THE GOVERNANCE OF TRANSMISSION OPERATORS

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I. INTRODUCTION

As power markets expand, insular transmission systems have become increasingly incompatible with competition. Regional grids with open-access tariffs and comprehensive congestion management will likely dominate electricity=s future. Beyond a growing consensus on regionalism lies controversy over the form of the providing organization. On the two sides are proponents of non-profit independent system operators (IBOS) that will control utility-owned transmission assets and proponents of regulated corporate entities (Transcos) that will own or lease the lines. Each side hopes to win the debate by repeating a single theme. The Transco=s friends believe that a profit motive will lead it to operate with greater productive efficiency than an ISO. Its opponents see in the same motive an incentive to exercise market power that is lacking in the nonprofit ISO.[1]

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[1] Compare Frank McCamant *et al*, *Uncrossing the Wires: Transmission in a Restructured Market*, 12 ELEC.J. 24 (1999); Richard J. Pierce, Jr., *Why FERC Must Mandate Efficiently Structured Regional IBOS X Now!*, *The Electricity Journal* 12 (Jan/Feb. 1999), 49-56; Joshua Z. Rokach, *Transcos: How FERC Can Lend a Hand*, 12 ELEC. J. 64 (1999), 64-71; Curt L. Hebert, Jr., *The Quest for an Inventive Utility Regulatory Agenda*, 19 ENERGY L. J. 1 (1998), Stephen Angle and George Cannon, Jr., *Independent Transmission Companies: the For-Profit Alternative in Competitive Electric Markets*, 19 ENERGY L.J. 229 (1998).

C. The Formation of ISOs

If the model of political participation provides insight into ISO formations, it may also provide useful predictions about how their governance operate in practice. That model first predicts that an ISO is more likely to be formed where its scope is less costly to determine. The more limited the geographic options, the easier it will be to settle on one of them. If there are no clear boundaries and the costs to a utility of staying out are low, an ISO may not form at all. All five currently operating ISOs have been geographically or otherwise constrained prior to their formation, while less constrained regions have seen ISO proposals die at various stages of development. The New England, PJM, and New York ISOs operate in regions that have long sustained tight power pools. Their contiguity sets some Anatural≅ boundaries on the organizations that may not coincide with economically efficient boundaries. One of the remaining two ISOs is ERCOT, composed of Texas systems that have long operated their own reliability area while separating themselves electrically from interstate commerce. The other, in California, was legislatively imposed on the state=s three largest utilities as part of a complex restructuring bargain, and controls only assets within the state.

Where organizational costs are higher, ISOs are less likely to form or to be smaller in scope. The original proposals for a comprehensive Midwest Independent System Operator (MISO) faced obstacles from the outset as utilities with low transmission costs resisted having their rates averaged with those of high cost systems.[48] Since the breakup of the original organization the higher cost utilities making up the Alliance group have filed for their own organization at FERC. They have done so amid comments that the resulting shapes of the Alliance and a possible MISO are inconsistent with regional operating efficiency and will not completely resolve rate pancaking.[49] Elsewhere, embedded cost inequalities and political conflicts between public and private power combined to bring an end to InDeGo, the Pacific Northwest=s proposed ISO, after two years of planning.[50] Nearly

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[48] *Midwest ISO Brouhaha Seen Slowing Competition, Testing FERC=s Policy*, POWER MARKETS WK., Dec. 15, 1997.

[49] *American Electric Power Service Corporation, supra* note 15, Massey *Takes Hebert to Task on Transcos, Berates Use of >Sweeteners=*, INSIDE FERC, Dec. 14, 1998, 7.

[50] *Last InDeGo Organizers Shelve ISO Plan but Hope that FERC Will Step in to Lead*,

half of the area=s transmission is operated by the Bonneville Power Administration, which is also the dominant supplier to a number of small public power systems and large industrial users in the area. Similar factors have halted the inclusion of municipal systems in California=s ISO, leaving nearly half of the state=s import-export capability beyond the ISO=s control. The Los Angeles Department of Water and Power has chosen not to join the ISO after learning that it would pay a cost-based average of 88 cents/kwh to access the grid while corporate systems are paying under 35 cents/kwh.[51]

ENERGY RPT., Mar. 9, 1998.

[51] *Calif. ISO Is Too Expensive to Join, LADWP Complains, Looks for Changes to Rules*, POWER MARKETS WK., Feb. 9, 1998, 10.

ISO filings at FERC provide indirect evidence that transmission-owning utilities disproportionately influence constitutions. Although the membership of Northeastern ISOs is more easily determined, FERC has been persistently dissatisfied with their governance arrangements. It has questioned and at times rejected portions of applications by the region=s three ISOs after determining that important committees and voting procedures were unacceptably dominated by transmission owners.[52] It has informed the New York ISO that if the ISO does not submit an acceptable governance plan it intends to impose one on the organization. The rejected arrangements of the Northeastern groups appear to reflect dominance of the planning process and pre-existing regional pools by transmission owning utilities.[53] In California, numerous parties accused utilities of unwarranted dominance in the ISO planning process, noting that the state=s three large corporate systems had both sufficient resources and the ability to recover most of their expenses. Those three utilities were the only parties allowed to vote on organizational design issues, and votes could be taken in non-public meetings.[54] Similar complaints about utility dominance of the constitutional process have occurred in ISOs that failed to form.[55] On the other side, utilities might reasonably claim that they are only protecting the values of assets their shareholders will continue to own, and that their extensive operating knowledge will be invaluable if the ISO is to succeed.[56]

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[52] *FERC Approves PJM Majority=s ISO and Congestion Pricing Proposal,*≅ FOSTER ELEC. RPT., Dec. 3, 1997, 1; *With Bailey Dissenting, FERC Orders NYPP to Revise Governance Rules for Key NY-ISO Committee*, FOSTER ELEC. RPT., May 5, 1999, 8; *FERC Conditionally Approves Its First [New England] ISO,*≅ FOSTER ELEC. RPT., July 2, 1997, 5.

[53] *Tensions Threaten N.Y. ISO*, ELEC. DAILY, July 16, 1996; *IPPs, Marketers Vote No on PJM Transmission Proposal*, ENERGY DAILY, Aug. 22, 1996.

[54] *Various Parties Protest California IOU=s ISO and Power Exchange Proposals*, FOSTER ELEC. RPT., June 26, 1996, 1; *California Utilities Defend Their three Applications at FERC for Implementing CPUC=s Restructuring Decision*, FOSTER ELEC. RPT., July 10, 1996, 1.

[55] *Midwest ISO Planners to Allow for More Input, but Industrials Still Fault Plan*, ELEC. UTIL. WK., April 21, 1997, 4. [referring to a predecessor of the current Midwest ISO]

[56] This reasoning has carried some weight at FERC. Commenting on the New York arrangements, Commissioner Bailey stated that she is Anot particularly concerned about the prospect of transmission owner dominance...[because] reliability organizations should be dominated by expertise.≅ *FERC Eases OASIS Posting Load, Okays N.Y. ISO,*≅ POWER MARKETS WK., June 29, 1998, 10. The Commissioner also stated that she had supported a PJM restructuring plan because A[w]hen seven of the eight [utilities] support one approach, it

The interests represented at the ISO are themselves determined in the constitutional process that sets its rules. Even if two groups have equal representation on the board, their effective power may differ if one (e.g. competing independent power producers) has less monolithic interests than the other. There is no clear link between the rule-setting power of transmission owners and the range of interests represented on an ISO=s board. Utilities may seek to dominate by attempting to exclude other interests or by creating large representations for themselves. Thus in New York alleged utility dominance of ISO formation has left as important a stakeholder group as power marketers unrepresented in its governance.[57] Also in New York, FERC rejected a proposal that would have given each of the state=s utilities, whether large or small, its own vote on important

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was difficult to reject that approach.≅ Independent power producers and marketers strongly opposed the plan. *PJM Majority=s Plan Wins FERC Nod for Restructuring Pool into ISO, PX*, ELEC. UTIL. WK., Dec. 1, 1997, 12.

[57] FERC has promised to take up the marketers= case after the ISO submits a revised governance proposal. *With Bailey Dissenting, FERC Orders NYPP..., Op. Cit.*

committees, with a provision that the number not be reduced in the event one of them vanished by merger.[58]

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[58] *Power Marketers Protest NYPP=s ISO Settlement Agreement and its Weighted Voting Proposal*, FOSTER ELEC. RPT., Dec. 16, 1998, 8.

There is no simple relationship between the structure of an ISO=s board and the influence of transmission owners in creating that structure. California=s utilities also dominated the structuring of its ISO, whose board contains numerous diverse interests. Utilities might choose such a strategy because it gives them a broader range of potential coalition partners, because it is easier to organize their own concentrated interests against a diffuse opposition, or because deadlocks and inertia on the board can facilitate transfers of effective power to a pro-utility ISO staff. California=s original FERC filing envisioned five classes on its Board of Governors, and subsequent state restructuring legislation proposed eleven.[59] Later activity led to 13 classes with 25 votes total, along with four non-voting AAdvisory Representatives.≅ The two largest classes are Municipal Utilities and AEnd-Users At Large,≅ with four members each.[60] Investor-owned utilities, which retail 75 percent of the state=s power, get three members.[61] None of the classes has stated that it wishes to consolidate with others. The more likely pressure will be to add new representatives as political conditions change, without necessarily deleting old ones.[62] As this occurs, free-rider problems will become more important and favor

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[59] *Pacific Gas & Electric Company et al, Order Conditionally Authorizing Establishment of an Independent System Operator and Power Exchange*, Docket Nos. EC96-19-000 and ER96-1663-000, 77 F.E.R.C. & 61,204 (Nov. 26, 1996). California A.B. 1890, *Op. Cit.*

[60] Standing over the ISO=s governors, California=s Oversight Board determines which organizations are able to choose individuals who will be seated on the ISO board, and has the final say on whether a nominee is acceptable. It has rejected only one nominee, a consumer representative whom it claimed did not have sufficient experience on boards of directors. *California Consumer Groups Charge that California ISO=s and Oversight Board=s Failure to Seat their Chosen Representative on the ISO=s Governing Board Violates FERC=s Directives*, FOSTER ELEC. RPT., June 17, 1998, 12.

The current representatives of At-Large End-Users are from the League of Women Voters, Proctor & Gamble, The California Public Utilities Commission=s Office of Ratepayer Advocates, and a self-employed person. See ACalifornia ISO Board of Governors: Class and Affiliation Listing,≅ available at www.caiso.com.

[61] During the formation process a representative of a California corporate utility stated that Athe government structure for the exchange and the ISO was specifically set up to favor the [municipal utilities],≅ presumably to keep them from protesting the structure. *Are California Munis Trying to Game the ISO System?*, ELEC. DAILY, May 9, 1996.

[62] The other ten classes include [1] one member from AGovernment Market Participant Entities≅ (California Department of Water Resources); [2] two from ANon-Utility

interests whose purposes are more concentrated and that are willing to devote relatively more resources to influencing ISO governance.

VI. Governance by Collective Choice

A. Models of Voting

In an ISO, stakeholders who once took their differences to regulators will now vote their interests directly. Economic models of collective choice give reason to expect that this change will have important and adverse consequences for efficiency. Those models rigorously demonstrate that it is impossible to design collectively governed institutions that will not under some conditions produce perverse or irrational voting outcomes. The paradoxes of choice by voting are straightforward, and students of government no longer view them as curiosities of interest only to

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Electric sellers≅ (Dynegy Inc. and the Independent Energy Producers Association); [3] one from APublic Buyers and Sellers≅ (Western Area Power Administration); [4] one from APrivate Buyers and Sellers≅ (Enron Corporation), [5] one from AAgricultural End-Users,≅ [6] one from AIndustrial End-Users,≅ [7] one from ACommercial End-Users,≅ [8] two AResidential End-Users≅ (consumer-advocate group TURN and a sometime consultant to TURN); [9] two APublic Interest Groups≅ (both environmentalist); and [10] two ANon-Market Participants≅ (International Brotherhood of Electrical Workers and engineering-construction firm Bechtel) Advisory Representatives are from the Bonneville Power Authority, Powerex (British Columbia), the California Energy Commission, and the California Public Utilities Commission. See California ISO Board of Governors, *Op. Cit.*