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## Standard Market Design: What Went Wrong? What Next?

*Notwithstanding its worthy objectives, few would contend that the Federal Energy Regulatory Commission's venture into SMD has been a success, measured by any yardstick. Now, the Commission has been forced to backtrack.*

*Mary Anne Sullivan, Joseph C. Bell, and John R. Lilyestrom*

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### I. Background

When Pat Wood and Nora Brownell were sworn in as commissioners of the Federal Energy Regulatory Commission (FERC) on June 5 and June 12, 2001, respectively, the California electricity crisis was into its third quarter, threatening not just electricity service but the economic well-being of the world's sixth-largest economy. They had to feel enormous satisfaction when their votes just days later, on June 19, provided FERC with majority support for capping wholesale electricity prices in California,<sup>1</sup> an action that had the nearly immediate effect of sharply reducing spot market prices to

levels far below the cap FERC had set.<sup>2</sup> That order, more than any other of the extraordinary steps taken by the various government entities that played roles in trying to rein in the crisis, brought it to an end.

Given its experience with California—and the contrast with success elsewhere—one cannot fault the Commission for turning its attention to the effort of trying to find the rules that would ensure competition, non-discrimination, and transparency in wholesale electric markets throughout the country so that a crisis like that in California could not recur there or elsewhere. Little more than a year later, the Notice of Proposed Rulemaking known

as Standard Market Design (SMD) emerged.<sup>3</sup> Although it left many issues open, the proposed rule attempted to embody all of the best learning about structuring electricity markets using bid-based, security-constrained, economic dispatch with locational marginal pricing and financial hedges against congestion, and it also tried to address the longer-term issues of resource adequacy.

Notwithstanding the worthy objectives, few would contend that FERC's venture into SMD has been a success—measured by any yardstick. The Commission has been forced to backtrack. All that remains to be seen is how far back it must recede. This article looks at what happened and why; it also considers the potential long-term adverse consequences on the functioning of the Commission.

## II. The Proposed Rule

The principal features of the SMD proposal were:

- Adoption of a single transmission tariff that would have applied to all transmission customers—wholesale, unbundled retail, and bundled retail;
- Transfer of control over all utility transmission systems to an Independent Transmission Provider;
- Establishment of locational marginal pricing (LMP) energy markets and tradable financial rights (congestion revenue rights,

or CRRs) as a means to fix the costs of transmission service; and

- Development of procedures for ensuring long-term resource adequacy.

In the accompanying press release, Chairman Wood explained:<sup>4</sup>

Our goal is to promote economic efficiency in electricity for the benefit of all Americans. Standard market design and standard transmission service lets sellers

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transact easily across geographic boundaries, cuts costs to customers, and improves reliability. We want solid infrastructure, just and reasonable rates, and balanced market rules so investors and competitors see some stability and opportunity in all aspects of the bulk power business. These clear rules and vigilant oversight under a uniform system will replace the obsolete patchwork we have today.

## III. The State Reaction

Others saw these worthy and high-minded goals differently. Many state utility commissioners, particularly in the Southeast and Northwest, quickly attacked SMD as an unwarranted move by FERC

into traditional areas of state regulation. The hue and cry was immediate and continued to grow throughout succeeding months during which allegations of market manipulation, misleading price reporting, and the withholding of gas needed for electricity generation during the California electricity crisis became topics the general public, state utility commissioners, and members of Congress could read about in the daily newspaper as they drank their morning coffee.

Some saw these problems as a justification for the very types of restructuring FERC was proposing. But the negative backdrop they created, combined with the Commission's recent history of inaction in California, suggested to many that FERC was simply not up to the task of assuming greater control over the nation's electricity systems.

While various states argued that FERC had not shown that the overall benefits of SMD adequately supported its costs, the focus of the state objections was most clearly on the loss of control over utility services and rates and what they saw, perhaps mistakenly, as their inability to protect their ratepayers from the loss of low-cost power and the exposure of the ratepayers to new risks, including the possibility of California-style market chaos.

As proposed, SMD would have required that all transmission service, including the transmission component of bundled retail service to native load customers, be provided at rates and under

terms and conditions established by FERC. State commissions in areas of the country that had yet to implement retail restructuring saw this as a completely unwarranted power grab by FERC. In many states, native load customers are served at fixed or capped retail rates, with such service wholly under the authority of the state commissions. FERC's expansion of authority under SMD would split up this jurisdiction and, states argued, could result in cost increases for transmission service being passed through to retail customers with no oversight from the affected state commission.

In particular, state commissions in traditionally low-cost states viewed SMD as forcing California-like risks on their traditional regulated utility model. States that took a go-slow approach to retail restructuring believed that the problems in the California market proved the wisdom of the go-slow approach. Indeed, in aftermath of California, a number of states stepped back from retail choice and the spinning off of generation from the regulated entity. But just as this was going on, FERC introduced its SMD proposal, which the states perceived—wrongly in our view—as forcing the disaggregation of all affected utilities and the replacement of traditional cost-of-service pricing for the generation component of service to native load customers with a market-driven pricing scheme.<sup>5</sup> Moreover, states objected that the creation of congestion revenue

rights would subject native load to costs of congestion that native load was not causing. While SMD proposed that CRRs would be allocated to native load initially, in future years they would be made available to the highest bidder in CRR auctions.

In most states in the Southeast, retail restructuring has yet to make any progress, and most native load customers have access to relatively low-cost power from their tradi-

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*States also expressed concerns regarding the establishment of ITPs, who would be outside of the scope of state regulatory jurisdiction.*

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tional regulated utility. These states viewed SMD as imposing the potential problems associated with a restructured electric market on a system that was working perfectly fine. In addition, Southeastern states expressed considerable concern that SMD would result in the export of their low-cost power to serve customers in higher-cost states to the north, again not necessarily the case but widely believed.

States in the Pacific Northwest also objected to the one-market-fits-all SMD approach on the grounds that LMP-based energy pricing does not send the right price signals with respect to the

dispatch of the region's predominantly hydro-based generation. In addition, Northwest interests argued that SMD was not appropriate for the Northwest because the largest generator and distributor of power in the region, the Bonneville Power Administration, is a federal power marketing agency not directly subject to the portions of the Federal Power Act that form the basis for the SMD proposal.

States also expressed significant concerns regarding the establishment of Independent Transmission Providers, who would be outside of the scope of state regulatory jurisdiction. Although the transmission component of service to native load would remain a cost-based service, the states would have no authority to monitor the ITP's costs and would have no ability to limit the passthrough of such costs in rates. As such, there would be very limited checks on the ability of an ITP to spend money and to "gold plate" its systems. Similar claims have already been made on numerous occasions regarding existing RTOs such as PJM in the Pennsylvania–New Jersey–Maryland region.

Many states also reacted strongly in opposition to the proposal in SMD to take resource adequacy decisions out of the hands of the states and hand them over to the ITPs. FERC's decision to act in this area seemed somewhat strange given that the states continue to control siting of transmission. Again, states viewed this as FERC unfairly usurping a traditional state function

necessary to ensure continuing reliability of service to native load.

As it turned out, the state commissioners proved very effective in persuading many that their concerns deserved more weight than FERC seemed likely to give them in the normal rule-making comment process.

#### IV. Why Was This Time Different?

Why, instead of relying on the usual Commission rulemaking processes and court review, did the challenges to SMD take an overtly political turn? The two words, "California" and "Enron" provide much of the answer to that question, but they are not the whole story.

As discussed above, it was state commissioners, who had been so recently traumatized by the evidence that, in a situation like the California crisis, they might be powerless to take meaningful action, who most loudly sounded the drumbeat against SMD. At another time, they might have been seen as simply fighting to preserve their turf, but now they could point with some moral suasion to the fact that FERC for nearly a year failed to protect consumers in California and most of the West.<sup>6</sup> The memories of the worst of the California price spike had no opportunity to fade because there was a steady stream of decisions coming out of FERC rejecting, or granting in only limited degree, requests for refunds and requests to void the

long-term contracts negotiated as the crisis period was drawing to a close.<sup>7</sup> Moreover, state commissioners were much more inclined (and better prepared) to seek political solutions to block SMD than traditional FERC litigants would have been.

For purposes of the fate of SMD, the issue is not whether the FERC decisions were correct. Rather, they provided an ongoing reminder that, having failed to

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act decisively to protect California ratepayers in the crunch, FERC was providing no meaningful after-the-fact relief, while it was at the same time seeking both to expand its jurisdictional reach and bestow broad new authority on RTOs, some of which were yet to be formed, relegating the state commissions to an advisory role on issues state commissioners saw as crucial to their ability to protect ratepayers. In the minds of SMD's critics, FERC's arguments about the need for balanced market rules, transparency, and congestion management had an academic and speculative air to them, while the risks to ratepayers based on the

California experience seemed far more tangible and dramatic.

Further fueling the anti-SMD flames was the emergence of the Enron debacle during the same period the SMD rule was on the street for comment. While FERC sees implementation of SMD as a means to protect against the kind of market manipulation that Enron and its fellow traders are now accused of, the politicians saw it as evidence that FERC could not manage the issues already under its watch. In that environment, it did not take much for the opponents of SMD to persuade members of Congress that FERC should not be allowed to proceed with a wholesale reconfiguration of electricity markets.

But the forces that came together to undo SMD as a mandatory, one-size-fits-all approach to regulation of wholesale electricity markets, were more complicated than California and Enron can explain. There were some important signs that FERC missed as to just how difficult it would be to implement its proposed version of SMD:

- The same kind of regional tensions and differences that sparked the opposition to SMD had precluded Congress from making any real progress on electricity restructuring proposals that have been floated for almost a decade.

- In the Northeast, where there are two strong, functioning ISOs, FERC's directive to meld them into one RTO met with failure.<sup>8</sup>

- The Midwest ISO, frequently described as the nation's first

functioning RTO, is running well behind schedule and well over budget in achieving full implementation.

- Bonneville Power Administration, whose low-cost power gives it enviable and consistent political support, has long resisted the idea that it can adapt to FERC's formula for an RTO. Without BPA, an RTO for the Northwest makes little sense.<sup>9</sup>

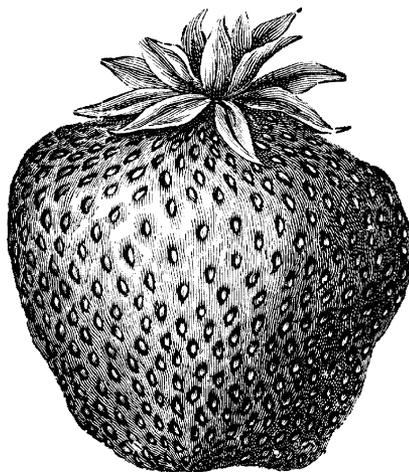
- Progress towards forming RTOs under the terms of Order 2000 was faltering or completely stalled not only in the Northwest, but also in the Southeast and portions of the Midwest. While other regions were making good progress, that progress demonstrated that they did not really need the SMD rulemaking. In effect, the only parties primed to support SMD did not seem to need it.

In its own defense, FERC points out that, before it issued the SMD proposal, it undertook an unprecedented level of regional consultation.<sup>10</sup> FERC consulted but, in the end, it did not recognize the depth of the concern and the strength of the opposition that was voiced at those regional conferences. It plunged forward, and the result has been neither pretty, nor promising for FERC's ability to move its agenda for opening up markets and increasing competition.

## V. Looking Forward

In its April 28, 2003, White Paper, FERC has drawn back from

some of the most controversial elements. In a sort of SMD Lite, renamed the "Wholesale Market Platform," FERC leaves the price regulation of bundled transmission with the states; keeps itself open in theory to non-LMP mechanisms for congestion management; establishes the right of entities with a service obligation to native load to obtain FTRs to



protect themselves from congestion charges on their firm transmission, removing the auction requirement; even further expands the role of market monitors, and enhances the role of the states (including taxing users to pay for the costs of state participation) in ISO and RTO activities.

While the White Paper preserves certain of the critical ideas, it is clear that progress forward is likely to be slow and uneven. For some areas—the Northeast, PJM, and the Midwest—most of the debate over SMD has in fact been largely irrelevant. The regions are already committed to most of the design principles and have or are well on their way to having large

regional functioning markets. There are complicated issues in front of these entities, but with pressure from FERC, they are already addressing them. These regions will continue to be the models, but the extension of the underlying principles and design to other regions will be slower and, as the Northwest already shows, may take a different and more evolutionary approach.

The White Paper maintains that virtually all utilities have already joined or have committed to join an ISO or RTO and suggests therefore that the requirement of the Wholesale Market Platform that all utilities join an ISO or RTO is not a major step. In fact, the picture is much more mixed. The expected merger of the Southwest Power Pool and MISO has fallen apart, and efforts to form RTOs in the Southeast are proceeding at various paces. For example, the GridSouth RTO has suspended implementation activity. Thus, just achieving this simple objective will take considerable effort. FERC, of course, will continue to have its basket of sticks and carrots to encourage those changes it believes desirable.

In some ways the slowdown is an advantage. There are important issues to be worked out such as the seams issue between PJM and the Midwest ISO. Getting those issues right in the Midwest and the Northeast is important in itself and can serve as a guide for further integration. To the extent that the LMP model is superior (e.g., correctly allocates costs and provides the correct signals

regarding generator location and generation/transmission trade-offs) it will eventually command assent or at least acceptance. The greater emphasis on cost/benefit analysis will also be salutary. The costs of setting up and running RTOs have been significant, and while in the early stage of development this is understandable, the governance structure does not create strong incentives for efficiency. Indeed, because of the overriding importance attached to reliability concerns, all incentives for management run the other way.

Conflicts with the Southeast have been postponed, but the issues are still likely to be joined. If FERC had proceeded stepwise to achieve SMD without proclaiming its universal message, it would have been in a much stronger position when the issue was joined. Now it must proceed having exposed its political vulnerability, which may require it to make still further compromises.

## VI. A Precautionary Lesson

FERC in Order 888 set the course for a fundamental change in the industry, but in doing so it chose very carefully to minimize its exposure on issues where the opposition was most vigorous, e.g., preserving existing contracts, eschewing unbundling. Further, through step-wise extensions since Order 888, very considerable progress has been made

towards opening markets to greater competition, especially in high-cost regions. By abandoning the measured, step-wise approach with its SMD proposal, however, the Commission has undercut its own ability to act in the future.

FERC has near-complete authority within the subjects of its jurisdiction, today most



notably interstate transmission of natural gas and electricity and wholesale sales of electricity. Over most of its history, FERC has exercised that jurisdiction in relative obscurity, and for a regulatory agency, such obscurity is a good thing. In FERC's case, it has been able to achieve important changes in energy markets, moving them incrementally but assuredly toward greater competition, creating in the process opportunities for new participants.

Virtually every significant regulatory change FERC has made has been challenged in the courts, even occasionally up to the Supreme Court.<sup>11</sup> But the debate was largely confined to the

halls of the Commission and thereafter to courtrooms. In the courts, FERC's *authority* has quite consistently been upheld. The rulings against it have generally been the result of a failure by the Commission to adequately explain or document its conclusions, not the result of findings that the Commission lacked the authority it sought to exercise.<sup>12</sup> Indeed, in FERC's last trip to the Supreme Court, in *New York v. FERC*,<sup>13</sup> the Supreme Court not only upheld FERC's Order 888, but gave a strong indication the Commission could have (and in the view of the three justices, probably should have) gone further and asserted jurisdiction over the transmission portion of bundled retail sales. Indeed, FERC's success in the appeal of *New York v. FERC* may have misled it regarding its real strength to impose change.

If FERC had been subject to only a judicial challenge to SMD, it would have likely experienced a similar success to that it enjoyed with respect to Order 888. But this time, the challenge was a political one, and FERC has learned that its *authority* to act is not the same as its *power* to act. This experience has undoubtedly made the Commission more sensitive to the political environment in which it operates and the limitations that may impose in its policy decisions moving forward. There may, however, be another "lesson" which FERC has learned. The experience with SMD and California may tempt the Commission to also look at politics in making

enforcement and legal decisions. Should this occur, it could be a profoundly negative development. ■

**Endnotes:**

1. *San Diego Gas & Elec. Co. v. Sellers of Energy and Ancillary Services*, 95 FERC ¶ 61,418 (2001). The Commission's actions in the June 19, 2001, order in which it established a western inter-connection-wide price cap established at the hourly market-clearing price in the California Independent System Operator's spot market auction can be contrasted to the Commission's reluctance two months previously to do more than establish monitoring and reporting requirements after the fact with regard to bids above a \$150/MWh breakpoint.

2. Market Analysis Report for June 2001, Anjali Sheffrin, *California Independent System Operator Director of Market Analysis* (available at <http://www.caiso.com/docs/2001/07/20/200107201733319105.pdf>).

3. *Remedying Undue Discrimination Through Open Access Transmission Service and Standard Electricity Market Design*, 67 Fed. Reg. 55,451 (Aug. 29, 2002), IV FERC Stats. & Regs. ¶ 32,563 (July 31, 2002).

4. Press Release accompanying Order in Docket No. RM01-12-000 (July 1, 2002).

5. While the proposed rule accommodated the restructured model where generation was spun off from distribution and operated competitively, it was in fact equally compatible with a vertically integrated model for generation and distribution where rate payers continued to be served by generation incorporated into rate base. Only transmission was restructured, but even there, it would have been possible to keep ratepayers of vertically integrated utilities in much the same position as they enjoyed prior to restructuring, with two possible important exceptions: (a) assurance that congestion rights would be allocated to protect native load; and (b) inclusion

of RTO administrative fees in rates. See SMD NOPR, at 34,331–34,336.

6. The fact that it was a different FERC is hardly comfort enough to answer the critics.

7. See *San Diego Gas & Elec. Co. v. Sellers of Energy and Ancillary Services*, 102 FERC 61,317 (2003) (initial refund order for period Oct. 2, 2000 to June 20, 2001 setting refunds at a level much lower than California sought); *PacifiCorp v. Reliant Energy Services, Inc., et al.*, 102 FERC ¶ 63,030 (2003)



(rejecting PacifiCorp complaint seeking abrogation of long-term contracts for Summer 2001); *State of California ex rel Lockyear v. British Columbia Power Exchange Corp.*, 99 FERC ¶ 61,295 (2002), *reh'g denied*, 100 FERC ¶ 61,295 (2002), *appeal filed sub nom. State of California v. FERC*, No. 02-73093, 9th Cir. (rejecting California claim for refunds from market-based rate pricing into California).

8. See *Bangor Hydro-Electric Co. et al.*, 96 FERC ¶ 61,063 (2001); *New York Independent System Operator, Inc. et al.*, 96 FERC ¶ 61,059 (2001); *PJM Interconnection LLC*, 96 FERC ¶ 61,061 (2001).

9. See Commission White Paper, Wholesale Power Market Platform, April 28, 2003, at 3–4. (“White Paper”)

10. See Press Release accompanying Order in Docket No. RM01-12-000 (July 1, 2002). Among other things, as part of the 10-month pre-SMD release process, FERC engaged in a week-long RTO technical conference in Oct. 2001, held follow-on conferences in January,

February, and July of 2002 regarding specific issues, issued a working paper and received comments from all segments of the industry thereon in the spring of 2002, and held a series of meetings with state commissions and industry leaders before issuing SMD.

11. See, e.g., *New York v. FERC*, 535 U.S. 1 (2002) (upholding Commission's Order No. 888 open access rule); *Amer. Paper Inst., Inc. v. Amer. Elec. Pow. Serv. Corp. et al.*, 461 U.S. 402 (1983) & *FERC v. Mississippi*, 456 U.S. 742 (1982) (upholding FERC interpretations of the Public Utilities Regulatory Policies Act of 1982).

12. Reviewing courts apply an arbitrary and capricious standard of review of FERC decisions under the Administrative Procedure Act. See *Union Pac. Fuels. Inc. v. FERC*, 129 F.3d 157 (D.C. Cir. 1997); 5 U.S.C. § 706(2)(A) (1994). Reviewing courts thus seek to determine if “the Commission's decisionmaking is reasoned, principled, and based upon the record.” *Penn. Office of Consumer Advocate v. FERC*, 131 F.3d 182 (D.C. Cir. 1997). Accordingly, FERC is often overturned on the grounds that there is no substantial record evidence for its conclusions, see, e.g., *Mississippi River Transmission Corp. v. FERC*, 759 F.2d 945 (D.C. Cir. 1985) or on the grounds that it has adopted new standards without substantial record evidence, see, e.g., *United Gas Pipe Line Co. v. FERC*, 597 F.2d 581 (5th Cir. 1979). Note, however, that FERC's authority with respect to ISOs was recently dealt a significant setback in *Atlantic City Electric Co., et al. v. FERC*, No. 97-1097, slip op. (D.C. Cir. May 20, 2003), in which the court concluded that FERC had overreached in an earlier order on remand and held that FERC has no authority to force utilities to give up their Federal Power Act Section 205 rights upon joining an RTO and that FERC cannot require Commission approval under Federal Power Act Section 203 before a utility can withdraw from an ISO.

13. See *New York v. FERC*, 535 U.S. 1 (2002) (Thomas, J., Scalia, J., and Kennedy, J. concurring in part and dissenting in part).