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Good Afternoon. My name is Randy Rismiller and I am the Manager of the Illinois Commerce Commission's Federal Energy Program. My remarks today are my own and not necessarily those of the Illinois Commerce Commission or any of its Commissioners. Today I'd like to talk about efficient price signals, the impact of those signals on market participant behavior and the implications of that behavior for resource adequacy.

The resource adequacy construct argument has tended to evolve into two basic schools of thought concerning how to incent the development of electricity infrastructure for long-term resource adequacy. One side promotes an administrative approach that enforces arbitrarily determined reserve margins and the other side advocates an "energy only" market that relies on efficient price signals to induce desired behavior. I should point out that the term "energy-only" is a misnomer. In particular, an efficient price signal for electricity service would reflect all of the costs and risks associated with the provision of electricity, including the costs and risks associated with the capacity needed to supply energy and operating reserves in the operating-day time frame, as well as capacity, if any, above that amount in the form of planning reserves to ensure resource adequacy.

An efficient price signal would also incorporate into the market all of the costs and risks currently dealt with separately through arbitrary RTO uplift charges, and it would address scarcity conditions.

In the past, the Commission has expressed a willingness to accept so-called "energy-only" market designs. For example, in a June 22, 2007 Order in a Midwest ISO case, the Commission stated that it has not mandated any one particular method of providing the proper investment incentives to ensure long-term resource adequacy, "but has instead endorsed the idea that an energy-only market may be one such reasonable method."[1]

The Commission also encouraged the Midwest ISO to design a market that provides the correct financial incentives "so that sufficient quantities of reserves of all types are available to the system operator at all times, but especially during shortage conditions" and that proper financial incentives exist to support any needed new entry, either supply or demand side.[2] The Midwest ISO's recent resource adequacy filing seems to show that the Midwest ISO may have declined the Commission's invitation to file a so-called energy-only market design in favor of a mandated administrative reserve margin approach. However, the Commission's endorsement of an energy only market still stands as a viable option for all RTOs.

In its recent Notice of Proposed Rulemaking regarding Wholesale Competition in Regions with Organized Electric Markets, the Commission acknowledged the importance of efficient price signals. In that NOPR, the

[1] *Midwest Independent Transmission System Operator, Inc.,* 119 FERC ¶ 61,311 (2007), at P. 137
[2] *Midwest Independent Transmission System Operator, Inc.,* 119 FERC ¶ 61,311 (2007), at P. 137

Commission concluded that existing RTO market designs may be unjust, unreasonable and unduly discriminatory or preferential because they prevent prices from accurately reflecting the true value of electric service. The Commission concluded that such market designs may harm reliability, inhibit demand response, deter new entry of demand response and generation resources, and thwart innovation.[3] I could not agree more. When price is disconnected from the true value of energy, market participants have little incentive to act in a manner consistent with efficient markets.

A market design featuring efficient prices would incorporate the costs of needed operating reserves and any needed planning reserves into the price signal. It would also incorporate into the price signal the cost of the diminished reliability that would occur during periods of shortage so as to achieve efficient economic signals for investment in generation, demand response and transmission. An efficient market design would also establish incentives for minimizing costs and increasing service quality.

The reticence to employ an efficient market design where energy and ancillary services prices are allowed to rise to levels necessary to induce the development of efficient amounts of supply and demand side resources appears to be because, without sufficient price elasticity of demand, such a market design would generate prices that would result in political intervention or set up conditions that would provide resource providers with an opportunity to exercise market power.

[3] *Wholesale Competition in Regions with Organized Electric Markets,* 122 FERC ¶ 61,167 (2008), at P. 107

AFPA has referred to this as a “chicken and egg problem” because it would require that prices be allowed to rise to efficient levels in order to induce investment in demand side response equipment needed to develop sufficient levels of demand elasticity, but it would prohibit prices from rising to efficient levels so as to preclude political intervention or exercise of market power unless there is already sufficient demand elasticity in the market.[4]

The response to this conundrum seems to be a desire by some to carve out certain costs, such as capacity and capacity planning reserves, for recovery via non-market or quasi-market mechanisms. One of the problems with such an approach is that capacity markets and other capacity constructs that are either in place or under development, force market participants to hedge everything, primarily with forward capacity, and obliterate the price signals necessary to induce investment in equipment needed for increased price responsive demand. A better approach would be to develop mechanisms to allow the market participants and customers in a position to quickly invest in demand response capability to voluntarily be exposed to the efficient price levels and reap the rewards of their investment, while allowing risk averse customers and market participants not in a position to offer demand response to forward hedge against the expected prices.

It is reasonable to question whether the Commission faces a true chicken and egg conundrum in this instance. The willingness and readiness of market participants, customers and state officials to invest in infrastructure to enable price

[4] Comments of the American Forest and Paper Association in FERC Docket No. RM07-19-000/AD07-7-000 (September 14, 2007) at 17.

responsive demand has already been demonstrated by the progress made on linking retail rates to the spot market price and in evaluations of advanced metering infrastructure. By employing capacity constructs that dampen efficient price signals where they should not be dampened and by raising total costs through inefficient capacity market designs that mandate certain kinds of hedging, the Commission risks killing the chicken or cracking the egg of price responsive demand.