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CONVERGENCE OF CONSEQUENCE AND AUTHORITY: AN EXPANDED ROLE FOR REGIONAL MULTISTATE ENTITIES IN FERC'S STANDARD MARKET DESIGN

Robert E. Burns, Esq.
Senior Research Specialist

The National Regulatory Research Institute
at The Ohio State University
1080 Carmack Road
Columbus, Ohio 43210-1002
Phone: 614/292-9404
Fax: 614/292-7196
www.nrri.ohio-state.edu

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EXECUTIVE SUMMARY

The Federal Energy Regulatory Commission's (FERC's) Standard Market Design (SMD) Notice of Proposed Rulemaking (NOPR) assigns several roles to state commissions. Pursuant to Order 2000, state-federal Regional Transmission Organization (RTO) panels are important forums for the FERC and state commissioners to discuss issues related to RTO development. The FERC suggests that a similar state commission dialogue with the operator of the electric system – the Independent Transmission Provider (ITP) -- will suffice for SMD issues. While dialoguing is sometimes an effective means of exercising regulatory oversight, it is not a clear substitute for legitimate regulatory oversight. As proposed, the function of the Regional State Advisory Committees (RSACs) is largely advisory. Yet regulatory oversight requires decision-making or enforcement authority to provide the teeth that make it a meaningful function. Typically the consequences of ill-conceived regulation are felt foremost by retail customers in their rates.

This paper examines the proposed role of the RSACs in the light of traditional state functions, concluding that effective state authority will be needed. The paper discusses several options as well as the RSAC. These include regional multistate entities, interstate compacts, voluntary regional oversight committees and federal-state joint boards, hearings or conferences.

The paper concludes that in order to have a meaningful but not overly burdensome role in oversight of RTOs and/or ITPs, state public utility commissions will likely find themselves drawn to the multistate entity and/or regional state oversight committee options.[1] These approaches create congruence between the responsibilities of the federal and state levels of government and the consequences for wholesalers and retail customers. The approaches are the ones most likely to avoid setting up a moral hazard, which would likely result in either ineffective or haphazard regulation of transmission.

The paper is one in a series examining the impact of FERC's proposal for SMD, and a close companion to *The FERC's Standard Market Design NOPR Adequacy Requirements: Implications for State Commissions*.

[1] For analysis of the underlying principles of regional regulation, see Robert E. Burns and Mark Eifert, *A Cooperative Approach Toward Resolving Electric Transmission Jurisdictional Disputes*, NRRI 94-06 (Columbus, Ohio: The National Regulatory Research Institute, 1994) and Douglas N. Jones, Robert E. Burns, et al., *Regional Regulation of Public Utilities: Opportunities and Obstacles*, NRRI 92-19 (Columbus, Ohio: The National Regulatory Research Institute, 1992).

BACKGROUND

The Federal Energy Regulatory Commission's (FERC's) Standard Market Design (SMD) Notice of Proposed Rulemaking (NOPR) provides that state commissions should play several roles and interact with the RTO/ITP. According to the NOPR (at para. 551), states have an important role in the process of creating and sustaining an efficient competitive wholesale market for electricity and the FERC cites the state-federal RTO panels as important forums for the FERC and state commissioners to discuss issues related to RTO development. In para. 551, the FERC recognizes, though, that there is not a formal process for a similar dialogue with the ITP that will operate the electric grid under the SMD. The nature of the earlier dialogues dealing with RTO development and formation have for the most part have been advisory in nature. While it can be encouraged by the state commissions, an RTO can only be authorized by the FERC. Nevertheless, the advice of state commissions is taken seriously, particularly since state commissions might need to approve transfer of transmission assets or transfer of control of the transmission system.

State commissions' primary role, however, is regulatory oversight, not "dialoguing" with "the regulated entity." The challenge for the FERC and the state commissions is to design a regulatory oversight role for state commissions that converges state commission regulatory authority with the regional consequences of their actions. In the NOPR, the FERC is suggesting that a similar state commission dialogue with an entity operating the electric system will suffice. While dialoguing or jawboning is sometimes an effective light-handed means of exercising regulatory oversight, it is not a clear substitute for legitimate regulatory oversight. The dialoguing function without any enforcement mechanism or decision-making authority is advisory. Regulatory oversight requires decision-making or enforcement authority to provide the teeth that make it a meaningful function.

Underlying the NOPR, there seems to be a fundamentally different role seen for state commissions. Under our system of federalism, state commissions exercise regulatory oversight over matters that are jurisdictional to the state and/or over federal matters that have been delegated to the state for enforcement or other purposes, for example the unbundled network elements (UNE) price proceedings in tele-

communications. Although representatives of state governments do sometimes serve on federal advisory councils, in most circumstances the primary responsibility of states is not to provide advice. It is to provide regulatory oversight. If what is intended is a form of cooperative federalism, then the involvement of state commissions should be one in which state commissions exercises their legitimate regulatory oversight. There are several ways that this might be accomplished, which are laid out in the options below.

There are two proposals in the NOPR bearing upon the FERC proposal that there be Regional State Advisory Committees (RSACs). One deals with how the states would engage in a "dialogue" process with the ITP. The second deals with transmission expansion planning and siting issues.

The first proposal, which deals with dialoguing with the ITP, is identified in para. 552. The FERC proposes that the ITP that operates the grid (which could be an RTO) would have a Regional State Advisory Committee (RSAC). The role of the RSAC would be to provide the ITP independent governing Board, the market participants, and the FERC with a consensus view from the states in the region. The RSAC is to have direct contact with the ITP governing board, in a manner which recognizes the ITP governing board's public interest responsibility. In other words, the role of the RSAC is to try to develop a consensus view from the states in the region and to provide advice as to what that consensus is.

The actual specifics of how an RSAC would be formed and how it would be operate in the context of an RTO could be decided on regional basis. (Canadian provinces are also encouraged to participate in the RSAC.) While the RSAC proposal calls for state commissions to participate on an ongoing basis in the decision-making process of the ITP, as described RSACs might be no more than an advisory role. The principal role of the RSAC is to provide the ITP board, the market participants, and the FERC with a consensus view of the states in the region. The FERC terms this providing a consensus as coordinated oversight in fulfillment of federal public interest responsibilities. While state commissions might find it useful to take part in stakeholder processes of an ITP or an RTO

when the decisions affect matters traditionally involving state commission authority, the proposed role of the states should be augmented, which could happen as part of regional flexibility.

Indeed, in para. 555, the FERC says the RSAC can bring a valuable regional perspective to the FERC. The FERC states that RSACs will play a role in deciding regional rate design and revenue issues. Once RSACs are established, FERC intends to work with RSACs to establish protocols for deciding regional rate issues.

Other issues that the RSAC is to work on with the regional transmission organization (RTO) include resource adequacy standards, transmission planning and expansion, market power monitoring and market monitoring, demand response and load management, distributed generation and interconnection policies, energy efficiency and environmental issues, and RTO management and budget. *SMD NOPR* at para. 554. It is FERC's view that these are issues that call for regional solutions, which may fall under federal, state or shared jurisdiction. FERC would also have the Market Monitoring Unit of the ITP provide reports directly to the Board of the ITP, to the FERC, and to the RSAC.

The FERC's RSAC proposal as described in the *SMD NOPR* indicates an advisory role rather than one explicitly recognizing the legitimate regulatory oversight responsibilities of state commissions. State commissions' caution about possible interpretations of the jurisdictional consequences of FERC's RSAC proposal is warranted. Except where it is clearly stated otherwise, for example, such as having the RSAC determine the resource adequacy requirement and the planning horizon, *SMD NOPR* at para. 491 & 524, it would appear that the principal role of the RSAC is advisory to the ITP governing Board and is not one of regulatory oversight. The resource adequacy "determination" is a model that could be followed regarding the role of state commissions in pricing and other areas in the NOPR.

It is indeed true that many of the functions that the FERC proposes that the RSAC handle have regional implications. Nevertheless, several of these areas have traditionally been areas of state commission regulatory oversight. State commissions and/or other state agencies in many states have explicit or implicit authority under statutes or their obligation to serve to oversee resource adequacy. Indeed, most state commissions have

reviewed utility resource plans for many years, sometimes as a part of integrated resource planning, sometimes as part of a regular reporting requirement, and sometimes as a prerequisite for obtaining a certificate that allows construction of new plant. Again, this area is traditionally an area of state regulation, yet it has regional effects and regional cooperation and coordination are desirable.

Likewise, transmission planning and expansion are areas traditionally assigned to state regulation which have regional effects and as a complement to large or small central power stations as well as sometimes distributed generators selling into the grid, it make sense for state commissions to continue to be involved in transmission planning and expansion, but in a manner that allows for regional cooperation and coordination. In the case of demand response and load management programs, state commissions have set up, monitored, promoted, and regulated these programs, sometimes going back to state programs set up in response to the Public Utility Regulatory Policies Act of 1978. The point is that state commissions know what works and what does not in their individual states and region. And, as the agency that has a history of being the interface and contact with the retail customer, it also makes sense for these programs to remain principally under state commission jurisdiction. But, since demand response and load management programs are a part of resource adequacy requirements, it makes sense that these state programs are coordinated on a regional basis.

State commissions and state agencies have also been the primary agencies in charge of enforcing environmental regulations and dealing with environmental issues, as well as dealing with issue of energy efficiency. Here too state commissions should naturally be the lead agency, although regional information-sharing on policies can lead to better regional cooperation and coordination of supply-side and demand response resource adequacy options as well as transmission planning and expansion.

State commissions have recently taken a lead on distributed generation (DG) interconnection policies for the interconnection of distributed generation into the distribution system, with the NARUC recently issuing *NARUC's Model Distribution Generation Procedures and Agreement for Interconnection to the Distribution System*. Distributed generators that are interconnecting into the distribution system (and the

subtransmission system) would primarily have a cost and a reliability effect at the local distribution system level. State commissions are best suited for dealing with these concerns because of their familiarity with the engineering of the distribution system and their closeness to the retail customers who will be affected by cost and reliability impacts of DG interconnections.

The second proposal would allow Multi-State Entities (MSE) to be established as a means to facilitate state coordination on transmission planning, certification, and siting, on a regional level. The MSE proposal, found in para. 553, is consistent with a recent report from the National Governors' Association Center for Best Practices entitled, *Interstate Strategies for Transmission Planning and Expansion: A Report of the NGA Task Force on Electricity Infrastructure*." The MSE is a voluntary regional entity that meets to determine and resolve issues within its purview. As proposed in the NGA report, the MSE would do transmission expansion planning on a regional basis, provide a region-wide basis for certifying the need for the transmission expansion, and provide a consistent region-wide siting plan. It would then be up to the individual state commissions or other agencies to individually implement the regional transmission siting plan.

The FERC seeks comments as to whether the MSE should be a part of a single RSAC for the ITP or whether the MSE should be separate. They also ask whether there should be separate RSACs for the different issues mentioned above and listed in para. 554, that is, resource adequacy standards, transmission planning and expansion, market power monitoring and market monitoring, demand response and load management, distributed generation and interconnection policies, energy efficiency and environmental issues, and RTO management and budget. As proposed by FERC, there would be no FERC backstop or preemption of MSE decisions in case there is no regional consensus or agreement. The United States Department of Energy has previously suggested that something similar to an MSE be established with a FERC backstop in case the MSE decision is not unanimous or if an individual state fails to implement the plan. In that case, the FERC would make the final decisions, including preemptive ones. See *National Transmission Grid Study,* (USDOE, May 2002), 53; and David Meyer and Richard

Sedano, *Transmission Siting and Permitting: National Transmission Grid Study #5*, E-48. Obviously, the US DOE's proposal on this is very likely unacceptable to state commissions and the FERC does not propose that.

AVOIDING MORAL HAZARD: CONGRUENCE BETWEEN RESPONSIBILITY AND CONSEQUENCES

Ideally, for regulatory oversight to be effective there needs to be congruence between responsibility and consequences. In the case of electricity, this would mean that the consequences of a regulatory failure are borne by stakeholders at the political level of the regulatory agency that was responsible for avoiding the error. The primary responsibility of the FERC is the wholesale electricity market and transmission in interstate commerce which supports the wholesale market. The primary responsibility of state regulators is the retail market, that is, that part of the market that serves the ultimate customer. State regulators enforce the utility obligation to serve customers in the retail market. The obligation to serve is an obligation to provide safe, adequate, and reliable electric service at a just and reasonable rates, although the purchased power and direct access generation portion of these rates might be set at market.

In most areas, the consequences of ill-conceived regulation are felt foremost by retail customers in their rates. In many cases consequences are regional in nature, and may affect both wholesale and retail markets. Inadequate resource planning affects both retail and wholesale markets within a region. Transmission planning and expansion affects the geographic size and hence the viability of the wholesale market, which in turn affects retail markets throughout the region. The traditional burden of ratepayers to bear the cost of new or enhanced transmission is passed through and ultimately reflected in retail markets. Rate design and revenue requirement matters have traditionally affect the ultimate retail customers. Market power and market monitoring affects both retail and wholesale markets, but often the effects of imperfect markets are borne by the ultimate retail customers.

Demand response and load management programs have always been coordinated with retail customers by state commissions. The effectiveness of these programs do have an effect on the demand response to price signals being given in the wholesale market, and having a demand response helps to make wholesale markets more competitive. Similarly, energy efficiency and both federal and local environmental issues have typically

been the province of state commissions. State commissions have been the principal contact with retail customers undertaking such energy efficiency measures and most of these programs have been funded at the retail level and the environmental issues are mixed with land use issues. Both are probably best handled regionally by state commissions, even though the outcomes affect the wholesale market.

Distributed generation and interconnection policies primarily affect the retail market when the distributed generators are small, the interconnection is to the distribution system, and only de minimus amount of power from the system flows into the system, while larger distributive generation and interconnection affect both wholesale and retail markets. Wholesale markets are affected by adding a generator, while using up available transmission capacity (unless transmission line upgrades are called for). If transmission upgrades are called for, retail customers are affected if they are called upon to pick up any of the costs.

The implication of attempting to align regulatory responsibilities with consequences would be that state commissions would play a meaningful role in some type of regional regulatory oversight entity that allows state commissions on a regional basis to cooperate, to coordinate, and to reach decisions.

OPTIONS

There are a wide range of options, most of which are not explicitly explicitly considered in the language of the NOPR. If state commissions believe that some form of regional coordination of the regulatory functions identified by the FERC as being in the purview of the ITP, then state commissions might need to advocate those options as alternatives to the RSAC and/or MSE entities proposed by the FERC.

FERC's Two Proposals

As previously mentioned, the first of the two options for the role of state participation in RTO operations is the Regional State Advisory Committee. The NOPR does propose one major actual decision-making function for the RSACs, that is, setting the minimum level of adequacy for the region. Otherwise, the RSAC is advisory only with its primary role to provide the ITP /RTO governing board, the market participants, and the FERC with a consensus view of the states in the region. The idea is that there will be coordination in the oversight of ITPs / RTOs, but that the primary regulatory oversight will be done by the FERC. Below are some key attributes of a RSAC.

- Regional State Advisory Committees
  - Advisory Only, except where otherwise specified. See *SMD NOPR* para. 552.
  - Real Decision-making done by ITP
  - Why Is This Option Worth Discussing from a State's Point of View? There is an implicit loss of jurisdiction, even where implementation of RSAC-set goals (such as the desirable level of adequacy) is left up to state implementation.
  - The Proper Role of State Commissions Is To Provide Regulatory Oversight

- Could Be a Non-Starter With the State Commissions. State Commissions might view RSACs as a Waste of Time, Resources, and Energy.
- If FERC's regulation of ITPs and RTOs is ineffective, then the states might be coopted through its participation in RSACs. If state commissions are involved in regional decision-making then they should have an actual role as a decision-maker in the process.
- The possible impact of the Federal Advisory Committee Act. This act requires that advisory committees to federal agencies and department be open and follow particular procedures, which would be cumbersome in the context of economic regulation dealing with the real time oversight of markets. There is a real issue here as to whether the FERC is delegating its regulatory authority to oversee wholesale markets to a third party, that is, the ITP. Without strict regulatory oversight (strict market rules with teeth), there is a danger that the ITP will act in its own interest and not as a Self-Regulating Organization. FERC places faith in the independent market monitor to detect market power, market abuse, and market failure and to assure that the ITP, the market participants, and the market itself perform workably competitively and in the public interest, so that consumer welfare is maximized. This might not be realistic.

The second type of role that the state commissions might play in relationship to the RTO/ITP is identified as a Multi-State (Regional) Entity. The MSE actually would play a meaningful role by providing regulatory oversight on a regional basis on any one of the many possible subsets of these issues: including resource adequacy planning, transmission planning and expansion, transmission siting, market power monitoring and market monitoring, demand response and load management policies, distributed generation and interconnection policies, energy efficiency and load management issues, and RTO management and budget.

If voluntary, the MSE approach is consistent with previous NARUC resolutions dealing with potential regional regulation of transmission. Also, there has been a NARUC

resolution specifically endorsing the MSE approach for transmission siting as set out in the National Governors' Association's Best Practice Center report. Below are some key attributes of the MSE:

- Multi-State (Regional) Entities
  - Voluntary, at least as proposed in the NGA Report.
  - Limited in the NGA Report to planning, siting, and certification. The FERC suggests the MSE be tasked with other tasks.
  - Voting rules – unanimity required, majority rule required, or unanimity FERC backstop as proposed by the USDOE?
  - State coordination on tasked issues only? Presuming that FERC will not seriously consider any other options than RSACs and MSEs, then the MSE is the option that is most friendly to state sovereignty and voluntary regional coordination by state commissions. The MSE if it were to take on additional tasks could provide a state-run regional oversight mechanism. Is this what the state commissions would like?
  - State joint regional oversight that involves regional cooperation and coordination would be desirable on many issues, as explained at length above.

Clearly, state commissions will probably be drawn to a system of regional regulatory oversight that has more of the attributes of the MSE than the RSAC. Indeed, state commissions might find the MSE appealing enough to expand its functions beyond the limited functions proposed in the NGA report.

Other Options for A State Role for Regional Regulation

There are also several other options that would provide a state role for regional regulation of an RTO or ITP, which are not considered or discussed in the SMD NOPR. One of them, State Regional Oversight Committees, should, like the MSE, be very

attractive to state commissions. The SROC is widely used by states in the regulatory oversight of regional bell operating companies. Hence, it is familiar. It is also consistent with previous NARUC Resolutions on voluntary state regional regulation of transmission. Here are the attributes of some of the other options.

- Interstate Compacts for Regional Planning, Siting, Etc. (Example, The Pacific Northwest Planning and Conservation Council) – Mandatory
  - The principal problem is that Congress is involved and Congress historically has tended to micro-manage how to approach a regulatory problem. If states were given a broad range of decision-making authority that they could exercise without hamstringing the ability of state commissions to oversee the implementation of regional decisions, this option might be more appealing. Also, all of the issues of who is represented on a decision-making body, who appoints them, and by what voting rules are decisions made are raised here. There are probably too many unknowns for this option to be considered a desirable one for state commissions to advocate.
  - Some environmental advocates believe the Pacific Northwest Planning and Conservation Council is a desirable model of regional transmission and generation expansion, because it requires consideration of environmentally friendly options first, before other supply-side options are adopted.
- Interstate Compacts for Regional Planning, Siting, Etc. (Example, Low-Level Nuclear Waste Repository) – Voluntary
  - The ability of states to exit the compact without any immediate consequences tends to make this approach infeasible
- State Regional Oversight Committees (Voluntary)
  - These voluntary state regional oversight committees have repeated been formed by state commissions, dealing with RBOC issues in telecommunications and also dealing with RTO formation, organization, and operation. It might make the most sense for the FERC to authorize the state commissions to set up such voluntary state regional oversight committees

and allow them to coordinate and to voluntarily act in tandem to provide regulatory oversight in most of the areas identified above where the primary impact of regional decisions is upon the retail customer.

- FERC Joint Boards
  - This could operate in a variety of ways. At the FCC, joint boards of state and federal regulators could meet and decide regional issues. Their decision is then endorsed by the full FCC. The question here is whether NARUC and the state commissions are satisfied with their experiences with FCC Joint Boards? If so, it might be a model to advocate to the FERC. The FERC Chairman earlier in the debate expressed concerns that the FERC Joint Board route will create an added layer of bureaucracy.
  - The FERC Joint Board has the advantage of already having a clear statutory basis by which FERC jurisdictional questions that have regional impacts can be addressed. It is not really meant to be a forum by which state regulatory decision that have a regional impact are to be addressed. In the latter case, the MSE might be more suitable.
  - FERC Joint Hearings – Probably can be used on episodic issues. May not be sufficient for ongoing regional issues.
  - FERC Joint Conferences – Available and likely helpful, but may not be sufficient for many ongoing regional issues unless combined with other approaches.

A BRIEF ANALYSIS OF OPTIONS

In order to have a meaningful role in regional oversight of RTOs and/or ITPs that is not overly burdensome, state public utility commissions will likely find themselves drawn favorably to the MSE and/or the RSOC options above. State commissions might also find it desirable to have either a MSE and/or RSOC have a more expanded range of authority which includes most of the functions set out in para. 555 above. As previously discussed, most of these functions are traditionally handled by state commissions. These are areas where state commissions have most, if not all, of the experience. However, they are functions that have regional impacts. Therefore, the most sensible approach would be to adopt a form of regional regulation that uses state regulatory authority and expertise in a manner that furthers regional cooperation and coordination.

On issues where there is significant state authority and experience, the MSE and/or RSOC seems to fit the bill. Further, these approaches are consistent with prior NARUC resolutions endorsing voluntary state regional regulatory oversight. These approaches are the ones most likely to avoid setting up a moral hazard, which would likely result in either ineffective or haphazard regulation of transmission. The MSE has one additional advantage in that its form can be very adaptable to suit the issue. For example, five states in a region might meet on resource adequacy planning. A decision might be made by the five states that requires a transmission line through three states. The five states could also determine how the line is to be paid for. Then, the three states through which the line will run will meet and actually site the line. States could also form MSEs across ITPs to deal with seams issues.

From the state commission point of view, RSACs that are advisory in nature have a limited, but important role to play. State commissions might choose to be part of RSACs on ITPs to provide ITPs with early input into its decision-making process, but only if such advice can be provided without the state commission be subject to a collateral attack if it tries to exercise its regulatory responsibility by other means. State commission staff have often found that membership on RSAC-type bodies provides them with insights into the workings and governance of the RTO / ITP.

Joint Boards might also be useful, but only if there are carefully crafted rules that allow state commissions full participation to help FERC solve FERC-jurisdictional matters that have regional impact. An alternative method for FERC to get regional advice on a FERC-jurisdictional matter would be to certify a question to the applicable MSE. The MSE could then reach a recommended decision and send it back to the FERC for FERC's ultimate decision.

FURTHER RECOMMENDED READING

There are two additional reports previously done by the National Regulatory Research Institute that analyze some of these issues addressed here and set out the underlying principles of regional regulation in far greater detail. They are:

Douglas N. Jones, Robert E. Burns, et al., *Regional Regulation of Public Utilities: Opportunities and Obstacles*, NRRI #92-19 (Columbus, Ohio: The National Regulatory Research Institute, 1992).

Robert E. Burns and Mark Eifert, *A Cooperative Approach Toward Resolving Electric Transmission Jurisdictional Dispute*, NRRI #94-06 (Columbus, Ohio: The National Regulatory Research Institute, 1994).