

# FERC's Flawed Assessment of the Benefits and Costs of Regional Transmission Organizations

*FERC's Economic Assessment does not meet the minimal requirements of a cost-benefit analysis of RTOs. It fails to address critical incentive questions associated with the RTO structure, and begs the question of whether RTOs will in fact make electricity markets more competitive and efficient.*

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## I. Introduction

The overall success of electricity deregulation depends, to a large extent, on the treatment of transmission. An efficiently functioning transmission network, with appropriate incentives to maintain and invest in capacity, is essential to increase reliability, avoid market power problems, and achieve the full benefits of electricity competition. Transmission is far more important under a competitive regime than under traditional regulation,

because it needs to support a much larger range of transactions.

The major policy initiative of the Federal Energy Regulatory Commission (FERC) with respect to transmission is the regional transmission organization (RTO). FERC is currently engaged in a major effort to restructure the nation's transmission grid by requiring transmission owners to place their capacity under the control of RTOs.

FERC's effort represents the culmination of a decade of activity on transmission policy issues

that started with enactment of the Energy Policy Act of 1992.<sup>1</sup> During the 1990s, at the same time that FERC was adopting open-access policies under Orders No. 888 and 889, it was also promoting the concept of the independent system operator (ISO), the precursor to the RTO.

Under this arrangement, which was adopted in the Northeast and in California, transmission owners transferred operational control of their networks to non-owner ISOs. FERC formalized its commitment to the RTO concept, broadly defined, in Order No. 2000, which envisions that transmission owners will join RTOs, but that they will do so "voluntarily." As written, the Order permits significant flexibility in how RTOs are structured. It is flexible enough to allow both ISOs (in which operational control of the grid is separated from its ownership), transcos (where owners retain operational control), or some hybrid. Order No. 2000 also permits substantial discretion in drawing the RTOs geographic boundaries.

More recently, however, FERC has signaled a more prescriptive approach toward RTOs. The agency is now moving more aggressively to divide the nation into a small number of large RTOs and to prescribe in detail how those RTOs should operate. FERC has announced its intention to undertake a new proceeding that would appear to supersede Order No. 2000, adopted only two years ago.

Although FERC has committed itself to requiring RTOs, it has not until now undertaken a cost-

benefit analysis or other type of economic analysis of the RTO concept. It is especially important to perform such an analysis, because the separation of ownership from operational control of economic assets—which is at the core of many RTO proposals—raises fundamental economic questions. In particular, no one really knows what incentive structure will guide these institutions and their behavior will be

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difficult to predict.<sup>2</sup> It was, therefore, good news that FERC decided late in 2001 to commission such an analysis of RTOs.

Cost-benefit analysis of major government regulatory initiatives has become routine over the last 25 years.<sup>3</sup> Simply stated, the purpose of cost-benefit analysis is to determine whether the action under consideration will on balance improve the functioning of markets and benefit consumers or whether there are other available courses of action that might be preferable. A series of executive orders from the Reagan Administration's Executive Order No. 12291 to E.O. 12866, signed by

President Clinton and still in effect, have institutionalized the process of preparing cost-benefit analyses across the federal government.

FERC's cost-benefit analysis has now been completed and released under the title "Economic Assessment of RTO Policy" (hereafter "Economic Assessment").<sup>4</sup> Unfortunately, the FERC study is not a cost-benefit analysis of RTOs. It is essentially a study of the benefits of electricity competition.

The FERC Economic Assessment simply *assumes* that the efficiency benefits of electricity competition will flow from the establishment of RTOs and then goes on to estimate those benefits. Thus, the estimated benefits of RTOs are really the benefits from competition itself. The study does not address the benefits and costs of the RTO form of organization relative to other ways of organizing the transmission grid. It does not show how RTOs will contribute to the development of competitive electricity markets, or evaluate whether they are the best way of achieving this important goal. It does not address the incentive questions associated with separating ownership from operational control of economic assets. The study does not even define what an RTO is.

## **II. Summary of FERC's Economic Assessment**

FERC's Economic Assessment is based largely on a linear-

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