BEFORE THE

FEDERAL ENERGY REGULATORY COMMISSION

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IN THE MATTER OF: :

CONSENT MARKETS, TARIFFS AND RATES - ELECTRIC :

CONSENT MARKETS, TARIFFS AND RATES - GAS :

CONSENT ENERGY PROJECTS - HYDRO :

CONSENT ENERGY PROJECTS - CERTIFICATES :

DISCUSSION ITEMS :

STRUCK ITEMS :

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815TH COMMISSION MEETING

OPEN MEETING

Hearing Room 2C

Federal Energy Regulatory Commission

888 First Street, N.E.

Washington, D.C.

Wednesday, January 15, 2003

10:05 a.m.

APPEARANCES:

COMMISSIONERS PRESENT:

CHAIRMAN PAT WOOD, III, Presiding

COMMISSIONER WILLIAM L. MASSEY

COMMISSIONER NORA MEAD BROWNELL

ALSO PRESENT:

DAVID L. HOFFMAN, Court Reporter

P R O C E E D I N G S

(10:05 a.m.)

CHAIRMAN WOOD: Good morning. This open meeting of the Federal Energy Regulatory Commission will come together to consider the matters which have been posted by the Secretary in accordance with the Government in the Sunshine Act for this time and place.

Please join us in our Pledge to the Flag.

(Pledge of Allegiance recited.)

CHAIRMAN WOOD: Before we start our business today, I would like to present two awards, the first of which is to John Anomi, who retired January the 3rd, after 30 years of Federal Government service.

He began in 1972 at the Federal Power Commission, and later spent two years at DOE and three at the NRC, and spent the last 18 years at FERC.

During his career, he has worked on a number of electric cost-based and market-based rate filings. During his time at FERC, he has also served as one of the chief technical experts on QF matters, writing and reviewing many dozens of qualifying facility orders and training Staff on these issues.

He's a highly respected expert, in and outside the industry and we hate to lose him. But we can't let him go without letting him know we appreciate him. So, John, come on up and get your Career Service Award. It's presented on the occasion of your retirement.

(Applause.)

CHAIRMAN WOOD: Presented on the occasion of the retirement of John Anomi, in gratitude and recognition of 30 years of dedicated service on behalf of this nation's energy customers and the vision, mission, and values of the FERC.

(Applause.)

CHAIRMAN WOOD: Since February 2002, we have had a FERC International Fellow, Naofumi Suzuki represented the Government of Japan's Ministry of Economy, Trade, and Industry. Nobe, which is what we call him, started his research fellowship at FERC studying energy regulatory theory in the United States. What a year to have that topic.

His major interest during that time has been how FERC does its work, and has focused on the different offices of FERC, including External Affairs, Markets, Tariffs, and Rates, Administrative Litigation, and OMOI. He's closely followed our work on standard market design, on the rate approval process, and, most recently, on market oversight.

I'm pleased to announce today that as Mr. Suzuki leaves, we're also working with the Ministry of Economy, Trade, and Industry to bring another International Fellow from Japan, scheduled to start in May.

In recognition of Mr. Suzuki's work at the Commission, I'd like to present him with a commemorative plaque as well. It reads: FERC, in recognition for international fellowship presented to Naofumi Suzuki, for exceptional personal commitment and dedication to gain knowledge of energy market regulations and to foster better relations between our nations. Again, with much appreciation and best wishes on the occasion of your departure form the Federal Energy Regulatory Commission, on this date, come on up.

(Applause.)

CHAIRMAN WOOD: This is given with many good wishes and much appreciation.

(Applause.)

CHAIRMAN WOOD: Madam Secretary?

SECRETARY SALAS: Good morning, Mr. Chairman, and good morning, Commissioners. The following items have been struck from the agenda, since the issuance of the Sunshine Notice of this meeting on January 8th: AE-4, E-1, E-4, E-13, and H-2.

The consent agenda for this morning is as follows, Electric: E-2, E-7, E-8, E-12, E-16, and E-17.

Gas: G-1, G-2, G-3, G-4, G-5, G-6, G-7, G-8, G-9, G-10, and G-13.

Hydro: H-1, H-3, H-7, and H-9.

Certificates: C-2 and C-3.

Commissioner Massey will vote first this morning.

COMMISSIONER MASSEY: Aye.

COMMISSIONER BROWNELL: Aye.

CHAIRMAN WOOD: Aye.

SECRETARY SALAS: The first item for discussion this morning is E-3, Proposed Pricing Policy for Efficient Operation and Expansion of Transmission Grid, with a presentation by Andre Goodson, accompanied by Mike Donnini, Steve Pointer, and Kim Bose.

MR. GOODSON: Good morning, Mr. Chairman and Commissioners. E-3 is a proposed policy statement that would create rate incentives for transmission owners that transfer operational control of their transmission facilities to a regional transmission organization, form independent transmission companies within RTOs, or pursue additional measures that promote efficient operation and expansion of the transmission grid.

The proposed policy statement concludes that independent regional grid operation and coordination will improve grid performance, reduce wholesale transmission and transaction costs, improve electric reliability, and make electrical wholesale competition in more effective in ways that benefit all customers.

Under this proposed policy, any entity that transfers operational control of transmission facilities to a Commission-approved RTO, would qualify for an incentive adder of 50 basis points on its return on equity for all such facilities transferred.

Further ITCs that participate in RTOs and meet the independent ownership requirement, would qualify for an additional incentive adder of 150 basis points. In addition, the proposed policy would provide an incentive adder of 100 basis points for investment in new transmission facilities which are found appropriate pursuant to an RTO planning process.

Finally, the draft invites comments on the proposed policy statements within 45 days of publication in the Federal Register. This concludes our presentation.

COMMISSIONER MASSEY: I will be voting for this proposed policy statement. It is performance-based, and there are three kinds of performance that it talks about.

If you're a transmission owner, the first step is, join an RTO. If you do that, you will be rewarded by the Commission with an enhanced return.

Number two, if you're within an RTO and you divest your transmission -- no strings attached, not passive ownership, no affiliation with merchant interests -- you will be rewarded by the Commission.

Performance, Step Number Three: If you invest in transmission, particularly the kinds of transmission enhancements that you can actually achieve, those that are environmentally friendly, those that use new technologies, those that expand the capacity of the grid and actually get accomplished, you will be rewarded by the Commission.

Those of you here that followed the debate over incentives for transmission operation over the past few years, may be surprised that I'm willing to vote for this proposed policy statement, because I have objected in the past to, quote, "throwing money at transmission," end quote.

My own view is that this policy announced in this proposal today is well conceived. It will incentivize the kinds of performance that this agency finds to be in the public interest, the kinds of performance that will actually eliminate discrimination once and for all.

That will allow -- that will create more efficient markets. As has been pointed out, it will make the grid more reliable. It's time for the Commission to take this step, so this proposed policy statement has my support, although I must say that I will be very interested in the comments that we get on it.

The mix of transmission incentives that we propose, as far as I'm concerned, are not chiseled in stone. I'm open to ideas about how to improve this proposed policy statement, but I do believe it's time for this Commission to send a clear statement that good performance in transmission ownership and expansion and in transmission operation, will be rewarded. Thank you.

COMMISSIONER BROWNELL: It's hard to match that eloquence, but I want to say that I will be voting for this. I am particularly pleased. This was a wonderful opportunity for the three of us and our staff, and certainly hard work, as always, by the Commission staff to really work closely together to talk about the important elements that we see and put value on to enhance the grid and to move the restructuring of this market forward.

I just want to say I'm grateful for the thoughts and input from my colleagues, because, actually, this was kind of fun, and we don't often necessarily have, as we are challenged with difficult issues, an opportunity to as thoughtful and work together as closely, so I thank you for that.

This is all about what restructuring means. It's about innovation, independence, and efficiency, and I think that as this debate moves forward, that's what we ought to keep our eye on. We're looking at ten years of disinvestment; we're looking at increased costs because of constraints and power quality disturbances; we're looking at opportunities denied to new and efficient generation;

We're looking at opportunities denied to the innovative technologies that are on the market that address many of the environmental issues that are important to all of us.

I, too, look forward, actually, to the comments, because this is a very, very important step, and I want to be sure that, in fact, we're sending the signals that we intend to send. So I would encourage everyone in the marketplace to participate.

I would also leave people with the thought that when we talk about transmission pricing and we talk about investment in transmission, we talk in terms of millions and billions of dollars, without ever sharing with the customer, the reality that a very small investment in transmission brings all kinds of rewards to the customer, to the end-use customer.

Once again, that is, of course, why we're here, and I think we need to be more effective in translating these investments to what they mean for that end-use customer.

We had a lot of discussion about that, and so I would encourage those of you who are following this also not to leave it up here in those billions of dollars, because that is not very meaningful to the people who are paying those bills every month.

That is why we're rewarding innovation,

independence, and efficiency. Thank you.

CHAIRMAN WOOD: I should exercise my prerogative and go first next time. Andre, Steve, Mike, and all the other folks that worked with y'all -- Kim was working as well -- thank y'all for a quick turnaround on this. It really started when we were presented the opportunity in the MISO rate case, back in October, to talk about concrete ways that the Commission can, in fact, put its money where its mouth is on independence.

I certainly think that the discussions on independence in here were, I think, well thought out and appropriate. We did ask in here and do look forward to feedback on -- I'm not certain we got the numbers right, but if there are additional gradations between RTO membership and independent transmission company status that are worthy of some gradation in between the 50 basis points and the total of 200 basis points that are awarded for those two endpoints on the book shelf, it's the third category that we put in here that was really the main reason we had to do this in December.

I think we do still leave it open in asking a number of questions on how do we actually get the right kinds of investment. As one who is still engaged in a lawsuit in my prior job, for approval of construction of a brand new right-of-way across a number of ranches and rural areas of southern Texas, I'm very mindful that there are different ways to get transmission enhanced so that power can move more efficiently and at better cost to customers.

One of those is certainly use of the new technologies. We've seen probably on at least a weekly or biweekly basis, innovators out there in the industry who are taking risks and creating new entrepreneurial opportunities to invest in the grid, not just in hardware, but in the way that the grid is actually managed and dispatched.

We've talked to a number of transmission owners or potential transmission owners about their plans for improved performance. Managing this important asset -- as Nora points out, this important asset comprises maybe three-tenths of a cent of every 8 to 10-cent kilowatt hour sold in this country.

It's a very small part of the overall equation, but as we have learned, it is the absolutely critical part to making sure that the competition between and among generation sources actually yields a benefit.

If you have insufficient transmission to tie together ten different generation owners that have access to a given customer, then that customer doesn't get the benefit of the fact that each of those ten can compete against each other, both in the long-term market and in the short-term market, and put downward pressure on price and upward pressure on service.

That's what we're all about; that's what this Commission has been about since Congress told it to get about that back in 1992, and I think certainly that we have the incentives of putting rewards on people who take the risks and who enhance the benefits of the overall system to ultimately reward customers.

Those are the kinds of things that we need to be doing, so I appreciate the collegiality of us. I appreciate your long history of this, Bill, and your advice to us on what you thought this ought to look like. I'm real pleased that we got here, and I'm hoping that the parties in the outside world will help us make it even better.

We'll look forward to seeing those comments later on this Spring. And it has my full support. Let's vote.

COMMISSIONER MASSEY: Aye.

COMMISSIONER BROWNELL: Aye.

CHAIRMAN WOOD: Aye.

SECRETARY SALAS: The next item for discussion is E-15, Communications with Independent Market Monitors, with a presentation by Susan Court.

MS. COURT: Good morning, Mr. Chairman, Commissioners. E-15 is an order modifying the application of the Commission's ex parte Rule, Rule 2201, to communications between the Commission and its Staff, and Commission-approved market monitors with respect to issues involved in pending contested on-the-record proceedings.

Specifically, the order creates an exemption as permitted under Rule 2201 for such communications. The order explains that less fettered communications with market monitors will enhance the Commission's efforts to receive timely reports from those monitors, even though the information may be related to contested on-the-record proceedings.

The order reasons that Commission-approved market monitors are akin to an extension of the Commission's own Market Monitoring Staff who may freely talk about themselves among issues in contested proceedings, so it makes sense that the two groups of monitors should be able to talk to each other about matters that may be related to such proceedings.

For like reasons, the order does not require these otherwise prohibited off-the-record communications to be disclosed or noticed in the Federal Register.

Lastly, the order recognizes that there are two instances where unfettered communication may be unfair to parties in contested proceedings where a market monitor himself is a party in a contested proceeding or where the market monitor is appearing on behalf of a party in such a proceeding. Accordingly, the exemption created by the order will not apply in those situations.

In brief, this order conforms to the Commission's concerted efforts to keep on top of what's happening in the energy markets.

Thank you.

COMMISSIONER MASSEY: Our painful experience has taught us that electricity markets can get out of hand very quickly. The market monitors that are on the ground watching these markets very closely are the Commission's eyes and ears. We must be able to communicate with our eyes and ears quickly so that we can fix problems that arise.

This order has my full support. It would make no sense whatsoever to have our eyes and ears in the marketplace cut off from us so that we cannot communicate with them, listen to their analysis of what's wrong with the markets and what's right with the markets and quickly take positive steps in the short term to fix failures and make the kind of changes that we need to make in market structures on a long-term basis to ensure customer benefit.

So this is a very good order that will enhance the ability of Bill Hederman's shop to do its job well, and enhance the ability of the entire Commission to stay on top of what's happening in markets.

MS. BROWNELL: I think this is a great expression of the seriousness with which we take our responsibility in terms of market monitoring. I just have one or two questions, Susan. In exploring the development of this, are we assured that there are no rules within the ISOs coming the other way that would be barriers to this kind of free communication and timely communication that we envision?

MS. COURT: I can't tell you for sure, Commissioner, if there are such. I would expect that if there are, this is the type of order that might give people a vehicle. This docket, this discussion today might give people an opportunity to bring that to our attention. I don't know anything in particular that would necessarily bar communication the other way.

MS. BROWNELL: I'd like to hear from the market monitors themselves and obviously any interested parties just to be sure that this is working both ways.

The other thing that I would encourage, and I think the Market Monitoring Group has made some efforts in these communications, is the timeliness of communications.

We're all now struggling with the challenge of recreating a market two years after the fact.

We've periodically had some situations in other marketplaces where it's been six or seven months before we were able to get the facts.

I think that now that we are staffed up, and I think now that we've developed better relationships, I encourage everyone to kind of have that sense of urgency. Because every minute that goes by that there's a dysfunction in the marketplace is a cost for customers and frankly makes it more difficult for all of us to solve the problem.

So I'm hoping we can address some of those issues as well.

CHAIRMAN WOOD: I think we can. I think clearly a couple of things had to happen. One was to have a home for those folks to plug back into the Commission, and that's one of the functions that OMOI clearly has under its wing. And another is to actually take care of issues like this that are structural impediments to a kind of open discussion. Certainly thinking through -- I met Dr. Shifrin from California, and our abilities or nonabilities to visit during a lot of this crisis and her oversight committee with Dr. Wallach and others out there that are helpful and thoughtful people that we would like to be able to continue to talk to them.

And back on December 3rd and 4th or 2nd and 3rd -- I was there on the 3rd -- the market monitoring units from all the existing and prospective RTOs were here for a two-day workshop. And I would say really from the roundtabling that I listened in on, this was the first topic out of the box that was raised by the market monitors as a real problem that needed to be fixed.

And I'm pleased that a mere five weeks later, which is light speed in regulatory timeline, we have before us a fix to address their problem.

Now I think one of the things fundamental here that we didn't focus on as much is that what we really want here and may not have today in the various ISOs yet and RTOs is a true independent market monitor. That's the predicate. And where those don't exist, this freedom is not so broad. And I think that that's appropriate.

I think we want to make sure that the market monitors are independent in name and indeed, that they are not just functionaries of the individual marketplaces, that they were objective extensions of our objectivity into these markets to look at the pros and cons of all the activity out there.

So this order makes that independence requirement emphatic. But as a reward for that independence, much like our last discussion, from that comes a different way of treating things on a regulatory format.

So I think it's needed and I do appreciate, Susan, you and Darryl and the folks on your staff working with really across the agency on a lot of input on getting this right, and I do support it.

Let's vote.

COMMISSIONER MASSEY: Aye.

MS. BROWNELL: Aye.

CHAIRMAN WOOD: Aye.

SECRETARY SALAS: The next item is C-1, Emergency Reconstruction of Interstate Natural Gas Facilities Under the Natural Gas Act with a presentation by Gordon Wagner, accompanied by Berne Mosley.

MR. WAGNER: Good morning, Chairman, Commissioners. In the wake of the events of September 11th, 2001, Commission Staff sought to assess the extent to which FERC's statutory and regulatory authorities might be used to assist pipelines in responding to a sudden, unexpected disruption in natural gas service.

The Commission and the industry have had extensive experience with disruptions due to natural disasters, such as earthquakes and landslides, or accidents such as excavation breaching a pipeline. However, the Commission and the industry have not had similar experience with emergencies due to deliberate damage to gas facilities.

To consider the consequences of and how to respond to an intention attack on gas facilities, the Commission and the Department of Transportation's Office of Pipeline Safety jointly convened a conference in April 2002 which brought together representatives of federal, state, local agencies, energy industry sectors, trade groups and interested individuals.

Among the concerns expressed was the request that the Commission ensure that interstate pipelines be able to act expeditiously to restore service in an emergency. This Notice of Proposed Rulemaking is a response to that request.

Although the Commission allows pipelines several options to respond in an emergency, in some situations our existing authority may take too long to implement, or where rapid reconstruction is permitted, may apply only to a limited class of facilities or only for a limited period of time.

In response, this Notice of Proposed Rulemaking would expand the scope of activities that a pipeline might undertake pursuant to Part 157, Blanket Certificate Authority. Almost all interstate pipelines currently hold blanket certificates. Blanket certificates give pipelines the authority to construct new facilities on their own initiative without first submitting an application to the Commission then waiting for project-specific approval.

Currently, blanket authority is restricted to lateral lines and relatively minor system modifications. The draft NOPR would increase the scope of projects permitted under blanket authority in an emergency. Specifically, the NOPR would allow pipelines to act under blanket authority in an emergency, to replace mainline facilities along a route other than an existing right of way, to commence construction without the existing blanket certificate regulation's 45-day prior notice waiting period, and to undertake projects that exceed the existing blanket cost limitations.

The reporting requirements would be amended so that a natural gas company acting under Part 157 in response to an emergency would report to the Commission before commencing an emergency reconstruction project and then could proceed without awaiting further Commission action.

Where appropriate, a Commission Staff member will be on site to monitor reconstruction activities. The NOPR is intended to address a situation where a main line is damaged and then access to that damage site is restricted due to investigation or contamination. Under the proposed expanded blanket authority, a pipeline would be able to build around the damage site to reconnect its main line in order to restore service.

This proposed expanded blanket authority would only apply in emergencies and would not alter pipeline's obligations to comply with existing environmental, safety and land acquisition requirements.

Thank you.

COMMISSIONER MASSEY: This proposal addresses a problem that exists now. And that is that there may be no way for the pipeline to ensure the rapid restoration of service if it is attacked.

And this proposed rulemaking addresses that problem and says to the pipeline, we want you to be able to restore service as quickly as possible. You can depart from the existing right of way. The Commission's existing landowner notification provisions would still apply. You still have to comply with environmental rules and regulations in taking the steps necessary to restore service.

The Commission will in most cases provide a staff person that will be on site with you as you take whatever steps are necessary to restore service. So the Commission will be involved in the process, but you don't have to seek formal approval from the Commission for taking whatever steps are necessary.

Have I stated this accurately? I have? Okay. I think this is a carefully balanced approach, and it has my support. Clearly the Commission needs a policy with respect to this unfortunate kind of issue, but we need a way for pipelines without having to go through a full Section 7(c) process to restore service as quickly as possible while complying with environmental laws.

This proposal has my support.

MS. BROWNELL: Good effort, and I appreciate the thoughtfulness and actually the ability to work with the other agencies. We need all the examples of that successful relationship that we can give to the public.

I have one question. I guess we raised the issue of the definition of emergency. In your description you describe an emergency as the result of a deliberate act of terror. And we don't actually define that in the order, but we raise the question in terms of how we would actually define an emergency. Is that correct?

I just want to be sure that we're applying this in the right set of circumstances, particularly given the issues that Commissioner Massey has raised about landowner and environmental concerns.

MR. WAGNER: That would be the intended circumstance. We don't expand the definition beyond that.

MS. BROWNELL: But we do raise the question for the public to respond to this? Okay. Good.

I think this is a good order. I think it's very important, but as with all new ventures, I think it's important to pay attention to the details, and I'm particularly interested in exactly what the circumstances are that we envision and that everyone understands that so we're not in a position where someone makes an interpretation of an emergency and proceeds with something that we didn't envision and support.

So I think that's an area that we really need to work on. Thank you. And I certainly will support this.

CHAIRMAN WOOD: As will I, and appreciate your work and the contribution from the many parties who work with us in the workshop and since then on these issues.

So I support it. I'm ready to vote.

COMMISSIONER MASSEY: Aye.

MS. BROWNELL: Aye.

CHAIRMAN WOOD: Aye.

SECRETARY SALAS: Our next item this morning is A-3, Seams Resolution presentation. And our guests for this presentation this morning are Mr. Bill Museler, President and CEO for the NYISO; Jim Torgerson, President and CEO for Midwest ISO; Rich Wodyka, Senior Vice President for PJM. And they are accompanied by Mr. David LaPlante, Vice President of Market Development for ISO New England.

MR. MUSELER: Good morning.

CHAIRMAN WOOD: Welcome back.

MR. MUSELER: Thank you. This morning I will give you a brief update on the status of the Northeast seams. This is a report on the work that New England PJM and New York have been doing and is our quarterly report as you requested when we set this process up approximately nine months ago.

We have hard copies of the schedules themselves, which will be very difficult to see on the screens. There are hard copies in the back, and I will describe the projects that were completed in the third quarter of 2002 and then the deliverables for 2003 and beyond, and then you had also asked about how we were ensuring that with the markets, the New England market, the New York SMD-2 market coming forward, how we were trying to coordinate to make sure that those market rules did not create seams issues.

So at the end, the last item I'll cover will be that.

As I said, the schedule is hard to read, but it is in your handout and it is in the back. Going to the fourth quarter of 2002 deliverables, Item 28, the New York Hydro Quebec Interconnection Agreement was signed by both parties in October, so that was completed.

I'll just jump to 28(a) and then come back to 29. PJM did implement its spinning reserves market in December of 2002.

With respect to Item 29, the coordination of controllable tie lines between New York and PJM, these are the lines from Ramapo and then down through New Jersey and into New York. As I believe you're aware, you did issue an order on Phase I of that proceeding. Unfortunately, settlement discussions did not succeed, and that is now again before you in the litigation process.

So we did attempt to get that resolved by the parties. This is really an issue more between a New York transmission owner and a PJM transmission owner. The New York ISO and PJM believe that we can implement whatever the outcome of that litigation is. So this will not be an operational problem. It's just a matter of getting the litigation resolved.

So I just wanted to point that out. We don't view it as a problem getting it implemented, but it's an issue that wound up on your plate.

(Slide.)

The next item is the Regional Resource Adequacy Model, and here New York, New England, PJM and our stakeholders have worked very well together. And the deliverable in the fourth quarter was to reach an agreement on submitting joint comments in the SMD docket, in your overall docket.

Originally, before -- actually before SMD came out, we had started this process, and our goal was to have a separate filing on ICAP at that time. But everyone agreed that the right way to do this was to operate in the context of the SMD proceedings. We have -- it's also in the deliverables for next quarter -- but we actually did file joint comments, so you have a unified position from PJM, New York and New England on that.

That group used to be called JCAG. It is now called RAM, to conform just to the terminology of your SMD NOPR -- is ongoing.

ISO New England presented their Resource Adequacy Model at your technical conference in November of 2002, and we believe that was well received. So those deliverables were accomplished.

CHAIRMAN WOOD: Bill, let me ask you a question there. At that November conference I recall there being someone, I'm not sure who, stating that there was going to be a filing in the February timeframe from New York, or discussion in New York.

David, you were there. What am I remembering here? Something that was going to come out on resource adequacy from the New York parties.

MR. MUSELER: Go ahead, David.

MR. LaPLANTE: I don't have it.

MR. MUSELER: I don't know if this came up at that conference, but what New York is talking about is in the context of the types of items that are in the JCAG RAM agenda, New York, its market participants have been trying to come up with a revised ICAP proposal to get it on because of the problems in terms of the amount of revenue that's being generated by the current ICAP rules is when you look at the need to attract investment in New York In generation, it looks like our current rules -- and that's why we're in this joint proceeding -- are inadequate.

So what I believe you heard was that we may file something which would be a modification of what New York does now, consistent, not inconsistent with the direction we're taking in RAM, but we felt we may need to do something for next summer so we don't go through another cycle in the market.

CHAIRMAN WOOD: That's what I'm remembering.

MR. MUSELER: But it would not be the final answer. It would be an interim measure that we in New York would try to propose.

Item 38 is the open scheduling system, and we did achieve the milestone of completing market trials. We had market participants working with us in December. Those trials were successful. And I'll report in the 2003 timeframe of our plans for where we're going with that.

But also ISO New England and the IMO are discussing the expansion of OSS to them. This is a communication media that transfers data, market data back and forth so that you don't -- it assists in reducing scheduling check-out anomalies, tagging anomalies, as well as -- it used to stand for one-stop shopping. It does accomplish that so people don't have to put it in in two different markets if you're doing transactions between the markets.

But it appears now that this data transfer is going to be the largest benefit. So the initial discussions and the initial setup is with PJM, and I'll report in a little bit on that. But now all four of us, actually, New England, the ISO and PJM was working on this with us earlier, I think are all in this game and all believe that we should move that up a little bit on the burner.

COMMISSIONER MASSEY: That would apply to scheduling across the interfaces?

MR. MUSELER: Yes sir.

COMMISSIONER MASSEY: I see. You would all apply -- the three ISOs would apply identical requirements? Or is it something less than that?

MR. LaPLANTE: A participant who wanted to transact between two ISOs now has to submit a transaction separate in each ISO. It would allow them to submit the transaction only once and then submit the transaction to both ISOs for them, and this reduces errors in terms of etags and schedules. So it makes it more likely that the transaction actually flows.

MR. MUSELER: It actually deals with the disparate rules. To the extent that we have not gotten the rules to be exactly the same on both sides, this harmonizes those rules so the transaction will follow. For example, different ramp rates in different ISOs, this takes that into consideration and says is the transaction feasible, and if so, it schedules it.

All of these things kind of were being done manually by the operators. The operators would have to check available capacity, they'd have to check ramp rates, and then they'd have to make sure that they did the scheduling checkouts, which are basically be operators going down a list and the other operator concurring that they got the transaction. And this is exactly the transaction, the source, the CINC, the tag number, and this all will do all that automatically.

It doesn't set the rules. It makes sure that the rules work together to get the transaction.

COMMISSIONER MASSEY: There's no technical barrier to this. It's just agreeing on a system and applying it?

MR. MUSELER: Yes. It's technically not simple, but --

COMMISSIONER MASSEY: It's doable?

MR. MUSELER: Yes sir.

COMMISSIONER MASSEY: It's really important.

MR. MUSELER: We think it is, because it also comes into what we'll probably talk about a little bit later, that this system or some similar system will be needed to deal with interregional congestion redispatch. You need the communication mechanism somewhere, and we believe this thing will do it. It's been designed to be able to be able to do that.

That's the list of the fourth quarter deliverables, as I mentioned, with the exception of Item 29. that's in litigation before you. The goals for the fourth quarter were accomplished.

Moving on to 2003-2004.

(Slide.)

What's in front of us, and one of them has been accomplished.

Item 30, this is on page 6. ISO New England is on track to implement SMD-1 on schedule. Dave LaPlante can certainly answer any questions you may have in that regard.

Item 31, New England ICAP implementation, is also on track and subject to market trials.

Item 33 is just a follow up to the agreement we reached in the fourth quarter. And that is, we did file the joint comments -- New York, New England and PJM -- on the framework for the regional resource adequacy model.

Item 38, the open scheduling system. As I said, market trials were successfully conducted in December. Commercial deployment of this is on track for March, and the first deployment is between New york and PJM. So we believe that that will work pretty well. We don't anticipate any problems.

Then as I said earlier, we are in discussions with both New England and the IMO to see if we can expand this system to those two control areas as well.

Moving to Item 32 on page 7.

(Slide.)

The New York SMD-2. The redo of our market to meet the conditions of the NOPR and also replace a fair amount of our infrastructure is scheduled for the first quarter of 2004, with most of the work being done this year, and market trials scheduled to start before the end of this year, before the end of '03.

We'll talk a little later about coordinating the rule changes with the neighboring ISOs.

The New York PJM Congestion Redispatch pilot was achieved. It was actually achieved in the third quarter. And I just wanted to report that it actually is in use. It's a limited area, but we picked it, PJM and New York picked it because it was a limited area, and we thought we could demonstrate the feasibility of it without trying to the entire control areas. It's in Western New York and Eastern Pennsylvania.

We actually, with the cooperation of the generation owner involved, because we did not know how we could do this from a confidentiality standpoint, the generation owner involved agreed to work with us. We actually send real time bid data form the New York generator to PJM. So when PJM has -- there are two units in New York that have a very high contribution to a congestion situation in the PJM.

So when PJM sees that they have congestion over certain lines in eastern Pennsylvania, and that congestion can be solved by two generating units in New York, PJM actually through us redispatches those units and moves them to solve the congestion problem, and we have a settlement system to deal with how we compensate those units or how PJM compensates those units.

This is working right now. I don't have the data for December, but it was used six times in November, and it works. So it's a fairly what I'll call very basic redispatch. Not the elegant way you'd like to do it ultimately, but I know that MISO and PJM are working on similar things in their venue. We're very encouraged that this shows at least that there's a way to do it. We're actually continuing discussions with PJM and New England in this regard.

New York has been doing work with MIT and some other contractors to come up with a way to expand this, basically to redispatch across price differences between the control areas. The redispatch is fairly, I don't want to say easy, but figuring out how to do that and redispatch the units in the other control area is the easier part of the problem. The tougher part of the problem is how are you going to settle that? How are you going to settle the actual payments for it. But we do have ideas on how to do that and I think what we'd like to leave you with here is that the three northeast ISOs and I believe the MISO also in their work with PJM have this as a high priority.

In the last week, we've had a fairly extensive meeting with PJM and I'm meeting with New England on this to compare notes to say how are you guys looking at it, how are we looking at it so that we can hopefully come to a way that we all decide. This is how we'll do it across the whole region, not just between the two control areas.

CHAIRMAN WOOD: Can you connect the dots for me between the OSS where you can schedule it across multiple areas, and then the actual dispatch and then the ultimate settlement. Tell me kind of how those three --

MR. MUSELER: The OSS if that's the ultimate mechanism chosen and at lesat we in New York and the other ISOs in the northesat believe that that's probablly the way to do it. That's more of a communications system that lets the two markets exchange market data and operational data to set the hour ahead schedule.

Right now when it goes into operation it will be dealing with hour ahead scheduling. What we're talking about here is moving towards real time scheduling when congestion exists between the two control areas. In other words, congestion translates into price differences across the seams, so the redispatch project is designed to deal with that price differential when congestion occurs between the control areas, and it will have to be -- and I'm getting a little out of my depth here because I'm not the IT techie but it will operate in what is now the standard real time dispatch, the security constrained dispatch which actually tells which unit where to go and sets the price and sets the LOMP price. That's what we have to develop.

As I said earlier, we beileve the OSS will facilitate this. That will allow the two markets to exchange the information and exchange the operational data, the bid data, and then the dispatch data. But the actual application that's going to say okay, how does the PJM market decide which units to redispatch and how much and the same thing on the other side.

That application will have to be put into the real time dispatch applications of all the ISOs that are doing this but that's doable. We think that's doable.

As I said, once we can solve the issue of how are we going to settle this, because the easiest way to do it is probably not the right way. There is a relatively easy way to do it but it involves the ISOs taking positions in the market, and I think we don't agree that that's a good thing to do. So then getting it to work with the market mechanisms, this is something we have to and are working with the stakeholders with the market participants on in terms of how are we going to design that settlement system. So it's doable but we've got to get the conceptual issues agreed to.

CHAIRMAN WOOD: You answered a moment ago about the need to get the generators up and kind of in the loop and the exchange of confidential information. Is that going to be a tricky issue from here on out? Is there something we can do?

MR. MUSELER: I think we will have to propose to use something that will allow the ISOs to exchange that bid data. We hopefully can work with our market participants to give you something that's a consensus position. We are only able to do this with PJM because the owner of those particular generating units agreed to allow us to exchange that information.

CHAIRMAN WOOD: If you all were a single control area that wouldn't be an issue, right?

MR. MUSELER: That's correct, it would not be an issue.

CHAIRMAN WOOD: My mind, I have been, since the NERTO was withdrawn. One of the benefits that we could get elsewise through coordination, but we wouldn't get through merger. You and I have talked about this recently. In real time the coordination of redispatch across the boundaries in real time is one we haven't captured. So I'm really very interested in what you all can do and what we can back you up to do to make sure that potential benefit of a single control area across a larger area than we have today can be captured anyway with two control areas. And I think this issue will still happen, Jim, over in your area, as long as there are multiple control areas, and I know that's anticipated for some time.

COMMISSIONER MASSEY: So Rich, in this example of the two units, are they in the New York region? Do you include them then in your security constraint to dispatch? Is that the way it works?

MR. WODYKA: At the right time, we do. We don't include them until there actually comes a constraint that we have to utilize those units for. Otherwise they're not in our dispatch area.

COMMISSIONER MASSEY: How significant an issue is this for the region. How often is that you say to yourself, boy, if I just had control over this generating unit that's across the border that's not in my control area I could solve this problem easily.

MR. WODYKA: This is a very current issue. It's a big issue with us and MISO. This is one of our critical issues as to how to solve some of our seams issues with MISO. This pilot work done in New York is going to go a long ways to at lesat coming up with a concept that we can utilize across any seam. No matter where we are, we are going to have boundaries with neighboring systems at some point in the geography. This will enable us to handle that across the congestion across these boundaries.

COMMISSIONER MASSEY: And it's technically doable? It's just harder with multiple control areas, is that right? Do you think there's any efficiencies? How would you describe it?

MR. WODYKA: Again this is a pilot. I think the pilot will prove out what we can and cannot do and what benefits it does bring and does not bring type thing. I don't want to prematurely state what's going to be accomplished but I think this is going a long way towards issues we need solved that we're working on as well as in the northeast.

COMMISSIONER BROWNELL: How long is the pilot?

MR. MUSELER: It's indefinite.

MR. WODYKA: Again, on a month-to-month basis we don't know how many times we're going to utilize the infrastructure. It really depends on how the system is working and where the constraints are.

As Bill indicated, six times in November, and I don't have the statistics either for December. It could have been zero or it could have been 20. I honestly don't know. It really depends on what experience we get over the next period of time, but I know this is a very active discussion which we're having with MISO as far as the resollution of congestion across our seams with MISO and how we're going to do this.

COMMISSIONER MASSEY: Jim, you're not going to be a single control area, are you? So this must occur within MISO among the control areas within MISO.

MR. TORGERSON: Keep in mind we're not running the market yet but it clearly is an issue. We'll be telling the different control areas which ones to dispatch, and we're going to have to get the information from each one and get the bids from each one. So we'll operate it across all these control areas.

COMMISSIONER MASSEY: The difference is you have control over all the control areas.

MR. TORGERSON: And the difference Rich was talking about is who has control over those generators. That's what we're working out so that when there is a situation we're utilizing a generator in a different area in PJM, for example, that could alleviate a problem in the MISO that we work out how that's going to occur and then the compesnation for that and how it's going to work and we'll both be doing the LMPs which again have to be consistent so the pricing gets determined correctly. So those are the issues and actually it's as Rich said; we're working on it right now.

We have an issue with working today between the PJM having the market and us not, we have to deal with that over the next year until we have our market operation, and then we have the issues of market-to-market and the things we were just talking about.

CHAIRMAN WOOD: As of today it's a seam between control areas that has to be worked on still? The fact that the ISO is going to be coterminous with the control area on the three; actually PJM now has PJM West. How do you all deal with that within one RTO? Do you have to deal with the same issue?

MR. WODYKA: PJM and PJM East are effectively operated as a single control area. We basically to dynamic scheduling across that interface every five minutes and true up the ties. It's a different operation.

MR. MUSELER: Going back to your original question, the other benefits that we can hopefully get with coordination even in the absence of the NERTO in the case of New York and New England. The single largest one is the elimination of pancaking. Also I think PJM and MISO's work is going to kind of blaze the trail there, and we think we should build on that as quickly as possible across the entire northeast. Even the IMO is interested in that. The Committees are interested in trying to find a way to eliminate pancaking as well.

CHAIRMAN WOOD: Should we set up a forum as we did in the midwest for that to happen with a time certain?

MR. MUSELER: Again, I think probably there's going to be some kind of a model that PJM and MISO are going to come up with which may set the way, but my opinion, speaking for myself now, my opinion is that it would be helpful if you did do that, if you set up a technical conference, again probably after they've settled what they're doing, and then got the rest of us in because this is one area, as opposed to the interregional redispatch which is really in our hands with our stakeholders I think, so we can work on that.

The pancaking issue obviously has a big state PUC component and again speaking for myself now, getting all of those parties, the PUCs and hte ISOs and the TOs in the same room would be very helpful in terms of driving that thing to some kind of a resolution. Because it's administrative, there's not a technical problem here. There's not a software problem in how we eliminate the pancaking. That's easy to do once you decide the policy issues.

CHAIRMAN WOOD: Thank you. Let me just ask for a frame of reference. What is the through and out rate for each of the three northeastern RTOs, ISOs?

MR. MUSELER: For New York, it's about five-and-a-half to six dollars.

MR. LaPLANTE: New England is around five bucks also.

CHAIRMAN WOOD: Per megawatt hour?

MR. LaPLANT: Yes.

MR. WODYKA: I think the new PJM is about two dollars.

CHAIRMAN WOOD: So for PJM into New York would be about two dollars.

MR. LaPLANT: New England would support a technical conference also. It's clearly a policy issue that the ISOs need help to resolve.

CHAIRMAN WOOD: I think we saw with you two guys it's not really, you can't really drive the outcome there. You've got broad stakeholders and it's really at our doorstep that that kind of stuff sits. We're willing to do that. We'll keep that under advisement and move on that when appropriate.

MR. MUSELER: The last issue is a short discussion in response to your question about how are we coordinating the rule changes in SMD-2; 2.0 in New York, 1.0 in New England. For example, PJM has just implemented their spinning reserve.

(Slide.)

We needed to make sure that all of those things are not going to cause seams problems. The diagram is actually I think fairly representative of this. There have been some of these issues that Phil Harris and I have dealt with or Gordon van Welie and I have dealt with. Others of them were taken into consideration in the design of new systems.

The ISO New England SMD 1.0 is based largely on PJM's rules, particularly with respect to the seams. New Yorks SMD 2.0 originaly didn't start as a response to your NOPR because that didn't exist. It started as a response to making the New York dispatch rules at the interface be consistent with PJM's so the initial design of our SMD 2.0, as far as the interface is concerned, came from PJM. That I think was a good basis, that we shouldn't run into too many problems in these designs. But the devil is always in the details. So the VPs, folks like Dave LaPlante, Chuck King, Ken Wallant from PJM have an on-going dialogue at their level. They're the three officers in charge of the markets and they have had meetings with --

I'll switch to the next page now to be a little more specific.

(Slide.)

The VPs have periodic joint meetings. There's a planning session scheduled for January 28th to lay out our plans for coordinating the market rule changes that are coming in for the next year. So there's a meeting scheduled for January 28th with the officer level. We also have meetings between the stakeholders and the chairman, the vice presidents and some of the managers, and the last meeting of that group was in the fourth quarter of '02 November 21st, and there's a meeting scheduled in the first quarter of '03. That's to make sure that on these rule change issues the stakeholders are also cognizant of the direction we're taking.

Moving to page ten. I won't go through all of those items listed under the first bullet.

(Slide.)

But it's an example of the kinds of things at the staff level there are working groups on to make sure we deal with all of that. The joint working groups, I think, are probably equally or even more important. The JCAG now, the

RAM group does have stakeholders involved in it. I think that's a good example of how, on an issue specific basis we have been able to put together these ad hoc groups consisting of the right people, and nobody's excluded from them.

Typically you have people that have interests in some specific issues working on that. We are in the process of forming another joint working group with the market participants on controllable line scheduling. Both will be within the control areas. We have controllable line scheuling but more importantly and that is an issue within hte control areas but more importantly now that the HVDC lines are going to probably be the largest new transmission investment thta we're going to see, at lesat between New York and New England and between New York and PJM, I believe all of the proposed projects except two are all HVDC.

So the scheduling and the operation of all of these controllable flow lines is something that sounds like it sholdn't be tough but turns out to be tough. That's why we're forming a separate group to concentrate on. Sometimes these groups have gotten to the point, not recently, but where they wound up having to meet every week or every other week to really drive these issues. That they have been effective and hopefully that one will also be successful.

CHAIRMAN WOOD: You're referring to which transmission facilities? The HVDC, which ones? Are there some prospective ones.

MR. MUSELER: Cross Sound Cable between New York and New England is one if we can get by the environmental problem that that particular cable is having. There are proposed lines between New Jersey and New York and New Jersey and Long Island, and I'm sure there are some in MISO and other places. But even if only a quarter of these lines that are proposed come in, we still need to deal with them. And as I said, between New York and PJM there are two proposed AC projects. One is just a radial line and that one will not be a problem, assuming the economics work and they go forward and build it.

That really concludes our report for this quarter on the PJM, New York, New England seams issues. I think we're making good progress.

As you pointed out, the two largest seams issues from the standpoint of customer value are the pancaking and the interregional dispatch. If you can help, particularly with the first one, we would sure appreciate it.

CHAIRMAN WOOD: Message delivered and received. Back to the very first item you mentioned, the Hydro Quebec Line, I remember one of the issues that came up in discussing the NERTO merger is that the dispatch of that line or the end-use capacity on that line could actually get kind of moved up to the full value of the line.

Is that something that was addressed in that October protocol? Am I remembering exactly?

MR. MUSELAR: You are. The October protocol did not include using the rest of the line. That's a project that we have in New York, working with New England.

The entire line can be used. The issue is being able to have the owner and LIPA -- and I'm not sure which one has the financial benefit here -- but to actually sell the unused portion competitively, LIPA -- if LIPA contracts for energy from New England -- and it meets New England's security requirements, they can use the entire capacity of the line. There is no limit on being able to flow across the line.

The issue is if LIPA only uses 80 percent of it for transactions to them, they'd like to be able to sell the line capacity to somebody else, to sell to a customer in Rhode Island or vice versa.

It's unlikely that we're going to have spare capacity on Long Island, but in the unlikely event we ever did, it might want to go the other way.

CHAIRMAN WOOD: So the Hydro Quebec Line is dedicated 100 percent to the use of LIPA?

MR. LaPLANTE: Are you talking about the Cross-Sound Cable? I think he's asking about the New York-Hydro Quebec agreement that was signed.

CHAIRMAN WOOD: I'm sorry. Stepping back to the one that was on the Hydro Quebec, there was a discussion, and I remember -- maybe it wasn't you all; maybe it was the TOs from New England, but one of the concerns is that that 2000 megawatts --

MR. LaPLANTE: Right, the 2000 megawatts between Hydro Quebec and Sandy Point.

CHAIRMAN WOOD: I remember this other issue. I understand that you said on that one, Bill. That makes sense.

MR. LaPLANTE: There's been some tariff changes that make it easily to use the full capacity of the line.

As part of SMD in New England, we had discussions with the owners of the Hydro Quebec Line, and they changed their scheduling protocols to make it easier to use the full line, so we were successful there.

MR. MUSELAR: There also is an issue with the Hydro Quebec Line to upstate New York. You may have heard about that one from Hydro Quebec. That interface and the line is rated for about 2300 megawatts, and we routinely can't operate it much above 1500.

That's due to internal constraints on the New York system in central New York, voltage constraints. That, in my view, is essentially in the realm of the overall planning and transmission investment area.

If transmission reinforcements in central New York were made to fix the voltage situation, we could use the full capacity of that line, and, assuming the competitiveness of the bids was appropriate, more would flow on it. But we can't open it up without transmission enhancements in New York.

The New York system -- that's not the only place where the New York system is constrained; it's constrained in the middle of the state, downstate, particularly trying to get into New York, and now we have constraints in western New York that we never had before.

So this transmission investment issue or placement of generators in different locations, is a real issue for us.

CHAIRMAN WOOD: What is the nature of the New York ISO planning process to address those?

MR. MUSELAR: Current New York ISO does not have planning authority. The type of planning order that New England has from you, which allows for something that I believe is consistent with the NOPR, New York does not have that authorization.

We actually can only do planning studies by tariff, if we are requested to by the State of New York. They have requested us to do some planning studies, so we are, but that's one of the things that the NERTO application was going to take care of, and we will certainly have to file something when you final SMD order comes out, to be compliant with that.

That's a major deficiency in the New York situation right now. We don't have planning authority.

CHAIRMAN WOOD: Do we need to wait for the Order? Can that go into effect tomorrow?

MR. MUSELAR: We are working with the Public Service Commission in the State of New York, based on the planning studies they asked us to do, to try to come up internally, between the New York transmission owners, the Power Authority of the State of New York, and the Public

Service Commission, to try to pick high-value transmission projects and to decide what to do about them.

The ISO can't mandate that; the Public Service Commission could, and we're trying to give them the facts and the amount of congestion costs that would be saved if some of these projects were, in fact, moved forward.

Our feeling was -- well, let me back up again. We are, in New York and New England, trying to move forward as far as we can on the interregional planning process, and I think our direction right now is to try, even if we can't get to the end of the process where somebody can, I'll say, dictate that a project need to be built -- that's obviously the most controversial phase.

But if we can get through the points where we deal with how you do the analysis, what are all of the ground rules and initial assumptions, and actually do the planning, that's going to take a year. That's what we're trying to do now, and I think we'll have agreement with our stakeholders, and we do have agreement with New England to move forward and get that process started.

And we've got, between the two NERC regions, between PJM and NPCC -- our planning process is under the auspices of NPCC -- we will coordinate with PJM between those two NERC regions.

CHAIRMAN WOOD: Where does it stand now as far as with the state PUC and what they have asked y'all to do? What is the time line on that?

MR. MUSELAR: We've actually completed the analysis. We have a transmission report that's being reviewed by our market participants right now. I would anticipate that no later than the end of next month, that that report will be public.

CHAIRMAN WOOD: And then at that point, the state PSC talks about siting an expansion?

MR. MUSELAR: At that point, it would have to be matter of whether or not someone either -- whether the TO voluntarily would decide that they wanted to try to move forward on some transmission enhancements or whether the PSC would decide that it's in the state's interest to do that. I can't predict that outcome.

CHAIRMAN WOOD: Can a non-TO merchant generator or merchant transmission developer come into New York? Are you familiar with the state siting laws, as to if they could do that or not? I know they can come into New York Harbor and all of these other activities. I just wonder if they can relieve some of the congestion.

MR. MUSELAR: I should know that, but I don't. Let me not speculate, but we'll get you that answer.

CHAIRMAN WOOD: I do remain concerned, you know, that your state that's got some high-cost generation, you've got a line that's one-third able to be used at peak from Hydro Quebec, which we know is pretty dependable, and a cost-effective power source, and then the increasing constraints within the state.

We can't assume that rules are going to fix all of that. It's going to need some hardware, and I know, from talking to Noreen, that's work in progress. I just want to see it get done in the time available, so we don't have issues with service up there and price.

COMMISSIONER MASSEY: The interregional dispatch issue, is there any policy on certainty that makes that difficult to accomplish, or is it simply a matter of doing it?

MR. WODYKA: I think it's more just an equity issue of how do you compensate the parties across the boundaries. That, to me, is the key issue we need to solve and need your guidance on.

COMMISSIONER MASSEY: Do we need to say something about that?

MR. WODYKA: It's between us and MISO, for example. It's part of the inter-RTO rate design that is under settlement discussions.

MR. MUSELAR: I think we, working with the market participants, need to bring you a rock in that case and suggest it later to deal with.

COMMISSIONER MASSEY: So you will propose something and we'll act and it will be fairly certain, what the policy is?

CHAIRMAN WOOD: Isn't the interregional rate issue related to how embedded costs of transmission are being treated, not how the energy market is being dealt with in real time?

MR. TORGERSON: It's really the embedded transmission, you're right. The energy market -- PJM and we will resolve the pricing on that for the energy component when we go to LMP.

CHAIRMAN WOOD: But your question, Bill, was what the interregional coordination that the pilot program --

COMMISSIONER MASSEY: It could be pilot, it could be broader. Just being able to call on generation in another control area to solve congestion.

CHAIRMAN WOOD: Yes. I'm wondering why that is, really.

MR. WODYKA: It's coupled to a transmission use issue on allocation of transmission as well. It's a multiple-part problem, not just the energy market part; it's the transmission and allocation issue as well and who pays for that.

CHAIRMAN WOOD: At the border, in a pilot program. Do you want to ask about the seam, the MISO and

PJM at the border? Are you just treating that as a continuation of the financial transmission rights in the New York ISO, or are they converted to a physical right at some border point?

MR. MUSELAR: Neither. That's why, as Rich points out, it's a multipart problem. Remember that there is only a single proxy bus in New York and New England at which you can look and determine the price differential across the border.

These lines that we're talking about are part of that. So the pilot does not deal with the price differences between those two proxy buses; they could be anything.

The pilot deals with there's congestion going on in PJM that we can solve in New York. That's why expanding this to actually the two markets dealing with congestion that causes price differences at those two proxy buses, is a more difficult and complicated problem because you're really dealing with, as Rich points out, both necks. You're dealing with congestion and you're dealing with LBMP dispatch.

That's why where you all have heard a lot of legitimate complaints, particularly last summer, where there was large price differences between PJM and New York or New York and New England, and yet there was room left on the transmission system.

So the question was, why isn't that price difference being arbitraged? That's where we have to go, because it wasn't being arbitraged, because you can only change the schedule once a hour. That's the short answer, because you couldn't do it real-time.

This deals with -- and there may not be any congestion in the condition I just described; there might not be any congestion across the interface.

If there were no congestion across the interface, and it was all one control area, there wouldn't be a price difference there. So, part of it is just because the scheduling is only done once an hour, and we move to 15-minute scheduling and that will make that better, but won't solve it completely.

You will still have, because the markets are different, you will still have the possibility that will happen, even in 15-minute scheduling. You'll still have price differential inside of that. One LBMP will start to move one way or the other, so you're leaving money on the table.

That's why the final step is to arbitrage. It may or may not have a congestion component, but, remember, there's a price differential across the seam. That means there's money to be saved.

Ultimately, that may be two steps away. It's multiple steps away from its pilot, but the pilot established that we know how to move the data, and we know how to redispatch, but the rest of this is not simple, and, as Rich points out, it is much capacity.

That's why I think we need to struggle with this and bring you a recommendation.

MR. WODYKA: Just to add a second piece to that, is the transmission allocation issue, is the primal flow issue of generation in one system utilizing the transmission of a neighboring system-type thing? And who has the rights and who receives the compensation from that? It's a multipart problem.

CHAIRMAN WOOD: The compensation you're talking about is related to the embedded cost of the transmission compensation?

MR. WODYKA: Correct.

CHAIRMAN WOOD: If that's dealt with, then what remains? Are the issues any more than what Bill just laid out, Rich?

MR. WODYKA: I think that would cover the spectrum of the issues that would enable us to solve this.

CHAIRMAN WOOD: In that regard, then, the resolution of the underlying interregional rate issue between PJM, MISO, and between PJM and New York, and, potentially, New England, is something that would at least take the transmission and the rights component off the table, so that you can focus on the operational aspects and how to get from that 15-minute market down to real time.

MR. WODYKA: That's what's known as the real-time system, to facilitate the relief of congestion in other systems and fairly compensate those units for doing that.

CHAIRMAN WOOD: Is this properly teed up in the 206 proceeding as something that would be an outcome?

MR. WODYKA: It is for PJM and MISO. The extension is what you suggested earlier, the development of a Northeast solution across the region from a single-area perspective.

CHAIRMAN WOOD: You're not going to be held to this answer, since I'm asking it cold. What should we do with regard to that issue? It's clearly moving forward on the PJM and MISO side.

MR. WODYKA: As Bill suggested, once the issue between PJM and MISO is done, that could set a model for a solution in the Northeast as well. It's the sequence of events here.

COMMISSIONER MASSEY: Once you work that out technically, what's fair compensation and so forth? That will just be a model for PJM New York; is that what you're saying?

MR. WODYKA: We're working with MISO. That's one of our critical issues, is, how to handle congestion between PJM and MISO. It's a multifaceted problem, and Jim already said that where we are today is, PJM is going to have its markets in our territory, operational before MISO's.

That presents one set of issues we have to deal with on how to handle congestion. When the markets interrupt MISO, then it's more compatible and there is a different solution, but, again, I think we're all on the same page, marching down to solve these issues.

COMMISSIONER MASSEY: Are you going to come up with a solution, even before the market is submitted in MISO, a solution that can then be used as precedent for New York?

MR. WODYKA: The solution with us in New York is more like the second stage in MISO.

What we're doing with PJM in New York is really the prototype for what we're going to do when PJM and MISO have markets. That is the prototype.

MR. TORGERSON: There actually is a session -- I think it's next week.

MR. WODYKA: There's a session tomorrow.

MR. TORGERSON: And there's another one next week to deal with the market-to-market issues that PJM and MISO have, and this is one of the things clearly on the table that has to be dealt with.

CHAIRMAN WOOD: But it's envisioned in the October 2004 market, that the issues of real-time dispatch that Bill has been laying out will be something that will be addressed by the integrated plans, or is that something that might be --

MR. WODYKA: I think they will be addressed by the end of 2003.

MR. TORGERSON: They have got to be addressed by the end of 2003 when we have our market operational.

CHAIRMAN WOOD: It's interesting that the rate pancaking stuff is moving faster here, and then kind of the integrated seams operational issues, that's good. That's the laboratory that we're looking for in these markets as they go to work.

So, gosh, I'm already to do the next one of these quarterly updates. I hope it's as good as the last one. I appreciate, Bill, your report on the three Northeastern RTOs, and we've also got Jim and Richard talking about. Do we have any more questions for David or for Bill? You might have some, so hang tight. We're going to switch a little bit.

MR. HEDERMAN: Mr. Chairman, I had one quick question. It relates to the New York and PJM seam. In mid- to late-November, a hot spot arose in northwestern Pennsylvania. It did not have the direct consequences for customers, because of the FTR allocation, but as I understand it, it was not until this week that the cause was determined, which was some generators that were down in western New York.

I was wondering if there were any lessons drawn from trying to track that down, that either we can help with, or that you're drawing for your own interaction?

MR. WODYKA: I would just say I think we have been coordinating much better. I'm a little disappointed it took us that long to find out the cause of this. I'm not exactly familiar with the circumstances, so you're probably ahead of me.

MR. HEDERMAN: Thanks. We're working on that at the staff level, but I just wanted to take advantage of this to check in on that. Thanks.

CHAIRMAN WOOD: Okay.

MR. TORGERSON: I'm pleased to have the opportunity to update the Commission on our progress on the elimination of seams and also on market development. We've made substantial progress, but there still is a lot to be done. For the Midwest ISO, we commit to continue our efforts to bring the Commission's vision to fruition. All I would ask from the Commission is a steady and consistent regulatory commitment to ultimate market objectives.

The regulated community is reluctant to give their whole-hearted support to an issue they feel may change in midstream. So assurances that this won't be the case should assist in the efforts.

CHAIRMAN WOOD: For example, what?

MR. TORGERSON: They're afraid, and I think you might have heard it when you were out at our place, that the SMD, when it comes through, will change what we have done and cause us to have considerably more costs in modifying what we've put in place. So having something that's consistent and will be consistent with SMD I think is the key, and that's what we want to make sure happens. And I think giving assurances to the people that that will be the case will help facilitate it.

So we are looking to get --

CHAIRMAN WOOD: I think we've got a filing that we're scheduled to look at on the 20th of February that asks a lot of those are we going in the right direction kind of questions.

MR. TORGERSON: The blueprint I'm working from was laid out in the Commission's July 31st order. There, the Commission imposed a number of conditions that must be satisfied in order to accommodate the RTO selection of the former members of the Alliance, and those conditions were to minimize the transmission to a single market spanning the Midwest ISO PJM footprint with a functional market in place by October 2004 accommodate ITCs that through common control have managed seams between PJM and MISO.

NERC approval of reliability plans addressing parallel flows contract the capacity in electric peninsulas, differing definitions and procedures between RTOs and some facilities in close proximities under different RTOs, development of joint Midwest ISO PJM operational agreements detailing how seams will be managed in the transition to a single market.

The elimination of through and out rates for the transactions with MISO PJM obviously is very important and has to occur and to hold harmless utilities in Wisconsin and Michigan from any loopflows. Those are all the issues outlined in the July 31st order of things we had to take care of.

Talking from a common market perspective, the Midwest ISO and PJM have established a number of working groups to development of a functioning common market. Today significant progress has been made on the development of data exchange standards.

In addition, the parties have selected a vendor that will create the standard template for the joint common market portal.

And finally, the joint Midwest ISO-PJM joint common agreement for their sharing of financial obligations and intellectual property rights related to the development and implementation and long-term maintenance of all efforts associated with the joint and common market.

By May 2003, we expect to adopt a coordinated TLR procedure to manage common constraint to flowgates. And by December of 2003, we expect to implement a coordinated market-based transmission management system. It's the one we were talking about before based on security constrained economic dispatch policies that share information on flowgates across regional market boundaries.

All these efforts will lead to the initiation in October 2004 of a single interface for all customers in the Midwest ISO and PJM, which will provide one-stop shopping for market and transmission services throughout the joint region.

We were a little behind in our IT plans, and the Midwest ISO needs to take the blame for that. My IT folks were focused on an industry-wide solution for data exchange. I have had them refocused on a single common market with PJM as a top priority, but not ignoring the other ISOs and RTOs and the solutions we come up with.

The first step toward the establishment of a joint and common market is the creation of an SMD-compliant market for the Midwest ISO. To this end, in December the MISO filed a petition for declaratory order seeking Commission approval of central elements of its market rules. Those rules would provide for security constraint dispatch, day ahead and real time energy markets.

Energy pricing and congestion management will be effectuated through LMP, and the Midwest ISO will offer financial transmission rights to allow participants to plan ahead. We'll initiate an SMD-compliant market for the

Midwest ISO footprint by the end of 2003, and that will leave us on schedule to implement the joint portal with PJM.

Participant training for this market is actually scheduled to begin in March and run through August. In August we will then start the market trials for the market. Some issues do remain outstanding. The collaborative stakeholder process used to develop the Midwest ISO market rules produced deviations from PJM's current market implementation.

MISO and PJM have identified those rules that can be different, those that need to be the same. Our analysis is going to be presented to the stakeholders at a meeting next week to resolve those serious issues that are created by those differences.

Barring any unforeseen developments, it appears that the MISO and PJM should be able to implement the joint and common market by October of 2004 as directed with Grid America. In July 2002, MISO filed an unexecuted ITCh agreement that set forth the terms for the MISO and Grid America to integrate their three major transmission systems into the MISO.

July 31st, the Commission accepted that agreement to get a participation agreement among the three companies of Grid America and National Grid, which is their managing member. And on November 1st, MISO and Grid America filed executed agreements on the July 31st order. Then by order of December 19th, the Commission accepted those agreement.

Grid America intends to commence operation during April of 2003. So it will be fully operational during the summer of 2003 peak season. Grid America and MISO are jointly on time to meet that April date. We have an excellent working relationship with Grid America. The MISO expects Grid America to be a robust addition to its membership. Moreover, we look forward to the insights and best practices that National Grid may provide, which was another requirement to utilize technologies, and we're working with Nation Grid given their expertise in the U.K. to help come up with new options for the transmission system.

NERC's approval of the Midwest ISO and PJM's respective reliability plans requires that the reliability seams issues identified by MISO and PJM to NERC be resolved and that the solutions to those seams issues are implemented. The progress on that, the first issue is the ATC/FC calculation.

A draft agreement has been reached. We're in the process of finalizing that agreement, initiating an implementation process. The MISO/PJM data exchange agreement will be completed and implemented before the PJM market expands to ensure models are synchronized, we've agreed on that.

The second issue is congestion management, a joint working group has identified proposed solutions that have been set forth in a revised whitepaper issued January 13th.

NERC approval has been secured for modified TLR approval to be used during the transition period. For the long term, we've resolved the market flow calculations. RTO's LMP engine will calculate market flows and include areas outside its market with at least the level of detail as the NERC IDC model.

Market flows will be provided in the NERC IDC for internal flows where TLR may be called, and e-tag transactions will reflect the granularity provided before the market expansion.

A third issue involves development of the common nomenclature and meetings are scheduled on January 21st to address standardized procedures for dispatch timing and market power bids in day-ahead market, market mitigation, load pockets, FTRs, losses, operating reserves, long-term generator adequacy and coordination.

Two proposed options have been developed to determine the magnitude of firm transmission allocation on each RTO flowgate. It is uncertain if either method is going to be acceptable to stakeholders. Stakeholders have raised concerns that the proposals will legitimize and provide entitlement to parallel flows.

The Midwest ISO is waiting for stakeholder feedback, which we will get next week, on both options, and any alternate proposals by stakeholders before recommending either an option or a new alternate proposal. In addition, we need to ensure the ATC/FC coordination agreement is integrating into the allocation and prioritization of firm and nonfirm uses of the transmission system and ensuring PJM economic dispatch of an entity doesn't conflict with the MISO Priority 6 network service from undesignated resources.

Congestion management of loopflows. Three options were proposed. MISO is waiting for feedback. We expect that next week. Before recommending any of those options, we need to make sure that tag flow is basically backed out of the market flows.

The elimination of rate pancaking remains a work in progress, though I'm optimistic that an acceptable solution will be forthcoming. Notwithstanding numerous meetings and good faith proposals, the parties failed to achieve a consensual resolution of through-and-out rates by the September 16th date mandated in the July 31st order. Hearings have been held before Judge Grossman with the evidentiary record actually closed yesterday.

I understand that there's a very raw level of support for the elimination of through-and-out rates, with most of the controversy centered around transmission or mitigation measures. Also following the Commission's actions on interlocutory appeal, the parties have requested leave to resume settlement negotiations in the formal sessions scheduled for January 24th.

I'm hopeful that a negotiated resolution is possible and helps to achieve this result. So as far as the settlement process doesn't delay the time of this resolution, we remain convinced that elimination of rate pancaking is essential to efficient market operation and membership stability.

On the hold harmless provision, as of yesterday, the parties engaged in extensive settlement negotiations before Judge Dowd. With respect to the loopflow issues, again it's my hope that a comprehensive resolution of these issues can be achieved in a larger settlement of economic issues related to the integration of the former Alliance companies.

In conclusion, I have been encouraged by the level of coordination between MISO and PJM. Both organizations really are blessed with dedicated professionals that are committed to the formation of the RTOs and having reliable operation and efficient market outcomes.

The largest remaining hurdle is to secure the support for our endeavor. There has been some resistance to market development by participants that fear that the effort is not worthwhile or a concern that the rules are going to be changed in midstream.

I do share the Commission's view that a large liquid market will procure significant benefits and is essential to allow voluntary RTO choices. So anything that the Commission can do to allay those concerns, and I think you're actually doing it already. So it's just a matter of continuing it, would be encouraged and to share our enthusiasm.

Thank you very much.

CHAIRMAN WOOD: Thank you, Jim. I know that you all are doing a lot to make the integrated portal work kind of prospectively, and know from our discussions from NERC and NAESB kind of the interplay of the ISOs there.

I just want to do kind of another check. Are we all on the same page? I don't want to see any industry efforts on the software delay, defer or ultimately alter y'all who are really at the front of the pack.

Y'all have a role to play there, and I haven't really kind of circled back to make sure that that triumvirate of implementation is working as to this specific group of issues relating to the software and market integration.

MR. TORGERSON: I don't think there's any delay. The things we're working out with PJM. We had actually started on the data exchange working with a very broad group. That was delaying our interactions with PJM. Our people got more focused on trying to make sure things were going to work in California and Texas and everywhere else, so we backed off from that.

And we're working directly with PJM again on what data exchange information software we're going to need for the single market, keeping in mind that it could be utilized by other RTOs, other ISOs, and we are keeping in contact. There's an ISO/CIO council that meets every few months where they're exchanging information and data, and their plans to make certain that the software development that Rich and I are taking care of could be utilized by others, or if they have something that we can use that we're hearing about that also.

I don't see any delay there, and I think the efforts in the software development are going forward posthaste right now.

CHAIRMAN WOOD: Looking at a number of the cost benefit studies for setting up ISOs around the country, I think, quite frankly, there is this assumption that we're going to have to reinvent the software wheel at every step.

And if you guys are kind of leading the pack, certainly on the Eastern Interconnection and perhaps in the country, I'd just as soon see that be something that there's a mindset toward that being where we go more broadly because of all the issues you address here.

There's probably ten ways to address it, none of which is any more religious than the other. It's just that that's the way that works. I just want to make sure that in our I guess blessing of different organizations to kind of take the lead on these fronts that there's a pretty clear understanding that the ones who are having to implement it to make it work in real time are the people who should be running at the head of the pack.

So if that changes, let me know. I'm very interested to make sure that these and you all working with NAESB, working with NERC, mutually enforce each other and not spend a lot of time worrying about turf issues because that's not what we need to have around here.

MR. TORGERSON: We agree. We do not want to have three different options for everything. I like standardization, and I think it's the most effective and cost effective way to do things. When we come up with something -- we have people working with NERC and NAESB right now -- we will keep that in mind.

CHAIRMAN WOOD: Great.

COMMISSIONER MASSEY: I have a question. Is Midwest RTO and PJM headed toward a single security constrained bid-based dispatch?

MR. TORGERSON: What we're going to have in October of '04 will be we'll have two systems doing that. But yes, we'll be sharing the information and making certain that the LMPs that are calculated by each one are coordinated.

We will have two systems, though. It's not going to be one system driving the entire region. In October 2004, we will be looking at whether we want to go to one system after that if the economics make sense to do it.

COMMISSIONER MASSEY: If I'm in the market selling power, will I know that there's two systems, or will it operate as if it's one system?

MR. TORGERSON: It'll operate as though it's one.

MR. WODYKA: Just to add to that, you saw the issue we talked about earlier utilizing generation in one area to solve a problem in the other. If we can solve that problem, which we think we can, maybe the practicality of having that single system do everything is not necessary. That's what we need to evaluate.

COMMISSIONER MASSEY: When the bids come in and you stack them, do you have two stacks or one stack?

MR. WODYKA: You would have one stack for each region, and when there was congestion relief needed across the boundary so to speak, you would utilize the most efficient solution for that, even if it was in your neighboring system.

MR. TORGERSON: We will be sharing those bids with each other so we know which bids to utilize.

MR. WODYKA: Effectively what that does is that creates that seamless marketplace across the entire region.

CHAIRMAN WOOD: Is that the same kind of resolution like what Bill, your pilot program with PJM was doing? How is it different?

MR. WODYKA: That's exactly what we're headed towards.

COMMISSIONER MASSEY: So if I'm a generator, it looks like a single market to me?

MR. WODYKA: Yes.

COMMISSIONER MASSEY: It's no more complicated for me.

MR. TORGERSON: If you're a generator let's say in the Midwest ISO, you'll be making the bid in the Midwest ISO. We will then share that data with PJM. If they need to utilize that generator to relieve a constraint or congestion, they will do that and they'll already have the prices and the LMPs will be calculated.

So, yes, to the generator, you're going to have access to the whole market. It's a matter of where you're going with the portal, whether it's through the Midwest ISO we haven't decided exactly how it's going to work here, whether it's going to be entrance points for the Midwest ISO and PJM, or we're just going to do one entrance point. That one we're still working on, what makes the most sense there.

MR. WODYKA: The coupling of the portal as a one-stop-shop type environment with this open scheduling architecture that we're working with in the Northeast, coupling all that stuff together is going to make a very seamless marketplace.

COMMISSIONER MASSEY: But if I'm a generator in the Midwest RTO, I'm just bidding into the Midwest RTO market?

MR. TORGERSON: Initially. But the bids will be reflected in the entire market.

MR. WODYKA: If you wanted to bid out of that specific market to serve load in an adjacent region, you could do that through that system.

COMMISSIONER MASSEY: Okay. So I can serve load in PJM and I'm in MISO?

MR. TORGERSON: Yes, that's the plan. They'll be able to do that.

CHAIRMAN WOOD: As a practical matter, that will put a lot of the generators closer to the seam at the heart of your market.

MR. TORGERSON: Exactly, yes.

COMMISSIONER MASSEY: Just thinking.

CHAIRMAN WOOD: It's scary sometimes.

(Laugher.)

CHAIRMAN WOOD: Rich?

MR. WODYKA: I'd just like to add a few brief updates on a couple fill-in-the-blanks that Jim did not cover. The impacts upon PJM specifically I guess, the progress we're making toward PJM's specific conditions from the July 31st order. I'll give you a brief update on our key event timelines, what we've accomplished since the last update, and some of the key milestone events in front of us.

A specific update on the PJM MISO reliability seams issues that we're working on and the progress we're making towards resolution of those and just a brief update on our events technology and issues that are going to enable the improvement of reliability as well as development of the market structures across our expanded territory.

On the July 31st order progress, there are a couple of conditions relating to the establishment of ITCs associated with RTOs and PJM. A couple of the conditions dealt directly with National Grid and the participation of Transmission Energy, Com Ed, and at the time Dayton to form an ITC. They're related to us, but that's really their business issues.

What I can report to the Commission is that in October, AEP and Com Ed decided that they wanted to continue their intent to develop an ITC with National Grid. Dayton at that time decided to pull out of that arrangement and just become a standard transmission owner under PJM.

My understanding is that AEP, Com Ed and National Grid are still in discussions establishing their business case to establish this ITC under our activities.

(Slide.)

More important from PJM's involvement, our responsibility was to come up with a split of functions that any ITC could utilize under the PJM RTO structure. And this is important for us in order to facilitate one or more ITCs under our RTO structure.

I am pleased to say that last week we filed our standard terms and conditions and our standard division of rights for the responsibilities and functions of an ITC to operate within PJM as well as a pro forma ITC agreement that would be utilized by this forming ITC or any other ITC that would run a form under PJM. We worked very extensively with the National Grid to come up with this split of functions and responsibilities as well as all the PJM stakeholders who were very involved in the debate of how these functions should be split out.

I can say that probably we have 95-percent consensus in the split of functions. There just remain probably a handful of issues that need Commission guidance for us to move this process forward within the PJM footprint.

That filing has been made and we anxiously await the Commission's Order on the couple remaining key issues that have to be resolved. We think this is the blueprint for the Commission of how to put the RTO/ITC split of functions under an established full-function RTO that has full functioning energy markets, as well as a regional planning process.

That's an important blueprint, I think, for the industry moving forward.

(Slide.)

MR. WODYKA: I know that Jim's interested in this issue, as his markets get established how these splits of functions should work with his ITC as well.

Our key event time line, I am pleased to report that since the last report we have, as Jim noted, gotten NERC's approval on our next version of our reliability coordination plans.

(Slide.)

MR. WODYKA: This involves providing transmission service for day one, which I will speak about in a minute.

Also, the new transmission owners and the existing PJM transmission owners have developed a rate design that was filed with the Commission in December, and also the tariff and operating agreement change that are needed to implement the new transmission owners within the PJM boundaries were filed.

We're currently working to set up our OASIS. We would offer this new transmission service to all the new transmission owners under the PJM tariff, and we are waiting for the day one operation for AEP and Com Ed to begin transmission service.

Our original target date was to begin to offer transmission service through this new OASIS on January 2nd and start on February 1st. Unfortunately, we're on a month-to-month delay until the Commission rules on the rate filing.

We cannot offer service under this new expanded geography, so if the Commission comes through with an Order this month, we will begin offering service on February 1st through the OASIS for the expanded territory for implementation on March 1st.

If we don't get an Order till February, then we're on a month-by-month basis. The technical structure is ready to go.

CHAIRMAN WOOD: That's for the filing that was made.

MR. WODYKA: On December 15th, in that timeframe. So I feel very confident that the technical infrastructure is ready to go, ready for day one operations. We're working hard towards appointing day two operations, which is the full integration of AEP and Dayton into the PJM marketplace.

We need to resolve the seams issues that I will talk further about in a minute. We also need to get through our state regulatory approvals, as well as any other further Commission approvals on the rates, and operating agreement filings, we've made.

(Slide.)

MR. WODYKA: But the technical infrastructure, I believe, will be ready to be started up on May 1st for an implementation of AEP and Dayton. We are targeting Dominion in October of this year and Com Ed by the end of the year, to fully integrate all the new transmission owners into PJM's operation planning and markets.

Any delays, though, in the implementation of these day two operations into our full function markets could impact upon the common market activities we have going with MISO, which are scheduled by the end of 2004.

We are at risk, a little bit, from making sure that we get these things done this year, in order to focus our time, attention, and resources for working with MISO on the activities necessary there.

We also do need to get the next increment of our reliability coordination plan. That is a critical event milestone that we need to get accomplished in order to move forward with an AEP and Dayton integration in May.

The reliability seams issues, Jim touched on several of these. The congestion and allocation issue, we talked about a couple of times already.

We developed several solutions. There have been white papers published to the stakeholders. There's a meeting in Chicago tomorrow that we're continuing our dialogue and debate and trying to produce a resolution of how these things are going to work.

This will enable us to model, track, and operate for congestion across our seams. What it doesn't do is what I suggested earlier, which is to handle the equity issue of the transmission allocation that we could help with your guidance on.

ATC-AEFC coordination, this is new technology we've implemented. It provides more automated and better information to the marketplace.

We're real excited that that's going to give us better coordination and improved reliability as we move forward. Contract tie capacity is tied to the congestion solution we're developing.

On definitions and procedures, we've done initial drills. We found some issues and we're correcting those issues and we're moving forward.

Voltage operating procedures have been already incorporated into our new reliability plans that have recently been approved by FERC, so we have agreed-upon procedures there, as well as agreed-upon procedures for outage and maintenance coordination, and we're working on the expansion planning and activities, and I don't see any deal-breakers or show-stoppers there, as well.

(Slide.)

MR. WODYKA: The seams issues update: We're continuing to work with all the stakeholders and we're continuing to work specific issues. We're working on conceptual designs and various technical solutions. We're going to be ready to implement these things when solutions are finalized.

This is a very aggressive timeframe that we need everybody's cooperation and support on. Jim's staff and PJM's staff is working diligently to make all this happen, but we could use your help in addressing the equity issues we talked about earlier, the rate issues.

(Slide.)

MR. WODYKA: Advanced technology: In the July Order, again, there was an encouragement to us to optimize the use of new technology and introduce new technology to enhance our ability to monitor and manage the grid, as well as develop a common market.

I'm pleased to say that we are doing these things, and this is just a brief list of some of the things we are doing to leverage technology in order to improve reliability.

This new automated through-gate capability is going to increase the adequacy and provide us better coordination between the two systems, using real-time telemetry and state-estimated data to replace our static modeling.

With the NERC interchange distribution calculator, we'll increase the accuracy of that data, so that we can make better real-time decisions on where the congestion is and how to relieve those things.

CHAIRMAN WOOD: What's the time line? You said "proposed" and "use of."

MR. WODYKA: We have to work through the NERC process to do that. We've already made that proposal through the appropriate NERC subcommittee, and we're having a dialogue of how that could work with them.

CHAIRMAN WOOD: What kind of issues would come up that could slow that.

MR. WODYKA: Whether their technology could receive that real-time data, I think, is the issue. They need to change their technology to have a more real-time telecommunications link between the data we can feed them in real-time, versus how the data is input.

CHAIRMAN WOOD: PJM is the security coordinator for that area, as is MISO for that area, so feeding it to them, it then goes to the NERC?

MR. WODYKA: To the NERC IDC, correct. PJM is using an automatic program, which makes it easier and faster for us to build the displays that our system operators, as well as others use to operate the system.

It makes it easier for us to implement these things from a software perspective, as well as to change what we need to change, moving forward.

We've leveraging the Common Information Model. This provides, again, model accuracy between our systems, as well as this synchronization of the models between us and MISO, as well as the other ISOs for making sure that the model that we are using in our security analysis tools, as well as the models they are utilizing are synchronized and getting the same results.

We've prototyped the parallel processing method that's going to analyze our transmission system continuously, and what that enables us to do, as we expand our market growth and doubled the size of our territory --

in essence, we want to be able to analyze the system conditions in the same timeframes we do today.

We have to apply new technology to our infrastructure in order to do that. We have, and we think, with very promising results. And we've developed some Internet tools for, again emergency communications with state regulatory commissions that are stakeholders, as well as our neighboring systems, so that when we get in a bind, people know what's happening; people know what kind of conditions are on the system.

All these things, individually, I think, are providing us benefits, but, collectively, all these types of technical initiatives that we're doing, I think, are going to leverage enabling us to not only maintain reliability, but improve reliability as we implement these marketplaces. I am very pleased to report that.

CHAIRMAN WOOD: With regard to all the stuff you talked about, what are the three things you are most worried about?

MR. WODYKA: I'm most worried about our state regulatory approvals that the new TOs have to get from the states to move forward; timely Commission response to the rate filing that was made to enable us to move forward with the implementation from your perspective.

CHAIRMAN WOOD: The 1210 fling?

MR. WODYKA: Correct. And, again, there's an area of activities that we're doing with MISO. We have very close coordination and cooperation, but the devil is always in the details, and that keeps me up at night as far as making sure that we're not missing anything.

CHAIRMAN WOOD: I will count on your four gentlemen and your respective organizations to let us know in real time, what you need us to do to support your efforts, because we view, quite frankly, what you're doing in restructuring wholesale markets in this whole region of the country as being a very critical item for us in our regulatory responsibilities and for the benefit of customers that you all are serving.

Do you know who to call? And if you don't, call me and I'll get you the right person. But we do appreciate the time you all took here today. Are there any more questions for these gentlemen?

(No response.)

CHAIRMAN WOOD: We appreciate the efforts that you and the many people behind you are going to make to integrate these markets. We'll meet again in about a calendar quarter or so, and until then, thank you very much.

We'll take about a two-minute break and conclude with Item A-5.

(Recess.)

CHAIRMAN WOOD: Our last item today is A-5.

SECRETARY SALAS: The next and final item for discussion is A-5, discussion of the Commission's use of natural gas price indices, with a presentation by Stephen Harvey, accompanied by John Carlson and Marsha Gransee.

MR. HARVEY: Good afternoon. Over the past year, Staff has gathered information that raises serious doubts about the accuracy of information reported in many wholesale natural gas price indices. Current industry practice is for the trade press to gather price information by polling traders.

We have seen ample evidence to raise serious questions regarding the functioning of this current industry practice. The natural gas industry cannot function without accurate, dependable, and trustworthy wholesale price information.

Consequently, some action must be taken by the industry to address the problem. We also propose action by the Commission to assure that the orders and tariffs it approves reflect accurate price information.

We would like to review our concerns today by first explaining the Commission's interest in price index formation; second, reviewing the public evidence that raises questions about price index formation; third, defining at a high level, the criteria important to developing trustworthy price information in the future; and, fourth, proposing some next steps.

The Commission's interest in natural gas price indices relates both to the overall functioning of the wholesale market, and to specific orders it has approved that reference these indices. In the 1980s, the natural gas industry developed an approach to developing and disseminating wholesale price information, using indices created and published by the trade press.

This practice followed the more established practice in oil markets. Soon thereafter, certain orders and tariffs proposed by natural gas companies and approved by the Commission, contained references to these price indices.

Natural gas price indices developed by the trade press remain central to the functioning of the wholesale natural gas markets.

Customers depend on these published price indices to make purchasing decisions. Numerous physical contracts refer to these price indices explicitly.

Financial contracts that value the difference in prices between locations across the natural gas delivery system known as BASIS, refer to these price indices.

Companies interested in investing in exploration and production, transportation and storage, rely on these prices to estimate the value of assets.

The Commission's current vision is dependable, affordable energy through sustained competitive markets. This vision cannot be achieved without the development and dissemination of fair and trustworthy price information.

More specifically, the Commission approved pipeline tariffs that refer to market price data. There are three areas where these references tend to happen: First, cash-out provisions.

On most major pipelines, when deliveries and receipts of natural gas are not in balance, the differences may be valued and sold to the shipper or purchased by the pipeline, using market price information.

These cash-out provisions allow the industry to quickly and efficiently account for and eliminate imbalances.

Second, pipeline penalties: In the determination of pipeline penalties, the Commission sometimes allows pipelines to use market prices to deter shipper conduct that could threaten system operations.

Third, basis differentials: Many negotiated rate transportation contracts establish transportation rates, using the basis differentials between two or more price-indexed trading points. The Commission does not approve natural gas price indices for market-based rates that are largely the result of contract negotiations between parties, however, failure of confidence in these bilaterally-negotiated prices could raise concern.

On August 13, 2002, Commission staff made publicly available, the initial report of its fact-finding investigation of potential manipulation of electric and natural gas prices in Western markets, Docket Number PA02-2. Staff inquired into the characteristics of publicly-recorded price indices, including natural gas spot prices at California delivery points, used in the California refund proceeding.

Staff found significant problems with published price indices. These problems included: First, the inability to independently verify published price indices. The sources of price information have not been disclosed, due to the publisher's concerns about revealing source data.

Second, undetected errors that may exist because trade publications reporting spot and foreign prices do not employ statistically valid sampling procedures or systematic formal verification procedures.

Third, significant incentives of market participants to manipulate spot market prices reported to trade publications because natural gas is the fuel input for the electricity generators that set the market price in

California.

Fourth, wash trades may have an adverse effect on reported price data.

Fifth, Enron Online, Enron's former electronic trading platform, was a significant source of price discovery and information, and was potentially susceptible to manipulation by market participants, which could affect the published price indices.

The final report from Staff handling this investigation is scheduled to be released in the first quarter of this year, and will offer its own analysis, conclusions, and recommendations on standards for indices.

Since the issuance of the Staff initial report, five companies have admitted that some of their employees provided false data to the trade press that publish energy price indices. On September 25, 2002, Dynegy announced that they had discovered that 15 Dynegy employees had engaged in reporting false data to trade publications that publish price indices.

On December 18, 2002, the Commodities Futures Trading Commission announced that it had reached a $5 million settlement with Dynegy and West Coast Power, LLC. The sum of it stated that Dynegy had, quote, "knowingly submitted false information to the reporting firms in an attempt to skew those indexes to Dynegy's marketing and trading financial benefit."

On November 8, 2002, the El Paso Corporation announced that it had discovered evidence that one of its employees had misreported trade data to the trade press. On December 4, 2002, the United States Department of Justice indicted Tom Gyger, a former Vice President of El Paso Energy on charges of false reporting and wire fraud.

On January 13, 2003, El Paso issued a statement saying it had found more instances of its traders providing inaccurate information to inside FERC.

On October 9, 2002, AEP announced that it had, quote, "dismissed five employees involved in natural gas trading and marketing, after the company determined that they provided inaccurate price information for use in indexes compiled and published by the trade publications.

On October 25th, 2002, Williams announced it had learned that natural gas price traders had provided inaccurate information regarding natural gas trades to an energy industry publication that compiles and reports index prices. Williams stated that the inaccuracies came to light during Williams' independent internal review of its trading activities.

On November 4th, 2002, CMS announced that it was conducting an internal review of the natural gas trade information provided to the trade press by two subsidiaries, CMS Marketing Services and Trading and CMS Field Services. CMS stated that a preliminary analysis indicated that employees had provided inaccurate data. CMS further stated that it would take appropriate disciplinary action and it would stop providing information to the trade press.

In the future, Staff proposes that the Commission require that certain minimum standards be met before natural gas pipelines are permitted to use natural gas price indices in new tariffs or for other new regulatory purposes.

Evidence for these new filings will need to be presented and reviewed to assure that any price index meet minimum index formation standards. In particular, the index would need to represent an accurate reflection of the market. To be approved, a new tariff containing a reference to an index would need to be shown as demonstrating first competence in the accuracy of price reporting, that is, the ability to verify the reporting of deals actually done, not simply aggregate opinions.

Second, adequacy of coverage, that is, the ability to assure the collection of adequate information to represent prices across the relevant marketplace well.

Third, information about market liquidity or some insight into how much trading is going on at a particular point in order to generate warnings from markets and confidence for more liquid for verifiability, the ability to ensure integrity of the process through independent review through a trustworthy third party.

Staff suggests that only after assuring the Commission that these conditions have been met, should the natural gas pipelines be approved for use under the new tariff. In summary, these reports raise serious doubts about the accuracy of the information reported in many natural gas price indices. The market cannot function without accurate dependable trustworthy wholesale price information.

The industry must take the lead in solving this problem. Staff is tracking several efforts to develop new approaches to solve it. Additionally, Staff proposes that the Commission require any new pipeline tariff reference to natural gas price indices be shown to meet the standards of accuracy, adequacy of coverage, information about market liquidity and verifiability as outlined today.

Thank you.

CHAIRMAN WOOD: Thank you Steve. I appreciate the efforts that have gone on across the staff to look at this issue. It's unfortunately not a one-day story from what came out in August in the Staff's initial report in PA02 and the subsequent information, I do think it's fair to a caveat out there that all the reports that have come in, we're not sure what impact that those did have on natural indices that are being used by parties are being used for all proceedings but I think it's important for all of us to be ahead of that curve and to provide some leadership as to what part of the universe it applies to us, expecting full well that that same leadership will have repercussions for other uses of gas.

The gas transition from a highly regulated industry to a very competitive one is one of the great moments of this Agency's history and I want to make sure that the actions we take in 2002 do not erode the significant benefits for customers that have come as a result of FERC and Congressional initiatives in the gas industry. I do fear, however, that the erosion of confidence in the gas indices that has taken place in the past six months particularly, as this has come more and more to public realization may well impede the benefits that customers get from this industry working as well as it does and I do look forward to constructive and thoughtful solutions from parties across the board to resolve this issue. And I'm pleased with Staff's thoughts in that regard and hope that can help inform and frame the debate going forward.

COMMISSIONER MASSEY: Thank you for this report. Let me ask you a couple of questions. On page five, it says in the future Staff proposes that the Commission require that certain minimum standards be met before the natural gas pipelines are permitted to use natural gas price indices in new tariffs or for other regulatory purposes. What about the existing purposes if these indices are inaccurate? What are we to do? Do you have any recommendations?

MR. HARVEY: At this point, the industry does have several initiatives looking at making revisions even as we speak. Those changes potentially could improve, possibly improve the performance of these indices. At this point, it's not completely clear exactly what will happen with regard to that kind of price formation. We have not spent time looking at all the existing orders and determining anything there.

COMMISSIONER MASSEY: I guess I was focused more on the question of Commission policy with respect to the existing use of indices that may not be accurate, existing tariffs, thing that are already on the books that are being relied upon. What should we do about that?

MS. GRANSEE: Commission Massey, I would assume that to some extent we would rely on parties bringing complaints before us if they feel that there's an unfairness going on there. As we detailed here on I think it was page two, where those are used, they're used in pipeline tariffs now in fairly limited instances for cashouts and penalties. Our policy all along on penalties has been that we hope that, for the most part, penalties are never actually used. I think the cashouts are used now to some extent but I think that those are used in fairly narrow circumstances today.

Of course the Commission could also undertake Section 5 action on a pipeline's tariffs but as you know, if we did that, the Commission would bear the burden of proof to change the company's tariffs at this point.

COMMISSIONER MASSEY: Thank you. A couple of other questions. It seems to me that much of this paper would also apply to spot electric indexes as well. We rely and certainly the marketplace relies on a number of these indices. COB, Paloverde, a number of others that are used as pricing plans. They've been used in Commission orders approving proposals to rely on those pricing points for ancillary service transactions and other kinds of transactions.

I have the same concerns with respect to the accuracy of the electric indices, and wondered if your looking at this and your reporting on this explored the electric market as well, or did you limit yourselves to the gas market?

MR. HARVEY: To my knowledge, we have not seen public information with regard to electric price index formation but certainly the formation would be similar and some of the same concerns would apply because we did not specifically look at it and we have not again, to my knowledge, seen public information as we went through here on natural gas indices with regard to electric. We did not pursue that.

COMMISSIONER MASSEY: It would seem to me that some of the same concerns would be applicable there too. I suppose that once there's an RTO functioning in every region of the country with transparent spot prices, locational marginal pricing that we solve a lot of these problems for the electric marketplace with respect to the validity of electric power indices. Would you agree with that?

MR. HARVEY: Absolutely. A much clearer resolution of price discovery.

COMMISSIONER MASSEY: The other question I have, I was talking to Pat about this yesterday, is a question I have about the involvement of the Energy Information Administration in gathering this data, gathering price information. At some point in the debate over this question for the past six months to a year, I know that issue was in play whether EIA would take this on as a responsibility, and I wanted to see what my colleagues know about that and see what Staff knows about that.

Is that a viable option? Is that a good idea, bad idea? What is your thinking about it.

CHAIRMAN WOOD: I met with the new administrator, Guy Caruso, about a month or so ago and I think certainly it's a resource issue for them and taking over the storage data has certainly been a challenge. You know, at that stage, I guess it was a little before some more of the dominoes kept coming. I think there's a strong institutional desire to have but I think we all know somebody on the government side of the fence has got to do it and we're going to have to talk about that.

Again I mentioned to them, I've got an open mind. This could perhaps be solved on the industry side of the fence, but quite frankly on the electric side, with order 2001, which we promulgated last year, we therefore have an underlying cushion that data come in from across the entire industry and that therefore the index is ultimately auditable, so we have to define it based on required data.

There are different roles that we need to play. I quite frankly did not move down that path. It's just not a place where it's quite as ripe as it is today.

COMMISSIONER BROWNELL: In answer to your question and kind of part of where I would like to us go with this, I for one think it's interesting. We've all read the newspapers and we're glad people have stepped up to the plate. But I haven't seen any substantive evaluation about the scope of the problem, the history of the problem, the impact of the problem and while I understand the press's reluctance to share source information, that's a long history in our country and I appreciate that. I think we have a whole lot more work to do before we come to any conclusions and so I would support aggressively pursuing this and getting a better understanding of what the issues really are before we try and provide an answer.

I'm assuming we're working with other agencies who are also concerned about this issue. Is that correct?

MR. HARVEY: Yes, we have had some conversations.

COMMISSIONER BROWNELL: I think we did get 20 or 30 sets of recommendations in the process of the West-Wide investigation, is that correct?

MR. HARVEY: I'm not exactly familiar with the West-Wide investigation but I believe they have been reported to have been discussing this issue.

COMMISSIONER BROWNELL: I would like to see us hold a technical conference in the not too distant future to really define the problem, maybe a cosponsored one with one of the other relevant agencies, and look at the range of solutions that have been recommended.

I know there are some industry initiatives. I think your set of recommendations reflects one of them but there is a problem and reading about it in the newspaper every day makes it more of a problem. I just wanted to understand how much more of a problem it was and what the impact really is so that we can craft a solution that is appropriate to that.

COMMISSIONER MASSEY: I agree with everything you just said.

CHAIRMAN WOOD: We will get ready if that's the right way to attack this. Any further questions or comments for Steve?

(No response.)

CHAIRMAN WOOD: Thank you for your efforts. We will continue to discuss this issue as days go forward. Anything else?

(No response.)

CHAIRMAN WOOD: Why don't we meet about 1:30. The Open Meeting is adjourned.

(Whereupon, at 12:35 p.m., the open meeting of the FERC was adjourned.)