A Strategy for Moving RTO West Development Forward

Allen Burns, BPA Executive Vice President for Industry Restructuring
Presented to
The Northwest Public Power Association
Policy Perspectives: Understanding Standard Market Design
December 13, 2002

As the Bonneville Power Administration faces its next steps in light of current events facing the energy industry, it is important to recognize where we all share common ground. While BPA clearly has issues yet to resolve, we believe we share a common goal with the Federal Energy Regulatory Commission: to build a future that assures that electricity consumers will receive high levels of service at the lowest possible cost. We agree with the primary objectives of assuring sufficient infrastructure and protecting customers' existing rights. We also agree with FERC's goals to create market rules that protect against market manipulation, ensure customer protection through market monitoring and oversight and establish clear transmission pricing and planning policies for grid expansion. We believe these goals are consistent with BPA's specific mission to provide an adequate, cost-based, reliable power supply for our Pacific Northwest customers.

While we share basic goals with FERC, recent developments cause BPA to take a more deliberate approach in regional activities related to RTO West development. Key factors for consideration include:

- The retreat from power project development by many merchant generators in the Pacific Northwest, and the relationship of this retreat to transmission expansion plans;

- The issuance of an order by FERC on the RTO West Stage Two filing and of its Standard Market Design Notice of Proposed Rulemaking;

- And lastly, an intense political reaction to the latter document by Northwest members of Congress, state regulators, investor-owned utilities and public power.

These events have led BPA to consider approaches that will allow us to best influence or shape a beneficial future for the Northwest. They have also led us to identify what we see as some of the key issues related to RTO West and SMD.

- The risk and complication associated with the proposed SMD congestion management approach, for example, any potential for price volatility, cost shifts or overall cost increases for consumers.

- The region's current rates predicament and concern about additional rate increases, which call into question the timing of large near-term expenditures for RTO West development.

- The uncertainty introduced by SMD approaches versus crafting a more stable regional solution via RTO West. If we come up with an RTO that works for the Northwest, will it be altered down the road by SMD or successor orders?

- The cost-benefit analysis for RTO West, which is not complete and cannot be completed until the institution is further developed.

- Pre-existing contract rights protection. We must be able to assure our customers that certain fundamental characteristics of what they have today, they will have in the future: access to transmission and cost-based rates.

While these are significant concerns, it is our intention to continue to proceed with the development of RTO West. These issues must be addressed and, therefore, the pace of the schedule for developing RTO West will be affected. Ultimately, our decision as to whether to participate in RTO West will be determined by our ability to meet our original set of principles (posted at *http://www.bpa.gov/corporate/kc/home/docs/2002/mso5AEA7.pdf*), many of which are implicated by the issues listed above.

We are choosing to proceed because we continue to believe RTO West has the potential for providing net benefits to Northwest consumers. In particular, we believe there is the potential for improvements in the reliability of operations, maximizing use of the existing transmission system, planning and implementation of capacity expansion and decreasing costs of power system dispatch through the elimination of rate pancaking within RTO West. We believe these improvements are not possible with the status quo. Of course, the ultimate form of RTO West will determine whether these benefits will be realized and whether the level of benefits will exceed the costs of RTO West formation.

We are working to find resolution to these issues that can meet the goal of developing a Pacific Northwest RTO that will benefit Northwest consumers, and we will need the help of FERC on some critical issues if we are to be successful.

Some have suggested that these improvements in reliability and efficiency could be better achieved by a federal Transco or a non-profit Transco. However, we believe the institutional and legal barriers to forming either entity likely are insurmountable.

So, how do we move forward?

It is important to understand the assumptions we are making that underlie our decision to continue to proceed with RTO West formation.

First, the electric power industry in the Northwest is living "in the middle of the river" between the old cost-of-service based rates regulatory model and a restructured model based on using competitive forces. Most likely, the region will stay in the middle of the river for some time to come, although as a whole we are closer to the side of the river that is based on cost-of-service based rates. The Northwest has one state that has restructured,

one that has partially restructured and two that are unlikely to embrace restructuring anytime soon. In addition, much of the load in the Northwest is served by public utilities that appear uninterested in pursuing restructuring at the retail level. Consequently, we are going to need a transmission system that meets a variety of needs. In effect, we need a hybrid transmission model that works for jurisdictions that embrace traditional cost-of-service based rates and those that choose restructuring.

Second, it is our full intention that the BPA power system, which serves about 45 percent of the load in the region, will be retained as a cost-based system. This power has historically been delivered over cost-based transmission. As a low-cost region it is our intention and highest priority to assure that the benefits of the existing system are retained and that the benefits of cost-based power are not taken away from customers through changes to transmission pricing.

Third, the problems FERC is seeking to solve for the country are not as great in the Pacific Northwest as they are in other parts of the country. There have been practically no issues regarding non-discriminatory access on the BPA system, which constitutes approximately 75 percent of the region's high voltage transmission. We do have concerns about the need to build transmission in the Northwest, but with respect to the BPA system, at least, the lack of an RTO is not a major stumbling block to non-discriminatory access. This is not intended to mean that there are not potential benefits from forming an RTO in the Pacific Northwest. But the need and urgency here are less than in the rest of the country.

Fourth, merchant plant development, which has been the vast majority of new generation development in the region, has slowed dramatically. It has been our view that merchant power plant development is an important component of meeting the needs of a growing economy in the region, and that the merchants need clear rules for access to transmission in order to generate capital for project development. In particular, new generation developers, whether independent power producers or utilities, need access to long-term firm transmission at stable prices in order to secure financing and facilitate long-term, fixed-price power sales to customers.

Fifth, the California experience has made us very aware that restructuring efforts have the potential to lead to bad outcomes. We have sought to learn from California's mistakes. Consequently there are some issues that are "must-haves" for us to move forward. In addition, this region has had to swallow huge rate increases in the last two years and we are still suffering from the hangover effect from the energy crisis. Across this region, utilities are having to reduce near-term costs, which is impacting long-term benefits.

From these assumptions and experiences we would identify two fundamental principles:

1. It has been our view that the move toward RTO West formation should be based on "evolution, not revolution." Recent events have only strengthened that view.

2. We believe that a fundamental premise for RTO formation in the Pacific Northwest must be that there will be assurance that the type of service currently provided will not be degraded. Customers must know that the fundamental characteristics of what they receive today, they will have the option of continuing to receive in the future: access to transmission and cost-based rates for their existing loads. If and when RTO West service proves to be superior to the existing service, customers should have the right to voluntarily convert.

Considering all these factors, we believe the following key objectives must be accomplished to ensure an RTO that is better than the status quo:

1. FERC needs to allow the Pacific Northwest the flexibility to develop a market design and RTO structure that meet FERC objectives yet will work for the Northwest.

We must ensure a market design that accommodates existing regional needs and structures. Specifically, the market design must allow for the fact our hydro generation system essentially operates as a single unit – not as individual resources acting on their own behalf. We must assure our final market design proposal limits price volatility and higher costs for Northwest consumers. We need to do much more work to develop and test that market design to be assured it will work in a hydro-based system and develop the necessary safeguards to make certain that we do not introduce higher costs, unproductive price volatility or cost shifts to consumers.

As part of its proposed Standard Market Design, FERC has proposed generation adequacy standards. BPA supports generation adequacy as critical to achieving a well-functioning wholesale power market. However, the principle of regional flexibility must be applied here also. The Northwest Power Planning Council has a legal mandate and responsibility for power planning in the Northwest. BPA also is currently conducting a process, which, when completed in the next one or two years, will clarify the power load serving obligations of BPA and its utility customers. And the hydro-dominated Northwest power system has abundant capacity reserves. The critical factor for the Northwest is the need to ensure adequate energy.

BPA believes that the existing processes and institutional structures in the Northwest, including the Council and the states themselves, are sufficient to ensure adequate resource development if mechanisms are introduced to assure that planned resources are built and integrated with the system in a timely manner and if developers have access to long-term transmission that is efficient and reliable with stable pricing. If RTO West can address the key factors addressed in this paper, it could become the vehicle to achieve the desired transmission part of this outcome. We understand that the Council intends to engage the region in a dialogue on how it can work with the broader RTO West region, including the states and British Columbia, on the issue of adequacy planning and enforcement. We intend to support that effort to develop regional solutions.

2. Preservation of Pre-existing Transmission Contract Rights is a must have for BPA's continued participation in RTO development.

Living in the wake of the West Coast energy crisis, consumers in this region need to know that the fundamental service they have historically enjoyed is not going to be compromised to their detriment. This is particularly important in a low-cost region that has a lot to lose. Fundamentally, we must be able to assure our customers that what they receive today, they will get in the future: access to transmission and cost-based rates for their existing loads.

BPA and many of its customers currently hold long-term network and point-to-point transmission agreements – many with terms of up to 30 years. Network service agreements obligate BPA to provide transmission capacity at points of delivery needed to meet customer loads, including load growth, over the term of the agreement. It is BPA's intent to allow these agreements to remain in place and to manage these agreements as non-converted contracts until such time as the transmission user decides to voluntarily convert to RTO West service. Additionally, BPA intends to provide customers assurance that certain "fundamental characteristics of service" under BPA's current FERC-approved tariff are set and subject to change only by mutual agreement. Because of the nature of our transmission agreements, we may need the support of FERC to successfully accomplish this strategy. As we potentially move to a new governance structure, certain assurances will be necessary for customers to know with certainty that what they receive today from BPA, they will continue to receive in the future. This may well be the most critical piece to move forward.

In addition, it is our full intent to pursue the strategy that we understand the FERC chairman has encouraged for regions with low-cost electricity generation. The chairman has suggested that regions with low-cost resources should seek to sign long-term contracts to assure the preservation of the value of the assets for existing customers. We have been conducting a public process on service from the BPA power system post-2006 and it is our goal to put in place long-term power contracts within the next one or two years. This strategy of seeking to assure the preservation of cost-based power rates increases the need to assure the quality and pricing of transmission service. Power customers that have locked in a cost-based power rate must also have assurances about transmission access and pricing to assure the value of the resource will be delivered to consumers.

3. Inclusion of sufficient transmission facilities under an RTO's operational control.

BPA's power customers served via investor-owned utility transmission facilities must not face additional costs as a result of facility inclusion decisions and must be assured of service quality, access and planning comparable to that provided by the IOUs to their own loads. BPA has included all its facilities of 34.5 kilovolts and above in the RTO West proposal for all purposes – pricing, planning and operation. We are actively working with the other filing utilities to respond to FERC's request for clarity in this area and to find a solution acceptable to our public customers and the IOUs.

4. Demonstration of sustainable benefits for the Northwest.

Before BPA will join an RTO, BPA must be able to demonstrate that consumers will be better off relative to a future without an RTO. More time is needed to design and test market structures and create a tariff that meets FERC's objectives, and to fully test and evaluate the benefits and costs of implementation.

We believe an RTO has the potential to produce sustainable benefits if correctly designed. There are critical issues that must be resolved prior to concluding a cost-benefit analysis. Among the most important are the cost and level of increased efficiency for power operations from combining multiple control area operations, the potential level of price volatility and the costs associated with mitigating such volatility (market monitoring and hedging costs), the risk of increased liability, the potential for new taxes being imposed and the potential costs of forming an RTO.

There is a strong interaction between our design of RTO West, FERC's views and, ultimately, the outcome of a cost-benefit analysis. For example, to the extent we preserve historical contract rights, it will limit the risk of price volatility. FERC has expressed its willingness to consider RTO tariff provisions that would limit liability exposure. We need to work with the states regarding how RTO West formation would impact tax considerations.

While some would argue that the cost-benefit analysis should be completed now, we believe that any cost-benefit analysis should not be completed until RTO is further developed. Ultimately, though, the cost-benefit analysis is a key test that must be used before any final decision to participate in an RTO.

Some have suggested that FERC should take a punitive approach with respect to organizations that choose not to participate in an RTO. We can understand why FERC has concerns about transmission owners who are market participants seeking to take undue advantage of others by remaining outside an RTO. But we would strongly urge that FERC not communicate the message that customers are going to be forced to choose between two bad alternatives: penalties or participation. We do not want to have our cost-benefit analysis rest on the basis that we must choose between two alternatives, both of which are worse for consumers than that provided historically. Instead, we hope to develop a proposal that is better for the Northwest than current practices and that can attract voluntary participation.

5. We need to continue to develop Western RTOs through the collaborative seams process established through SSG-WI.

We have worked hard here in the region and with adjacent RTO developers to craft a Western market vision that responds to FERC needs, yet does not call for the creation of a single West-wide RTO. We also have established a forum (SSG-WI) for facilitating

further development and detail of that vision. We appreciate FERC's acknowledgement of this work through several RTO orders. We are eager to continue that collaboration and believe that execution of the recent Memorandum of Understanding among the Western RTOs is a significant step in the right direction.

6. We need to have it clearly established that concepts critical to regional interests and to BPA's authority to participate in an RTO, which were accepted in FERC's recent order on RTO West, will not subsequently be undermined or changed by the final rule on SMD, its successor or follow-on RTO West orders.

Our goal is to focus on development of RTO West as a means to accomplish FERC's objectives while accommodating regional differences and needs. This goal is not achievable if FERC can change critical elements of RTO West agreements. We need assurance that critical elements agreed to in the RTO forums will prevail. In addition, the RTO West order can be read in many different ways. We urge FERC to seriously consider the hearing requests on this issue and provide the assurance needed to move forward.

7. We need a realistic time frame to work through the detailed development of RTO West concepts.

We believe we are being driven to achieve implementation deadlines that no longer make sense, given the uncertainty introduced in the Sept. 18 RTO West Order and the intensity of the regional dialogue around SMD. We recommend a reassessment of the RTO West implementation timeline we submitted to FERC. In particular, we must accommodate the need to address the preservation of pre-existing transmission contract rights, which has become our highest priority.

8. We need to be open to potential improvements in governance structure.

While we have an approved governance structure, we need to continue to be open to discussion with key stakeholders about potential improvements in governance structure that could further help assure cost management and responsiveness to regional priorities without compromising the test for independence between transmission and generation functions, and without compromising the independence of RTO West.

In conclusion, the Northwest has come a long way in the last two years in its effort to design a proposal for a regional transmission organization that will meet national objectives of open, reliable transmission systems while meeting unique regional needs. We believe RTO West has the potential to provide a better future for Northwest consumers and are committed to taking actions where we can to realize that potential. We will seek additional regional support for this effort and are seeking opportunities to engage in collaborative efforts to resolve regional issues. BPA remains committed to our fundamental goal of providing enhanced benefits for the region, while preserving the value of the federal power system in the Pacific Northwest.