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VIA ELECTRONIC FILING

Kimberly D. Bose, Secretary
Federal Energy Regulatory Commission
Office of the Secretary
888 First Street, N.E.
Washington, D.C. 20426

RE: Wholesale Competition in Regions with Organized Electric Markets
Docket Nos. RM07-19-000 and AD07-7-000

Dear Ms. Bose:

Enclosed please find for electronic filing Comments of American Forest & Paper Association in the above captioned proceedings.

Thank you for your attention to this matter.

Regards,

Donald J. Sipe/s/

Donald J. Sipe
Counsel to American Forest & Paper Association

Enclosure
CC: Service List

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Wholesale Competition in Regions with Organized Electric Markets	**Docket Nos. RM07-19-000 and AD07-7-000**

COMMENTS OF AMERICAN FOREST & PAPER ASSOCIATION

Pursuant to Rule 212 of the Commission's Rules of Practice and Procedure, 18 C.F.R. §385.212 (2005), American Forest & Paper Association ("AF&PA") hereby submits its comments in the above captioned proceeding. In support thereof, AF&PA states as follows:

I. COMMUNICATIONS.

All correspondence and communications to AF&PA in this docket should be addressed to:

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II. DESCRIPTION OF AMERICAN FOREST & PAPER ASSOCIATION.

AF&PA is the trade association of the forest, pulp, paper, paperboard, and wood products industry in the United States. AF&PA's members are among the nation's largest consumers of electric power, purchasing over 82 billion kilowatt-hours of electricity annually nationwide. AF&PA is not now, and will not be, adequately represented by any other party in this proceeding, and may be bound or adversely affected by the Commission's action herein.

III. SUMMARY OF ARGUMENT.

AF&PA appreciates the opportunity to comment on the Commission's June 22, 2007 Advance Notice of Proposed Rulemaking ("ANOPR").[1] We support wholeheartedly the Commission's initiative to closely examine the operation and competitiveness of the current markets and welcome the opportunity to work with the Commission and other interested parties in exploring constructive alternatives and adjustments to existing market mechanisms to better harness the forces of competition to the benefit of consumers. The Commission has begun its inquiry in an appropriate way by holding a series of technical conferences which asked parties broad questions about the operation of the current competitive markets. The Commission has heard a fairly consistent critique of the organized markets from consumers at those hearings that highlight several themes that are important to consider. AF&PA believes that the Commission's ANOPR is asking constructive questions based upon the feedback it has received from those conferences regarding concerns over lack of demand response, lack of long term contracting opportunities, and concerns with the responsiveness of RTOs. The recommendations AF&PA makes herein are directly responsive to the Commission's invitation for parties to present concrete, constructive proposals for market modifications which may address these specific concerns.

[1] 119 FERC ¶ 61,306 (June 22, 2007), 72 FR 36,276 (July 2, 2007).

AF&PA wishes to emphasize, however, that while it has done its best to make specific constructive proposals in response to the questions raised by the ANOPR, there remain deeper, fundamental questions regarding the appropriateness and effectiveness of the current market design that still require the Commission's attention. We remain concerned that levels of market concentration, instability in fuel cost relationships and a suboptimal resource mix all pose special and difficult challenges that may call into question the appropriateness of the current market design as a means of meeting the demand of fundamental fairness that underlies the just and reasonable rate standard. We recognize that these are not easy questions to answer, or even to frame in an analytic context that allows for precise quantification of the costs and benefits of alternatives. But we urge the Commission to continue its investigation into the possible, deeper causes of the current consumer dissatisfaction with the organized markets.

AF&PA's comments are divided into seven sections. In Section A, AF&PA presents the conceptual framework it believes is appropriate for addressing the Commission's various questions. We begin by identifying the product which consumers are hoping the markets would be able to deliver. We identify that product simply as "safe and reliable service at just and reasonable rates." We note that competition cannot be considered an end in itself, but must be viewed in terms of whether it has succeeded in delivering this product at lower cost to consumers. We note that price is an embedded feature of this product, and that the concept that the price to consumers should be reasonably related to the cost of providing service is a social decision, codified in the FPA's just and reasonable standard, that competition was meant to further, not obviate. We further note that electricity, as conceived by the FPA, is a service, not a strict commodity.

Based on these initial observations, AF&PA then notes that the current market structures are designed not around the idea of service, but around the independent provision of two (or more) "pure" commodities: energy and capacity. AF&PA analyzes these products on a conceptual level as revenue recovery devices for achieving the goal of the FPA of delivering safe and reliable service at an overall cost which reflects the cost of providing that service. We conclude that while KW and KWhrs are useful billing units when used in bundled service contexts to recover the known costs of a system, when treated as independent products they are not related in any rigorous way to the recovery of legitimate cost of providing service from the electric system as a whole. AF&PA notes that the physical inseparability of these two products requires some explicit pricing relation between them in order for the overall service to be reasonably priced. For these reasons, AF&PA rejects the contention that these erstwhile billing units of Vertically Integrated Utilities are in any sense "natural products" which must be traded as pure commodities for competition to work. Focusing all the Commission's market design energies on the delivery of these two supposed commodities, has led to a series of difficulties and embarrassments. AF&PA does not argue for the abandonment of either LMP or any current capacity product, but notes they are not embedded in a market structure that delivers the "service" customers asked for restructured markets to deliver.

In Section B of our comments, AF&PA applies this basic insight into product definition to frame its response to several of the Commission's inquiries on demand response. Focusing on the Commission's obligation to assure safe and reliable service at just and reasonable rates, we note that the current market has recognized structural flaws which would make it unjust and unreasonable to remove or relax price caps at this time. First, Demand Response infrastructure is not sufficiently developed to permit scarcity pricing without unjust and unreasonable results. Second, we note that the lack of long term contracting opportunities to hedge short term

volatility will expose customers who cannot respond in real time (even if the Demand Response infrastructure were there) to unacceptable levels of market power and unjust and unreasonable rates. Third, we note that it is not a legitimate objection to price caps that they "interfere" with the free trade of capacity or energy as independent commodities. Because these are not the products the Commission is charged under the FPA to deliver to consumers, the decision of whether or not they ought to be traded, and how must hinge completely upon whether the mechanisms adopted for trading them will result in safe and reliable service at just and reasonable rates. We reiterate that trading these abstractions as independent commodities is a rate and market design choice, not a recognition of any "natural" product.

AF&PA goes on to acknowledge that the Commission faces a chicken and egg problem in attempting to assess the appropriate range of demand response which is available before scarcity pricing has unacceptable social and economic affects. AF&PA recognizes that in order to incent demand response, a greater use of scarcity pricing may be appropriate for some customers. In later portions of its comments, AF&PA proposes a specific market modification called a Financial Performance Obligation, which will immediately create an effective hedge for non-price elastic load from short term volatility while at the same time, permitting greater use of scarcity pricing at wholesale. In addition, it will incent suppliers to seek ways to make scarcity pricing available to any customer who can offer demand response in real time. Thus, while AF&PA believes removing or substantially raising the price caps under the current market design would be unjust and unreasonable, we provide a constructive suggestion that may permit greater use of scarcity pricing in the future under a modified market structure.

AF&PA next addresses the Commission's questions on whether allowing demand resources to be paid the clearing price in addition to their avoided consumption cost, is an

inappropriate double compensation . Again, focusing upon the Commission's charge to deliver safe and reliable service at just and reasonable rates, we conclude for all the reasons detailed herein that the double counting issue is a red herring based, again, on a mis-conceived notion of the product the Commission is charged with developing markets to deliver effectively. AF&PA concludes that while the Commission should always evaluate demand response programs empirically to assure that they promote safe and reliable service at just and reasonable rates, the yardstick for that measurement must be whether such programs provide better service at lower costs to all other customers. Comparability between demand side and supply side resources requires paying demand side resources the clearing price for energy, capacity, or any other ancillary product unless it can be demonstrated that doing so would raise prices to all other consumers beyond what other consumers would pay without demand response.

Finally, AF&PA addresses the Commission's request for comments on 1) removing deviation penalties, 2) requiring RTOs to purchase ancillary services from demand response providers, and; 3) allowing retail aggregation of demand response. AF&PA supports adopting each of these initiatives.

In Sections C and D of our comments, AF&PA addresses the Commission's request for ideas to encourage greater long term contracting. First, we provide a theoretical critique of the bifurcated capacity and energy commodity structure of the current market design and particular features of LMP in order to identify the significant economic forces that are currently hindering long term contracting. The purpose of this critique is not to argue for the abandonment of either LMP or of particular capacity products. Rather, it is to identify, based upon empirical models of economic analysis, specific economic dynamics created by LMP which may be hindering efficient operation of the market. Having identified these shortcomings in the way LMP is

currently incorporated into the market structure, AF&PA moves on in the next section to offer a very specific market modification which addresses these concerns. Therefore, AF&PA's critique of LMP is offered not for purposes of "complaining", but to motivate constructive discussion and understanding of how an alternative deployment of LMP could directly address many of the problems identified by consumers and the Commission in the ANOPR.

The market design alternative suggested by AF&PA is termed a "Financial Performance Obligation ("FPO")." The Financial Performance Obligation is designed to partially reintegrate capacity and energy for pricing purposes, thereby re-establishing a commercially reasonable cost based relation between these products. The Financial Performance Obligation would require every unit receiving a capacity payment to financially guarantee the delivery of energy to the real time market at or below a specified strike price in any hour. The obligation is financial in nature, and is not a requirement for physical delivery of energy from the unit in any hour. As explained further in that section, the strike price is based on a fuel indexed marginal production cost per MWhr as established by the applicable heat rate for a proxy peaking unit. Theoretically the FPO is on all fours with several previously approved Energy and Ancillary Service Adjustment mechanisms used in conjunction with various capacity products. AF&PA goes on to explain, however, the reasons the Financial Performance Obligation is superior as a hedge for load and far more just and reasonable as a means of adjusting out scarcity rents to assure ratepayers do not pay for capacity twice, once through capacity payments and again through scarcity rents.

After describing the Financial Performance Obligation, AF&PA goes on to explain in detail how the institution of a Financial Performance Obligation structure addresses each of the shortcomings identified in the previous economic analysis of current LMP structures. In particular, AF&PA explains how the current impasse of long term contracting in the markets

may be addressed by a move towards Financial Performance Obligations. Because the clearing price now represents a risk to be hedged by suppliers in return for capacity payments, suppliers are incented to take steps, such as long term contracting, resource additions and the creation of financial instruments to hedge the short term volatility of the market. AF&PA explains in detail how, under a Financial Performance Obligation model, suppliers are motivated to seek out demand response as a means of hedging short term volatility at wholesale. In addition, AF&PA explains how the use of Financial Performance Obligations may allow the Commission to avail itself of a greater level of scarcity pricing than at present, without the social disruption and political heat (or the unjust and unreasonable results) which would attend such changes under the current market structure. Finally, AF&PA explains how the use of a Financial Performance Obligation model will reinstitute commercially reasonable relations between the cost of capacity and energy that would obtain under normal bilateral contracting, or cost of service regulation while still relying upon competitive forces to drive efficiencies.

Although AF&PA acknowledges that Financial Performance Obligations will not solve all the ills of the present market, we believe it represents a reasonable incremental improvement based on sound economic analysis which can assist the Commission in addressing many of the persistent problems noted by consumers in the present markets.

With regard to issues surrounding the governance of RTOs, AF&PA recommends that the Commission not move away from current rules which encourage and/or require ISO and RTO board members to be independent of Stakeholders. AF&PA believes that the current independence of RTO and ISO boards is a valuable consumer protection which permits those bodies to exercise a certain level of "volume control", that allows the ideas and arguments of consumer representatives not to be drowned out by the sheer ubiquity of better funded and more

numerous advocates of the supply side who populate ISO and RTO committees. AF&PA is concerned that that same resource imbalance will make itself evident in the context of the RTO board room, and may therefore lessen RTO responsiveness specifically to consumer concerns if permitted. AF&PA does recommend that the Commission consider requiring each RTO to provide separate independent counsel to Stakeholders as a group for purposes of protecting and enforcing Stakeholders rights to fair procedure and due consideration by RTO Staff and to assure fair representation of consensus Stakeholder positions when those positions are not in accord with the views of the RTO or its Staff.

In response to the Commission's Request for Comments on the appropriate role and structure of the Market Monitor, AF&PA recommends an internal Market Monitoring function that reports simultaneously and directly to the RTO Board, the Commission and other Stakeholders. We recommend the Board evaluate Market Monitoring performance and be permitted to seek approval from the Commission to retain or remove the Market Monitor for cause. Further, AF&PA recommends that the Market Monitor retain or be granted enforcement authority to apply market mitigation standards and enforce the same in any situation where its investigations reveal market rule violations. AF&PA believes such authority vested in the Market Monitor is necessary to protect consumers.

Finally, the Commission has invited comments on any other aspect of the markets that parties believe should be improved in order to assure a better use of competition. In Section G of its comments, AF&PA recommends that the Commission revise the current dual Energy/Network Resource interconnection standard to allow displacement of incumbents through price competition at the relevant level of pricing granularity. AF&PA offers an extensive critique of the concept of "deliverability" as it is embedded in current interconnection

protocols and demonstrates that deliverability can be an inappropriate and discriminatory barrier to entry which provides preferential access to incumbents at the expense of ratepayers if it is not conditioned upon recognition of locational pricing structures. AF&PA acknowledges that under current technological limitations, capacity cannot be "nodal", but argues the adoption of price competition at the appropriate level of granularity is needed to prevent unnecessary and incumbent preferential barriers to entry in the capacity markets.

IV. COMMENTS OF AMERICAN FOREST & PAPER ASSOCIATION.

A. FRAMEWORK FOR ANALYSIS AND DISCUSSION.

1. What is "the Product" Competition Should Deliver?

In his open meeting Commission statement, Chairman Kelliher observed:

> I want to draw the distinction between competition and deregulation. Deregulation is not and has never been Commission policy to federal policy with respect to wholesale power markets. Deregulation is the absence of regulation, and wholesale markets and wholesale power sales have never been unregulated. The character of our regulation has changed, but we never stopped regulating.
>
> It is also important to recognize that the Commission has never relied solely on competition to assure just and reasonable wholesale power prices. Instead, we rely on a mixture of competition and regulation.
>
> Federal Energy Regulatory Commission *Open Commission Meeting Statement of Chairman Joseph T. Kelliher*, Item E-3 (June 21, 2007).

The distinction made by Chairman Kelliher crystallizes one of the central conceptual issues that needs constantly to be borne in mind. The interdependence of competition and regulation (i.e. rules, laws) in any market is complex and unavoidable. Recognizing the necessary interdependence of these two components can neutralize much unconstructive rhetoric in the debate over market design.

The shift in emphasis from regulation towards competition under electric restructuring was undertaken with specific goals in mind. Those goals may have varied between different

parties. From a consumer point of view, the goal of restructuring was to provide a level of electric service that was equivalent to or better than what could be obtained under regulation, but at lower cost. The goal of restructuring was to use competition among vendors as a means to lower the cost of delivering a product which, naively perhaps, was called simply "electricity".

In many respects the problems identified by consumers with current electricity market models stem from a failure to answer the most basic question: what is "the product" consumers want competition to deliver more efficiently?

"The Product" competition was meant to deliver more efficiently is called "safe and reliable service at just and reasonable rates." This product consists, at least, of the following characteristics:

1. Supply at particular voltages and frequencies of electric power sufficient to meet the instantaneous demands of all customers with no more than a one-day-in-ten-year forced outage rate at prices that reflect the efficient cost of production plus a reasonable return on investment to producers.

2. In addition, consumers wanted suppliers to anticipate load growth and economic development in order to supply additional power at non-discriminatory rates to incremental customer demand (i.e. the obligation to serve).

One of the important things about this particular product is that price is one of the characteristics. There is a reason for this that goes beyond the general concern that market power is a bad thing or that monopoly pricing should be avoided. The FPA "just and reasonable" standard[2] embodies an explicit social and legal decision that pricing any significant

[2] A word on cost and prices. One of the embarrassments in all of these discussions about the benefits or costs of restructuring is the lack of any rigorous benchmark for determining success or failure in achieving the cost objectives of the FPA. This is not a manufactured difficulty, and is not the fault of any party, but neither can it be swept under the rug based on religious faith in the efficacies and justice of markets. The theory of regulatory practice was that perfect cost of service regulation should yield the same result as perfect competition in terms of costs and returns (*see* Bonbright). As a matter of theory, this remains sound; though neither regime can ever achieve perfection, efficient competition and efficient cost of service regulation ought to be roughly comparable in terms of overall cost to consumers. Cost of Service is, therefore, not an illegitimate standard for assessing whether competition, in its current form, is yielding "just and reasonable" results.

segment of society out of the electricity market should be avoided if possible. The availability of safe and reliable electricity at "just and reasonable" rates is neither a societal luxury nor a legislative "option".

"Electricity", as described above, is not a "simple" product, but in general, consumers did not contemplate a major deterioration of "electricity's" basic attributes under competition. Consumers did not agree to, and did not seek, the opportunity to suffer rolling blackouts based on scarcity pricing in order to "further competition". They did not desire, or volunteer to pay more for this product than they would have under regulation.[3] They did not agree to forego the opportunity to expand usage at non-discriminatory rates in the name of vindicating competition. What they expected, simply, was that competition would deliver the product described above with greater options and at a lower cost.

Consumers have been told that, based on economic theory, this product can be effectively delivered to them under a market design which relies primarily upon treating KWhrs (LMP) and KWs (FCM, RPM, ICAP) as "products" and allowing vendors to bid to supply them independently of one another. For several reasons, all of which will be discussed more thoroughly hereafter, reliance upon this design choice has had mixed results.

Much of what passes for "economic analysis" in current discussions about the value and use of competition in the electricity sector, is based on an error in product definition. Too often the theory surrounding markets has been misused to attempt to dictate the type of product which

[3] A point well made based on empirical analysis by PCA in their initial comments in this docket. The disparity in pricing between regulated and restructured markets is not just unfortunate, it calls into question the entire enterprise of structuring "competition" in the way the organized markets have structured it. The old complaints about vertical integration and regulation were that it cost too much because of inefficiencies. If costs have in fact increased in the organized markets over what would have prevailed in a cost of service context, this is direct and fairly incontrovertible evidence, not that competition is a bad idea, but that existing market structures may not make efficient or effective use of competitive forces.

consumers or society "ought" to want. When customers have complained the "product" being delivered is not the one they asked for because it lacks certain of the attributes listed above, the reply has too often been that the requested attributes are "not consistent" with the theory of competitive markets. If competition were an end in itself, this would be an acceptable answer. Because it is not, further inquiry is warranted.

2. The Proper Relation of Current Products to "the Product."

Killowatts and KWhrs under regulation were not "products." Rather, they were billing units used by vertically integrated utilities to recover the regulated costs of a system designed to deliver safe and reliable service. KWs and KWhrs under regulation were (and are) real, physically measurable quantities. But they function as revenue collection devices, whose price is set to recover specified revenue requirements. As revenue collection devices under regulation, they allocate the cost of the system among users in what rate designers hope is a rough approximation of cost causation. This rate design and cost relation between these billing units assures that the total amount collected for service remains just and reasonable. The current reliance upon KW and KWhr pricing under LMP and current resource adequacy products is also a "rate design" choice, but one that many consumers contend has become unhinged from any rigorous (some would argue, even "coherent") revenue recovery justification.[4] In section B below, AF&PA provides an extensive economic analysis that demonstrates that many of the basic theoretical assumptions relied upon to support the idea that "competition" in these two products as independent commodities can be counted on to create a reasonable cost based relation between them are at best highly questionable if not entirely untenable.

[4] PJM Industrial Customer Coalition, "Whitepaper: Changing the Direction of PJM's Dysfunctional Energy Markets," August, 2007.

This doesn't mean that one cannot use the insights of commodity trading and markets to help fashion a rate design, such as LMP, which creates trading incentives for KWhrs based on competitive signals and which will help restructured markets deliver safe and reliable service at just and reasonable rates. But any insistence that "economic theory demands" that the billing units of formerly integrated utilities must be traded as pure commodities and that any infringement upon the "free trade" in these hyper defined abstractions is "anti-competitive", is misplaced piety.

In what follows, AF&PA will suggest a partial reintegration of the current capacity and energy product design whose purpose is to better reflect the cost of service while still relying upon competitive forces to drive efficiencies. By reestablishing a cost based relation between these erstwhile billing units of vertically integrated utilities, a product can be constructed that has the reliability and financial robustness characteristic of "safe and reliable service at just and reasonable rates." The solution we propose is not a panacea for all the ills of the market, but we believe it is a reasonable, incremental improvement that should greatly enhance opportunities for long-term contracting and demand side management.

B. DEMAND RESPONSE.

These foregoing general observations regarding product definition and rate design, all lead to very specific recommendations with regard to the proper pricing and incentives for demand response.

At the outset, AF&PA observes that there are two generally recognized forms of demand response; 1) long term energy efficiency and 2) short term curtailment. Accurate and even predictable long-term average prices may be a better inducement to long term energy efficiency than periodic bouts of scarcity pricing and black outs. On the other hand, short term price volatility is an essential ingredient to making short term load curtailment attractive. Ideally, the market would provide pricing structures which encouraged both; an accurate long term average

price signal, but also the availability of occasional, spectacular savings through short-term response. Customers would self-select through bilateral contracting opportunities or other market mechanisms, the rate design that was optimal for their DSM opportunity profile. The availability of both pricing options would spare customers without short term flexibility the unproductive bludgeoning by volatile prices to which they have no way to respond.

Unfortunately, neither of these two pricing regimes are reliably or practically available for customers to self-select at present. As will be discussed in Section C below, lack of availability of long term contracts leaves most customers without stable long term competitive prices which conversely, leads to a situation where the Commission is rightly cautious about exposing these customers to unrestrained prices they lack the ability to hedge, dodge, or profit from.[5] AF&PA believes there is a rate design alternative that can break this stalemate, but before turning to a discussion of that alternative, we address the Commission's request for comment on specific points with respect to demand response.

We first address the Commission's various requests for comment on raising or eliminating the bid caps under certain conditions.

1. The Commission Should not Permit Greater Use of Scarcity Pricing at This Time Absent More Fundamental Market Reforms or Improvements.

Most discussions of price caps uncritically assume that they are an economically inappropriate constraint made necessary either by the presence of market power or the absence of demand response (which, in many ways, are two ways of saying the same thing). The implication is that if we could remove market power from the KWhr market and periodically price certain segments of the consuming public out of the market, we would have achieved the

[5] Commissioner Kelly, concurring in part and dissenting in part, 101-103, ANOPR, *supra.*

delivery of safe and reliable service at just and reasonable rates. There are many good reasons for believing that this is an overly-simplistic view of the Commission's true charge.

Price caps are a rate design choice. As the Commission has acknowledged, the imposition of price caps may require other rate/market design choices, such as development of capacity products to round out the collection of needed revenues. Price caps may be a good or a poor rate design choice depending on the market context in which they are embedded. At the present time, it is apparent the market lacks the physical and institutional infrastructure necessary to make full or even partial scarcity pricing applied generally at retail just and reasonable. However, a market modification AF&PA will propose in what follows is designed to allow the relaxation of the price caps on KWhr trading under circumstances which offer a better, less disruptive means of testing the demand elasticity of the market than removing the price caps "without more" would accomplish.

It is not clear at this time what range of efficient demand response is available for electricity before scarcity pricing has unwanted social or economic effects.[6] We agree with the Commission's intuition that the level of demand response that would be available without being disruptive to the economy or inequitable to consumers is probably greater than is evinced under current market structures. This is true in large part because, as the FERC Demand Response Assessment has concluded, the technologies in terms of metering and other resources needed to effectuate demand response do not have sufficient market penetration at this time. Without such technology in place, scarcity pricing may elicit nothing more than economic and social disruption. It will be a gradual process of accommodation before the efficient balance of capital

[6] Such as businesses failure, exorbitant risk premiums and credit requirements, greater than 1 day in 10 year scarcity, dangers to health and safety, etc.

investment between generation, transmission and demand response enabling infrastructure is determined by market forces.

We recognize that the Commission is in somewhat of a chicken and egg quandary. There is every indication that it will take more accurate pricing, (though not necessarily Value of Lost Load pricing) somehow communicated to the retail level in order to sufficiently test the amount of demand response which can be achieved while still maintaining reliable service at just and reasonable rates. In Section D of these comments, AF&PA proposes a market structure which may allow the gradual lifting of price caps in a fashion which creates appropriate incentives so that wholesale suppliers will place an appropriate value upon demand response as a means of hedging their own risk. This approach involves establishing a modified relationship between the capacity and energy pricing components of the current rate design.

That modification, called a Financial Performance Obligation, should achieve the goal of creating an active demand among suppliers for effective short term demand response as well as create an improved incentive framework to encourage long term contracting. As will be discussed more fully in Section D below, the Financial Performance Obligation structure will immediately create an effective hedge for load against short term price volatility while at the same time permitting greater use of scarcity pricing at wholesale and incenting every supplier to seek ways to make that pricing available to any consumer who can offer demand response at a price competitive with supply side hedging alternatives.

Thus, while AF&PA believes there is likely to be a market context in which the increased use of scarcity pricing for KWhrs can be used to help provide safe and reliable service at just and reasonable rates, current market structures require a more fundamental adjustment than simply raising or removing the price caps in order to achieve this. Each of the Commission's proposed alternatives runs a substantial risk of significantly harming captive customers who do not have

the practical ability to respond either through short term actions or long term contracting. As will be discussed in Section C below, the lack of long term contracting is at least in part due to economic factors that "stronger" LMP scarcity pricing signals are likely to aggravate rather than ameliorate.

2. Paying Demand Response Resources the Clearing Price is Not Appropriate Double Compensation.

The Commission has asked whether paying Demand Side Management Resources for capacity and energy when they interrupt is inappropriate "double counting" because those same customers are also relieved of the obligation to purchase product. The Commission has also asked for recommendations regarding the proper compensation for demand response services. For all of the reasons stated below, AF&PA believes that, given the level of benefit to all other customers, and the principle of treating demand and supply resources equivalently, demand should be "paid" the clearing price[7] unless empirical evidence shows doing so would not generate savings to other customers. The issue of "double compensation" is irrelevant to making this determination and objections to paying for demand response predicated on this should be rejected by the Commission.

In no area does the problem presented by misconceived product definition cause greater mischief than in discussions of compensation for demand side management resources. Because the desired product is safe and reliable service at just and reasonable rates, the only real question is; are the rates paid to demand response providers to achieve safe and reliable service "just and reasonable." This has nothing to do with whether there are two payment

[7] Anticipating the discussion somewhat, if a supplier had an obligation to deliver to load under a fixed price contract, and found himself short at the time of system peak and subject to settlement at the clearing price, he should be indifferent to paying either a demand response provider to interrupt or a generator to come on line to hedge his load obligation.

streams associated with any identified physical quantity of goods. Rather the question is whether the overall service provided to consumers as a result of demand response is superior in terms of safety, reliability and price to what would be delivered to consumers without demand response.

The principle of "not paying twice" relies upon an implicit assumption that paying twice means paying twice as much. In the case of demand response, it certainly does not. AF&PA believes that the double counting arguments made by those who object to paying for demand response are unpersuasive because they ignore the price effects of demand response for all other customers and they are premised on an inappropriate product definition.

We begin with the proposition that people who do not consume a product are not being "compensated" when they are not charged for it. It is true that if I buy less of a product, my bill will be lower, but I am not being compensated by the grocery store when I leave with an empty cart. While it is true that the Commission will get a certain level of demand response and efficiency as prices increase, it is not true that relying on that mechanism alone is the best way to provide safe and reliable service at just and reasonable rates for all customers. This is because there is a mismatch between the value to the system and to other customers of a load interruption at the time of system peak, and the value as realized by that customer by simply avoiding peak prices. In a clearing price market for both capacity and energy, the value of load response to other customers in lower clearing prices for both capacity and energy, can be many orders of magnitude greater than the value realized by a particular customer from interrupting. There is ample evidence that you get more demand response when you pay customers money in addition to their avoided cost not to consume on peak. It is also reasonable to conclude that if you stop

paying them, you will get less and rates for all other customers will go up disproportionately to the amount invested in paying for demand response.[8]

There is a common misconception that demand response is "free", that it requires no capital or other investment to arrange production schedules or heating and cooling for office towers in order to achieve interruptions on peak. This is obviously inaccurate. In fact, not consuming can be a very capital and labor intensive exercise. Further, as opposed to energy efficiency, load interruptions are a matter of load shifting which means that, generally, energy which is not consumed on peak, must be made up and purchased at another time. Thus, it is only the difference between on peak and off peak costs minus other capital and operational expenses that a consumer avoids directly. If society is not willing to pay for these capital and operating costs, investment in them won't be made. In this respect, demand response is akin to pumped storage.

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[8] RTOs such as PJM, NYISO, and ISO-NE have quantified the cost-effectiveness of demand response in their wholesale markets. They assessed both the reduction in market prices due to demand reductions and the value of demand response to system reliability. These assessments conclude that the demand response programs they operate produce net benefits associated with lower wholesale prices. For example, ISO-NE found that the benefits of its various economic and emergency demand response programs in 2005 more than compensate for its costs, largely payments to demand response participants and its own extra operating costs. PJM and NYISO found similar positive results in evaluations of their programs.

ANOPR at 40, *supra.*

See also Early August Demand Response Produces $650 Million Savings in PJM: Reducing Electricity Use Stretches Power Supplies, Lowers Wholesale Electricity Prices at p. 1 (August 17, 2006), citing data showing an example of the cost benefits exceeding the demand response payments, i.e. in the first weeks of August, 2006, PJM reported price reductions of an estimated $650 million in payments for energy, making the energy savings for all consumers at an unprecedented 130 to 1 ratio. *Also,* ISO-NE 2005 Demand Response Program Evaluation, Docket No. ER02-2330-040 (December 30, 2005), ISO New England states that with regard to real-time price "the benefits exceeded its costs by 80%" and the day-ahead programs had an impressive margin of benefits exceeding payments by 37%. New York ISO also had similar positive results, thereby showing the cost benefits of demand response (For further details, *see* NYISO 2006 Demand Response Programs, Docket No. ER01-3001-016 (February 17, 2007)).

A pumped storage unit consumes power off peak in order to provide power from the pond when called upon. Just as with a demand response customer, the pumped storage unit is "compensated" when it does not consume power on peak, because it does not pay on peak prices. No one seems to argue, however, that it is "double compensation" for the pumped storage unit, when it performs on peak and gets paid. The reason no one makes this argument against pumped storage, but they do make it against demand response, is because they incorrectly believe that the "product" the pumped storage unit is being paid for is KW hours rather than safe and reliable service at just and reasonable rates. In fact, KW hours only represent the billing units to determine how much service is being provided at the time of system peak. The actual service being provided is system response. In this respect, the system operator will see the same system response whether a customer interrupts 100 Kilowatts or a pumped storage unit supplies a 100 KWs. From a system response point of view, both provide exactly the same service to other customers.

a.) Paying Demand Response Providers the Clearing Price is Just and Reasonable and Fair to All Other Customers.

We next turn to the question of whether it is fair to other customers to pay a demand response provider the same price for a KW hour of foregone consumption as they pay a producer of a KW hour. The KW hours demand response is providing are KW hours of system response, and paying for them does mean that consumers, as a whole, pay for the same number of billing units as they would have if the customer had simply continued to consume. But the fact that the number of billing units hasn't changed would only be harmful to other consumers if the price for the billing units stayed the same. But, unless you improperly design the program, what in fact happens is that by paying for the same number of billing units using demand response, the price of every billing unit is lower to all consumers and the savings generated to all consumers far outweigh the price paid to the interrupting customer. Thus, in terms of providing safe and

reliable service at just and reasonable rates, consumers are far better off for having paid for demand response[9] than they would have been not paying and getting less of it.[10] Given that the clearing price applies to every KW sold in the hour, it will always be in consumers' interest to pay for more demand response rather than less so long as the total payment to demand response providers is less than the sum of the decrease in payments generated by lower clearing prices across all customers.

b.) It is Not Unduly Discriminatory to Generation Suppliers to Pay Demand Response the Clearing Price.

We now address claims that it is unduly discriminatory to pay demand response providers for not consuming on peak when a pumped storage unit has to provide "real" KWhrs in order to be paid. In terms of system response, and providing safe and reliable service at just and reasonable rates, this argument, too, is easily dismissed.

A pumped storage unit that does not consume on peak is not providing system response by not consuming for the following reasons. A pumped storage unit who consumed on peak would destroy its own arbitrage opportunity. Thus, they can already be counted on not to do so. As a practical matter, its production processes are not interfered with by not consuming on peak because its "product" is the arbitrage itself. Thus, paying a pumped storage unit for not consuming on peak would be paying a "free rider", not a demand response provider. This is not true for an industrial facility or an office tower whose product is well cooled and lighted office space, chemicals, paper, or other goods. Even among consumers, market rules need to be

[9] Regardless of the irrelevant contention that they "paid twice" for the same service.

[10] While our analysis is based on price impacts, one should not lose sight of the environmental and greenhouse gas reduction benefits that accrue through demand response activities. Those benefits can be significant, especially as more attention is paid to air quality and global climate change concerns.

designed to avoid paying for free riders[11] but the distinction between the two cases[12] should be sufficient to overcome concerns of undue discrimination.

c.) Paying Demand Response the Clearing Price is Necessary to Allow Competition to Work Properly.

Another claim often made is that paying demand response providers "nothing" is required to avoid paying them "more than necessary" to induce interruptions. This formulation invites the question: More than necessary for what? The irony does not escape consumers, and it should not escape the Commission, that suddenly "cost of service" rather than "competitive principles" looms as a large issue, but only if it can be used to discourage demand response.[13] As pointed out above, demand resources are not free, there are capital, labor, lost production, operation and other costs associated with interruptions. If the cost of these interruptions are lower than the cost of central station generating units, and DSM providers "make a lot of money" selling interruptions at the clearing price, this is no more illegitimate than a low-cost generator making money at the clearing price. When consumers complain that low cost generators are getting a "windfall" selling at the clearing price, generation proponents reject this contention as "economically unsound." If compensating demand response providers for system response services on the same basis as generation proves lucrative, this should encourage more demand response, just as it is argued on the "other side", it should encourage more cheap generation. In a competitive market, customers should invest in demand response until the clearing price drops

[11] e.g. customers whose facilities are already off line for maintenance or unexpected outages when called at the time of system peak, etc.

[12] i.e. pumped storage and consumer load.

[13] AF&PA does believe that cost of service is the ultimate standard by which just and reasonable rates must be judged. The theory of competitive markets, however, is that they ought to drive prices down close to the cost of service. If a clearing price market is not doing this for Demand Response, there is no reason to support its use to price generation either.

and the payment stream afforded does not cover the needed return on the invested resources. If there is, in fact, a significant number of resources who can justify DSM investment on nothing more than their avoided consumption costs, these parties will step forward and lower the clearing price by bidding or interrupting at successively lower and lower prices, until the correct balance of demand response and generation is reached. Customers are continually assured that these competitive forces will be effective at assuring generators are not being paid "more than necessary". The argument that these same competitive forces are inadequate to similarly condition demand response is either "economically unsound" or points to a deeper inadequacy in relying on a market clearing mechanism to price services appropriately.

d.) Conclusion.

In each case, the Commission needs to ask whether the program or the market rule is designed in a way that promotes the provision of safe and reliable service at just and reasonable rates, and it should adopt common sense, empirical methods for determining this. The default rule of paying, for demand response on the same basis as other supply is a fair rule of thumb unless benefits can only be achieved by paying less…or more. Any empirical analysis should pay attention to the interplay between state and federal rate design choices to avoid trapping costs or burdening any group of customers unfairly. The issue of "double counting", however, is irrelevant to such analysis.

3. Other Demand Response Issues.

The Commission has asked for comments on a variety of demand response product issues. In general, AF&PA supports the more detailed comments made by ELCON in this proceeding with regard to specific demand response products. Specifically, AF&PA recommends that each ISO/RTO be required to purchase demand resources to satisfy ancillary services requirements where separate markets for these services exist. The technical and bidding

requirements for these resources to participate in such markets should be tailored to maximize efficient use of such resources and, where consistent with reliability objectives, should recognize the unique physical and operational characteristics of these resources as distinguished from traditional generation.

AF&PA supports allowing demand response resources to bid demand response as operating reserves without the obligation to simultaneously sell into the energy market. Such sales are not necessary in order to comply with reliability needs or to effectively provide system response from demand side resources when called upon.

The Commission has asked a series of questions on deviation charges to buyers who consume less energy in the real time market than scheduled in the day ahead market. AF&PA supports the elimination of all such charges, and urges the Commission to require each ISO and RTO to completely eliminate collection of those charges which are based on penalizing deviations in order to encourage accurate scheduling, and to develop protocols to reallocate other deviation charges in a fashion which avoids undue or unreasonable burdens on other market participants.

AF&PA also supports allowing aggregators of retail customers to bid demand reductions of behalf of those customers. The rules should be non-discriminatory and fungible between aggregated and non-aggregated demand response bids. To the extent there is sufficient congruence in the market rules to trade products such as ancillary services across ISO's and RTO's, there should also be standardized rules in each market for allowing aggregators to participate and aggregate within RTOs or across RTO seams with minimum transaction costs.

C. INCREASING LONG TERM CONTRACTING.

1. The "Incentive" Structure of the Current Market; Shifting to a Descriptive Approach.

Too often the discussion of "incentives" in market structures is overly simplistic. There is an unstated assumption, that an incentive can be represented as an amount of money which can be either gained or lost and that gains and losses can be summed using a simple linear calculus to determine net incentives for or against particular behaviors. Thus, if the predicted sum of a series of short-term transactions is X with a verified probability of Y, then a long term contract which yields XxY adjusted by an appropriate discount rate, should be just as attractive as the series of short term transactions to any rational market participant. In short, when discussing market structures and the "incentives" they supposedly provide to various players, we often assume such quantities are linearly additive, largely independent of context, and temporally neutral. In what follows, this simplified model of economic decision making will be referred to as "expected utility theory." Expected utility theory has been widely assumed to represent an accurate model of economic decision making. In fact, however, it has been repeatedly demonstrated that decision makers do not operate in accordance with its percepts in many real market contexts.

One of the more interesting exchanges at the Commission's hearings on competitive markets was that between Professor Hogan and Mr. Thilly regarding the economic incentives surrounding Valentines Day. At a certain point, frustrated by the uncritical assumption that the market "must" be working because normative theory predicted that it "ought" to, Mr. Thilly told the story of a putative recent analysis by academic economists that had clearly demonstrated that money was the "most efficient" Valentine's Day gift. Dr. Hogan's response was that, for the record, he always gave chocolate.[14] Although this exchange was good natured, it made several important points which were implicitly recognized by everyone at the hearing. The first is that

[14] Commission Conference on Competition in Wholesale Power Markets, Docket No. AD07-7-000 Transcript, 155, 13-14 (February 27, 2007).

"everyone knows" market behavior is motivated by more than expected utility calculus. The second that, in fact, expected utility theory routinely predicts behaviors that no one truly believes will occur. The third is that even classically trained economists understand this, as Dr. Hogan emphasized. Yet while everyone at the hearing "got the joke" and recognized its relevance to the discussion, no one seemed to know what to do with the punch line.

This reticence may be due, in part at least, to a fear that there is no constructive use to be made of such a recognition; that if we "lose our faith" in the simplistic calculus of profit maximization in a vacuum postulated by expected utility theory we are left, well . . . with just the vacuum. This anxiety is unfounded. At least since the late 70's, there has been a growing body of economic theory and analysis that provides a useful critique of expected utility theory on the basis of empirical observation and experiment.[15] This work has demonstrated conclusively that expected utility theory does not accurately describe or predict the actual behavior of even highly sophisticated market participants in many real world situations. Basic axioms of expected utility theory, including but not limited to 1) The substitution axiom[16] 2) Description invariance[17] 3) Linearity of probability[18] and 4) Dominance[19] have all been shown to be predictably and

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[15] Of particular relevance to this discussion is the development by Daniel Kahneman and Amos Tversky of an empirical and descriptive model of decision making under risk called "Prospect Theory." *See*, Kahneman, Tversky, Prospect Theory: An Analysis of Decision Under Risk, Econometricia, 47:2, 263-91 (1979) and Advances in Prospect Theory, *Journal of Risk and Uncertainty*, 5, 297-323 (1992).

[16] A.K.A. "cancellation." This posits that if a person prefers an outcome B, to outcome A, then they should also prefer alternative outcome scenario "B or P" to "A or P".

[17] This posits that presented with two descriptions of the same outcome (e.g. a. five dollars now and ten dollars on Friday or b. two dollars plus three dollars now, no money until Friday, then ten dollars on Friday) their preferences for that outcome compared with some other outcome (e.g. twenty dollars in two weeks) should not change.

[18] This posits that the utility of any prospect is increased equivalently by raising the probability of its occurrence from .1 to .2 or from .25 to .26.

[19] If one option is better than another in one state and at least as good in all other states, it is the dominant option and should invariably be chosen.

systematically violated by decision makers in certain situations. These observed violations, however, are not random; they turn out to be just as predictable as Professor Hogan's preference for giving chocolate on Valentine's Day. Because of this, acknowledging and anticipating these departures from "rational choice" can lead to market designs that produce predictably better results than could be achieved by pretending market behavior is actuated only by the axioms of expected utility theory.

A good example of how reliance on expected utility theory can be unhelpful is the now longstanding debate about the effects of LMP on long term contracting. There is now general agreement that the electricity markets would function better and provide more reliable service if there were more long term contracting taking place. Consumers have often argued that one of the chief impediments to long term contracting is the institution of LMP pricing. They have claimed that the "guarantee" to every supplier in every hour of the highest cleared bid by any supplier (LMP) makes suppliers reluctant to enter into long term contracts at reasonable prices. Suppliers, on the other hand, say they would be willing to enter into long term contracts, but consumers are simply unwilling to pay a reasonable price. Traditional expected utility theory provides only the unhelpful obfuscation that, clearly, one side or the other of this debate must be "right". This is because, under expected utility theory there should be some "value" out there that both sides, if they were "rational", should be able to agree on how to calculate. In the case of a contract whose term is shorter than the build cycle, this value is roughly the simple sum of the expected short term clearing prices for the expected term. If there is risk associated with the estimates of short term prices, that too should be amenable to reasonable assessment. That some reasonable parties may differ from others on these assessments is not the issue; in a competitive market the collective wisdom of many players all making their own estimate should find the "right" number. Under expected utility theory there is "no rational explanation" for "sellers", as

a class, to have a consistently different view than "buyers", as a class, of the value of long term contracts. Yet this anomalous result has become the standard in the organized markets. [20] Relying only upon expected utility theory, the commission is powerless to frame a remedy, so instead, must simply blame one side or the other (or both) for not understanding the "true economic situation". Thus, either 1) suppliers are irredeemably greedy and asking for too much money or 2) consumers are hopelessly naive and do not understand the new realities of escalating fuel costs and too long neglected transmission infrastructure.

By adopting a descriptive approach to the problem, however, the commission can move beyond this and 1) identify the consistent patterns in market behavior that have led to this impasse and 2) use that knowledge to construct market mechanisms to eliminate the impasse. Looking at the long term contracting impasse from the standpoint of descriptive economics, we conclude it is the expected result given certain, well documented behavioral tendencies in real world economic decision making working in conjunction with current market structures.

2. A Descriptive Economic Analysis of the Current LMP Pricing Regime as it Effects Valuation of Long Term Contracts.

As noted accurately by several commentators, there is a valuation dynamic associated with real time LMP pricing that hinders formation of long term contracts. This dynamic has been questioned, not based on any evidence of acceptable levels of long term contracting, but

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[20] "Customers and sellers differed sharply, however, on the nature and extent of any impediments to long-term contracts. Customers argued that suppliers are reluctant to sell power under long-term contracts at a price attractive to those customers. They argued that the presence of liquid spot markets gives suppliers an incentive to sell most of their output on a daily or hourly basis, not through long-term contracts. By contrast, suppliers and their representatives said they are willing to sign long-term power contracts but asserted that buyers simply do not want to pay the long-term cost of power. In particular, they alleged that customers do not want to pay enough to finance new generation and any needed transmission investment. With respect to existing assets, suppliers argued that customers often want a price pegged to a particular fuel (e.g., coal or nuclear), even if that price does not reflect the long-term market value of electric power."

ANOPR at 87, *supra* (footnote omitted).

because it is supposedly "irrational" based on expected utility theory's view of how market participants will act. In fact, several well documented and persistent valuation dynamics lend not just plausibility, but almost an aura of inevitability to the failure of LMP (as currently structured) to create a reasonable platform for long term contracting.

The first of these is loss aversion. Described in the early 1980s by such authors as Tversky and Kahneman, it is now a well documented fact of economic decision making under risk, that losses loom larger than gains in real world utility calculus. Second, despite being a violation of a central tenet of expected utility theory[21], there is ample empirical evidence that the way an economic choice is framed can influence how the choice is perceived (e.g. either as a gain or a loss) and therefore effect the choice made. One of these framing effects is known as the Endowment Effect[22] under which recipients of a good or benefit tend to value that good or benefit disproportionately. Such disproportionate valuation substantially impacts their willingness to trade or give up the endowment in return for other goods or money. Third, there are "evaluation period"[23] effects which arise from the frequency with which decision makers evaluate performance and outcomes. In this regard, LMP's hourly and daily evaluation protocols likely contribute to a form of economic myopia that consistently skews valuation assessment of long-term contracting opportunities. Evaluation period effects can be significant for firms

[21] Expected utility theory assumes description invariance: equivalent formulations of a choice problem should give rise to the same preference order.

[22] The endowment effect (or *divestiture aversion*) is a hypothesis that people value a good or service more once their property right to it has been established. In other words, people place a higher value on objects they own relative to objects they do not.

Thaler, R. Towards a Positive Theory of Consumer Choice. *Journal of Economic Behavior and Organization*, 1, 39-60 (1980).

[23] Benartzi, Thaler, Myopic Loss Aversion and the Equity Premium Puzzle, *Quarterly Journal of Economics*, 110:1, 31 (1995).

facing such "irrational" pressures as quarterly reporting of gains and losses, where a single bad quarter can cost a career or damage stock prices even when such fluctuations are relatively meaningless in terms of long term profitability. [24] Analyzing the "incentives" created by LMP in light of the above, the current lack of long term contracting in the organized markets would not have been difficult to predict.

a.) The LMP "Reference Price" and the Effects of Loss Aversion.

Locational Marginal Pricing guarantees to each seller the highest price received by any seller in any given interval. Further, one does not need to find any particular customer[25] in order to be guaranteed this price or exert any particular effort to determine an appropriate price to bid.[26] Under LMP, transaction costs are comparatively minimal. The minimization of transaction costs may create its own inertia, but far more importantly for our purposes here, is the knowledge that by staying with the real time LMP or entering into contracts whose price terms simply pass through LMP results,[27] one cannot be faulted in any particular interval for "losing

[24] Analysis of the asymmetrical bias in corporate reporting surrounding gains and losses which evince considerable creative accounting 1) to avoid having to report a small loss in favor of concocting even a smaller gain and 2) the tendency to account for as many losses as possible in any single quarter when it is determined there is no way to avoid reporting a loss in order to "get it over with." The fact that there is no "rational" explanation for this behavior under expected utility theory does not stop it from occurring with the predictability of clockwork. *See also* Professor Ross L. Watts, Conservatism in Accounting Part I: Explanations and Implications, *American Accounting Associates*, 207-221 (September 2003).

[25] Contrast this situation to the gas market where although there is an index price, the index is based on reported bilateral transactions between particular buyers and sellers.

[26] Unless 1) one believes one is the marginal unit, or 2) that the marginal unit price will be below your cost of production .This of course does not count for purposeful attempts to manipulate the market price by bidding at significant increments over cost of production or similar behavior by participants in true scarcity situations where the tolerance of the political process would, absent much greater demand response than is available at present, presumably be the only break on pricing in an unconstrained market.

[27] One of the complaints consumers often make is that although "long term" contracts are available, many of these simply use the market clearing price plus a markup as their pricing terms rather than providing a stable fixed price in the long term commitment as past bilateral contracts would have.

money". Few marketing employees would expect to be fired for "not making" a million dollars, but could very easily lose their positions if it could be shown they had "lost" a million dollars.[28] The market dynamics created by LMP create a perception that in any hour where a contract price is not as high as a particular hour of LMP, a loss has been suffered. This perception does not need to be rational to be a significant motivator of behavior. The over-weighting of losses as compared to gains means that in any evaluation of a long term contract, even if the expectation were that losses would be balanced by corresponding periods where the contract price exceeded the clearing price, those losses (as opposed to the gains) would be overweighted and require a risk premium out of proportion with the value being offered.[29]

One of the major insights of descriptive economics is that decision makers evaluate risk from particular reference points rather than in terms of overall wealth. In particular, the carriers of value are net changes, either negative or positive, from a particular reference point. Further, from any particular reference point, losses are weighted more heavily than gains when evaluating

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[28] Or as articulated by Kahneman, Knetsch and Thaler:

> The striking difference between WTA and WTP [Willingness to Accept-Willingness to Pay] in these studies probably reflects the large difference in the responsibility costs associated with voluntary assumption of additional risk, in contrast to a mere failure to reduce or eliminate existing risk. The asymmetry between omission and commission is familiar in legal doctrine, and its impact on judgments of responsibility has been confirmed by psychological research (Ritov and Baron, forthcoming). The asymmetry affects both blame and regret after a mishap, and the anticipation of blame and regret, in turn, could affect behavior.

The Endowment Effect, Loss Aversion and Status Quo Bias, Daniel Kahneman, Jack L. Knetsch and Richard H. Thaler, *Journal of Economic Perspectives*, 5:1, 193-206 (1991).[Text Added to Quote]

[29] We have noted above the contention of consumers that where long term contracts are available, they are over priced and the corresponding contention from suppliers that consumers do not want to pay the "value" of long term contracts. The point here is not to claim that either side in this debate is right or wrong about the true valuation of long term contracts, rather it is to demonstrate that because the parties frame the decision differently, their valuations can be expected to differ such that that no amount of "experience" or education is likely to bring them around to a common valuation.

prospects.[30] This means that a potential loss of $1.00 is given more evaluative weight than a potential gain of $1.00. Under expected utility theory, by contrast, people are "supposed" to weight a dollar (either positive or negative) as equivalent to any other dollar. LMP creates a reference "price." Although the price is not known in advance, what is known is that, in any hour, that price will reflect the highest bid cleared and thus, every supplier, except, perhaps the marginal one, knows it will receive more than its cost in every hour it operates under LMP. For purposes of this analysis, it does not matter whether the supplier expects to receive a great deal more, or just barely more than its cost. In either case, LMP provides a reference point from which long term contracting opportunities are evaluated.

b.) LMP Hourly Evaluation Contributes to Myopic Loss Aversion and Hence Higher Risk Premiums.

Unfortunately for long term contracting opportunities, however, that evaluation does not take the form of a simple arithmetic summation of expected clearing prices over the term of the contract (although, even in this context, potential losses would be overweighted compared to gains). For LMP embodies an evaluation period effect which presents any long term contract as a series of risky prospects, rather than as a single gamble. This can be expected to drive up risk premiums beyond what would otherwise be the case.

This effect has been termed "Myopic Loss Aversion" by Shlomo Benartzi and Richard Thaler (1995)[31] and has been postulated as an explanation for the well documented historic phenomenon of the premium required by inventors in the stock market as opposed to the lower returns for bonds. Looking at the historic performance of the two markets, stocks have

[30] As a simple intuitive example of this, most people find 50/50 bets of Win $100/Lose $100 distinctly unattractive.

[31] Myopic Loss Aversion and the Equity Premium Puzzle, *Quarterly Journal of Economics*, 110:1, 73-92 (1995).

outperformed bonds by a very large margin over the past century. As noted by Benartzi and Thaler, even assuming "plausible levels of risk aversion", "the combination of a high equity premium, a low risk free rate, and smooth consumption is difficult to explain."[32] It is clear that stocks are more volatile than bonds. But under expected utility theory, this short term volatility should be "rationalized" into a simple arithmetic sum (like the series of LMP prices) over the anticipated term of the investment. Under such an analysis and any reasonably long term investment framework (e.g. 10 years), the premium demanded for stocks (or, conversely, the inanity of bond holders) is "irrational" even granting loss aversion. However, by presuming an evaluation period shorter than the expected investment horizon, the premium is explainable in terms of simple loss aversion.

Frequent evaluations of loss or gain have a multiplicative effect on the impact of loss aversion. Put another way, unpacking any single risky prospect into a series of risky prospects of equivalent value increases the premium demanded to overcome loss aversion. In the case of stocks, although most investors remain in the market for a long time, they typically evaluate performance on a quarterly or yearly basis. Because stocks are volatile, frequent evaluations provide frequent opportunities to observe changes in value from the reference point of the previous year or quarter. Some of these will invariably be negative. Because, as noted above, it is these changes in value from a reference point that are significant drivers of economic decision-making, any negative change from a previous year or quarter is experienced as a "loss" and is overweighted as against any period showing a gain. Hence, these frequent evaluations multiply the effects of loss aversion even when performance over the expected investment horizon is

[32] *Id* at 73.

positive. Interestingly, even "knowledge" that one is investing for the long term does not considerably dampen this effect.[33]

The hourly and daily evaluation period dynamic created by LMP, frames any long term contract as a series of risky prospects each of which is subject to the disproportional weighting of losses. As with stocks, the shorter the evaluation period, the greater the risk premium demanded to compensate for short term volatility. Importantly, increasing the volatility of this market in the short term would, under this analysis, have the likely result of exacerbating this dynamic unless other changes recommended by AF&PA are adopted. Proposals to raise or eliminate the bid caps could aggravate the long term contracting dilemma faced by consumers under LMP if not coupled with other market reforms.

c.) LMP as an Over-Valued Endowment.

Finally, compounding this already significant dynamic, is the over valuation of the guarantee of the highest price in any hour offered by LMP because of the "endowment effect." [34] Suppliers who are "handed" a guarantee of the highest price paid to any provider in any hour, can be expected to place an disproportionate value upon that entitlement. Receiving the highest

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[33] "The reason for this is that in prospect theory, the carriers of utility are assumed to be changes in wealth, or returns, and the effect of the level of wealth is assumed to be second order. Therefore, every year Y will solve her asset allocation problem by choosing the portfolio that maximizes her prospective utility one year away, just as X does. In this sense, when we estimate the evaluation period of investors below, we are also estimating their implicit time horizons.

Of Course, in a model with loss aversion, the more often an investor evaluates his portfolio, or the shorter his horizon, the less attractive he will find a high mean, high risk investment such as stocks."

Id at 307 (footnote omitted).

[34] *See* Loss Aversion in Riskless Choice: A Reference-Dependent Model, Amos Tversky and Daniel Kahneman, *Quarterly Journal of Economics*, 106:4, 1039-61, (1991), The Endowment Effect, Loss Aversion and Status Quo Bias, Daniel Kahneman, Jack L. Knetsch and Richard Thaler, *Journal of Economic Perspectives*, 5:1, 193-206 (1991).

cleared bid is perceived as a default entitlement, and the only risk of failure to perform is the correspondingly undervalued forgone gain of receiving it. In short, LMP creates a framework for economic decision making under which the ability to receive the market clearing price is an over-valued endowment, and any risk of downward deviation is viewed as a "loss" and weighed disproportionately against the potential gain of receiving more than that price. Further, because LMP frames economic decision making in an hour by hour settlement process, it creates an evaluation period effect that increases risk premiums. From the buyers side, not surprisingly, while the LMP market is undesirably volatile, the risk premiums quoted to avoid this volatility seem disproportionate to the risk covered.

3. Moving Towards a Solution.

Again, the issue is not whether one side or the other in the debate is mistaken in their valuation of long term contracting opportunities. As the Commission has aptly noted, it cannot command parties to enter into long term contracts based on what it believes rational people should agree to. But neither can, or should, the Commission ignore the actual behavior of market participants, rational or otherwise, based upon modes of analysis that do not accurately reflect that behavior.

Although the jury is still out, the Commission appears to have incorporated many of the same incentive features into its recent formulations of capacity markets. Under each of these regimes, (RPM, FCM, and ICAP), clearing prices (unlike price indices in the gas market which are actually the product of averaging a series of bilateral transactions) represent an entitlement to everyone who bids and may create the same dynamic of over weighting any departure from that entitlement on the down side, while under valuing any chance of a gain beyond it. For these reasons these designs may produce the same results for long term contracting. The forward nature of some of these contract structures, which mandates some form of forward procurement,

will likely be the backbone of any long term contracts, but is unlikely to be supplemented by much independent long term contracting so long as a no-lose, minimal transaction cost auction clearing price is the default entitlement for capacity suppliers in the market. In determining the length of commitment for a standard product, the Commission should consider the effects of any evaluation period its settlement rules for capacity may entail.

These observations do not imply that the Commission needs to abandon either LMP or structures like RPM in order to have long term contracting take its proper place in the future supply pantheon of the organized markets. LMP has several well-documented benefits including encouraging efficiency in dispatch, correctly pricing congestion, and encouraging suppliers to bid at marginal cost. Yet both LMP and current resource adequacy mechanisms are embedded in an overall market structure under which they acquire the undesirable characteristics described above. If other market structures could condition these effects, LMP could continue to deliver the benefits of efficient dispatch, congestion management, and minimizing transaction costs without hindering long term contracting.

In what follows, AF&PA proposes a specific market structure or product called a Financial Performance Obligation which we believe addresses some of these undesirable dynamics. The Financial Performance Obligation is designed to link the revenue streams from capacity and energy to better reflect the product that has value to consumers. Under an FPO approach, LMP continues to drive efficient dispatch and manage congestion. But under an FPO approach, LMP is a tool for allocating the risk of and/or preference for dispatch among suppliers who each have a settlement obligation to supply energy to load at a specific fuel indexed strike price in return for receiving a competitively bid capacity payment. From the consumer point of view, this recreates an important aspect of the obligation to serve that traditional return on rate-base (now, capacity payments) was meant to secure. Further, it recreates in the organized

market structure the common sense cost relation that would exist in any rational bilateral contract for long term supply[35] between capacity and energy components. Finally, AF&PA believes it will fundamentally alter the reference point for evaluation of long term contracting opportunities. Under an FPO, the clearing price is not a risk free entitlement, but an opportunity with some potential downside to be hedged through appropriate forward contracting or investment in capital infrastructure. When scarcity is no longer an unmitigated short term benefit to suppliers, investment strategies designed to maximize long term profitability may not be so constrained by the current evaluation period aggravation of loss aversion under LMP. This may serve to bridge the current valuation gap between buyers and sellers and thereby facilitate a greater level of long term contracting at both wholesale and, where state law permits, retail.

D. FINANCIAL PERFORMANCE OBLIGATION.

Financial Performance Obligations would require every unit which receives a capacity payment to financially guarantee the delivery of energy to the real time market at or below a specified strike price in any hour in which it is dispatched by the RTO to provide service. The obligation is financial in nature, and is not a requirement that physical delivery of energy from the unit must be made in any hour. The unit may fulfill its obligation either by operating to provide an amount of energy up to the capacity it is receiving capacity payments for in any hour, or it may purchase energy from the real time market at its nodal price and effectively re-sell it through the settlement system at or below the strike price. Under FPO, load pays the lesser of the clearing price or strike price in any hour. Amounts collected from load are paid to all generators based upon their load ratio share obligation in each hour. In addition, every generator

[35] No reasonable business man would agree to a fixed price for either capacity or energy in a bundled contract while leaving the other component solely in the discretion of the supplier.

is charged or paid the clearing price for any deviation from its load ratio share in any hour. In any hour a unit is not dispatched, and the price is below the strike price, this is a wash. However, if a unit fails to supply in any hour where the price is above the strike price, it effectively pays the difference between the strike price and clearing price for each MWhr deviation from its load ratio share for that hour.[36]

Under any capacity mechanism such as RPM, in which the cost of new entry is set by reference to a particular proxy unit, the strike price of a Financial Performance Obligation should be set at the marginal production cost per MW, as established by the applicable heat rate for the proxy unit and a properly indexed fuel price. Under the Financial Performance Obligation approach, ratepayers pay the cost of capacity (including the appropriate return on investment) plus the marginal operating costs of the proxy unit. If the economic theory underlying RPM, LICAP, and FCM is sound, this should return sufficient amounts to recover operating costs plus capital costs and spur new investment.

1. The FPO Substantially Improves Upon Current Peak Energy Rent or EAS Adjustment Mechanisms.

The Financial Performance Obligation is based on the same principle as several Energy and Ancillary Service ("EAS") revenue adjustment mechanisms approved by the Commission. These mechanisms are designed to provide assurance that ratepayers will not be required to pay twice, once through a capacity payment and then again through scarcity rents, for Resource Adequacy. Such mechanisms are supposed to provide consumers a hedge against scarcity payments in return for fixed capacity payments. Current EAS mechanisms, however, contain several undesirable features which render them ineffective as hedges for load, inappropriate as

[36] Generator ratio share =10MW. Strike price $100MW. Clearing price $200MW. Generator is paid by load $1,000 (10 x 100), Generator only produces 9MW, generator pays clearing price ($200) for 1MW deviation. Generator nets $1000-$200=$800 or (9MW x 100) –1MW (CP 200 – SP 100).

pricing mechanisms, poor restraints against market power abuse and a deterrent to long term contracting. These problems arise from three main design flaws all of which are corrected under the Financial Performance Obligation approach.

First, the EAS approaches currently in place are based on the use of historical and/or estimated data which invariably fail to represent unit or even class specific actual revenues. Layering the hypothetical characteristics of a proxy unit over a historic or (even less accurate) a projected load and price duration curve and manipulating these figures into an estimate of what a proxy unit "should have" or "might" earn based on a presumed forced outage rate and host of other assumptions, while better than not protecting consumers at all, produces numbers which in addition to being contentious, highly sensitive to small changes in methodology or assumptions and burdensome to calculate, are also guaranteed to be "wrong" when applied to any particular unit.

Moreover, EAS adjustments based on historic information, are not a hedge, but simply an inaccurate, partial refund mechanism. Consumers are not actually hedged against price volatility in the current market (or even presented with an actual refund). Rather, suppliers are presented with an "adjustment," known in advance, to a capacity curve or price which they then incorporate into any bid. The longer the historic period used, the more arbitrary the adjustment becomes either as a measure of expected revenues or as a reflection of current costs. In the case of new entrants, even if the adjustment were accurate, their capacity price is being adjusted to "refund" revenues other people earned in prior years.

Second, the timing of the adjustment defeats its purpose as a hedge. Known in advance, the adjustment simply becomes an input into every supplier's next set of profit maximizing capacity bids, raising these as far as the curve allows to compensate. Thereafter, in every hour, units still seek to maximize energy revenues because (1) higher prices will always increase

profits and (2) next years' EAS adjustment is a communal average that will not net out extraordinary profits by any particular supplier if there is some way these can be earned.

Third, and related to the second point above, unlike a true hedge (like a bilateral contract) the EAS adjustment leaves the price of capacity and the price of energy to be determined in two independent transactions each of which offers a clearing price, profit maximizing, endowment inducing, risk free chance to get the highest price paid to anyone in any hour or year. Presenting these two decision points as entirely independent, frames the decision on each component in a fashion, which as described above 1) over values each clearing price entitlement; 2) over weights any potential loss from selling at a potentially lower price and 3) under values any potential gain form selling at a potentially higher price. In short, it perpetuates the features of the current market that are most likely hindering the formation of long term contracts.

By contrast, the Financial Performance Obligation exactly nets out, on a unit by unit basis, the appropriate adjustment to assure that ratepayers in fact receive safe and reliable service at just and reasonable rates. But the most profound change to the market structure and expected market behavior of market participants comes from the revolution in incentives and risk allocation the Financial Performance Obligation structure works.

2. The FPO Allocates Risk Efficiently to the Party Best Able to Hedge at Lowest Cost.

Under the Financial Performance Obligation model, the strike price does not represent a bid cap or price cap at wholesale. Rather, it represents a price that caps total consumer contribution in any hour. It provides a hedge to load by shifting the short-term[37] risk of

[37] AF&PA understands that, in the end consumers will pick up the tab for any costs incurred due to volatility in the market. No hedge comes for free. However, as discussed further below, it is always more efficient and cheaper to place any particular risk on the party who can most easily and effectively hedge it. The Financial Performance Obligation will deliver just this efficiency to the markets and therefore should lower overall costs.

extreme[38] market volatility to suppliers. But it does not limit the bidding behavior of any supplier at wholesale. Under the Financial Performance Obligation structure, suppliers remain free to bid any price in any hour in order to ration the risk of dispatch or recover scarcity rents from suppliers who either fail to perform or remain unhedged during high cost hours. In this way, the Financial Performance Obligation creates tremendous incentives for unit availability during high cost hours.[39] That incentive is created because the market clearing price is no longer simply a lost opportunity to earn additional revenues, but also a risk of losing the difference between the strike price and the energy clearing price. This is the same risk that lifting the price caps, without more, would place directly upon consumers. But unlike consumers, the ability of suppliers to respond to this risk in a constructive and beneficial fashion is much greater.

It is an axiom of market design that the most efficient way to allocate risk is to give it to the party that can hedge it most effectively. Unlike suppliers, the only choices available to consumers to hedge this risk are demand response or entering into long-term contracts. For the reasons discussed above, the current market does not properly support either of these options. Suppliers, on the other hand, have a multitude of avenues readily available to hedge this risk. It is true that consumers will pay the price for this hedge in capacity clearing prices, but that price should be far lower and less disruptive to society (for all the reasons discussed above), than going without the hedge or leaving this risk with consumers. Importantly, most of the

[38] Consumers continue to bear the risk of volatility up to the strike price, but in times of scarcity that volatility is replaced by the obligation to pay for capacity directly.

[39] Some have suggested that Financial Performance Obligation would be so effective that there would be no need for continued use of availability adjustments to adjust capacity prices. This confuses the issue of incentives and just and reasonable rates. An availability adjustment is a measure of performance that assures customers receive what they are paying for when they make a capacity payment. A Financial Performance Obligation assures that rate payers will not pay twice for the same service, once through a capacity payment and a second time through scarcity rents in excess of the marginal operating costs of a peaker which are supposed to be replaced by the capacity payment.

mechanisms available to suppliers to hedge this risk are the precise types of market behavior which will lead to greater long-term contracting and assure resource adequacy.

One of the most obvious ways to hedge the risk of price volatility is with additional physical supply adequate to cover the obligation undertaken for the receipt of capacity payments. Because suppliers now have a direct interest in hedging price volatility, there is a market created for physical supply and financial bilateral trades on a long term basis which match the capacity obligations undertaken by suppliers. Assuming RTO's will continue to require the purchase of capacity to meet ICR, this means suppliers have a direct financial incentive to plan for and support additional infrastructure sufficient to hedge the risk of excessive price volatility (i.e. scarcity). By creating the physical, financial, and product infrastructure to efficiently allocate and hedge the risk of market volatility among suppliers, any particular supplier's exposure to such risk should be reduced. As these hedging tools become more common at the wholesale level, risk premiums associated with long-term contracts for consumers should also go down. No longer will LMP represent only a series of short-term decision points and profit maximization opportunities for suppliers. LMP will also represent a potential "risk of loss" that can be effectively hedged.

3. The FPO Will Encourage Demand Response and Improve the Valuation Dynamic That Currently Hinders Long Term Contracting.

For all of the reasons discussed previously, framing the economic decision as an opportunity to avoid a loss will have powerful incentive effects. Perhaps the greatest positive impact can be expected on the value placed by suppliers on demand response opportunities. In a market where suppliers at wholesale are exposed to the financial risk of market volatility, the value to suppliers of loads with demand response capabilities is tremendously enhanced. In terms of hedging risk to LMP volatility, a KWhr of demand response has the same value as a KW of supply at the market clearing price. If a consumer or demand response aggregator can

provide a supplier with a cheaper hedge against price volatility than generation, the supplier now has their own motives to seek out that product. Demand resource providing firms should then have a ready market at wholesale for the aggregation of demand response at retail. Under a Financial Performance Obligations model, the proper incentives are in place for the wholesale market to seek out and pay for efficient demand response opportunities as a hedging vehicle. With these incentives, it may be possible for reliance upon RTO sponsored "programs" with administratively set prices to gradually give way to truly market driven DR procurement under bilateral contracts with suppliers.

Under a Financial Performance Obligation structure, the perception of the risks and benefits of hedging short term volatility should be better aligned between consumers and suppliers than at present because both should view that volatility from a similar decisional framework.

Under any scheme of "competitive" capacity bidding, capacity suppliers "should" already be estimating expected revenues to be earned in the energy market and lowering their bids based on those expected revenues. Because of the current bifurcation between capacity and energy and the availability of two separate auctions; one for each of these supposed "products" and further, the inability of any particular supplier to put in a combined bid which fixes either one of these components based on the result of the other, this interplay is likely negligible in real world bidding behavior. The Financial Performance Obligation on the other hand, standardizes the capacity product in a commercially meaningful manner by requiring capacity bids based on a firm parameter of service; the strike price. From the consumers point of view, capacity is no longer simply a license for the supplier to ask for as much as possible in the energy market, but is a commodity which functions as capacity would in any ordinary bilateral contract, as a coherent part of an overall cost of expected service. From the suppliers' side, all suppliers will have to

continue to make an assessment of what the real time energy market will yield in terms of scarcity rents, including some estimate of their forced outage rate and availability on peak. But this is no different than the analysis which, supposedly, they should have been doing anyway based on competitive pressures to keep capacity bids as low as possible. The re-integration, for pricing purposes, of capacity and energy re-institutes a useful dynamic similar to long-term bilateral contracting. But the FPO structure does this without eliminating the hour to hour volatility that drives efficient dispatch and fuels short term demand response.

The Commission has asked whether there are market mechanisms or approaches that would help incent long term contracting. For all of the reasons stated above, AF&PA believes there is a market solution available to encourage long term contracting. It is a solution that has the additional virtues of assuring that capacity payments for all units will not double count revenues received in the energy market. It is simple, straight-forward, increases efficiency, is 100% accurate, encourages market behavior the Commission seeks to encourage, eliminates estimation error and controversy, reduces regulatory risk, mitigates market power, provides value to load in the form of an energy hedge in return for capacity payments, incents long term contracting, improves generator performance, encourages demand side resources, and may allow a more robust energy clearing market without the political "heat" and social and economic disruption of other proposals. That pure market mechanism is a Financial Performance Obligation required of each participant receiving capacity payments.

E. STRENGTHENING THE MARKET MONITOR.

The Commission has requested comment on several issues surrounding the proper structure of Market Monitoring Units and their relation to the RTO. In general, AF&PA believes that in order to be effective, the market monitoring function must have direct and unfettered access to all information and activities taking place within the RTO. A purely external approach

to market monitoring may jeopardize the in depth insight and understanding into RTO operations necessary in order to consistently evaluate performance. Although the Market Monitor should always have at its disposal sufficient independent analytic capability and resources to develop independent market data and analysis, it must also be familiar with and have unimpeded access to all information and analysis compiled by the RTO relevant to the performance of the RTO and its markets. Providing such information and access to an external entity could prove unnecessarily cumbersome. The ability of the MMU to have ready access to and familiarity with all relevant information is necessary to support any independent determination the MMU may be empowered to make. Thus, AF&PA supports the internalization of market monitoring functions.

AF&PA does not believe, however, that an internal market monitor should be reporting to RTO management regarding the performance of its duties. Instead, the market monitor should report simultaneously to the RTO board, the Commission, and other interested Stakeholders such as state commissions and market participants. A fully independent "chain of command" between the MMU and the RTO board will obviate any potential for interference with market monitoring functions, and should also allow adequate evaluation of Market Monitor performance, in much the same way as management performance is evaluated by the RTO board. The RTO board should not be empowered to foreclose publication of reports or analysis by the Market Monitor, but should be responsible for reviewing performance and, if necessary, requesting approval from the Commission to remove the market monitor for cause. Though the Commission should use a deferential standard when reviewing RTO board decisions to retain or remove a Market Monitor, it should nonetheless exercise informed judgment to assure the Market Monitor is not being removed for improper reasons (such as displeasure that the RTO's markets have been criticized).

With regard to any information and analysis developed by the Market Monitor, the RTO and its Staff should be given access to any such information and analysis upon request to inform

their own decision making, but should not be permitted to alter, control or change the format of any MMU report or analysis, or restrict the Market Monitor in any way from performing any analysis he/she may believe is necessary.

AF&PA does not object to hybrid internal/external structures such as that in New England, provided the internal component of the Market Monitoring function is robust enough to ensure thorough familiarity with all information and operations relevant to RTO performance and markets and full independence is assured.

1. AF&PA Does Not Support the Commission's Proposal to Limit or Remove the Enforcement Role of The Market Monitor.

The Commission has suggested that allowing the Market Monitor a role in the enforcement of Market rules creates a conflict of interest. The Commission has asked for comment on whether this potential conflict requires the Market Monitor to not be involved in enforcement actions either initiated by the Market Monitor itself, or the RTO. For the reasons stated more fully below, AF&PA believes the Market Monitor should continue to have a role in enforcement of market mitigation rules and for actions in response to any violation of the market rules its investigations uncover.

AF&PA believes that it is not possible to locate the enforcement of market rules and mitigation procedures in a body which does not have some potential conflict of interest, without removing the role of enforcement completely to the Commission itself. We believe because of the number of markets and market rules that need to be observed, and the need for close to real time consumer protection from abuse, that this ideal cannot be practically accommodated within the Commission's current workload and Staff. Actions often need to be taken quickly to prevent situations spiraling out of control. In many cases, because of the diffusion of market interests, attempting to unravel market violations and determine who collected what from which parties in a potentially abusive situation is all but impossible. Although any arrangement will inevitably

have imperfections, consumers need the assurance of immediate and, in some cases, even preemptive action in certain circumstances, to assure that the markets produce just and reasonable results. Therefore, enforcement must initially be handled at the RTO and Market Monitor level with as much proscriptive and policy guidance from the Commission as is reasonable.

AF&PA believes, however, that, if mixed incentives are in fact a problem, the RTO has far greater potential for having improper incentives than the Market Monitor when dealing with potential violations or problems with the market rules or the behavior of individual participants. The RTO as the organization primarily responsible for the development of market rules and designs has a vested interest in their success. RTO personal retention and advancement decisions may be based upon the perceived success or failure of market design or implementation efforts. For the same reasons RTO's may have motives for interfering with vigorous MMU inquiry or criticism, they are just as likely to be reluctant to take actions that imply there are problems with the functioning or implementation of the markets. Further, it is far more difficult to be vigilant, skeptical and objective regarding projects or ideas one has invested time and personal resources in developing.

Moreover, the Market Monitor is likely to be in the best position to spot problems early and take action quickly, when circumstances so require. AF&PA does not object to a coordination of this function between the RTO and the Market Monitor in terms of sharing all available information, consultation, and proper coordination of mitigation strategies under the market rules. Despite recent concerns with some particular instances and specific behaviors, AF&PA does not believe it is reasonable to expect Market Monitors and RTOs not be able to coordinate constructively to address such problems where needed. AF&PA believes that both organizations are composed of individuals of good faith who share a mutual desire to have the

markets operate efficiently and fairly. That there may be occasional disagreements about particular enforcement actions or outcomes under certain circumstances is not a fatal flaw. A certain amount of healthy tension between entities does not require or mandate their complete estrangement, and both perspectives may be extremely valuable in achieving the correct outcome. That said, there obviously needs to be some place where the decisional buck stops. AF&PA believes that, ultimately, the best place for the buck to stop is with the Market Monitor itself, guided both by its interactions with the RTO and its Staff, and the decisional rules and appropriately circumscribed discretional authority granted by the Commission.

Under the structure we have proposed above for Monitor reporting directly to the board, the Commission and other Stakeholders, all parties, including the Commission, should have ample opportunity to understand, comment upon and, in the case of the Commission, correct as necessary particular actions or patterns of enforcement which do not comport with either Commission policy or the proper function of the market. We believe that these are adequate long-term safe guards. However, as noted above, we believe in the short term, because the consequences of market manipulation and abuse are so difficult to disentangle once they are committed, there must be a first line of defense to identify, correct and on occasion even preempt such undesirable outcomes. We believe the best place for that function is the Market Monitor.

F. RESPONSIVENESS OF RTO'S.

1. The Commission Should Not Compromise the Independence of RTO Boards.

The Commission has asked several questions regarding governance changes that might improve the responsiveness of RTOs. AF&PA wishes to limit its comments to a single issue raised directly by the Commission; the participation of stakeholders on RTO boards, and to offer

one suggestion for improvement of stakeholder processes; provision of independent counsel to stakeholder groups.

For the reasons stated below AF&PA believes that the best guarantee consumers have of fair and balanced consideration of their interests is by retaining the current requirement that all RTO board members be independent of market participants.

As noted by several consumer organizations, at the RTO committee level consumers are often out-spent, "out-experted", and out-voted by supplier and utility interests. These problems are not all attributable to problems with voting structure but are also due to the fact that consumers, although financially liable for every decision made, cannot generally aggregate the resources to retain the consultants and representatives to attend and participate effectively in numerous committee meetings. The opportunity to participate in these stakeholder committees is extremely valuable to consumers and they have spent considerable effort trying to be effective, yet the mismatch in resources available means that, even with changed voting structures, they are unlikely to be wholly successful in defending their interests adequately on the basis of such participation alone.

In these circumstances, the independence of the board from stakeholders is an extremely valuable protection for consumer interests. Though the board should listen to all stakeholders, their independence guarantees a certain level of "volume control" that allows the ideas and arguments of consumer representatives not to be drowned out by the sheer ubiquity of better funded and more numerous advocates on issues that come before the committees. Unfortunately, allowing stakeholders to be part of the board may simply perpetuate the dynamic of the lower committees, and allow better funded utilities and suppliers to transfer their already significant advantage in numbers and resources at the committees into the board room itself. Thus while the idea of stakeholder representation on RTO boards might seem, on paper, to provide consumers

greater opportunities to present their views, the practical reality is that it will likely only increase the influence of non-consumer interests and groups at consumers' expense. For these reasons we urge the Commission not to remove the current consumer protections afforded by the independent RTO board structure but to focus instead on improvements to the stakeholder process and the encouragement of participation by end users in those processes.

One of the areas the Commission might explore is allowing stakeholders greater independence from RTO staff in the developmental positions and the conduct of meetings. One of the problems noted by stakeholders in PJM is that the machinery of governance and the representation of consensus stakeholder views are controlled exclusively by RTO staff. Absent ad hoc coalitions among stakeholders, there is no unifying voice representing stakeholders rights to due process, full consideration of stakeholder views as expressed in committee votes, or independent representation of unified stakeholder positions when those positions differ from those adopted by RTO staff. By contrast in New England stakeholders, as stakeholders, are represented by independent counsel who zealously defends stakeholders' right to process and is empowered to directly represent the views of stakeholders to the Commission and to the RTO and its board when the RTO staff or board takes positions that do not conform to stakeholder consensus or which infringe on stakeholder procedural safeguards. AF&PA believes this is a healthy institutional tension which greatly increases responsiveness of the RTO and its board if only because the interests of stakeholders are coherently represented in a way that provides a focus for discussion and mutual accommodation. It is, by contrast, extremely difficult for an RTO board to be responsive to procedural or organizational concerns of "stakeholders" when each group only speaks and is authorized to speak only for itself.

For these reasons AF&PA believes that the Commission should consider requiring every RTO structure to include provision for independent counsel retained specifically to represent

stakeholders qua stakeholders on procedural and substantive issues which come before the RTO. To the extent the stakeholders cannot come to unified positions on substantive issues, such counsel would not be authorized to take any particular position. However many issues, such as the establishing of agendas, the procedural manner in which business is conducted, the form of votes and motions presented for stakeholder review and vote, all greatly affect stakeholders' ability to effectively participate and make their views known. These procedural due process protections are best secured through giving stakeholders independent counsel to monitor RTO activity and assure, at the very least, stakeholders are given full fair non-discriminatory opportunities to make their views known under procedures designed to permit full expression of those views.

G. OTHER TOPICS.

1. Commission Interconnection Policy Should be Adjusted to Reflect the Shift to Locational Competition in the Capacity Markets.

The Commission has invited comments on any other aspect of the markets that could be improved. AF&PA believes that the current generator interconnection policy in PJM and perhaps other RTOs is in need of revision in order to lower barriers to entry, curb incumbent market power and complete the unbundling of transmission from generation that must be achieved to rationalize system planning and expansion in competitive markets.

The Commission has recently finalized new generation interconnection rules.[40] These new rules represent a substantial improvement in many areas of interconnection policy. In one respect, however, the rules perpetuate a potentially discriminatory interconnection standard based on a concept (adopted from PJM) called "deliverability". The deliverability concept is

[40] Order 2003, Docket Number RM02-1-000, 104 FERC ¶61,103 (July 24, 2003), 68 FR 49846 (August 19, 2003).

generally incompatible with competitive entry into ISO/RTO markets. New York and New England RTOs have adopted a different, non-discriminatory standard as a "regional variation" on FERC's rule. That standard, known as the Minimum Interconnection Standard, maximizes competitive entry to the grid.

Those standards are still evolving as system operators learn the limits of how dynamic and competitive the interconnection process can be made while still preserving the ability of the operator to accurately assess generation adequacy. It is now established Commission policy that capacity prices should be allowed to separate based on locational surplus and shortage. The Commission has adopted a series of capacity products in New England, New York and now PJM that explicitly recognizes that all generation cannot be delivered to all loads. AF&PA has supported the move towards locational capacity markets. We now ask that the Commission take the next logical and necessary step and reform the PJM and other RTO interconnection process to allow non-discriminatory price competition on a locational basis. AF&PA recognizes that technical limitations and market concentration concerns prevent capacity from becoming a "nodal" product. But where the Commission has permitted zonal price separation to occur, logic and fairness to consumers dictates that it cease requiring deliverability beyond a pricing zone as a requirement of interconnection as a capacity resource.

2. Statement of the Problem.

Transmission systems are built to serve load, not the aggregate amount of generation on the system. A typical transmission system will have more generation connected to it than the total amount of load which is available to take service from that generation. This is necessitated both by reserve requirements and by competitive principles. Without some surplus supply, competition between suppliers is ineffectual because all suppliers are needed just to serve load reliably.

In regions without competition, where utilities engage in Vertically Integrated Resource Planning, there is a more careful match between utility generation and the expected load. With the exception of reserve requirements, utilities do not routinely build more generation than needed to serve expected load. The situation becomes more complicated, however, under competition. In order to have competition, there must be a certain amount of surplus generation. Particularly in a bid-based market with LMP, market power concerns would be overwhelming if generation supply "just matched" the normal, vertically integrated utility planning criteria of load plus reserves.

The two types of system; competition and vertical integration; also affect transmission planning. In a vertically integrated system it is logical to plan transmission based on the expected flow from particular generation resources to specific load. Differences in cost between generators, while still effecting dispatch, are subsumed under average cost of service rates that do not rely on scarcity pricing to recover costs. Under competition, however, generation may come from a variety of directions or sources to serve load depending upon the prices offered and those prices, conversely, have huge impacts on cost and cost recovery under scarcity pricing.

Under the current dual Energy/Network interconnection standard, the concept of "deliverability" limits competition in the capacity markets from new entrants who wish to displace higher cost incumbents from the transmission system. Under the "Energy Standard" of interconnection, a unit can interconnect in a fashion which meets all the reliability criteria for safe operation, but will only be allowed to compete in the non-firm energy market. Such a unit cannot be counted as a capacity resource. To play in the capacity markets, the unit must be connected under the "Network Resource" standard which requires a study to prove that output from the unit is "deliverable."

By contrast, in New England and New York, any unit which is interconnected to the grid in a fashion which preserves the reliability, stability and existing transfer capacity of the grid (without expanding the grid) is entitled to compete in both the capacity and energy markets. If there is not enough capacity on the transmission system to "deliver" the output from both the new and existing units, then the units are forced to compete on the basis of price to see who gets chosen as a capacity provider. Whoever wins the bidding war is dispatched and is obviously "deliverable" to the load. If the system needs to be expanded so that more generation in total can be delivered from, say, a low cost to a high cost area, that decision is made by the Independent System Operator as part of a comprehensive transmission planning and expansion process. New entrants are not forced to expand the system so incumbents who they have underbid can continue to "deliver" to load who would rather buy from the new, cheaper source anyway. This pro-competitive notion of deliverability, however, is not the concept embodied in the FERC Network Interconnection Policy. Under the Network Resource Standard, deliverability means insuring enough transmission is built to protect incumbents from being displaced by newer, cheaper units.

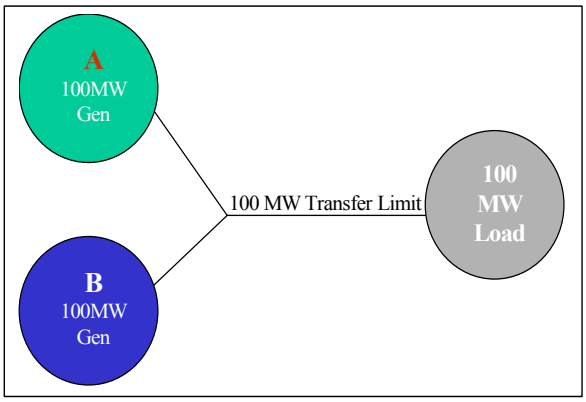
AF&PA understands that in New England modifications to this standard are being developed to recognize that there cannot (at least with present software) be infinite granularity in the capacity market. However, relying on the zonal boundaries created by the locational capacity product, deliverability within the zone should allow displacement of existing generators based on price. Recognizing these granularity issues, we turn to a higher level discussion of the competitive principles which argue for a revision of the PJM standard to allow such local displacement.

3. The Concept of Deliverability.

In a purely physical sense, any unit connected reliably to the electric grid and capable of delivering energy to any load can deliver both energy and capacity with no further modification

of the electrical system. This physical idea of deliverability, however, is not the test applied under the Network Resource Standard.

To illustrate, we offer a simplified example. The diagram below represents a system composed of a single transmission line connected to a 100 MW load. At the other end of the line, interconnected to the line in an electrically indistinguishable fashion, are two 100 MW generators.



The load has the option of choosing either of the generators to serve it. Whichever one it chooses, the system is capable of delivering the output (both capacity and energy) of the generator to the load. While it is true that, both generators cannot run simultaneously (for one thing there isn't enough load to absorb them both) it is obviously true that as a matter of electrical engineering, either could run (or each could run at ½ output) to serve the load. It is the load which, in a competitive market, would generally get to decide what combination of generation serves it. Under the "deliverability" standard of FERCs Interconnection Policy, however, that is not the test (at least with regard to capacity). Rather, the test for deliverability will produce the anomalous result that, even though both generators are absolutely equivalent from an electrical point of view, one of them could be considered "deliverable" and one of them might not be. The choice will not be made based on any economic or engineering rationale, but simply on the basis of who was there "first."

Under the deliverability test in FERC's Rule, a new unit must be connected so that "the aggregate of generation can be delivered to the aggregate of the load". Obviously, this is a highly imprecise standard which, depending on the details and assumptions in the study, can be used to discriminate in a variety of ways. For instance, in any existing system, it is obviously not possible to deliver all (i.e. "the aggregate") of the generation simultaneously to load, since there is always more generation than load. It is always some subset of generation that is serving load. The usual manner of applying the deliverability standard is to first choose the "preferred" subset of incumbent generation which is dispatched to serve load. After this preference has been established, the new entrant is treated as the "marginal unit" which must somehow be worked into the mix and be capable of running simultaneously without "disturbing" the preferred units' "right" to run at any level they choose. Despite all the convolutions of the study protocol, this is simply a matter of favoring the incumbent units and treating new entrants as if they are the "marginal" unit.[41] In our simple example, if A were the incumbent, the study would dispatch A at 100MW, and then see if there were any room for B (the new entrant). Since A and B can't both run, B is not "deliverable" and is not allowed to compete for the load's business as a capacity resource.

4. An Inappropriate Interconnection Standard Protects Incumbent Market Power.

Deliverability can be used by incumbents as an excuse to create a "straw that broke the camel's back" argument which requires the last new entrant to fund major transmission upgrades to relieve constraints which the incumbents have neglected to remedy in the past. For instance,

[41] In PJM's case, the set of protected units is developed based upon a distribution factor analysis that identifies lines or interfaces that would be affected by the addition of a new unit then identifies all units that have a specified distribution factor on any of those interfaces. This then comprises the set of units loaded at full output whose operations cannot be disturbed even if the new entrant would underbid all of them in the capacity market.

going back to our simple model of two identical 100 MW generators ("A" and "B") connected to a 100 MW line. Presume that on the end of the line there is 200 MW of load, but there is still only 100 MW of transfer capability. It is true that if Generator B comes on line, it is not possible to deliver any additional MW to the load at the other end without an upgrade. However, there can still be significant benefits (to at least 100 MW of the 200 MW load) if B is offering a substantially lower capacity price. However, in order to protect incumbents, the deliverability test will be structured such that B will not be considered deliverable because there are already 100 MW of "network resource" (i.e. unit A) on line and 100 MW is all that can be delivered over the line. Thus, unit B will face a major interface expansion in order to be deliverable to the 200 MW load even though he could underbid the incumbent and deliver both capacity and energy at a lower cost by displacing him.

This straw that broke the camel's back scenario is likely to be a real world situation which will face consumers in the near future. The Commission has allowed price separation between regions in PJM based on transmission limitations between regions. It claims this will induce price competition within the regions based on these prices. The straw that broke the camel's back scenario will occur every time a unit in an export constrained region tries to compete on price with existing resources. Major transmission constraints created by incumbent citing or planning preferences will dictate major transmission upgrades for the unit to avoid "bottling up" generation in the zone before the unit can compete even within its supposedly zonal market. On the other hand, allowing displacement within the zone without requiring increasing export capability would permit locational competition based on price.

The argument usually advanced for requiring inter zonal expansion is that "it is sending the wrong signal to the Generator" to allow it to locate in a place where it does not increase the total capacity available to load outside the zone. As a result of this "signaling," an incumbent

can protect its generation in an export constrained zone by not building transmission. Further, this argument ignores the broader competitive principles which drive efficiency and lower cost for consumers in a competitive generation market, in favor of a command and control approach based on tying generation to a supposedly "unbundled" product; transmission.

Siting of generation in a competitive market is driven by a host of cost factors, none of which can or should be ignored or overridden in the name of incumbent preference. These factors include availability of land, environmental regulation, proximity to fuel sources, and tax considerations among others. In the case of cogeneration opportunities, generation needs to be sited where industrial processes are located and no amount of transmission based disincentives will allow it to be sited anywhere else. All such disincentive regimes do, in fact, is prevent cheaper alternatives, like cogeneration, from competing in the capacity markets or raise the cost of these alternatives to protect less efficient incumbents. Using preferential access to transmission as a command and control device to force generation to site in particular regions is therefore not only 1) ineffective and 2) discriminatory, but also creates large inefficiencies in the competitive market for generation development.

Beyond this, it is also unnecessary. Under LMP and locational capacity mechanisms, there are ample price incentives to get generation sited in the correct place based on need. Any competitor entering the market in a surplus region will see low LMPs and should see lower capacity prices. The developer who persists in building in such a region, like a cogenerator serving a large industrial, is clearly responding to legitimate market forces and circumstances that drive that particular decision. The best approach in a competitive market is to let those forces, in conjunction with locational based signals like LMP and RPM, operate. If those competitive forces result in a build up of surplus capacity in a region, the opportunity then exists

to profitably expand the transmission system in a non-discriminatory fashion as part of the Regional Planning process.

Finally, some have suggested that "deliverability" is a good thing because it makes generators, instead of consumers, pay for transmission expansion. This is obviously incorrect. Consumers pay for everything. Raising the cost of generation development by layering on added transmission costs is not a free lunch for consumers. If those projects "succeed" they recover their costs from consumers (including the transmission). If they fail, they raise risk premiums, restrict supply and discourage new investment. There is no free lunch for consumers based on "who pays" for generator interconnections or transmission expansion in the first instance. In fact, deliverability by 1) leaving system planning to the ad hoc determination of generator siting decisions, 2) discouraging competitive entry, 3) perpetuating incumbent market power, 4) interfering with competitive generation development and 5) depriving ratepayers of the beneficial use of the transmission system their rates support, does and will cost all consumers money.

5. Capacity Injection Rights Should Not be Converted Into Physical Rights to Exclude Competitors From the System.

Incumbent generators in PJM have sometimes argued that the network resource interconnection standard is necessary to preserve their alleged property interests in capacity injection rights. Under the PJM tariff, once a unit is connected as a network resource, it has capacity injection rights and does not ever need to build additional infrastructure in order to be counted as a capacity resource.

Nothing in AF&PA's proposal, however, would require any existing generator to install or fund additional transmission in order to remain a capacity resource. To the extent, however, that existing generators claim Capacity Injection Rights are intended to provide economic

immunity from price competition, that argument must be rejected by the Commission if it wants to use competition to establish just and reasonable rates for capacity on a locational basis. New entrants can only displace a capacity resource by bidding a lower price. This is not a matter of physically excluding anyone from the system or interfering in any way with any party's physical rights to use the system. The current market is a financial rights model, and the attempt to convert Capacity Injection Rights into physical rights of dispatch, regardless of price, is antithetical to the entire idea of competitive markets. It makes no more sense to provide incumbents an economic preference in the capacity markets than it would in the energy market. Network resources can already be "displaced" in the dispatch on the energy side by units who underbid them. The fact that these units have "Injection Rights" has never given them a guarantee that they can be dispatched regardless of price, it has only assured them the right to run if they are in merit order.

To the extent that any incumbent unit has invested in specific transmission upgrades or infrastructure, such units should receive the benefit of those upgrades. However, those who claim capacity injection rights seek not only to preserve their right to use particular pieces of transmission that they have contributed, but also to exclude other units from the entire bulk transmission system which they have not constructed or paid for. A large portion of the transmission system used by incumbent generators was not built or paid for by interconnecting generators, but as part of the bulk transmission system planning and expansion process which is entirely supported by ratepayers. Generators have not paid for this system, and any formulation of capacity injection rights which permits incumbents to exclude competitors who could lower costs for the ratepayers who <u>have</u> paid for it, must be rejected. Capacity injection rights, therefore, are appropriate if they simply guarantee that any unit connected to the system has the opportunity to bid to supply capacity without the need for any further upgrades. Allowing local

price competition does not interfere with any existing unit's ability to put in a bid to provide capacity.

6. Conclusion.

The notion of universal deliverability has always been false. It has never been possible at any time to deliver all generation to all loads. There has always been congestion and operating constraints which have not made it possible at various times to dispatch particular units, even those qualified as Network Resources, to support load in every part of the grid. The Commission in a series of decisions has insisted that market designs recognize this reality and has developed resource adequacy mechanisms which clearly recognize that capacity has different values in different locations for the very reason that it cannot all be delivered simultaneously to load, even in emergency situations. These locational based mechanisms have necessarily included procedures for accurately determining how much of the generation in a particular region can be exported or imported to serve another region. Allowing a greater number of resources to compete to be in the subset chosen for export or local delivery will not create reliability concerns. That's just competition. The fact of regional price separation for generation makes clear that even existing units are not universally deliverable. This is not surprising.

Changing patterns of load growth, generator bidding behavior, generator siting decisions, load response, merchant transmission expansion and resource retirements, will each individually and cumulatively contribute to creating new capacity and energy congestion patterns on any but the most drastically overbuilt transmission system. Thus, the question of how to evaluate the value of capacity in various regions from the standpoint of satisfying system load and reliability will have to be continually reexamined for all existing units on the system, not just new units. No generator interconnection standard can eliminate the need to address this issue for existing resources, or new resources as usage patterns change on the grid. The Commission has already

recognized this in moving to locational capacity mechanisms in PJM, New York and New England.

For all of these reasons, competitive principles require variations to the FERC's dual Interconnection Standard in any region where competition is the prevailing model. The Minimum Interconnection Standard approved in New England and New York can serve as the basis for a non-discriminatory, pro-competitive approach which will lower barriers to entry and increase competition. Interconnection under that standard should permit a new unit to compete as both a capacity and energy resource. To the extent the Minimum Interconnection Standard needs to be adjusted to assure that the level of granularity and price separation does not become unmanageable, the goal should be to allow the maximum role for competitive forces consistent with the level of price separation by location the Commission has approved in the capacity market construct. This requires allowing new entrants into the capacity market on a basis which permits "bottling up" generation within a pricing zone and maximizing the ability of new entrants to displace incumbents based on price competition within such zones.

V. CONCLUSION.

AF&PA greatly appreciates the opportunity afforded by the Commission to comment on issues surrounding possible improvements to the structure of the competitive markets for electricity. AF&PA has limited its comments herein either to specific questions raised by the Commission, or to areas of critique and analysis wherein, in addition to our observations about the shortcomings of the current markets, we felt able to offer specific, constructive suggestions and proposals seeking to address these. We have tried to suggest or support modifications to the present markets which we believe could be made in a relatively short time on the basis of limited further factual and/or technical proceedings before the Commission to clarify outstanding issues and identify specific market rule or tariff provisions necessary to accomplish the desired goals.

AF&PA believes, however, that the Commission should continue to consider the longer term questions raised by many consumer groups and others regarding the appropriateness and viability of the current market designs.

Chief among these concerns are continuing unacceptable levels of market concentration that make the use of scarcity pricing and market based rate mechanisms extremely worrying to many customers. The conjunction of market power, and the extreme short term volatility that can be induced by its exercise, argue for the continuing and constant vigilance of the Commission over market behaviors and activities. To the extent short term price spikes in these markets are based on market manipulation, investors cannot be counted upon to treat these as legitimate scarcity signals and respond with added investment. Thus, many consumers fear that they are caught in a "worst of both worlds" scenario where prices are unacceptably high or volatile and yet these prices fail to bring the long term investment one would expect from a competitive model. Although AF&PA believes that this situation can be partially mitigated by Market Monitoring and Enforcement as recommended by AF&PA above, it is more difficult to identify a long-term structural fix to address this concern.

A second valid concern cited by numerous consumers is the disproportionate price increases suffered by consumers in organized markets because of increases in the price of natural gas. The assumption that inframarginal revenues earned by non-gas fired units in these markets are just and reasonable is based on an optimized system analysis which presumes a market at or near equilibrium in the long run. However, the assumption that competitive forces can or will bring the system to a point at or near long run equilibrium, is itself based on a host of generalized propositions which may or may not be empirically valid. One of these is that an efficient market will identify the correct trade off between fuel and capital costs to achieve an efficient portfolio of resources. But this, in itself, implies there is sufficient stability in the relationship between

fuel costs that investors can make long term investment decisions based upon such trade offs. The unprecedented increases in the cost of natural gas in relation to other fuel sources may call this basic paradigm assumption into question. In a system without stable relationships between fuel costs, in which operating and capital costs cannot effectively be balanced long term on a portfolio basis, the notion that competition in a clearing price market will yield results at least no worse than regulation may be empirically questioned. AF&PA reiterates that the notion of just and reasonable rates under the Federal Power Act must, in the end, come back to some way of assuring "cost plus a reasonable return" in recognition of the old saw that perfect regulation and perfect competition should yield similar results. AF&PA has not done sufficient analysis to determine whether the current short term run up in gas prices coupled with a persistently non-optimal recourse mix has called this basic equivalence into question for the organized markets. We do, however, support those who insist that this is the question which market analysis needs to answer and, that "safe and reliable service at just and reasonable rates" is the product all market structures need to be designed to secure.

AF&PA looks forward to continuing to work with the Commission and all other parties towards the reform and improvement of the markets.

Dated at Augusta, Maine this 14th day of September, 2007.

Respectfully submitted,

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UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Wholesale Competition in Regions with Organized Electric Markets	**Docket Nos. RM07-19-000 and AD07-7-000**

CERTIFICATE OF SERVICE

I hereby certify that I have this day served via electronic service list the foregoing document upon each person who is designated on the service list compiled by the Secretary in this proceeding in accordance with the requirements of Rule 2010 of the Rules of Practice and Procedure.

Dated at Augusta, Maine this 14th day of September, 2007.

Donald J. Sipe/s/

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