



Principles to Power America

*Competitive Market Evolution:
The next decade of progress*



Electric Power Supply Association
*Advocating the **power** of competition*

Organized wholesale power markets already serve over two-thirds of the country and continue to expand. They work well, and deliver benefits for consumers, but can and should be improved.



FOREWORD

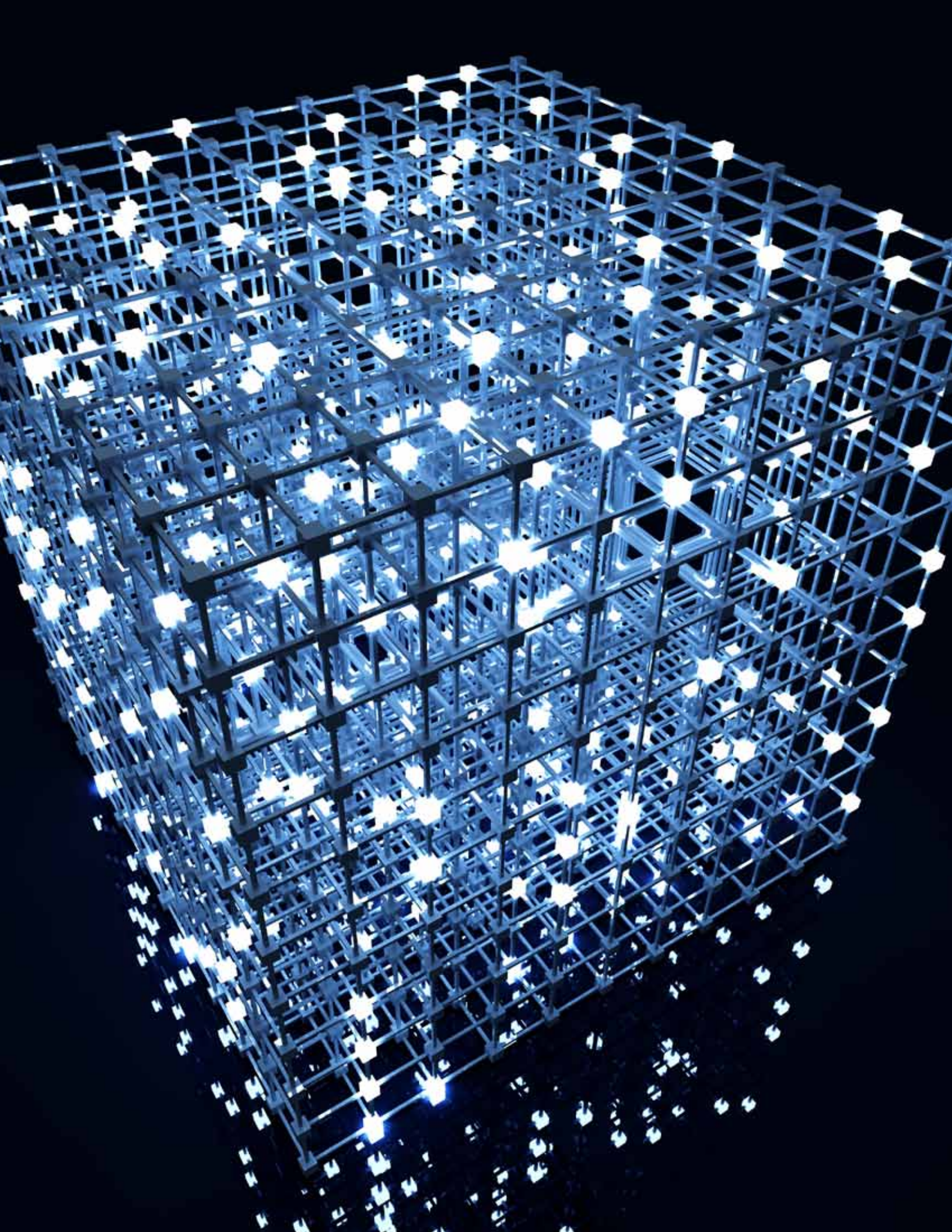
Since its inception the Electric Power Supply Association's core mission has been to harness the power of competitive electricity markets. EPSA members operate in the various types of wholesale electricity markets that exist nationwide. Having competitive markets benefits consumers in every part of the country.

This paper focuses on those wholesale electricity markets administered by Regional Transmission Organizations (RTOs) and Independent System Operators (ISOs) that have evolved over nearly two decades and today serve more than two-thirds of the country. Independent operation of the transmission grid and administration of various regional markets for electricity products and services continue to produce valuable benefits for consumers, the economy and the environment.

The design of these markets and the rules under which they operate are critical to their success. The next several years will be challenging for the entire electricity sector. Substantial investments will be required to bring our nation's power generation infrastructure forward to continue serving consumers efficiently, cleanly and reliably. Competition puts private investments to work to help meet these and other energy imperatives.

As the national trade association representing leaders of the competitive power sector, EPSA developed these principles as a framework for a continued dialogue with policymakers and other stakeholders to help spur necessary action. The focus is on how market design and rules should continue to evolve in organized markets in order to realize the full benefits of competition in the time frame the nation requires to succeed in the 21st century.

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INTRODUCTION

Congress and the Federal Energy Regulatory Commission (FERC) promote competitive wholesale power markets, and states restructured retail electricity markets, for good and sound reasons that resonate today and going forward. Organized wholesale power markets already serve over two-thirds of the country and continue to expand.

Consumers have reaped significant benefits from competitive electricity markets, including greater transparency, major innovation through new technologies, more efficient operation of existing facilities, efficient price risk management, and the shift of much of the infrastructure development risk to investors. Competition, both wholesale and retail, will continue to bring these and other benefits to consumers but market designs and rules can and should be improved consistent with sound competitive principles.

A key decade is underway for policymakers, the wholesale power supply sector (both generators and marketers) and consumers. This presents

the opportunity to take a step back and examine market design and rules on file with FERC and relevant state regulatory practices and how they can best be improved within the construct of competitive markets that continue to deliver long-term consumer benefits.

From EPSA's perspective, the organized markets under existing wholesale market designs and rules are working, broadly speaking, but they can and should be improved. Poorly designed markets and rules can produce economically inefficient outcomes that increase costs for consumers. Notably, there are no "deregulated" markets. Instead, the focus should be on the degree to which wholesale power markets are well regulated consistent with these principles.

Investment in existing and new power supply resources can and should continue to be made on a competitive basis by competitive suppliers reacting to market prices and revenues. This requires durable market designs and rules that

allow economic fundamentals to set prices and revenues consistent with the long term nature of power generation investments.

The question is what changes to current market designs and rules are needed to "get prices right" so that organized markets consistently reflect economic supply/demand fundamentals. While flawed market design and rules could artificially lower prices for a short time, doing so would undercut the critical price signals and revenue streams needed for longer term investments for reliability. Market sustainability is at risk if FERC-approved market design and rules allow prices and revenues to persist below or exceed competitive levels.

As improvements are made on particular elements it is important for there to be a period of relative regulatory stability so that market participants and their investors can rely on the enhanced market design and rules when making significant investment decisions.

ORGANIZED MARKET DESIGN PRINCIPLES

Competitive power suppliers provide energy, capacity and ancillary services to organized wholesale power markets to reliably and efficiently serve consumers. Each RTO/ISO has its own particular approach to how to design their markets for these services. EPSA offers these principles as a framework to guide further policymaker deliberations about important issues on organized market design and market rules.

1. *Consumer Benefits from Organized Markets*
2. *Open Competition Among Supply Resources*
3. *Competitive Market Price Signals*
4. *Centralized Capacity Market Improvements*
5. *Proper Role for Demand Response*
6. *Ancillary Services Pricing*
7. *Market Mitigation in Perspective*

The comments contained in this statement of principles represent the position of EPSA as an organization, but not necessarily the views of any particular member with respect to any issue.

1. **Consumer Benefits from Organized Markets**

Market design and rules should first and foremost result in consumers benefiting from competitive prices for the resources necessary to reliably serve them over the long term within applicable legal, policy and operational constraints (e.g., environmental and reliability rules). In other words, “the best deal for consumers” is not literally just “least cost” at any given point in time regardless of the full range of consequences for such a capital intensive industry. Market design and rules need to support development and maintenance of reliable and economically sustainable competitive wholesale power markets that match the long-term nature of power sector investments.





2. Open Competition Among Supply Resources

Market design and rules should facilitate competitively-determined, economically rational investment decisions as to existing and new supply resources. For example, market design and rules must not discriminate between supply resources on the basis of plant vintage or fuel type. This principle applies to and conditions the rest of these principles. Market rules should not seek to make all fuels and technologies economically neutral; rather market rules should be neutral to let the inherent economics of various competing options govern.



4. Centralized Capacity Market Improvements

While having the capacity to reliably serve peak consumer demand for electricity is important in each organized market, the RTOs/ISOs differ on how to do so. Some organized markets are “energy only” without a separate capacity market mechanism. Others rely primarily or entirely on bilateral contracts. Several RTOs/ISOs have implemented centralized capacity markets to compensate for overly mitigated energy markets among other concerns in their regions where bilateral contracts also continue to play an important role. The following comments apply to RTO/ISO regions with a centralized capacity market:

Centralized capacity markets should provide stable and sustainable price signals for capacity needed to satisfy reserve margins. Capacity market prices should be competitive; prices should be neither artificially suppressed nor artificially inflated. This can be achieved going forward by considering each of a series of issues, including lengthening the time period for price signals from centralized capacity markets, minimizing regulatory price volatility, and factors impacting the availability of bilateral capacity contracts.

- a) Policymakers and stakeholders should explore options for a longer term centralized capacity market price signal than provided under existing market designs and rules. It is important that this be done on a non-discriminatory basis.** Providing price signals for at least some amount of capacity up to 5 to 10 years in advance of a given year is worth exploring to allow suppliers the option of participating in capacity product mechanisms that would acquire various amounts of capacity over multiple time periods. There are trade-offs involved for consumers and suppliers that will have to be understood.
- b) Policymakers and stakeholders should explore why capacity prices are volatile.** Regulatory volatility stems from changes to rules and creates major risks that make it a challenge to finance investments in existing and new facilities that support cost-effective reliable service. Policymakers should examine how to reduce regulatory volatility to help permit centralized capacity markets to have greater liquidity and more consistent, predictable forward prices. Specific examples of issues to address include a less steep demand curve, the quantity of capacity to be procured, how reserve margins are set, when planning parameters are released in relation to the auction date, and the negative impact of subsidized demand response. A goal should be to better align capacity acquisition and transmission planning time frames.
- c) Policymakers and stakeholders should determine whether impediments exist under current rules to longer term mutually agreeable bilateral capacity arrangements.** The lack of adequate transparency as to key economic drivers appears to be the major impediment to such bilateral contracts.
- d) Policymakers and stakeholders should continue to pursue market designs and rules that prevent the exercise of market power through subsidized capacity resources, including those fostered by state mandates.** State actions can impact the integrity of the wholesale capacity markets, which are exclusively regulated by FERC. State mandates that procure or encourage the development of new capacity in amounts that exceed what is necessary to meet reliability requirements are problematic. They artificially over supply regional capacity even beyond the excess already built into reserve margins. Some states are taking actions for the express purpose (or at least with the effect) of artificially suppressing centralized

capacity market prices. Federal and state policies should allow market-based solutions to find the most cost effective ways to be sure the right amount of capacity is in place when and where necessary for reliability. Failure to do so will frustrate the efficiencies associated with regional markets and the economic and reliability benefits of organized wholesale markets. If this occurs, the centralized market for capacity will not be based on competition between the most cost-effective resources but will instead be driven by the state that offers the most subsidies. This is not the foundation for a well-functioning market.

- e) **Policymakers and stakeholders should explore the extent to which market rules for capacity and energy are properly coordinated to promote economically rational investment decisions.** This includes how and the extent to which the three principal revenue streams from energy, capacity, and ancillary services markets are linked and coordinated to ensure an overall competitive outcome. If not done properly, competitive suppliers will not see accurate price signals and revenues sufficient for long term investment decisions.

- f) **Policymakers and stakeholders should explore existing market rules to make sure that their cumulative impact has not overly mitigated capacity market outcomes below competitive results consistent with long term investments.** Centralized capacity markets were developed in response to the unique feature of reserve margins needed in electricity markets to reliably meet load needs and because of energy market price and other caps. As centralized capacity markets have evolved, new issues have arisen in part as a result of attempts to formally and informally impose “price caps” on capacity market outcomes.

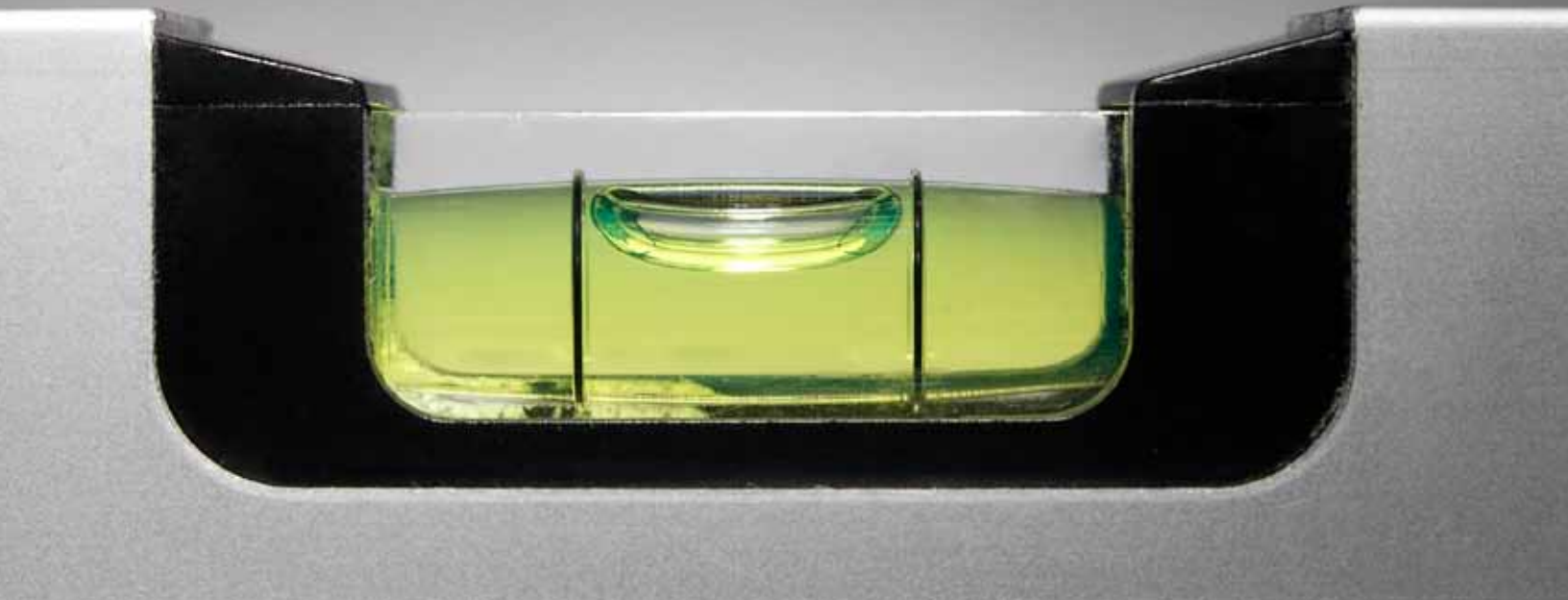
5. Proper Role for Demand Response

FERC has issued a final rule on demand response (DR) compensation in wholesale energy markets. EPSA and other trade associations have challenged FERC's jurisdiction to do so. DR market rules should result in an economically rational role for DR, not the subsidized, discriminatory role envisioned in the final rule. If, as is the case under the final rule, DR is not compensated properly consistent with the Federal Power Act, and thus adversely impacts supply resources, then no matter what other market design and rules are improved, organized markets will not produce sustainable, competitive results consistent with long term investment needs.

DR should have the same performance obligations as generation if it is to receive the same level of compensation as generation. It must provide the same level of availability, longevity, flexibility and contribution to resource adequacy as generation. Thus, for example, DR should be required to bid in to the day-ahead market and face penalties equivalent to generation facilities.

Because of the saturation level that DR has reached in certain markets it is critical that it be subject to rigorous measurement and verification tests, performance obligations and market rules. There should not be a lower threshold for DR to comply with market rules (e.g., must offer obligations and being dispatchable) than for other resources. Such market rules should define actual DR apart from conventional energy efficiency, energy conservation and "behind the meter" (or "off the grid") power generation.



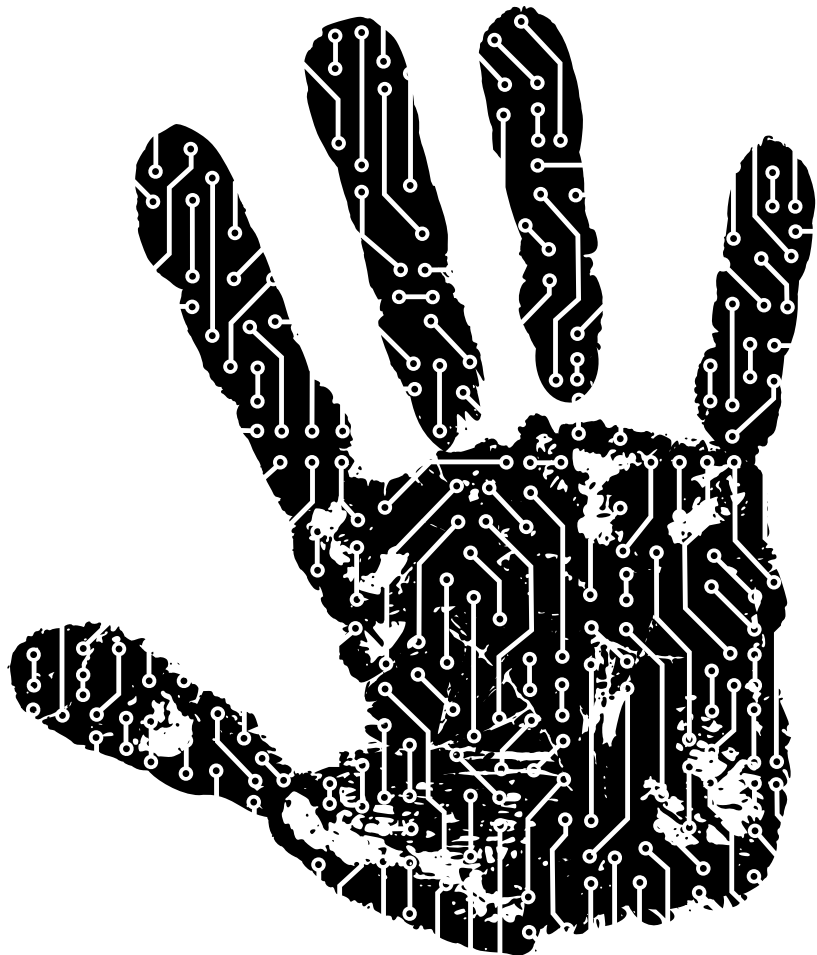


6. Ancillary Services Pricing

Ancillary services keep the grid reliable on a minute-by-minute basis. Market rules for ancillary services should reflect the flexible operational attributes and economics of the particular types of resources that can provide necessary ancillary services. These services will become an increasingly important market element as increased use of intermittent resources stress the system and result in a greater need for fast start and ramping capabilities. Market rules must send accurate competitive price signals for flexible reliable ancillary services products, including new investment, if those same services are to be available in the amounts needed as wholesale markets integrate more intermittent and non-traditional resources.

7. Market Mitigation in Perspective

The organized wholesale power markets include market rules designed to produce competitive outcomes, including price mitigation rules in energy, capacity and ancillary services markets. Market mitigation of suppliers must be approached cautiously, as over-mitigated markets distort price signals thus reducing liquidity and discouraging economically rational decisions about investments in existing and new resources. As FERC makes changes in some rules or adopts new ones in the name of achieving competitive results, FERC should pay close attention to whether such additional steps are in fact necessary based on empirical data and analysis of market results. FERC should also implement expanded use of competitively-based energy market price signals that truly reflect supply and demand during times of high demand to best allocate resources.





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