

Wholesale Electricity Markets

Summary

In response to continuing problems facing members of the American Public Power Association (APPA) in regional wholesale power markets, primarily in regions with Regional Transmission Organizations (RTOs)/Independent System Operators (ISOs) that are under federal jurisdiction, APPA instituted the Electric Market Reform Initiative (EMRI) in March of 2006. EMRI was established to first assess and then address the market failures and other serious challenges facing public power systems across the country.

The migration to RTOs in certain regions of the country coincided with a push in the 1990s to deregulate state retail electricity markets. This push was coupled with assertions by state policymakers and federal regulators that lower prices and increased infrastructure investments would be the result. It has become increasingly clear to APPA, however, that RTO-operated markets are not benefiting electricity consumers, and that prices have increased disproportionately to inflation and other factors like rising fuel costs. In our view, these markets are not competitive; and we believe consumers are exposed to prices for electricity that fly in the face of the standard of “just and reasonable” rates required by the Federal Power Act.

This issue is important to APPA because almost all public power utilities rely to some extent on purchases from the wholesale markets for the energy they supply to their customers, and many rely almost exclusively on such purchases. APPA, and many other organizations, asked the Federal Energy Regulatory Commission (FERC) to investigate the problems in these markets identified through the EMRI studies and to take corrective action, but FERC denied that request. Thus, APPA believes that Congress should exercise its oversight and

other authorities to ensure that FERC addresses the problems in these markets, and adheres to its statutory obligation under federal law to protect electricity consumers.

Background

Often termed “restructuring” or “deregulation,” a major transition has taken place in some of both the retail and wholesale electricity markets over the past 15 years. These changes were based in part on the belief that electric utilities should no longer be regulated monopolies and instead should be deregulated and face competition, just as trucks, railroads and airlines did during the 1980s. In the retail markets, which are under state control, policy changes in the 1990s encouraged or required abandonment of the traditional vertically-integrated utility company model in order to disperse ownership of generation facilities and thus spur competition. In most states that made such changes, public power utilities were allowed to “opt out” of the retail access programs, and almost all of them did so. That means that public power utilities retained their legal obligation to serve all customers in their service territory and to plan for and acquire the necessary resources, either through ownership or contract.

In the states that “deregulated,” retail customers of private utilities were given the right to purchase power from non-utility providers. As mentioned above, the private utilities were required to sell their generation facilities, but in many cases those power plants were simply sold to an unregulated affiliate of the same holding company that also owns the distribution utility that sold them. As a result, the private utilities were also

forced to purchase their power on the wholesale market, often generated from the same plants they used to own, but at much higher prices. Two agreements were generally reached between utilities and customer representatives as part of the new retail market regime. First, consumers were often required to finance the unpaid debt on the existing generating facilities, known as “stranded costs.” Second, retail rates for residential customers were frozen during what was thought to be a “transition” period until all customers could participate in the markets by choosing alternative suppliers.

Meanwhile, the federal agency that regulates wholesale power sales, the Federal Energy Regulatory Commission (FERC), began to push for restructuring of the wholesale markets and the creation of RTOs/ISOs to oversee these markets. FERC abandoned the requirement that electricity sold in the wholesale market should reflect the cost of producing the power (plus a reasonable profit) – the traditional approach to meeting the just and reasonable standard in federal law mentioned above. Instead, they used certain economic tests to analyze various market conditions and determine whether they were sufficiently “competitive” to set prices, subject only to reporting and limited oversight requirements. These changes in the wholesale and retail markets were predicated on assertions by federal and state officials and other RTO proponents that they would promote competition, spur efficiencies and innovation, and lower rates for consumers – assertions that, for the most part, have not come to fruition.

In response to FERC’s encouragement, wholesale markets in the Northeast, Mid-Atlantic, Midwest regions and California are now operated by RTOs/ISOs. These organizations administer markets where electricity is bought and sold under highly complex arrangements. RTO-run markets generally cover the same regions in which the majority of the retail access states are located. As a result, these states are home to a large pool of generation with prices that are unregulated at both the state and federal levels.

In most retail access states, competitive suppliers at the retail level have not materialized for most residential and small business customers, and thus these cus-

tomers still purchase power from their local utilities. But because these utilities no longer own generation (as discussed above), they must procure such power on the wholesale markets run by RTOs/ISOs through various “auctions” and other procedures used to select the suppliers of the power. Again, as discussed above, often the suppliers winning these auctions are the unregulated owners of the generating plants formerly owned by affiliated utilities, and largely paid for by customers. Yet, because the prices for electricity are no longer cost-based, these new owners are able to charge much more than they were paid prior to deregulation.

One core function of an RTO is to provide non-discriminatory open access transmission service for electricity transactions. This requires that owners of transmission lines do not give any preference or deny the use of their transmission lines to other sellers and purchasers of electricity. To carry out this responsibility, RTOs have functional control, but not ownership, of the transmission system. RTOs also coordinate regional planning for new transmission lines and eliminate rate “pancaking” (charging multiple transmission fees for one transaction). Most RTOs handle these functions well and provide benefits to consumers.

A second core function of RTOs is to administer markets for various electricity services in their regions including energy, capacity and ancillary services. RTO-administered markets are intended to provide a centralized marketplace in which electricity can be bought and sold at prices established by “competitive” forces. RTOs do not own the power plants that generate the power bought and sold in the market, but rather develop the rules to administer the markets, decide which generators will run and at what levels, grant (or deny) the transmission services needed for transactions to occur, and run the billing systems for payments for power. The problems that have developed stem from this second core function—the energy-related markets operated by the RTOs—and are attributable to certain fundamental features of the market design, the exercise of market power by some generators, and lack of sufficient FERC oversight.

Congressional Action

The Energy Policy Act of 1992 opened wholesale markets to independent power producers, which in turn underscored the need for open access by these new market participants to the bulk transmission lines largely owned by vertically-integrated investor owned utilities. In April of 1996, FERC issued its landmark Order Nos. 888 and 889. In Order No. 888, FERC directed the electric utilities under its jurisdiction (primarily investor-owned utilities) to provide open and nondiscriminatory access to their transmission lines in order to help bring down the cost of electricity through increased wholesale competition. FERC also encouraged the formation of RTOs/ISOs, and set out certain functions they should perform. In Order No. 889, FERC required jurisdictional utilities to establish electronic bulletin boards, called “Open Access Same Time Information Systems,” to help manage the non-discriminatory flow of electrons across transmission systems.

As regional power markets began to develop, it became clear that new transmission facilities were not being built at the same rate as new generation (and almost all of that generation was non-utility owned and natural gas-fired). Therefore, in December of 1999, FERC encouraged all transmission owners to voluntarily develop and join RTOs. Order No. 2000 was then issued and required FERC-jurisdictional transmission owners to submit an RTO plan by October of 2000, and targeted December of 2001, as the date by which all RTOs would be operational. However, since Order No. 2000 did not contain a mandated obligation to join an RTO, they did not form in a number of regions of the country. In response to this situation, in 2002 FERC pushed to standardize RTO functions and markets across the nation and to require jurisdictional utilities to participate in them. This FERC initiative, called “Standard Market Design” (or SMD) spawned significant opposition in Congress and further stalled RTO development in regions of the country that did not yet have them – primarily the Pacific Northwest, the South and the desert Southwest.

In early 2008, companion Senate and House legislation to provide cost accountability to Regional Transmission Organizations (RTOs)/Independent System Operators (ISOs) was introduced. The Consumer Pro-

tection and Cost Accountability Act (S. 2660 and H.R. 5547, respectively) was sponsored in the Senate by Senators Sanders (I-VT) and Snowe (R-ME), and cosponsored by Senators Kerry (D-MA), Kennedy (D-MA), Leahy (D-VT), Collins (R-ME) and Mikulski (D-MD); while in the House it was sponsored by former Representative Allen (D-ME) and cosponsored by Representatives Delahunt (D-MA), McGovern (D-MA), Michaud (D-ME), Welch (D-VT), and Tierney (D-MA). It is unclear as of this writing if this legislation will be reintroduced during the 111th Congress.

Also in 2008, the Government Accountability Office issued a report on wholesale electricity markets as requested by Senators Lieberman (I-CT) and Collins (R-ME) which urged FERC to investigate these markets to ensure that rates are just and reasonable.

APPA and other like-minded organizations continue to encourage leadership in both the Senate Energy and Natural Resources Committee and the House Energy and Commerce Committee to hold investigative hearings into the functionality of these RTO/ISO-run electricity markets and to urge FERC to undertake an investigation of these markets as recommended by the GAO.

APPA Position

APPA members in RTO regions report substantial problems that impair their ability to provide reasonably priced and reliable long-term service to their own electric customers because of RTO-run markets. Studies undertaken by APPA’s Electric Market Reform Initiative have shown that there is substantial evidence that prices in these regions are “unjust and unreasonable.” FERC has the ability to use its existing and new authorities (provided in the Energy Policy Act of 2005) to remedy this situation.

In December of 2007, APPA joined 40 other consumer, business and public interest groups in asking FERC to conduct a broad investigation of fundamental RTO-run market problems and to take the necessary steps to protect consumers as required by law. In a final rulemaking issued by FERC in late 2008, this request was denied. APPA has also spearheaded a new coalition of industry and consumer groups called the Campaign for Fair Electric Rates. This group is asking Congress to

put pressure on FERC, either through oversight hearings or legislation, to fulfill its obligation of ensuring just and reasonable rates for electric consumers.

In addition, APPA has developed detailed proposals for both short- and long-term solutions to the problems in RTO markets. The most recent of these is APPA's Competitive Market Plan released in February of 2009, and available on APPA's website at www.appanet.org. In summary, the plan proposes to retain the RTO functions that are working well—principally those associated with planning for and operating the regional

transmission grid—and replacing those functions that are not benefiting consumers, mainly the design and operation of the energy and capacity markets. The Competitive Market Plan focuses on moving market participants away from short-term, high-priced spot markets, and into long-term bilateral contractual arrangements that will stabilize electricity prices and provide the financial certainty necessary for investments in new generation and transmission infrastructure necessary to meet future reliability requirements.