

Exhibit No. _____

FEDERAL ENERGY REGULATORY COMMISSION

DOCKET NO. RM99-2-000; ORDER NO. 2000

COMMISSION CONCLUSIONS ON SECTION III.A
*EXISTENCE OF BARRIERS AND IMPEDIMENTS TO ACHIEVING
FULLY COMPETITIVE ELECTRICITY MARKETS*

Exhibit No. 727
Date 7-13-00 Case No. RM99-2-000-292
Reporter me

control area reservation and back office staff to handle the five percent of its transmission business that is wholesale related and still is having difficulty keeping pace with OASIS and tagging administrative processes. FirstEnergy asserts that due to relatively new processes associated with open access transmission, there are often good faith disputes over the proper interpretation of the Commission's requirements and these disputes should not be mischaracterized as continued discrimination.

Commission Conclusion

Engineering and Economic Inefficiencies

In this Final Rule, we affirm our preliminary determination that the engineering and economic inefficiencies identified in the NOPR ⁹⁰ are present in the operation, planning and expansion of regional transmission grids, and that they may affect electric system reliability and impede the growth of fully competitive bulk power markets. The sources of these inefficiencies involve: difficulty determining ATC; parallel path flows; the limited scope of available information and the use of non-market approaches to managing transmission congestion; planning and investing in new transmission facilities; pancaking of transmission access charges; the absence of clear transmission rights; the absence of secondary markets in transmission service; and the possible disincentives created by the level and structure of transmission rates. Virtually all commenters agree

⁹⁰FERC Stats. & Regs. ¶ 32,541 at 33,697.

that at least some of these inefficiencies exist. There is substantial agreement among commenters that most of the engineering and economic obstacles identified by the NOPR arise from the current industry structure and can be rectified through development of regional transmission entities.

As noted by Allegheny, the industry historically has done an excellent job of regional coordination in implementing voluntary standards to maintain the security of the transmission system through various study groups and planning committees. However, virtually all commenters agree that new competitive pressures are interfering with the use of traditional methods of coordinated regional transmission planning. As a result, new transmission additions that will benefit reliable grid operations are being delayed. Some commenters state that the increasing frequency and duration of power outages have cost the economy billions of dollars, and they predict that unless this problem is addressed now the reliability of power supply will worsen. The traditional use of regional coordination through study groups and planning committees is no longer effective because these entities are usually not vested with the broad decisionmaking authority needed to address larger issues that affect an entire region, including managing congestion, planning and investing in new transmission facilities, pancaking of transmission access charges, the absence of secondary markets in transmission service, and the possible disincentives created by the level and structure of transmission rates.

We recognize, as some commenters point out, that the degree to which these inefficiencies act as obstacles to electric competition and reliability varies from system to system. However, we believe it is clear that such inefficiencies exist and are sufficiently widespread that they must be addressed to prevent them from interfering with reliability and competitive electricity markets.

Continuing Opportunities for Undue Discrimination

As noted, many transmission customers and some transmission providers argue that there are continuing opportunities for undue discrimination under the existing functional unbundling approach. A number of the commenters provide examples of events that, in their view, indicate that transmission owners are engaging in undue discrimination. These commenters also generally believe that even the perception of undue discrimination is a significant impediment to the evolution of competitive electricity markets. A number of transmission providers challenge the relevancy of these examples, characterizing them as unsubstantiated or anecdotal allegations that do not rise to the level of evidence of undue discrimination necessary to support generic action. These transmission providers further contend that many disputes simply reflect good faith efforts of transmission providers to interpret the Commission's pro forma tariff and standards of conduct. These commenters also generally share the view that the Commission should not base its decisions in this rule on mere perceptions that may be prevalent in the industry.

For the most part, the challenges mounted by these commenters are focused against a determination by the Commission that it should mandate participation in RTOs in this Rule. As noted in Section C.1 of this Rule, we have also determined that a measured and appropriate response to the evidence presented and concerns raised is to adopt a voluntary approach to the formation of RTOs. However, as discussed below, we do conclude that opportunities for undue discrimination continue to exist that may not be remedied adequately by functional unbundling. We further conclude that perceptions of undue discrimination can also impede the development of efficient and competitive electric markets. These concerns, in addition to the economic and engineering impediments affecting reliability, operational efficiency and competition, provide the basis for issuing this Final Rule.

At the outset, it is important to note that the conclusion that there are continuing opportunities for undue discrimination should not be construed as a finding that particular utilities, or individuals within those utilities, are acting in bad faith or deliberately violating our open access requirements or standards of conduct. However, we cannot ignore the fact that the vertically integrated structure reflected in the industry today was created to support the business objectives of a franchised monopoly service provider that owned and operated generation, transmission and distribution facilities primarily to serve requirements customers at wholesale and retail in a non-competitive environment. Clearly, there are aspects of this vertically integrated structure that are difficult to

transition into a competitive market. As we noted in the NOPR and Order No. 888, vertically integrated utilities have the incentive and the opportunity to favor their generation interests over those of their competitors. If a transmission provider's marketing interests have favorable access to transmission system information or receive more favorable treatment of their transmission requests, this obviously creates a disadvantage for market competitors.

While we have attempted to rely on functional unbundling to address our concerns about undue discrimination, there are indications that this is difficult for transmission providers to implement and difficult for the market and the Commission to monitor and police. In cases in which the Commission has issued formal orders, we have found serious concerns with functional separation and improper information sharing with respect to at least four public utilities.⁹¹ In addition, our enforcement staff is receiving an increasing number of telephone calls about standards of conduct issues, ranging from simple questions about what is permissible conduct to more serious complaints alleging

⁹¹See *Wisconsin Public Power Inc. SYSTEM v. Wisconsin Public Service Corporation*, 83 FERC ¶ 61,198 at 61,855, 61,860, order on reh'g, 84 FERC ¶ 61,120 (1998) (WPSC's actions raised "serious concerns" as to functional separation; WP&L's actions demonstrated that it provided unduly preferential treatment to its merchant function); *Washington Water Power Co.*, 83 FERC ¶ 61,097 at 61,463, further order, 83 FERC ¶ 61,282 (1998) (utility found to have violated standards in connection with its marketing affiliate); *Utah Associated Municipal Power Systems v. PacifiCorp*, 87 FERC ¶ 61,044 (1999) (finding that PacifiCorp had failed to maintain functional separation between merchant and transmission functions).

actual violations of the standards of conduct. In a number of cases, our staff has verified non-compliance with the standards of conduct.⁹² The petitioners for rulemaking in Docket No. RM98-5-000 allege that there are common instances of "unauthorized exchanges of competitively valuable information on reservations and schedules between transmission system operators and their own or affiliated merchant operation employees."⁹³ They also cite OASIS data showing an instance where a transmission provider quickly confirmed requests for firm transmission service by an affiliate, while service requests from independent marketers took much longer to approve. We believe that some of the identified standards of conduct violations are transitional issues resulting from a new way of doing business, and we acknowledge that many utilities are making good-faith efforts to properly implement standards of conduct. However, we also believe that there is great potential for standards of conduct violations that will never even be reported or detected. Moreover, as we stated in the NOPR,⁹⁴ we are increasingly concerned about the extensive regulatory oversight and administrative burdens that have resulted from policing compliance with standards of conduct. The use of standards of

⁹²See, e.g., Communications of Market Information Between Affiliates, Docket No. IN99-2-000, 87 FERC ¶ 61,012 (1999) (Commission issued declaratory order based on hotline complaint clarifying that it is an undue preference in violation of section 205 of the FPA for a public utility to tell an affiliate to look for a marketing offer prior to posting the offer publicly).

⁹³Petition at 15.

⁹⁴FERC Stats. & Regs. ¶ 32,541 at 33,711-12.

conduct is not the best way to correct vertical integration problems. Their use may be unnecessary in a better structured market where operational control and responsibility for the transmission system is structurally separated from the merchant generation function of owners of transmission.

We also cannot dismiss the significance of reports of undue discrimination simply because they are not reduced to formal complaints. As many intervenors have asserted, the cost and time required to pursue legal channels to prove discrimination will often provide an inadequate remedy because, among other things, the competition may have already been lost.⁹⁵ The fact that evidence of discrimination in the fast-paced marketplace is not systematic or complete is not unexpected. The fact remains that claims of undue discrimination have not diminished, and there is no evidence that discrimination is becoming a non-issue.

⁹⁵For example, EPSA has told us:

Furthermore, even if the exercise of such discrimination could be adequately documented and packaged in the form of a complaint under section 206 of the Federal Power Act under a more streamlined complaint process contemplated by the Commission, it would still be extremely costly and inefficient to deal with such complaints on a case-by-case basis. More than likely, the potential power transactions for which transmission principally was sought would disappear by the time a Commission ruling was obtained. Motion to Intervene and Comments of Electric Power Supply Association in Support of Petition for Rulemaking, Docket No. RM98-5-000 (filed Sept. 21, 1998), at 3.

Finally, we continue to believe that perceptions of discrimination are significant impediments to competitive markets. Efficient and competitive markets will develop only if market participants have confidence that the system is administered fairly.⁹⁶ Lack of market confidence resulting from the perception of discrimination is not mere rhetoric. It has real-world consequences for market participants and consumers. As stated by NERC, there is a reluctance on the part of market participants to share operational real-time and planning data with transmission providers because of the suspicion that they could be providing an advantage to their affiliated marketing groups,⁹⁷ and this can, in turn, impair the reliability of the nation's electric systems. Lack of market confidence may deter generation expansion, leading to higher consumer prices. Fears of discriminatory curtailment may deter access to existing generation or deter entry by new sources of generation that would otherwise mitigate price spikes of the type that have been experienced during peak periods in the last two summer peak periods. Mistrust of ATC calculations will cause transactions involving regional markets to be viewed as more risky

⁹⁶For example, a representative of Blue Ridge told us:

There simply is no shaking the notion that integrated generation and transmission-owning utilities have strategic and competitive interests to consider when addressing transmission constraints. Functional unbundling and enforcement of [standard of] conduct standards require herculean policing efforts, and they are not practical. Regional ISO Conference (Richmond), Transcript at 20.

⁹⁷NERC Reliability Assessment 1998-2007, at 39.

and will unnecessarily constrain the market area, thereby reducing competition and raising prices for consumers. The perception that a transmission provider's power sales are more reliable may provide subtle competitive advantages in wholesale markets, e.g., purchasers may favor sales by the transmission provider or its affiliate, expecting greater transmission service reliability. We believe that the potential for such problems increases in a competitive environment unless the market can be made structurally efficient and transparent with respect to information, and equitable in its treatment of competing participants.

In summary, we affirm our conclusion in the NOPR that economic and engineering inefficiencies and the continuing opportunity for undue discrimination are impeding competitive markets. As noted below, we conclude that RTOs will remedy these impediments and that it is essential for the Commission to issue this Final Rule.

B. Benefits That RTOs Can Offer to Address Remaining Barriers and Impediments

In the NOPR the Commission explained how the use of independent RTOs could help eliminate the opportunity for unduly discriminatory practices by transmission providers, restore the trust among competitors that all are playing by the same rules, and reduce the need for overly intrusive regulatory oversight.⁹⁸ The Commission further identified a number of significant benefits of establishing RTOs: (1) RTOs would

⁹⁸FERC Stats. & Regs. ¶ 32,541 at 33,714.