

## Summary of the NOPR

Our proposal would be implemented in two basic stages. The first step (the "Interim Tariff") would be to have all customers take service under the same tariff already used by public utilities (modified as discussed below). The second step (the "SMD Tariff") would be to implement the new rules and procedures for standardized transmission service and market design.

### **Interim Tariff**

As an initial step, all public utilities that own, operate or control transmission facilities in interstate commerce would be required to file with the Commission a revised open access transmission tariff that places their load under the tariff and eliminates undue preferences for the transmission owner's native load customers and own uses of its system. For example, this will eliminate the potential for transmission owners to implement transmission curtailments preferentially. The U.S. Supreme Court, in its recent opinion upholding Order No. 888, clarified that the Commission has authority over transmission bundled into retail sales upon a finding of undue discrimination in retail electricity markets.

The Commission recognizes that States historically have regulated bundled retail transmission and we are not taking this step lightly. However, Congress has given us not only the authority but the obligation to prevent undue discrimination, and we cannot fulfill this obligation if we allow one set of customers (a transmission provider's retail customers) to have preferential use of the interstate grid over other retail and wholesale customers.

### **SMD Tariff**

#### Independence of the Transmission Provider

While RTOs can eliminate many problems, they have not yet been implemented in various regions of the country. We expect that most if not all utilities will become members of RTOs to increase their efficiency and reduce administrative costs. However, this rule may become effective at a time when some transmission owners and operators have not yet become members of functioning RTOs, and still have significant opportunities for discriminating against competitors in the marketplace. Thus, we propose that all transmission owners and operators that do not join an RTO must contract

with an independent entity to operate their transmission facilities. The proposed rule refers to both RTOs and those independent entities as Independent Transmission Providers. Independent Transmission Providers can be for-profit or non-profit entities, so long as they are independent of participants in the region's markets.

While the functional separation of generation and transmission through an RTO or other independent transmission provider can eliminate many discrimination problems, there is still the need to prevent discrimination and inefficiencies caused by the lack of uniform rules for buying and selling transmission and electric energy. The Commission therefore has proposed new transmission tariffs that would standardize wholesale market design. The fundamental goal is to create "seamless" wholesale power markets that allow sellers to transact easily across transmission grid boundaries and allow customers to receive the benefits of lower-cost and more reliable electricity supply.

#### Network Access Service

The Independent Transmission Provider is required to file a tariff that includes a single flexible transmission service (Network Access Service). The proposed Network Access Service combines features of the existing network and point-to-point services available under Order No. 888, to allow all transmission users to schedule power deliveries with the same operational flexibility enjoyed by transmission owners. A customer will have the right to transmit power between any points on the transmission system, so long as the transmission does not threaten the system's reliability.

#### Pricing of Transmission Service

Our proposal will allow recovery of the revenue requirement of a transmission owner through an access charge paid by transmission customers taking power off the grid. The access charge could either be a license plate rate (with the charge depending on the zone of delivery) or a postage stamp rate (same rate applies throughout the system).

To facilitate trading across regions, the Commission proposes not requiring an additional charge for transactions that start and end in different transmission systems. Thus, a transmission customer will pay a single access charge regardless of how many transmission systems it uses.

#### Pricing of Congestion

The proposed rule incorporates a form of congestion pricing known as locational marginal pricing (LMP). LMP allows a more efficient management of the transmission grid by allocating scarce transmission capacity to those who value it most. This market-

based congestion management system has been used in PJM and New York, and is proposed for use in several other markets, including those that are or would be operated by California ISO, ISO-New England, SeTrans RTO, GridFlorida, GridSouth and (in a modified version) RTO West.

LMP uses congestion revenue rights, which are financial rights that lock in a fixed price for transmission across power-grid bottlenecks or congested pathways. Transmission customers paying access charges will receive these rights or, alternatively, their financial equivalent – revenue from the auction of these rights. LMP with these rights would provide price signals indicating where investment in transmission, generation and demand response infrastructure is needed to relieve congestion.

LMP reduces the need for curtailment of transactions as a means of preserving grid reliability. This in turn will prevent transmission owners from curtailing their competitors discriminatorily.

The proposed rule provides an incentive for power grid enhancement by allowing companies that invest in new transmission to retain the congestion revenue rights for the added transfer capacity. This policy provides predictable rules and clear rewards for investment to secure the needed expansion of the Nation's interconnected grid.

### Transmission Planning

Our proposal recognizes that transmission planning has historically been performed by regulated utilities in conjunction with, or subject to oversight by, State regulators. We do not propose to undermine this practice, but instead seek the development of new regional mechanisms for these same entities and others to perform planning with a broader, regional perspective.

The need for regional planning was emphasized in the U.S. Department of Energy's National Transmission Grid Study, issued in May 2002. This report found that there was an urgent need to modernize the existing transmission system in the United States. According to the study, the existing transmission system has become congested because investment in new transmission facilities is lagging far behind investment in new generation facilities and growth in electricity demand. The congestion has been exacerbated by the incomplete transition to fully efficient and competitive wholesale markets. These bottlenecks increase electricity costs to customers by hundreds of millions of dollars annually and threaten reliability of the grid.

The study found that regulatory certainty and regional planning are needed to stimulate investment in transmission. The study recommends that RTOs should be

responsible for maintaining the reliability of the grid and ensuring that transmission bottlenecks are addressed on a regional basis. The study further recommends the establishment of multi-state planning entities with a long-term timeframe and an inclusive process to identify needed transmission, generation and efficiency improvements that will benefit entire regions.

Our proposed rule provides regulatory certainty by standardizing both transmission service and market design. It also identifies regional planning to be undertaken by all public utilities that own, control or operate transmission facilities in collaboration with States and others, with the Independent Transmission Provider playing a greater role after the rule is fully implemented. The rulemaking proposes a congestion management system that is designed to increase the efficiency of transmission operation, identify bottlenecks and provide price signals indicating where investments in infrastructure are needed to relieve congestion.

### Pricing of Transmission Grid Expansions

The Commission proposes participant funding as a method to price transmission expansions where the proposed transmission facilities are included in a regional planning process conducted by an independent entity. Our goal is to allocate costs to the region that benefits from the expansion, which may not be the same as the region in which the expansion facilities are located. In the absence of an independent entity conducting the regional planning process, we propose to apply a default pricing policy that rolls in on a region-wide basis all high voltage network upgrades of 138 kV and above. Since lower voltage transmission facilities are less likely to benefit the whole region, the cost of network facilities below 138 kV could be more appropriately allocated to the sub-region containing the transmission facilities. Further, we would look favorably upon pricing proposals recommended by Regional State Advisory Committees (discussed below), provided that such proposals are consistent with the Federal Power Act.

The nexus between participant funding and the need for independence is that certain aspects of this method can be subjective, including the decision of which generators in the queue should be responsible for which facilities, the cost of the facilities and the assumptions underlying the power flow analysis needed for system impact and facilities studies. Thus, a transmission provider that is not independent would have the ability and the incentive to exploit this subjectivity to its own advantage. An Independent Transmission Provider would make these decisions on an objective and non-discriminatory basis.

## Spot Markets

Central to our proposal is its reliance on bilateral contracts entered into between buyers and sellers. While we continue to strongly encourage such contracts, the proposed rule also establishes short-term electricity markets. The proposed rule creates short-term markets to allocate transmission and generation capacity where it is most valuable among competing uses in different markets through LMP pricing. All Independent Transmission Providers would operate short-term markets for energy and for the procurement of certain ancillary services in conjunction with markets for transmission service. These markets would be operated in two time frames – a day ahead of real-time operations and in real time.

Significantly, an Independent Transmission Provider would not accept physically infeasible schedules in the day-ahead market that ignore known transmission constraints. This will prevent one aspect of the market dysfunctions that occurred in California. Other aspects are addressed below.

## Avoiding a Repeat of the "California Crisis"

California experienced severe market problems and many of these problems stemmed from the poor design of the California electricity market and the lack of adequate reserves and demand response. These conditions appear to have allowed some market participants to exploit, unreasonably profit from, and possibly exacerbate the magnitude of California's problems.

There are important differences between our proposal and the market design in effect in California when it experienced problems in its energy markets in 2000-2001. First, the standard market design is premised on the use of bilateral contracts. While load-serving entities may purchase energy in the spot markets, these purchases should constitute a small percentage of their total needs. In contrast, the California market design required the load-serving entities to purchase almost all of their energy needs through the spot markets. Second, the standard market design includes trading rules, a congestion management system, market power mitigation measures and market monitoring to address the manipulation strategies encountered in the California markets. Third, the standard market design includes a forward-looking long-term resource adequacy requirement to avoid the types of supply shortages that adversely affected California.

## Market Power Mitigation and Monitoring

The proposed rule would establish procedures to monitor and mitigate market power. First, as to monitoring, each region will have an independent market monitor to rapidly alert the Commission to potential anti-competitive problems. This market monitoring unit will report to the Commission, the Regional State Advisory Committee and (in regions with RTOs) the Board of Directors of the RTO. It will evaluate the conditions in markets, identify the need for changes in market rules and identify load pockets and areas where additional infrastructure is needed.

Second, as to mitigation, the proposed mitigation measures would prevent sellers in spot markets from withholding economical supplies from the market, while permitting prices to reflect true scarcity. Three of the mitigation measures are specifically tailored to address structural flaws in the wholesale electricity market. These are: (1) load pocket mitigation requiring generators to run and to bid no more than a reasonable price into the market; (2) a safety-net bid cap to prevent exorbitant prices, similar to the circuit breakers used by stock exchanges; and (3) a resource adequacy requirement to reduce the risk of shortages. An optional fourth measure may be approved if a market monitor's analysis determines that it is needed. This measure limits a seller's bids if they increase suddenly and drive up overall market prices significantly.

The proposed rule would limit the ability of power providers to "game" flawed market rules or market inefficiencies to derive higher revenues. These measures are to make sure that the strategies allegedly used by various participants in Western energy markets will be infeasible.

## Long-Term Resource Adequacy

The Commission also proposes a resource adequacy requirement that will complement, and not supplant, the States' traditional role in this important area. This requirement will help ensure that future energy needs are addressed through adequate generating, transmission and demand-response infrastructure, and avoid over-reliance on spot markets.

Load-serving entities would be required to arrange sufficient supply and demand response resources to meet peak demand plus at least a 12 percent reserve margin (this margin may be higher to satisfy a State's requirement). This new approach is expected to ensure investment in new, cleaner, more efficient generation. This approach also will help maintain an adequate balance between energy supplies and demands so that wholesale prices will remain just and reasonable.

We recognize that supply planning and retail customer demand response are generally the States' responsibility, and thus, the proposed resource adequacy requirement does not in any way replace existing State programs. In particular, the Commission proposes that each Independent Transmission Provider must forecast its region's future needs, facilitate regional determination of an adequate future level of resources and assess the adequacy of the plans of load-serving entities to meet the regional needs. Each load-serving entity would be required to meet its share of the future regional needs through a combination of generation and demand response. If a load-serving entity fails to satisfy the resource adequacy requirement, the Independent Transmission Provider will inform the appropriate State regulatory authority that the load-serving entity will be assessed a penalty for spot market purchases in the event of a shortage, and the customers of that load-serving entity may be denied spot market energy in extreme conditions.

### Respect Existing Contractual Rights

The Commission proposes not to abrogate existing pre-Order No. 888 contracts. These contracts should be accommodated within the standard market design. The Commission proposes to give customers with these contracts an opportunity to convert these existing contracts to the new Network Access Service upon implementation of standard market design if consistent with their contract terms.

### Native Load Under SMD

The proposed rule would ensure that native load is adequately protected. First and most importantly, native load could retain through contractual arrangements the benefits of any inexpensive power they now receive. Our proposal would not require the sale of such power through a centralized market or the export of inexpensive power to higher-cost regions. Native load customers would be able to secure their power supplies from their current suppliers or any other willing sellers if consistent with State law.

Second, customers paying the access charges under our proposal, such as native load through its load-serving utility, would receive congestion revenue rights (or the revenues from auctioning these rights) for their current share of the capacity on the transmission grid. These rights (or the auction revenues) in essence would allow them to be held harmless from the costs of congestion on the grid.

Third, the congestion revenue rights would also serve as a "tie-breaker," if the bids to use available transmission capacity on a given day regardless of the price exceed the amount of such capacity. In these circumstances, the holders of these rights would be assured of service. A load-serving entity, on behalf of its native load, could choose to

obtain auctioned rights by outbidding others, knowing that the sale proceeds will be returned to it on behalf of the native load.

Finally, as noted above, the Commission proposes to allow participant funding for the cost of grid expansions in appropriate circumstances. This proposal will ensure that native load does not bear the financial brunt of expansions that benefit only others.

This package of provisions provides strong protection for native load.

### Coordination with States

The proposed rule provides a framework for complementary State and Federal jurisdiction on regional issues, while providing States with a more prominent role in advising the Commission on matters that fall within the Commission's jurisdiction but affects States. We recognize in the proposed rule that the States have exclusive jurisdiction, of their own, over transmission siting.

While the Commission has exclusive jurisdiction under the Federal Power Act to assure that rates for transmission in interstate commerce are just and reasonable, the proposed rule states that the Commission would look favorably on a pricing approach for grid expansions proposed by the Regional State Advisory Committee, provided it is consistent with the Federal Power Act.

The Commission proposes a formal role for State representatives concerning Independent Transmission Providers. Each Independent Transmission Provider would have an advisory committee of State representatives called the Regional State Advisory Committee. The Commission believes that the advisory committees can bring a valuable regional perspective to rate design and planning issues. Once the advisory committees are set up, the Commission will work with them to establish protocols for deciding regional rate issues. Additionally, the advisory committees can provide valuable advice to Independent Transmission Providers on regional plans for transmission planning and expansion.

Finally, in outreach sessions, some States have raised concerns about the Commission's proposal to assert jurisdiction over the transmission component of bundled retail sales and to have all transmission of public utilities placed under the same non-discriminatory open access rules. This proposed assertion of jurisdiction is based on findings in the NOPR of undue discrimination between bundled retail customers and other transmission customers; in other words, there is undue discrimination in both wholesale and retail electricity markets. I want to emphasize, however, that in proposing to assert this jurisdiction in order to remedy undue discrimination, the Commission is not

proposing to interfere with the States' ability to set rates for retail power sales, local distribution or other State-jurisdictional charges. States would retain control over rate design for retail customers, retail customer billing, and the decision to adopt or not adopt retail choice programs. Further, to the extent the Commission's assertion of jurisdiction might raise concerns about the level of retail transmission rates possibly changing as a result of transition to a Commission-jurisdictional tariff, the Commission will continue to work with States to address their concerns.

The Commission recognizes that there is a need for a strong and continuing State and Federal partnership if competitive markets are to flourish and provide all customers lower cost and reliable supply of electricity.

### Regional Flexibility

As I mentioned earlier, the SMD Tariff is flexible enough to accommodate a range of regional differences. For example, in implementing the SMD Tariff, regions will have flexibility in establishing the rate design for new Independent Transmission Providers. The proposed approach on the resource adequacy requirement allows each region to set its own level of resource adequacy, set its own planning horizon and select from a combination of supply and demand response resources for meeting its needs. The congestion management system allows customization in that: (1) regions would have flexibility in converting the rights of existing customers to Congestion Revenue Rights or auction revenues and in setting the initial terms for the Congestion Revenue Rights sold in auctions; and (2) recognizes and allows Congestion Revenue Rights that may be valued differently in different regions of the country based on the physical configuration of the transmission system and the types of resources connected to the system.

### Implementation

The Commission recognizes that implementation of the proposed rule will take some time. Thus, the Commission proposes a phased compliance process. By July 31, 2003, public utilities would have to file Interim Tariffs to become effective September 30, 2003. By December 1, 2003, public utilities would have to file SMD Tariffs, to become effective no later than September 30, 2004, or such other time as directed by the Commission. The Commission and its staff commit to work with regional organizations and stakeholders in facilitating full and efficient compliance with this proposed rule.