The Evolving Marketplace

The restructuring of wholesale power markets, with retail access initiatives nipping at its heels, is sweeping across North America. Customers with high priced electricity want access to competitively priced power, and low priced producers want access to customers currently paying high prices. To date, the progress has been quite slow and the benefits somewhat dubious. The End State of restructuring appears to be years away.

But in the interim, the utility sector is assumed, justly or unjustly, to have market power in generation, as well as monopoly transmission and distribution systems. But, market power and monopolies just aren’t as popular as they used to be (at least in the eyes of the regulators and those of us who don’t have either). Order Nos. 888 and 889, issued in April of 1996, required all investor owned utilities subject to the Federal Energy Regulatory Commission’s (FERC) jurisdiction to file “open access” tariffs and to post on the Internet information about the capabilities of their transmission systems. FERC intended to allow market entry for more competitors, while at the same time mitigating market power; but mergers and acquisitions have run rampant and, in some situations, contrary to the Commission’s objectives.
In these times of electricity market restructuring, all industry stakeholders are called upon to make compromises in order to move the ball forward. In some states, such as California and Massachusetts, retail access proceedings have resulted in the incumbent utilities either partially or completely selling their generation facilities. Divestiture is the cleanest way to mitigate generation market power and to quantify stranded costs. It is also the preferred action by competitors, including utilities in other regions that want a foothold outside of their historical franchise areas. For some reason, though, not all generation owning utilities are racing to sell the assets they own, possibly because they will ultimately be unregulated. Therefore, the compromise has been to offer to let third party organizations administer or operate the monopoly transmission systems. Independent System Operators (ISOs) are, at a minimum, a near-term—and perhaps short-term—compromise solution to some of the inequities in the historical and current power and transmission markets.

**The State of Play: One Marketer’s Perspective**

The FERC has required ISO proposals to accommodate an independent board of directors. In California and Texas, the ISOs have all stakeholder boards that, in theory, prevent any single market segment from dominating the agenda or blocking needed changes. NGC has representatives on both of those ISO boards and, based on experience, does not generally advocate a stakeholder-only board. The size of the ISO boards is significant enough that chaos would erupt if every member demanded equal floor time to debate issues. The fact is, though, that typically a half dozen members dominate the meetings, the majority of others primarily watch from the sidelines, and the voting
accommodates the views of the most vociferous members. This is neither independent
nor balanced governance; however, a similar situation could occur in a non-stakeholder
board of directors if they are not carefully selected.

Nevertheless, in California the stakeholder-only board seems to be functioning well. This
is in large part due to the fact that the ISO evolved out of the collaborative process that
transpired in California, starting in 1994. The California ISO (CAISO) Board is quite
representative of diverse industry segments, but the individual members have been
working with each other for quite some time and they work quite well together. Many of
them have been involved in the restructuring of the California market from the beginning,
so they know each other and the issues. As in ERCOT, the Electric Reliability Council of
Texas, not all board members get their say in the monthly meetings, but the debates are
typically not dominated by a single sector so the alternatives provide balanced choices.

In contrast to the governance of the California and ERCOT ISOs, the PJM ISO has a
totally independent board that includes no stakeholders. The technical experts on the
professional PJM staff supplement the Board’s decision-making processes, responding to
challenges created by the evolving market. Recommendations forwarded to the Board by
the PJM staff are handled expediently, although this sometimes results in members being
blind-sided by PJM FERC filings that they do not support. Although this is quite an
efficient arrangement, it is deficient in that it does not accommodate maximum
stakeholder input for those not physically participating in the various committees—that
is, until the interventions are due at FERC, which ultimately adds to everyone’s cost of doing business.

Market Monitoring or Interference?
The FERC has been quite interested in delegating some degree of “market monitoring” responsibilities to the ISOs. This makes a great deal of sense, given the FERC’s limited resources and expertise. However, the authority and scope of the ISOs’ monitoring efforts must be quite clear and they must not be unnecessarily intrusive into the commercial arena. An NGC subsidiary was recently questioned by an ISO regarding its bid price for ancillary services, although the price was significantly under that offered by other sellers. This attempt to influence the market is not an acceptable practice. Even more intrusive, the power exchange was training other customers by revealing our specific bidding strategies and advising them how to counteract them. The point is, the more an ISO dabbles in the commercial side of the business, the more it is trespassing into an area where it does not belong and should have no authority.

On the other hand, the FERC, the state commissions, and all industry participants would benefit by having more information about the effectiveness of these new institutions. Such information might include: total number of service requests, total requests approved, total requests denied, total requests scheduled, curtailments and re-dispatch occurrences, change in number of transactions, number of new customers, size of transactions, duration of transactions, rate schedules utilized, dollar value of transactions, etc. In other words, the market monitoring function of an ISO should not be a commodity
market policing function, but it should provide relevant information that could be used to
gauge the success of these new institutions and their contribution to competition.

One View of the Future

Last September, this writer made a presentation at the Harvard Electricity Policy Group’s
Fourteenth Plenary Session that compared the FERC’s ISO principles to the NERC’s
Security Coordinator procedures, attempting to illustrate the significant overlap of
functions. Virtually all proposals for ISOs incorporate responsibilities that are already the
responsibility of NERC’s Regional Reliability Organizations (RROs), who have
sanctioned the Security Coordinators. The good news is that the industry and its
regulators all feel that these functions that are necessary to maintain reliability are
important enough to ensure some redundancy in responsibilities. The bad news is that this
ambiguity will create confusion and additional costs, neither of which this industry or its
customers will tolerate for long.

Fortunately, at the early stages of policy development for ISOs, NERC is re-casting itself
as the North American Electric Reliability Organization (NAERO). NAERO is being
proposed as a Self-Regulating Reliability Organization (SRRO), which is consistent with
the recommendations of both the NERC’s Electric Reliability Panel (ERP) and the
Secretary of Energy Advisory Board (SEAB) Electric System Reliability Task Force.
These somewhat parallel tracks for ISOs and NAERO create a unique opportunity to
envision and pursue an end result that does not necessarily run counter to institutional
roadblocks.
In any event, ISOs and RROs must be conceptionally and functionally reconciled sooner rather than later. Today, the responsibilities for ensuring reliability and compliance with reliability standards are assigned to or assumed by the Interconnection, the RROs, the ISOs and individual control area utilities. This ambiguous ownership of responsibility will result in operating errors, frustration for market participants, turf protection and discord. For example, NERC established the “tagging” process to assist its Security Coordinators in the administration of reliability. The transmission customers objected to the implementation of tagging, not necessarily the justification for it, because it impacts terms and conditions of service under the pro forma tariffs, which are FERC jurisdictional. Several protests were submitted to FERC, and FERC validated those concerns in its order in Docket EL97-58, issued on April 7. Furthermore, one RRO has, to this day, elected not to implement tagging; and the CAISO has modified the tagging requirement to suit its particular needs. These types of situation, whereby those with the power to do so can set the rules—or ignore the rules if they want to—must be remedied.

Both the SEAB and the NERC’s ERP recommended a Self-Regulating Reliability Organization (SRRO) to take the place of NERC, to be referred to as NAERO. The advantages of an SRRO are desirable due to the international nature, both physical and commercial, of the electric industry. There is no international regulatory body that could satisfy the jurisdictional requirements for America, Canada and Mexico, combined. Additionally, a high degree of electric industry technical expertise is not resident on a grand scale at the regulatory agencies. With proper governance, many if not most of the
difficult technical issues could be resolved through the SRRO processes. Eventually, commercial issues may be addressed by a Self-Regulating Organization (SRO).

(Attachment 1)

On Attachment 1, an organizational model is depicted for relationships that could exist between countries, federal and state regulators, reliability organizations, ISOs and other market participants. All participants should have regulatory protections and oversight at the highest level. In the future, though, the responsibility for reliability must be unambiguous, including the setting of standards, compliance and enforcement. It is likely that ISOs will be in the best position to administer transactions, monitor activities, and perform the necessary reliability functions. If vested with these responsibilities, it would be quite logical for the ISOs to also be responsible for development of regional reliability standards. Industry personnel resources are too valuable to be spread across redundant, competing organizations. The economics do not justify financing duplicative, bureaucratic organizations, either.

Therefore, it is proposed that a mid-term—say five years—transition should occur that results in the transformation of NAERO and the RROs. A Continental Electricity SRO (CESRO) would result that would not only have oversight of reliability standards development but would also oversee ISOs. This would expand the scope of the CESRO to not only establish baseline reliability standards and procedures, but also to establish universal ISO operating criteria, including, perhaps, governance, committees, tariffs and communications. Each ISO could submit required deviations from the continental
standards to the CESRO and, with justification, the CESRO would approve them. Once
the CESRO has approved any deviations that impact jurisdictional terms and conditions
of service, the CESRO would file them with the appropriate regulator(s). If governance is
structured properly and the process is open, then little opposition should arise in the
regulatory process.

Under this model the RROs are phased out as stand-alone organizations. The RROs have
been and will be funding NERC/NAERO for the next few years. The total budget for
NERC and the RROs is currently in the tens of millions of dollars, annually. As
NAERO, the expenditures will likely be greater, but the funding mechanisms will be
modified. The ISOs are experiencing hugely varying implementation costs, from as low
as $4-6 million in ERCOT to $210 million in California. At this pace, to reform NERC
and establish ISOs could easily approach a billion dollars, plus the annual operating
expenses! We have to sell a lot of megawatts to make a billion dollars! The point is that
we should be careful not to spend such a significant portion of the benefits we may
experience from wholesale power competition just to maintain organizational perpetuity.
ISOs and RROs should ultimately be common entities.

The finer details of such a model have not been developed, recognizing that significant
proposals with broad impacts must be developed through a collaborative process. Perhaps
there are other more acceptable ways to accomplish clarification of responsibilities and
the establishment of necessary industry institutions in the most economical fashion. Some
constructive alternatives will certainly be put forth in the FERC’s ISO conference, next
week. But regardless of whether or not this model or another is ultimately adopted, the most important feature of future ISOs is that they must have economic incentives to provide excellent service and promote competition. A non-profit ISO that does not have real commercial and operational control of the transmission system, including full responsibility for throughput, cost recovery and congestion management, will likely result in a diminution of competition and a reduction of services. While a for-profit corporation, perhaps in the form of a regional “TransCo,” may not be realistic in the early years of restructuring, this is likely where the industry needs to end up. In the meanwhile, personal compensation incentives should be liberally applied to the ISOs that demonstrate superior performance relative to their peer groups, and relative to the previously disaggregated transmission system operations. If we don’t end up with competitive transmission services, then we’ve missed the target.
The Future of the Independent System Operator

Regulators
U.S., Canada, Mexico

Continental Electric Self-Regulating Organization (CESRO)

Western SRO District  ERCOT SRO District  Eastern SRO District

ISO  ISO  ISO  ISO  ISO  ISO  TransCo

NGC Attachment 1