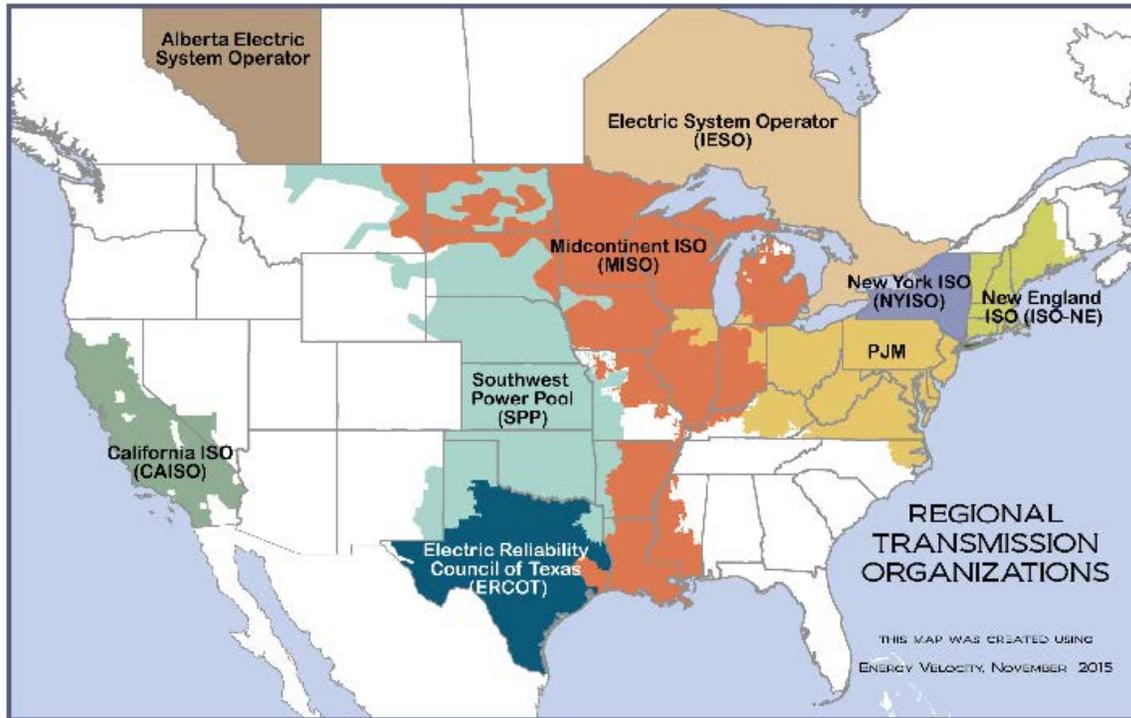


# Regulation and Markets: Ideas for Solving the Identity Crisis



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\* With thanks to my colleagues Ray Gifford, Michael Keegan, Matt Larson and Robin Lunt.

## I. Introduction

The current discussion and debate about electricity policy reflects and reiterates an earlier time of tumult. Understanding this history can help states choose their path forward. The 1990s were a time of tremendous change in utility regulation in the United States. The Federal Energy Regulatory Commission (FERC) was putting the finishing touches on a decades-long, incremental overhaul of natural gas regulation, from the wellhead to its sale and transport. Crude oil and refined product pipelines regulation was dramatically changed with Congressional passage of the Energy Policy Act of 1992. When it came to electricity, FERC's Order No. 888 was a major breakthrough in the effort to ensure open access to the nation's transmission infrastructure.

Public policy debates and changes within the states were no less consequential. The 1990s marked the heyday of state electric utility restructuring. My personal introduction to the public policy debate was as a legislator in my home state of North Dakota. Even as a newcomer to elected office and from a state that was unlikely to ever be an early-adopter in restructuring, it was nearly impossible to avoid the debate. Committees studied restructuring, and white papers explored it. As a public policy matter, I recall being intrigued, but ultimately unpersuaded that full restructuring was the right move for my state. As a philosophical conservative, the notion of a freer market, competition, and consumer choice resonated with me. But as an operational and practical conservative, my natural tendency to support a system that was working was a more powerful pull.

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Like nearly all other states with much below average cost electricity, the value proposition for North Dakota did not pencil out. My own thinking was, "we have really cheap electricity, so what's the point?" Eventually, circumstances in neighboring Montana, where restructuring was widely viewed as a failure, and the California energy crisis that included rolling blackouts seemed to vindicate North Dakota's go-slow approach.<sup>1</sup>

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<sup>1</sup> Former Montana Governor Brian Schweitzer referred to Montana's deregulation of electric utilities as an "unmitigated disaster." See, Governor's Signing Statement on House Bill 25 (May 14, 2007), available at [http://leg.mt.gov/content/committees/interim/2007\\_2008/energy\\_telecom/assigned\\_studies/hb25page/hb25signstat](http://leg.mt.gov/content/committees/interim/2007_2008/energy_telecom/assigned_studies/hb25page/hb25signstat)

Similar debates were held in states across the country. States and regions with below average electricity costs tended to maintain their current system. States struggling with higher than average costs tended to look for a different path, hopeful that market efficiencies might be able to deliver relief for their consumers. What is noteworthy about this fact pattern is that the decision for a state to restructure its electric utilities was, more often than not, a practical matter, not a philosophical one (and by “restructure” I refer to the full retail choice, unbundled distribution, transmission and merchant generation model that is today prevalent in much of the East Coast and Texas). Though the debates were often given a veneer of a philosophical choice between “markets” and “monopolies,” the reality was often anchored in public choice theory, which would suggest that market benefits could not displace the political support for regulated utilities that provided affordable power to consumers

There were and are, no doubt, many sincere believers in the purely philosophical rationale behind a

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move to full electric unbundling and retail choice. Nonetheless, I believe the dominant motivator for public policy makers was purely practical. Elected officials in states that chose to restructure were not dissimilar to the majority of my colleagues in states that did not do so. All states were seeking a singular outcome: cheap electricity. States that felt they already had it stayed put. Those that did not restructured. Now, 20 years later, merchant generators are seeing just how thin the veneer of pro-market fidelity often really

was. In states today, just as in the 1990s, the name of the game remains practical outcomes driven by public choice theory.<sup>2</sup>

The events of recent years, in which restructured states appear to be backtracking into a quasi-regulated wholesale space, reflect the evolution of the desired outcomes in the states. Two decades

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ement.pdf. The California energy crisis is well documented and stands as a case study in a failed approach to electricity restructuring.

<sup>2</sup> In other words, political ends such as diversity, affordability, job creation or retention, and the like drive decisions rather than fidelity to a pure economic theory.

ago states were primarily chasing the goal of more affordable electricity. Today, many states are pursuing other public policy goals such as incenting in-state jobs, promoting “green” energy or other politically favored resources, preserving carbon-free resources, and retaining substantial tax revenues to state and local government. This paper does not intend to either applaud or denigrate these state efforts but to look clearly at the dynamics driving our current electricity policy conversation. Indeed, the move to some form of increased state control over the wholesale generation market is consistent with the factors that have driven public policies in electricity for the last two decades, not a departure from it. For many, a “freer market” was never the end goal. The market was a tool. Affordable power was the goal. The current markets are still procuring affordable power,<sup>3</sup> but many state public policy makers no longer see that as the only goal. It is little wonder we hear some decry that the markets are not delivering what people want. It is because they were never designed for job creation, tax preservation, politically popular generation, or anything other than reliable, affordable electricity. To the degree policy makers and elected officials have moved the goal posts, it is time to consider rational pathways forward. That discussion is the heart of this paper.<sup>4</sup>

*[Markets] were never designed for job creation, tax preservation, politically popular generation, or anything other than reliable, affordable electricity. To the degree policy makers and elected officials have moved the goal posts, it is time to consider rational pathways forward.*

## II. State Utility Regulatory Models

As a frame of reference, it is useful to consider the three principal ways that states have chosen to structure their utilities. Broadly speaking, these models are (1) the Traditional Bi-Lateral Market Model, (2) the Joint Dispatch Market Model, and (3) the Restructured Administrative Market Model.

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<sup>3</sup> This is in large part due to the fact that natural gas prices are historically low. By and large “restructured states” continue to have higher prices than their counterparts. *See, e.g.*, U.S. Energy Information Administration (EIA), Electric Power Monthly, accessed July 11, 2017, available at [https://www.eia.gov/electricity/monthly/epm\\_table\\_grapher.php?t=epmt\\_5\\_6\\_a](https://www.eia.gov/electricity/monthly/epm_table_grapher.php?t=epmt_5_6_a).

<sup>4</sup> The states that fully restructured to an administrative market model surrendered their resource decisions to Independent System Operators or Regional Transmission Operators governed by tariffs (or giant administrative rule books) approved by the Federal Energy Regulatory Commission. FERC, however, does not have the same authority as the states to pick and choose generation resources, rather the tariffs are fuel neutral procuring capacity, energy and ancillary services. The paper focuses on pathways for states.

- *Traditional Bilateral Market Model* states are, as the name suggests, the manner in which nearly all states traditionally structured and regulated their utilities prior to the 1990s. It is still the widely accepted model of regulation throughout the Southeast and most of the West. It consists of vertically integrated monopoly utilities serving customers predominantly through the utilities' own bundled generation, transmission and distribution assets. Under this framework, states, more than the federal government, play the primary role in regulating the industry. States oversee an integrated resource planning regime that comprises a fundamental component of the regulatory compact. Wholesale sales of electricity are executed bilaterally, not through an organized energy market.<sup>5</sup>
- *Joint Dispatch Market Model* states are those that maintain many aspects of the Traditional Bilateral Market Model, such as monopoly franchises, utility owned generation and integrated resource planning.<sup>6</sup> However, there is one major difference. States in the Joint Dispatch Market Model have authorized their utilities to cede control of their transmission operations and dispatch of generation assets to a FERC jurisdictional Independent System Operator that runs an optimized dispatch model that assures both reliability and least-cost resource dispatch.<sup>7</sup> This model has been widely adopted throughout the Midwest, the Plains states, California and portions of the South. The Midcontinent Independent System Operator (MISO), Southwest Power Pool (SPP) and California ISO (CAISO) all represent regions that are typical of the model, though certain states operating within the PJM and ISO-New England regions are Joint Dispatch Market Model states. Utilities operating in this space still have states overseeing major aspects of their operations, such as resource procurement and resource adequacy. But the utility also participates in a fully functioning organized day-ahead and real-time energy market, which is comprehensively regulated by FERC under the auspices of the Federal Power Act.

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<sup>5</sup> Some utilities operating in the traditional model have authorized their utilities to join an “Energy Imbalance Market,” which allows the utility to participate in an energy market in a limited way. Though it inches a utility towards a joint dispatch energy market, utilities participating only in an EIM must be viewed as still firmly inside the traditional model of regulation given the limitation of the market. There are also states, in the Southeast in particular, that operate with security constrained economic dispatch across a region, making them look more like a Joint Dispatch Market, but without the overlay of an ISO.

<sup>6</sup> Many wholesale sales of electricity, particularly long-term sales, may be bilateral transactions.

<sup>7</sup> Energy markets are commonly referred to as the “Security Constrained Economic Dispatch Model.”

- Restructured Administrative Market Model states are those that most completely adopted the market reforms of the 1990s. States that adopted this model fully unbundled their utilities, in many cases requiring utilities to divest their generation resources. While the distribution “wires” business remains a regulated monopoly, consumers are free to exercise retail choice to access competitive electricity providers of their choosing (which have been approved by, or have registered with, the state regulator). Generators operate as wholesale merchants dependent on price signals in a properly functioning administrative market as a basis for decisions regarding where to invest and when to retire units. This model is most widely adopted in the Northeast and Mid-Atlantic regions, as well as in Texas. It is the dominant regulatory structure in PJM, New York-ISO, ISO-New England and the Electric Reliability Council of Texas (ERCOT). Because states that fully embraced this model effectively gave-up the type of resource adequacy planning authority that exists in the other two models, these markets often employ a separate FERC jurisdictional capacity market construct to offset the “missing money” problem that can exist in energy-only markets that lack the traditional paradigm of the state regulatory compact as a backstop for certain fixed and unrecovered costs.<sup>8</sup>

*The last several years have seen a retreat from the restructured model, though the retreat tends to be of the tacit sort... There is a very real concern and possibility that certain wholesale electricity markets will become so dysfunctional as to undermine the just and reasonable standard that FERC is duty-bound to uphold.*

These three models of regulation had been remarkably stable for the better part of two decades. While certain states have jumped from the Traditional Bilateral Market Model to the Joint Dispatch Market Model in recent years<sup>9</sup>, and while some states have retrenched to more traditional models,

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<sup>8</sup> ERCOT, which relies on an energy-only market is the outlier.

<sup>9</sup> Specifically, utilities in a number of states in the Mid-South and along the Gulf Coast, particularly in the Entergy region, have recently joined organized markets.

few if any states have made significant movement towards the Restructured Administrative Market Model from either the Traditional Bilateral Market Model or the Joint Dispatch Market Model.<sup>10</sup>

To the contrary, the last several years have seen a retreat from the restructured model, though the retreat tends to be of the tacit sort. While there are from time to time open discussions of a state moving explicitly from a Restructured Administrative Market Model to a more traditional model, these open discussions and debates are the exception and not the rule.<sup>11</sup>

It is far easier to find examples of states employing what I will call the Tacit Re-Regulation Model.<sup>12</sup> From Illinois and New York, where nuclear generators stand to receive millions of dollars in state sponsored subsidies, to states in New England and the Mid-Atlantic, where massive out of market contracts and payments threaten the underpinnings of price formation in both the energy and capacity markets, there is a very real concern and possibility that certain wholesale electricity markets will become so dysfunctional as to undermine the just and reasonable standard that FERC is duty-bound to uphold.<sup>13</sup> FERC itself has acknowledged the significant challenges of these state-led tectonic shifts in electricity policy landscape and the agency recently held a technical conference to explore the issue.<sup>14</sup>

With so much change afoot, the time is ripe to consider whether there is a need to assert a set of regulatory first principles, or at least a framework for state regulators and lawmakers to consider as they head down their chosen roads.

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<sup>10</sup> Montana is an example of a state which outright repealed restructuring, a number of other states effectively halted or reversed restructuring after the Western Energy Crisis. Nevada has been a recent exception to the rule, where the state is exploring retail choice.

<sup>11</sup> For example, certain Ohio legislators recently openly discussed the possibility of “re-regulating” the state’s utilities. *See, e.g.*, John Funk, “Ohio electric deregulation on the chopping block?” *The Plain Dealer*, Jan. 28, 2017, *available at*, [http://www.cleveland.com/business/index.ssf/2017/01/ohio\\_electric\\_deregulation\\_on.html](http://www.cleveland.com/business/index.ssf/2017/01/ohio_electric_deregulation_on.html); Robert Walton, “AEP to push ‘surgical’ approach to power market reforms in Ohio,” *UtilityDive*, Jan. 27, 2017, *available at*, <http://www.utilitydive.com/news/aep-to-push-surgical-approach-to-power-market-reforms-in-ohio/434927/>.

<sup>12</sup> My Wilkinson Barker Knauer, LLP colleagues Ray Gifford and Matt Larson have written extensively on the matter of state “around market” solutions and the roiling effect they are having on those organized markets in which significant numbers of states have fully restructured.

<sup>13</sup> PJM Market Monitor Joseph Bowring has warned about subsidies being “contagious” and that seems an apt description of state around market actions. Monitoring Analytics, LLC. *2016 State of the Market Report for PJM*, Vol I (Monitoring Analytics, LLC 2017), 2, *available at*, [http://monitoringanalytics.com/reports/PJM\\_State\\_of\\_the\\_Market/2016/2016-som-pjm-volume1.pdf](http://monitoringanalytics.com/reports/PJM_State_of_the_Market/2016/2016-som-pjm-volume1.pdf).

<sup>14</sup> FERC Technical Conference on *State Policies and Wholesale Markets Operated by ISO New England, Inc., New York Independent System Operator, Inc., and PJM Interconnection L.L.C.*, Docket No. AD17-11-000 (May 1-2, 2017).

### III. Regulatory Recommendations

As with any aspect of American electricity policy, it is difficult to make sweeping national pronouncements about what policy makers should do because electricity is highly regional in nature. State regulatory regimes and goals are different, as are each state's electricity production resource base. Despite recent notable attempts to break down some of the silos that separated electric utilities, the nature of the industry is still greatly influenced by the legacy investments of utilities that were by nature regional, not national.<sup>15</sup>

With that in mind, this paper considers regulatory recommendations for states to consider in light of the state utility regulatory models that exist across the nation. While there is great diversity amongst states within each category,<sup>16</sup> the challenges faced by each state are either enhanced or lessened as a result of its choice of a regulatory model.

#### A. *Recommendations for all states*

1. *Distribution asset rate design is key.* Regardless of other regulatory constructs, states still maintain control over the rate design and cost recovery for those monopoly distribution assets that deliver electricity to an end-use consumer.<sup>17</sup> With the quickening pace of the development of distributed energy resources (DERs) such as solar rooftop systems and other behind the meter resources, it is critically important that states assess whether their rate structures adequately reflect the changing landscape and promote fair, equitable and sustainable innovation on the distribution grid. While super-compensatory rate designs such as full retail net metering have been a boon to DERs, the mechanism has come at the cost of pitting one group of customers (non-adopters) against another (adopters). This mechanism is politically popular with the heavily subsidized, but it is hardly a sustainable long-term strategy. If consumers are still connected to and benefitting from a networked grid, then there has to be an adequate mechanism to fully compensate the owners and operators of that grid. In this vein, an interesting parallel to the telecommunications industry can be drawn. Much like today's electric distribution rate design, after the breakup of the AT&T

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<sup>15</sup> FERC Order No. 1000 is one such example of an attempt to break down these silos.

<sup>16</sup> Take, for example, the vastly different nature of the resource bases of utilities in Florida and Washington state, both Traditional Bilateral Market Models.

<sup>17</sup> Understanding that public power utilities and rural electric cooperatives often maintain a level of independence not granted investor owned utilities.

monopoly, there were numerous implicit subsidies embedded in the rates of the Regional Bell Operating Companies. One of the most glaring subsidies was the manner in which long distance service subsidized local service through a mechanism known as access charges. With the advent of new technologies that could bypass these access charges, the gig was up. New entrants could effectively arbitrage the entire implicit subsidy system. To deal with the economic distortions, states were forced to finally make more explicit what was implicit, since such implicit subsidies can only exist within a hermetically sealed monopoly

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environment. A similar response is now needed in regulating the rates of distribution utilities. The soundest approach is for states to accept rate designs that move utilities closer to a straight fixed-variable rate construct. That is to say, states should be requiring utilities to assign fixed costs of networked service to fixed charges and variable costs of service to variable charges. Not only does this ensure that distribution utilities fully recover the value they provide customers (making would-be arbitrageurs pay their full freight), it has the added benefit of making utilities more neutral to a customer's choices regarding DERs and energy efficiency.<sup>18</sup>

2. *Make sure your state does not fall into the "One Piece at a Time" trap.* There is a great old Johnny Cash song, "One Piece at a Time,"<sup>19</sup> that tells the story of a General Motors assembly line employee

that wants a Cadillac so badly that he decides to steal a new Cadillac one piece at a time over a multi-decade career. By the time he has assembled his treasure, it's a Model '49, '50, '51, '52, '53, etc., resulting in an automobile that is ridiculous in its Rube Goldberg-like

<sup>18</sup> Failing to address the issue has ancillary spillover effects on the organized wholesale market. One need look no further than California, where DER's on steroids (primarily solar) have changed the entire CAISO dispatch curve to the point the market is in need of substantial pricing reforms so that still needed dispatchable power is available for those times when variable energy resources cannot produce.

<sup>19</sup> Wayne Kemp, *One Piece at a Time*, recorded by Johnny Cash on ONE PIECE AT A TIME (Columbia 1976).

appearance and function. Regulators and policy makers need to be vigilant that our current electricity public policy superstructure does not take on a similar form. Today, depending on the region of the country, there is a layered mix of policies including: some form of a “market,” a carbon pricing regime, renewable portfolio standard mandates, renewable energy credits, subsidized demand response or energy storage, zero emissions credits, production tax credits, investment tax credits, super-compensatory retail net metering, energy efficiency subsidies, out of market direct subsidies, and Public Utility Regulatory Policies Act (PURPA)<sup>20</sup> mandates, to name a few. At a certain point, the sum of *all* these parts works at cross-purposes. Additionally, distribution grid innovations also impact wholesale generation and transmission; you cannot view the system piecemeal and expect it to run seamlessly.<sup>21</sup> It is then that policy leaders have to thoughtfully step back and consider a comprehensive approach.

3. *Clearly define your goals.* This point is an adjunct to the previous recommendation. To help

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insulate your state from drifting aimlessly and stacking one public policy on top of another, consider your real goal: Is it carbon reduction? Then perhaps a high renewable portfolio standard mandate that undercuts both nuclear units and fails to credit hydropower assets, thereby forcing 24/7 zero emission energy sources out of the market may not be the right path. If you are a Traditional Bilateral Market Model with state and cost stability and affordability as your goal, rather than hoping to ride a soft spot market forever, consider acceding to regulated utility rate base growth during times of

low prices as a hedge against the inevitable rise in prices later on. Is your goal demand side price responsiveness? Then it pays to consider whether overcompensating demand side aggregators really furthers the cause more than giving direct end-use customers the option of true price responsive demand engagement with the wholesale market. Without clearly

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<sup>20</sup> 16 U.S.C. § 2601 *et. seq.* (2012).

<sup>21</sup> For example, a recent California study identified the increased communications and coordination necessary to keep the system stable and reliable with increased distributed energy resources. *See*, More than Smart, *Coordination of Transmission and Distribution Operations in a High Distributed Energy Resource Electric Grid* (June 2017).

defined goals developed through discussions among elected officials, regulators, and the regulated community, a slide into the *One Piece at a Time* trap becomes ever more likely.

***B. Recommendations for Vertically Integrated States<sup>22</sup>***

When states begin to untether from the limited goal of least cost resources and begin to assert prerogatives over electricity resource mix decisions, the states that have chosen to remain vertically integrated have a number of noteworthy advantages over their brethren who are attempting similar ends within the Restructured Administrative Market Model. For one thing, the Traditional Bilateral Market Model and the Joint Dispatch Market Model are internally consistent. These states can transparently and thoughtfully use electricity policy to pursue a variety of goals. For example, if it wishes, a state can value a certain out of market resources, create a hedge against over-reliance on one particular fuel source, encourage innovative grid edge technologies, authorize utility investments when the cost of capital and market prices are low to avoid being subject to a spiking market later, specifically address fuel diversity, carbon emitting resources, incorporate an analysis of the jobs created or retained through certain electricity resource decisions, or promote electric vehicles. States using the Joint Dispatch Market Model have a number of other advantages for consumers. In addition to maintaining control and transparent decision making around resource decisions, they have access to broader regional resources for cost effective joint dispatch. These more traditional regulatory structures do not face the existential crisis found in the Restructured Administrative Market Model, nonetheless there are still things regulators should be assessing:

1. *Consider innovative regulatory models such as performance based ratemaking, decoupling and price cap regulation.* As “edge of the network” innovation proliferates using a smarter grid and new generation and storage technologies, there is a danger that traditional utilities will find themselves caught in an unenviable trap: These utilities are consigned to traditional cost of service regulation over a legacy network, yet unable to innovate due to various state regulatory strictures that punish innovation. Drawing again on lessons learned from the telecommunications industry, one way to deal with the problem of a networked industry in a technologically changing world is to look beyond simple cost of service regulation, and look to reform methodologies such as decoupling or price cap regulation. If structured properly,

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<sup>22</sup> For the purposes of this section, I combine states that have vertically integrated utilities operating under either the Traditional Bilateral Market Model and Joint Dispatch Market Model.

such a regime can include assurances for quality of service, incent efficient business operations and allow the utility more freedom to innovate and compete.

2. *Consider ways to enable consumers more choice, but within the context of a vertically integrated utility.*

Though there has not been a stampede of states looking to restructure their utilities of late, there is little doubt that today's consumers, especially younger consumers, and corporations with sustainability goals, are more inclined to demand options, choices and control. The electric industry provides reliability that consumers have come to expect. Historically, price was the main attribute of electricity to consumers. But there is mounting evidence of a significant shift.<sup>23</sup> Sophisticated utilities are coming to understand that different types of consumers place different values on the service provided. Some place a premium on affordability. Some place a premium on rate stability. Some place a premium on a particular type of generation. Some are early adopters of DERs, electric vehicles, and new technologies. Monopoly utilities should be creative in thinking how to provide not just electricity but value to these various types of consumers. Just as important, regulators need to be open to thinking about ways to accommodate and allow these changes without slipping into a one-size fits all mentality that tends to dominate the cost of service regulated space.

***Though PURPA may be a relic of the same era as bell bottoms and disco, today it is wreaking much more real world havoc than merely questionable fashion and music choices.***

3. *Get ahead of the PURPA curve.*<sup>24</sup> Though PURPA may be a relic of the same era as bell bottoms and disco, today it is wreaking much more real world havoc than merely questionable fashion and music choices. The law was designed to assist nascent generation

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<sup>23</sup> Large companies and data centers are actively engaged in energy procurement, driven in large part by corporate sustainability goals. In Fact 72% of corporations responding to a PWC survey report actively pursuing renewable energy procurement. *Corporate Renewable Energy Procurement Survey Insights*, PWC (June 2016), available at <https://www.pwc.com/us/en/sustainability-services/publications/assets/pwc-corporate-renewable-energy-procurement-survey-insights.pdf>. Consumers have also begun to engage with electricity more robustly through smart devices. See, e.g. Tom Flarety, Norbert Schwieters and Steve Jennings 2017 Power and Utilities Trends, PWC available at <https://www.strategyand.pwc.com/trend/2017-power-and-utilities-industry-trends>.

<sup>24</sup> This issue is of particular importance to vertically integrated states that do not operate within a joint dispatch market. FERC's rules promulgated pursuant to the Energy Policy Act of 2005's (EPACT 2005) amendments to the Public Utility Regulatory Policies Act of 1978 (PURPA) established a rebuttable presumption that QF's of a certain size within joint dispatch or administrative restructured markets have nondiscriminatory access to just and reasonable rates, and therefore utilities within these markets are relieved of substantial PURPA burdens. See 16 U.S.C. § 824a-3(m).

technologies at a time when there was little concept of cost competitive utility scale renewable projects. Indeed, there is a growing list of examples of PURPA abuse wherein developers attempt to game the system by chopping up uncompetitive projects into smaller “Qualifying Facilities,” thereby forcing a vertically integrated utility to “eat” the PURPA contract regardless of whether (1) the power is needed or not, (2) the facility is beneficial to the operation of the system or not, and (3) the addition of the facility harms consumers or not.<sup>25</sup> Although PURPA facilitated some level of generation competition, PURPA today is just as often used to undermine rational, competitive integrated resource planning decisions

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made by utilities and utility regulators. As an entitlement, PURPA has evolved into the antithesis of what it was meant to improve: competitive outcomes for consumers. While the majority of PURPA reform is within the prerogatives of the US Congress, (and to a lesser extent, FERC) states can at least help stanch the hemorrhaging of consumer money to unnecessary projects by proactively ensuring their avoided cost rates are set at a level that does not encourage gaming the system by heavily subsidizing resources that are in no way the equivalent of (and often inferior to) resources that are part of a well-thought-out integrated resource plan.

### ***C. Recommendations for Restructured States<sup>26</sup>***

A state can choose to be like any of our nation’s three largest states. It can be like Texas and fully restructure. It can be like California and have vertically integrated utilities within an organized market. It can be like Florida and maintain its organization as a vertically integrated state with a bilateral market. But no state should choose to be Texas, California and Florida all at once. That is

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<sup>25</sup> FERC Technical Conference on *Implementation Issues Under the Public Utility Regulatory Policies Act of 1978* Docket No. AD17-16-16-000 (June 29, 2016).

<sup>26</sup> In this section, I discuss states with utilities operating under the Restructured Administrative Market Model.

one path all restructured states should seek to avoid, the path of the RINO – Restructured in Name Only – attempting to straddle the middle of the road between a merchant market while simultaneously deploying state sponsored around market resource selection. We should not expect anything close to an acceptable market outcome if a state drifts towards what Acting FERC Chairman Cheryl LaFleur has called, “unplanned reregulation.”<sup>27</sup> To appropriate a phrase coined by commentator and activist Jim Hightower, “there’s nothing in the middle of the road but a yellow stripe and dead armadillos.”<sup>28</sup> In this case the Independent Power Producer model may be the road kill. For years, restructured states in the Eastern Capacity Markets have engaged in arguably deleterious actions that have undercut the Restructured Administrative Market Model.<sup>29</sup> These actions have always seemed somewhat *de minimis* in scope, but as with many things in the electric business, that is changing. Restructured states are now seeking to procure vast amounts of megawatts of capacity around markets that were designed with the merchant generator model in mind. Accordingly, we have reached the tipping point where things can no longer be benignly ignored.<sup>30</sup>

***There has long been a somewhat false dichotomy between markets and regulation. All electricity markets are regulated administrative constructs, and the only question is how - and how much - these markets are regulated.***

1. *Stay true to your model.* Each of the major models of utility regulation has its own strengths. One of the strengths of the restructured model is that the risk of investment in generation

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<sup>27</sup> See, e.g., Rich Heidorn Jr., “LaFleur Plans Tech Conference on State Generator Supports,” *RTO Insider*, Feb. 16, 2017, available at, <https://www.rtoinsider.com/ferc-lafleur-technical-conference-38829/>; Gavin Bade, “FERC chair outlines three paths for power market reforms ahead of technical conference,” *UtilityDive*, Apr. 19, 2017, available at, <http://www.utilitydive.com/news/ferc-chair-outlines-three-paths-for-power-market-reforms-ahead-of-technical/440777/>.

<sup>28</sup> Jim Hightower, *There’s Nothing in the Middle of the Road but Yellow Stripes and Dead Armadillos: A Work of Political Subversion*, (New York: Harper, 1997).

<sup>29</sup> For example, many states impose renewable portfolio standards or offer subsidies to renewable generating resources that interfere with accurate pricing in the energy markets. In New England, utilities in all six states participate in the organized markets operated by the ISO-New England. All six states have renewable portfolio standards with Vermont’s as high as 71% in 2030 (recognizing large-scale hydropower as renewable). In addition, all six states promote reductions in greenhouse gas emissions either through legislative requirements or aspirational goals.

<sup>30</sup> For example, in 2016, the New York Public Service Commission adopted a system of “zero emission credits” (or “ZECs”) to provide payments to three upstate nuclear plants to recognize their value as producers of non-fossil fuel-based electricity generation. See *Proceeding on Motion of the Commission to Implement a Large-Scale Renewable Program and a Clean Energy Standard, et al.*, Case 15-E-0302; Case 16-E-0270, *Order Adopting a Clean Energy Standard*, 2016 N.Y. PUC LEXIS 425 (Aug. 1, 2016); *Order on Petitions for Rehearing*, 2016 N.Y. PUC LEXIS 632 (Dec. 15, 2016).

assets is placed not on captive consumers, but on the shareholders and investors competing in the wholesale market. When a state restructures, it therefore lets investors shoulder the risk and reap the rewards. I would argue that it also carries with it a certain moral obligation for state leaders not to engage in actions that result in the inevitable tanking of the market, and undermine those very investors who the states rely on to risk their private capital.

2. *If you cannot stay true to your model (for whatever reason), at least be deliberate and fully own-up to the responsibilities of your choice.* In saying this I emphasize the difference between restructured utilities versus vertically integrated utilities (which does constitute a meaningful and important distinction), as opposed to the generic notion of “markets versus regulation.” There has long been a somewhat false dichotomy between markets and regulation. All electricity markets are regulated administrative constructs, and the only question is how - and how much - these markets are regulated. Thus, should a state choose to backtrack from restructuring, it need not be said that the state is rejecting markets. Indeed, there are legitimate ways a state could fulfill its desire to be more active in selecting resources while bringing certain market forces to bear. Competitive long-term PPA procurement and bilateral contracting could be one likely scenario.

The current constructs that exist in Eastern Capacity Markets cannot long endure restructured states wishing to procure a large portion of their needs around the market. These state decisions undermine capacity markets and will drive out the merchant fleet if the capacity market cannot generate value for merchants not favored by state around market solutions. Currently, the Eastern Capacity Market regions of the country seem to be pursuing stakeholder processes to deeply explore an effort to accommodate state choices while maintaining the markets as the essential mechanism for resource adequacy.<sup>31</sup> While I applaud their efforts to look at creative solutions, I am skeptical of whether further dissection of administrative auctions into state sponsored resources and competitive resources can succeed. The complexity of these administrative constructs is remarkable as it exists today. Layering even more auctions, set-asides and carve outs onto to the current construct may ultimately tumble the house of cards. I would encourage a more direct

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<sup>31</sup> ISO-New England has developed a proposal to reform its capacity market to integrate greater amounts of subsidized generation while seeking to preserve price signals for unsubsidized resources. See ISO-New England, *Competitive Auctions with Subsidized Policy Resources*, (April 2017), available at, [https://www.iso-ne.com/static-assets/documents/2017/04/iso\\_caspr\\_highlights\\_april\\_2017.pdf](https://www.iso-ne.com/static-assets/documents/2017/04/iso_caspr_highlights_april_2017.pdf). ISO-New England also has a Wholesale Markets and State Public Policy Initiative (materials online and available at, <https://www.iso-ne.com/committees/participants/wholesale-markets-state-public-policy-initiative>).

approach for states to “take ownership” of their resource choices. States should be deliberate in their choices and honest about the impact of resource procurement decisions, which may lead these Restructured Administrative Markets to look more like the Joint Dispatch Markets.

*One of the clear successes of wholesale electricity markets is the security constrained economic dispatch that allows a region to more efficiently utilize generation resources for the benefit of consumers across a larger footprint than a single state or utility. All states can access this without surrendering their control over resource decisions.*

#### IV. Conclusion

One of the clear successes of wholesale electricity markets is the security constrained economic dispatch that allows a region to more efficiently utilize generation resources for the benefit of consumers across a larger footprint than a single state or utility. All states can access this without surrendering their control over resource decisions.

In fact, security constrained economic dispatch paired with the stability of rate based assets, which allow utilities to cover costs over the assets’ useful life, has demonstrated its value time and again. It also enables states to transparently pursue goals such as diversity, resiliency, carbon limits, emerging innovation, or building specific resources in specific locations. States need to be clear about their goals and take the responsibility of pursuing them.

It is also clear that other regulatory regimes can work for the benefit of consumers if structured properly and if policy makers are prepared to accept the tradeoffs that inevitably exist *when they maintain fidelity to the utility regulatory framework they have adopted*. This last point is crucial. While it can be alluring to think one can maintain all the benefits of a restructured market while also selecting your generation winners and losers, I have come to the conclusion that is a siren’s call best left unanswered.<sup>32</sup> There may be plenty of reasons a state might wish to exert more control over its generation mix, some of them entirely legitimate. But it must be well thought out and not done haphazardly.

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<sup>32</sup> The reverse is also true. A state that has adopted, for example, the Traditional Bilateral Market Model has a responsibility to ensure utilities are not subjected to “review-mirror regulation,” wherein investments previously deemed prudent are subjected to subsequent rate recovery denial because a perfect 20/20 hindsight review of “the market” deems the investment unpalatable.

If states desire to have control over the resource mix, then use of the 'Traditional Bilateral Market Model or the Joint Dispatch Market Model is superior to the current trend of the Restructured Administrative Market Model with 'around market' state policy preferences layered on top.

If a state wants to continue to use the Restructured Administrative Market Model, it needs to fully commit to that model and restrain itself from the allure of 'around market' solutions or other state policies dictating portions of the resource mix.<sup>33</sup> If a state does not believe that its constituents, elected officials, utilities, regulators and stakeholders will be able to resist the temptation of 'around market' solutions' then the state must determine whether the Restructured Administrative Market Model is really the right fit. Given the lure of public choice theory, the ongoing electric fleet transition, and the political significance of electricity to state governance, this will likely be very difficult, and any changes to the Restructured Administrative Markets will have to be reviewed, hashed out and resolved state by state and RTO or ISO by RTO or ISO; a process that is cumbersome, at best.<sup>34</sup>

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<sup>33</sup> This is not to suggest there are not ways for restructured states to influence resource selection in a competitively neutral way. Placing an across-the-board price on carbon is one potential way to do this. Although some states, most notably members of the Regional Greenhouse Gas Initiative (RGGI), are imposing a carbon price, I would argue that no serious attempt at using carbon pricing as a driver for resource selection has truly been made. Carbon prices have traditionally been set low enough so that they do not effectively drive resource decisions. The reality is carbon prices would have to be set significantly higher than they are currently to have a major impact on resource selection, and I have yet to observe a widespread embrace of that position amongst elected officials. Up to this point, the path of least political resistance has been the adoption of the around market and layered mandates and subsidies I have previously discussed.

<sup>34</sup> A recent DC Circuit opinion trimmed FERC's ability to modify RTO and ISO filings under Section 205 of the Federal Power Act. The ruling limits the flexibility FERC historically used when approving ISO tariff filings. This seems likely to affect stakeholder processes because there will be less flexibility for a stakeholder to "fix" its issue at FERC after a tariff is filed. Except for very minor modifications, FERC must either accept imperfect ISO and RTO tariffs without modification or issue more outright denials, thereby forcing tariffs changes to take place more iteratively. FERC can also deploy its authority under 206 to impose a new rate scheme, but to do so FERC has to carry a heavy legal burden. This adds a level of complexity to any major market changes. *NRG Power Mktg., LLC. v. FERC*, No 14-1452, Lexis 12137 (DC Cir. July 7, 2017).