

## The Life and Death of Regional Transmission Organizations

*Transmission should be allowed to emerge as a healthy, stand-alone business accountable to shareholders, customers, and consumers. A binary model comprised of independent transmission companies and independent market administrators would best fulfill FERC's goals of a national grid for the seamless movement of electric energy.*

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Led by its new Republican chairman, Pat Wood, the Federal Energy Regulatory Commission (FERC) has embarked on the creation of four regional transmission organizations (RTOs) that will, in due course, assume control of the national electric grid. The RTOs, one each for the Northeast, Southeast, Midwest, and West, will be institutions built by administrative law judges (ALJs) with blueprints designed by stakeholders. The owners of the transmission system hold minority status in the proceedings. The FERC process is driven by the search for accommodation of the myriad private interests that have grown disillusioned

with the first-generation independent system operators (ISOs) that FERC now seeks to re-make. FERC is driving an important stake in the ground by asserting its legitimacy in the morass of electric deregulation.

The present level of FERC regulatory intervention in the marketplace has not been seen since the Securities and Exchange Commission restructured electric utilities in compliance with the Public Utility Holding Company Act of 1935. FERC justifies its unprecedented activism on the belief that it must create the largest possible RTOs in order to also create competitive markets for power. This thesis is

without foundation; the experience of energy sector deregulation suggests, rather, that market creation is neither a function of organizations like RTOs nor a regulatory mission. The competitive markets for natural gas, oil, and telecommunications emerged, in fact, as a result of regulatory *withdrawal* from the marketplace.

## I. The Problem

The United States experience with ISOs is less than five years old. The available data indicate that in that time consumers in regions served by fully operational ISOs (California, New England, New York, the Mid-Atlantic) were not better off than consumers in regions without ISOs. ISOs have proven to be costly undertakings, each requiring between a quarter and a half billion dollars merely to come into existence. The ISOs have tended to increase the cost of service on the grid while presiding over a sharp increase in congestion. They have not succeeded in fostering new investment to expand the system, nor in facilitating the path of new generators seeking connection to the grid. Most importantly, with one notable exception, fully competitive markets for electric energy have not yet surfaced.

In 2000, Northeast customers paid \$3.7 billion for transmission service, comprising \$2.3 billion for normal service and \$1.4 billion for transmission congestion. Customers in New York bore \$1 billion of those congestion charges, which resulted from the running of more

expensive generation than the market could economically dispatch due to physical limitations of the grid. Those charges, over one-third of the transmission bill, have not been reduced by the ISO model and are likely to be perpetuated by a structure that has no motivation or means to build new transmission facilities. Given this record, it is unclear why FERC would wish to advance an institutional model that seems to have

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been overwhelmed by the mission assigned to it. FERC may have erred in granting the first-generation ISOs the sweeping functions and authority they have held for the last four years. Stakeholders who supported the ISO model assumed that their "nonprofit" status would assure the equivalent of low-cost public service. This expectation proved naïve.

History suggests that although four RTOs could be expediently formed by regulatory fiat, they will inherit institutional constraints of near-paralytic proportions. The new RTOs will not be evolutionary organizations with institutional

memory. Rather, they will be required to craft new structural and operational missions out of stillborn predecessor ISOs. There will be no seamless inheritance of commitments and authority, but rather a general mood of resentment and suspicion among market participants who have lived through one too many regulatory bouts of trial and error. FERC's RTOs will be government creations lacking business purpose, unsuited to the grid architecture of their regions.

## II. What FERC Wants

FERC has convinced itself that competitive markets for power are a function of the size of RTOs. It equates the structure, size, liquidity, and volatility of markets with the scope and configuration of RTOs. It has reasoned that the non-competitive electric market conditions existing nationwide can only be rectified by the constitution of RTOs comprising the number of market participants found only in very large geographic areas. In sum, FERC envisions four power markets, coincident, in the end state of the settlement discussions, with the four RTOs that FERC will create.

No study exists to support the view that the four markets in question, bounded by FERC's arbitrary geography, will be feasible or viable or better or worse than markets that would emerge in the absence of a federal mandate. Efficient markets are actually constituted by the logic of trading patterns, energy flows, and economics,

suggesting, for example, that the abundant and cheap power of the Midwest would be transmitted seamlessly to load centers in the North, East, and South. Markets, in other words, have no boundaries except those dictated by competitive opportunity. FERC can no more assign geography to markets than it can order markets to be competitive.

**S**till, FERC wants unequivocal dominion over the interstate transmission system: grid functions organized and operated independently of the essentially deregulated generation business and of the states-controlled local distribution systems. FERC wants grid institutions that are few in number (for ease of oversight) and responsive to its policy direction. It will give preference to RTOs that are accountable to regulators rather than to those who would be accountable to shareholders. In sum, FERC will continue to pay lip service to its self-declared but ill-defined "open architecture" organizational models, while sanctioning RTOs that, in fact, are not.

FERC wants one-stop shopping for transmission service, postage stamp rates, independent calculation of available capacity, the correct pricing of congestion though not necessarily its actual reduction, and an energy market of only moderate volatility. It wants a single tariff across large territories, and planning and expansion functions that supersede those of the transmission owners. And yet, the ISOs it has sanctioned have produced results that are incompatible with these objectives.

### III. What Transmission Owners Want

As was the case with the restructuring of natural gas pipelines, transmission-line owners (TOs) seek to manage these assets as a profitable business, an option so far denied by the FERC. First-generation ISOs imposed the requirement that owners relinquish control of their transmission systems to an independent third

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party while retaining ownership rights exercisable mainly to secure cost-based revenue. Tax policy also proved a disincentive to transmission-only business creation, given the penalties imposed on the selling utility. The market organizations that evolved in conjunction with ISOs further confused TO decision-making by questioning owner's rights to transmission service on their own wires. In sum, the initial phase of restructuring raised grave doubts in the minds of the TOs as to the actual control they could exert over their assets and as to the shareholder value they were likely

to derive from an ISO-controlled transmission system.

In the present, reconstruction phase of RTO development, FERC has the choice of repeating previous structural errors by showing deference to nonprofit RTOs that will control but not own the grid, or it can encourage structures that unite rather than separate ownership and control of wires. Given the chance, TOs will develop and perfect business models for the operation and management of transmission, but only in the context of a regulatory environment that is both more certain as to policy and more respectful of property rights than indicated by recent FERC behavior.

### IV. What States Want

The statutory tensions between federal and state regulators have seldom been more pronounced than in the restructuring process of the electric utility sector. Jurisdictional jealousies, some dating back to the grand compromise that was the Federal Power Act of 1935, have prevented state commissions and FERC from seeking policies' common ground. FERC has guarded its prerogative to restructure the interstate commerce for electricity, whether or not the resulting institutions would assist or harm state efforts to induce competition in retail markets. For their part, state commissions and legislators—in more than half of the nation—have restructured their electric utilities with little regard for the eventual cost or viability of their

proposals. The results have been haphazard.

The great states of California, New York, Pennsylvania, Texas, and Illinois, with variations on the theme of stranded costs and divestiture of assets, have created what are essentially single-state markets, operating under frozen retail rates, but dependent on wholesale energy that is bought and sold at market prices. This formula proved disastrous in California. Illinois has been unable to foster the creation of either a wholesale or retail market. New York has imposed costs on its consumers that could have been largely avoided if the state had joined its neighbors to the east and south in creating a unified marketplace. Texas, using a design developed under the tutelage of Wood, the new FERC chairman, is at the start of its process, but carrying all of the vulnerabilities of the other single-state markets. Pennsylvania, home to Commissioner Nora Brownell, the second Bush appointee, succeeded in diversifying suppliers to its retail customers but at prices that reflect the competitive limitations of the Pennsylvania-New Jersey-Maryland (PJM) marketplace.

States appear to want a competitive wholesale electric market that nevertheless guarantees a very modest degree of price volatility. They seek transmission rates that will remain flat or frozen over time, while requiring reliable service without regard to the need for investment—and siting—in new plant. States want preferences for their native customers, nonprofit

RTOs whose management they can influence, and unregulated prices for energy that mimic the stability of regulated rates. States, in short, want the implausible.

### V. A Better Model

A proper diagnosis of the present debacle in the power sector would lead to the conclusion that the problem is fundamentally with the structure of the electric

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markets, and only secondarily and perhaps inconsequentially with the actual operation of the grid. There is no doubt that competitive wholesale electric markets require changes in transmission tariffs and grid management practices. Current practices, principally economic in nature, impede transactions across the nation's 130 electric control area boundaries. The necessary changes, however, can be made without indiscriminate federal control of privately owned transmission businesses. FERC can mandate unified tariffs and common business practices as it did earlier this year between the

Midwest ISO and the Alliance RTO. That effort created a vast, essentially seamless Midwest market, the largest in the world, which can be placed under the control of an independent market administrator (IMA). The IMA will be able to handle spot and forward energy markets, forward markets to manage congestion, and markets for ancillary services. Thus, the transmission grids can be organized and managed as businesses by independent transmission companies (ITCs) such as the newly proposed TransLink, and the American Transmission Company of Wisconsin.

A similar division of responsibility had been proposed in filings to FERC from transmission owners in the Northwest and Northeast. Yet, FERC has demurred exceptionally in all such filings, claiming insufficient understanding of the contemplated division of authority between the ITCs and the IMAs. Since the July 12 RTO orders, more transmission owners have expressed interest in a binary IMA/ITC model than have in replication of ISOs.

The binary model satisfies most of the participants on most of the issues that currently divide them: assurance of ownership rights; nondiscriminatory open access to the grid; clear opportunity for expansion; seamless transmission of energy at reasonable cost; congestion reduction by physical and market means; a business model for profitable grid enterprises; independent security, reliability, planning, market monitoring, and

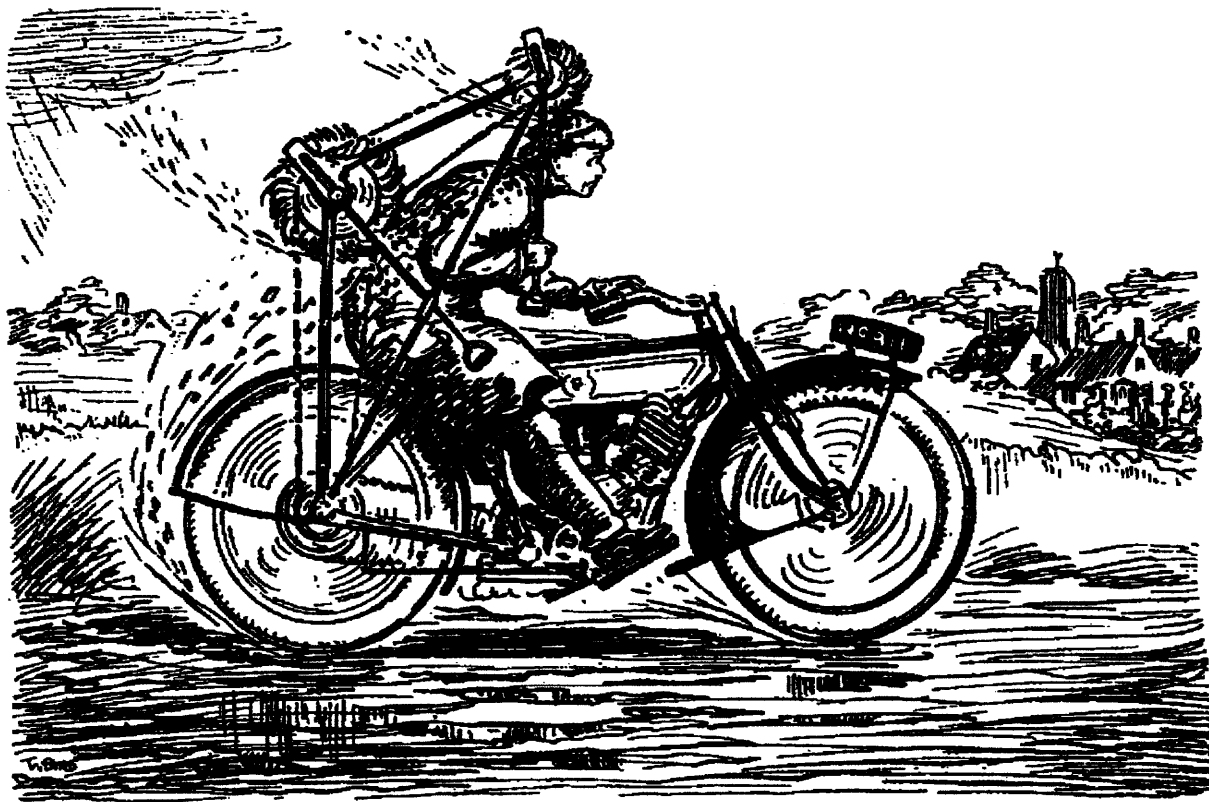
dispute resolution functions; and, most of all, a market operator whose sole objective will be to organize and operate a competitive market for electric energy.

**M**arkets are the key to FERC's policy objectives. Their size, scope, and configuration are more critical to competition than the size, scope, and configuration of the regional grids, and far more important than the number of transmission companies that would be established in any given region of the country. Electricity markets need undivided attention if they are to achieve the same degree of commoditization that is the case with the petroleum and natural gas markets.

Binary RTOs provide an appropriate division of labor between the business functions of ITCs and the public policy functions of IMAs. The number of ITCs that will emerge in any given region will matter less than the fact that they will operate within unified markets, under a single tariff, and with common reliability and financial oversight. Furthermore, electric energy markets will be broader and more competitive if, contrary to FERC's thesis, they did *not* coincide with the proposed geographic limits of FERC's proposed RTOs. Natural gas and oil markets are national rather than regional in scope. The evidence is incontrovertible that markets become less competitive when they are geo-

graphically fragmented, as was the case with gasoline, whose market structure collapsed as a result of regulatory intervention for localized blends.

**T**ransmission should be allowed to emerge as a healthy, stand-alone business accountable to shareholders, customers, and consumers. The organization and nurture of a vibrant marketplace for electric energy should be the concentrated task of separate, specialized organizations, whose sole purpose will become the creation of competitive markets for power. Together, ITCs and IMAs can be expected to fulfill FERC's goals of a national grid for the seamless movement of electric energy. ■



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