

ELCON REPORT

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NUMBER THREE

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FERC Proposes Standard Market Design, ELCON Supports Key Provisions

The Federal Energy Regulatory Commission (FERC) on July 31 issued its long-awaited notice of proposed rulemaking (NOPR) on standard market design (SMD) with some innovative proposals that would significantly restructure the wholesale electricity market. The proposal's potential impact has led some to call it a "giga-NOPR."

Most important from ELCON's perspective, the proposal embraces the objective of competition and reduced costs for consumers. It supports the concept and implementation of regional transmission organizations (RTOs) or their equivalents and strongly endorses independent governance and appropriate stakeholder representation.

Although, as expected, FERC used the "PJM Model" as the platform for SMD, it included several measures to address shortcomings that ELCON and others had pointed out. These include the elimination of the installed capacity requirement, a fair allocation of what are now called "congestion revenue rights" (previously financial transmission rights or FTRs), the

adoption of strong market power mitigation measures, and the introduction of option and flowgate rights.

The Commission endorsed the concept of locational marginal pricing (LMP), which is part of the PJM model and is something ELCON has long opposed for its complexity and lack of transparency. While inclusion of LMP is a *fait accompli*, ELCON is encouraged by FERC's willingness to consider modifications to LMP as it finalizes its rule.

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Energy Bill Not Very Consumer Friendly

The conference committee representing members of the House and Senate selected to resolve differences between their two versions of the comprehensive energy bill (HR 4) met twice before the August recess, first for pro forma opening statements, then for staff assignments from conference chairman Billy Tauzin (R-LA) to develop negotiated compromises on several contentious issues -- including electricity. Work done over the recess will allow conferees to address the issues in early September.

Members of Congress, as well as representatives from the Administration, have stated continuously that their objective is to produce a pro-consumer bill with provisions on electricity. Yet, as the bill has progressed, ELCON has found few -- if any -- pro-consumer provisions. The Senate bill has several notably anti-consumer provisions. The House bill does not

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even address electricity issues, but several House conferees, including Joe Barton (R-TX) chairman of the Energy and Air Quality Subcommittee, have stated that they hope to change this. ELCON believes such additions would make the total package less attractive to consumers, not more so.

Given the transition in wholesale and retail markets and the existence of market abuses, it is more important than ever to have a strong market monitor and enforcement role at the federal level. The Senate bill is silent on this.

A significant shortcoming in the Senate bill is the "reliability" section,

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Uncertainty and Volatility: My Perspective

As the energy manager for a large corporation, one of my responsibilities is to minimize risk. That is never easy under the best of circumstances since energy prices are historically erratic and unpredictable. In addition, my company's electricity and gas demands hinge on our production schedules which, to some extent, are related to consumer demand and price for product. I cope with uncertainty every day.

As chair of ELCON for 2002, one of my tasks is to ensure that ELCON continues to represent the views of large industrial electricity consumers. That includes making sure that the annual ELCON/PGC seminar is topical and provides the types of presentations that will help other energy managers do their jobs.

Since my company is an energy producer and supplier as well as consumer, we track energy markets closely. Our staff is always busy. I don't think that I have ever seen such uncertainty and volatility in gas or electricity markets. Managing the risk in a volatile market has occupied much of my time this year. So it was almost a "no-brainer" to focus on uncertainty in planning the seminar this fall.

We are fortunate that several big "names" in the energy industry -- people like FERC Chairman Pat Wood and Alliant CEO (and Edison Electric Institute Chair) Erroll Davis, who will be shaping energy markets and policy -- have agreed to participate in the seminar. If history is a guide, the Q&A at the seminar will be as valuable to me as the presentations.

As an advocate of free and open markets, I recognize that price fluctuation -- in its extreme, that's volatility -- is an unavoidable by-product. As a company, we don't want the prices of our energy sources and feedstocks to be fixed (though we get heartburn when they are priced too high). And we certainly don't want the price of our product to be fixed, even when supply and demand push that price

By Carol
Hyams
Guthrie,
ELCON
Chair

to a level where consumers may experience enough short-term pain to alter their consumption patterns.

Are those supply and demand curves that I remember from Economics 101 still the driving force for price volatility? In recent months, we have heard that market

manipulation may have had as much impact on energy price as supply and demand. We are also learning that investors and consumers, including industrial consumers, may have been deceived by some participants who abused open markets, and that these abuses also contributed to market volatility.

In California, where I live and work, we have literally seen an electric market collapse and be deconstructed. Hopefully, we will see the wholesale and retail electric markets reconstructed in a way that makes some sense. The cause of our market failure in California was complex. A full spectrum of theories has been offered -- a poorly designed plan, a shortage of generation, market manipulation by generators and others -- to explain events that would baffle Sherlock Holmes. But the fact is that, in California and around the country, uncertainty and volatility are an integral part of open and competitive markets that we navigate every day in our businesses.

California and several other areas now have market monitors to watch for market power abuse and market-distorting activities. But there is no textbook for them to read. No one has published "Market Monitoring for Dummies." It will prove to be a self-taught job. Will market monitors be able to make ISOs and RTOs user friendly, or will they become part of the problem? For energy managers, that question is more real than it is rhetorical.

These are the kinds of questions that my colleagues and I are facing on a day-to-day basis. And these are the kinds of issues that will be addressed at the 20th

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Opportunities Seen For Demand Response

The Federal Energy Regulatory Commission's Standard Market Design (SMD) proposal offers opportunities for development of demand response mechanisms through requirements for regional transmission organizations (RTOs) to operate day-ahead and real-time markets for energy, ancillary services and congestion, and separate markets for capacity, ELCON Executive Director John Anderson told the Electric Power Supply Association (EPSA) at its annual meeting recently.

These are the natural markets for demand response, he said.

Demand response is a physical transaction by retail customers in the real-time, wholesale spot market as well as a financial transaction in the day-ahead market, Anderson said. It is not a "back door" attempt at customer choice.

Demand response customers do not "bypass" the load-serving entity except where allowed by state law or regulations, but states deny development of such markets at their risk, he said.

Demand and supply resources should be treated equally in all markets, he said. Demand response markets -- not programs -- should be created, he stated.

Anderson said FERC's proposed SMD requires RTOs to operate relevant markets and to develop market power mitigation rules, a market monitoring plan and a regional transmission planning process. Demand response should be an essential feature.

The ISO/RTO should establish rules, facilitate markets and play the role of lifeguard/policeman, Anderson said. Market rules designed for supply resources should apply equally to demand resources.

Many people now clearly understand that we can't have a real electricity "market" without both the supply and the demand sides to the equation, he said. E

SeTrans RTO Model Laudable With a Few Changes, Industrials Say

ELCON and ally industrial groups filed comments with FERC commending, with a few exceptions, the governance structure and business model of SeTrans' proposed regional transmission organization (RTO). SeTrans is seeking FERC approval of its governance structure and business model, not the formal RTO. A separate market design protocol is under development.

An incentive-driven, independent system administrator (ISA) would manage but not own the transmission facilities dedicated to the RTO. It would assume the essential functions of an RTO except for market monitoring, which would be performed by another organization.

The industrials were particularly happy with three points about model: 1) it separates transmission ownership from operation, averting a situation where a self-interested market participant makes decisions about congestion and transmission that do not further the public interest; 2) it allows appropriate performance incentives not associated with asset ownership; and 3) it facilitates the participation of public power entities, inviting more utilities under the RTO umbrella.

On the other hand, the industrials had concerns with some features of the model, such as SeTrans' plan to use participant funding for certain new transmission expansions. Participant funding refers to a

mechanism whereby one or more parties seeking the economic expansion of a transmission network assume funding responsibility. The opposite is base funding, in which upgrades to maintain adequate reliability are paid by all customers.

Generally, participant funding should be required where expansion will only benefit an identifiable customer or group of customers, they said. (See below ELCON's participant funding principles.)

On SeTrans' proposal to accommodate

grandfathered transmission rights preferentially, and to encourage holders of physical rights to convert to financial rights, the industrials urged FERC to inquire into the extent of the grandfathering and to evaluate the effects of the conversion plan.

Third, while complimenting SeTrans for its stakeholder advisory committee (unlike some, this one gives industrial customers their own seat), the industrials asked FERC to ensure continued balance between the supply side and demand side over time on this and all RTOs boards.

Joining ELCON in the filing were the American Iron and Steel Institute and the American Chemistry Council. **E**

ELCON's Principles for Participant Funding Of New Transmission Projects

- Rolled-in rate treatment is appropriate for a new transmission project if it is 1) necessary to maintain reliability or 2) will likely increase economic benefits to customers in excess of the project's cost.
- Participant funding should be required where transmission expansion will only benefit an identifiable customer or group of customers. After some period of time (but less than the economic life of the project), if the benefits begin to accrue to a broader group of customers, some form of crediting mechanism should be established to reimburse the original funding participants.
- The RTO or transmission utility must show that the costs of a new or upgraded transmission facility should be recovered by participant funding.
- Regulators should exercise considerable discretion when evaluating the merits and financing of any new transmission project. The risk is low that too much transmission will be built and higher that too little will be built, harming consumers. However, regulators must also recognize that transmission investments tend to be "lumpy" because of scale economies. Incremental expansions may be inefficient in the long run and more costly to consumers.
- Providing financial transmission rights (FTRs) in exchange for participant-funded investment is meaningless. The project will likely reduce or nullify the value of the FTRs and may encourage piece-meal development.
- The criteria proposed by SeTrans to identify projects for participant funding assume continuation of the contract-path method of transmission pricing, which the proposed SMD is expected to abolish.
- If other forms of capacity rights to new transmission are adopted as a quid pro quo for participant funding, the owner(s) of any such capacity rights must not create new transmission bottlenecks and thereby exercise market power by the economic or physical withholding of that capacity. **E**

Chair's Column From Page 2

Annual ELCON/PGC Seminar this October 10-11 in Arlington, Va., just outside of Washington. This year's topic is "Coping with Uncertainty and Volatility: An Energy Manager's Dilemma." If these are topics of interest to you and others in your company, I hope you will join me in October. Come up and say hello. We can compare notes on how we are coping.

*Carol Hyams Guthrie is General Manager,
Electric Market Strategies,
ChevronTexaco*

Coping with Uncertainty and Volatility: *The Energy Manager's Dilemma*

October 10-11, 2002
Hyatt Regency
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For nearly two decades, the ELCON/PGC Seminar has brought together leading experts and advocates in electricity and natural gas to analyze and debate the pivotal issues. This year, the Seminar, will be unsurpassed in terms of influence and leadership on both sides of the issues.

WHO SHOULD ATTEND

Business, consumer, and government interests with a stake in the supply of electricity and gas such as:

- Energy Managers
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- Energy Policy Analysts

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For more information and registration visit www.elcon.org. or call 202/682-1390.

Can Markets be Made User Friendly?

- Will Standard Market Design work to benefit consumers?
- How can gaming be eliminated?
- What should Market Monitors be doing?

Price Volatility – What Can be Done?

- How much volatility is healthy in gas and electricity markets?
- Can customer response mitigate volatility?
- What is the role of fuel switching and fuel diversity?

Are Trading and Derivates a Cause or a Cure?

- What are the fundamentals in electricity and gas trading?
- Should electricity and gas trading be subject to more regulation?
- Does the use of derivatives provide any “positives” for consumers?

Is the Infrastructure Sufficient?

- Is there enough pipe for increased demand for natural gas?
- Can the market coordinate increases in supply and demand for gas without volatility?
- Is there enough transmission capacity in a changing electricity market?
- Are incentives or other new pricing mechanisms necessary to increase capacity?

Confirmed Speakers Include:

Pat Wood, Chairman of FERC
Uncertainty and Volatility: The Federal Regulator’s Dilemma

Erroll Davis, President and CEO, Alliant Energy, and Chairman of EEI
Uncertainty and Volatility: The Utility Executive’s Dilemma

David Svanda, Member of Michigan PSC and President-designate of NARUC
Uncertainty and Volatility: The State Regulator’s Dilemma

Frank Wolak, Stanford University and California Market Monitor
Making Markets User Friendly

Joel Gilbert, CEO, Apogee, Inc.
Price Volatility and the Demand Side

Arthur Gelber, President, Gelber and Associates
Price Volatility and Working Markets

Philip McBride Johnson, former member of CFTC
The Role of Trading and Derivatives in Controlling Volatility

Randall Dodd, Director, Derivates Study Center
The Role of Trading and Derivatives in Controlling Volatility

Dale Landgren, Vice President, American Transmission Company
Do We Need Incentives for New Transmission

Brubaker and Associates will hold a competition symposium at the Hyatt Regency Crystal City Hotel on Wednesday October 9, 2002, the day before the ELCON/PGC Seminar. For more information please call 800/650-1239

Coping with Uncertainty and Volatility:

The Energy Manager's Dilemma

October 10-11, 2002

**Hyatt Regency
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Registration Fee:

Early bird by September 20—\$550. After September 20—\$650. (A fee of \$95 is offered for regulatory commissioners and staff and "non-utility" government employees.) These fees include admission to the seminar, materials, a luncheon, refreshments throughout the program, two receptions and two continental breakfasts. We accept AMEX, Diners Club, Mastercard, and VISA. Registration is available online at www.elcon.org. Alternatively, fax or email the information requested on the form below or mail the form with a check payable to ELCON, 1333 H Street, NW, The West Tower, 8th Floor, Washington, DC 20005. Tel.: 202/682-1390. Fax: 202/289-6370. Email: elcon@elcon.org.

Register by September 20 and save \$100!

Cancellation:

Refund requests must be submitted to ELCON in writing prior to the Seminar. Refunds will be reduced a fee of \$50. Substitutions are welcomed and encouraged at no charge. Please contact the ELCON office to designate a substitute.

Hotel Accommodations:

Please make your reservations directly with the Hyatt Regency Crystal City, 2799 Jefferson Davis Highway, Arlington, VA 22202. Tel.: 703/418-1234 or 800/233-1234. Rates: Single/Double \$165.00. These rates are guaranteed only until September 24, 2002. Any reservations made after this date will be accepted on a space-availability basis and at current hotel rates.

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Energy Bill From Page 1

which directs FERC to approve one organization for electricity reliability (most likely the reformed North American Electric Reliability Council). Commercial decisions will be made by a separate organization (most likely the North American Energy Standards Board), meaning that consumers must devote scarce resources to two different forums. More important, the bill ignores the linkage between "reliability" issues and "commercial" issues. This will harm consumers -- especially industrials -- since investor-owned utilities and other large power suppliers will continue to dominate the decision-making process on reliability.

The "reliability" section also defers to any regional advisory body organized on an interconnection-wide basis. This language, requested by the Western Governors Association, could well lead to balkanization of the market.

ELCON members believe that the Senate bill's provision for a renewable portfolio standard would increase costs for consumers. By requiring any supplier of electricity either to utilize new renewable energy sources for 10 percent of their supply or to purchase "credits" equivalent to 1.5 cents/kWh, most suppliers will simply purchase the "credit" and pass the costs on to end users. The credit will, in essence, be an excise tax borne by consumers.

Despite some claims to the contrary, the Senate bill harms industrial users who self-generate. Language on standard interconnection rules was deleted on the Senate floor, and although the Carper-Collins amendment preserving most PURPA rights for cogenerators was a major political victory, the current bill is still a step *back* from the rights cogenerators have today.

ELCON members believe there is a need for electricity legislation, but no bona fide consumer group supported the current provisions or alternatives likely to be offered in conference. When the conferees get down to work after Labor Day, we hope they keep in mind the views of consumers -- who ultimately pay the bills and whose voices too often are unheard. E

Contact the Conferees!

If your company or association has an interest in any of the provisions of the the comprehensive energy bill (HR 4), you should make your views known. Now is the time to contact House and Senate conferees on the legislation. Faxes, e-mails and phone calls may be better than traditional letters given security concerns and the sometimes-lengthy mail screening process. If you need help contacting any conferee, call ELCON.

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Barton (TX) Burr (NC)
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Democrats

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Craig (ID) Grassley (IA)

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Lieberman (CT) Baucus (MT)
Reid (NV) Breau (LA)
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Jeffords (I-VT)

Standard Market Design

From Page 1

Many features of the NOPR, such as the creation of independent transmission providers (ITPs), are sure to draw opposition. FERC did not make RTO membership mandatory when it issued Order 2000 (despite general agreement that it had legal authority to do so), so many utilities proposed structuring RTOs in ways that virtually guaranteed they would never receive FERC approval. Accordingly, FERC is now proposing that all transmission owners and operators that have not yet joined an RTO must contract with an ITP to operate their transmission facilities.

ITPs would have no financial interest, either directly or through an affiliate, in any market participant in the region. All affected transmission owners and operators would have to inform FERC which ITP would operate their facilities by July 31, 2003. ITPs would have to provide nondiscriminatory standard transmission service to all customers.

The proposal also would require a

"single tariff" so that all users of a transmission system come under the same rates, terms and conditions of service. ELCON and other industrial consumers have advocated this requirement since Order 888 was issued in 1996. According to the NOPR, the "single tariff" requirement could take effect prior to the July 2003 deadline for ITPs.

ELCON has long believed that stakeholder participation should be representative. Too often stakeholder allocation has rewarded the supplier and marketer segments at the expense of the end user. The SMD creates a fair balance by specifying six stakeholder classes: (1) generators and marketers, (2) transmission owners (including vertically integrated utilities), (3) transmission dependent utilities, (4) public interest groups, (5) alternative energy providers (distributed generation, renewable energy sources, etc.), and (6) end users and retail energy providers (LSEs that do not own transmission or distribution).

The entire 641-page proposed rule can be downloaded from FERC's website at <http://www.ferc.fed.us>. E

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WHAT IS ELCON?

- **DATE ORGANIZED:** January 15, 1976
- **WHO WE ARE:** The Electricity Consumers Resource Council (ELCON) is the national association representing large industrial consumers of electricity. ELCON was organized to promote the development of coordinated and rational federal and state policies that will assure an adequate, reliable and efficient supply of electricity for all users at competitive prices. ELCON's member companies come from virtually every segment of the manufacturing community.
- **MEMBER COMPANIES:** A.E. Staley Manufacturing Company • Air Liquide • Alcan Aluminum Corporation • Anheuser-Busch Companies, Inc. • BOC Gases • BP • Central Soya Company, Inc. • Chevron Texaco • Delphi Automotive Systems • E.I. du Pont de Nemours & Co. • Eastman Chemical Company • Equilon Pipeline, L.L.C. • ExxonMobil • FMC Corp. • Ford Motor Company • GNB Technologies • General Motors Corporation • Honda • Honeywell • Intel Corporation • International Paper • MG Industries • Monsanto Co. • Occidental Chemical • Owens-Corning • Praxair • Rockwell Automation • Smurfit Stone Container Corp. • Solutia, Inc. • Weyerhaeuser • Williams Energy Services
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