

SPARK

Letter #12
December
2004

The on-line gateway for readers of Public Utilities Fortnightly magazine.



Will 2005 finally mark the passage of an energy bill? I have been waiting since the passage in 1992 of the federal bill making wholesale electric competitive, and have become more cynical as each year passes. But Fortnightly's Michael Burr sees reasons for optimism in the new Congress, and he'll tell you why.

Regional Transmission Organizations face FERC scrutiny regarding their true costs of operation, and I take a look at why accounting changes are needed and what the outcome may be.

Also, where does electric retail competition in the US go now? Read the latest on the customer experience and benchmark metrics for judging retail market competitiveness.

Happy New Year to all.

Lori A. Burkhardt
Editor

ENERGY POLICY IN THE 109TH CONGRESS

MTBE, ANWR Could Hold Bush Legacy Hostage

BY MICHAEL T. BURR

When the final gavel came down on the 108th Congress, it signaled the end of one of the most bitterly divided legislative sessions in memory. And when legislators re-convene in January 2005 to open the 109th Congress, those divisions will remain – especially in the Senate. But this time, the Republican senators' 55-45 majority might allow long-awaited energy-policy legislation finally to reach the goal line.

The last serious attempt to pass the omnibus energy bill took place in late 2003. The bill, H.R. 6, passed the House of Representatives by a comfortable margin, but became mired in controversy in the Senate. Namely, a section that would have shielded the petroleum industry from liability for groundwater contamination fractured support for the bill among Democrats and Republicans alike.

Early in 2005, legislators are expected to bring forth a revamped version of the bill for consideration. This time, the legislation stands a better chance of being enacted. What form it takes might set the tone for the 109th Congress – and could affect the long-term legacy of President Bush.

Policy analysts expect a revived energy bill to be among the first major legislative actions to move forward in 2005. »

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The legislation is expected to closely resemble the bill that failed in 2003, with a few notable exceptions.

ANWR Anyone?

In October 2004, Congress passed the American Jobs Creation Act, also known as FSC/ETI. This grab-bag tax bill – which even Treasury Secretary John Snow criticized as a “myriad of special-interest tax provisions” – included several measures that were lifted from the failed omnibus energy bill. Specifically, the bill included a phased-in 9 percent tax deduction for domestic energy production, including electricity; expansion and extension of the Section 45 renewable energy production tax credit; and favorable tax treatment for gains from sales of electric transmission assets. Also, in a separate measure, Congress reauthorized the Price-Anderson Act to provide liability insurance coverage for nuclear generators.

As a result, these provisions won't be necessary in a revived energy bill, but their removal won't appreciably affect the legislation's chances for enactment. Bigger issues remain the bill's most important components (See “Energy Policy Grab Bag,” this page). They also are its most controversial.

Two of the biggest issues involve petroleum – specifically, oil drilling in the Arctic National Wildlife Refuge (ANWR) and the aforementioned liability protection for petroleum companies regarding groundwater contamination from the carcinogenic fuel additive methyl tertiary butyl ether (MTBE).

In 2003, a provision opening ANWR to oil exploration and drilling was removed from the omnibus energy

ENERGY POLICY GRAB BAG

The failed omnibus energy bill (H.R. 6) in 2003 included a wide variety of provisions that likely will be revived in the 109th Congress. Some of the most important for utilities include:

- A provision directing FERC to create an electric reliability organization with the authority to establish and enforce reliability standards
- Repeal of the Public Utility Holding Company Act (PUHCA)
- Termination of mandatory purchase requirements in the Public Utility Regulatory Policies Act (PURPA)
- New requirements for utilities to provide customers with real-time pricing, time-of-use metering and net metering
- Increased research and development funding for a wide range of power-industry technologies, and incentives for investing in clean-coal technologies
- Streamlined permitting processes for the Alaska Natural Gas Pipeline, and authorization of a federal loan guarantee up to \$10 billion.—*MTB*



Will President Bush use his political capital to push through an energy bill?

bill during House-Senate conference markup, thus ANWR was not a factor in the bill's final demise. The MTBE issue, however, sparked furious opposition from most Senate Democrats – as well as several Republicans from states where communities are facing MTBE contamination – and ultimately scuttled H.R. 6.

In the hiatus between the 108th and 109th Congresses, predictions about energy legislation in 2005 center largely on the MTBE and ANWR measures. While raw numbers in the Senate suggest Republicans might have the votes necessary to pass an energy bill with MTBE provisions and possibly ANWR, doing so likely would lead to a take-no-prisoners fight on the Senate floor. Republican leaders might not take the chance that such a fight would poison the environment of a fresh, new Congress, and thereby complicate the broader legislative agenda. (*Cont. on p. 10*)

FORTNIGHTLY'S

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RETAIL ELECTRIC COMPETITION

Just What Marks Success?

BY ERIC CODY AND PAUL GREY

Since early 1998, more than 15 US states and the District of Columbia have restructured their electricity markets and introduced varying forms of electricity retail competition. Each regulatory jurisdiction essentially adopted its own unique model for retail choice aimed at providing all consumers with both economic benefits and a widening range of product choices. Yet the resulting mishmash of inconsistent retail market structures insures that competitive benefits ultimately reach only a small minority of consumers.

This state of affairs begs the question: what ultimately constitutes success in a competitive retail electricity market? Today in the US the question is rarely even asked, but when it is, the topic is clouded by uncertainty and can spark division and disagreement. There is no short answer; however, by examining some of the most successful retail electricity markets, such as the UK, Australia, New Zealand and Finland, plenty of evidence emerges as to what constitutes a successful market, and what paths lead to success.

Viewing Customers Differently

One of the best ways to picture a successful retail electricity market is to envision success through the customer's own eyes, as after all, markets exist to meet customer needs as much as suppliers. Instead, some US policy makers believed breaking the utility's supply monopoly and the presence of a handful of competitive players alongside the regulated incumbent would be sufficient to unleash market forces and kindle full-scale retail competition. In truth, utility restructuring was neces-

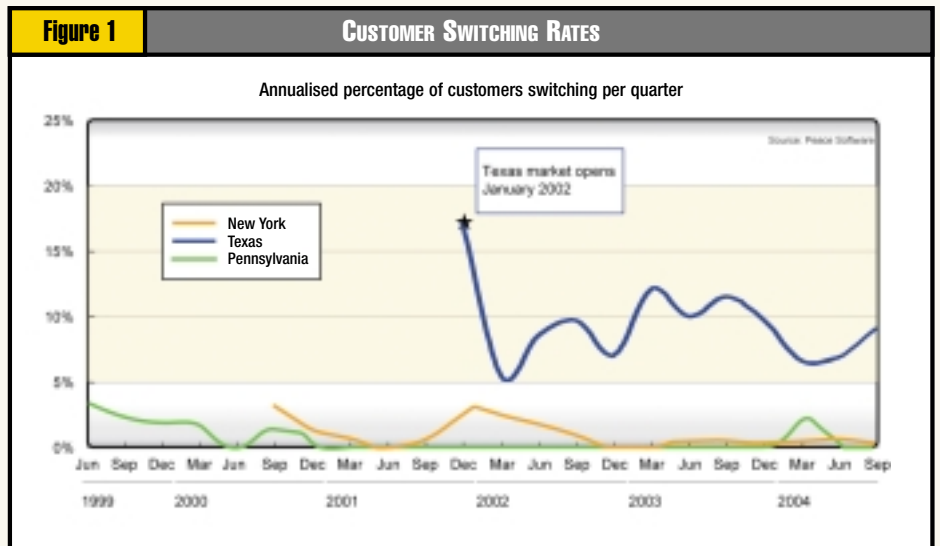
sary, but has not been sufficient to create truly competitive markets.

The tentative experiments with competition have been stifled by the fact that most US utilities are barred under "Codes of Conduct" from offering competitive supply service to their customers. Unable to compete, and considering the infrequency of major rate cases, it is virtually assured that utilities' customer relationships are doomed to remain static. The cumbersome nature of the rate-case process essentially guarantees that the utility-customer relationship can only change in slow motion, and since the first US retail electricity markets opened in 1998, most customers have lacked access to competitive offers and remain stuck in a regulated supply situation.

Regulated supply simply cannot match the speed or ability to differentiate and respond to customer needs that is possible in a competitive market setting. The regulated rate-making

process, reflecting the utility's overall cost-to-serve in tariffs, implicitly assumes almost every residential customer is "average." Not surprisingly then, regulated rate-making results in "one size fits all" pricing, with many customers in each class subsidizing others, and few customers being served in the way they might have chosen given a choice of product and supplier. Yet how many customers out there can truly be deemed "average?" Real competition inevitably means discarding the notion that all customers are somehow "average" and embracing the concept that groups of customers—niche segments of each customer base—should be able to be served with products, prices and services that best meet their individual needs and willingness to pay.

The benefits of "real customer choice" are often subtle and complex, not well measured by traditional utility customer satisfaction ratings, and can change dynamically. Yet these benefits can be directly reflected in benchmark metrics for judging a retail electricity market's competitiveness and success. Figure 1 lists market success criteria drawn from a number of studies, such as Plexus Research's November 2003 report *Beyond the Standard Offer* for the »



Massachusetts Division of Energy Resources and Peace Software's research into customer switching trends in competitive energy retail markets.

How is the US Doing?

Early switching activity by large commercial and industrial (C&I) consumers in California, Pennsylvania and Massachusetts between 1998 and 2001 appeared to be evidence that US retail competition was building up a head of steam. With the possible exception of Texas, however, no US state has at any stage come close to meeting or exceeding the benchmarks outlined in figure 1. The mass market segment, in particular, has been slow to develop competition, due in large part to transitional regulated pricing and misspecification of the role of the regulated delivery companies in the market.

Is the Market Fully Open?

Take the criteria that in a truly competitive market, 100% of customers are served by competitive retailers and, when inclined, switch from one competitive retailer to another. In most US states the option for customers to switch back to their regulated utility as a last resort is likely to remain in some form forever – a significant barrier to entry for many retailers – and utility supply options continue to be priced in ways that shield customers from true market signals.

This means customers have limited opportunity to exercise choice. This is especially true in US residential electricity markets that have seen little or no customer switching activity – a measure of customers exercising choice – largely as a result of regulatory measures originally intended to protect customers. The unintended effect of such prescriptive regulatory rules has been to protect customers from the competitive market, which in turn has deterred major mass market retailers from entering a number of nominally open US markets.

In Texas, this meant that on day one of competition 100% of customers were supplied by competitive retailers.

Texas—Active Market Retailers

The highest concentration of active mass market retailers in the US is in Texas, where new entrant and competitive incumbent retailers essentially compete on the same terms for six million electricity customers. Four of the six largest competitive North American electricity retailers are active in Texas

In Texas, the electricity retail role is disaggregated from the distribution role and each of the pre-competition regulated utilities have separated their retail and distribution functions into distinct businesses with competitive energy retailers managing customer relationships and regulated distribution utilities managing energy delivery and supply reliability. In successful competitive markets around the world, the traditional regulated utility customer bases have become incumbent retail customer bases, and those incumbent retailers compete with one another and with new market entrants. In this and other fundamentals of the electricity market design, Texas is similar to the successful markets of the UK and Australia.

In Texas, this meant that on day one of competition 100% of customers were supplied by competitive retailers.

Today, retailer TXU Energy Services competes with Reliant Energy Services and other incumbent retailers, as well as with Green Mountain Energy, Gexa Energy and 40 or more other energy retailers who have entered the market. No other US state has adopted a full electricity retail disaggregation approach similar to Texas.

Healthy Switching Levels

Texas exhibits a substantial and healthy annual customer-switch rate. Customer switching between competitive retailers is an important dimension of market competitiveness and has the advantage of being measurable and comparable across markets. Industry analyst group Datamonitor highlights the importance of customer switching targets in its recently published, *Energy Market Competitive Intensity Index*, and KPMG's December 2003 paper, *The Effectiveness of Competition and Retail Energy Price Regulation*, stresses the importance in Australia of switching as evidence of successful competition.

In the US, state regulators require switching to be reported in a wide variety of ways, such as load switched, rather than numbers of customers switched. While the load switched metrics are appropriate for analysis of large C&I account activity and wholesale market operations, these customers typically represent a small percentage of the energy consumers in a market. Some authorities also report the cumulative total number of customers switched since the market opened, but in a market open for a number of years this metric loses relevance as it conveys little about current customer switching activity or changing patterns of competition.

In retail energy markets, a better indicator of the market's competitive health is the annual customer switch rate, defined as the rate at which customers are switching from one retailer to another and expressed as a percentage per year. In a market with low »

| FIGURE 2 | BENCHMARK METRICS FOR JUDGING RETAIL ELECTRICITY MARKET COMPETITIVENESS | | |
|---|---|---|--|
| | CRITERIA | INDICATIVE MEASURE | BENCHMARK |
| Full Market Opening | Market share among competitive retailers | The percentage of customers supplied by competitive retailers. | In a fully competitive market 100% of customers are supplied by competitive retailers. |
| | Customer returns to regulated rate options | The number of customers switching back to their regulated utility. | In a fully competitive market customers do not return to regulated utility supply, but rather exercise their choice and move to another retailer. |
| Presence of Active Mass Market Retailers | Number of active Retailers | The number of active competitive retailers. | In all fully competitive markets around the world there are more than five active retail market participants with mass market (residential and small business customers) product offerings. |
| | Retailer entries | The number of new retailers entering the mass market. | A continual stream of retailers entering the market brings product innovation from both the new entrant and existing retailers in competitive response and usually indicates an increasingly competitive market. |
| | Retailer exits | The number of retailer exits. | Retailers leaving the market in significant numbers tend to indicate the market is losing its competitiveness. |
| Healthy Levels of Switching | Customer switching | Proportion of customers changing from one competitive retailer to another, or in the US from a regulated incumbent to a competitive retailer. | A healthy annual churn rate for a competitive market is generally between 5% and 20%, which has been reached and sustained in markets such as the UK, New Zealand, Texas and the Australian states of Victoria and New South Wales. |
| Trading off Price for Value | Range of product offers | The range and types of offers provided and the number of customers able to take these up. | Customers should have the choice of product and price that meets their particular needs. |
| | Wholesale/retail price spread | The spread between the wholesale and retail price. | A very low spread will discourage new entrants and discourage product innovation. A higher spread will encourage new entrants and encourage product innovation and price competition. |
| The Customer Experience | Customer awareness | Proportion of customers who know they have choice and can exercise it. | Customers need to reach a point where the majority understands they have the ability to choose a supplier and can evaluate the relative costs and benefits associated with exercising this choice. |
| | Customer satisfaction | Proportion of customers satisfied with their retail supplier, the switching process, the available product choices and prices. | Customer dissatisfaction with the switching process indicates a barrier to successful retail competition. Customer dissatisfaction with available product choices and prices may indicate room for increased competition and product innovation. |

| | | |
|---|--|--|
| <p>customer switching, say less than 2% of customers per year, it will be difficult for new entrants to acquire sufficient market share to drive economies of scale. In a 2% market, four new entrant mass market retailers splitting customer switches evenly with four incumbent suppliers would theoretically require 20 years to achieve a mere five per cent market share each – most likely an untenable business case. Potential market entrants may choose to avoid these types of markets and take their investment elsewhere.</p> | <p>Conversely, markets with annual switch rates between 5% and 20% represent healthier competition and greater opportunity for new entrants to win market share, increase cash flow and cover overheads.</p> <p>Figure 2 highlights annual customer switch rates for three of the leading customer choice markets in the US: Texas, New York and Pennsylvania. The contrast between Texas and the other two states is striking, with Texas having by far the most consumers exercising choice. The graph also highlights</p> | <p>that switching in Texas fits neatly into the five to 20% “healthy market” band, in common with other competitive electricity markets. For example, when Peace researchers analyzed 2004 customer switching activity, the UK and the Australian state of Victoria came in between 15% and 20%, New Zealand at 10% and Finland, Norway, Sweden and Australia’s New South Wales at 5%. There is a distinction between these switch rates in advanced competitive retail markets, which reflect customer switching between competitive >></p> |
|---|--|--|

retailers, and switching in the US, which, outside of Texas, generally covers customer movement from the utility's regulated supply service to a market contract with a competitive retail supplier.

Trading off Price for Value

Some market watchers focus on price reduction alone to measure market success, but this fails to recognize that in many competitive electricity markets, and in other consumer mass markets for that matter, customers often have complex expectations and have consistently demonstrated willingness to trade off price against value. For example, some consumers choose a higher-priced product where it is perceived to deliver high value. The cellular services market exhibits this type of customer choice, with options for customers whose patterns of usage are distinctly different and incentives for service bundling and affinity deals.

In the UK and Australian electricity markets this idea is borne out in a wide cross section of product and pricing offerings from both existing market players and new entrants alike. For example, Australia is seeing the emergence of the "lifestyle product", which emphasises non-price attributes such as convenience through consumer preferences for billing and payment method and frequency, and is typically designed and packaged for niche customer segments. For example, TXU Australia markets individual TXU Life Energy plans to suit a variety of household types, such as families, couples, singles and pensioners. Other customers might be drawn to "green" products, which was underlined dramatically in the Netherlands between July 2001 and the end of 2003, when the number of customers choosing green energy rose from 540,000 to 1.8 million.

In the UK, retailers are expanding their portfolios into other home services beyond commodity supply, such as boiler repairs and drainage mainte-

nance, a point emphasized by Peter Westwood, Head of Retail Strategy, E.ON UK at the November 2004 International Energy Agency European Energy conference in Berlin. He added that constant innovation is required in both product and pricing options to tailor energy and energy-related products to meet a customer's needs.

In successful competitive electricity markets, customers have been shown to value dimensions other than price. That is not to say that lower prices are not available – a recent study by uSwitch.com, a website offering price comparisons in the UK, found that customers who switched could save up to £170 annually – but not all customers choose the lowest price.

The Customer Experience

All the evidence points to the needs of the customer, but are customers satisfied with their lot in a truly competitive retail electricity market? According to UK regulator, Ofgem, "customer satisfaction levels are high with the majority [of customers] finding switching easy." The statement highlights a key point in judging retail market competitiveness: whether a customer has reached what Dr. Philip Lewis, Group Director of VaasaEmg and a leading global expert in the field of energy customer loyalty, terms a customer's "critical awareness."

Critical awareness is the point where a customer understands through trusted sources, such as the market regulator and the media, that they have the ability to choose suppliers and they can evaluate the relative costs and benefits associated with switching. In the UK, a high percentage of customers have reached critical awareness, and over 50% of all customers have switched retailer at least once. In Texas, by mid-2004, over 1.5 million customer switches had taken place—fully 25% of the market.

In Finland, evidence suggests that customers who have switched supplier are more satisfied than they had been

previously. In VaasaEmg's report, *The Electricity Customer's Lot*, nearly 90% of residential and over 80% of I&C customers were satisfied with their decision. When considered in the context that many Finnish consumers are not switching to the lowest-priced supplier, it can be concluded that customer satisfaction derives from other non-price attributes. In Texas too, customer satisfaction levels are on the rise. According to a November 2003 study conducted by the Center for Research and Public Policy (CRPP) for the Public Utility Commission of Texas (PUC), 65% of Texans believe electric competition is good, a substantial increase over the previous year.

From this research into customer attitudes it is apparent is that "real" customer satisfaction often consists of more dimensions than are typically measured by a regulated utility, such as: are customers getting the range of products and prices they want, do they get the payment options they want and are they more satisfied simply by having the freedom to choose?

Can the US get There from Here?

Striking proof is available from markets around the world that retail electricity competition can work to the benefit of all customers. Demonstrated benefits include value-added products, lower prices, convenience, new methods of billing and payment, risk-mitigation products and relevant affinity programs. Yet most US states remain mired in the transition from monopoly to market where successive regulatory decisions often implement piecemeal aspects of retail access for a particular utility territory, and there is seldom a clear statement of a desired end goal. With US regulators' policy focus still mainly on issues of regulated utility versus competitive retailer, it is not surprising that many critical retail market fundamentals have not yet been established.

Perhaps most important, lack of serious mass-market competitive >>

activity has created a dilemma for US policymakers. Costs to implement retail electricity competition are borne by all customers; however, the benefits of the limited competition seen to date are heavily concentrated amongst only the largest customers.

Only time will tell whether US states have the necessary desire and willpower to enhance the prospects for future retail competition and bring about widely recognized consumer benefits, but Texas' pursuit of an approach similar to successful overseas markets should serve as an important bellwether for other US markets. In the meantime, the adoption of more meaningful and consistent benchmarks for measuring market progress, such as

those suggested in this paper, as well more monitoring and reporting of these benchmarks, would undoubtedly focus attention on the ways in which markets ultimately operate and what successful retail electricity markets represent. ■

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by consumers."

Rep. Paul E. Gillmore from Ohio also let FERC know that his constituents are restless. "I have been hearing increasing concerns from my Ohio municipal electric constituency about their first hand experiences with transmission organization costs and procedures (detailed in letters to you)." He wants FERC to ensure that RTOs provide tangible net benefits to consumers and are held to appropriate standards of accountability and cost control.

Starting Over

Some parties to the proceeding, such as state commissions and RTOs themselves, think FERC needs to start from scratch and develop an entirely new accounting system just for RTOs. But the contrary view comes from investor-owned utilities (IOUs). The Edison Electric Institute, which represents them, calls only for better adherence to the existing USOA system.

The National Association of Regulatory Utility Commissioners (NARUC), and the ISO/RTO Council (IRC), both want a major overhaul. (The IRC is made up of the nine functioning ISOs and RTOs in North America and was formed to collaboratively develop standard processes for improving competitive electric markets.)

Both NARUC and IRC call for comprehensive reforms to the USOA, which they believe is not well suited to RTOs, as the USOA was developed for traditional public utilities, not for application to the different business segments and services offered by RTOs.

IRC advocates adoption of an entirely new accounting system that better meets the needs of RTOs and would make it easier for FERC, state commissions and stakeholders to monitor and compare RTO costs. NARUC agrees that the USOA for traditional utilities simply does not fit the RTOs. It explains that RTO costs largely are associated with sophisticated system control and communications hard- ➤

REGIONAL TRANSMISSION ORGANIZATIONS

FERC Seeks Better Financial Oversight

BY LORI A. BURKHART

Money matters, which is why the Federal Energy Regulatory Commission (FERC) launched a notice of inquiry (NOI) on Sept. 16, 2004 to solicit comments on RTO/ISO accounting, cost management and cost recovery issues. Specifically, FERC wants to explore "whether changes to RTO/ISO accounting, financial reporting, and cost recovery practices are necessary to ensure rates charged by RTOs/ISOs and their member transmission-owning public utilities are just and reasonable." [See *Re Financial Reporting and Cost Accounting, Oversight and Recovery Practices for RTOs and ISOs*, Docket No. RM04-12-000, 108 FERC ¶ 61,237, Sept. 16, 2004 (F.E.R.C.)].

FERC thinks the best road may be to

make changes to its Uniform System of Accounts (USOA) for public utilities to better allow RTOs to report financial data to FERC. FERC will investigate if RTOs have appropriate incentives to be cost efficient, and whether its rate review methods are sufficient.

The proceeding has caught the eye of lawmakers on Capitol Hill, and one filing targets the California ISO, still haunted by the Western power crisis of 2000-01. Rep. Doug Ose, chairman of the Government Reform Subcommittee on Energy Policy, Natural Resources and Regulatory Affairs, recommends that FERC require RTOs to obtain prior approval from FERC of their proposed budgets. He specifically decries the "ever-escalating costs incurred by the California ISO that ultimately are paid

ware and software designed to oversee the transmission grid, while the IOU's costs are dominated by costs of generation, transmission and distribution facilities. The accounting rules contained in USOA were designed to capture financial information for traditional utilities along those functional business lines, and while RTOs are classified as public utilities so as to allow FERC regulation, the rules do not apply so well to RTO business lines.

"Since there does not appear to be a connection between FERC USOA accounts and (a) FERC-required RTO functions and (b) Day-2 or Day-Ahead schedules, a more detailed FERC USOA, with greater clarity and relevance for current day business models (including updated nomenclature) is needed for RTOs and ISOs," NARUC argues. It urges FERC to develop a new financial reporting format for functions typically performed by RTOs, such as management of congestion, ancillary services, market monitoring, OASIS and more.

But another RTO, the Midwest Independent System Transmission Operator (MISO) cautions that FERC must ensure revised accounting regulations and associated data collections are not overly burdensome. If excessive, MISO warns, the added regulatory burden could undermine RTO efficiencies while producing only marginal benefits. It pointed to that situation occurring now with the requirement that public utilities and RTOs report transmission of electricity for others at the transaction-specific level. MISO believes transaction-specific reporting is not justified in the RTO context.

IRC believes a new USOA could lead to new rate designs. IRC said the accounting changes "can serve as a foundation for cost management and innovative rate initiatives proposed by individual RTOs that are suited to their particular needs in light of their level of development." IRC wants individual RTOs to originate innovative proposals

RTOs—Love 'em or Leave 'em

The California Department of Water Resources (DWR) State Water Project (SWP) in its filing in the FERC RTO accounting docket, told FERC that RTOs do not have appropriate incentives to be cost efficient, and that FERC's rate review methods for RTOs are not sufficient. It pointed to one method to escape the high costs of dealing with the California ISO—withdrawal—mentioned in an editorial in the *Sacramento Bee*, entitled *Un-gilding the Grid*:

Under the culture of self-enrichment behind closed doors, it should come as no surprise that the ISO's great problem has been cost. It is so expensive that, when the Sacramento Municipal Utility District and the Western Area Power Administration were given the choice, they chose another way to get their power onto the grid rather than paying the ISO's tariffs. (Oct. 26, 2004)

DWR SWP also pointed to testimony given before a California PUC law judge, after which Sacramento Municipal Utility District (SMUD) became its own control area:

Q: Okay. So what signal is SMUD receiving per your testimony? It's located out side of a local reliability area, which you said is what load should do, the signal load should receive, is to locate out of congested areas, which SMUD is. What's the signal?

A: The signal is Nevada is also outside of the former control area and local reliability area.

Presiding Judge: And?

The Witness: To the extent that the load was located, decided to move to Nevada, it wouldn't incur any of these costs.

Re Pacific Gas & Electric Co., Docket No. ER00-2360, testimony of California ISO Witness Deborah Le Vine at Tr. 1322-23.—L.A.B.

suited to particular needs, and cautions the FERC against "one size fits all."

But EEI disagrees. Instead, it prefers FERC provide direction to RTOs as to the proper, existing USOA accounts where they should record categories of income, expenses, assets and liabilities. EEI supports standardization of RTO accounting and financial reporting to FERC, in line with accounting definitions currently used by utilities and other market participants.

Benchmarks

Accounting changes may help RTOs be measured against each other, an important goal in the movement towards greater transparency and more effective oversight.

The California Department of Water

Resources (DWR) State Water Project (SWP), a state agency that is the California ISO' single largest transmission user representing 5 percent of load on that grid, is critical of the California ISO's spending. SWP argues that FERC "must establish criteria and benchmark measures to define success or failure in advance," plus it must monitor RTOs to ensure efficiencies actually occur, or the mandate of the Federal Power Act for ratepayer protection will not be met.

SWP argues RTOs should allocate all costs based on cost-causation principles or bear the burden of justifying why costs must be socialized. SWP believes cost socialization and cross-subsidies defeat the objective of greater efficiency. »

It cited a California PUC conclusion that: "Since the restructuring of California's electricity industry to incorporate an ISO, California ratepayers have seen marked increased in transmission spending, a large new set of costs unique to the ISO, and large increases in generation costs." *Re Comments of the Public Utilities Commission of the State of California on Proposed Pricing Policy for Efficient Operation and Expansion of Transmission Grid, Docket No. PL03-1, filed Mar. 13, 2003.*

The SWP related its experience to illustrate what it believes to be a problem with RTOs. It says that prior to restructuring, it enjoyed unbundled network and point-to-point transmission service in California under two sets of transmission contracts with two transmission providers, Pacific Gas and Electric and Southern California Edison. In contrast, now it would need to use five different tariffs to obtain the same service with the California ISO. "The transactional, administrative, legal and related costs of these highly complex ISO structures entail substantially more expense than was the case when SWP operated under two sets of mutually exclusive contracts," SWP concluded.

Senior elected representatives of the PJM finance committee in its filing recommend FERC encourage PJM to develop detailed benchmarks for performance against its budget, plus develop a series of metrics to measure and control performance. While PJM has initiated such actions, the finance committee wants such development to be a priority and to allow the finance committee to track project priorities and provide input into reallocation or deferral of dollars as priorities change. It argued the FERC can facilitate development of operations parameters and metrics by requiring RTOs to provide supporting data in a defined, consistent, comparable manner, which will allow benchmarking across the industry and easier identification of best practices.

"The direct impact of a new Day-One RTO should be less than one-half of one percent of a retail customer's bill."

—FERC Staff

IRC argues that a reformed USOA would help the FERC compare RTO costs to transmission provider costs in non-RTO regions, and to determine what portion of RTO costs would otherwise be borne by traditional transmission providers. That would allow the FERC to better measure efficiencies resulting from creating RTOs, to ensure that traditional transmission providers' costs decrease as RTOs' expenditures increase, and to create a consistent, national regulatory framework for reviewing industry costs.

But IRC cautions FERC on benchmarking due to the many differences, the most obvious being geographic, but including political, among RTOs. IRC urges FERC to define what it means by benchmarking. It argues that even if FERC develops a range of costs, the differences among organizations would make comparisons difficult.

Also, because the functions for which FERC seeks the ability to provide meaningful comparisons are performed both by RTOs and traditional transmission providers in non-RTO areas, the revised USOA accounts should permit at least two distinct types of comparisons. First, IRC argues for allowing comparison of RTO/ISO costs against the costs of the same functions being performed by transmission providers in

non-RTO areas. Then, a second set of benchmarks would permit comparison of functions among RTOs.

Rep. Doug Ose wants FERC's regulations at a minimum to define basic RTO day-one functions that RTOs should use in their filings requesting prior budget approval. Ideally, Ose thinks basic market functions should be defined as well, in order to lay a foundation for cost comparisons among RTOs.

"Real" RTO Costs

Estimates of the "real" costs of operating RTOs have been quantified in various reports and findings differ dramatically for reasons involving varied study methods and differences in RTO market design.

In a recent FERC staff report, staff concluded that "the direct impact of a new Day-One RTO should be less than one-half of one percent of a retail customer's bill." *Re Staff Report on Costs Ranges for the Development and Operation of Day One RTOs, Docket No. PL04-16-000 (Oct. 2004).*

The IRC eyes total costs of operating RTOs involved in Day-Two functions (bid-based security constrained dispatch and unit commitment, locational pricing, financial transmission rights or capacity markets) and argues they are a "small fraction" of the size of markets they operate. IRC acknowledges comparisons of Day Two RTO costs are very imprecise at present due to differences in market designs, market definitions and flaws in the USOA..

However, IRC proffers total 2004 annual costs for the New York ISO of approximately 1.7 percent of the value of transactions in its energy market. It says PJM's costs represent 2.5 percent of total market activity in 2003, with an expected decline to 2.4 percent in 2004 and 2.1 percent in 2005. Also, it notes the Texas ERCOT has annual costs less than one percent of the size of its market, and the Ontario IMO's costs are less than two percent of wholesale market transactions and less than one »

percent of the total retail bill.

The MISO stresses that FERC should not base any action on “unsupported suggestions” that RTO costs have been excessive or assume they will keep rising. It attributes many RTO expenses as one-time start-up costs, and believes they will stabilize once initial outlays are made and market redesign is completed.

MISO compared its expenses paradigm to that of a new power plant project, where costs level off after being placed in-service. MISO explained that after its initial start-up period in 2000-2001, those capital expenditures for Day-One operations declined substantially in subsequent years. Also, the operating budget for Day-One operations leveled off in 2003 and 2004, reflecting maturation of operations. MISO predicates that same pattern for Day-Two operations implementation.

Rep. Ose does not believe systemic incentives exist at present to encourage RTOs to provide cost-effective services. He thinks rates continue to increase and existing RTOs appear in certain instances to perform the grid management roles less cost efficiently than did the vertically integrated utilities. Ose urged FERC to provide RTOs with detailed principles to assist them in determining which expenditures are prudent before the fact.

NARUC cites a lack of strong management controls that can be relied on to control costs, and says FERC needs to implement some type of review process that provides for non-recovery of excessive costs or costs considered unreasonable or imprudent. State commissions are concerned, NARUC explains, that FERC largely has relied on an RTO advisory committee process as a check on RTO expenses, especially since the advisory board has no ability to block the expense.

NARUC called on FERC to allow RTO stakeholders to help develop cost containment incentive plans that are enforced by FERC. It also advocates before-the-fact regulatory prudence reviews by FERC, after RTOs submit spending plans in plenty of time for some type of proceeding to take place. A related concern is that some IOUs believe they are being forced to justify RTO spending before state commissions, due to lack of adequate review of the expenses at other agencies. Once RTO rates are set by FERC, NARUC is concerned that state commissions will be precluded from making disallowances in rate proceedings for utilities in their states. ■

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Bush Legacy

(Continued from p. 2)

“Whether MTBE limitations are included, and how strongly they are pushed, could be important for how consonant Congress is in the future,” said Joe Andrew, a partner with the law firm of Sonnenschein, Nath & Rosenthal in Washington, D.C., and former chairman of the Democratic National Committee. “Republicans have been split on the MTBE issue, but proponents are more confident

now that they can get it through.”

In what context they will pursue it, however, remains uncertain. One scenario could be to include an MTBE measure in a broader corporate liability related bill. Republican leaders and the Bush administration have made no secret of the fact that tort reform will be one of their top priorities in the 109th Congress, and MTBE liability could fit within the rubric of tort-law changes. »

Next Month's FORTNIGHTLY

In January, *Fortnightly* kicks off the New Year with a look ahead at the future of energy information technology. Another fascinating article takes a look at the possibilities offered by methane hydrate as a solution to the ever-increasing demand for natural gas. Here is some of what you will find:

► IT Roundtable: Future Shock

Technology leaders at Pacific Northwest National Laboratory, the Electric Power Research Institute, and the National Rural Telecommunications Cooperative present their visions of energy IT in the 21st century.

► Reversing the Gas Crisis: The Methane Hydrate Solution

Are methane hydrates the key to averting a North American natural-gas crisis? The U.S. potential is enormous—at least 100,000 Tcf—but commercial production lags.

► The Business Case for Co-op Acquisitions

When do the pros of a co-op acquisition outweigh the cons? One feasibility analysis led to some surprising results.

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At this early stage, however, the future of MTBE liability is difficult to predict.

"I suspect the leadership on the MTBE issue will figure out some way to thread the needle," said Toby Anderson, a vice president with Lighthouse Energy Group, a government and public affairs consulting firm in Washington, D.C. "In retrospect, there may have been some overreaching on the matter in the last Congress, and those who care about the MTBE issue might be a little more receptive to compromise this time around."

Removing MTBE liability from the energy bill would eliminate the biggest stumbling block it faced in the final hours of the 2003 session. But at the same time, pressure is rising to introduce ANWR provisions that perennially have proved to be as contentious as MTBE. President Bush has promised to push once again for ANWR's opening, and Republican leaders seem prepared to pursue the legislation in some form.

"ANWR development is at the top of the Republicans' list," said Michael Zimmer, a partner with Thompson Hine in Washington, D.C. "But it's not necessary that it will move in an omnibus package."

Namely, like MTBE, ANWR could be pursued separately, or as part of another legislative effort.

"It's looking like the Republicans will try to do ANWR as part of the budget reconciliation bill early next year, because they only need 51 votes

on that bill and can avoid a filibuster," Anderson said.

This approach fits into the budgeting procedures of the legislative and executive branches. The Bush administration's budget almost certainly will assume – as it has for every year of the Bush presidency – that revenues will come from prospective oil operations in ANWR. Congress uses the annual reconciliation bill to change laws as necessary to implement the budget, hence ANWR's place in the bill.

This approach to ANWR legislation has a historic precedent. Republicans included ANWR provisions in the budget reconciliation bill in 1995, but President Clinton vetoed it. Whether proponents of ANWR drilling have the votes to prevail with such an attempt this time is uncertain; analysts suggest the count is very close, even with the vice president's vote.

In any case, the budget reconciliation bill appears to be a more hospitable venue for an ANWR provision, and thus a broader energy bill, *sans* ANWR, might enjoy relatively smooth sailing in the Senate.

Legacy Building

A significant factor in the equation involves the long-term aspirations of President Bush, and the degree to which Republicans in Congress support those aspirations. Specifically, Bush has signaled that he plans to pursue an aggressive agenda of economic and social reform – collectively labeled

the "Ownership Society." The biggest items on this agenda are Social Security reform – namely, partial privatization of the system – and tax reform – possibly a flat tax or consumption tax.

Energy legislation in 2005 could represent a bellwether of Congressional Republicans' interest in helping George W. Bush forge a strong legacy for his presidency. To the degree the president is able to gain loyalty from Republican legislators to pursue the Ownership Society agenda during his lame-duck second term, Congress will be more likely to pursue an expedient approach on the energy bill. But to the degree legislators are more interested in advancing their own agendas – including re-election in 2006 and even the presidential race in 2008 – they might be less likely to seek compromise.

"Ironically, Bush is now less powerful within his own party because he is not running for re-election," Andrew said. "You have a half-dozen senators thinking about running for president, and they all see everything through the lens of their own campaign. Will they do what is in the interests of the president or their own campaign?"

The answer to that question might determine whether major energy legislation becomes mired in political struggle or actually succeeds in 2005. ■

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