Summary of Testimony of
Pat Wood, III
Chairman, Federal Energy Regulatory Commission
Before the Committee on Energy and Natural Resources
United States Senate
September 17, 2002

The Commission has proposed a standard set of rules and procedures for open access transmission service and electricity market design. The Commission and its staff have undertaken a tremendous amount of outreach and will continue to do so to craft a fair proposal that is in the public interest.

Our goal is to create a seamless, national market for wholesale electricity, so that sellers can transact throughout broad regions and customers can receive the benefits of less expensive and more reliable electricity. The proposed rule will remedy remaining undue discrimination in the use of the Nation's interstate transmission grid and also maximize competition in wholesale markets.

The proposed rule requires all transmission customers of public utilities to be placed under the same tariff to remove discriminatory practices that give preferences to one type of customers over another. It also defines a new flexible transmission service that would be available to all transmission customers. Further, the proposed rule establishes a transmission congestion management system to assure that the grid is managed efficiently. Importantly the rule would ensure that existing customers retain the same level and quality of transmission service they currently receive. The customers and regions benefiting from inexpensive power today could continue receiving these benefits in the future through contractual arrangements.

A critical piece of the NOPR would protect customers against the exercise of market power when conditions do not support a competitive market by requiring market monitoring at all times, and market power mitigation when needed. Long-term planning and resource adequacy requirements are proposed to assure that infrastructure needs are met without wasteful and dangerous "boom and bust" cycles. We also propose participant funding as an option to price transmission grid expansion in regions with an independent transmission provider, so that cost responsibility follows cost causation.

The Commission is also proposing a framework for complementary State and federal regulation, where States will have a more prominent and direct role in advising the Commission on matters that fall exclusively within the Commission's jurisdiction. Finally, the proposed rule generally standardizes the market design, but allows flexibility in a number of areas to reflect regional differences.

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Thank you Mr. Chairman, Senator Murkowski, and members of the Committee for inviting me to testify here today. My colleagues on the Federal Energy Regulatory Commission and I welcome your focus on the efficiency of interstate wholesale power markets. We welcome your input on our July 31, 2002 proposed rule which endeavors to complete the decade-long transition to stable, efficient electric markets.

In addressing almost every facet of the wholesale electric markets, our July 31st Notice of Proposed Rulemaking to remedy continuing discrimination in the Nation's electric power markets and standard electricity market design has a broad reach. A summary of the proposed rule is in Appendix C. Our proposal is built upon the real experience and best practices of the world's best competitive markets – for electricity and other products. It was written after an extensive ten-month public outreach process in which we sought input on the breadth of issues facing the wholesale power markets. Before our unanimous vote July 31 to propose the rule for public comment FERC Commissioners and staff held over 25 meetings and technical conferences with experts and others across the country to hear their concerns, suggestions and recommendations. A summary of all of our outreach efforts appears in Appendix B.

I would like to use this opportunity to first explain why my colleagues at the FERC and I believe that our approach is necessary for interstate wholesale electric markets and good for our country. I will follow that with some background on the current state of the evolution in the nation's power markets. Then I will review some of the major concerns that people have raised about the proposed rule during our outreach over the past seven weeks, so we can better understand what this proposal does and doesn't do and how it will affect customers.

Why a More Standard Approach to Electricity Markets is Good for America

Under the Federal Power Act, the Commission must regulate in the public interest. That mandate colors every action we take.

The wholesale power market today has many of the worst features of both regulated and competitive markets, and few of the benefits of either. There is continuing discrimination against certain buyers and sellers that harms new market entrants and raises costs to end-use customers; there are extensive loopholes between state and regional rules that allow market manipulation to raise prices and compromise reliability; there is under-investment in transmission that raises energy costs by billions of dollars across the grid and exacerbates reliability problems; and the practically-inelastic demand curve means there is little customer discipline on price and supply.

To serve the public interest, we must look ahead and work to facilitate the electricity system that Americans in the 21st century deserve – a strong, secure network that is technologically advanced and capable of delivering the high reliability our society needs at a reasonable cost. That network will use existing rights-of-way, advanced materials and electronics to link electricity users and producers more smartly and more reliably. The generators of the power moving over that grid will be technologically and environmentally improved, so that we have a diverse portfolio of generators, using every energy fuel, under the control of many owners, with plants of every size located across the nation.

We believe that a clearer focus on getting a firm foundation established for wholesale electric power markets will accelerate our evolution to this 21st century system and save Americans billions of dollars along the way. As with Congress' and the Commission's efforts in the wholesale natural gas markets in the last decade, these will be real savings that will lower the costs of America's goods and services, create and protect more American jobs, and keep more precious dollars in customers' pockets. How do we know this? Because in England, the real costs of electricity under wholesale competition dropped significantly, and in the ERCOT market of my home state of Texas, wholesale prices under wholesale competition have dropped by 28 percent in six years. Our Commission's experience with natural gas competition is telling. Wholesale competition in natural gas has provided, on average, $6,000 in savings to the average American family over the past ten years versus charges under continued regulation.

Present Progress toward Regional Power Markets

Following adoption of the Energy Policy Act in 1992, FERC began working to remove barriers to open, competitive transmission access with Order Nos. 888 and 2000. Although those made significant progress toward opening up the grid to new competitors, the biggest obstacle to full competition remains the fact that grid ownership and operation is fragmented and access is limited by many owners who have incentives to discriminate against those seeking transmission service. Order No. 2000 encouraged the establishment of Regional Transmission Operators (RTOs) to serve as independent grid operators across large regions of the country, reducing operational costs and making energy flow more efficiently through smarter operation.

To date we have seen progress toward RTO formation. FERC has approved an RTO for a large footprint in the Midwest, and has conditionally accepted RTO proposals elsewhere. See Appendix A for a map of the existing and proposed regional organizations. FERC's July 31st proposed rule builds upon that progress, answers a number of questions that have arisen in RTO formation and provides guidance toward a more uniform and efficient approach toward wholesale power markets. We will continue to work through these "real world" dockets to better inform ourselves of regional variations that are needed in the various power markets.

The Commission's July 31 Proposed Rule

Following the most intensive public outreach in Commission history, on July 31, the Commission issued a proposed rule addressing many of the crucial details needed to be resolved in order to capture the benefits of competitive wholesale power markets for customers. Every aspect of the rule is open to comment and we particularly invite comment on over 70 specific issues. The proposal followed from ten months of specific workshops, technical conferences, hearings and targeted outreach both in Washington and across the country. What we have heard and learned was publicly disseminated well in advance of the rule through Commission documents and our web site, and we have received virtually continuous feedback from all quarters on the various issues. Our July 31 proposal represents the broad consensus reached through the process in addition to our "cuts" on a handful of non-consensus issues.

Although the proposed rule represents our best judgment given the information available, our minds remain open to new views, information and ideas.

Since we issued the proposed rule, we have been actively meeting with groups and individuals across the country to help them understand the proposal and understand their concerns. To date, FERC staff and commissioners have given over two dozen presentations to groups of state regulators, public officials and conference attendees and discussed the proposal in every press call and speech. At this time, we have another 30 outreach presentations scheduled to interest groups, trade associations, conferences, and others. Appendix B lists many of the activities and meetings we conducted in developing the proposal, and many of the formal outreach meetings scheduled since the July 31 issuance of the proposed rule.

To better ensure that the public and parties have maximum opportunity to review, consider and comment on the proposed rule, we have extended the 75-day comment period for another 30 days and we have also asked for reply comments as well. In our outreach to affected parties following July 31, we heard this suggestion repeatedly and responded. We are scheduling additional technical conferences to explore specific issues in greater depth over the Fall, and have reserved a week in January for any necessary additional public discussion after the close of the comment period. Four of which have been scheduled already relate to market monitoring, software issues, limitations on liability and Western market concerns. These efforts will assure that everyone with a stake in this rulemaking has a further chance to be heard with the goal being a fully fleshed out set of practical market rules.

Concerns raised in August/September Public Outreach

We have actively reached out to state utility regulators and governors, customers, industry members from every sector and region, academic experts, and other stakeholders from every perspective in developing our proposed rule. And on a number of key issues we have been persuaded to adopt a different policy that we began with because we concluded that it would better serve the public interest.

Let me address some of the key concerns we have heard about the proposal to date.

How do we know it works? – From the outset, our rulemaking process has been geared to adoption of the best of the practices that are working in the world's and America's markets. We have found and incorporated what is working today in the wholesale markets of the Eastern U.S., Texas, Canada, Great Britain, New Zealand, and Europe, as well as features that make markets work better for commodities, financial instruments, and consumer goods. We are responding to problems explored and documented by groups from the U.S. Department of Energy, the National Governors Association, the National Association of Regulatory Utility Commissioners and academic experts. And the solutions we propose have been explored and recommended by groups and authors ranging from President Bush's National Energy Policy to the Western Governors Association and innumerable blue ribbon panels, academics and public interest groups. What is new about FERC's proposed rule is that it is comprehensively pulled together in one place and is being proposed at a time when it can actually improve the lot of the nation's energy customers.

There is one provision, the Resource Adequacy Requirement, that is not currently in operation in other energy markets. This important provision has already received recommendations for improvement in our outreach and I expect it will improve through further public discussion.

Cost-shifting -- One of the most widely-voiced concerns about the proposal is that it could cause cost-shifting between states -- that low-cost states will see electricity prices rise as competition lets high-cost states buy up the cheap power. We don't believe that will happen and have made several parts of our proposal clear in this regard. The proposed rule does not abrogate existing contracts for power or transmission; it encourages load-serving entities in low-cost states to keep their existing low-cost power at home under long-term contracts and/or retail state regulation.

One important issue that I believe needs further work is the potential mismatch between the duration of "Congestion Revenue Rights" (financial hedges for transmission usage charges) and the corresponding length of generation supply contracts. We need to assure wholesale customers that they will have protection against transmission congestion costs for supply contracts for the life of those contracts, if they desire it.

Funding for new transmission lines – Our proposed rule encourages independent transmission providers to charge the cost of new transmission lines to those who will need them. This prevents local customers from paying for transmission upgrades to serve other regions unless those upgrades have benefits at home as well -- yet the state keeps the property tax and employment benefits of new generation and transmission facilities. But while the proposed rule expresses a preference for the beneficiary pays approach, it states clearly that it will be up to the Regional State Advisory Committees (comprised of state representatives from across the region) to determine the appropriate cost allocation method for new facilities, so we could see regional differences in how costs are allocated. This is a departure from FERC's historical "rolled in" transmission pricing policy. But it is both sensible and fair to ensure that the costs of new transmission lines are borne by those determined by an independent operator to be the beneficiaries of their construction, even though it is not always easy to identify the beneficiaries in an electricity network where the electrons flow as they choose. Because of these concerns, there is wide diversity of opinion about this issue nationwide. Due to this, I expect the various Regional State Advisory Committees will propose, and we will have, different cost allocation methods across the country.

Market oversight – Some commenters express fear that the rule will not avoid a repeat of wholesale market malfunction that the nation saw in the western energy markets two years ago. The proposed rule is a direct response to these events. It is clear that many of those problems were caused by bad market rules within California, mismatched rules and gaps between California and other states' markets, an over-dependence upon spot markets, and a shortfall in power supplies relative to customer demand. We designed our rule with these problems in mind, and are confident that these rules address and avoid the problems and loopholes which were exploited, at such great public cost, in the West. And because a standardized approach to rules is taken, it will not be possible to exploit gaps between markets with such strategies as "Fat Boy" and "megawatt laundering". Unfortunately, however, no regulatory rule can protect society against those who lie or deceive, as appears to have happened in the Western market. That is why it is important to have an independent region-based market oversight function working on the front line, as the proposed rule requires.

Our proposed set of rules for market mitigation and oversight are balanced ones that will protect the market while not impeding investment. Because these rules and triggers will be known in advance, and the market monitoring is continuous, this preventive regulation will serve to keep market participant behavior in check. These measures have already been tested successfully in market situations, and FERC is currently imposing them in regional power markets today. They will prevent the kind of market meltdown and delayed response that occurred in the West.

I should add that the Commission has already developed and implemented rules outside the context of this proposal to increase the clarity and transparency of market transactions. These rules – including Order 2001, to report discrete information on all electricity sales -- will help market participants and observers (including regulators) better understand and react to changing prices and conditions in the marketplace, and increase investor and participant confidence in the integrity of market transactions.

State Authority – Some objections to our rule proposal have come from some state energy regulators. This is understandable given our proposal to treat all transmission uses the same. We don't take this step lightly, but it is not possible to create a fair and equitable marketplace without use of a single set of rules for uses of the transmission grid. In our proposed rule, we explain in detail why we find that undue discrimination continues to this day, and its negative effects upon the competitors and customers of the wholesale electric market.

Electric transmission facilities have evolved in use from support of local service provision to one of facilitating regional power reliability and commerce. One of the principal concerns raised by transmission-owning utilities during our outreach is the uncertainty created by having two regulatory "masters" and the resulting doubt about being able to recover investments made to benefit the regional grid. Our proposed rule's cost recovery provisions are an effort to provide clarity in this regard. We have already heard suggestions about how this can be made clearer and I expect we will make the necessary refinements and clarifications.

Regional Market Oversight -- The proposed rule only applies to matters affecting transmission and wholesale power markets. Some states have opened the retail service franchise to competition; others have chosen not to. That is a state choice which we respect. Just as with wholesale natural gas competition, benefits can be achieved by customers under either regime. The only difference is who allocates the savings: a state regulator or the marketplace? The national vision that we have put forward for the wholesale power markets accommodates either approach. I should add that I think it is unwise for a state to adopt retail customer choice without a healthy wholesale market operating as a foundation.

Our proposal recognizes that there are many areas where federal and state regulators must work together. We cannot build a strong, competitive and fair market without effective federal and state cooperation. Three of our four members are former state commissioners, and we want to continue to maintain strong ties with our colleagues from state agencies to protect our nation against the ravages of mismanaged, poorly planned, under-invested, and inefficient energy markets.

This proposed rule recognizes the critical role that state regulators play. Consistent with the July 2002 recommendation of the National Governors

Association, we endorse the establishment of regional, multi-state entities, with representatives appointed by governors, to collect information and make decisions that reflect regional values and preferences on key issues including resource adequacy, system expansion, cost allocation for new investments, transmission siting, and demand response. Because these issues cross state boundaries, it is necessary to look for regional solutions to them. We seek to be a catalyst for making these regional solutions come to the fore and get implemented.

Unless Congress chooses to give the FERC backstop authority over transmission siting, this agency will not make decisions about transmission planning and siting, which is the traditional purview of the states. We do strongly endorse, however, the empowerment of regional organizations to do this work, which we believe will result in better system expansion and resource planning.

We have also heard about this issue in our outreach since July 31. A number of state authorities are concerned about the relatively vague role that regional state advisory commissions would have in overseeing regional power markets. With the energy legislation in conference, I welcome any action the Congress would make to state that such regional bodies are specifically empowered to act on these various issues, with appeal to the Commission where consensus is not reached.

Demand/customer participation in wholesale markets -- One of the more crucial aspects of a successful wholesale power market is enabling customer demand response and small-scale generation. Timely customer demand response is crucial to the success of power markets. One of the best ways to stabilize volatile energy prices and check supplier market power is to ensure that customers can respond to market signals by reducing their consumption. Evidence to date indicates that even a small amount of demand response can have a significant impact in dampening prices during times of high demand and resource scarcity. All customers benefit from demand response. And one way for customers to respond to high electricity prices is turn on their own small generators, reducing their load on the electric system on the other side of the customer meter.

Demand response lies squarely at the nexus between wholesale and retail energy markets and jurisdiction – demand response to price is critically needed in wholesale markets, but it will only occur if retail customers see a price (or price proxy) and change their load accordingly. We can lay out market rules that allow demand response and small-scale generation to participate in wholesale markets, but state regulators have the ability and authority to enable retail customers to see the wholesale energy price (or not) and to give them options to respond to it (or not). We are working closely with state regulators – particularly in a current pilot project in New England – and transmission system and electric market operators to develop and implement a suite of demand response programs that will satisfy the needs and concerns of state energy and environmental regulators, create new options for customers, improve reliability for the electric grid, and help competitive wholesale markets work better.

Native load – Our national electrical system has generally worked well for local customers and this should not be jeopardized. We have crafted the proposed rule with many features that ensure that retail customers are not harmed by the proposed changes, but benefit. The major one, of course, is the proposal's reliance on long-term contracts (not the spot market) to supply the bulk of the customers' needs. Against strong encouragement to hold initial auctions of Congestion Revenue Rights (CRRs), we specifically permit regions to allocate CRRs to native load customers through their current utility providers (load-serving entities); thus, existing loads would be protected from congestion costs. When CRRs are auctioned off in later years, it would be done in a way that holds existing customers financially harmless if they seek to keep the rights. And in retail customer choice states, we propose that the CRRs follow the loads, so that if a customer chooses to move to a new retail provider the CRRs needed to serve that customer will also move to the new provider.

Specific Regional Issues -- Pacific Northwest -- The Western region relies heavily on hydro resources. The operation and dispatch of hydropower has been negotiated over decades under international treaties. Market participants in the Pacific Northwest are concerned over whether the many values and needs of their hydro systems can be preserved under a market-based system that assumes power will be dispatched based on price.

There is nothing in the proposed rule, or in a locational marginal pricing transmission market, that would require the Western hydropower system to operate any differently than it does today. The operators of that system will still be able to dispatch power based on the operating constraints that have been forged through the complex regional and international arrangements already in place. Our proposed rule would require that these hydro owners quantify their river basin needs carefully and specify "shadow prices" that reflect the availability and value of their hydro resources for electric generation. We anticipate that CRRs can be fashioned to accommodate the special needs of hydro operators -- for example, CRRs could be designed to allow multiple receipt points for customers purchasing hydropower, so power can be delivered from any of a number of hydro plants along a single river system. CRRs could be designed to accommodate seasonal differences, or multi-year planning. These details will be fully fleshed out with impacted parties over the next few months both in this rulemaking docket and in the pending RTO West proceeding.

The West also contains a large proportion of transmission facilities that are owned and operated by public power entities. Our proposed rule intends that regional transmission systems be operated by Regional Transmission Organizations (or Independent Transmission Providers), and there is concern that if public power or cooperatively owned utilities opt out of joining an RTO, the proposal cannot work. This same concern is also expressed over the participation of Canadian market entities. We believe that the benefits of market participation and the substantial efficiencies and cost savings offered by large RTO operation will be attractive and beneficial for non-FERC-jurisdictional utilities and that most will want to join. To be able to benefit from the plentiful Canadian energy resources, it is critical to resolve these issues in the Pacific Northwest.

Infrastructure investment issues -- The nation's wholesale electric markets have been in flux for the last 25 years, first because of evolving technology and then because of changing regulation. Over the past decade this uncertainty has led to gross under-investment in transmission facilities and energy efficiency, but substantial investment in generation. We need to stabilize the regulatory rules for the market. Recognizing both the current market situation and future capital needs of the industry, I follow investor reaction closely. Many of the investors and analysts I talk with welcome our proposal because it offers the promise of consistent, dependable market rules that will apply across the country. Once adopted, the wholesale market rules will be clear and stable over time. They will open the door for and lower the risk of new investment opportunities that the nation desperately needs, by leveling the playing field between incumbent and new players, traditional and new technologies, and between supply and demand resources. The power of predictable rules to unleash investment has been proven in Texas, which has seen $1.2 billion in new transmission and 65 new power plants built since the wholesale market rules were adopted in 1996.

I expect to hear in the comments and reply comments about a number of clarifications or changes that can be made in the rule to further stabilize investment prospects in this industry. One that has been raised several times is the seemingly complex nature of regional planning. Our attempts to include the regional regulators and other interests ahead of time could perhaps be balanced as effectively in a different manner. I look forward to working further with my colleagues and with interested parties on the planning and cost recovery issues.

Environmental Impacts – I have heard a concern that wholesale competition will lead to more power plant emissions and more transmission lines across the land. Regulated or competitive, the country's electric industry is growing just as our overall economy is growing. However, a more fluid, competitive wholesale marketplace offers features that should improve rather than compromise the environment. These include: efficiency-driven retirements of high-polluting, high-cost power plants; more efficient use of existing transmission facilities through independent operation; greater use of demand-side resources, which reduce energy use and air emissions; and more equitable treatment of intermittent resources (such as wind power) in wholesale electric markets. The Commission is performing an environmental assessment as part of the Final Rule.

Conclusion

Congress made the critical policy determination in the 1992 Energy Policy Act that transmission and power markets needed to support competition. Since that time, the FERC has sought to implement that policy. It is our expectation that our proposed rule, improved by further input from the public and affected parties, will complete the task. Thank you.