

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

Financial Reporting and Cost Accounting,
Oversight and Recovery Practices for
Regional Transmission Organizations and
Independent System Operators

Docket No. RM04-12-000

**Initial Comments of the
Electricity Consumers Resource Council
(ELCON)**

The Electricity Consumers Resource Council (ELCON) appreciates the opportunity to submit comments in response to the Commission's September 16, 2004 Notice of Inquiry (NOI) on accounting and financial reporting requirements for and oversight of Regional Transmission Organizations (RTOs) and Independent System Operators (ISOs) costs. As a national consumer group representing the interests of large industrial end users, few issues are as important to us as the assurance that rates for recovering the costs of public utilities are just and reasonable.

Introduction

ELCON's long-standing advocacy of industry restructuring is predicated on increased application of competition to instill greater cost efficiency and accountability. RTOs and ISOs—which are widely touted as the crown jewels of the restructured industry—are rapidly evolving into large bureaucracies with equally large budgets. The Commission has delegated to RTOs and ISOs many operational, planning and market responsibilities that previously were exercised

solely by vertically-integrated utilities. It is important that the same high standards of accountability and prudence that were expected of traditional utilities also be applied to RTOs and ISOs. The Commission’s inquiry is thus timely and important.

The NOI’s stated intention is to “explore whether changes to RTO/ISO accounting, financial reporting, and cost recovery practices are necessary to ensure the rates charged by RTOs/ISOs and their member transmission-owning public utilities are just and reasonable.” NOI ¶ 16. The Commission seeks comments on these issues, in general, as well as specific responses to seventeen (17) questions on (a) accounting and financial reporting issues for RTOs/ISOs, (b) accounting and financial reporting issues for public utilities and licensees that are members of an RTO/ISO, and (c) cost management. In these Initial Comments, ELCON takes no position on accounting and financial reporting issues, including the appropriateness of the existing Uniform System of Accounts (USofA). However, we may file follow-up comments on the recommendations of other interested parties on these matters.

Comments of the Electricity Consumers Resource Council

Our Initial Comments focus on the issue raised in the questions on cost management, especially the first question:

Do not-for-profit RTOs/ISOs currently have the appropriate incentives to contain costs? If not, what are the right incentives (and why would they be the right incentives) and how should they be implemented?

Notwithstanding the fact that most of the questions directly posed in the NOI address reporting and accounting issues, this particular question provides an opportunity to introduce potential structural changes to the RTO/ISO business model that may create—if implemented—more effective and enduring incentives for containing costs.

The NOI correctly notes that all operating RTOs and ISOs are not-for-profit entities, argues that the Commission has not mandated any particular business model, and says that not-for-profit status “makes cost review more difficult.” NOI ¶ 9. The fact that all operating RTOs/ISOs are non-profit corporations is no surprise given the huge controversy associated with attempts to form transmission-owning RTOs (called “Transcos”). Asset ownership in this industry carries with it—unfortunately—the potential exercise of undue discrimination. This is a problem Order No. 888 did not fix and which the Commission has been wrestling with ever since. Thus, as things stand, the not-for-profit business model is the Commission’s *de facto* mandate for RTOs/ISOs.

Reliance on the not-for-profit business model presents a challenge for regulators because the model conflicts with the original motivation for restructuring which is to take advantage of the favorable economic behaviors induced by the profit incentive in real market environments. But there is middle ground that the Commission is urged to consider. The Commission should require each RTO/ISO to restructure its business model and shift its business functions to an *Independent System Administrator* (ISA) that serves under an incentive-driven contract.¹ This business model induces the Administrator and its staff to operate efficiently, to innovate, and holds them accountable for their performance.² It also avoids establishing a self-perpetuating

¹ The ISA model was adopted by the now-defunct SeTrans RTO effort in the Southeast. The model was extensively vetted during the two-year ISA solicitation and selection process, and subsequently approved by FERC. The SeTrans ISA contract was for an initial term of five (5) years.

² The “incentive-driven” contract proposed for the ISA is different from so-called Performance-Based Regulation (or PBR), as PBR is usually defined and practiced, because the ISA does not own a rate base consisting of generation, transmission and/or distribution assets. This approach is analogous to traditional regulatory practice establishing a “bandwidth” around the allowed rate of return (profit) that rewards exceptional behavior and punishes unexceptional behavior.

bureaucracy that can arise from utilization of the existing RTO/ISO business model that we believe can significantly mitigate the potential principal-agent problem.³

In addition to meeting annual productivity objectives in the ISA contract (including penalties for productivity declines), there are powerful economic incentives associated with efforts to retain the right to serve as Administrator once the term of the contract expires including being forced to compete against alternative proposals that may offer new and more superior innovations or cost efficiencies. These advantages cannot be replicated by a not-for-profit firm whose existence is guaranteed in perpetuity.

As RTOs evolved from ISOs in the late 1990s, a process of re-integration of utility functions occurred and this trend is continuing with so-called Day Two operations and new resource adequacy mandates. The RTO model is now essentially a huge, regional, vertically-integrated utility with a small rate base. The Commission's policies in Orders 888 and 2000 were ostensibly to unbundle the utility industry, but, in fact, the Commission has been slowly putting the pieces back together. This trend is totally at odds with the trend in the rest of the global economy where there is a dramatic increase in vertical specialization (or "de-verticalization").⁴ The efficiency gains of modern global corporations are increasingly the result of outsourcing traditionally internal functions to specialized firms. A notable and well-known example is Dell Computers. A major feature of Dell's business model is that it assembles parts that are manufactured by other firms—a feature that other computer firms are rapidly copying.

³ The "principal-agent problem" is a source of inefficiency in the way businesses and governments are operated that occurs because those making decisions (agents) have different goals than those affected by the decisions (principals). The classic example of this problem is when ownership (of assets) and control of those assets are separated.

⁴ See Richard N. Langlois, "The Vanishing Hand: The Changing Dynamics of Industrial Capitalism," November 2002. Can be downloaded from: <http://www.sp.uconn.edu/~langlois/Vanishing.html>

There is no compelling argument that public utility shareholders and consumers will not also benefit from outsourcing key functions to specialized firms. Thus, for example, the Commission is urged to consider requiring RTOs/ISOs to spin off their market operations functions to independent, for-profit entities. This would allow a single, specialized firm to operate the markets of more than one RTO/ISO and more effectively accomplish what has eluded “seams committees” – operation of a truly joint and common market. There is an important secondary benefit of outsourcing these functions. A potential conflict in mission exists within a RTO/ISO that is both responsible for grid reliability and market operation, and unbundling grid operations from market operations mitigates that potential.

Conclusion

The Commission is urged to consider implementing two structural changes to the RTO/ISO business model to instill the “right incentives” for cost management. First, each RTO/ISO should adopt the Independent System Operator model whereby the grid administrator serves under an incentive-driven, performance-based contract. Second, each RTO/ISO should outsource its market operations functions to independent, for-profit firms with the specialized capabilities to bring efficiencies and innovation to the markets.

Respectfully submitted,

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