

**Second-Generation Regulatory Capture  
as an Explanatory Factor in the Performance of  
Regional Transmission Organizations**

**Presented to the  
Center for Research in Regulated Industries  
Advanced Workshop in Regulation and Competition  
27th Annual Eastern Conference  
Skytop, Pennsylvania**

**May 15, 2008**

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# “SECOND GENERATION” REGULATORY CAPTURE AS AN EXPLANATORY FACTOR IN THE PERFORMANCE OF REGIONAL TRANSMISSION ORGANIZATIONS

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## I. INTRODUCTION

A significant body of public policy and economic literature has developed around the concept of “regulatory capture”—a condition in which a governmental regulatory agency created by legislators to serve the interests of the public becomes dominated by incumbent members of the industry it oversees, leading to regulatory decisions and policies that serve the commercial goals of regulated firms rather than those of the intended beneficiaries. The capture analysis provides a useful tool for understanding regulatory agency actions that appear contrary to the policy goals that motivated an agency’s creation. Capture has been used to explain the actions of a variety of regulatory agencies in the U.S. and abroad. Notable examples include analyses of the Federal Aviation Administration, the Federal Communications Commission, and state utility regulatory agencies.<sup>2</sup>

This paper applies the tools of the capture analysis to a different category of “agency”: regional transmission organizations (“RTOs”) created under regulations adopted in 1999 by the Federal Energy Regulatory Commission. RTOs are independent, non-governmental entities that operate bulk power electric transmission facilities and wholesale electricity markets in large portions of the United States. They are quasi-regulatory in the sense that their decisions, policies and actions substantially affect entry and prices in wholesale electricity markets, both directly and indirectly. In addition, RTOs administer the conferring of what might reasonably be considered “public goods” (primarily, access to the use of the regional transmission grid) among parties vying for those benefits. In these and other ways (discussed in more detail below), RTOs have functional similarity to governmental regulatory agencies such that application of the capture analysis may have explanatory value in understanding the performance of RTOs.

The goal of this paper is to explore the usefulness of the regulatory capture analysis in the RTO setting—that is, to see whether the capture model is helpful in understanding RTO decisions and actions. In particular, we examine a variant of the regulatory capture model that has been termed “second generation” capture: a subtler construct that focuses on the adoption by regulators of basic principles and perceptions that accord with and promote the commercial goals of the firms subject to their oversight. Our analysis is admittedly preliminary and does not attempt to argue that RTOs have (or have not) been “captured” by incumbent market participants. As much as anything, our goal is to stimulate discussion, and possible further

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<sup>1</sup> The views set forth in this paper are solely those of the authors and are not presented as representing the views of the authors’ law firm or of any past, current or prospective client of the authors’ law firm. Any attribution of the views set forth herein either to the firm or a client of the firm would be without basis.

<sup>2</sup> For a useful survey of the capture literature, *see* Ernesto Dal Bó, “Regulatory Capture: A Review,” *Oxford Review of Economic Policy*, 22:203 at 203 (2006).

research, as to the explanatory value of the capture analysis in this setting. To that end, in Part V below, we state a number of questions that (in our view) should be addressed as part of any further exploration of this topic.

## II. “SECOND GENERATION” REGULATORY CAPTURE

### A. *Overview*

The modern version of the “regulatory capture” analysis generally is traced to George Stigler’s work in the early 1970s,<sup>3</sup> although several capture-oriented analyses predate that work.<sup>4</sup> Stigler posited as his central thesis that, “as a rule, regulation is acquired by the [regulated] industry and is designed and operated primarily for its benefit.”<sup>5</sup> In essence, a regulatory agency is deemed to have been “captured” when it consistently produces regulatory outcomes that favor the business enterprises the agency was created to control more often than those outcomes benefit the consumers or other parties the agency was charged with protecting. Ernesto Dal Bó describes the concept in these terms:

[T]he term “regulatory capture” ... receives both a broad and a narrow interpretation. According to the broad interpretation, regulatory capture is the process through which special interests affect state intervention in any of its forms, which can include areas as diverse as the setting of taxes, the choice of foreign or monetary policy, or the legislation affecting R&D. According to the narrow interpretation, regulatory capture is specifically the process through which regulated monopolies end up manipulating the state agencies that are supposed to control them.<sup>6</sup>

The mechanisms by which regulatory capture may be accomplished will vary. Some of the means by which regulators may be captured are blatant and even unlawful (*e.g.*, conferring financial benefits on individual commission members in return for favorable decisions). Others are less overt, though often not by a great deal (*e.g.*, the express or implied promise of later employment within the regulated industry). Oftentimes, capture may be accomplished by indirect means, such as where regulated companies exert political pressure on legislators to reduce an agency’s budget or authority with the goal of pressuring the agency to adopt a more industry-friendly stance. The proposition underlying the conventional regulatory capture model is that regulated firms are able to influence or control regulatory outcomes through the firms’ ability to confer on (or withhold from) regulators pecuniary or other rewards.

Avinash Persaud has formulated a more modern view of capture that does not depend on improper enticements or coercion. He describes this model as “second generation regulatory capture.” As Persaud outlines the model, second-generation capture achieves its result through means that are more subtle than bribes, political pressure or promises of future employment. Second-generation capture occurs when regulated firms succeed in creating a commonality of

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<sup>3</sup> G. Stigler, “The Theory of Economic Regulation,” *Bell Journal of Econ. and Mgmt. Science*, 2, 3-21 (1971).

<sup>4</sup> See, *e.g.*, L.H. Kohlmeier, *The Regulators: Watchdog Agencies and the Public Interest* (Harper & Row, 1969).

<sup>5</sup> Stigler, *supra* note 3 at 3.

<sup>6</sup> Dal Bó, *supra* note 2, at 203.

foundational perspectives between regulators and the firms they oversee. Persaud described the concept as follows:

[R]egulatory capture today is second generation capture. It's much more subtle and sophisticated than in the past. It's not about bribery and corruption of officials. ... It's about big business persuading regulators about certain principles that seem eminently sensible, although on further examination I believe are hollow and bankrupt; principles that the regulators grab hold of and believe are right, but actually ultimately support big businesses and the regulated.<sup>7</sup>

Dal Bó outlines a similar analysis but attributes the emergence of shared perspectives to the “revolving door” between industry and agency employment:

The channels through which industry employment may affect regulatory performance are multiple. An important distinction is whether such employment is held before or after regulatory involvement. Coming from industry may induce regulators to make pro-industry decisions because of the regulator having been “socialized” in an industry environment. This in turn may yield different cases. In one extreme, we might find fairly irreflexive, partisan pro-industry types; on the other, well-meaning individuals who tend to see the concerns of industry as more legitimate, salient, or relevant to general welfare, because those are the concerns they are most familiar with. An example of the latter case might be a person with industry background who worries about the fact that low prices may discourage investment, and in turn hurt future consumers. The possibility of post-regulatory employment is different: regulators may bias their decisions in order to enhance their chance of future employment in industry. An explicit *quid pro quo* may exist, whereby lenient regulation is rewarded with future employment in industry. At other times, firms may mainly hire former regulators because the latter possess valuable skills and not because such hiring is part of a reward scheme. Still, given skills, firms may prefer employees that seem to have industry interests more at heart. Then, regulators may try to signal their appeal to industry by being lenient to it. In this last situation, a pro-industry regulatory bias is more of an instance of the “collateral damage” of a free circulation of human capital.<sup>8</sup>

Although Dal Bó sees at one extreme an express *quid pro quo* in which favorable decisions are traded for future employment, the other end of his spectrum is closely akin to what

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<sup>7</sup> A. Persaud, “Regulatory Capture,” Gresham College Lecture Series (June 28, 2005). A transcript of the lecture is available at <http://www.gresham.ac.uk/event.asp?PageId=45&EventId=265>.

<sup>8</sup> Dal Bó, *supra* note 2 at 214.

Persaud describes as “second generation” capture. According to the “second generation” model, capture does not depend on venality or self-interested motives on the part of regulators. Indeed, it may be assumed for purposes of the analysis that regulators formulate policies and decide cases based on a sincere desire to promote the public good. Their decisions, however, will tend to favor the interests of the regulated sector when their concept of the public good and how to achieve it has been skewed.

Thus, second-generation capture arises when regulators adopt and apply as their own one or more paradigms<sup>9</sup> that have been promoted by the firms being regulated. Adherence to these paradigms will lead captured regulators to discount or ignore evidence that the interests of the public are not being served by the agency’s actions. The tendency may be likened to one of the mechanisms (“trivialization”) identified by psychologists and organizational scientists as a means of mitigating cognitive dissonance.<sup>10</sup> Here, regulators generally perceive themselves as acting in the public interest; indeed, this belief may a factor in their election of government service. To that extent, regulators will tend to discount any suggestion or indication that their policies and decisions may be disserving the public interest. It follows that, if regulators’ view of the public interest itself has been skewed by the adoption of industry-promoted beliefs or models, they will be forced to trivialize or reject any conflicting beliefs or models.

The commonality of perspectives that is emblematic of second-generation capture likely will exist at foundational levels. One example would be a belief that unconstrained market forces can be relied upon to achieve the most efficient allocation of resources in virtually any industry, including those (like the electricity industry) that historically have been regulated because of their perceived “natural monopoly” attributes. Another example might be a belief that, when market dysfunction occurs, regulators should adopt a course of minimal intervention, acting only as necessary to assure that suppliers recover their costs. Firms that expect to prosper in this setting can be expected to favor and promote market-oriented policies and approaches, and to lend their goodwill and support to regulators who share their free-market beliefs.

When regulators and the firms they oversee share such foundational paradigms, their more specific views on day-to-day regulatory outcomes also will tend to converge. Over time, a body of agency precedent will be established that reinforces and institutionalizes the industry-sponsored tenets. In that way, second-generation capture becomes a self-validating, and therefore self-perpetuating, phenomenon.

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<sup>9</sup> As we use the term in this paper, a “paradigm” is a system of precepts, beliefs or principles regarding one or more fundamental economic issues.

<sup>10</sup> Cognitive dissonance occurs when an individual holds two cognitions (*i.e.*, elements of knowledge, or attitudes, emotions or beliefs) that are incompatible. According to cognitive dissonance theory, the individual’s perception of the incompatibility acts as a driving force that compels her to acquire or invent new thoughts or beliefs, or to modify existing beliefs, in order to alleviate the psychological discomfort created by the conflict (or dissonance). *See* Leon Festinger, *A Theory of Cognitive Dissonance*, Stanford University, Stanford, Calif., 1957. Although cognitive dissonance theory initially found application in the framework of clinical and social psychology, it also has been applied to provide insight into organizational behavior. *See, e.g.*, B. Burnes and H. James, “Culture, Cognitive Dissonance and the Management of Change,” 15 INT’L J. OP. & PROD. MGT. 14 (1995).

## ***B. Contributory Factors***

Because second-generation capture is less overt than the conventional (or “first generation”) form, one of the challenges in applying the second-generation model is to identify the factors that promote a commonality of basic perspectives between regulators and the firms they oversee. The literature points to several conditions that promote, or contribute to the emergence of, capture:

- Mission/interest convergence. A significant factor in capture is convergence between an agency’s perception of its primary regulatory mission and the interests of the “capturing” industry sector.<sup>11</sup> Early in an agency’s life-cycle, it will perceive its primary mission as that of reining in the industry newly placed under its supervision. In these circumstances, such “capture” as may occur likely will favor smaller market participants or the consuming public, rather than the larger industry members whose misdeeds may have prompted the legislative decision to regulate. An agency’s perception of its mission may shift over time, however, for any number of reasons.<sup>12</sup> For example, the regulated industry might have fallen on hard economic times, in which case the agency may come to perceive its role as preserving the regulated firms’ financial viability. Or, Congress may adopt statutory changes reflecting new public policies, causing the agency to perceive its mission differently. An example of this can be found in Congress’ adoption of provisions reflecting pro-competitive policies in a number of long-standing regulatory statutes, including the Federal Power Act. These changes are likely to cause an agency to perceive its new mission as promoting (and rewarding) the formation of industry structures that facilitate reliance on market forces to set prices and ration supply. If firms expect to earn higher than competitive returns in bid-driven markets,<sup>13</sup> there will develop a convergence between the agency’s perception of its new pro-market mission and the more self-interested commercial goals of the (previously) regulated firms. This convergence will be manifest in a commonality of perspectives on a range of market issues, signaling the presence of second-generation capture.

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<sup>11</sup> As may be readily apparent, our reference to an agency’s perception of its “primary mission” is a simplification. In reality, regulators attempt to satisfy a number of mandates at once, not all of which are necessarily consistent. In the context of utility regulation, for example, FERC seeks to promote competitive market formation, encourage infrastructure investment, protect reliability and prevent the exercise of market power, all while ensuring that consumers pay rates that are “just and reasonable.” Of necessity, regulators will (consciously or unconsciously) prioritize their various perceived missions. What we describe as “mission/interest convergence” is most likely to affect regulatory outcomes when the convergence involves an agency’s highest priority mission(s).

<sup>12</sup> See, e.g., D. Martimort, “The Life Cycle of Regulatory Agencies: Dynamic Capture and Transaction Costs,” 66 REV. OF ECON. STUD. 929 (1999) (“[R]egulatory agencies evolve over time. Casual observations suggest that agencies start to behave in the public interest and then become increasingly inefficient, bureaucratized and more eager to please private interests.”).

<sup>13</sup> The operative assumption is that regulators allow firms to earn returns approximating the returns that would be achievable under perfect competition. When conventional price regulation is removed or relaxed, however, market imperfections may allow some (but usually not all) firms to earn supra-competitive returns, at least in the short term.

- Impact concentration: In any regulatory setting, agency decisions will affect different groups of stakeholders to varying degrees. An increase in rates charged by a utility, for example, might add only a dollar or two to an individual customer's monthly bill, but could bring the involved utility millions of dollars in additional revenue. Parties with very large stakes in the outcome of regulatory decisions generally are much more active in seeking to promote their views to regulators than parties that would incur much smaller individual impacts. This is especially true if these large-stakes parties are able to act collectively (*e.g.*, through trade associations), since collective action allows them to devote more resources to shaping and presenting their views to regulators, thereby promoting capture. On the other hand, where the impacts of regulatory action are widely dispersed, parties will have less incentive to take actions that promote capture.
- Migration of personnel. Notwithstanding efforts to limit the “revolving door” between regulatory agencies and the firms they oversee, it remains the case today that agency staff members often are able, after some period of government service, to secure far more remunerative positions in the industry they once oversaw. In part, this pattern simply reflects supply and demand in the market for specialized expertise. Government service often serves as a form of post-graduate training for specialties that are prized in the private sector. Occasionally, the flow will reverse, as when an executive or employee of a regulated firm leverages his or her background to secure a position in the regulating agency.<sup>14</sup> Thus, the free migration of professional personnel between regulatory agencies and regulated companies will reinforce the commonality of perspectives that is the core attribute of second-generation capture.<sup>15</sup>
- Asymmetric distribution of expertise. In highly complex markets, in-depth expertise on market operation issues often is scarce, primarily because meaningful expertise can be gained only through extended, direct participation in market transactions. Regulated companies are in a better position to attract personnel with the background and knowledge required to

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<sup>14</sup> It is not uncommon, for example, for the executive ranks of regulated firms to serve as a source of high level federal agency personnel. The current Secretary of the Treasury, for example, previously headed a major investment banking firm subject to Treasury oversight. The sitting Chair of the Securities and Exchange Commission previously headed the Corporate Department of an international law firm, where he specialized in venture capital and corporate finance. The Chief Counsel of the Food and Drug Administration came from a law firm that lists large pharmaceutical and agribusiness firms among its clients. This pattern is not at all new; it has been ongoing almost from the inception of regulation. *See* Kohlmeier, *supra* note 4.

<sup>15</sup> In a discussion of *ex ante* consideration of optimal regulatory structures for recently privatized markets, it was observed that “what practitioners typically recommend – *i.e.*, that ensuring that the regulators are appointed on the basis of professional rather [than] political criteria – may not be the optimal strategy to minimize capture since the professional experts are likely to come from the sector they are supposed to regulate and are likely to return to it sooner or later.” A. Estache and D. Martimort, “Politics, Transaction Costs, and the Design of Regulatory Institutions,” published by the Regulatory Reform and Private Enterprise Division of the World Bank Economic Development Institute (World Bank Policy Research Working Paper 2073 (March 1999)) at 20.

understand complex market operations. As a result, regulatory agencies may suffer a disadvantage in terms of technical market expertise and practical experience. In these circumstances, agency staff are more susceptible to regulated firms' efforts to promote the adoption of models and principles that further the firms' commercial objectives.

- **Information costs.** Many regulated markets are characterized by high costs of information acquisition. In the electric utility industry, for example, it is expensive for regulators to gather and process the voluminous data that provide insight into market functionality. Well-resourced market participants, on the other hand, generally have direct access to the data. Regulated companies may become the best (or only) sources of detailed information about activities in the market. As a result, regulated companies gain considerable control over access to the information and knowledge that regulators need in order to discharge their functions effectively. Smaller stakeholders, by contrast, often lack the resources to gather and process comparable volumes of information, particularly if legal strictures limit the sharing of market-related information. This creates a situation in which regulators come to depend on the regulated firms themselves for data needed by agency staff to perform their regulatory activities. The manner in which data are packaged, shaded and presented can help forge the commonality of perspectives that typifies second-generation capture.<sup>16</sup>

These factors all play a part, to varying degrees, in the emergence of second-generation capture and its effect on regulatory outcomes. The importance of each factor will depend on the circumstances of an agency and the markets under its supervision. Understanding the role played in specific settings by each factor would be important in formulating solutions.

### ***C. Indicia of Second-Generation Capture***

The literature includes various attempts to correlate first-generation capture with objective market structure and performance metrics, such as concentration of ownership, ease and frequency of entry,<sup>17</sup> price volatility and price trends. Second-generation capture can be

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<sup>16</sup> Levine and Forrence describe the role of information costs in the capture dynamic as follows:

Special-interest policies or actions are those that would only be ratified by a self-interested subset of a polity. These policies or acts provide concentrated benefits to a subset of a polity at the expense of the general polity, but do not result from an other-regarding general-interest willingness to ratify a wealth transfer to the special beneficiaries. Special-interest policies or actions can exist in a democratic polity only if the magnitude of information, organization, and transaction and monitoring costs for a subgroup is lower in comparison to benefits which can be concentrated on them than they are for the general polity.

"Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis," VI J. LAW, ECON. & ORG. 167 at 168 (1990).

<sup>17</sup> Stigler's landmark paper on capture, for example (*see* Stigler, *supra* note 3), sought to correlate the existence of occupational licensure (an entry restriction that improves the economic circumstances of licensed individuals and firms) with the size of the occupation relative to the labor force as a whole (which Stigler equated with the ability to affect political outcomes on such matters as licensing legislation) in each state.

expected to manifest itself in similar outcomes. But since the nub of second-generation capture is a commonality of foundational perspectives between regulators and regulated firms, more subjective indicia also may be important.

As an example, a fruitful area for any inquiry into the existence of second-generation capture would be the views of “stakeholders” regarding the efficacy of the regulatory mechanism. In most instances, the principal stakeholders will be the users of goods or services provided by the regulated firms. To the extent a consistent set of stakeholder views is discernable, it will give insight into whether the intended beneficiaries of the regulatory regime perceive that their interests are being served. If a large body of stakeholders believe their interests consistently are subordinated to those of regulated firms, this belief may have its roots in a tendency by the regulator to discount or disregard paradigms at odds with his own (which, in turn, originated with the regulated firms). In such instances, second-generation capture is likely to be present.

Another indicator of second-generation capture is the emergence of a collaborative relationship between an agency and one or more members of the regulated industry. This collaboration can take a number of forms, many of which are harmless but others of which can greatly impair an agency’s regulatory effectiveness. Of the latter type, for example, would be excessive agency deference to industry members or to organizations composed of (or controlled by) industry members. At the extreme, deference of this sort may become an unlawful delegation of regulatory authority. Although the point at which unlawful delegation occurs usually will depend on the circumstances, the danger of illegality arises when lines of responsibility between the agency and the regulated firm become blurred.<sup>18</sup>

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<sup>18</sup> An example of the described blurring of responsibilities is provided by a recent inquiry into Southwest Airlines’ violation of mandatory airliner inspection rules. An investigation conducted by the Department of Transportation’s Office of the Inspector General found that “FAA’s Southwest inspection office developed an overly collaborative relationship with the air carrier.” That relationship resulted in the FAA permitting Southwest to “self-report” fuselage cracks that in fact had been discovered by FAA inspectors. This abuse of the self-reporting program allowed Southwest to keep a number of aircraft flying long after they would have been pulled from service for mandatory inspections and repairs, had the fuselage cracks not been treated as “self-reported.” See “Actions Needed To Strengthen FAA’s Safety Oversight and Use of Partnership Programs,” Statement of Calvin L. Scovel III, Inspector General, U.S. Department of Transportation (dated April 3, 2008). A copy of the Inspector General’s statement is posted at [http://www.oig.dot.gov/StreamFile?file=/data/pdfdocs/OIG\\_STATEMENT\\_ON\\_SWA.pdf](http://www.oig.dot.gov/StreamFile?file=/data/pdfdocs/OIG_STATEMENT_ON_SWA.pdf).

### III. APPLICATION OF THE “SECOND GENERATION” CAPTURE ANALYSIS TO FERC-APPROVED RTOs

Although others have noted the possible relevance of capture to FERC-approved RTOs,<sup>19</sup> we are not aware of any focused attempt to apply the capture model’s analytical tools in this context. We undertake the attempt in the remainder of this paper. As a necessary simplification, we address the RTO as a unitary decision-making entity; that is, we do not undertake to address in detail the internal governance structures that underlie RTO decisions and actions. Doing so would require a far more exhaustive analysis, especially considering the significant variation among RTOs in this regard. Viewing the RTO as a unitary decision-making entity allows us to discuss the elemental dynamics of capture without getting bogged down in the mechanisms through which capture becomes manifest. Nevertheless, we acknowledge the importance of governance issues<sup>20</sup> and suggest that a further exploration of the question take governance structures into account.

#### A. RTOs as *Quasi-Regulatory Bodies*

The past three or four decades have witnessed a strong and pervasive federal policy favoring competition in many sectors of the economy that previously were characterized by regulated monopoly service. The wholesale electricity market is one such sector. The Federal Energy Regulatory Commission has been charged by statute with promoting competition in the supply of wholesale electricity generation services, and the agency has been decidedly proactive in adopting and implementing pro-market policies and regulations.

An important element of FERC’s effort has been to encourage the formation of Regional Transmission Organizations. FERC adopted regulations governing the formation and activities of RTOs in late 1999, and there now are six FERC-approved RTOs operating in the United States.<sup>21</sup> A core RTO function is to foster competition by providing non-discriminatory open access transmission service for wholesale electricity transactions. RTOs exercise “functional control” over the high-voltage grid and grant (or deny) use of the network by parties seeking the most economic sources of bulk electricity supply. Each RTO also formulates the rules for conduct of the wholesale power market in its region and is responsible (directly or through an outside contractor) for monitoring the markets to identify instances of manipulation or abuse.

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<sup>19</sup> In a recent article on RTO accountability, Dworkin and Goldwasser briefly discuss the relevance of the capture analysis but suggest that, because RTOs are “sheltered” from the federal political process, they may be less subject to capture than governmental bodies. Dworkin and Goldwasser acknowledge, however, that “RTOs do set market rules that benefit one group of participants over another,” and that “[t]he RTO decision-making process is one that inherently creates winners and losers.” M. Dworkin and R. Goldwasser, “RTO Governance and Accountability,” 28 ENERGY L. J. 543 at 582-3 (2007) (accessible at [http://www.eba-net.org/docs/elj282/Governance\\_of\\_RTOs.pdf](http://www.eba-net.org/docs/elj282/Governance_of_RTOs.pdf)). In that way, Dworkin and Goldwasser seem to recognize that RTOs may be subject to some of the same capture-related forces as statutory governmental agencies.

<sup>20</sup> The importance of governance issues is underscored by FERC’s recent initiation of a formal rulemaking proceeding to consider alternative governance models. See Notice of Proposed Rulemaking, *Wholesale Competition in Regions with Organized Electric Markets*, 122 FERC ¶ 61,167 (February 22, 2008).

<sup>21</sup> The six FERC-approved RTOs are: ISO New England; the New York ISO; PJM Interconnection (which covers the Mid-Atlantic states and some parts of the Midwest); the Midwest ISO (which covers other parts of the Midwest); the California ISO and the Southwest Power Pool (which covers parts of Texas, Louisiana, Arkansas, Missouri, Kansas and Oklahoma).

RTOs are expressly prohibited from having direct commercial interests in the electricity markets and also are required to have boards of directors composed of individuals that have no financial tie to any market participant. For these reasons, FERC assumes that RTOs will be independent and unbiased in granting transmission access, developing market rules and monitoring the wholesale markets in their respective regions.

Each RTO operates under its own FERC-approved tariff, and the detailed duties and functions of the RTOs run a broad gamut. It would be a lengthy undertaking to specify the respects in which each RTO's functionality may fairly be viewed as quasi-regulatory in nature.<sup>22</sup> At a generic level, however, the following RTO characteristics may be noted:

- RTO decisions affect price levels for wholesale electricity, both by direct and indirect means. Although prices for competitive services generally are based on bids submitted by market participants, RTOs initially are responsible for developing the tariff provisions that specify what products will be subject to bid-based pricing, how bids must be structured, how often bids may be submitted, the portions of the RTO market area that are subject to one bid or another, and the conditions in which bid-based pricing may be suspended due to anomalous market conditions (*e.g.*, locational supply shortages). Although FERC requires that these rules be specified in filed and approved tariffs, RTOs retain varying amounts of *de facto* discretion in administering the relevant tariff provisions. As a result, RTOs and governmental rate-setting agencies both function in ways that directly affect prices, notwithstanding that the specific mechanisms obviously differ.
- RTOs establish capacity requirements for load-serving entities (“LSEs”). RTOs are responsible for establishing “capacity adequacy” requirements governing the amounts of generating capacity LSEs must install or have available in order to satisfy applicable reliability criteria. Capacity adequacy rules have far-reaching impacts on all market participants but for LSEs in particular. Unlike merchant suppliers, LSEs do not have the option of exiting the market if capacity rules or prices become onerous. At the same time, capacity adequacy rules will impact individual LSEs to differing degrees, depending on an LSE's location, the amount of capacity it owns, the amount of demand response capability it has at its disposal and other factors. Thus, RTO capacity rules can have significant wealth transfer and competitive effects, in addition to their impacts on reliability.
- RTO determinations affect ease and cost of market entry by potential new competitors. RTOs are responsible for developing and applying rules and requirements that determine the ease and cost of entry. As an example, RTOs administer strict creditworthiness and financial security requirements for

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<sup>22</sup> Such an analysis, for example, might evaluate the powers granted each RTO under its individual tariff with the ability to confer one or more of the four state benefits described by Stigler as being the objects desired by regulated entities: (a) direct subsidy of money (ability to tax and distribute cash to particular players); (b) control over entry by rivals; (c) availability and cost of substitutes and complements; and (d) price determination (keeping prices at levels that yield profits in excess of competitive returns). *See* Stigler, *supra* note 3.

market participants. Potential entrants may be barred from market entry if they are unable to meet those requirements. RTOs also administer reporting requirements and bid-submission standards that affect potential entrants' ability to enter and remain in the market. In these ways, RTOs serve a gate-keeper function somewhat akin to the certification role historically played by governmental regulatory agencies.

- RTOs play a market oversight role that is fundamentally regulatory in nature. As noted, market monitoring is one of the fundamental duties of FERC-approved RTOs. That duty encompasses the collection and analysis of market data and, in some instances, includes the authority to require submission of additional information by market participants when deemed to be needed by the RTO. Even if the oversight function is outsourced (as often it is), the RTO ultimately is answerable to FERC for the effectiveness of its market monitoring activity. Market monitoring is both informational (apprising stakeholders and statutory regulators about market functionality) and enforcement-oriented in nature. It is no exaggeration to say that market monitors serve as the “eyes and ears” of the statutory regulatory body in RTO-administered markets.
- RTOs mediate between market participants and statutory regulatory authorities. RTOs stand between the agencies possessing statutory regulatory jurisdiction and authority (primarily, FERC) and individual market participants. Among other things, RTOs are responsible for monitoring the wholesale markets they operate and informing FERC of actions that may subject a market participant to FERC's civil penalty authority. These were among the functions FERC highlighted, in adopting its RTO regulations, as permitting reduced regulatory scrutiny (that is, “light-handed regulation”) by FERC itself.<sup>23</sup> FERC also has indicated its willingness to give deference to RTO determinations, especially those that were preceded by stakeholder processes, while also applying the statutory “just and reasonable” standard.<sup>24</sup> These factors infuse the RTO's discharge of its duties with a quasi-regulatory quality, inasmuch as the RTO's decisions may determine whether and when the formal legal authority of the statutory agency is brought to bear.

The analogy between RTOs and statutory regulatory agencies deserves further development in the context of capture analysis. To be sure, the analogy has gaps and imperfections. As important as an RTO's specific powers and duties, however, is the extent to which interested parties believe that the RTO is in a position to confer benefits similar to those previously obtainable only through operation of the formal regulatory process. So long as that is the case, the incentive for capture will exist.

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<sup>23</sup> *Regional Transmission Organizations*, Order No. 2000, 65 FR 809 (Jan. 6, 2000), FERC Stats. & Regs. ¶ 31,089 (1999), *order on reh'g*, Order No. 2000-A, 65 FR 12088 (Mar. 8, 2000), FERC Stats. & Regs. ¶ 31,092 (2000), *aff'd sub nom. Public Utility District No. 1 of Snohomish County, Washington v. FERC*, 272 F.3d 607 (D.C. Cir. 2001).

<sup>24</sup> *See, e.g., Midwest Independent Transmission System Operator, Inc.*, 115 FERC ¶ 61,296 (2006).

## ***B. Presence of Identified Contributory Factors in the Context of FERC-Approved RTOs***

As noted in Section II.B above, there are several factors that appear to contribute to the emergence of closely shared perspectives between a regulatory agency and the firms it oversees. Many or most of these contributory factors (or analogues thereto) also can be identified in the RTO context, as follows:

- Mission/interest convergence: In the years since Congress adopted pro-competitive amendments to the Federal Power Act,<sup>25</sup> a strong convergence has developed between FERC's perception of its regulatory mission and the interests of the merchant generation sector. Indeed, FERC has stated that "[t]he foundation for today's wholesale gas and electric energy markets lies in the reliance on open-access transportation and transmission service," which "allows independent suppliers to compete for gas and electric energy sales at market-based prices...."<sup>26</sup> FERC encouraged RTO formation to provide regional platforms for competition, and the RTOs clearly have internalized that objective.<sup>27</sup> The RTO market development mission obviously converges with the desire of merchant generators to expand the range of products they are able to bid into RTO-operated markets. In fact, as the products offered in RTO markets become increasingly exotic, the merchant generators' interests are further served, since the associated market rules become increasingly arcane. This affords sellers a host of advantages over less-sophisticated buyers.
- Impact concentration: RTO decisions often have highly concentrated impacts on suppliers. This is particularly true for RTO decisions that affect the rules governing market operations and pricing. A change in market rules may allow suppliers to reap very substantial rewards (or, alternatively, may cause them to incur large costs). The impacts on individual consumers, however, are far more diluted. This impact concentration incentivizes suppliers to engage in aggressive advocacy for their positions with RTO management and staff.

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<sup>25</sup> The first step on the road to wholesale electricity competition was taken in the Public Utility Regulatory Policies Act ("PURPA"), which created strong incentives for the development of cogeneration and small power production facilities that were entitled to sell their output to nearby utilities. FERC was charged with adopting regulations to implement PURPA's mandate, which it did in FERC Order No. 69 and related orders. Subsequent Congressional actions gave FERC increasing authority to promote competition in the electricity supply sector.

<sup>26</sup> Federal Energy Regulatory Commission, "FY 2007 Performance and Accountability Report" at 9 (posted at <http://www.ferc.gov/about/strat-docs/2007-audit.pdf>).

<sup>27</sup> PJM operates the world's largest wholesale electricity market and states that "since 1997, when its competitive wholesale market began operating, PJM has led a dynamic process that has expanded the kinds of markets available to participants...." See the summary of PJM markets posted at <http://www.pjm.com/about/downloads/20061129-pjms-market.pdf>). Initially, PJM operated only day-ahead and real-time energy markets, but since has expanded its markets to include certain ancillary services and financial transmission rights. It currently is in the process of implementing additional markets for reserve products (e.g., Day-Ahead Scheduling Reserves).

- Migration of personnel: Professional staff members generally may migrate with freedom between RTOs and market participants.<sup>28</sup> RTO employees who gain hands-on familiarity with market operations are desirable hires for market participants. On occasion, the manpower flow actually has gone in the other direction (for example, when a market participant downsizes its staff). Either way, the migration of professional staff reinforces the commonality of foundational beliefs that is emblematic of second-generation capture.
- Information costs: The wholesale electricity markets in RTO regions are, by and large, immensely complex. The markets are highly data intensive, and any data that are acquired must be aggregated and processed to discern patterns and trends. As a result, actionable information about market functionality tends to be costly to acquire. RTOs have invested substantial resources in acquiring the ability to gather and manage such information, but important data may lie beyond an RTO's reach.<sup>29</sup> For these reasons, RTOs remain dependent for certain categories of data upon parties with direct commercial interests in the market.
- Asymmetric distribution of expertise: Disparities in access to market-related expertise may exist. Although RTO staffs typically include individuals with expertise in market operations, they frequently are outnumbered by the market operations staffs of the larger market participants. Merchant generators, for example, have developed impressive capabilities to model future market conditions and adopt bidding strategies based on those models. Differences in expertise would create a further measure of dependency between the RTO and larger market participants.

### C. *Evidence for the Existence of Second-Generation Capture of FERC-Approved RTOs*

Although much of the evidence is anecdotal and incomplete, there are a number of indicators suggesting varying degrees of second-generation capture in the RTO arena. This paper highlights some of those indicators while inviting a more thorough and rigorous analysis by others.<sup>30</sup>

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<sup>28</sup> Some RTOs do restrict Board of Directors participation by former officials of market participants. In PJM, for example, a prospective Board member would be disqualified if he or she had been employed by a PJM Member (or an affiliate of a member) within the five year period before that person's selection. Dworkin and Goldwasser, *supra* note 19, at 568.

<sup>29</sup> As an example, the PJM market monitoring unit recently identified a need to gain access to information about parallel electrical flows ("loop flows") in the Eastern Interconnection. The PJM market monitor stated that accessing such information is important because "loop flows have negative impacts on the efficiency of market prices in markets with explicit locational pricing and can be evidence of attempts to game such markets." See PJM's *2007 State of the Market Report* (posted at <http://www2.pjm.com/markets/market-monitor/downloads/mmu-reports/2007-som-volume1.pdf>) at 4. Presumably, such gaming would only be possible if market participants have greater access to information about parallel flows than does the RTO market monitor.

<sup>30</sup> In fairness to all concerned, we acknowledge that there also are many examples of RTO conduct, decisions and positions that probably would support a contrary assertion – *i.e.*, that no capture has occurred. Contrary evidence

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More specifically, among the possible indicators of second-generation capture of RTOs are these:

- Many RTO stakeholders (primarily, wholesale transmission customers and others that depend on RTO-provided services) hold the view that RTO management is unduly solicitous of the interests of one industry segment or another. Interestingly (for capture analysis purposes), the industry segment perceived to be the “capturer” is not always the same from one RTO to another. In some regions, it is believed that incumbent vertically-integrated utilities hold sway over the RTO, while in other areas merchant generators are believed to wield undue influence. For present purposes, however, it suffices to note that in each region one sector is believed by some number of stakeholders to have established a strong commonality of views with RTO management and staff. Stakeholder dissatisfaction may indicate that RTO personnel are discounting views that conflict with industry-sponsored perspectives adopted by the RTO.<sup>31</sup> Discounting of that sort can be expected to arise from a high degree of mission/interest convergence (as discussed in Section II.B above).
- In regions with a high level of market penetration by merchant generators, the RTO itself often is at the forefront in seeking to extend market-based pricing methods to additional commodities and products (both physical and financial). Examples can be found in RTO initiatives to push bid-based pricing beyond simply the hourly energy markets into products, such as capacity, regulation service, spinning reserves and financial hedging rights.<sup>32</sup> Especially in the immediate post-startup phase of a new market, incumbent suppliers often will enjoy opportunities to realize supra-competitive margins in the short term, before new entry occurs. The prospect for supra-normal returns is likely to be especially high where the

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may demonstrate the absence of capture or, alternatively, may demonstrate simply that capture is not an “all or nothing” proposition. That is, the existence or influence of capture may be issue-specific or controversy-specific. The factors that contribute to capture may organize to affect decisional outcomes in some contexts but not others. The existence of contrary evidence neither proves nor disproves the fundamental hypothesis, but, rather, invites a more in-depth analysis to identify the circumstances that allow capture to affect RTO outcomes in particular instances.

<sup>31</sup> As an example, in May 2007 the ISO/RTO Council (an industry organization consisting of representatives of North American RTOs and independent system operators) published a document entitled “Myths and Facts About Competitive Wholesale Energy Markets.” The document responds to, and seeks to debunk, a number of criticisms leveled at organized wholesale markets that had been advanced by LSEs and their representatives. The document is posted at [http://www.isorto.org/atf/cf/%7B5B4E85C6-7EAC-40A0-8DC3-003829518EBD%7D/Myths\\_Facts\\_About\\_Competitive\\_Energy\\_Markets%20.pdf](http://www.isorto.org/atf/cf/%7B5B4E85C6-7EAC-40A0-8DC3-003829518EBD%7D/Myths_Facts_About_Competitive_Energy_Markets%20.pdf).

<sup>32</sup> An example lies in PJM’s attempt in 2004 to expand bid-based pricing for Regulation Service to two geographic areas that recently had been integrated into the PJM footprint. PJM’s internal market monitoring unit expressed reservations based on its determination that incumbent providers had a dominant position in ownership of resources capable of providing Regulation Service. PJM overrode the market monitor’s reservations and went forward with its proposal. Initially, FERC approved the request but retrenched on the eve of effectiveness, requiring instead that the incumbent providers be limited to charging prices reflecting a markup over their actual costs. See *PJM Interconnection, LLC*, FERC Docket No. ER05-10-000.

incumbent providers had direct involvement in drafting the rules under which the new market will operate.

- To the extent increased price levels are indicative of capture,<sup>33</sup> it may be noted that RTO markets certainly appear to exhibit the trait. There is a growing body of empirical evidence that electricity prices in RTO-operated organized markets have risen far more than in non-RTO markets.<sup>34</sup> This trend cannot be explained away simply by reference to higher fuel costs or uncertainties over carbon limits, because those trends affect RTO and non-RTO markets alike. Instead, prevailing market rules, as well as supplier bidding strategies, appear to have produced consistently higher prices for wholesale purchasers in regions with organized markets. As noted above, RTO management plays a central role in developing (or, at least, promoting) those market rules. Accordingly, the price data may be interpreted as support for the hypothesis that capture has caused RTO management to adopt market rules that drive prices higher for the benefit of incumbent producers.
- Another factor to be considered is rule complexity – *viz.*, the extent to which complex rules have evolved to govern the operation of the relevant market. Rule complexity is both a cause of capture (regulators become dependent on well-resourced participants to decipher the market’s complexities) and also an indicator that capture has occurred.<sup>35</sup> *Apropos* of this view, it may be

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<sup>33</sup> See Stigler, *supra* note 3.

<sup>34</sup> The American Public Power Association (APPA) recently published an analysis of data collected by the U.S. Department of Energy’s Energy Information Administration (EIA). The data show that, between 1997 and 2007, increases in retail electric prices were significantly greater in states with deregulated electric markets than in regulated states. The deregulated category includes states located in markets under FERC’s jurisdiction and those that allow end-use customers to choose their electricity provider (retail choice) but no longer have rate caps. Without rate caps, the higher prices in wholesale markets become manifest in retail rates. States in the deregulated category started out with a price disadvantage relative to the national average; in 1997, they had average rates that were 3.1 cents per kWh higher than the rates in the regulated states (9.1¢ vs. 6.0¢). Over time, that gap grew so that, in 2007, deregulated states had rates that were, on average, 4.4 cents per kWh higher than the rates in regulated states (12.2¢ vs. 7.8¢). APPA attributes the widening of the gap to, among other factors, the divestiture of utility generation assets and the effect of wholesale rates in RTO markets. “Retail Electric Rates in Deregulated and Regulated States: A Ten Year Comparison,” American Public Power Association (March 2008), available at <http://www.appanet.org/files/PDFs/10year.pdf>.

Another recent analysis found that, in restructured states where customers are now fully exposed to market prices, electricity rates increased almost 40 percent since 2002. The rate of increase in states that remain regulated was only 19 percent. K. Rose, “The Impact of Competition on Electricity Prices: Can We Discern a Pattern?,” presentation to the Harvard Electricity Policy Group, December 6, 2007, available at <http://www.appanet.org/emri.cfm>. See also, S. Blumsack, L. Lave and J. Apt, “Electricity Prices and Costs Under Regulation and Restructuring” Carnegie Mellon Electricity Industry Center Working Paper CEIC-08-03 (available at [http://wpweb2.tepper.cmu.edu/ceic/PDFs/CEIC\\_08\\_03\\_epc.pdf](http://wpweb2.tepper.cmu.edu/ceic/PDFs/CEIC_08_03_epc.pdf)) (finding increases in price-cost markups in restructured markets, and stating that “most of the gains from restructuring have, thus far, gone to producers rather than consumers”).

<sup>35</sup> When an industry sector succeeds in capturing its regulators, incumbent industry members then may seek to increase the complexity of the market rules to preserve their position in the market. As Persuad states, “[b]ig business loves complex regulation. For a start, only they understand it.” Complexity also increases the cost of

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noted that RTO market rules are inordinately complex. The PJM Open Access Transmission Tariff, for example, which contains many of the written market rules by which PJM market participants must abide, now exceeds 1,500 pages in length. Additional market rules appear separately in various PJM Manuals and in the PJM Operating Agreement and Transmission Owners Agreement. Any entity contemplating entry into the PJM markets would need to devote significant resources to comprehending the body of existing rules and staying informed about pending and approved rule changes. This is a daunting task. Hence, the very complexity of the rules functions as a barrier to entry by smaller competitors.<sup>36</sup> That the market rules have been permitted to evolve to such complexity suggests capture by industry segments able to use that complexity to their advantage.

- Finally, another sign of capture may lie in efforts by RTO management to promote the interests of the “capturing” sector by curbing the RTO market monitor’s ability to oversee that sector. Possible examples include PJM’s 2006 filing of tariff changes aimed at eliminating the authority of its internal market monitoring unit (MMU) to issue “demand letters” when it believes a tariff violation is occurring,<sup>37</sup> and later complaints (in 2007) that RTO management had attempted to interfere with the MMU’s performance of its duties.<sup>38</sup> It should be noted that, in both instances, assertions regarding the

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market participation, since more staff must be hired and analysis conducted to understand and follow the complex rules. Complexity thus serves as a barrier to new entry which protects the market share of incumbent participants.

<sup>36</sup> Levine and Forrence also point out that complexity serves as a curtain for regulator behavior that manifests capture. They argue that complex rules and procedures, and subjects difficult to comprehend without sufficient education or background, present high information, monitoring and organization costs. These high costs, in turn, “create ‘slack,’ which shields officials from accountability to the general polity” because “[m]embers of the general polity ordinarily do not have an incentive to learn issues well enough to comprehend their impact or to monitor and discipline the behavior of all those officials whose acts might affect them.” Levine and Forrence, *supra* note 16 at 185.

<sup>37</sup> In April 2006, PJM filed tariff revisions that it stated were aimed at achieving consistency between the market monitoring provisions of its Open Access Transmission Tariff and a FERC Policy Statement on market monitoring. Among the filed revisions was a deletion of tariff provisions under which the PJM MMU could issue “demand letters” and make requests that market participants “discontinue actions” that the MMU believes violate the PJM tariff. FERC approved the change (though with one partial dissent) over the objections of consumer representatives. “Order Accepting Tariff Filing, Subject to Revisions,” *PJM Interconnection LLC*, 116 FERC ¶61,038, *reh’g denied* 117 FERC ¶ 61,263 (2006).

<sup>38</sup> In April 2007, the manager of PJM’s MMU stated that PJM management had “taken a series of actions towards the MMU which I believe are inconsistent with independence and with the objectives of the MMU as stated in the tariff. As examples, these include ordering me to modify the State of the Market Report, preventing me from making a presentation to a membership committee on the exemption of certain interfaces from mitigation when PJM management disagreed with my analysis and delaying the release of an MMU report regarding the regulation market based on management disagreements with our conclusions.” “Prepared Statement of Joseph E. Bowring - PJM Market Monitor,” *Review of Market Monitoring Policies*, FERC Docket No. AD07-8-000, filed April 5, 2007, at 3. PJM denied the allegations. In September 2007, FERC issued an order finding that PJM had not violated its tariff but that: (i) certain of the incidents alleged “reflect a systemic problem in the relationship between [the manager of the MMU] and PJM management, as well as a fundamental disagreement between them as to the appropriate balance between independence and accountability of the MMU;” and (ii) “the significant tension between PJM management and the Market Monitor could compromise the MMU’s ability to perform its tariff-defined functions.”

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intentions of RTO management were vigorously contested. Nevertheless, proponents of the capture analysis might argue that such self-limiting conduct is best understood as a manifestation of capture.

The foregoing examples (or, more accurately, possible examples) are neither conclusive nor exhaustive; undoubtedly, there are other RTO behaviors or outcomes that may be considered symptomatic of capture. Conversely, there are examples of RTO actions and positions that perhaps could be cited as disproving the existence of capture. A more systematic and less impressionistic analysis would be necessary to conclude that RTO behaviors and outcomes demonstrate the existence of capture.

#### **IV. CASE STUDY: APPLICATION OF THE REGULATORY CAPTURE ANALYSIS TO PJM’S ATTEMPT TO INCREASE THE “COST OF NEW ENTRY”**

As a further test of the usefulness of the capture analysis in the RTO setting, we select for more focused discussion a recent FERC proceeding that lately has attracted considerable attention due to both the substance of the proceeding and its lessons regarding RTO independence. The proceeding involved PJM’s attempt to gain FERC approval for an increase in the Cost of New Entry (“CONE”) value used in pricing capacity in PJM’s forward capacity market. The tested hypothesis is that PJM’s actions in this instance demonstrate second-generation capture of the RTO by the merchant generation supply sector (firms that own and operate merchant generating resources and that bid capacity and energy from those resources into one or more of the bid-based wholesale electricity markets that PJM operates in its region). The following discussion tests that hypothesis using the tools of the capture model. Although we attempt to do so without making normative determinations, the authors urge readers to note our participation in the docket on behalf of parties with a direct interest in the outcome.<sup>39</sup>

##### **A. Background**

CONE is a key value used in determining prices for capacity purchased and sold through PJM’s capacity auction mechanism (the “Reliability Pricing Model,” or “RPM”). RPM is the mechanism PJM uses to procure sufficient capacity to ensure reliable service throughout the PJM footprint. PJM proposed the RPM capacity market mechanism in an August 2005 tariff submittal (FERC Docket Nos. ER05-1410-000 and EL05-148-000). The proposal drew vigorous opposition from load-serving entities and consumer representatives. After lengthy and contentious settlement discussions, RPM was re-submitted through an offer of settlement. The settlement offer was supported by most merchant generator interests but few load-serving or consumer interests. Generators claimed that RPM was necessary to encourage the construction of new capacity and protect reliability. Load-serving interests and consumer representatives

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*PJM Interconnection, LLC*, 120 FERC ¶ 61,254 (2007). The matter ultimately was settled with the approval of tariff provisions that moved the PJM market monitoring function to an external entity. *Allegheny Elec. Coop., Inc., et al. v. PJM Interconnection, LLC*, 122 FERC ¶ 61,257 (2008).

<sup>39</sup> The authors are counsel of record in the CONE proceeding for American Municipal Power – Inc. (“AMP-Ohio”), a load-serving entity in the PJM region that has participated in RPM-related proceedings at FERC and that opposed PJM’s proposal to change the value of CONE. The comments and observations set forth in this paper, however, are not presented on behalf of AMP-Ohio or any other client of the authors’ law firm, nor are the views or conclusions set forth herein necessarily shared by AMP-Ohio or any other client of our firm.

argued that RPM would cause significant increases in charges to customers, that it would not address the many non-price impediments to generation investment, and that it would invite gaming and the exercise of market power. FERC approved the contested RPM settlement in December 2006.

The capacity payments produced by RPM are intended to provide a stream of revenues sufficient for generators to maintain existing units while also providing incentives to build new generation. The essential elements of the RPM mechanism are: (i) the procurement of capacity through a competitive auction conducted by PJM three years prior to the “Delivery Year” in which the capacity is required; (ii) a phase-in of locational pricing to reflect the differing capacity needs of defined load delivery areas (“LDAs”) within PJM; and (iii) use of a variable resource requirement (“VRR”) curve to clear the auctions so that the price for capacity established in each LDA varies based on differences between the amount of supply and the target reserve margin.<sup>40</sup> CONE is used to establish the price points along the VRR curve, and therefore is a key determinant in establishing the level of payments received by generation owners that bid their resources into the auction.

### ***B. PJM’s Filing to Increase CONE***

On January 31, 2008, PJM filed with FERC a request to increase the level of CONE.<sup>41</sup> The CONE Filing asserted that the costs of constructing new electric generating units had escalated rapidly since RPM was implemented and that an upward adjustment of CONE was needed in order to adequately compensate generators. PJM argued that, unless CONE were increased, generators would not receive sufficient financial incentive to build new generating units or to keep existing units on-line, and that service reliability would be jeopardized. For these reasons, PJM proposed a significant increase in CONE.<sup>42</sup> PJM asked that the increase be made effective immediately so that the new CONE value could be used to set the VRR curve for the May 2008 RPM auction.

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<sup>40</sup> As RPM now is structured, generation owners bid capacity for a one-year term that commences approximately three years in the future. Prices are based on the intersection of generator bids (the supply curve) and a downward sloping Variable Resource Requirement (“VRR”) curve, sometimes referred to as a “demand curve.” The VRR curve is not a demand curve in the traditional market sense (that is, it does not represent the aggregate prices at which consumers would purchase capacity in a free market); rather, it is an administrative mechanism intended to satisfy capacity-procurement objectives. To do so, the VRR curve provides suppliers with revenue equal to a multiple of “net CONE” (CONE less expected revenues from sales into the energy and ancillary services markets) at varying levels of supply. Suppliers receive revenue equal to 100 percent of net CONE at the point where the level of capacity supplied is equal to PJM’s target Installed Reserve Margin (“IRM”) plus one percent. At supply levels below the IRM, generators would receive higher prices for capacity, but never more than 150 percent of net CONE. Conversely, at supply levels above the IRM, generators receive progressively diminishing prices for capacity. The downward sloping VRR curve and CONE values are designed to attract new entry when the market is short of capacity, and to produce lower prices and to discourage generation construction when there is excess capacity.

<sup>41</sup> PJM’s January 31, 2008, request (hereinafter, “CONE Filing”) is available at <http://www.pjm.com/documents/ferc/documents/2008/20080130-er08-xxx-000.pdf>.

<sup>42</sup> PJM’s filing would have increased the existing CONE value by more than 40 percent in certain portions of the PJM footprint (from \$72,207/MW-yr. to \$106,904/MW-yr. in New Jersey; from \$74,117/MW-yr. to \$105,414/MW-yr. in Maryland; and from \$73,866/MW-yr. to \$104,260/MW-yr. in Illinois).

In submitting its request, PJM acknowledged that it had been unable to achieve stakeholder consensus on the CONE increase.<sup>43</sup> The proposed increase was rejected by stakeholder votes conducted at two levels within PJM: first, before the Markets and Reliability Committee, and later by the full PJM Members Committee. As PJM reported, the votes split largely along sector lines.<sup>44</sup> Merchant generators by and large supported the increase as necessary to reflect higher costs of new peaking units<sup>45</sup> (although some generators argued that it did not go far enough in the direction they desired). Load interests argued in response that an increase in CONE had not been proven necessary, that the PJM tariff did not permit an immediate CONE increase in any event, and that any increase in CONE must be reduced by offsetting increases in revenues from sales into the energy and ancillary services markets. The latter set of sentiments prevailed in the PJM committee votes. PJM nevertheless proceeded to file the CONE increase with FERC based on its view that an increase is needed to ensure reliability.<sup>46</sup>

Numerous parties (primarily LSEs, state commissions and large industrial customer organizations) filed comments with FERC opposing the CONE increase. They argued, among other things, that PJM: (i) failed to follow procedures specified in the tariff for changes in CONE;<sup>47</sup> (ii) impermissibly updated CONE without reflecting the effect of the higher offsetting revenues generation owners could expect to receive from sales into PJM’s energy and ancillary

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<sup>43</sup> See *CONE Filing* at 5-6.

<sup>44</sup> The PJM Members Committee employs sector-weighted voting. When the Members Committee considered the CONE increase, the sector votes cast *in favor* of the increase were as follows:

Generation Owners	93%
Transmission Owners	79%
Other Suppliers	53%
Electric Distributors	9%
End User Customers	0%

*CONE Filing* at 5 n.6.

<sup>45</sup> RPM defines CONE as the cost of constructing new simple-cycle combustion turbine peaking generation. To the extent CONE is increased, the VRR curve will yield higher prices for each increment of capacity that clears in the auction.

<sup>46</sup> After reporting the Members Committee’s rejection of the increase proposal, PJM stated in its filing as follows: “The PJM Board of Managers ... determined that a revision to CONE is necessary in order to promote the efficient pricing in the PJM capacity market, and that it is vital in this regard that prices accurately reflect the costs actually faced by developers. PJM therefore proceeds with this filing at the direction of its Board.” *CONE Filing* at 5-6. In addition, in responding to protests of the CONE increase request, PJM stated that “the cost of new entry currently used to design the VRR curve is substantially below the likely cost of building a new peaking generator in the PJM region,” and that “PJM has the right to correct this glaring shortcoming in the auction parameters, so that RPM has a chance to fulfill one of its basic reliability purposes of attracting new generation.” “Answer of PJM Interconnection, L.L.C. to Protests and Comments,” filed March 21, 2008 in *PJM Interconnection, L.L.C.*, FERC Docket No. ER08-516-000 at 8.

<sup>47</sup> Pursuant to the RPM settlement, the tariff required PJM to submit the increase for stakeholder review by September 1, 2007, which PJM had not done. That deadline was established in the settlement in order to give parties time to analyze and to respond to any proposal to increase CONE. Instead, PJM included in its filing a change in the tariff that would have retroactively eliminated the September 1, 2007, deadline. See *CONE Filing* at 5.

services markets; and (iii) lacked any basis for assuming that recent sharp increases in construction costs would continue over the long term.<sup>48</sup>

On April 4, 2008, FERC issued an order rejecting PJM's CONE-increase request.<sup>49</sup> FERC based this decision in large part on PJM's failure to satisfy the tariff's procedural requirements for CONE increases (requirements that originated in the RPM settlement). FERC stated that the RPM settlement provisions "are not merely procedural formalities," but rather "represent an important, if not critical element of the bargain struck by the parties to the RPM settlement."<sup>50</sup> FERC rejected PJM's contention that the tariff procedures should be modified retroactively to avoid future reliability problems. FERC stated: "While PJM vaguely suggests that a 'significant reliability concern' motivates its filing, it provides no support for the claim. PJM simply provides conclusory statements that because construction costs have increased, a change in CONE is warranted."<sup>51</sup> Finally, FERC acknowledged the customers' concern that PJM had failed to consider the higher offsetting revenues that generation owners would receive from sales in the PJM energy and ancillary services markets. FERC therefore stated that, in any future filing to adjust CONE, PJM must consider whether the proposed change would "create a mismatch with the determination of energy and ancillary services revenue."<sup>52</sup>

### ***C. Application of Second-Generation Capture Analysis to the CONE-Increase Filing***

Close examination of the background and substance of PJM's CONE-increase filing reveals several indicators of second-generation capture by the merchant generation sector. We first apply the tools of the capture analysis to identify the existence of shared precepts and beliefs; we then briefly discuss the relevance of the contributory factors described in Section II.B above.

#### **1. Shared Precepts and Beliefs**

The first indicator of capture is PJM's adoption of market-oriented precepts and beliefs that have been actively promoted by parties whose commercial interests are served by those precepts and beliefs. Most notably (and relevant to the example), PJM has adopted — and now presents as its own — the premise that there is a direct nexus between the level of locational capacity prices and patterns of investment in new generation. Thus, the justification PJM advanced for its CONE-increase filing was that higher capacity prices are needed in order to

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<sup>48</sup> See, e.g., "RPM Buyers' Protest to PJM Interconnection, L.L.C.'S Filing to Change RPM Parameters and Request for Rejection of Filing or, in the Alternative, for Five-Month Suspension and Evidentiary Hearings," filed March 6, 2008, in *PJM Interconnection, L.L.C.*, FERC Docket No. ER08-516-000.

<sup>49</sup> *PJM Interconnection, L.L.C.*, 123 FERC ¶ 61,015 (2008) (hereinafter, "*CONE Order*").

<sup>50</sup> FERC observed, for example, that the tariff's procedural requirements give customers time to mitigate the effect of higher prices resulting from a CONE increase. *CONE Order* at P 28.

<sup>51</sup> FERC found that PJM's reliability claim also was undermined by the fact that PJM had achieved a capacity reserve margin exceeding the level dictated by PJM's own reliability requirements. *Id.* at P 29.

<sup>52</sup> *Id.* at P 30.

elicit needed investments in specific capacity-short areas. PJM has relied on substantially identical reasoning in a number of its own reports and regulatory filings.<sup>53</sup>

The notion of a causal nexus between locational pricing and patterns of investment may appear to be a matter of simple economics, but its applicability to the electricity industry is not at all simple or self-evident. This is so because there are significant institutional and practical constraints that limit the flow of generation investment capital to high-price areas. Nevertheless, merchant generators steadfastly assert the existence of such a nexus. In the proceeding that culminated in the RPM settlement, for example, generators argued that higher capacity prices are necessary as “price signals” to “incentivize” construction of the right resources in the right locations.<sup>54</sup> Load interests (customers and state regulators) disputed that premise, arguing that too many exogenous factors affect generation investment patterns to assume a meaningful nexus between locational prices and patterns of investment.<sup>55</sup> PJM’s statements and positions indicate that it has adopted the merchant generators’ perspective on this fundamental question. PJM stated in its CONE-increase filing, for example, that “it is critical to set prices that will spur the required investment to preserve future reliability.”<sup>56</sup>

Another indicator of second-generation capture is the tendency of a captured entity to discount or dismiss evidence contrary to the premises it shares with the regulated firms. In this instance, PJM acted in accordance with the assumption of a causal nexus between locational pricing and investment even though empirical evidence indicates the weakness of that link. Specifically, as opponents of the CONE increase pointed out, the first four RPM auctions produced dramatically higher capacity prices but very few commitments to construct new generation.<sup>57</sup> Yet, in responding to protests of its CONE filing, PJM argued again that “generation investment decisions tied to the May auction are dependent on timely adoption of an

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<sup>53</sup> In its latest strategic report, for example, PJM stated that “[c]ancellation of proposed new generation and the retirement of some older plants are the market’s response to expectations of insufficient revenue to meet investment goals.” “PJM 2007 Strategic Report” at 19 (available at <http://www2.pjm.com/documents/downloads/strategic-responses/report/20070402-pjm-strategic-report.pdf>).

<sup>54</sup> See, e.g., “Post Technical Conference Comments of Reliant Energy, Inc.,” filed March 2, 2006, in *PJM Interconnection, L.L.C.*, FERC Docket No. EL05-148, stating (at 5): “Time is of the essence to repair PJM’s current flawed capacity market structure so that appropriate price signals may be transparent to all market participants and encourage the needed investment in new and existing resources.”

<sup>55</sup> Parties disputing the existence of such a nexus noted the importance of environmental constraints, land-use restrictions, access to high-voltage transmission facilities, proximity to fuel-delivery infrastructure, population density and likelihood of landowner opposition as powerful exogenous factors that undermine the strength of any purported nexus between locational capacity prices and investment patterns. See, e.g., J. Wilson, “Raising the Stakes on Capacity Incentives: PJM’s Reliability Pricing Model (RPM)” published by the American Public Power Association (March 14, 2008) at 11 (“There are many non-price obstacles to building new capacity, especially in developed areas where it may be needed most.”). Also cited is the fact that building new generation would depress locational capacity prices, thereby reducing profits realized by incumbent producers from their existing resources.

<sup>56</sup> *CONE Filing* at 4-5. More to the point, in the original RPM docket PJM acknowledged the existence of exogenous constraints but claimed that locational pricing nevertheless should be adopted because it was more likely than the then-current non-locational method to bring forth needed investments in the right locations. See “Answer of PJM Interconnection, L.L.C. to Comments and Protests,” filed November 8, 2005, in *PJM Interconnection, L.L.C.*, FERC Docket No. ER05-1410-000, at 30.

<sup>57</sup> See Wilson, *supra* note 55 at 39.

accurate CONE calculation.”<sup>58</sup> PJM’s assertions closely accord with those of the PJM Power Producers (an organization created by merchant generators to advance their interests) which — in a letter sent to PJM’s Board of Managers shortly before the Board considered the CONE increase filing — argued:

For RPM to fully achieve its promise, it is critical that the CONE calculation on which the market design is based reflect actual costs of new entry. If CONE is updated properly, the demand curve can be set at a level that will send the appropriate signals to the market. A CONE value that is set too high will encourage the construction of too much generation and likewise a CONE value that is set too low will not incent enough generation. Either way, if CONE is not reflective of present reality, the market’s response will likely frustrate the objectives of RPM. That is why it is so important for the PJM Board to send the appropriate signals to the market through its action on the CONE.<sup>59</sup>

Through its decision to proceed with the CONE filing, PJM demonstrates its continuing acceptance of the merchant producers’ view that price is the crucial factor in locational investment decisions.

Also indicative of capture is the tendency of an agency to apply industry-sponsored approaches despite the objections of the regulatory regime’s intended beneficiaries. The parallel here lies in PJM’s decision to proceed with its CONE increase filing notwithstanding two negative votes by the responsible PJM committees and vigorous customer opposition. As noted above, the votes split fairly cleanly between load interests and producer interests.<sup>60</sup> Regardless of the lack of stakeholder consensus for the CONE increase, PJM went forward with its filing. PJM’s decision to do so in these circumstances demonstrates: (i) a strong commonality of perspective with merchant producers as to the existence of a price-investment nexus; (ii) a discounting of evidence contrary to the shared perspective; and (iii) a failure to give weight to objections raised by the intended beneficiaries of the RTO capacity market (end-use customers and wholesale load-serving entities). PJM’s decision thus can be understood to indicate second-generation capture of PJM by the merchant generation sector.<sup>61</sup>

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<sup>58</sup> See PJM’s “Answer to Protests and Comments,” filed March 21, 2008, in FERC Docket No. ER08-516-000 at 2.

<sup>59</sup> The letter is posted at <http://www.pjm.com/documents/downloads/corp-documents/20080125-board-letter-cone.pdf>.

<sup>60</sup> See note 44, *supra*, and accompanying text.

<sup>61</sup> This impression is unlikely to be dispelled by PJM’s conduct subsequent to FERC’s issuance of the CONE order. On April 21, 2008, a group of wholesale purchasers, state utility commissions and state consumer advocates wrote to PJM requesting “an open dialogue with the Board of Managers to discuss the CONE filing and to establish whether any lessons can be learned from this proceeding.” The buyers group proposed that this dialogue be conducted during the forthcoming PJM Annual Meeting or at a special purpose meeting in the near future. See <http://www.pjm.com/documents/downloads/corp-documents/20080421-cone-filing-letter.pdf>. PJM’s Chief Executive Officer responded two days later, denying the request for a separate meeting and recommending that the buyers group “communicate any views it may have on any matter through the available processes and forums.” See <http://www.pjm.com/documents/downloads/corp-documents/20080425-t-boston-letter-to-the-pjm-buyers-group-regarding-c.pdf>.

Finally, as FERC found in rejecting PJM's CONE-increase filing, the submittal was inconsistent with specific provisions of the PJM tariff. Inarguably, PJM failed to satisfy the tariff requirement that it notify stakeholders by September 1 of a CONE increase proposed for the following May. PJM's request to vitiate this requirement through a retroactive tariff change was rejected by FERC as neither just nor reasonable. PJM also failed to meet the tariff's requirement that it reduce the CONE-increase request by reflecting increased revenues for generator sales into the energy and ancillary services markets. It does not seem unwarranted to interpret PJM's failure to abide by its own tariff as an indicator of capture.

## 2. Presence of Contributory Factors

Accepting for purposes of the analysis the existence of second-generation capture by the merchant producers, the task shifts to identifying the causes. In this regard, certain of the contributory factors described in Section II.B above may be observed, although the evidence is admittedly (and perhaps unavoidably) circumstantial.

We have noted the importance of convergence between an RTO's perception of its principal mission and the interests of a particular stakeholder group. Here, we can identify a convergence between two key PJM missions that appear to converge with the merchant generators' commercial goals. First is PJM's mission of expanding participation in the markets it operates. PJM takes pride in the size and diversity of its membership<sup>62</sup> and undoubtedly realizes that the success of the PJM-operated markets requires robust participation. PJM's mission of expanding participation converges with the merchant suppliers' interest in higher capacity revenues, since generators are free to withdraw from the PJM markets if they conclude that better returns can be earned elsewhere. A CONE increase would serve PJM's goal to the extent it also provides generators a return that is sufficient for them to consider PJM markets attractive.

The second instance of convergence involves PJM's mission of ensuring reliable service. According to PJM, portions of its footprint continue to face serious capacity shortages in the next several years. Even though the VRR curve adopted in the RPM settlement was designed to elicit investment in these capacity-short areas, generators still have not invested in the amounts of capacity PJM believes are necessary.<sup>63</sup> At the same time, the generators advised PJM that

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<sup>62</sup> PJM observes in the introduction to its 2007 Annual Report: "Our members now number more than 500 and represent all facets of the electric industry."

<sup>63</sup> Recently, PJM claimed that RPM *has* succeeded in incenting new generation, and that, through the RPM auction for Delivery Year 2010, "the net minimum increase in capacity was 10,000 megawatts compared to what would have been available absent RPM." "PJM Reliability Pricing Model Auction Draws Largest Amount of New Capacity So Far," PJM press release dated February 1, 2008 (posted at <http://www.pjm.com/contributions/news-releases/2008/20080201-jan-08-rpm-auction-results.pdf>). PJM's estimate is debatable, however, because it: (i) uses an incorrect capacity measure ("installed" rather than "unforced" capacity); (ii) includes capacity that was being exported to other markets before RPM and capacity that the owners had threatened to retire (in neither instance is the capacity "incremental"); (iii) includes Demand Response resources that were bid into one or more earlier RPM auctions but not the most recent auction; and (iv) includes capacity that was offered but did not clear in the auction. Furthermore, even if PJM's estimate were accepted, it would mean that "roughly two percent of the RPM cleared quantity and payments represents new resources in each auction, with 98 percent associated with existing resources." Wilson, *supra* note 55 at 40-41. PJM's claim also begs the question: if RPM already has proven successful in incenting the construction of new generation, why was it necessary to seek a substantial increase in CONE? Finally, even if RPM has succeeded in attracting new generation, the further question is whether new

[Footnote continued on following page]

they would decline to participate in the May 2008 RPM auction (which seeks capacity bids for the 2011/2012 Delivery Year) unless higher prices were forthcoming.<sup>64</sup> From PJM's perspective, an increase in CONE was the only tool at its disposal to obtain needed capacity investments. Thus, PJM's capacity-preservation mission squarely converged with the generators' interests in obtaining higher returns on their PJM assets.

Another contributory factor noted in Section II.B is impact concentration. Here, an increase in CONE would have brought many millions of dollars in additional capacity revenues to a handful of large merchant producers, while having a more modest (though non-trivial) impact on the monthly charges for electricity service borne by individual households and businesses. Merchant producers thus had a very large stake in the outcome and for that reason were willing to devote substantial resources to prosecuting (both pre- and post-filing) an increase in CONE. They also were able to marshal their resources through collective action by forming a new organization dedicated exclusively to their interests.<sup>65</sup>

A third contributory factor is an asymmetrical distribution of expertise and access to information. To be sure, PJM has developed a strong in-house data gathering and analytical capability. PJM, however, does not have direct involvement in generation development (indeed, FERC's RTO rules prohibit such involvement). The merchant producers, by contrast, have direct and ongoing involvement in developing new units. This difference provides the merchant suppliers with an advantage over PJM vis-à-vis expertise in estimating the costs, timeline, resource needs, capital costs and revenue requirements for new peaking generation (which is used as the basis for CONE). Compounding the asymmetry, current location-specific data regarding generating unit costs (new and existing) may be deemed proprietary by owner/developers and, so, could be difficult for PJM to verify.<sup>66</sup> PJM also must rely on the generators' representations as to the internal rates of return that are necessary to offset the perceived business and other risks of constructing and maintaining new generating units in capacity-short portions of the PJM footprint.

The upshot is that PJM appears to lack the in-house capability to deconstruct generator claims regarding sufficiency of the "price signals" yielded by RPM. This practical reality leaves

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generation has been committed for construction in the specific portions of the footprint that PJM identified as being capacity deficient.

<sup>64</sup> In proposing to increase CONE in time for the May 2008 capacity auction, PJM relied on the statements of generators that they would not participate in the auction absent an increase in capacity costs. PJM stated in the FERC proceeding that "proponents of new-entry projects have gone on record in this proceeding to advise the Commission that their investment decisions for the May auction are heavily dependent on ensuring a reasonable CONE value, and emphasizing that the present outdated CONE value is not sufficient to induce them to submit an offer into the auction." PJM's "Answer to Protests and Comments," *supra* note 58 at 6.

<sup>65</sup> See note 59, *supra*, and accompanying text.

<sup>66</sup> In the case of the CONE-increase filing, PJM hired a consultant to prepare a study evaluating current costs to construct new peaking generation in the PJM region. The consultant PJM retained, however, previously was employed by a generation development company (see <http://www.pjm.com/committees/working-groups/pjramwg/downloads/20040924-item-2-new-entry-ct-presentation.pdf> at 3), and his current consulting firm also lists among its current client base several merchant generation developers (see <http://www.pasterisenergy.com/Pasteris%20Energy,%20Inc.%20Brochure%202006.pdf>) -- the industry group whose interests would be served most directly by higher CONE estimates.

aside the more difficult question of whether PJM's institutional interests lie in *not* challenging those claims.<sup>67</sup> Be that as it may, PJM appears to have little choice but to adopt and sponsor as its own the generator positions on these matters.

## V. SUGGESTED AREAS FOR FURTHER RESEARCH

This paper has discussed an analytical model (the “second-generation” regulatory capture analysis) that has proven useful in evaluating governmental regulatory behaviors and outcomes, and suggests the potential usefulness of that model in considering the behaviors and outcomes of FERC-approved regional transmission organizations. The discussion thus presents for consideration whether the capture analysis may have explanatory value in the context of RTOs. We acknowledge the need for additional analysis before any conclusions can be reached and suggest that the areas for more focused research might include the following:

- Other than as suggested in Section III.A above, are there attributes of RTOs that make the capture analysis applicable or relevant? What are those attributes?
- The fact that RTO management adopts a perspective or paradigm that also is espoused by one or more market sectors cannot in all instances indicate the presence of “second-generation capture.” Is there an analytically rigorous method for distinguishing between outcomes attributable to capture and those that are the products of a fully independent and unbiased decision-making process?
- What factors other than those discussed in Section II.B might be viewed as causing or promoting the “second generation capture” of an RTO?
- How does the structure of asset ownership affect the likelihood of capture? As an example, in PJM a number of merchant generating entities are corporate affiliates of large PJM transmission owners. This is an outcome of state restructuring laws that required divestiture of generation assets but permitted sale of those assets to unregulated affiliates. It has been argued that certain of the larger PJM transmission owners (which, as it turns out, also own considerable merchant generation portfolios) are able to exercise undue influence over the RTO's decision-making through “exit leverage”—the express or implied threat of terminating PJM membership and removing transmission assets from the RTO's functional control.<sup>68</sup> “Exit leverage” can be exercised for any number of purposes, including to bring about changes in

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<sup>67</sup> As noted in Section III.B, PJM perceives one of its missions to be expanding the scope of competitive markets within its region. In order to fulfill its perceived mission of expanding markets, PJM must promote broad participation by merchant generators. If generators were to view PJM as hostile to their claims for higher prices and returns, they might be expected to redirect their capital investments elsewhere. PJM undoubtedly realizes that a decline in generator participation would impede achievement of its market expansion goals.

<sup>68</sup> See “Comments on the Advance Notice of Proposed Rulemaking on Behalf of Coalition of Midwest Transmission Customers, NEPOOL Industrial Customer Coalition, [and] PJM Industrial Customer Coalition,” filed on September 14, 2007 in *Wholesale Competition in Regions with Organized Electric Markets*, FERC Docket Nos. RM07-19-000, *et al.*, at 31-32.

market rules that benefit a transmission owner's affiliated generation interests. Is "exit leverage" relevant to the capture analysis? Would full corporate separation of generation and transmission assets reduce the risk of RTO capture?

- Recognizing that each RTO serves a number of constituencies with varying interests, should RTO management attempt to give equal weight to the interests of all such constituencies, or is a differential weighting of interests appropriate (even necessary) in some issue contexts?
- Are there objective indicators that can be used to identify instances in which RTO management is according undue weight to the interests of one constituency over others? What factors might cause RTO management to give undue weight to the interests of a particular constituency?
- Is "capture" of an RTO by one or another class of market participants intrinsically adverse to the public interest? Are there informational or other efficiencies inherent in capture that might offset or ameliorate any such adverse impacts?
- If capture is deemed adverse to the interests of the public in all cases, how can it be prevented or reversed? Are there lessons to be learned in this regard from the literature on capture of statutory regulatory agencies?

Firm conclusions about the presence (or absence) of RTO capture, as well as the implications of capture in this context, must await more detailed analyses.<sup>69</sup> The authors hope that this paper stimulates interest in a more thorough examination of the topic.

Finally, in encouraging a more thorough analysis, we point out the very considerable importance of the question. The six FERC-sanctioned RTOs oversee markets in which many billions of dollars in electricity products are bought and sold each year. Even minor perturbations in those markets cause massive transfers of wealth.<sup>70</sup> For that reason, understanding the organizational dynamics that affect RTO decision-making is vitally important. Further analysis may shed light on whether the indicators of capture discussed in the body of this paper truly reflect the occurrence of capture or, instead, manifest some other dynamic or influence. To the extent such analysis may point toward structural or other reforms that would minimize the potential for RTO capture, the integrity of the wholesale electricity markets would be enhanced. This, in turn, should provide wholesale purchasers and other stakeholders with a greater level of confidence in RTO market outcomes.

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<sup>69</sup> Also reserved for separate analysis are potential solutions to capture. We offer no views as to whether the governance alternatives being considered in FERC's "Organized Markets NOPR" might prove effective in combating capture. Likewise, we offer no views as to whether PJM's recent creation of a stakeholder-Board "liaison committee" might serve to offset the effects of capture.

<sup>70</sup> According to PJM's most recent Annual Report, its aggregate billings to customers in 2007 totaled \$30.5 billion. By comparison, 101 of the 179 countries tracked by the International Monetary Fund had Gross Domestic Products less than that amount. International Monetary Fund, *World Economic Outlook Database* (April 2008).

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