

Docket No. RM01-12-000

BEFORE THE FEDERAL ENERGY REGULATORY COMMISSION

TESTIMONY OF ROBERT B. NELSON, COMMISSIONER
MICHIGAN PUBLIC SERVICE COMMISSION

NOVEMBER 19, 2002

I want to take this opportunity to thank the Commission for allowing me to testify today about an issue that affects not only the state public utility commissions, including the one I represent, but the ability of the electric industry to develop the infrastructure necessary for a reliable transmission system in this country. As the Commission indicated in the Notice of Proposed Rulemaking on Standard Market Design (SMD NOPR), a resource adequacy requirement is necessary to ensure such development because new resources take years to develop and spot market prices may not signal the need for new resources in time to avert a shortage. I intend to address those questions related to resource adequacy that were identified in the Commission's Notice of Technical Conference issued on October 22, 2002 that are critical to the interests of Michigan ratepayers.

I. Accommodating differences in state requirements for reserve margins, resource adequacy, and retail access to achieve a standard of seamless resource adequacy within each region

There is no question that differences among states in reserve margins, resource adequacy requirements and the existence of retail access programs dramatically affects the ability to create a regional resource adequacy requirement. It is not only possible, but necessary, to accommodate these differences and create a resource adequacy requirement for each ITP in consultation with the Regional State Advisory Committee (RSAC). More specifically, differing state requirements for resource adequacy and reserve margins can be accommodated in states with retail access programs and those without such programs. Even states with rigorous resource planning requirements and no retail access programs can continue to administer those

requirements without contravening the regional resource adequacy requirements envisioned by the SMD NOPR.

Since 1982, Michigan has allowed each electric utility to obtain approval of its power costs through an annual power supply cost recovery process (PSCR). That process includes a requirement that the utility make an annual filing that sets for its "... a 5-year forecast of the power supply requirements of its customers, its anticipated sources of supply, and projections of power supply costs, in light of its existing sources of electrical generation and sources of electrical generation under construction." MCL 460.6j(4)

Michigan's PSCR process should complement the resource adequacy requirements in the Midwest as contemplated by the SMD NOPR. A Michigan utility's forecast of power supply requirements, filed pursuant to Michigan law, can be used by the RSAC and the Midwest ISO in determining that utility's resource adequacy for the purposes outlined in the NOPR. In addition, Michigan's responsibility to its ratepayers can be considered contemporaneously with this determination without violating or superseding state law.

In Michigan, the "Customer Choice and Electricity Reliability Act" (Act 141) was enacted in 2000. Among its many provisions is Section 10 f (1), which reads:

"If, after subtracting the average demand for each retail customer under contract that exceeds 15% of the utility's retail load in the relevant market, an electric utility has commercial control over more than 30% of the generating capacity available to serve a relevant market, the utility shall do 1 or more of the following with respect to any generation in excess of that required to serve its firm retail sales load, including a reasonable reserve margin: (a) Divest a portion of its generating capacity. (b) Sell generating capacity under a contract with a nonretail purchaser for a term of at least 5 years. (c) Transfer generating capacity to an independent brokering trustee for a term of at least 5 years in blocks of at least 500 megawatts, 24 hours per day." (Emphasis added).

*Act 141 freezes the rates of Michigan's two largest electric utilities, Detroit Edison and Consumers Energy through at least 2003, during which time annual power supply cost filings are not required.

It is anticipated that when the electric utilities in Michigan have met the market power tests outlined in Act 141, they will no longer seek recovery of power supply costs in an annual proceeding. Instead, market forces will determine what electric utilities charge for purchased and interchange power and Michigan will be in the same position as other states that have fully deregulated electric generation. The need for a long-term resource adequacy requirement, as proposed in the NOPR, will be even more critical.

States with reserve margins mandated by their commissions or Legislatures that exceed the 12% minimum reserve margin proposed by the NOPR should be allowed to follow their mandates, with the knowledge that the State would be responsible for any additional costs that would be required to sustain the higher level. States without mandates may be free to adapt to the resource adequacy requirements of the NOPR.

Although Michigan utilities have maintained a 15% reserve margin in the past, the fact that Act 141 requires only a "reasonable" reserve margin by each utility for purposes of meeting the market power test means that Michigan could adapt to the 12% reserve margin proposed by the NOPR and meet the requirements of state law. If Michigan chose, under Act 141, to interpret "reasonable reserve margin" as requiring a greater than 12% reserve margin, it could still do so for purposes of determining compliance with the market power test at the same time that the NOPR, for purposes of ensuring long term resource adequacy for the region, required only a 12% reserve margin for each Load Serving Entity (LSE). Similarly, states with definite statutory requirements for their utilities to provide for more than a 12% reserve margin could continue to enforce those requirements, consistent with the NOPR and with federal law. See

II. Designing appropriate elements for resource adequacy requirements in areas that have retail access

The fact that the NOPR would require all LSEs to achieve a 12% reserve margin would enhance Michigan's ability to create a workable retail access program. Act 141 does not impose any such requirement on Alternative Electric Suppliers (AESs) and currently an AES may fail to secure adequate resources to meet commitments to customers without any sanction imposed by the Michigan PSC (save forfeiture of the license). Accordingly, Michigan supports the imposition of reserve margin requirements on all LSEs.

Standards need to be developed for determining whether resources satisfy the resource adequacy requirement. As commercial sources constitute an ever larger share of total resources, standards will become crucial to achieving the purposes of SMD. NAESB could be assigned this task.

III. Ensuring adequate methods for resource deliverability

The NOPR proposes to enforce the resource adequacy requirement by: 1) imposing a tariff penalty on a LSE that takes energy from the spot market during a shortage in a year for which it fails to meet its requirement, and 2) requiring that the spot market electric service of such a LSE must be curtailed first when the shortage is severe enough. Each mechanism would occur at the end of the planning horizon. Michigan supports these measures but prefers a longer planning horizon and penalties closer to the front end of the period. Both will improve reliability without becoming a barrier to entry.

IV. Assigning value to demand-side resource participation in meeting resource adequacy

Michigan shares FERC's belief that it is crucial for the SMD to incorporate demand-side response as a vital mechanism to strengthen competition as well as provide assistance with market power mitigation. Indeed as stated in the NOPR, SMD should "encourage long-term

efficiency in the development of transmission, generation, and demand response infrastructure”.

We are also mindful that, as stated in the SMD, “the lack of price-response demand” is one of the most significant remaining barriers to competitive markets. In particular, as stated by FERC in the SMD NOPR, “[T]he ability to bid demand reduction into the spot market in response to supplier prices is still limited and needs to be improved significantly for short-term markets to operate more competitively.” We concur and would add that, in addition to full-scale integration into short-term energy markets, demand-side resources must be incorporated into long-term resource adequacy planning as well.

Demand-response resources must be effectively relied upon to moderate energy prices, both in the short-run thorough participation in spot market bidding auctions and in the long-run as a viable resource option to generation and transmission expansion in the regional planning process. For markets to fully succeed, demand-response resources must be placed on equal footing with supply and transmission. Much work remains to be accomplished for this to become a reality. To date, demand-response is largely underdeveloped and at a considerable relative disadvantage. A good case illustrating the point is the PJM ISO. Market operations in the PJM system, serving as the FERC SMD model, are well along and have rightfully been applauded by FERC for many of their market design elements supportive of a competitive energy spot market bidding mechanism and improved transmission operational efficiency. However, PJM is only beginning to address demand-response in their bidding mechanism. Recently a pilot program was introduced to allow demand-reduction bidding into the spot market. While introduction of demand-side bidding is a step forward, the PJM approach raises serious questions regarding comparability between demand and supply options and should be challenged on that score.

Regarding resource planning, it is equally important that demand-response resources be fully integrated into the regional planning framework. In particular, it will be important to establish appropriate mechanisms to evaluate and verify the validity and reliability of demand response resources, so that they can stand on equal footing with supply and transmission options. Much work needs to be done on this. Likewise, it is important to establish appropriate planning horizon time frames such that all resources, including supply, transmission, and demand resources can compete on a level playing field. And, certainly most critical to successful regional planning is the need to develop and nurture effective regional planning institutions to accommodate regional interests and needs. If regional markets are to develop and flourish, states will be challenged to work together and cooperate in ways that have not been accomplished in the past. Change will not be easy or universally embraced. The potentially huge energy savings and electric grid reliability improvements expected to be generated from establishment of robust competitive wholesale electricity markets, however, are well-worth the effort needed to succeed.

Twenty years from now when this country looks back and recognizes the substantial benefits that SMD provided the nation's economy, I believe that states with retail access programs and those without such programs (if there are any at that time) will heartily thank this Commission for including resource adequacy requirements in the SMD proposal and for reaching out to the states and other interested parties in the development of the final rule.