RTO markets and the state of competition in these markets. Studies have concluded that there is no reliable and convincing evidence that consumers are better off as a result of the restructuring of the U.S. electric power industry. Yet the *laissez faire* approach persists as though it is the responsibility of consumers to show that RTOs are hurting the public interest rather than it being the responsibility of FERC to ensure that regulation with or without RTOs is fulfilling its statutory duties.

In 2008, Congress requested that the Government Accountability Office ("GAO") conduct its own review of RTOs and FERC's oversight. GAO was asked to review: (1) RTO expenses and key investments in property, plant, and equipment from 2002 to 2006, the most current data available; (2) how RTOs and FERC review RTO expenses and decisions that may affect electricity prices; and (3) the extent to which there is consensus about RTO benefits.

² Throughout the past fifteen years, FERC's faith-based approach to regulating the markets operated by RTOs bears striking similarities to the oversight (or lack thereof) applied to financial institutions over the last decade that is now being blamed as having primary responsibility for the current global financial crisis. In recent remarks reflecting on the root causes of this financial crisis, governmental leaders have concluded that the regulatory failures that contributed to the current financial crisis arose, in part, because the regulatory structure did not focus on outcomes and was too inwardly focused on structure and jurisdictional debates.

GAO found that the RTO markets were extremely complex. GAO also found that FERC had not conducted any empirical analysis to identify if RTO markets were producing benefits.

Faced with rising electricity prices and the belief that organized RTO markets are contributing to the run up in electricity prices, customers, both individually and collectively, have repeatedly requested that FERC take action to address root cause problems. Although FERC has acknowledged these concerns, it has declined to undertake any comprehensive review of RTO markets and the impacts they are having on ultimate customers.

Many stakeholders have supported, and continue to support, efforts to enable dynamically efficient electric markets. They favor replacing regulation with such markets where and when such markets are capable of providing customers with results that are superior to those available from and through traditional rate regulation. However, experience since the early 1990s consistently shows that the actual results of the changes federal regulators and RTOs have implemented have been diametrically different than FERC's projections.

The Commission and the federal energy advocate have been statutorily tasked with examining the value of RTO participation and whether continued participation by Ohio utilities is ***in the interest of consumers***. Answering this question will require the Commission to examine the objectives of RTOs to see if they are designed to serve the interest of consumers. If the RTOs are not designed and operated to this end, then any positive relationship between RTOs and the interest of consumers is purely happenstance. If the Commission finds that the RTOs are designed and operated to

serve the interest of consumers, then the Commission must escalate its analysis to determine if the RTOs are prudently and responsibly achieving outcomes that serve the interest of consumers. Examining RTO functions on a piecemeal basis may not produce actionable or practical results, or facilitate answering whether continued RTO participation is in the interest of Ohio's consumers.

As the Commission plans for the future and satisfies its regulatory obligations, IEU-Ohio believes that the Commission must acknowledge that history demonstrates that FERC has no interest in considering the impacts its policies are having on the electricity prices paid by ultimate customers. For these reasons, the Commission's longer-term focus should extend an objective-based analysis to the identification and examination of how the interest of consumers could be better served by means other than those offered by MISO and PJM. In this context, IEU-Ohio recommends the Commission consider two options. The first option would result in Ohio utilities migrating back to so-called day-one RTO status, in which an ISO would assume responsibility for reliability and scheduling functions, but not operate a centrally-cleared day-two market. The second option would look at the creation of an Ohio-only RTO but, again, limited to assuming responsibility for reliability and scheduling functions. In the meantime and as stated above, it is IEU-Ohio's position that it is not in the public's or customers' interest to continue to permit (1) participation in RTOs as such participation may relate to "Day 2" market structures; and, (2) EDUs to pass on the cost of RTO participation to Ohio retail customers until they make an affirmative demonstration that the direct customer benefits of the RTO selections (made by the EDU's or their affiliates) exceed the costs.

INTRODUCTION

In its Entry, the Commission posed a series of questions soliciting views on whether specific functions either provided by RTOs or inherent through an RTO's operation of regional energy markets are providing value or benefits to Ohio customers. The questions themselves reflect perhaps a myopic view of the analysis the Commission and federal energy advocate have been delegated to undertake by the Ohio legislature. While the Entry itself recognizes that both qualitative and quantitative analysis may be relied upon to ascertain the benefits of RTO participation, the questions posed in Appendix A to the Entry have been drafted with a bias towards quantitative analysis, implicitly suggesting that a monetary value can be identified for various functions derived for each RTO function, and if the sum total is positive, the analysis the Commission has been delegated to undertake by the legislature is complete. From IEU-Ohio's perspective, a broader analysis is necessary to answer the overarching question of whether continued RTO participation by Ohio utilities is in the public interest.

A CONDENSED VERSION OF RTO HISTORY

Utility regulation was initially introduced as a result of legislative determinations that competition, duplication of systems and unmanaged redundancy had to be eliminated for the benefit of customers.³ However, regulation is not a static concept. For example, Ohio did not geographically assign customers to electric suppliers until the

³ Statement of D. Bruce Mansfield on RCNLD (reproduction cost new less depreciation) before the Joint Select Committee on Energy, June 24, 1975 at page 4 (emphasis added). Mr. Mansfield was retained to speak on behalf of the investor-owned electric, gas and telephone utilities following his retirement as President of Ohio Edison Company.

mid-70s and Ohio has never geographically assigned natural gas customers to suppliers.

In broad concept, government commanded that public utility prices and service be regulated because unmanaged competition was not in the public interest. Over time, the scope of regulation has been specified and periodically re-specified to effectively reach the best outcomes for customers on prices, service quality, accounting, financing, issuance of securities, acquisition and disposition of properties, mergers and the withdrawal of service or facilities from public service. In other words, regulation was inspired by a search for the best outcome for customers.

The blueprint for the regulatory structure envisioned that "... the process of fixing reasonable rates requires the application of standards which will substitute for free competition - methods which will assure that the service provided be adequate and satisfactory and permit the price to approximate that which would result from unrestrained, free competition."⁴ The regulation of rates was and is regarded as a legislative function but it was not practical for the legislature to exercise this power itself. Thus, the introduction of regulation quickly resulted in the creation of commissions or agencies charged with specific duties and designed to hold and use special skills. Over the years, Ohio, other states and the federal government have struggled to find the methods and processes by which government regulation might "approximate that which would result from unrestrained, free competition."

Applying governmental regulation in ways that appropriately balance the interests of utilities and the public has not been an easy task. For example, during his

⁴ *Id.* at 6.

presidential campaign in 1932, Franklin Delano Roosevelt ("FDR") spoke often of the disconnection between the performance of private electric utilities and the public interest. In a Portland, Oregon speech on September 21, 1932, he said:

Speaking in the language of the Navy, with which I was associated for many eventful years, I want at the outset of this discussion to take my bearings, to know my destination, to chart my course. In discussing electrical power, the speaker, like a ship sailing in dangerous waters, must avoid not only unseen shoals and rocky reefs, he must also be on his guard against false lights on the shore. His only protection against all of these dangers is to set squarely and fairly before him the course that he must steer.⁵

He went on to describe the common law's concept of a public utility (quoting Lord Hale)⁶ and society's search for a means to assure that **services were "... satisfactory and cheap enough while ... making possible the safe investment of private capital."** President Roosevelt described the "... subtle, deliberate and unprincipled campaign ..."

⁵ The speech is available via the Internet at <http://newdeal.feri.org/texts/60.htm> (last visited April 14, 2009). In the Portland Speech, FDR also described his findings upon becoming Governor of the State of New York:

When I became Governor, I found that the Public Service Commission of the State of New York had adopted the unwarranted and unsound view that its sole function was to act as an arbitrator or a court of some kind between the public on the one side and the utility corporations on the other. I thereupon laid down a principle which created horror and havoc among the Insulls and other magnates of that type. I declared that the Public Service Commission is not a mere judicial body to act solely as umpire between complaining consumer or the complaining investor on the one hand, and the great public utility system on the other hand. I declared that, as the agent of the Legislature, the Public Service Commission had, and has, a definitely delegated authority and duty to act as the agent of the public themselves; that it is not a mere arbitrator as between the people and the public utilities, but was created for the purpose of seeing that the public utilities do two things: first, give adequate service; second, charge reasonable rates; that, in performing this function, it must act as agent of the public, upon its own initiative as well upon petition, to investigate the acts of public utilities relative to service and rates, and to enforce adequate service and reasonable rates.

⁶ "The greed and avarice of some of these ferry-boat owners were made known by an outraged people to the King himself, and he invited his great judge, Lord Hale [Sir Mathew Hale], to advise him. The old law Lord replied that the ferrymen's business was quite different from other business, that the ferry business was, in fact, vested with a public character, that to charge excessive rates was to set up obstacles to public use, and that the rendering of good service was a necessary and public responsibility. 'Every ferry', said Lord Hale, 'ought to be under a public regulation, to-wit: that it give attendance at due time, keep a boat in due order, and take but reasonable toll.'"

of “misinformation,” “propaganda” and “lies and falsehoods” “... bought and paid for by certain great private utility corporations” and his commitment to returning government to its position as a regulator driven proactively by the public interest.

History tells us that the search for the best means to make safe, adequate and reasonably priced utility services available to the public and gaining the benefits of private capital investment has been going on for several centuries. It also tells us that reported discoveries of the *true solution* are really discoveries of a solution that becomes unstable over time when exposed to change and when manipulated for unhealthy purposes.

The movement towards relying upon competition to discipline electricity prices can in some respects be traced to 1978 federal legislation that gave small producers of renewable power (solar, wind, geothermal, etc.) a guaranteed market with utilities.⁷ The latter were required to buy this power at the utilities’ avoided cost of generation, which represents the cost the utilities would have had to incur to provide generating capacity equivalent to that offered by the independent producer.

A second step along the way was taken in the Energy Policy Act of 1992, which gave FERC more effective authority (improving on a seldom-used grant in 1978) to order utilities to provide transmission service (wheeling) to all who demanded it and relaxed existing restrictions to permit growth of independent power producers (“IPPs”).

The specific origins of RTOs can be traced to the issuance in 1996 by FERC of Order 888, which required all jurisdictional utilities to publish nondiscriminatory open-access tariffs to be applied to other providers of electricity seeking to use their

⁷ Public Utility Regulatory Policies Act of 1978, Pub.L. 95-617, 92 Stat. 3117.

transmission systems. The order also required utilities to unbundle their transmission function from their generation function in the interest of effective competition. FERC's decision to advance Order 888 reflected both practical and legal judgments. Technological changes had resulted in continuing pressures by customers for changes in the way electricity was bought, sold, and transported. FERC concluded it was statutorily obligated under sections 205 and 206 of the Federal Power Act ("FPA") to remedy undue discrimination in access to and use of utility transmission systems. However, FERC also found that the potential benefits to consumers of lower electricity prices made its actions imperative:

The Commission estimates the potential quantitative benefits from the Final Rule will be approximately \$3.8 to \$5.4 billion per year of cost savings, in addition to the non-quantifiable benefits that include better use of existing assets and institutions, new market mechanisms, technical innovation, and less rate distortion. The continuing competitive changes in the industry and the prospect of these benefits to customers make it imperative that this Commission take the necessary steps within its jurisdiction to ensure that all wholesale buyers and sellers of electric energy can obtain non-discriminatory transmission access, that the transition to competition is orderly and fair, and that the integrity and reliability of our electricity infrastructure is maintained.

Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, 75 FERC ¶ 61,080 (1996) at 3. FERC viewed Order 888 as establishing a common carrier obligation on the use of jurisdictional electric utility transmission systems. Order 888 also introduced the concept of ISOs. FERC recognized that the mandatory open access requirements of Order 888 were only a part of a set of broader actions that would be necessary to ensure the full development of competitive markets. FERC envisioned that:

In particular, we believe that ISOs have great potential to assist us and the industry to help provide regional efficiencies, to facilitate economically efficient pricing, and, especially in the context of power pools, to remedy undue discrimination and mitigate market power.

Id.

Some parties commenting on FERC's draft rules urged the agency to take broader steps than functional unbundling to remedy discrimination, such as divestiture, or the mandatory transfer of the functional control of transmission facilities to ISOs. FERC was not persuaded that this degree of response was necessary at that time. For utilities other than those in tight power pools, FERC mandated functional unbundling of transmission but stopped short of imposing an ISO participation requirement. However, utilities in tight power pools (at that time New York Power Pool, New England Power Pool and the Pennsylvania-New Jersey-Maryland Interconnection) were required to form ISOs and have these independent entities assume operation of regional transmission facilities to comply with Order 888.

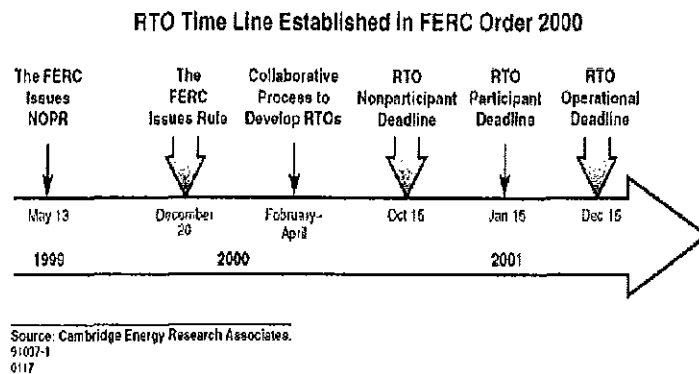
RTOs were the next step in FERC's ISO and common carrier evolution. In December 1999, FERC issued Order No. 2000 requiring investor-owned utilities to file with FERC, by October 2000, proposals for joining an RTO or an explanation of why the utility could not join such a regional organization.⁸ At the time, it appeared that FERC

⁸ FERC Order No. 2000 identified minimum characteristics and functions that RTOs must satisfy.

The four minimum characteristics are: Independence from Market Participants; Scope and Regional Configuration; Operational Authority; and Short-Term Reliability.

There are eight minimum RTO functions: (1) Administer its own tariff and employ a transmission pricing system that will promote efficient use and expansion of transmission and generation facilities; (2) create market mechanisms to manage transmission congestion; (3) develop and implement procedures to address parallel path flow issues; (4) serve as supplier of last resort for all ancillary services required in Order No. 888 and subsequent orders; (5) operate a single OASIS site for all transmission facilities under its control, with responsibility for independently calculating total transmission capability ("TTC") and available transmission capability ("ATC"); (6) monitor markets to identify design flaws and market power; (7) plan and coordinate necessary transmission additions and upgrades; and, (8) undertake interregional coordination.

was moving to make RTO participation mandatory and to take aggressive action to standardize commercial practices as well as reliability protocols.⁹ Indeed, FERC issued a schedule indicating that fully-functional RTOs would be in place and ready to perform their important responsibilities by December 15, 2001.



In our region, a lot of the expectations about how and when the all-important ISO/RTO would be put in place to remedy the anticompetitive structure of the electric industry and perform the critical reliability and market-enabling common carrier functions were focused on efforts to form MISO. These efforts began in 1997. Early discussions indicated that all of Ohio's investor-owned utilities would be meeting the FERC Order No. 2000 requirements by participating in MISO. However, and literally moments before the participation papers were to be filed with FERC, AEP¹⁰ and

⁹ For example, FERC used its review and approval authority over electric utility mergers to push participation in RTOs. In the order conditionally approving the formation of FirstEnergy, FERC said: "The Commission believes that FirstEnergy's full participation in a properly formed regional ISO is a practical approach to addressing the ... effects of the proposed merger. Therefore we expect FirstEnergy to participate in the Midwest ISO or another appropriate ISO. If applicants fail to participate in an ISO process, the Commission will use its [after the fact] authority under section 203(b) of the FPA to address our concerns." However, FERC ultimately determined the RTO participation pursuant to Order 2000 was a voluntary election by jurisdictional utilities.

¹⁰ This development occurred as Ohio was completing its effort to enact electric restructuring legislation. On May 27, 1999, AEP issued a press release announcing a FERC filing planned for the following week

FirstEnergy exited the MISO effort and went off, over the protests of many stakeholders, with other utilities to, supposedly, create a separate RTO called the Alliance RTO ("Alliance"). The Alliance effort subsequently inspired utilities that had become members of MISO to propose to exit MISO (subject to FERC's approval) and join the Alliance.

The announcement of efforts to establish a separate RTO within the Eastern Interconnection and more specifically our Midwest region set off a fierce reaction by many stakeholders and some state regulatory authorities.¹¹ For some time FERC seemed content to entertain the prospects of two competing RTOs with different business models, notwithstanding the fact that this was not rational from the standpoint of physically managing the regional transmission grid. However, not wanting to pick a winner between the MISO and Alliance proposals, FERC did what it usually does when

by AEP and four other Midwestern and southeastern electric utility companies. The press release is available via the Internet at <http://www.aep.com/newsroom/newsreleases/default.asp?dbcommand=displayrelease&ID=577>. AEP said the filing would fulfill a merger-related commitment AEP made to the FERC trial staff.

'AEP has been a proponent for the creation of large, independent RTOs,' said J. Craig Baker, AEP vice president - transmission policy. In a settlement earlier this week relating to our pending merger with Central and South West Corporation (NYSE: CSR), AEP made a commitment to the Federal Energy Regulatory Commission trial staff that prior to the completion of the merger we would begin the process to relinquish control of our transmission system. 'The Alliance filing will fulfill our commitment to the FERC trial staff,' Baker said. 'It is a significant commitment on our part and a significant step toward reshaping our industry for the future competitive marketplace.'

On March 15, 2000, FERC conditionally authorized the proposed merger between AEP and Central and South West Corporation ("CSW"). The FERC conditions included AEP transferring operational control of its transmission facilities to a fully-functioning, FERC-approved RTO by December 15, 2001, the date specified in FERC's RTO Final Rule for RTO formation.

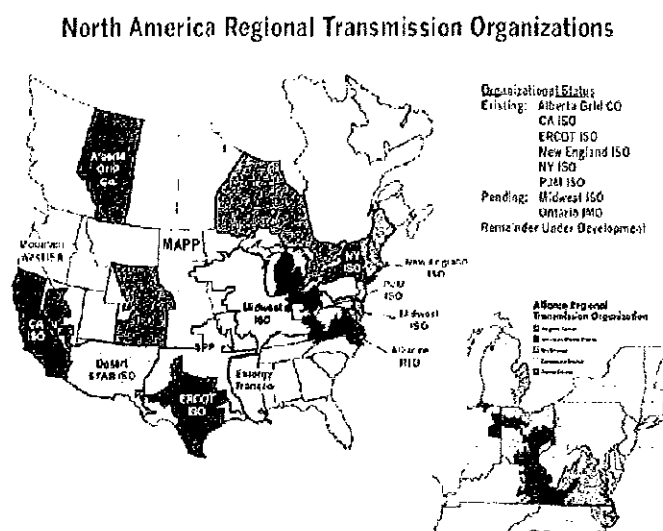
¹¹ Whenever there is more than one RTO within an interconnected area, "seams" issues arise. While there is no official definition of this term, commentators have noted two types of seams issues: reliability practices across seams and market practices across seams. Seams are eliminated when there are, for example, coordinated operations and consistent methods of access, pricing, and congestion management. In addition to seams relating to operations, seams can develop in ways that are less obvious but no less important to the efficient and reliable functioning of the wholesale power markets. Differences between RTOs over governance structures, stakeholder involvement and incentive structures (such as incentives relating to the construction of transmission facilities) also can be impediments to trade.

it is confronted by difficult circumstances; it set up a settlement conference hoping that the warring parties would be able to fashion a compromise that would allow FERC to avoid making a hard decision. FERC ordered the MISO and Alliance Companies to enter into settlement discussions to address seams issues, whether that meant becoming one RTO or creating some other way for the two entities with their differing business models to coexist in the Midwest.

Ohio Commissioners and Staff were directly involved as an interested party in those settlement discussions that resulted in the "Settlement Agreement Involving the Midwest Independent Transmission System Operator, Inc., Certain Transmission Owners in the Midwest ISO, the Alliance Companies and Other Parties" ("Settlement Agreement") and the accompanying Inter-RTO Cooperation Agreement ("IRCA") between MISO and the Alliance Companies in FERC Docket Nos. ER01-123-000, *et al.* The IRCA, attached to the Settlement Agreement as Attachment A, specifically committed MISO and the Alliance Companies to coordinate activities for transmission and transmission-related services so that the regions would be able to operate as a seamless market. See Settlement Agreement at 2. The Settlement Agreement, including the IRCA seams resolution, was approved by FERC in May 2001.

Unfortunately, the IRCA began facing implementation issues as a result of inadequate stakeholder input/communication, differences of opinion between the parties, and FERC actions. Following the approval of the Settlement Agreement, MISO and the Alliance Companies began developing protocols and procedures to address the interregional coordination issues without effective stakeholder input. When the resulting agreements were presented to stakeholders, it became apparent that less than ideal

resolutions were reached. It was also evident that the two entities had different interpretations of the intent of the Settlement Agreement, thereby protracting negotiations. In addition, as progress was made, albeit slow, FERC issued an order on July 12, 2001, indicating that the Alliance was not an independent entity, and it was required to cease any critical decision-making activities until it became independent. This impeded any further development of IRCA implementation and RTO development in the Midwest remained fragmented.



Soon after, the Alliance filed a proposed business plan with FERC requesting that National Grid ("NG") be approved as its independent managing member. However, FERC was not satisfied that NG was truly independent and thus, delayed its decision to put NG in an attainable business position, which effectively stalled IRCA implementation.

In November 2001, FERC issued a set of questions to Midwest state commissioners regarding RTO development in the Midwest. In its response to FERC, the PUCO continued to support the Settlement Agreement, believing that it was a

meaningful platform upon which different RTO business models could operate seamlessly in the Midwest. The PUCO recognized that IRCA implementation had been problematic and urged FERC to take immediate action to settle the IRCA implementation issues.

Although FERC had initially approved the Alliance Companies' development plan, it concluded in December 2001 that the Alliance RTO lacked sufficient geographic scope to exist as a stand-alone entity. See *Alliance Cos.*, 97 F.E.R.C. ¶ 61,327, 62,529-30 (2001). However, rather than directing the Alliance Companies to join MISO, FERC instead directed them to explore whether their distinct business plan (as a for-profit transmission company) could be integrated in MISO.

FERC's December 2001 decision to once again punt on some of the hard RTO choices before it did little to end the game of RTO musical chairs plaguing the Midwest. As part of the very muddled FERC process described above, the PUCO filed comments¹² with FERC on March 22, 2002 (more than 15 months after Ohio's electric restructuring law went into effect and more than 3 months after FERC's December 15, 2001 deadline for operational RTOs). The PUCO's March 22, 2002 comments include the following statements:

The Public Utilities Commission of Ohio ("PUCO" or "Ohio Commission") respectfully submits the following comments regarding the Federal Energy Regulatory Commission's (the "Commission") December 20, 2001 Order and resulting negotiations between the Midwest Independent System Operator (MISO) and the Alliance Companies (Alliance). The Order required the Alliance Companies to explore whether their business plan could be accommodated with the MISO or an alternate RTO umbrella. It currently appears those negotiations have broken down without resolution. The effect on Ohio is both disconcerting and troublesome in that the state could again be faced with unregulated monopolies. Our unusual situation

¹² In FERC Docket No. EL02-65-000.

compels us to file these comments along with proposed resolution of the issues.

Ohio's Unique Situation

Ohio is in an unusual and perhaps unique position in the matter of recognizing the impact of the similarities and differences in the characteristics and functions of RTOs and ITCs. Ohio is in fact a "bridge" state between a newly-established, very large RTO, MISO, and an equally large proposed ITC [independent transmission company], Alliance, while also having a literal "toehold" in the proposed "western" extension of yet a third well-established transmission operator, PJM, that boasts a history and tradition reaching back more than 75 years. As proposed, the majority of Ohio's utilities would be part of the Alliance. Thus, the final outcome of where the Alliance falls out in the realm of RTOs is vitally important to the State of Ohio.

A Seamless Market is Needed

FERC deregulated the wholesale generation industry in recognition of a viable competitive market. In reliance upon the Commission's commitment to a competitive market, Ohio followed suit in restructuring the retail electric utility industry. Ohio began retail competition on January 1, 2001, and for Ohio to truly become a viable retail market place, the wholesale market needs to be viable as well. Without true separation between generation and operational control of the transmission system, vertically integrated monopolies would stay as such, and those states that chose the path of a competitive generation market will realize a result of unregulated monopolies. Therefore, the PUCO is very anxious to assist functional RTOs in becoming operational in the near future.

Ohio's state laws and the PUCO support the development of regional transmission entities, but are indifferent as to the number of regional transmission entities required to provide a seamless market. The State's electric industry restructuring legislation, signed into law July 6, 1999, by Governor Bob Taft, not only permitted retail electric competition, but required entities that owned or controlled transmission assets to transfer control of those facilities to one or more qualifying transmission entities approved by the Federal Energy Regulatory Commission. Ohio law specified that the regional transmission entities implement, to the extent reasonably possible, policies and procedures designed to minimize pancaked transmission rates within Ohio. Ohio's law also mandated that a regional transmission entity be of sufficient scope or otherwise operate to substantially increase economical supply options for consumers. Ohio Revised Code Section 4928.12.

Ohio's geographical location in the Eastern Interconnection system positions the state to have a large stake in supporting a "seamless" wholesale bulk power market from Midwest to Mid-Atlantic, being caught, as it were, "in the seams." Ohio has less concern regarding the number of RTOs or ITCs that it may take to provide this seamless market. For that reason, the PUCO supports as much coordination and cooperation as possible among neighboring regional entities, whether RTOs or ITCs. Therefore, the PUCO is a strong proponent of a seamless market in the Midwest to ensure that effective wholesale competition in our region and effective retail competition in our state will succeed. While we wish to accommodate various business models, such as for-profit and not-for profit RTOs in the same region, a seamless Midwest marketplace is our priority.

A few weeks prior to the PUCO's comments quoted above, several other state regulatory agencies made their views about the Alliance more plainly known to FERC.

Their March 6, 2002 letter stated as follows:

The Kentucky Public Service Commission, State of Michigan, Michigan Public Service Commission and Illinois Commerce Commission ("State Commissions") submit this letter to the Federal Energy Regulatory Commission ("FERC" or "Commission") in response to the letter report filed by the Alliance Companies ("Alliance") in Docket No. RT01-88-000, et al., on February 19, 2002. The State Commissions write this letter to voice our concerns, similar to those articulated by the Midwest ISO (MISO) and by stakeholders of both MISO and Alliance, that further guidance and direction from the Commission to Alliance unfortunately appears necessary to move the RTO formation process forward.

The heart of the problem is reflected in a few passages from the Alliance letter report. In its report Alliance asserts that it had negotiated an agreement in principle with Midwest ISO, only to be 'dismayed' to learn, days before its February 19 report was due, that Midwest ISO could no longer support the agreement because of the 'unexplained' opposition of Midwest ISO's stakeholders (Alliance Letter Report at 8-9), a group it characterizes as 'an intractable obstacle to achieving the reasonable and equitable arrangements necessary to accommodate Alliance Gridco.' *Id.* at 14.

These remarks are, regrettably, symptomatic of a continuing, twofold problem in the Alliance relationship with stakeholders. The State Commissions have pointed out on numerous occasions that Alliance has taken neither the steps needed to ensure Alliance GridCo's independence from transmission owners nor its willingness to develop a meaningful

stakeholder process. Alliance and MISO stakeholders are, to a large extent, one and the same group. The *only* reason that MISO stakeholder objections to Alliance's 'agreement' with MISO would have remained 'unexplained' is that Alliance, in contrast to MISO, chose not to consult those same stakeholders about its plans.

State Commissions agree with the views expressed in the responses of MISO and the stakeholders in their respective letters of February 25 and 27 that stakeholders are not an 'intractable obstacle,' but an essential part of the process that will lead to integration of the Alliance transmission grid into a single Midwest RTO -- MISO. Accordingly, State Commissions urge the Commission to send a message to Alliance: If it is not clear from the December 19 Order already, the Alliance Companies have two options for participation in MISO -- they can join as individual transmission owners or they can seek qualification as a Transco under the terms of Appendix I. If they choose the latter option, because it is closer to their 'business model,' but cannot assure through National Grid the Transco's independence within a reasonable period, then, as stakeholders suggest, the individual Alliance companies should, in the interim, join MISO as transmission owners. The bottom line, as Kentucky Public Service Commissioner Gillis stated on behalf of the State Commissions, is that Alliance participate in MISO so as to end rate pancaking and form a seamless market:

The states have worked for a long time now, in many different forums, to develop a consistent regulatory framework for the Midwest that resulted in a seamless market.

We have been involved in the advisory committee and its many sub-committee work groups, and will continue to do so.

My comments now, however, are not made as one of many stakeholders. Rather, I make these comments representing state regulators who have higher statutory obligations to the public interest.

Any negotiations, with the Alliance Companies, National Grid, or any future entity, should not negotiate away what has already been established by FERC or the states. Any settlement that results in creating seams rather than eliminating them is a non-starter. Any settlements that result in pancaking of rates are a non-starter. Our message to both the MISO and the Alliance Companies is to urge them to continue to negotiate in good faith. We should recognize the parameters of the reality of what has already been laid

out by the FERC orders, as a minimum. The time to make the hard choices is now, and we urge both parties to conclude these discussions and get the much need certainty into the Midwest markets.

MISO seems to have taken Commissioner Gillis's words to heart. Alliance has not.

On April 25, 2002, FERC responded to this request for further guidance by issuing an order requiring the Alliance Companies to make a definitive decision on RTO participation within 60 days. As a result of this directive, some companies (including AEP) elected to pursue membership in PJM, while others (including FirstEnergy) elected to become members of MISO. The resulting ragged physical seam between the MISO and PJM border that would result from these elections made little sense. However, to address these concerns, MISO and PJM committed to undertake development of a single common market that would span the combined RTO regions and be fully operational by 2005. Based on and conditioned upon these commitments, FERC blessed the RTO elections of the Alliance Companies on July 31, 2002.

FERC's blessing did not end the RTO saga, as the agency's decision did not sit well with some state commissions. Several state commissions, fearing FERC's RTO decision would degrade reliability and increase costs to customers in their states, initiated proceedings to determine whether they would allow utilities in their states to transfer functional control of their assets to either MISO or PJM. The states of Virginia and Kentucky actively resisted AEP's election to become a member of PJM. The dispute over AEP's RTO election was ultimately resolved through a settlement that allowed AEP to join PJM. However, the settlement was prompted in part by FERC threatening to invoke federal preemption over AEP's RTO election.

The delay in resolving AEP's RTO election also delayed several other utilities from joining PJM as their transmission systems were not electrically contiguous to PJM in the absence of AEP. Ultimately, AEP and other utilities were integrated into PJM in early 2004, nearly six years after AEP withdrew at the 11th hour from commitments to participate in MISO.

Although the RTO elections of the Alliance Companies were conditioned upon MISO and PJM implementing a single common market by 2005, their willingness to pursue this effort waned quickly. After several skirmishes at FERC that attempted to define what a single market should look like, FERC signaled it did not intend to hold the RTOs to their prior commitment to implement a single common market.¹³ Today,

¹³ In November 2005 and January 2006, several parties filed a complaint at FERC alleging that MISO and PJM had effectively abandoned their commitment to implement a single common market. In March 2006, FERC dismissed the complaint as premature, based upon a representation by MISO and PJM that they were still studying what initiatives to undertake. A second complaint was filed in August 2006 making similar allegations. In February 2007, FERC dismissed the complaint and terminated further single market progress reports by MISO and PJM:

The complaint requests that the Commission direct the RTOs to promptly institute joint unit commitment and single system dispatch as part of their obligation to create a functional joint and common market encompassing the entire Midwest ISO and PJM footprints. WPS Companies allege that the RTOs' production cost study, which was filed as part of a report to the Commission on the status of their implementation of the joint and common market, shows that the RTOs should be required to implement a single system dispatch system as part of their obligation to establish a joint and common market.

This order dismisses the complaint because the record provided does not establish that, at this time, the current tariffs and systems of the RTOs are unjust and unreasonable without implementation of a single-dispatch system. The RTOs have made many improvements to their systems to address seams issues and pricing disparities between their systems, and have committed to further analysis of possible future improvements. Given the potential cost of trying to establish a single system dispatch, we cannot find that such a system is necessary to resolve seams issues that may still remain. In addition, this order revisits the reporting requirements regarding the RTOs' joint and common market obligations and terminates those requirements.

Wisconsin Public Service Corp. et al, v. Midwest Independent Transmission System Operator, Inc. and PJM Interconnection, L.L.C., 118 FERC ¶ 61,089 (February 8, 2007) at PP 2-3.

although the RTOs engage in extensive regional coordination, there are no plans to pursue a single common market.

Against this RTO backdrop painted by FERC, the PUCO was tasked with the prospect of implementing Ohio's electric restructuring legislation, Amended Substitute Senate Bill 3 ("SB 3").

SB 3 relied significantly upon RTOs (called regional transmission entities in the Ohio legislation) to break down barriers in the bulk power market and improve service or price outcomes for customers. In Section 4928.12, Revised Code, the General Assembly required that, as of January 1, 2001, each entity that owns or controls transmission facilities as defined by federal law must transfer control of such facilities to an operational regional transmission entity meeting the specifications in Section 4928.12(B), Revised Code. The PUCO was given ample authority and guidance to ensure that this important part of the restructuring puzzle was put in place for the benefit of Ohio's retail electric customers. Perhaps as a result of FERC's missteps and failures to deliver on the expectations FERC created, the PUCO deferred addressing regional transmission entity issues in 2000, when it addressed Ohio utilities' transition plans. In any event, and to this date, the important RTO-related requirements of SB 3 remain unfinished.

FERC AND MARKET-BASED RATES

While the wholesale market in electricity is open to commerce as a matter of law, the transition to effective competition in the wholesale market has been slow and muddled. Many retail markets are not open to competition although, at one time, some 24 states, including Ohio, had modified their laws and regulations to do so.

Under the FPA, wholesale electric rates must be “just and reasonable.” Historically, this statutory requirement was met through active, cost-of-service rate regulation by FERC. However, for almost 15 years, FERC has been pursuing a variety of activities that it commenced after it determined in 1995 that the electric utility industry’s structure was anticompetitive. As discussed further herein, this evolution has included the RTOs, such as MISO and PJM. RTOs were originally intended to provide more efficient and better coordinated transmission grid planning, coordination and reliability. Over time, RTOs have evolved into broader roles, operating regional energy markets (“organized markets”) for day-ahead energy, real-time electric energy, electric generation capacity and associated “ancillary” services. This process began shortly after FERC issued Order 888.

Soon after FERC required tight power pools to transfer control of transmission facilities to ISOs, some parties advocated that FERC needed to take broader steps in restructuring the industry. They argued that it was impossible to distinguish the functions necessary to maintain real-time reliability of the grid with the rules for the operation of commercial markets. They urged FERC to require ISOs to operate centralized markets with responsibilities for dispatching generation suppliers to meet demand. For example, in the early stages of these policy considerations, Dr. William W. Hogan¹⁴ urged FERC to require ISOs to operate centrally dispatched power markets that relied upon the use of LMP:

The process of restructuring wholesale electricity markets in the United States has added to the extensive worldwide debate about the range of possible and preferred alternatives for organizing regional electricity

¹⁴ At that time, Dr. Hogan was the Lucius N. Littauer Professor of Public Policy and Administration, John F. Kennedy School of Government, Harvard University and Principal of the Law and Economics Consulting Group.

markets. Given the highly interconnected network, it is clear that some aggregation to regional transmission organizations would be necessary. The issues raised are important, but the discussion has tended to focus on ownership and governance questions. These can distract from the more difficult but, in the long run, more fundamental consideration of the rules for market operations within and across regions in network systems.

A critical summary of the institutional debate and issues provides the context for a review of the market rules that can support a competitive electricity market.

Policy for the continuing evolution of electricity restructuring should emphasize the institutions for market operations. Interconnections through the transmission grid create the necessity for regional organizations that can accommodate competition in services, generation, and contracting while preserving the reliability of the transmission system. Alternative models are many, but can be grouped under the general headings of "Transcos," "Gridcos," "ISO/PX," "ISOs," and finally, organizations for transmission loading relief. The different models present alternatives for the mix of responsibility of the necessary system operator. At one end of the spectrum, a Transco is an independent entity both owning the transmission assets and controlling system operations. By contrast, a Gridco is an entity owning the transmission assets but not responsible for system operations. System operations may be separated into a power exchange (PX) and transmission operations, or combined under an independent system operator (ISO). And finally, whatever regional choices are made, there must be institutions for coordinating transmission loading relief (TLR) across the regions.

The developing experiences around the world provide insight into the options and implications of alternative models. Comparison of these models also provides further information about some of the details of market operations. It is apparent from this experience that there must be a close connection between the design of options for market flexibility and the pricing principles for use of the transmission grid. If prices closely reflect operating conditions and marginal costs, then market participants can have numerous choices in the way they use the transmission system. However, if pricing does not conform to the operating conditions, then substantial operating restrictions must be imposed to preserve system reliability. Customer flexibility and choice require efficient pricing; inefficient pricing necessarily limits market flexibility.

Examples of failure and success illustrate the close connection between pricing provisions and operating rules. Events from markets as diverse as California, Australia, England and Wales, the New England Power Pool (NEPOOL), and the Pennsylvania-New Jersey-Maryland Interconnection

(PJM) illuminate the basic point. The conclusion supports the integrated independent system operator (ISO), de jure on its own or de facto within a larger transmission organization, with locational marginal cost pricing rules, as the model most likely to be successful in supporting competitive markets with customer choices while preserving system reliability.

Restructuring the Electricity Market: Institutions for Network Systems, William W. Hogan (April 1999).¹⁵

By the time FERC issued Order 2000, it was evident that these arguments held some sway with FERC. As previously noted, one of the eight minimum functions FERC required RTOs to provide was market mechanisms to manage transmission congestion. Although FERC allowed some system operators (California) to initially employ non-nodal transmission congestion management options, these fell out of favor quickly and were also implicated in contributing to market manipulation activities by power marketers such as Enron. Over time, management of transmission congestion based upon the use of LMP to perform system dispatch in RTO markets became the *de facto* FERC standard.

FERC, electricity generators and RTOs themselves continued to push for expansion of grid operators into market makers, not only operating markets for electricity but tacking on capacity, ancillary services and other markets. Many RTOs share market features that are common; most operate two markets for the purchase and sale of electricity: a day-ahead and a real-time market. The day-ahead market calculates hourly prices for energy over the course of the next day based on projected customer needs and the prices offered by suppliers. In real time, the RTO instructs generation owners to provide sufficient electricity to meet the customers' actual

¹⁵ Copies of this publication are available on the Harvard Electricity Policy Group website at: http://www.hks.harvard.edu/hepg/rlib_rp_competitive_models.html (last accessed April 16, 2009).

demands for electricity over the course of the day. These spot markets have, in many cases, displaced long-term contracts as a means of selling wholesale power.

There are two key attributes of these RTO-run markets: the ability of generators to sell electricity at “market-based” rates and the use of a single-clearing price auction to establish the market price. First, FERC has given electricity generators the authority to sell at whatever price the market will bear (subject only to the price caps and market power mitigation regime of the RTO), under a finding that market power was sufficiently mitigated to protect consumers (i.e., keep rates “just and reasonable” and ensure adequate supplies). Second, under the single-clearing price method, all sellers earn the price paid to seller of the last increment of power needed to clear the market.

Through a highly controversial rulemaking proceeding in 2002, FERC attempted to require the formation of these organized power markets similar to those in place within RTOs in every region of the country – a proposal known as SMD. The timing of FERC's initiative was somewhat odd given that it was on the heels of the so-called western power market crisis of 2000-2001. During this period, prices in California spiked to over \$3,000 per MWH and remained persistently high (in the several hundred dollars per MWH range) after trading historically in the range of \$50 per MWH. The state even experienced several rolling blackouts. The price spikes were not limited to California, and had spillover effects throughout the western interconnection. The initial response by FERC to this crisis was fairly limited and reflected tweaks to the market rules in place within the California ISO. Evidence was presented to FERC that some companies, such as Enron, had engaged in extensive efforts to manipulate the market for their financial gain. Manipulation strategies were employed by energy traders and

the trading strategies were discussed under names such as "Fat Boy", "Death Star"¹⁶, "Forney Perpetual Loop", "Ricochet", "Ping Pong", "Black Widow", "Big Foot", "Red Congo", "Cong Catcher" and "Get Shorty". Under the face of mounting evidence of manipulation, FERC eventually stepped in and ordered refunds. The mess of who owes what to whom is still being sorted out.

Perhaps enlightened or frightened by FERC's handling of the western power crisis, FERC's SMD proposal prompted a strong political backlash from Congress and others. FERC retreated and subsequently withdrew its SMD proposal. However, in existing RTOs, it encouraged, with support from the RTOs themselves, both expansion of the number of markets operated by RTOs and required significant changes to the structure of existing markets. Many of these changes are viewed by consumers and state regulators as serving to increase wholesale electricity prices. For example, PJM's introduction of its reliability pricing model ("RPM") in 2005 was universally criticized by consumers, state regulators and public power authorities as unnecessary and likely to lead to higher electricity prices for ultimate customers.

Throughout this time, FERC has made determinations (chanted) that market forces could better serve the public interest than traditional rate regulation, and that customers would see lower prices, better service and innovation as a result of RTO-run

¹⁶ The Death Star strategy was the name Enron gave to its practice of shuffling energy around the California power grid to receive payments from the state for "relieving congestion." According to the company's internal documents, it would be paid for moving energy to relieve congestion, without actually moving any energy or relieving any congestion.

For example, if the California power grid was congested with energy flowing south, Enron would schedule energy to be transmitted north to Oregon. It would receive a payment from California for apparently relieving congestion on the grid. Then Enron would schedule the energy to be transferred back to its point of origin, but not through California. Ultimately, the energy would end up right back where it started, and Enron would be paid by California without actually putting any electricity on the grid.

energy markets. However, FERC's determinations have not been based upon empirical findings or supported by quantitative evidence. FERC's faith-based regulatory approach, which reflects an institutional bias toward approaches rather than outcomes, has not served the public interest particularly well. FERC's regulatory choices are substantially similar to the *laissez faire* approach to our Nation's regulation of financial institutions over the last decade, an approach that has pushed us into a global financial crisis.

In the absence of empirical analysis by FERC, others have stepped forward to fill the void and attempt to answer the question of whether RTO markets are providing consumer benefits. In 2006, the American Public Power Association ("APPA") established the Electric Market Reform initiative ("EMRI"). The initial purpose of EMRI was to assess, and then address, the pervasive and increasingly serious problems in the nation's wholesale electricity markets, particularly the FERC-approved, RTO-run markets. The assessment phase involved the commissioning of a series of research and analytical studies to gather more information about wholesale market operations and impacts.

APPA members and others, including various groups of large industrial customers, pointed to specific subjects and issues that warranted closer investigation, and raised questions about certain assumptions and assertions that are often made in support of the current markets, but without supporting data or rigorous examination.

The results of the initial EMRI studies were released in February 2007. The studies painted a very disturbing picture of RTO markets and the state of competition in these markets. There were a number of studies prior to 2007 attempting to examine

whether RTO markets benefit consumers. Part of the initial EMRI assessment was to examine whether the previous analyses employed valid methodologies to reach their conclusions. EMRI commissioned a study entitled "*Restructuring the U.S. Power Sector: Review of Recent Studies*," by John Kwoka, The Neal F. Finnegan Distinguished Professor of Economics at Northeastern University.¹⁷ He reviewed the major studies published at that time that attempted to evaluate whether the restructuring of the wholesale and retail electricity markets had provided net benefits to consumers. Dr. Kwoka found that the methodologies used by these studies fell short of the standards necessary for good economic research. Because of these deficiencies, Dr. Kwoka concluded that "despite much advocacy, there is no reliable and convincing evidence that consumers are better off as a result of the restructuring of the U.S. electric power industry."¹⁸

Further analysis commissioned by EMRI was intended to address recent claims that increasing prices being experienced in RTO markets was attributable to a large extent by increases in fuel prices. EMRI commissioned Dr. Ken Rose of the Public Utilities Institute at Michigan State University to test this thesis. Dr. Rose's findings from his study, *The Impact of Fuel Costs on Electric Power Prices*,¹⁹ were that data on natural gas costs and spot-market price trends show that fuel costs cannot fully explain the increase in wholesale electricity prices and that "simply attributing electricity price

¹⁷ A copy of the complete study is available at: <http://www.appanet.org/files/PDFs/RestructuringStudyKwoka1.pdf> (last accessed April 16, 2009)("Kwoka Study").

¹⁸ Kwoka Study at 82.

¹⁹ A copy of the complete study is available at: <http://www.appanet.org/files/PDFs/ImpactofFuelCostsonElectricPowerPrices.pdf> (last accessed April 16, 2009)("Rose Study").

increases to only the cost of fuels used to generate electricity is overly simplistic at best.”²⁰

Dr. Rose also appeared before the Public Utilities Committee of the Ohio House of Representatives on February 5, 2008 during its consideration of Am. Sub. SB 221, to offer his insights into how electricity restructuring was faring. His key conclusions included:

Since the California and Western power crisis of 2000 and 2001, the momentum has shifted away from states adopting retail access. At this time, a total of 35 states have repealed, delayed, suspended or limited retail access to just large customers, or are no longer considering retail access. Six states have altered their restructuring laws in the last two years and several other states are considering changes.

Ohio is a special place, but it is not immune to the law of unintended consequences or the economic realities of market conditions that do not favor the development of robust retail markets.

These unintended consequences have been severe in other states, including Connecticut, Delaware, Illinois, Maryland, and Montana. These should be taken into account when considering any future course of action for Ohio.

It was generally widely expected that retail customers' prices would decrease, or at least be lower than they would have been under continued regulations. Based on EIA data, the evidence suggests that, at least so far, no discernable price benefit can be seen for customers in restructured states once the rate caps have expired. Moreover, the evidence now suggests that prices for customers in restructured states are actually increasing faster than for customers in states that did not restructure.

The costs incurred to serve retail customers' "full requirements" service has been greater than expected when retail markets began. This is from some higher-than-expected costs for some items (energy, for example) and from the additional unexpected costs.

In 2008, Congress requested that the GAO conduct its own review of RTOs and FERC's oversight. GAO was asked to review: (1) RTO expenses and key investments

²⁰ Rose Study, Executive Summary at i.

in property, plant, and equipment from 2002 to 2006, the most current data available; (2) *how RTOs and FERC review RTO expenses and decisions that may affect electricity prices*; and (3) the extent to which there is consensus about RTO benefits.

On the issue of RTO benefits to consumers, GAO came to conclusions similar to those of John Kwoka. GAO found that:

FERC officials, industry participants, and experts lack consensus on whether RTOs have brought benefits to their regions that outweigh their costs. Many agree that by integrating multiple transmission systems into larger service areas, RTOs provide opportunities for certain benefits, such as more efficient management of the transmission grid and improved generator access to electricity markets, but some believe that these benefits could have been achieved without RTOs. Many experts and industry participants agree that RTOs are better positioned to more frequently use the least costly and most efficient power plants, although they do not agree about whether this has translated into prices for consumers that are lower than they otherwise would have been. Experts and industry participants are divided about whether the markets developed and administered by RTOs provide benefits to consumers and how they have influenced consumer electricity prices. Specifically, advocates and critics of RTOs debate the extent to which RTO markets, rising fuel prices, and other factors have contributed to rising costs of electricity generation and generally higher prices in RTO regions. Assessments developed by RTOs generally find that RTOs benefit their regions. FERC officials also believe that RTOs have resulted in net benefits to the economy, such as new efficiencies in operating the regional transmission grid; however, FERC has not conducted an empirical analysis of whether RTOs achieved the benefits expected of them or developed a comprehensive set of publicly available, standardized measures to help evaluate such performance. GAO's Standards for Internal Control identify the value to organizations of comparing actual performance to planned or expected results; however, according to FERC, neither an empirical analysis nor performance measures are necessary parts of FERC oversight of RTOs and both would be methodologically challenging to develop.

Experts agreed that a onetime empirical analysis of RTO performance would be difficult but added that tracking certain measures of RTO success—for example, measures relating to transmission and generation investment, plant efficiency, and reliability—could encourage better RTO performance and potentially identify areas for improvement. Without such measures, FERC will remain unable to demonstrate the extent to which

RTOs have provided consumers and others with benefits—information that could aid FERC in its evaluation of the success of its decision to encourage the creation of RTOs. Furthermore, information gleaned from such measures could help FERC address the divisions among experts and industry participants about the benefits of RTOs.

FERC Could Take Additional Steps to Analyze Regional Transmission Organizations' Benefits and Performance, GAO-08-987, a report to the Committee on Homeland Security and Governmental Affairs, U.S. Senate (September 2008) at 7-8 (footnotes omitted). GAO also characterized the electricity markets operated by RTOs as complex.²¹ GAO also found that FERC had not conducted any empirical analysis to identify if RTO markets were producing benefits.²²

FERC has not conducted an empirical analysis to measure whether RTOs have achieved these expected benefits or how RTOs or restructuring efforts more generally have affected consumer electricity prices, costs of production, or infrastructure investment. FERC believes data exist to support its conclusion that RTOs have provided benefits—for example, data illustrating changes in generating capacity in RTO regions and data about the number of transmission interruptions used by system operators to address congestion. However, FERC has not used these or other available data to analyze whether RTOs have produced benefits. Furthermore, FERC has not reexamined its prospective estimate of the benefits RTOs were expected to produce—estimated in 1999 at \$2.4 billion annually in cost savings—to determine whether these expected benefits are actually being realized or how actual outcomes have differed from original estimates.

GAO recommended that FERC develop an approach for regularly reviewing RTO budgets and annual financial reports, and develop and report on standardized measures that track RTOs' performance. FERC generally agreed with GAO's report and recommendations, but to date has not initiated any formal activity in response to GAO's recommendations.

²¹ *Id.* at 61.

²² *Id.* at 55.

Faced with rising electricity prices and the belief that organized RTO markets are contributing to the run-up in electricity prices, customers, both individually and collectively, have repeatedly requested (begged) FERC to take action to address root cause problems. On June 22, 2007, FERC issued an Advanced Notice of Proposed Rulemaking ("ANOPR") indicating FERC planned to undertake a formal review of the organized power markets operated by RTOs. However, rather than undertaking a comprehensive assessment, the ANOPR indicated FERC's review would reflect a narrow focus and be limited to four issues: demand response and pricing during power shortages, long-term power contracting, market monitoring policies and information sharing, and responsiveness of RTOs and ISOs. In both written and verbal comments, numerous consumer representatives urged FERC to expand the scope of its inquiry. In fact, on December 17, 2007, forty-one consumer advocacy, business, and public power organizations formally requested that FERC initiate an investigation into whether RTO wholesale electricity markets were producing unjust and unreasonable wholesale power prices.²³

²³ The organizations formally requesting FERC initiate the review included AARP, American Antitrust Institute, American Chemistry Council, American Forest & Paper Association, American Iron and Steel Institute, American Municipal Power—Ohio, American Public Power Association, Association of Businesses Advocating Tariff Equity, Citizen Power, Citizens Utility Board of Illinois, Coalition of Midwest Transmission Customers, Colorado Office of Consumer Counsel, Consumer Federation of America, Council of Industrial Boiler Owners, Democracy and Regulation, Electricity Consumers Resource Council, Florida Industrial Power Users Group, Illinois Industrial Energy Consumers, Illinois Public Interest Research Group, Industrial Energy Consumers of America, Industrial Energy Consumers of Pennsylvania, Industrial Energy Users—Ohio, Louisiana Industrial Users Group, Maryland Office of the People's Counsel, Maryland Public Interest Research Group, Missouri Industrial Energy Consumers, National Association of State Utility Consumer Advocates, NEPOOL Industrial Customer Coalition, Office of the People's Counsel of the District of Columbia, Ohio Hospital Association, Ohio Manufacturers' Association, Ohio Partners for Affordable Energy, PJM Industrial Customer Coalition, Portland Cement Association, Power in the Public Interest, Public Citizen, Inc., Public Utility Law Project of New York, Inc., Steel Manufacturers Association, West Virginia Energy Users Group, Wisconsin Industrial Energy Group, Inc., and Wisconsin Paper Council.

While acknowledging these concerns, FERC initially declined to undertake a more comprehensive review, suggesting it was not possible to undertake such a review and still respect regional differences between RTO markets. On October 16, 2008, on the heels of the issuance of the GAO report critiquing FERC and its inability to quantify RTO benefits, FERC issued a final rule limited to the four issues identified in its initial ANOPR, and declined to undertake any systematic review of RTO prices and their impacts on ultimate customers.²⁴

Former President Ronald Reagan had a favorite phrase he used quite often – “trust, but verify.”²⁵ In the case of FERC, a more appropriate catch phrase could be “ignorance is bliss.” Throughout the past fifteen years, FERC’s approach to regulating

²⁴ FERC’s unwillingness to take a hard look at the impacts RTO markets are having on retail customers is not limited to its rulemaking. As previously noted, the western electricity crisis had its roots in actions by some participants to manipulate the market. More recent examples demonstrate a continued unwillingness by FERC to investigate whether market manipulation is affecting RTO prices.

On May 19, 2008, FERC issued an Order Approving Stipulation and Consent Agreement, closing a non public investigation into bidding practices by Edison Mission Energy, *et al.* *In re Edison Mission*, 123 FERC ¶ 61,170 (May 19, 2008). The order was the outcome of FERC’s Office of Enforcement conducting a non-public investigation pursuant to Part 1b of the Commission’s regulations (Part 1b investigation), 18 C.F.R. Part 1b, into the behavior of certain Edison Mission entities in PJM Interconnection, LLC (PJM). These entities own and operate generation units that are designated as capacity resources pursuant to the PJM tariff. The Part 1b investigation focused on whether these entities may have violated any statute, rule or regulation administered by the Commission by engaging in a “high offer strategy.”

Over the course of the Part 1b investigation, Edison Mission made representations to FERC staff that turned out to be incomplete or inaccurate, and which resulted in the misallocation and misdirection of staff resources. The Part 1b investigation was resolved by settlement, embodied in the Stipulation and Consent Agreement (Agreement), which provides that Edison Mission will pay a \$7,000,000 civil penalty for violating its duty of candor to the Commission, and will implement a comprehensive compliance plan at an estimated cost of \$2,000,000. The Agreement contains no stipulation with respect to the high offer strategy and no penalty associated with it. The Agreement stipulates, however, that Edison Mission voluntarily discontinued use of that strategy in April 2006, and commits not to engage in that strategy in the future.

After FERC publicly announced the Agreement, several parties sought to intervene for the purpose of obtaining data to determine if Edison Mission’s behavior affected the prices they paid in PJM. FERC denied all motions to intervene, and closed the investigation.

²⁵ President Reagan used the phrase in discussing the nature of the United States relationship with the Soviet Union during the later stages of the Cold war.

the markets operated by RTOs bears striking similarities to the oversight (or lack thereof) applied to financial institutions over the last decade that is now being blamed as having primary responsibility for the global financial crisis we are caught in. In a recent speech²⁶ at the Federal Reserve System's Sixth Biennial Community Affairs Research Conference, Federal Reserve Board Chairman Ben S. Bernanke described some of the history that contributed to the current financial crisis:

The concept of financial innovation, it seems, has fallen on hard times. Subprime mortgage loans, credit default swaps, structured investment vehicles, and other more-recently developed financial products have become emblematic of our present financial crisis. Indeed, innovation, once held up as the solution, is now more often than not perceived as the problem. I think that perception goes too far, and innovation, at its best, has been and will continue to be a tool for making our financial system more efficient and more inclusive. But, as we have seen only too clearly during the past two years, innovation that is inappropriately implemented can be positively harmful. In short, it would be unwise to try to stop financial innovation, but we must be more alert to its risks and the need to manage those risks properly.

The process of financial deregulation began in earnest in the 1970s, a period when stringent regulations limited competition and the range of product offerings in the markets for consumer credit. For example, Regulation Q, which capped interest rates on deposits, hampered the ability of depository institutions to attract funding and thus to extend credit. Restrictions on branching were a particularly significant constraint, as they limited the size of the market that individual depository institutions could service and thus their scope to reduce costs through economies of scale.¹ The lifting of these regulations, especially branching restrictions, allowed the development of national banking networks. With national networks, the fixed costs of product innovation could be spread over larger markets, making the development and marketing of new products more profitable.

Mortgage markets saw similar product innovations. For example, in the early 1990s, automated underwriting systems helped open new opportunities for underserved consumers to obtain traditional forms of mortgage credit. This innovation was followed by an expansion of lending

²⁶ The full text of Mr. Bernanke's remarks is available at:
<http://www.federalreserve.gov/newsevents/speech/bernanke20090417a.htm>.

to borrowers perceived to have high credit risk, which became known as the subprime market. Lenders developed new techniques for using credit information to determine underwriting standards, set interest rates, and manage their risks. As I have already mentioned, the ongoing growth and development of the secondary mortgage market reinforced the effect of these innovations, giving mortgage lenders greater access to the capital markets, lowering transaction costs, and spreading risk more broadly. Subprime lending rose dramatically from 5 percent of total mortgage originations in 1994 to about 20 percent in 2005 and 2006.

In his speech, Mr. Bernanke described how these changes, coupled with technological innovation, had the positive effect of broadening consumer access to credit. However, reliance upon the market, without adequate oversight, came at a cost:

Yet with hindsight, we can see that something went wrong in recent years, as evidenced by the currently high rates of mortgage delinquency and foreclosure, especially in minority and lower-income neighborhoods. Indeed, we have come almost full circle, with credit availability increasingly restricted for low- and moderate-income borrowers. And the damage from this turn in the credit cycle--in terms of lost wealth, lost homes, and blemished credit histories--is likely to be long-lasting. One would be forgiven for concluding that the assumed benefits of financial innovation are not all they were cracked up to be.

Mr. Bernanke concluded that greater regulatory oversight should be exercised and be driven by outcomes:

[T]he recent experience has shown some ways in which financial innovation can misfire. Regulation should not prevent innovation, rather it should ensure that innovations are sufficiently transparent and understandable to allow consumer choice to drive good market outcomes. We should be wary of complexity whose principal effect is to make the product or service more difficult to understand by its intended audience. Other questions about proposed innovations should be raised: For instance, how will the innovative product or practice perform under stressed financial conditions? What effects will the innovation have on the ability and willingness of the lender to make loans that are well underwritten and serve the needs of the borrower? These questions about innovation are relevant for safety-and-soundness supervision as well as for consumer protection.

In sum, the challenge faced by regulators is to strike the right balance: to strive for the highest standards of consumer protection without eliminating

the beneficial effects of responsible innovation on consumer choice and access to credit. Our goal should be a financial system in which innovation leads to higher levels of economic welfare for people and communities at all income levels.

In recent testimony before the U.S. House of Representatives, Committee on Financial Services,²⁷ U.S. Secretary of the Treasury Timothy F. Geithner, on the causes and impacts of the financial crises, came to similar conclusions:

Over the past 18 months, we have faced the most severe global financial crisis in generations. Some of the world's largest financial institutions have failed. Equity and real estate prices have fallen sharply, eroding the value of our savings. The supply of credit has tightened dramatically. Confidence in the overall financial system, in the protections it is supposed to afford for investors and consumers, has eroded. These financial pressures have intensified the recession now underway around the world.

And as in any financial crisis, the damage falls on Main Street. It affects the vulnerable. It affects those who were conservative and responsible, not just those who took too much risk.

Our system is wrapped today in extraordinary complexity, but beneath all that, financial systems serve an essential and basic function. Financial institutions and markets transform the earnings and savings of American workers into the loans that finance a home, a new car or a college education. They exist to allocate savings and investment to their most productive uses.

Our financial system does this better than any other financial system in the world, but our system failed in basic fundamental ways. The system proved too unstable and fragile, subject to significant crises every few years, periodic booms in real estate markets and in credit, followed by busts and contraction. Innovation and complexity overwhelmed the checks and balances in the system. Compensation practices rewarded short-term profits over long-term return. We saw huge gains in increased access to credit for large parts of the American economy, but those gains were overshadowed by pervasive failures in consumer protection, leaving many Americans with obligations they did not understand and could not sustain. The huge apparent returns to financial activity attracted fraud on a dramatic scale. Large amounts of leverage and risk were created both within and outside the regulated part of the financial system.

²⁷ Statement by Timothy F. Geithner, U.S. Secretary of the Treasury before the Committee on Financial Services, U.S. House of Representatives, March 26, 2009.

These failures have caused a great loss of confidence in the basic fabric of our financial system, a system that over time has been a tremendous asset for the American economy.

To address this will require comprehensive reform. Not modest repairs at the margin, but new rules of the game. The new rules must be simpler and more effectively enforced and produce a more stable system, that protects consumers and investors, that rewards innovation and that is able to adapt and evolve with changes in the financial market.

On February 25, after meeting with the banking and financial services leadership from Congress, President Obama directed his economic team to develop recommendations for financial regulatory reform and to begin the process of working with the Congress on new legislation. The Treasury Department has been working with the President's Working Group on Financial Markets (PWG) to develop a comprehensive plan of reform. This effort has been and will be guided by principles the President set forth earlier this year and in his speech as a candidate at Cooper Union in March 2008.

Financial institutions and markets that are critical to the functioning of the financial system and that could pose serious risks to the stability of the financial system need to be subject to strong oversight by the government. Our financial system and the major centralized markets must be strong and resilient enough to withstand very severe shocks and the failure of one or more large institutions. We need much stronger standards for openness, transparency, and plain, common sense language throughout the financial system. And we need strong and uniform supervision for all financial products marketed to consumers and investors, and tough enforcement of the rules to ensure full accountability for those who violate the public trust.

Financial products and institutions should be regulated for the economic function they provide and the risks they present, not the legal form they take. We can't allow institutions to cherry pick among competing regulators, and shift risk to where it faces the lowest standards and constraints.

And we need to recognize that risk does not respect national borders. We need to prevent national competition to reduce standards and encourage a race to higher standards. Markets are global and high standards at home need to be complemented by strong international standards enforced more evenly and fairly. These are global markets and challenges. Building on these principles, we want to work with Congress to put in place fundamental reforms that create a stronger, more stable

system, with much stronger protections for consumers and investors, and a more streamlined, consolidated, and simple oversight framework.

Finally, on March 31, 2008, Treasury Secretary Henry M. Paulson, Jr. outlined his office's Blueprint for Financial Regulatory Reform,²⁸ and why such measures were appropriate:

Before I describe our Regulatory Blueprint, I will briefly outline why updating our financial regulatory structure is essential.

Evolution of our Financial Regulatory System

Our current regulatory structure was not built to address the modern financial system with its diversity of market participants, innovation, complexity of financial instruments, convergence of financial intermediaries and trading platforms, global integration and interconnectedness among financial institutions, investors and markets. Moreover, our financial services companies are becoming larger, more complex and more difficult to manage. Much of our current regulatory system was developed after the Great Depression and it has developed through reaction --- a pattern of creating regulators as a response to market innovations or to market stress.

We have five federal deposit institution regulators in addition to state-based supervision. We bifurcate securities and futures regulation. And regulation of one of our largest financial services industries, insurance, is almost entirely at the state level. The bulk of these regulatory responses made sense at the time they were created, but as we look at today's financial markets, the lack of a comprehensive design is clear.

The 1991 Bush Administration study, known as the "Green Book," made the case for many of the changes adopted in the last comprehensive financial regulatory overhaul, the Gramm-Leach-Bliley Act of 1999. That Act made important changes to our financial regulatory structure by allowing broader affiliations of financial services firms through a Financial Holding Company structure. But, it also maintained separate regulatory agencies across the traditional securities, futures, insurance and banking industry segments. This functional division is at odds with the increasing convergence of financial service providers and products. It creates jurisdictional disputes among regulators, and it is a likely result that some

²⁸ A complete copy of Secretary Paulson's remarks is available at: <http://www.ustreas.gov/press/releases/hp897.htm> (last accessed April 20, 2009).

financial services and products are exported to more adaptive foreign markets.

This complex structure can invite regulatory arbitrage, where business models are chosen based on regulatory structure, or even worse, based on the regulator itself. Regulators have adapted to keep pace with innovation, but they do so within a rigid structure that can not readily adapt as the financial services industry evolves. The current system fosters duplicative requirements and can allow important regulatory matters to fall through the cracks.

That said, I do not believe it is fair or accurate to blame our regulatory structure for the current market turmoil. As we work through this period, our regulators are cooperating to the extent appropriate, recognizing their different roles, responsibilities and authorities. They are also working cooperatively with their global counterparts. They share information when appropriate, minimize duplication and try to avoid jurisdictional conflict. We are very fortunate to have experienced professionals acting out of a shared sense of responsibility for the public good.

I am not suggesting that more regulation is the answer, or even that more effective regulation can prevent the periods of financial market stress that seem to occur every five to ten years. I am suggesting that we should and can have a structure that is designed for the world we live in, one that is more flexible, one that can better adapt to change, one that will allow us to more effectively deal with the inevitable market disruptions, one that will better protect investors and consumers, and one that will enable US capital markets to remain the most competitive in the world.

This is a complex subject deserving serious attention. Those who want to quickly label the Blueprint as advocating "more" or "less" regulation are over-simplifying this critical and inevitable debate. The Blueprint is about structure and responsibilities – not the regulations each entity would write. The benefit of the structure we outline is the accountability that stems from having one agency responsible for each regulatory objective. Few, if any, will defend our current balkanized system as optimal.

I also want to make clear that today's recommendations will not alter how we continue to set policy and coordinate the implementation of rules designed to protect the financial system from money laundering, terrorist finance and other illicit activities. Our challenge is to thoughtfully evolve to a more flexible, efficient and effective safety and soundness regulatory framework – and that is the purpose of this Blueprint.

The Optimal Financial Regulatory Model

We concluded we could only do justice to this topic by asking a rather theoretical question: If we could start over, which of course we can't, what regulatory model would we build? The idea here was to put forward an aspirational model, which could only be achieved after many years. But the model would serve as a beacon guiding us as we take necessary steps to modernize our financial regulatory structure to reflect today's market realities. Several difficult but unavoidable issues must be confronted, and we have put forward specific intermediate term recommendations to address these transitional issues over a two to eight year period. And we have a few recommendations for the near-term. But let's begin with the optimal or aspirational model.

We took a deliberative approach to developing this Blueprint. We met extensively with US and international financial regulators. We considered several models currently used in other global financial centers. We requested public comment on a broad range of issues and received hundreds of thoughtful and constructive comments. We interviewed thought leaders, industry, academics, and advocates of all political persuasion, including former Treasury leaders from both sides of the aisle. To a person, everyone agreed with two things: first, it was a difficult task and second, we must do this to retain our competitive advantage.

Our work led us to recommend a regulatory model based on objectives, to more closely link the regulatory structure to the reasons why we regulate. This model would have three regulators: a regulator focused on market stability across the entire financial sector, a regulator focused on safety and soundness of those institutions supported by a federal guarantee, and a regulator focused on protecting consumers and investors. A major advantage of this structure is its timelessness and its flexibility. It can more easily respond and adapt to the ever-changing marketplace because it is organized by regulatory objective rather than by financial institution category.

Market Stability Regulator

Given its traditional central bank role of promoting overall macroeconomic stability, the Federal Reserve is the natural choice for the important task of market stability regulator. In our model, the Federal Reserve's market stability role would continue through traditional channels of implementing monetary policy and providing liquidity to the financial system. In addition, the Federal Reserve would be provided with a different, yet critically important regulatory role with broad powers focusing on the overall financial system.

This role would replace the Fed's more limited role of bank holding company supervision because we recognize the need for enhanced regulatory authority to complement market discipline to deal with systemic risk. To do its job as the market stability regulator, the Fed would have to be able to evaluate the capital, liquidity, and margin practices across the entire financial system and their potential impact on overall financial stability. The Fed would have the authority to go wherever in the system it thinks it needs to go for a deeper look to preserve stability.

To do this effectively, the Fed will collect information from commercial banks, investment banks, insurance companies, hedge funds, commodity pool operators, but rather than focus on the health of a particular organization, it will focus on whether a firm's or industry's practices threaten overall financial stability. It will have broad powers and the necessary corrective authorities to deal with deficiencies that pose threats to our financial stability.

To illustrate, consider that our current regulatory system is almost solely focused above the ground at the tree level. But, the real threat to market stability is below the ground, at the root level where the health of financial firms is intertwined. Obvious root systems requiring the attention of our market stability regulator would include the interconnected OTC derivatives markets with their lack of a cohesive design for clearing, settlement, and novation protocols. Similarly, a market stability regulator would have the authority to review certain private pools of capital, such as hedge funds and private equity, which have the potential to contribute to a systemic event.

This market stability regulator's job sounds difficult and I assure you, it is. No regulator can prevent all instability and market turmoil, and this one won't either. I would expect that we will continue to go through periods of market stress every five to ten years. But hopefully with the proper tools and authorities, greater transparency and better information flow, we will be better able to avoid some problems and more effectively work through others. As a nation we have placed great faith in the powers of market discipline and this regulator is designed to better harness those forces.

Prudential Financial Regulator

Our second regulator combines all federal bank charters into one charter and consolidates all federal bank regulators into a single prudential regulator. For further regulatory efficiency, we recommend a federal insurance charter and put oversight of these guaranteed products within the jurisdiction of our federal prudential regulator. By its singular focus on prudential regulation that ensures the safety and soundness of institutions

with federal guarantees, this regulator would serve a role similar to the current Office of the Comptroller of the Currency, the OCC.

Conduct of Business Regulator

Third, we propose a dedicated business conduct regulator with the responsibility to vigorously protect consumers and investors, one which will focus on achieving greater consistency across product lines. This regulator would monitor business conduct regulation across all types of financial institutions and entities. Business conduct regulation in this context includes key aspects of consumer protection such as disclosures, business practices, chartering and licensing of certain types of financial institutions, and rigorous enforcement programs. This agency would assume many of the roles of the CFTC, the SEC, and the consumer protection and enforcement roles of our insurance and banking regulators. Having one agency responsible for these critically important issues for all financial products should bring greater consistency to regulation where overlapping requirements currently exist. Mortgages are an example of a consumer financial product that has suffered from uneven and inadequate treatment in our current regulatory and enforcement regime.

The premise of our optimal structure is that clarity of mission and objective will lead to strengthened regulation and improved capital markets efficiency.

We chose an objectives-based structure because we believe it provides a flexible framework that fosters and embraces innovation, helps ensure competitiveness and better manages risk. Such a structure would be better able to adjust to market and institutional changes. It would allow for clearer focus on particular goals – how do we prevent market failures – and provide a clear view across the financial landscape of functions, products, practices and institutions to meet those goals. Establishing regulatory lines by objective also has the potential for establishing and enforcing the greatest levels of market discipline by aiming regulation at the most vulnerable points.

An objectives-based model is substantially different from our current system and, realistically, will not and could not be implemented any time soon. However, we are anchoring our recommendations in a tangible, aspirational Blueprint even though it will take many years to evolve to this model. In the interim, the model can guide us as we consider and then take steps along the way.

A common theme among these remarks by government leaders is that the regulatory failures that contributed to the current financial crisis arose in part because

the regulatory structure did not focus on outcomes, and was too inwardly focused on structure and jurisdictional debates.

Under the FPA, wholesale electric rates must be “just and reasonable.” Historically, this statutory requirement was met through active, cost-of-service rate regulation by FERC. However, as discussed herein, for more than 15 years, FERC has been pursuing a variety of activities that it commenced after it determined in 1995 that the electric utility industry’s structure was anticompetitive. Rather than conducting any empirical analysis to determine if, in fact, RTO-run markets are producing results consistent with underlying expectations (just and reasonable prices), FERC has adopted a faith-based approach on RTO markets, at the expense of consumers.

Unfortunately, instead of lower prices, better service and enhanced infrastructure, customers are confronting rate shock. Customers are extremely frustrated with the seeming lack of recognition by federal regulators and RTO officials to their repeated cries for relief from unproductive policies and theories that have demonstrated themselves to be defective in the real world.

Federal regulators and RTO officials attribute the rate shock to higher fuel costs and to the retail price caps that states imposed, in part, due to FERC’s requirement that utilities be allowed to collect their “stranded costs” arising from electric restructuring. FERC has directed us to the EPAct of 2005 to search for potential relief. Customers are confronted with studies commissioned by the RTOs that purport to show customer benefits. These studies have given due consideration. Customers share the belief that the problems confronting us are significantly broader than higher fuel prices and state-imposed price caps.

Today, instead of having prices set by negotiated transactions between willing buyers and sellers, prices are dictated by “organized markets” and the mysterious and ever-changing commands of very expensive RTOs that have no “skin in the game.” Meaningful responsiveness to customers is lacking in RTO governance and policymaking.

Instead of FERC’s grant of market pricing authority to sellers of generating supply being conditioned on a demonstration that competition will ensure just and reasonable rates in compliance with the FPA, FERC has granted sellers of generation services market pricing authority based on a presumption that such competition exists in RTO regions. If FERC were obligated to ensure that real competition is in place before granting sellers authority to set their own prices using market pricing authority, customers might finally have a chance to get the benefit of their restructuring bargain. Where sellers of generation supply are not permitted to use market pricing authority, FERC must then use its traditional regulation tools to meet the just and reasonable standard in the FPA.

Instead of a market that accepts the business and financial risk associated with the capital investment required to add and replace supply-side assets, investor-owned utilities are demanding and receiving incentives and customer-funded guarantees as a condition for committing capital to serve the public interest.

Instead of a system that proactively enables the value that can be provided by customers through the control of their load and usage characteristics, demand response is slow-walked behind supply-side approaches that fortify market power. Instead of an organization that yields standardization and scale or scope economies within the logical

physical and commercial markets, “seams” have been established and maintained to encumber physical commerce, degrade reliability and add upward pressure to prices.

Instead of an implementation plan that features proactive, timely, complementary and coordinated action by state and federal regulatory authorities, stakeholders are forced to jump from one venue and case to another to try, at great expense, to mitigate the damage inflicted or perpetuated by dysfunctional markets and institutions.

The conditions described above are symptoms of a failure to recognize that both regulation and markets are potential **means** by which to serve the public interest and that the chosen means, whatever it may be, ***must be dynamically accountable to the public interest.*** Competition is a means to an end – not an end in itself.

Many stakeholders have supported, and continue to support, efforts to enable dynamically efficient markets. They favor replacing regulation with such markets where and when such markets are capable of providing customers with results that are superior to those available from and through traditional rate regulation. However, experience since the early 1990s consistently shows that the actual results of the changes federal regulators and RTOs have implemented have been diametrically different than FERC’s projections.

The Commission and the federal energy advocate have been statutorily tasked with examining the value of RTO participation and whether continued participation by Ohio utilities is ***in the interest of consumers.*** Answering this question will require the Commission to examine the objectives of RTOs to see if they are designed to serve the interest of consumers. If the RTOs are not designed and operated to this end, then any positive relationship between RTOs and the interest of consumers is purely

happenstance. If the Commission finds that the RTOs are designed and operated to serve the interest of consumers, then the Commission must escalate its analysis to determine if the RTOs are prudently and responsibly achieving outcomes that serve the interest of consumers. Examining RTO functions on a piecemeal basis may not produce actionable or practical results, or facilitate answering whether continued RTO participation is in the interest of Ohio's consumers.

In some respects, participation in RTO markets (at least as it is currently blessed by FERC), is an all-or-nothing proposition. One cannot, for example, choose to participate in PJM, but elect not to be subject to RPM rules. Similarly, being a MISO market participant subjects the customer to the seemingly endless litigation at FERC over potential liability for revenue sufficiency guarantee ("RSG") charges. You cannot be a transmission owner member of MISO and elect to take a pass on RSG charges. Thus, while a piecemeal examination of RTO functions may identify areas of potential improvement if continued RTO participation is assumed, it will not in and of itself resolve the question of whether continued participation by Ohio utilities is in the interest of consumers.

The Commission's review of RTO options should also be mindful of the realities presented by Am. Sub. SB 221. For the pricing of generation service, Am. Sub. SB 221 permits Ohio electric distribution companies to propose either an electric security plan or a market-rate option.²⁹ Under either option, the pricing of generation service is considered to be market-based pricing. Ohio retail customers are going to be paying

²⁹ For Ohio distribution companies that continue to own generation assets, Section 4928.142(D) requires the first filed market-rate option to include a blending of competitively bid purchases and generation service under its existing standard service offer.

market-based rates for generation service, irrespective of whether Ohio utilities are a member of PJM or MISO.

As the Commission plans for the future and satisfies its regulatory obligations, IEU-Ohio believes that the Commission must acknowledge that history demonstrates that FERC has no interest in considering the impacts its policies are having on the electricity prices paid by ultimate customers. For these reasons, the Commission's longer-term focus should extend an objective-based analysis to the identification and examination of how the interest of consumers could be better served by means other than those offered by MISO and PJM. In this context, IEU-Ohio recommends the Commission consider two options. The first option would result in Ohio utilities migrating back to so-called day-one RTO status, in which an ISO would assume responsibility for reliability and scheduling functions, but not operate a centrally-cleared day-two market. The second option would look at the creation of an Ohio-only RTO but, again, limited to assuming responsibility for reliability and scheduling functions. In the meantime and as stated above, it is IEU-Ohio's position that it is not in the public's or customers' interest to continue to permit (1) participation in RTOs as such participation may relate to "Day 2" market structures; and, (2) EDUs to pass on the cost of RTO participation to Ohio retail customers until they make an affirmative demonstration that the direct customer benefits of the RTO selections (made by the EDU's or their affiliates) exceed the costs.

IEU-Ohio provides additional comments on these two options in its responses to the questions issued by the Commission in its Entry.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Lisa G. McAlister".

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APPENDIX A

RTO INQUIRIES

RTO Value

1. Are FERC's Order 2000 goals and objectives being realized to promote efficiency in wholesale electric markets and to ensure that electric consumers pay the lowest price possible for reliable service?

In Order 2000, the Federal Energy Regulatory Commission ("FERC") concluded that traditional management of the transmission grid by vertically-integrated electric utilities was inadequate to support the efficient and reliable operation that is needed for the continued development of competitive electricity markets, and that continued discrimination in the provision of transmission services by vertically-integrated utilities may also be impeding fully competitive electricity markets. FERC found that these problems may be depriving the Nation of the benefits of lower prices and enhanced reliability.

FERC determined that transferring operational control of the regional transmission grid to an independent system operator ("ISO") would enhance the benefits of competitive electricity markets. FERC's reliance upon competition in wholesale electricity markets was based upon a belief that competitive markets would protect the public interest and ensure that electricity consumers pay the lowest price possible for reliable service.

FERC reasoned that regional transmission organizations ("RTOs") would address the operational and reliability issues confronting the industry, and would eliminate any residual discrimination in transmission services that can occur when the operation of the transmission system remains in the control of a vertically-integrated utility. Appropriate regional transmission institutions could also: (1) improve efficiencies in transmission grid management; (2) improve grid reliability; (3) remove remaining opportunities for discriminatory transmission practices; (4) improve market performance; and (5) facilitate lighter handed regulation.

Notwithstanding its findings, it should be noted that FERC considered compliance with Order 2000 voluntary. Electric utilities were not required to transfer functional control of their transmission facilities to an RTO. RTOs that were in existence or subsequently formed were required to demonstrate that they meet certain minimum functions and characteristics specified in Order 2000.

RTOs are not fulfilling the primary goals and objectives identified in Order 2000 of ensuring that electricity consumers pay the lowest price possible for reliable service. In fact, although considerable sums are spent annually to operate and

administer RTOs, the question of whether RTOs are providing benefits to ultimate customers has never been empirically considered by FERC, nor has the agency developed a comprehensive set of publicly available, standardized measures to evaluate RTO performance.

2. Are RTOs providing value to Ohio's customers through more effective management and use of the grid by:

(a) Addressing discrimination in access to transmission service?

RTOs have been able to address some of the operational concerns identified by FERC in Order 2000 associated with fragmented operation of the regional power grid. For example, RTOs have in place state estimators that collect data in real time from thousands of observation points on the transmission grid and provide system operators with important knowledge and visibility of the grid. RTOs have also reduced or eliminated the ability for vertically-integrated utilities to discriminate with respect to the use of their transmission assets.

(b) Eliminating of pancaked transmission rates?

Although RTOs serving Ohio have nominally eliminated pancaked transmission rates, it is difficult to identify if this has resulted in value to Ohio customers. The reasons for this are twofold. First, when pancaked rates were eliminated, it resulted in a dramatic reduction in revenues associated with through-and-out transactions. The revenue from through-and-out transactions was historically used to reduce the revenue responsibility for transmission assigned to native load customers. When transmission charges were eliminated on through-and-out transactions, the transmission rates for the remaining customers (native load) were increased to offset the lost revenues. Thus, the elimination of pancaked rates resulted in net increases in transmission rates for some Ohio customers.

Second, FERC justified the elimination of pancaked rates as a policy based upon the desire to expand the geographic scope of RTO markets. Thus, imposing higher transmission rates on native load customers was premised upon an expectation that electricity consumers would pay the lowest price possible for reliable service in regions in which RTOs operated. However, as previously noted, FERC has never empirically considered whether RTOs are providing benefits to ultimate customers. Thus, while the higher transmission charges Ohio customers bear as a result of eliminating pancaked rates can be identified, the question of whether eliminating pancaked rates is providing value to Ohio customers cannot be determined at this time.

- (c) Regional transmission scheduling, tariff administration, and settlements?

RTOs have provided more effective management of scheduling, tariff administration and settlements.

- (d) Enhancing reliability?

RTOs, if properly managed and operated, should result in enhanced reliability.

- (e) Improved utilization of transmission assets and management of transmission congestion?

RTOs have provided better management of transmission congestion through the use of coordinated system redispatch.

- (f) Regional unit commitment and security constrained economic dispatch?

Although RTOs perform regional unit commitment and security constrained economic dispatch, it has not been demonstrated that this provides value to ultimate customers. As previously noted, the question of whether RTOs are benefitting ultimate customers has not been empirically examined by FERC. Other studies have produced conflicting results, as noted by GAO.

- (g) Regional procurement of Ancillary Services and consolidation of Balancing Authorities?

The Midwest ISO's ("MISO") consolidation of balancing authorities has resulted in a reduction in the amount of reserve capacity being carried in the region. However, there is no indication that any ultimate customers are seeing the benefits of reduced operational costs.

It is premature to comment on MISO's operation of ancillary services markets given the January 2009 start up.

- (h) Regional transmission planning?

Regional transmission planning undertaken by MISO and PJM is still in its early stages and therefore it is premature to conclude whether this is an area in which RTOs provide value. The criteria by which RTOs may approve proposed transmission projects, including which customers have financial responsibility for funding projects, are also evolving. Therefore, any conclusions on transmission planning are premature.

It should also be noted that recent FERC orders call into question whether FERC will respect the decisions that result from the regional planning processes performed by RTOs, or will impose its views on what constitutes appropriate transmission expansion projects based upon its policy objectives, which may or may not align with regional objectives. FERC's actions have prompted the ISO/RTO Council to seek clarification from FERC on this issue:

Although the Commission found that the Green Power Express project would ensure reliability and reduce costs by relieving congestion, the Commission also acknowledged (but disagreed with) protestors' concerns that granting such incentives was premature because the Green Power Express project had not been evaluated through and approved by either the PJM or Midwest ISO regional planning expansion plans. In response to those concerns, the Commission explicitly stated that granting such incentives will not "prejudge the findings of a particular transmission planning process or the siting procedures at state commissions."

Despite such assurances, the IRC is unclear as to how this project should be handled under the current planning processes in light of the fact that: (i) the factors used to demonstrate that the Green Power Express project will ensure reliability and/or reduce congestion under a section 219 review differ from the more rigorous Commission-approved tariff criteria set; and (ii) both the Commission and Green Power have acknowledged that the current Commission approved planning processes may not allow for approval of projects, such as Green Power Express. Accordingly, the IRC seeks clarification on the following overarching question:

What is the interrelationship between the Commission's findings in its April 10 Order (and repeated in certain subsequent incentive rate orders) concerning reliability and market economics specific to section 219 of the FPA and the findings that ISOs and RTOs are required to make on reliability and economics (pursuant to their tariffs and Commission approved planning criteria) regarding which projects are to be included in, or excluded from, their respective regional planning processes?

The genesis of this general, overarching question stems from a host of more specific concerns facing ISOs and RTOs, such as:

□

- *What is the impact, if any, of the Commission's section 219 findings on the findings to be made on these same issues in a regional transmission expansion planning process?*
- *To what extent should the RTO planning processes incorporate the Commission's findings concerning reliability and economic benefits of a proposed project, such as Green Power Express or Pioneer?*
- *What selection process does the Commission intend to use where two or more projects are designed to accomplish the same goals in whole or in part?*
- *If the RTOs were to find (hypothetically), that the proposed Green Power Express project did not meet the existing planning criteria, are the RTOs free to distinguish the Commission's findings in its April 10 Order as not consistent with the RTO's planning tariff criteria for determining reliability and economic benefits or should such findings be afforded some level of deference in the regional planning processes?*
- *Given the Commission's findings, should the ISOs and RTOs attempt to distinguish projects such as Green Power Express as the ISO and RTO applies its planning tariff criteria?*
- *Are the Commission's section 219 findings binding on the ISO or RTO analysis in any way?*
- *Is the approval of the Green Power Express project through the ISO or RTO planning process still a condition precedent to the project going forward and to whether the project is eligible for cost allocation under the RTO tariff?*

Green Power Express LP, Motion To Intervene Out Of Time On Behalf Of Certain ISO/RTO Council Members And Motion For Clarification Of The ISO/RTO Council at 6.

3. Are the RTOs' locational marginal pricing ("LMP") policies providing value to Ohio's consumers?

The economic dispatch performed by RTOs that reflects the use of LMP does provide an operational tool to physically balance generation and demand in real time. The dispatching performed by RTOs requires regional knowledge of actual

real-time transmission grid conditions, and this has translated into a better ability to manage transmission congestion with other tools, such as NERC's transmission loading relief ("TLR").

Regional economic dispatch is not a new phenomenon, nor does it require the use of LMP. Power pools have performed regional economic dispatch for decades and economic dispatch can be performed under other pricing conventions, such as shared or split savings. Thus, the question of whether the use of LMP provides value must be considered in the context of what other operational methods would be alternatively used.

As previously noted, the question of whether RTOs are providing benefits to ultimate customers has never been empirically considered by FERC, nor has the agency developed a comprehensive set of publicly available, standardized measures to evaluate RTO performance.

4. Are the RTOs' ancillary services markets and the integration or co-optimization of those markets with the RTOs' energy markets efficiency providing benefits to Ohio's consumers?

In the case of MISO, given the fact that its ancillary services market has operated for less than five months, it is premature to reach any conclusions on its operation.

It should be noted that the structure of MISO's market, which relies upon reserve delivery zones, raises concern over whether the market can be competitive. For example, if reserve zones are binding in some areas, this can produce a monopoly supplier.³⁰

5. Are the RTOs' market monitoring and mitigation policies effective in ensuring competitive prices and providing value to Ohio's consumers?

Currently, the Independent Market Monitors ("IMM") in both MISO and PJM have relatively limited authority and scope and cannot address bilateral market issues. The IMM has little or no remedial authority.

In instances where an IMM has identified issues, FERC Enforcement Staff has been slow to respond and generally avoids considering refunds to the customers that are adversely affected by the misbehavior. For example, in an investigation into bidding practices by Edison Mission Energy in the PJM market, FERC imposed only \$7 million and \$2 million in compliance costs for Edison Mission Energy's "high offer strategy", which may have caused customer losses of

³⁰ A map of MISO reserve zones can be viewed at:
[http://www.midwestmarket.org/page/Zonal+Regulation+MCP+\(EOR\)](http://www.midwestmarket.org/page/Zonal+Regulation+MCP+(EOR)).

multiples of those amounts. Customers' attempts to obtain information about the scam, for the purposes of filing their own Section 206 complaint, were rebuffed by FERC on procedural grounds (appeal now pending).

When evaluating RTO market outcomes, IMMs generally use a contorted definition of "competitive". The absence of market power does not equal "competitive," as claimed by the IMMs. Competition results in a significant risk of losing sales if bids are too high. The concentration of ownership in PJM and MISO, and the localized markets that tend to arise due to congestion means that head-to-head competition is infrequent.

6. Are the RTOs' resource adequacy requirements and the resulting capacity markets (or, in the case of PJM, its Reliability Pricing Model and Fixed Resource Requirement) reasonable and providing benefits to Ohio's consumers? Are these policies effective in promoting needed resource investment and long-term contracts which could help finance such investment? Do these policies promote an appropriate level of investment that is consistent with the needs and preferences of Ohio consumers?

The initial Reliability Pricing Model ("RPM") auctions produced disproportionate results. Clearing prices were grossly disproportionate to the amount of capacity that was being procured, with no demonstration that RPM benefits exceeded the costs.

The experience to date reflects RTOs deploying novel market designs and design elements with no appreciation for cost-benefit ratios, expected results, or performance monitoring.

RPM may, over the long-run, provide an appropriate level of capacity, but likely not an appropriate level of investment. It's more likely that we'll get the required number of MWs, but the cost of ensuring capacity under RPM will be higher than necessary.

MISO's approach to resource adequacy is a work in progress, with significant details unresolved. Therefore, it is not possible to identify whether MISO's policies on resource adequacy are benefitting retail customers. However, we believe MISO's choice to not operate centrally-cleared capacity markets will mitigate the upward pressure on capacity prices that has resulted from approaches such as PJM's RPM.

7. Are RTOs effective in facilitating transmission planning and needed transmission investments that benefit Ohio's consumers? Are they effective in facilitating transmission planning and investment that may be needed for the development of renewable energy resources?

It appears that the RTEP process has been successful in identifying the transmission projects that would provide an overall benefit to the PJM region. The RTEP process is not designed to facilitate transmission planning and needed transmission investments that benefit the customers in any one state. The general pattern in PJM RTEPs is the recommendation of transmission facilities that move less-expensive power from areas in the Western area of PJM to concentrated load areas in the Eastern area of PJM. This general pattern would have the effect of equilibrating supply and demand across PJM, with a corresponding increase in prices in the West and decrease in prices in the East, all else being equal.

To date, both the MISO MTEP and PJM RTEP processes have not been geared to facilitate one type of resource over another, so the question of whether they have been “effective in facilitating transmission planning and investment that may be needed for the development of renewable energy resources” is mostly a moot point.

Recent orders by FERC approving requests for transmission incentives for certain types of projects have called into question whether the RTO regional planning process is effectively being preempted by FERC actions to facilitate transmission projects with a bias towards supporting the interconnection of certain types of generation resources.

8. Are the RTOs’ policies and practices effective in facilitating long-term contracts between load serving entities and generation developers or suppliers that may be needed to support the construction of additional base load generation facilities?

Anecdotal evidence suggests that RTO policies and practices have not facilitated long-term contracts that may be needed to support investment in new baseload units. In fact, the evidence is to the contrary. Most of the new generation built in PJM since the markets began in 1998 has been intermediate, and peaking capacity has been fueled predominantly by natural gas.

Also, anecdotally speaking, customers have been unable to enter into long-term bilateral contracts with either new or existing generation, even at prices consistent with natural gas forwards. The inability to demonstrate long-term creditworthiness is having a significant and deleterious impact on long-term contract prospects. These two phenomena – (1) a market design that emphasizes short-term transactions; and (2) ongoing problems in the credit markets – have all but ensured that long-term contracts are scarce.

9. Are the RTOs’ transmission cost allocation methodologies and policies resulting in value for Ohio’s consumers?

Although RTOs are responsible for proposing transmission cost allocation methodologies through a section 205 filing at FERC, ultimately transmission cost allocation reflects FERC policies, with RTOs simply being the messenger. With that being recognized, we share some of the concerns that have been conveyed by the Commission to FERC that FERC's current transmission cost allocation methodologies may place a disproportionate burden on Ohio customers.

10. Are the RTOs' Financial Transmission Rights and other transmission congestion hedging policies and practices effective and providing value to Ohio's consumers?

Financial transmission rights ("FTRs") provide a useful tool to allow customers to hedge some of their exposure.

In the case of MISO, there is evidence that suggests the periodic reconfiguration auction is being used to effectuate a substantial wealth transfer from native load customers. FERC's policy is that customers that pay for the embedded costs of the transmission system (principally native load customers) should receive the benefits of the congestion hedges that the transmission system can physically support. MISO allocated congestion hedges to network transmission customers based upon their historical use of the transmission system, but sells unallocated hedges through an auction. For several years, the majority of the hedges bought in the auction have been by market participants that are not network transmission customers. Several market participants have bought congestion hedges for pennies on the dollar, with profits from acquiring these hedges exceeding \$100 million per year. In the absence of an auction, these profits would be considered excess congestion costs and would be returned to network transmission customers.

11. Are the RTOs' demand response programs, policies toward behind-the-meter generation, and other Load Modifying Resources effective and providing value to Ohio's consumers over and above state sponsored programs?

PJM has appropriate treatment of behind-the-meter generation. For MISO, there are significant hurdles that create extreme difficulty for behind-the-meter generation to provide demand response. In PJM, ILR has been effective for demand-responsive customers to hedge the otherwise extraordinary costs of RPM; beginning in 2011, redesigned incremental auctions must fill the void that will be left by the elimination of ILR. Much more work needs to be done, most likely in the context of PJM's Order 719 compliance filing, to re-establish a structure that promotes large volumes of price-responsive demand, both from LMP-priced customers and non-LMP-priced customers.

In the case of MISO, there are presently limited to no opportunities for the participation of demand response resources in MISO's markets. The majority of demand response results from bilateral arrangements with load serving entities. MISO has acknowledged significant barriers to demand response in its recent Order 719 compliance filing and has committed to try and address some of these barriers.

12. Are the RTOs' policies and practices relating to the treatment of Price Responsive Demand ("PRD") consistent with facilitating the development of PRD through dynamic and time-differentiated retail pricing? (PRD is consumer demand that predictably responds to changes in wholesale prices as a result of dynamic or time-differentiated retail rates.).

Certainly, day-ahead and real-time energy markets are designed to be capable of providing the dynamic pricing required for efficient demand response. There is no need to expand the use of scarcity pricing or eliminate bid caps to encourage price-responsive demand. There is plenty of room for additional demand response without need to further increase the level and volatility of wholesale prices.

13. Are the RTOs' queue and interconnection policies providing value to Ohio's consumers?

Both PJM and MISO's interconnection queue are significantly bottlenecked at this time with large amounts of potential wind generation projects. Both RTOs have recently revised their queue procedures in an attempt to reduce the size of the interconnection backlog. It is premature to determine whether these efforts will be successful. However, at this time, the current queue status indicates that any new generation attempting to site in Ohio (or elsewhere in the RTO regions) may face a significant delay in getting interconnection studies completed.

14. Is the resolution of seams issues being thoroughly addressed and resolved by the RTOs operating in Ohio?

Both PJM and MISO have identified that they do not plan at this time to pursue a single common market.

15. Do the RTOs' treatment of financial-only market participants (or virtual traders) provide value to Ohio's consumers?

Proponents of virtual trading in RTO markets claim that such trading provides liquidity and helps ensure convergence between day-ahead and real-time market

prices. Observing actual performance in both MISO and PJM indicates the cure is worse than the disease.

RSG Charges and Refunds

In the case of MISO, it is not practical or possible to assess the true impact that virtual trading has made to market prices because of a series of orders by FERC in which the agency has repeatedly flip-flopped on the question of the proper allocation of revenue sufficiency guarantee ("RSG") charges, and whether virtual traders should be assessed some level of RSG costs. As a result of FERC's actions, the level of RSG charges owned by every market participant since the start-up of MISO's market in April 2005 remains unresolved, and the true cost of MISO's market to individual market participants is unknown. As these comments are being submitted, MISO is preparing to embark upon yet another round of resettlements to comply with FERC's latest order, in which FERC reversed in part a prior decision requiring refunds, which MISO had already begun to process.³¹

A short history of the RSG saga is provided for context. On April 1, 2005, MISO started its regional energy market. RSG charges are associated with so-called "make-whole" payments to generators. Generators submit three-part offers to MISO (start-up, no load and energy offers). Due to the structure of an LMP-based market, there is a possibility that a generator that MISO commits for energy may not fully recover the total dollars associated with its start-up, no load and energy offers. If this occurs, the generator is eligible for make-whole payments if it follows dispatch instructions. The revenues to provide make-whole payments are collected from market participants that are allocated RSG charges.

As of the April 1, 2005 start of MISO's markets, the relevant approved tariff language allocated RSG charges in part to market participants that "actually withdraw energy" during an operating day. This language would have resulted in some liability for allocation of RSG charges to market participants that engage in virtual trading. Although this was the effect of MISO's tariff, several months after market start-up MISO Staff discovered that its business practices differed in that MISO had not been allocating RSG charges to virtual traders.

After discovering this discrepancy, MISO made a filing at FERC in October 2005. MISO sought to modify its tariff to not allocate any RSG charges to virtual traders under the belief that RSG charges would create an economic hurdle for virtual traders. Several parties objected to MISO's proposal, arguing that virtual traders should assume some responsibility for RSG charges, and that their trading activities could contribute to the need to provide generators' make-whole payments.

³¹ MISO's plans to perform the latest set of refunds were outlined at the May 19, 2009 Informational Forum. A copy of the presentation, which details these plans at pages 57-68, is posted at: http://www.midwestmarket.org/publish/Folder/2c41ee_1200f54a695_-7f0d0a48324a.

In April, 2006, FERC issued an initial order finding that MISO had violated its tariff.³² FERC also denied MISO's request to prospectively exempt virtual traders from RSG charges.

A number of parties sought rehearing of FERC's April 2006 order. They argued against FERC's decision to require refunds. They also raised arguments over the interpretation of words that appeared in MISO's tariff that limited the allocation of RSG charges to parties "actually withdrawing energy" in real-time.

In October, 2006, FERC issued an order granting rehearing with respect to its requirement to provide refunds. FERC determined that it would not require refunds of amounts associated with RSG charges incurred before the date of its April 2006 order.

Subsequently, MISO initiated refunds based upon its interpretation of FERC's order. However, MISO interpreted FERC's order in a manner that shifted significant RSG funding responsibilities away from virtual traders and generators and placed more responsibility for RSG costs on load-serving entities.

Numerous parties challenged whether MISO was interpreting FERC's order correctly. However, MISO proceeded to process refunds based upon its interpretation of FERC's order.

On March 15, 2007, FERC issued an order accepting in part and rejecting in part MISO's compliance filing. FERC also issued an order that indicated FERC would not use its review of a compliance filing to change an RSG rate that is approved as part of MISO's tariff.

Frustrated by the significant shift of RSG costs to load-serving entities, and the inability to resolve their concerns through FERC or the MISO stakeholder process, several parties filed complaints at FERC in August 2007 alleging that MISO's RSG charges were unjust and unreasonable. When a party filed a complaint at FERC challenging a rate, it established a refund effective date in which all parties are on notice that a FERC order may require refunds of any charges made under the challenged rate after the refund effective date.

On November 10, 2008, FERC issued an order finding that MISO's RSG rate was not reasonable.³³ The order approved an alternative formula to allocate RSG charges recommended by some of the parties that filed complaints. The

³² *Midwest Indep. Transmission Sys. Operator, Inc.*, 115 FERC ¶ 61,108, at P 48-49 (Revenue Sufficiency Guarantee Order), *order on reh'g*, 117 FERC ¶ 61,113 (2006) (First Rehearing Order), *order on reh'g*, 118 FERC ¶ 61,212 (Second Rehearing Order), *order on reh'g*, 121 FERC ¶ 61,131 (2007) (Third Rehearing Order).

³³ *Ameren Servs. Co. v. Midwest Indep. Transmission Sys. Operator, Inc.*, 125 FERC ¶ 61,161 (2008).

order also found that MISO had improperly interpreted FERC's prior order in establishing the RSG formula and allocation used subsequent to FERC's April 2006 order.

The effect of FERC's order required MISO to perform two separate refunds. One refund was required to use a different formula to allocate RSG charges on and after the August 2007 refund effective date associated with the complaints. The second refund was required for resettlement every day, from April 2005 through the August 2007 refund effective date, to correct for MISO's improper interpretation of FERC's prior order.

Once again, numerous parties sought rehearing and objected to MISO's compliance filing. Some parties also sought a stay of FERC's order. However, MISO began processing refunds. Prior to initiating refunds, MISO estimated that approximately \$750 million in RSG charges were involved, and on a net basis there would be a shifting of approximately \$250 million in funding responsibility for RSG charges among market participants (principally shifting some funding responsibility away from load-serving entities back to virtual traders).

As market participants received invoices from MISO to process the refunds, at least eighteen companies that were engaged in virtual trading defaulted and were unable to pay amounts due, even after reflecting collateral provided to MISO. To date, MISO has estimated these defaults may result in a \$25 million shortfall that ultimately will have to be paid by other customers. The amount of the default may increase as MISO processes further refunds. An initial estimate by MISO indicated approximately \$75 million was at risk for default.

On May 6, 2009, FERC issued its order on rehearing in the complaint proceedings.³⁴ FERC granted in part and denied in part the request for rehearing. FERC upheld its prior determination that MISO's original RSG rate was unreasonable. FERC also upheld the new RSG rate it approved as a result of the complaint proceedings. However, FERC granted rehearing and reversed its decision to require refunds as of August 2007. FERC directed MISO to cease ongoing market resettlements and to reconcile all RSG invoices and payments based upon the latest FERC order.

Tower Companies' Positions in FTR Markets

In PJM, financial traders' involvement in certain PJM markets was responsible for one of the largest credit defaults in PJM history, over \$50 million.³⁵ On March 7, 2008, PJM filed a complaint against "the Tower Companies," which included

³⁴ *Ameren Servs. Co. v. Midwest Indep. Transmission Sys. Operator, Inc.*, 127 FERC ¶ 61,121 (2009).

³⁵ This amount was ultimately allocated among all PJM market participants, as required under FERC-approved rules for allocation of credit defaults.

several affiliated market participants. PJM's complaint alleged that the Tower Companies manipulated the PJM FTR markets by using the Tower Companies' various corporate entities to engage in coordinated, offsetting positions in the PJM FTR markets, with the objective of having one entity default on its PJM obligations while other affiliated entities benefitted from the offsetting positions. FERC's Office of Enforcement conducted a non-public investigation and found, in a report issued to the Commission on March 11, 2009, that insufficient evidence existed that the Tower Companies deliberately or intentionally engaged in FTR market conduct that constituted manipulation. On the basis of the Office of Enforcement's investigation and finding, FERC dismissed this aspect of PJM's complaint by order issued April 2, 2009.³⁶ On May 4, 2009, PJM, PJMICC, and several other parties requested rehearing of the April 2 Order, arguing that FERC incorrectly relied exclusively on the Office of Enforcement's report and failed to address the merits of PJM's complaint.

A separate issue – whether the Tower Companies placed increment and decrement bids in the Day-Ahead Market for the purpose of increasing congestion and benefitting affiliates' FTR positions – remains pending before the Office of Enforcement and FERC. On a parallel track, PJM continues to pursue a civil action against the Tower Companies, under the Racketeer Influenced and Corrupt Organizations ("RICO") Act, in U.S. District Court. That action is progressing toward trial, perhaps as early as this summer.

16. Are the RTOs' administrative expenses and corresponding assessments to member companies reasonable and resulting in value to Ohio's consumers?

For the pricing of generation service, Am. Sub. SB 221 permits Ohio electric distribution companies to propose either an electric security plan or a market-rate option.³⁷ Under either option, the pricing of generation service is considered to be market-based pricing. Ohio retail customers are going to be paying market-based rates for generation service, irrespective of whether Ohio utilities are a member of PJM or MISO. From that perspective, subjecting Ohio retail customers to market-based generation rates and also requiring them to pay the costs of RTO administration adds insult to injury. The Commission should find that the incurrence of RTO administrative costs by Ohio distribution companies is imprudent absent the ability to demonstrate lower generation prices for retail customers as a result of RTO participation.

³⁶ *PJM Interconnection, LLC v. Accord Energy, LLC, et al.*, 127 FERC ¶ 61,007 (2009).

³⁷ For Ohio distribution companies that continue to own generation assets, Section 4928.142(D) requires the first filed market-rate option to include a blending of competitively bid purchases and generation service under its existing standard service offer.

RTO Alternatives

1. Are there viable, cost-effective alternatives to the existing RTO memberships of Ohio utilities or to Ohio utility participation in RTO managed functions (e.g. renewable tracking, reserve sharing groups, etc.)?

It would be possible for Ohio utilities to withdraw from PJM and MISO and contract with a third party for independent operation of their transmission assets. In this capacity, the third party would be responsible for performing scheduling and reliability functions. This would be similar to the arrangements put in place when LG&E withdrew from MISO and contracted with the Southwest Power Pool to perform scheduling and reliability functions. It should also be noted that MISO acts in a similar capacity for other non-transmission owners. MISO provides scheduling for Duke Energy's non-Midwest electric utility operations located in the Carolinas.

If Ohio utilities were to withdraw from RTO administered markets, it would not necessarily result in an inability to participate in reserve sharing groups. In the case of MISO, participation in the regional reserve sharing group is not limited to utilities that are transmission owner members of MISO, and currently includes other utilities. Therefore, it would likely be possible for Ohio utilities to participate in a regional reserve sharing group regardless of RTO membership status.

Another option would be to pursue reform of RTO markets. Several proposals have been made to FERC over the past few years, including in the context of its analysis of organized market reform. One proposal, styled as the "Alternative Market Design Proposal" ("AMDP"), was supported by PJMICC and several other industrial customer organizations in the Northeast as a preferable alternative to the centralized capacity auction approach employed in PJM (and New York and New England). The American Public Power Association ("APPA") has published a similar Competitive Market Plan for reform of wholesale electricity markets administered by RTOs. The plan recommends the following primary changes to the Day 2 RTO markets. These changes are intended to move these markets from *de facto* oligopolies to more competitive markets, while ensuring reliable electric service at just and reasonable rates.

- Current RTO-run energy and ancillary services real-time and day-ahead markets would be replaced by an RTO-run "optimization" market, in which customers can balance supply deficiencies or excess purchases, and generators can sell excess generation.
- Offers to sell into the optimization market for both energy and ancillary services would be limited to generators' marginal costs of generation. Generators would be required to submit their unit-specific operating costs to the RTO market monitor in advance to provide cost support for their offers. Prices would be set initially using a cost-based single clearing price

mechanism, with evaluation of the results of that mechanism after three years of operation.

- The optimization market would contain a cost-based day-ahead component for the purpose of generation resource commitment.
- Generator offers into the optimization market would be made public on the next operating day, including the identity of bidders.
- FERC-jurisdictional generators entering into bilateral contracts with load serving entities (LSEs) in an RTO region would not be subject to cost-based restrictions, i.e., they could use market-based rates if they have obtained such authority from FERC. APPA recommends, however, that FERC separately evaluate generation market power for long-term power supply products in determining seller eligibility for market-based rate authority.
- Generators would be subject to a must-offer requirement into the optimization market for energy not already committed under bilateral contracts or owned generation arrangements (subject to forced outages, scheduled maintenance, and special rules for limited-run units).
- Demand-side resources could sell into the optimization market, but would not be subject to a cost-based offer restriction; rather, they would take the single-clearing price that clears the market, assuming they have previously offered to reduce demand at that price level. Existing RTO-administered locational capacity markets would be phased out and capacity would be supplied through bilateral contracts entered into by LSEs with resource suppliers (both generation and demand response), LSE-owned generation arrangements and LSE-managed demand response.
- The RTOs would determine and implement overall resource adequacy standards applicable to LSEs within the RTO footprint. States would have substantial input into RTO development of regional transmission plans and regional resource adequacy requirements.
- States would establish resource acquisition processes to secure a diversified portfolio of generation and demand-side resources for state regulated investor-owned utility (IOU) LSEs. Competitive procurements, including consideration of both LSE self-build/self-supply and third-party supplier options, would be conducted for state-regulated IOU LSEs, with an option for self-regulated LSEs to participate.
- States and LSEs would be free to explore broader LSE resource procurement initiatives, such as regional procurements or LSE resource pooling.

- RTOs would conduct centralized least-cost dispatch of generators based on actual operating costs. Generators and demand response providers would be paid based upon contracted prices for quantities sold through the bilateral market. For quantities sold through the optimization market, generators and demand responders would receive the cost-based market-clearing price.
- Data on bilateral contracts would be submitted to the RTO for the purposes of market monitoring, running feasibility tests to assess transmission adequacy, and developing regional transmission plans.
- Financial transmission rights (FTRs) would be allocated to LSEs. Long term FTRs would also be granted to support longer-term (e.g., 10-year) bilateral power supply arrangements and LSE-owned resources.
- Existing transmission rights would be maintained to the maximum extent feasible.
- RTOs would continue to ensure non-discriminatory open access to the transmission system.

A copy of APPA's Competitive Market Plan is available at: <http://www.appanet.org/files/PDFs/EMRICompetitiveMarket.pdf>

2. Would it be reasonable, cost effective, and viable for the Ohio Commission to pursue the construct of an Ohio-only RTO?

The Ohio Commission should consider an Ohio-only RTO as an option for Ohio utilities to contract with a third-party to administer scheduling and reliability functions.

3. What recommendations could be made to FERC or required of Ohio's RTO member companies that would result in increased value to Ohio's consumers?

FERC has shown little willingness to consider the impacts of its RTO policies on retail customers. Given the limited receptivity at FERC, Ohio's interests would likely be better-served investing in recommendations to Congress.

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing *COMMENTS OF INDUSTRIAL ENERGY USERS-OHIO* was served upon the following parties of record this 26th day of May, 2009, via electronic transmission, hand-delivery or ordinary U.S. mail, postage prepaid.


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