Independence Considerations for Organizations Performing Reliability Functions

Report from the Control Area Criteria Task Force to the NERC Board of Trustees
February 12 – 13, 2001

Revised February 2, 2001

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Foreword

The Control Area Criteria Task Force presented its first in-depth report to the Board in June 2000, describing a new Reliability Model that included the basic functions required to ensure reliable interconnected systems operation. Now the Task Force returns with the first of its two-part Final Report. This installment deals with the independence requirements for organizations performing certain basic functions defined in the Model. The Board specifically asked the Task Force to prepare this report for the Board's February 12 – 13, 2001 meeting.

This report is divided into four sections plus five attachments:

1. Reliability Model Development
2. The Role of Independence of the Reliability and Merchant Functions to Ensure a Viable Marketplace
3. Definitions of "Independence" and "Merchant Function"
4. Specific Independence Issues Pertaining to the Security, Balancing, and Interchange Authorities, and the Transmission Service Provider

Attachments 1 and 2 – Public comments and Task Force Responses Regarding the Issue of Independence from the Task Force's two White Papers.

Attachment 3 – Comments on this Report

Attachment 4 – Interconnected Operations Services Independence Issues

Attachment 5 – Control Area Criteria Task Force Roster

The Task Force will present the second part of its final report, which covers the technical details of the Reliability Model's reliability and Merchant Functions[1], to the Operating Committee on March 28 – 29, 2001 and to the Board in June.

Executive Summary

The Operating Committee's Control Area Criteria Task Force has created a Reliability Model that defines the responsibilities and relationships of "Service" and "Operating" Functions[2] that are necessary to ensure real-time operating reliability. Using this new Reliability Model as a guide, NERC will be able to restructure its Operating Policies and Standards to more accurately focus on the basic reliability Service and Operating Functions instead of simply assuming that Control Areas perform those functions, as the Policies do today. Then, the organizations that are now forming—RTOs, ISOs, Transcos, and so on—can simply "roll up" these functions as necessary into their organization structure.

The Operating Committee also asked the Task Force to address the needs of the marketplace, and to ensure that those organizations who perform reliability Service Functions do not realize a commercial advantage in providing those services by favoring their affiliated Merchant organizations. This charge led

[1] The Reliability Model does not address the financial arrangements ("business practices") for organizations performing the Merchant Function. The Reliability Model primarily deals with the physical implementation of those arrangements.

[2] Includes Operating Functions performed by Merchants that are needed to ensure operating reliability as defined in the Model.

to the Task Force recommending that only physical and corporate[3] separation provides the marketplace with the maximum assurances that the organizations performing reliability Service Functions do not favor one set of customers or suppliers over another.

This report provides the background for the Task Force's recommendations. It also includes the public comments that NERC received on two drafts of the White Paper that the Task Force posted.

The Task Force emphasizes that the resolution of *organization* independence issues in this report is not a prerequisite for the applicability of the *functions* defined in the Reliability Model. The Model itself, with the technical details of each Service and Operating Function, will be brought to the Board for approval in June 2001.

Reliability Model Development

During the past few years, the NERC Operating Committee has been increasingly aware that many of the traditional, vertically integrated Control Areas have unbundled their operating functions. As a result, the current NERC Operating Policies, which are centered on Control Area operations, have lost their focus. As a result, these Policies are becoming more difficult to apply and enforce. The Operating Committee has also noted that Control Areas with affiliated generators and merchants appear to have a commercial advantage over independent power producers and independent power marketers in several operational areas, such as Inadvertent Interchange payback and transaction "parking." This became more obvious as independent power producers and merchants began forming generator-only Control Areas. (We will address both the Inadvertent Interchange payback and "parking" issues in the second part of the Task Force's final report.)

Forming the Control Area Criteria Task Force. In 1999, the Operating Committee formed the Control Area Criteria Task Force and approved its scope containing 12 fundamental objectives that are listed below. Five were short-term objectives, all dealing with Control Area issues, for which the Operating Committee was looking for recommendations as soon as possible. These recommendations would then be "handed off" to standing committees or subcommittees. The other seven objectives would take longer to achieve, and the Task Force decided to address these objectives by developing a new "Reliability Model."

Short-Term Objectives – Control Area Issues

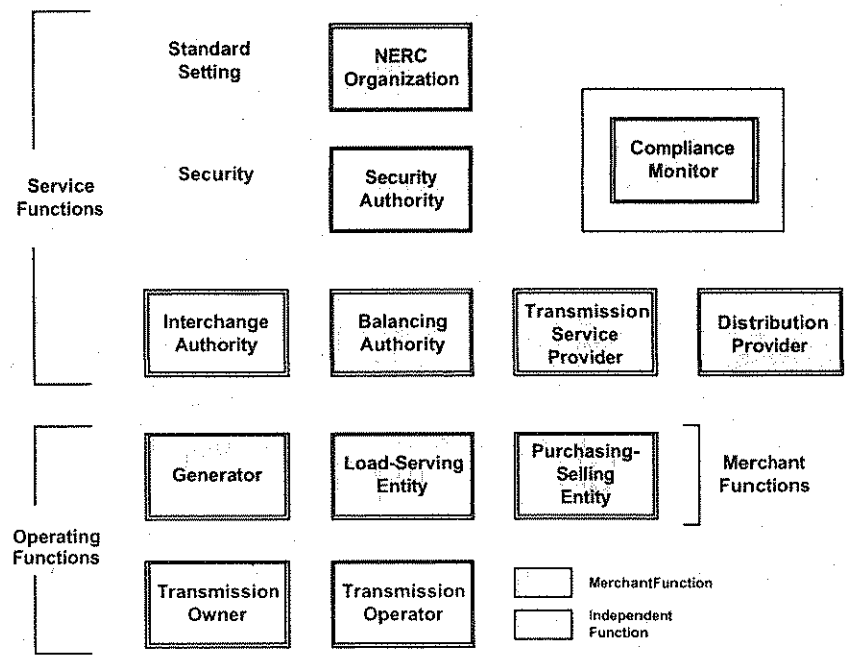
1. Identify the incentives and obligations for being a Control Area.
2. Remove the economic advantages of performing reliability functions.
3. Define compliance requirements for Control Areas.
4. Define the process for certifying new and existing Control Areas.
5. Define the process for announcing new Control Areas and changes to existing Control Areas.

Longer-Term Objectives

6. Define the functions and responsibilities for ensuring real-time operating reliability (adequacy and security) of the Interconnection.
7. Define the roles of entities (Control Areas, Security Coordinators, Transmission Providers, Generators, etc.) that may provide all or part of the functions or responsibilities for security.

[3] In this report, "corporate" is used in the general sense of a structured organization regardless of ownership, and is not restricted to "incorporated" organizations.

8. Include definitions and criteria for each entity.
9. Address states rights vs. federal government (U.S. and Canada).
10. Define the relationships of entities in Item #7 with each other for ensuring operating reliability (authority, coordination, geography, etc.).
11. Accommodate retail access.
12. Accommodate the needs of the marketplace.



The Reliability Model. The Task Force has taken its charge to heart. It created a Reliability Model that defines the responsibilities and relationships of "Service" and "Operating" Functions that are necessary to ensure real-time operating reliability. The Model describes the Security, Interchange, and Balancing Authorities, the Transmission Service Provider, and Distribution Provider as reliability Service Functions the "traditional" Control Area has performed for decades, but are now being defined per se for the first time. The Reliability Model also defines the Operating Functions performed by the Purchasing-Selling Entity, Generator, and Load-Serving Entity (these three are further classified as "Merchant Functions"), and the Transmission Owner and Operator, and explains the interrelationships between the reliability Service Functions and these Operating Functions. Finally, the Model includes the Regional Councils and NERC Service Functions and the roles they play in developing the Policies and Standards and monitoring compliance. Most importantly, the Reliability Model defines *functions*, not organizations or their structures.

Approving the Reliability Model. The technical details of the Reliability Model's reliability Service and Operating Functions will be included in the second part of the Task Force's final report that will be presented to the Operating Committee on March 28 – 29, 2001 and to the Board in June. Once approved, NERC can then begin to "unbundle" its Operating Policies, which are written for Control Area Organizations, and restructure the Policies around the Reliability Model.

Operating Policy Restructuring. Using this new Reliability Model as a guide, NERC will be able to restructure its Operating Policies and Standards to more accurately focus on the basic reliability Service and Operating Functions instead of simply assuming that Control Areas perform those functions, as the Policies do today. Then, the organizations that are now forming—RTOs, ISOs, Transcos, and so on—can simply "roll up" these functions as necessary into their corporate structure. Control Areas will also probably continue to exist, but the Operating Policies will no longer address Control Areas per se, but rather the reliability functions that Control Areas may perform.

The Role of Independence of the Reliability and Merchant Functions to Ensure a Viable Marketplace

We now begin the discussion of the independence issues that comprise the heart of this report to the Board of Trustees. It is very important to recognize that the requirements for independence of the organizations performing the reliability Service Functions is not a prerequisite for the validity of the functions themselves as defined in the Reliability Model. However, as we discuss below, independence of the merchant from certain reliability Service Functions is an important part of ensuring a reliable power supply as well as providing market solutions to reliability problems.

Marketplace and Reliability. Some of the Operating Committee's assignments to the Control Area Criteria Task Force were not purely technical. As listed above, these assignments included "accommodating retail access," and, more generally, "accommodating the needs of the marketplace." This includes "removing the economic advantage (the Task Force uses the term "commercial advantage") of performing the reliability functions (Service Functions)." It is these marketplace issues that led the Task Force to explore the interactions within organizations that perform both reliability service and Merchant Functions. However, before the Task Force could begin to address these interactions, it needed to develop its own guiding principles on the relationship between reliability and the marketplace. The Task Force began with NERC's classic definition of "reliability:"

NERC has traditionally defined "reliability" as having two components:

1. **Security** – the real-time ability of the transmission system to deliver energy to the customer, and
2. **Adequacy** – the sufficiency of the energy supply itself, both in real-time operations and in the future.

While NERC, in years gone by, included the responsibility for ensuring both security and long-term adequacy, deregulation of the generation supply in the U.S. and Canada has relegated future adequacy, to varying degrees depending upon the state or province, to the marketplace. This leaves NERC with the single task of developing the standards and policies to ensure the security of the transmission system.[4] But the security of the transmission system is closely tied to the adequacy and reliability of the generation system in real time because the generation system provides a number of reliability "products," (which NERC calls Interconnected Operations Services) such as load-following, frequency response, black-start, and so on.

The Task Force and its various task groups discussed, argued, and debated the relationship between the marketplace and reliability, and how the Task Force should address this relationship. The Task Force eventually agreed to the following two guiding principles regarding this relationship:

1. Reliability and commerce are inseparable and mutually dependent, and
2. A viable electricity market is essential for a reliable bulk power system, and vice versa.

The Importance of Independence. It has been argued within the Market Interface Committee, the recent Search Conferences, the public comments on the Control Area Criteria Task Force's two White Papers, and in other forums, that independence of certain reliability Service Functions from Merchant Functions

[4] These rules extend into the "market interface" area, which include policies on the physical implementation of the "deals" that merchants set up. However, NERC does not write the rules for the financial arrangements between merchants ahead of this physical implementation.

is an essential element of these reliability principles, especially the second one. The basis for this argument is twofold:

1. A lack of independence could establish competitive barriers that limit the market's ability to provide reliability services, such as regulation, frequency response, contingency reserves, and black start, and
2. A lack of independence may introduce an actual or perceived lack of accountability in the administration of the reliability Service Function.

Therefore, the Task Force believes that NERC should promote a highly reliable transmission system as well as a viable marketplace, not only for retail and wholesale energy sales, but also for the reliability services that the marketplace will be expected to provide. And in order to promote a viable marketplace, it is necessary that the Merchant Functions be independent from the Service Functions.

Definitions of "Independence" and "Merchant Function"

The Task Force believes that the Balancing Authority, Security Authority, and Transmission Service Provider must be independent of the Merchant Function. Otherwise their affiliated generation could preclude other merchants from the marketplace thus discouraging marketplace investment in generating plants that may be needed to ensure adequate energy resources or Interconnected Operations Services.

Later in this report we will explain two exceptions to the independence requirements for the Balancing Authority.

The Interchange Authority may or may not be independent, as we explain in the "Interchange Authority Independence" section.

Definition of "Independence"

Degrees of Independence. To set the stage for this discussion, we should first look at the various degrees of independence that exist today:

Case 1. **No separation, single organization.** One corporation performs both reliability Service Functions and the Merchant Functions in the same control room.

Case 2. **Physical separation, single organization.** One corporation performs both reliability Service Functions and Merchant Functions, but with different people in separate rooms (and no communication between them).

Case 3. **Physical separation between two affiliated organizations**. Two affiliated corporations, one performs reliability Service Functions, while the other performs Merchant Functions, and with different people in separate rooms (and no communication between them).

Case 4. **Physical and corporate separation.** Two non-affiliated corporations, one performs reliability Service Functions, while the other performs Merchant Functions.

The Task Force Recommends Physical and Corporate Separation. The Task Force believes that only physical and corporate separation (Case 4) provides the marketplace with the maximum assurances that the organizations performing reliability Service Functions do not favor one set of customers or suppliers over another. This applies to the Balancing Authority, Security Authority, Interchange Authority, and Transmission Service Provider functions.

Exceptions to requiring Balancing Authority independence are explained in the "Specific Independence Issues Pertaining to the Security, Balancing, and Interchange Authorities, and the Transmission Service

Provider" section of this report. The Interchange Authority may be performed by either an organization that is independent, or one that is affiliated with the Merchant Function, as we also explain in that section.

Variations. The Task Force asked the participants at its fall 2000 workshop to suggest what "physical and corporate" separation might entail. Three scenarios emerged (there are certainly others):

Option 1

- Separate Boards
- No way to benefit affiliates
- Separate stock

Option 2

- Separate Boards
- Passive ownership in other company stock

Option 3

- One-time separation of books
- Pure Holding Company

The Task Force's versus FERC's Definition of "Independence." Many readers pointed out in their comments on the first draft of the White Paper that the Task Force's Independence requirements go beyond those established by FERC. The readers are correct, and there are four reasons for this:

1. **FERC's definition of Independence pertains only to the Transmission Provider (in Order 888/889) and the RTO (in Order 2000).** The Reliability Model also defines the Balancing Authority and Interchange Authority, neither of which FERC has addressed in its orders. Also, the Reliability Model defines functions that may be rolled up into various types of organizations, such as Gridcos, ISOs, RTOs, Control Areas, and so on.

2. **Functional separation alone does not provide the maximum assurances of fairness to the marketplace.** The Task Force believes that Independence requires *physical and corporate separation* of reliability Service Functions from Merchant Functions. Agreements, Standards of Conduct, and audits are also important, but only physical separation at the corporate level provides the marketplace with maximum assurances that those entities performing reliability Service Functions do not favor one set of customers or suppliers over another.

3. **Independence from the retail Merchant Function is no less important than from the wholesale Merchant Function.** While FERC extends its Independence requirements to only the wholesale Merchant Function, the Task Force sees no logical reason that "Independence" should not also include the retail Merchant Function. For example, without independence from the Merchant Function, the Security Authority or Transmission Service Provider could favor its own native load customers when performing line loading relief, or the Balancing Authority could favor its affiliated generators when supplying energy to the Load-Serving Entities within its area.

4. **Many organizations are not under FERC's jurisdiction.** The Task Force knows that many non-FERC jurisdictional utilities have filed their version of the *pro forma* tariff and have reciprocity agreements with Transmission Providers who are under FERC jurisdiction. Nevertheless, there are municipal and cooperative utilities who are not bound by any FERC regulations. Other than the reasons discussed in the requirements for Balancing Authority

Independence listed above, the Task Force believes that FERC jurisdiction is not a prerequisite for adhering to Independence requirements of the reliability Service Functions described in the Reliability Model. However, the Task Force also recognizes that regulatory requirements may prevent physical and corporate separation. This may be the case with some municipal, state, provincial, or federal utilitie s.

Independence versus Standards of Conduct. In their comments on the first White Paper, some readers suggested that Standards of Conduct with audit provisions should be sufficient to prevent preferential treatment. The Task Force agrees that Agreements, Standards of Conduct, and audits are also important and these need to be developed by the NERC Board of Trustees[5]. However, it is the Task Force's opinion, supported by many in the industry, that standards of conduct alone are insufficient to prevent preferential treatment, real or perceived. FERC explains the need for independence—not just standards of conduct requirements—in its RTO rehearing order:

Rehearing Requests

> Duke objects generally to the Commission's focus on ownership, asserting that the Commission's approach is overly rigid and that the Commission has not examined whether there are less restrictive means to meet the independence criterion. Duke first asks the Commission to reconsider the structure allowed for the natural gas industry, where affiliated production and marketing companies are permitted. Duke does not challenge the Commission's observation that the electric industry evidences a much higher level of vertical integration, but argues that there is no reason to require separation of control of transmission and merchant activities to a greater extent than is permitted in the gas industry. Duke also suggests that the Commission could allow affiliated transcos subject to a requirement that they retain an independent auditor to review the activities and decisions of the affiliated transco from the standpoint of potential discrimination and compliance with codes of conduct and file regular reports of its findings.
>
> Conectiv asks that the Commission clarify that the ownership requirements do not apply to the non-profit ISO form of RTO, but would only apply to transcos and other for-profit entities with voting securities. It asserts that the record does not support ownership restrictions for non-profit RTOs.

Commission Conclusion

> We do not agree that the structure currently in place for the gas industry would adequately support independent RTOs. As Duke itself notes, it would allow the senior management of an entity that operates in both the transmission and generation arenas to participate in decisions involving the transmission business. These decisions would, as a matter of course, have a significant effect on that same entity's

[5] The Task Force recommends that NERC prepare Standards of Conduct for the Security, Balancing, and Interchange Authorities, as well as the Transmission Service Providers, Transmission Owners, and Transmission Operators.

> generation business. **We also disagree that independent auditing alone can substitute for the independence requirement. As we noted in the Final Rule, we have found that in the electric industry, it is difficult to monitor compliance with codes of conduct** *(emphasis added by Task Force)*. Moreover, it is a very intrusive form of regulation and ultimately requires us to be "chasing after conduct." As we noted in the Final Rule, this is not the light-handed regulation that is essential to support emerging competitive markets. *(Pages 27 – 28)*

Delegation of Authority. The Task Force believes that the delegation of functions can only be handled by entities who meet the same independence requirements as the delegating authority. But in stating this, it is important to recognize the difference between delegating *functions* and contracting for *services*. For example, a Balancing Authority may arrange for Interconnected Operations *Services* from a merchant entity, who, by definition, isn't independent. On the other hand, the Balancing Authority may delegate the frequency response *function* to another entity, in which case that entity must meet the same independence requirements as the Balancing Authority. Similarly, the Security Authority may delegate some of its security functions, such as administration of Transmission Loading Relief procedures, to another entity. In that case, that entity must meet the same independence requirements as the entity serving as the Security Authority function.

Definition of "Merchant Function"

As we explain above in the "Definition of Independence," the Task Force does not believe that FERC's definitions in Order 888/889 or 2000 are comprehensive enough to adequately address the relationship between the Reliability Model's various reliability Service Functions and authorities and those entities and organizations who are directly engaged in buying and selling in the marketplace. Therefore, the Task Force developed a **definition of the "Merchant Function" as "The generation, selling, reselling, or purchasing of electric energy, capacity, or resources-related services for wholesale and retail customers."** Entities responsible for performing the Merchant Function include:

- Generators (generation, including capacity, energy and generation-based Interconnected Operations Services)
- Purchasing-Selling Entities (selling, reselling, or purchasing capacity or energy),
- Customer Aggregators (purchasing and selling energy), and
- Load-Serving Entities (purchasing energy from Generators or Purchasing-Selling Entities and selling to customers).

Transmission Service Providers may purchase Interconnected Operations Services and "package" them to supply Ancillary Services as required in the tariffs, but the Task Force does not consider this to be a Merchant Function. Nor does the Task Force consider the Balancing Authority to be a Merchant Function when it is serving as the Provider of Last Resort of Interconnected Operations Services.

Inclusion of the Retail and Wholesale Merchant Function. The Task Force received many objections to including *retail* customers in its definition of Merchant Function. Even the Board of Trustees has been engaged in this debate. The customers who receive the energy, capacity, or Ancillary Services include both wholesale customers (who purchase energy and capacity for resale) and retail customers (who purchase energy and capacity for their own use). Therefore, the Task Force believes the definition of Independence must include those Merchant Functions that deal in both wholesale sales and purchases and retail sales. For example, if the Security Authority or Transmission Service Provider is affiliated with retail customers, it could favor those customers when invoking either "local" or Interconnection-wide line load relief procedure (such as the TLR Procedure or Unscheduled Flow Reduction Procedure). Balancing Authorities with affiliated retail customers could likewise favor those customers should the Balancing Authority need to shed retail load in system emergencies.

Following the Board of Trustee's discussion of this issue at its June 2000 meeting, NERC included the following definition of "Merchant Employees" in the Security Coordinator Standards of Conduct. This definition stated that the "Merchant Function" includes service to both retail and wholesale customers[6]:

"...employees/persons who engage in retail (energy purchases for or sales to native load customers) or wholesale (energy purchases or sales for resale) merchant functions ("Merchant employees")."

Specific Independence Issues Pertaining to the Security, Balancing, and Interchange Authorities, and the Transmission Service Provider

Security Authority and Transmission Service Provider

Even in areas where markets do not exist, organizations performing the Transmission Service Provider and Security Authority functions must be independent in all situations because their actions, such as invoking local or Interconnection-wide line load relief procedures, can affect the marketplace in other areas of the Interconnection. Allowing the Transmission Service Provider or Security Authority to be affiliated with the Merchant Function provides the opportunity for the organizations performing these authority functions to favor their own customers or generation resources over others.

The Task Force received few comments challenging this recommendation, other than objections to the definition of "Independence" and "Merchant Function" that the Task Force was recommending.

Balancing Authority

When the Task Force prepared its first White Paper, it recommended that the Balancing Authority be independent from the Merchant Function. This evoked many comments arguing that if there were no customer choice options and no market for Interconnected Operations Services then there was no point in requiring Balancing Authority independence. The Task Force agreed, and concluded that the Balancing Authority needs to be independent under the following two circumstances:

1. **To ensure a fair market for providing energy, capacity, or Interconnected Operations Services.** If there is any kind of formal, competitive marketplace, facilitated by the Balancing Authority for either energy or capacity or Interconnected Operations Services, then the Balancing Authority must be independent from the Merchant Function. This is to ensure that the Balancing Authority does not bias the marketplace by favoring its affiliated generators.
2. **To ensure impartiality when issuing dispatch or load shedding orders to maintain real-time generation/load/interchange balance**..Such dispatch orders, when given by an entity that is affiliated with a Merchant Function, will be subject to challenges for real and perceived bias (unless the Balancing Authority is a single-entity, generation-only).

[6] The Board also discussed the independence requirements for Security Coordinators at that meeting, and agreed that Security Coordinators should "operate independently" from the Merchant Function. The Board also agreed that "operate independently" does not mean or require corporate separation of the Security Coordinator from the Transmission Provider or Merchant employees or Merchant Function.

Therefore, the Task Force concluded there may not be a need for the Balancing Authority to be independent under these situations:

1. **Where the customer has no choice of energy suppliers** (e.g., the Load-Serving Entity is using its own generation to serve its load). Some states have not deregulated their electric utilities, or in some cases, do not allow merchant plants to be built within their borders. Therefore, there is no market for energy or Interconnected Operations Services.

2. **In the case of a "generation-only" Balancing Authority** that does not serve native load and where generation is owned by a single corporate entity. In this case, there would be no market within that Balancing Authority for energy or Interconnected Operations Services.

Interchange Authority

The Task Force has debated the Interchange Authority "independence" issue at great length and concluded that the Interchange Authority could be either affiliated or independent. The Task Force believes that there are opportunities for both kinds of Interchange Authorities to exist simultaneously, depending on the need and situation. It is likely that an Interchange Authority who is affiliated with a merchant would only provide Interchange Authority services for that merchant. Other merchants would either form their own Interchange Authorities or use an independent Interchange Authority.

The Interchange Authority only knows those transactions that are submitted by Purchasing-Selling Entities to the Interchange Authority—the Interchange Authority cannot obtain information on any other Transactions.

The Task Force believes that the Load-Serving Entity should be able to specify which Interchange Authority the Purchasing-Selling Entity uses in setting up the Transaction. Therefore, if a Load-Serving Entity is not comfortable with using the services of an Interchange Authority that is affiliated with the Merchant Function, it can specify that the Purchasing-Selling Entity use an Independent Interchange Authority.

Attachment 1 – Public Comments and Responses on "Independence" from First White Paper Draft

As one would expect, at least one-half of the comments the Task Force received were related in some way to the recommendations on independence requirements of the Security, Balancing, and Interchange Authorities, and the Transmission Service Provider. This Attachment includes the public comments and Task Force responses on the independence issue based on the Task Force's first White Paper. The Task Force is still working on its responses to the comments on its second White Paper.

Independence – General

The issue of "Independence" evoked the most comments.

Terry Boston
Tennessee Valley Authority

- NERC's responsibility and consequently that of the CACTF is reliability. Elements of the white paper that attempt to set direction relative to the structure of markets and industry restructuring, particularly how individual entities are organized, should be removed.
- The NERC CACTF definition of *independence* is inconsistent with FERC's definition. *Independence*, as referenced in this document, must be "functional only" as defined by FERC.
- Organizational efficiency is important. By focusing the white paper on function only, independence can be maintained while allowing for efficient organizational design for entities performing multiple functions.

Jim Maughn
SERC

Organizational efficiency is important. By focusing the white paper on function only, independence can be maintained while allowing for efficient organizational design for entities performing multiple functions.

Vern Colbert
Virginia Power

There is a mention in the paper of Security Authority independence from all merchant functions, the assumption being this is in reference to both the retail and wholesale functions. If this is the paper's intent this should be made clear up-front, to allow comments on this by all parties. While we can possibly see the basis for this proposal from a pure security viewpoint, nevertheless, we note again that this is an area that the FERC has extended its jurisdiction over, and to-date the FERC has not established a separation criteria for retail merchant functions or security functions. To the contrary, the FERC has indicated that it feels stringent separation criteria are not necessary to ensure independence between security coordination and transmission operation (such as in Order 2000 specifying that RTOs will also be security coordinators), or that the retail function cannot be associated with the transmission function.

Furthermore, it is not clear that NERC has the authority to propose regulations of this type in any case, especially those that would in some situations require major restructuring of a corporation. Neither the white paper nor the NERC board should adopt a position in this matter that is in conflict with existing FERC requirements, and that has not been put through full due process in accordance with NERC policy.

Joseph Fox
Hydro-Québec

The definition of 'Independence' should be in agreement with FERC and therefore should be changed to reflect that functionally separated entities are subject to the code of code of conduct and confidentially of data.

Charles Yeung
Enron

NERC must take the next step and revise existing policies and create new policies that will incentivize the industry to move towards reforming into either an independent entity or commercial entity. The establishment of the ability to Park and Hub will incentivize PSEs to stay out of the independent functions. Likewise, strict Codes of Conduct for Security Coordinators will separate the commercial functions from these entities.

Vern Colbert
Virginia Power

If an independent function or entity contracts with an another entity to do some part of their role, can that contractor be non-independent? We believe that this should be allowed.

John G. Mosier, Jr.
NPCC

The key difficulty still facing the Control Area Criteria Task Force remains all aspects of independence, both the functional concept and its physical realization. To resolve this continuing dilemma, it is essential to return to the paramount goal of a new control area model- the segregation of all commercial benefits from those control responsibilities of the traditional control area. When this charge is fully realized, independence of function will have been naturally achieved.

David Kiguel
Hydro One Networks, Inc.

The definitions of Merchant Function and Independent Function should be expanded to link them with and make them consistent with the FERC Order No. 2000.

FERC defines a market participant as (i) an entity that, either directly or through an affiliate, sells or brokers electric energy, or provides transmission or ancillary services to the RTO, unless the Commission finds that the entity does not have economic or commercial interests that would be significantly affected by the RTO's actions or decisions; and (ii) any other entity that has economic or commercial interests that would be significantly affected by the RTO's actions or decisions.

When defining the independence of any market participant requirement of RTOs, the order establishes that the following conditions must be met:

(i) The entity, its employees, and any non-stakeholder directors must not have financial interests in any market participant.

(ii) The entity must have a decision making process that is independent of control by any market participant or class of participants. By way of example, this could be achieved by a non-stakeholder governing board and a prohibition on market participants having more than a de minimus (one percent) ownership interest.

(iii) The entity (in this case the RTO) must have exclusive and independent authority to propose rates, terms and conditions of transmission service provided over the facilities it operates.

Charles Yeung
Enron

Independent Function.
No corporate affiliation with the merchant function.

Similar response as above (for merchant function).

In FERC Order 2000 and 2000A, RTOs are required to maintain a level of independence from market participants. The independence criteria in those FERC Orders should be reflected here by words or by reference.

Raymond L. Vice
Southern Company

Corporate versus Functional Independence: Statements in the CACTF white paper define the "Independent Function" to be "no corporate affiliation with the merchant function." This definition goes far beyond the definition mandated by FERC, which requires functional independence. Corporate independence provides no increased reliability to the power system. The definition of independence should be changed to:

Independent Function: Functional independence as required by FERC.

Robert S. Henry
Duke Power

The definitions of Independence and Market Functions need to be clarified. Depending on the definition of 'merchant function', the white paper may be suggesting a level of independence that is inconsistent with Order 2000 and that adopts a higher standard than that required by FERC.

Linda Campbell
FRCC

The **Independent Function** is defined as "No corporate affiliation with the Merchant Function". FRCC is not clear on the intent of this definition and not sure that it supports it as written. NERC's definitions should focus on reliability concerns only and should not be more stringent or restrictive than FERC's.

V. (Wally) Koschik
Manitoba Hydro

Manitoba Hydro supports the model proposed by the CACTF for the purposes of re-writing the Operating Policies to align the reliability requirements with the function. Presently, Control areas possess responsibilities that they may not be able to fulfill. Also the model could be put to good use to clearly delineate responsibilities of staff within a control area. In that aspect the work of the CACTF will well serve the evolution of the electricity industry.

However, we are concerned with the model's potential to degrade reliability if the intent is to force organizational separation (beyond requiring independence from the merchant function) of the Reliability functions from each other. This would tend to destroy the synergy that exists within the control areas and create potential for poor coordination and miscommunication between these functions.

Moreover, Manitoba Hydro does not support the CACTF notion of the independence of functions. Independence of function is not a reliability issue but one of energy policy, and NERC has no authority or mandate to be dealing in such matters. In Manitoba Hydro's case, vertical integration of function is a matter authorized by Canadian federal and provincial legislation and not by NERC. NERC is therefore venturing far beyond writing reliability standards and is attempting to prescribe energy policy for North America.

We also believe that the arguments that led the CACTF to propose independence and organizational separation of control area functions are extremely weak. There should be less complex, disruptive, potentially expensive solutions to the problems the CACTF has identified. Eliminating competitive advantages by control area affiliated marketers can be accomplished without specification of independence and organizational separation of the control area functions. For example, the inadvertent energy interchange problem could be addressed by requiring the control areas to implement an inadvertent pay-back scheme based on market value of energy, such as the one proposed in the ECAR Reliability Region.

Jim Maughn
SERC

Independence/Market Restructuring

SERC members fully agree that wholesale merchant functions must be independent from reliability functions; however, the White Paper introduces the term "corporate independence" which implies an industry restructure requirement that goes far beyond the "functional" independence standard imposed by FERC. NERC has no justification or authority to impose a more restrictive independence standard than that established in FERC Order No. 888 and 889. All references to "corporate independence" in the White Paper should be replaced with "functional independence". This is possibly the most critical issue in the White Paper.

George Bartlett
Entergy

The White Paper's "Corporate" Independence Requirement Attempts to Restructure the Electric Industry in a Manner that is not only Unnecessary, but is also Inconsistent with FERC Precedent.

Although Entergy agrees that reliability authorities should remain functionally independent from their wholesale merchant function, the White Paper not only exceeds NERC's authority, but it imposes an additional layer of independence requirements that are neither necessary nor advisable. The White Paper's restructuring proposal is inappropriate because: (1) FERC has already rejected a "corporate" independence requirement; (2) the prohibition on corporate affiliation undermines the FERC-approved concept of passively-owned Transcos; (3) many current Security Coordinators would be disqualified as Security Authorities unless they divested from their wholesale and retail merchant functions or alter stakeholder boards of directors; and (4) the additional costs associated with the restriction are significant and unjustified.

Under current FERC policy, transmission providers are required to "functionally" unbundle their transmission and wholesale merchant functions by restricting employees to performing one function. FERC also requires these employees to adhere to the Standards of Conduct, which governs employee conduct and prohibits the discriminatory disclosure of market information. Additionally, in Order No. 888, FERC rejected "corporate unbundling" or otherwise requiring transmission providers to separate transmission and wholesale merchant functions into separate corporations. FERC also does not require that the retail merchant function be independent from the transmission function.

The "corporate" independence requirement now proposed by the CACTF goes far beyond the "functional" independence requirement mandated by FERC. Through the corporate independence requirement, the White Paper radically restructures the electric industry by prohibiting corporate affiliation between a transmission provider and its wholesale, *and even retail*, merchant functions. This means that utilities that pass muster under FERC's functional independence standard would nevertheless have to divest their wholesale and retail merchant functions to be considered Transmission Service Provider's under the CACTF's White Paper. The White Paper fails to even address retail service issues, such as the "provider of last resort," that would arise from separating retail service from traditional utilities. Entergy does not believe that NERC has the authority to fundamentally alter the industry in this fashion, particularly where FERC has rejected similar restructuring proposals in the past.

The White Paper's independence requirement would also fundamentally restructure other aspects of the electric industry. For example, the prohibition against corporate affiliation directly undermines the FERC-approved concept of passively-owned Transcos (i.e., transmission companies that remain affiliated through passive ownership with merchant functions or other market participants). Order No. 2000 requires RTOs, including Transcos, to be Security Coordinators. The corporate independence criteria would prohibit a FERC-approved Transco from serving as a Security Authority (the successor to the Security Coordinator) or a Transmission Service Provider, in addition to performing any other Control Area functions to which the corporate independence standard is applied. A NERC-imposed requirement that Transcos contract with third-parties to perform Security Coordinator or Control Area functions is contrary to FERC policies allowing passive ownership and allowing RTOs flexibility in determining how to perform Security Coordinator and Control Area functions. Prohibiting a passively-owned Transco from serving as a Transmission Service Provider would effectively prevent these Transcos from becoming RTOs. In essence, the corporate independence standard is a direct attack on the very concept – already endorsed by FERC – of a passively-owned Transco.

Another example of the impact of a corporate independence standard relates to the Security Authority. Many current Security Coordinators have: (1) affiliated retail and wholesale marketing subsidiaries; or (2) stakeholder Boards of Directors whose board members often are affiliated with companies that have merchant functions. These entities would apparently also be disqualified from being Security Authorities by an independence requirement prohibiting corporate affiliation.

Notwithstanding the lack of authority to impose such a restructuring proposal, the White Paper's radical proposal is even more inappropriate because there is a less intrusive and less costly way of maintaining independence between reliability and merchant functions. Specifically, FERC concluded in Order No. 888 that functional unbundling was sufficient to ensure the independence of transmission providers from their wholesale merchant functions. There has been no showing that FERC's functional independence standard is inadequate for ensuring independence between Security Authorities, Balancing Authorities, Transmission Service Providers and wholesale merchant functions. In contrast, the corporate independence standard would impose significant costs by: (1) requiring utilities to divest or sell-off their wholesale and retail merchant functions to remain transmission providers; (2) mandating that a number of current Security Coordinators contract with third-parties to provide control area services; (3) separating retail service from the transmission provider utilities that have traditionally served retail customers; and (4) possibly requiring that Balancing Authorities (owners of generation) be corporately independent of merchant functions. In addition to the costs discussed above, the corporate independence standard is significantly more intrusive because it prohibits corporations from freely structuring their business operations. Thus, although the White Paper claims that its does not "favor a specific reliability or market organization or structure," in practice, it does in fact limit the ability of market participants to structure their operations.

Finally, if NERC accepts these restructuring proposals, it will be imposing industry-wide restrictions – inconsistent with and certainly more stringent than those currently deemed necessary by FERC – that relate to how transmission operations, wholesale merchant functions and even retail merchant functions may be organized or affiliated. The White Paper justifies this result – not on the basis of reliability – but solely on commercial grounds. Yet, NERC has traditionally considered itself primarily a reliability organization whose purpose is to ensure the reliable operation of the national grid. The White Paper's corporate independence standard and its treatment of retail merchant functions extend far beyond that reliability role and should be rejected.

Accordingly, the CACTF should eliminate the prohibition on corporate affiliation and modify its White Paper to adopt the functional independence standard endorsed by FERC. The White Paper should also be modified to specify that this functional independence applies to *wholesale* merchant groups – not *retail* merchant groups.

Code of Conduct

Provisions Affected:

r Security Authority, Criteria and Compliance (page 9)

- r Balancing Authority, Criteria and Compliance (page 11)
- r Transmission Service Provider, Criteria and Compliance (page 13)
- r Transmission Owner, Criteria and Compliance (page 15)
- r Transmission Operator, Criteria and Compliance (page 16)
- r Interchange Authority, Criteria and Compliance (page 17)

Text of Provision:

"Subject to Code of Conduct"

Proposed Revision:

"Subject to **FERC's** Code of Conduct"

Comments:

The CACTF White Paper fails to discuss what Code of Conduct must be adhered to by the new functional entities. The Code of Conduct already approved, and routinely enforced, by FERC should be more than adequate to achieve the desired effect. The FERC Code of Conduct provides for functional separation of employees who work in sensitive areas where the discriminatory sharing of information could lead to commercial advantage for some market participants. Additionally, the FERC Code of Conduct requires that *all* market information shared between affiliated entities must be simultaneously disclosed to the public, so as to avoid any unfair preference or advantage. The Code of Conduct also protects captive ratepayers from their potential subsidization of stockholder return on equity.

Pete Steitz and Pat Connors
Wisconsin Public Power Inc.

Wisconsin Public Power Inc. (WPPI) strongly supports the work of the Control Area Criteria Task Force and the conclusions and recommendations made in the White Paper of that Task Force. While we provide specific comments on the White Paper below, we wish to make it clear at the outset that we believe that the White Paper appropriately restructures the control area function. In particular, we strongly support the proposed independence requirements for the Security Authority and Balancing Authority functions identified. We also believe that the best policy would be to require independence from the Merchant Functions for the Interchange Authority.

In wrestling with the ENRON/TVA control area dispute last year, the Special Policy Interpretation Task Force appointed by the NERC Board urged NERC to take swift action to remove all competitive advantages from the control area function in order to preserve and enhance reliability. With the industry moving quickly to a competitive model, it is very clear that significant changes must be made in how reliability is ensured. First, as the NERC Board of Trustees has recognized, it is essential to move to a reliability system that is independent, mandatory and applies to all participants in the market. Competitive pressures create far too much of a risk that individual participants will cut corners and take actions that threaten reliability and violate NERC rules if the system is not enforceable.

It is equally clear that key reliability functions must be performed in a highly credible fashion that is competitively neutral. A system, as we have today, where some competitors, usually dominant incumbents, are able to exercise reliability authority over competitors and new entrants that affects the ability of those entities to participate in the market economically and a system that also provides those incumbents with reliability authority with valuable market information not available to others, undermines the credibility of the reliability function and distorts the market. As we have seen, control area status today provides significant competitive advantages not related to reliability. We face the threat of a massive proliferation of control areas with new players seeking to create control areas that are unnecessary electrically or for reliability in order to gain the competitive advantages that control areas have. This trend is inevitable, unless NERC acts to take away control area competitive advantages, as urged by the Policy Interpretative Task Force. Clearly, the creation of many new unnecessary control areas is not consistent with the goal of enhancing reliability and efficiency in the industry. The recommendations of the White Paper should be implemented promptly so the industry can move in the far more rational direction of a consolidation of control areas.

The White Paper would require the Security Authority and the Balancing Area functions to be "independent" of any market participant. Correctly and courageously, the White Paper defines independence as having no corporate affiliation with the Merchant Function and the Merchant Function is defined to include generating, selling, reselling or purchasing electric energy or capacity or related services. In other words, the Merchant Function embraces activities related to the retail provision of electric service, as well as wholesale service. WPPI believes these definitions are correct and essential. Some commenters undoubtedly will seek to limit the Merchant Function to wholesale sales, omitting coverage of most of the use of the bulk power system and thereby retaining significant competitive advantages for some participants. They will rely on FERC's code of conduct deliberations, but will neglect to recognize that FERC only regulates wholesale and not retail service. NERC, in contrast, is responsible for the reliability of the bulk power system, whatever its use. Competitive advantages at retail gained from the current control area function pose the same negative impact on reliability as the competitive advantages gained at wholesale.

The standard of corporate independence is very important. The alternative is a complicated separation of function requirements within a single entity and is clearly second best. Codes of conduct and "walls" are very hard to police and monitor and will provide no where near as much crucial credibility as corporate separation. It is obvious that employees of a company will naturally and, perhaps, unconsciously, tend to make decisions in the interest of the company of which they are a part. They often know what is in the interest of their company as a whole without discussion with others in other functions and employees are rotated between functions in ways that help spread this knowledge.

The Security Authority function is solely to safeguard the reliability of the bulk power system in real time. A Security Authority must have complete credibility to be effective. Security Authorities will take actions to preserve reliability that have very significant economic consequences for different participants in the market. To have those actions taken by a large competitor harming other competitors is simply untenable and will undermine market participants in the validity of what may be, in fact, essential reliability measures. Where there is no corporate affiliation whatsoever, this problem is completely alleviated. The same observations apply to the Balancing Authority function that will keep the regional market in real time balance, enabling sellers and buyers of energy to participate in a market on equal terms.

As noted above, WPPI also believes that the Interchange Authority should be independent because of the knowledge that the Interchange Authority necessarily will have of the transactions of a large number of market participants. Clearly, this knowledge provides a significant competitive advantage. If any compromise is made on requiring corporate separation, it should be at the Interchange Authority level, but not at the Security Authority or Balancing Authority level, but an independence requirement should still be imposed.

WPPI expects the conclusions and recommendations of the White Paper to be contested vehemently, in particular, by some large, vertically-integrated utilities that operate control areas today and benefit significantly from the competitive advantages bestowed on them in this role. The very strength of their opposition will validate the conclusions of the White Paper and the need for change. The competitive advantages identified in the White Paper are obviously very real. Just as clearly, the functions of ensuring real time security, keeping the system in a broad geographic area in balance and on frequency and of reconciling schedules should be separated from the market and should not bestow significantly competitive advantages on any market participant.

Response

The Task Force agrees with the reasons stated by Messrs. Steitz and Connors on the needs for independence for the Security Authority and Balancing Authority. The Task Force also believes the Transmission Service Provider must be independent of the Merchant Function.

On the other hand, many readers state that the CACTF has overstepped its bounds, first, by requiring that certain authorities or functions be "Independent" of the "Merchant Function," and, second, by setting such independence requirements beyond those that FERC defines in either Order 888/889 or Order 2000. The Reliability Model does indeed require Independence of certain reliability functions and authorities that goes well beyond FERC's requirements. The Task Force understands the strong feelings of those who object to this, but believes that FERC's definitions of Independence in Order 888/889 and 2000 are not comprehensive enough to adequately cover the functions and authorities in the Model.

Also, many readers have clearly pointed out that NERC, at least in its present form, can not require any organization to physically separate its reliability functions from its merchant functions. The Task Force agrees. Nevertheless, the Task Force believes it must identify the Independence requirements that it feels are necessary to meet the objectives stated in its Scope and include those requirements in its recommendations to NERC. It will then be up to the NERC Standing Committees, Board of Trustees, and probably federal regulators, state public utilities commissions, and provincial governments to ultimately decide marketplace structure, including the breadth and depth of Independence of the reliability functions from the merchant functions.

The CACTF believes that NERC should neither wittingly nor unwittingly develop Operating Policies and Standards that provide a commercial advantage to performing reliability functions or preclude market viability. Therefore, NERC must look at those functions that should be independent from the marketplace.

Requirements for Independence

As the Task Force explained in the "Introduction" Section, the market plays a major role in providing MW resources for energy sales and Ancillary Services in many parts of the U.S. and Canada, and the Task Force believes that a viable electricity market is essential for a reliable bulk power system. The Task Force is quite concerned that allowing the Balancing Authority, Security Authority, or Transmission Service Provider to also engage in the merchant function could preclude other merchants from the marketplace and discourage their investment in generating plants that are needed to ensure adequate energy resources or Ancillary Services. The Task Force does not agree with those readers who imply that commercial functions have no impact on the reliability of the customers' electricity service.

Even in areas where markets do not exist, the Transmission Service Provider and Security Authority must be independent in all situations because their actions, such as invoking local or Interconnection-wide line load relief procedures, can affect the marketplace in other areas of the Interconnection. Allowing the Transmission Service Provider or Security Authority to be affiliated with the Merchant Function provides the opportunity for the entities performing these authority functions to favor their own customers or generation resources over others. The FERC believes similarly in its Order 888/889 regarding Transmission Providers and Order 2000 regarding the Security Coordinator function of the RTO. (We note that FERC requires independence from the wholesale merchant function only, while the Task Force believes that independence should also extend to the retail merchant function as explained in the "Definition of 'Independence'" Section below.)

Regarding the Balancing Authority, in reviewing these public comments as well as comments from the Spring workshop "breakout" sessions, the Task Force agrees there may not be a need for the Balancing Authority to be independent under the following three circumstances:

1. **Where the customer has no choice of energy suppliers** (e.g., the Load-Serving Entity is using its own generation to serve its load). Some states have not deregulated their electric utilities, or in some cases, do not allow merchant plants to be built within their borders.
2. **When regulatory requirements would prevent such independence**. This may be the case with some municipal or state utilities or utilities in Canada.
3. **In the case of a "generation-only" Balancing Authority** that does not serve native load and where generation is owned by a single corporate entity.

The Task Force will discuss Balancing Authority Independence in the next version of the White Paper, but it will be up to NERC's Policies and Standards to explicitly list those situations where the Balancing Authority would be excused from the Independence Requirements defined in the Reliability Model. (see "Independence – Balancing Authority" section of these comments)

Mr. Koschik expressed concern that the Independence requirements would tend to "destroy the synergy that exists within the Control Areas and create potential for poor coordination…". The Task Force emphasizes that the Control Area can still exist as an organization that has "rolled up" several reliability functions.

Definition of "Independence"

As many readers have pointed out, the Reliability Model does set Independence requirements that go beyond those established by FERC. There are four reasons for this:

1. **FERC's definition of Independence pertains only to the Transmission Provider (in Order 888/889) and the RTO (in Order 2000).** The Reliability Model also defines the Balancing Authority and Interchange Authority, neither of which FERC has addressed in its orders. Also, the Reliability Model defines functions that may be rolled up into other types of organizations, such as Gridcos, Transcos, Control Areas, and so on.
2. **Functional separation alone does not provide the maximum assurances of fairness to the marketplace**. The Task Force believes that Independence requires *physical, corporate separation* of reliability functions from merchant functions. Agreements, Standards of

Conduct, and audits are also important, but only physical separation at the corporate level provides the marketplace with maximum assurances that those entities performing reliability functions do not favor one set of customers or suppliers over another.

3. **Independence from the re tail merchant function is no less important than from the wholesale merchant function.** Even though FERC extends its Independence requirements to only the wholesale merchant function, the Task Force sees no logical reason that it should not also include the retail merchant function. For example, the Security Authority or Transmission Service Provider could favor its own native load customers when performing line loading relief, or the Balancing Authority could favor its affiliated generators when supplying energy to the Load-Serving Entities within its area.

   The NERC Board of Trustees broached the subject of Independence of Security Coordinators at its June 22 – 23, 2000 meeting. While it took no formal action, the sense of the Board is that Security Coordinators must be independent from both the wholesale and retail merchant function.

   As Mr. Yeung suggests, the next version of the White Paper will include the definition of Independence as including both the wholesale and retail merchant function. The Task Force will also review the Security Coordinator Standards of Conduct with regard to the definition of Merchant Function as Ms. Campbell suggests.

4. **Many organizations are not under FERC's jurisdiction.** The Task Force knows that many non-FERC jurisdictional utilities have filed their version of the *pro forma* tariff and have reciprocity agreements with Transmission Providers who are under FERC jurisdiction. Nevertheless, there are municipal and cooperative utilities who are not bound by any FERC regulations. Other than the reasons discussed in the requirements for Balancing Authority Independence listed above, the Task Force believes that FERC jurisdiction is not a prerequisite for adhering to Independence requirements of the reliability functions described in the Reliability Model.

Delegation of Authority

The Task Force believes that the delegation of market-sensitive functions can only be handled by entities who meet the same independence requirements as the delegating authority. It's important to recognize the difference between delegating *functions* and contracting for *services*. For example, a Balancing Authority may contract for ancillary *services* from a merchant entity, who, by definition, isn't independent. On the other hand, the Balancing Authority may delegate the frequency response *function* to another entity, in which case that entity must meet the same independence requirements as the Balancing Authority.

Codes of Conduct

Regarding Codes of Conduct for the Balancing Authority, Security Authority, Interchange Authority, and Transmission Service Provider, the Task Force agrees with several readers that these need to be defined. This will be handled through NERC Policies and Standards, not the White Paper.

Inadvertent Settlement

In response to Mr. Koschik's suggestion about inadvertent settlement, the CACTF agrees that a market-based inadvertent settlement procedure is one example of a way to address one of the commercial advantage issues. However, Policies, Standards, Codes of Conduct, and penalties do not afford the same effectiveness in promoting viable electricity markets in many cases as requirements for Independence between reliability and merchant functions. (See "Independence – Balancing Authority" Section that follows for additional details.)

Independence – Balancing Authority

Raymond L. Vice
Southern Company

BA Independence: The Balancing Authority (BA) function must be functionally independent of any merchant functions if it is specifying and procuring Ancillary Services as it is required. Ancillary Services are **required** of the market participants in amounts and, essentially, at network locations as dictated by the entity responsible for real time control (BA).

Another point requiring BA functional independence of the marketing entity is it approves all transactions sourcing or sinking under the BA's authority. It will know all deals. Confidentiality before implementation requires functional independence.

Linda Campbell
FRCC

Balancing Authority: On page 9 (of the White Paper), under the Criteria and Compliance section, it states, "Must be independent of the Merchant Function". FRCC does not support the conclusion of the CACTF that the Balancing Authority (BA) must be independent. FRCC is very concerned about the cost impact this requirement would impose. The CACTF should provide a cost estimate along with a benefit analysis. FRCC does not see any benefit in requiring the BA to be independent.

Since the Balancing Authority should not have to be independent, the functions of the Interchange Authority could be accomplished by the Balancing Authority; thereby eliminating the need for the Interchange Authority.

Stephen S. Crutchfield
CP&L Energy Control Ctr.

CP&L feels that the CACTF has done a commendable job in creating the vision presented in the White Paper. The major issue that we have is the requirement of independence for the Balancing Authority (BA). This would preclude most current control areas from continuing to operate their own generating resources for load and interchange. We understand the independence requirement in a completely deregulated environment with retail competition. However, until full retail competition is in place, we do not feel the need to have an independent BA. We do not agree with the requirement of independence for the BA and feel that it should be removed from the White Paper and any NERC documents and Policies that may come about as a result of the work by the CACTF.

If NERC or its other members believe that the Balancing Authority has incentives to not follow and comply with NERC policies, then CP&L would rather NERC establish economic balancing incentives for balancing entities. Even with independent BA acting as balancing authorities, there could be times when balancing policies are circumvented for economic gain of the region.

Thus, the "independence" criteria should not be a substitute for proper balancing policies that include proper economic signals.

Vern Colbert
Virginia Power

Finally, although this is only addressed indirectly in the white paper, we want to make it very clear that we would also oppose any similar independence criteria being extended to the Interchange Authority or Balancing Authority. The statement made in the paper that "*Since the Balancing Authority will be deploying Interconnected Operations Services in load-generation balancing, the Task Force believes this must also be independent of all merchant functions*" simply has not been supported with fact. Furthermore, given the current ongoing debate on even adopting Policy 10 as a NERC guide, it appears extremely premature to then propose independence criteria of this kind. The whole premise of the white paper that ultimate reliability can only be achieved by strict independence of all its component parts, needs to be carefully reviewed in total and in the light of existing FERC policies.

Ron Gunderson, Al Boesch, Paul Brune
Nebraska Public Power District

The Balancing Authority (BA) should not be required to be independent from Generation and Load.

The experience of current ISO's which have attempted to develop a market for regulation and balancing services has not had much success in getting a competitive market established. The services that are required of a BA are not services that the merchant community is jumping to provide. Most generators would prefer not to provide these services. Standards of Conduct with audit provisions should be sufficient to prevent preferential treatment. The redundant AGC costs of independence would require are not warranted given the questionable benefits to reliability. The fact that the BA has generation that can be ordered to move is a benefit when responding to emergency conditions on the power system. Appendix 9B to the NERC Policies is a fine example of the reliability advantages of having a Balancing Authority associated with generation and load. Making this function independent from the resources necessary to accomplish the function would actually be a detriment to reliability. The BA will ultimately be responsible for the load and generation within its balancing area and therefore is the natural choice to be the provider of last resort. If an entity does not arrange for these services it is the BA who will provide these services by default.

Response

As Mr. Vice points out, the Balancing Authority needs to be independent:

1. To ensure a fair market for providing Ancillary Services, and
2. Ensure impartiality when issuing dispatch orders to maintain real-time generation/load/interchange balance. Such dispatch orders, when given by an entity that is affiliated with a merchant function, will be subject to challenges for real and perceived bias (unless the Balancing Authority is a single-entity, generation-only).

The Task Force is not making claims that reliability can only be achieved by strict independence; rather, it is of the opinion that independence is the key to remove the commercial advantages of the existing

Control Areas and the perceived preferential treatments by the existing Security Coordinators and Control Areas.

Regarding Messrs. Gunderson, Boesch, and Brune's comments that Standards of Conduct with audit provisions should be sufficient to prevent preferential treatment, it is the Task Force's opinion, supported by many in the industry, that codes of conduct alone are insufficient to prevent preferential treatment, real or perceived. FERC explains the need for independence—not just code of conduct requirements—in its RTO rehearing order:

> **Rehearing Requests**
>
> Duke objects generally to the Commission's focus on ownership, asserting that the Commission's approach is overly rigid and that the Commission has not examined whether there are less restrictive means to meet the independence criterion. Duke first asks the Commission to reconsider the structure allowed for the natural gas industry, where affiliated production and marketing companies are permitted. Duke does not challenge the Commission's observation that the electric industry evidences a much higher level of vertical integration, but argues that there is no reason to require separation of control of transmission and merchant activities to a greater extent than is permitted in the gas industry. Duke also suggests that the Commission could allow affiliated transcos subject to a requirement that they retain an independent auditor to review the activities and decisions of the affiliated transco from the standpoint of potential discrimination and compliance with codes of conduct and file regular reports of its findings.
>
> Conectiv asks that the Commission clarify that the ownership requirements do not apply to the non-profit ISO form of RTO, but would only apply to transcos and other for-profit entities with voting securities. It asserts that the record does not support ownership restrictions for non-profit RTOs.
>
> **Commission Conclusion**
>
> We do not agree that the structure currently in place for the gas industry would adequately support independent RTOs. As Duke itself notes, it would allow the senior management of an entity that operates in both the transmission and generation arenas to participate in decisions involving the transmission business. These decisions would, as a matter of course, have a significant effect on that same entity's generation business. **We also disagree that independent auditing alone can substitute for the independence requirement. As we noted in the Final Rule, we have found that in the electric industry, it is difficult to monitor compliance with codes of conduct.** Moreover, it is a very intrusive form of regulation and ultimately requires us to be "chasing after conduct." As we noted in the Final Rule, this is not the light-handed regulation that is essential to support emerging competitive markets. *(Pages 27 – 28)*

Mr. Colbert correctly notes that the Interconnected Operations Services that NERC is defining are not yet in place. But these IOServices are only a way of breaking the FERC-specified Ancillary Services—which are in place—into their basic building blocks. Even if Policy 10 is not approved, there will be a need for generation-based Ancillary Services, and the Task Force believes that Balancing Authority independence is important to ensure a viable market for providing those services.

Regarding Mr. Crutchfield's comments regarding the need for Balancing Authority independence only "…in a completely deregulated environment with retail competition," we agree that in those situations, Balancing Authority independence may not be necessary. (See discussion in Independence – General" Section)

As Ms. Campbell suggests, the Balancing Authority and Interchange Authority could be rolled into a single organization. And one could even call this organization a Control Area.

Independence – Interchange Authority

Raymond L. Vice
Southern Company

Definition of the Interchange Authority and Its Independence: Most definitely, further discussion and definition is needed on the functionality of the Interchange Authority(IA). There is confusion over the current definition and hence the debate over whether or not this function should be functionally independent of the energy merchant function. The IA can be seen providing a service for the merchant function in being the contact for real-time operation problems, final approval on deals, etc. Yet, it also provides the security function of distributing and assembling approvals and communicating transaction status. Due to data timing requirements, each marketing entity could not be an IA as that would create too many entities involved in checkout, etc. Therefore an IA must handle more than one marketer's data which would require it to be functionally independent of the merchant function. A strong factor contributing to functional independence is the marketing entities would demand the IA's functional independence of any merchant function.

Linda Campbell
FRCC

Interchange Authority: On page 15, under the Criteria and Compliance section, it states "Subject to Code of Conduct". FRCC is not clear what this code of conduct is for and why it would be required.

Gerald Mellinger
Allegheny Power
(White Paper markup comments)
Due to the commercial sensitivity of the information that will be handled by the IA, it is imperative that this entity be independent of all merchant functions. Closely monitoring this entity will not dispel any appearance or suspicion of collusion. Plus, even if this entity is closely monitored, there will be ways to use the system to commercial advantage. Therefore, ties to any merchant function should be dissolved.

Why be subject to Code of Conduct if they are not required to be independent of the Merchant Function? The argument that the IA does not have decision-making authority may be true.

However, this entity is privy to a great deal of market sensitive information. The second bullet is incorrect. This entity **MUST** be independent.). Based on the responsibilities listed below, the merchant would indeed be privy to information that is truly market-sensitive if this is not independent of the merchant function. Therefore, it must be independent.

Ron Gunderson, Al Boesch, Paul Brune
Nebraska Public Power District

The Interchange Authority (IA) does not have to be independent from any Merchant Function.

Having the interchange authority independent of any merchant function does not enhance or degrade the reliability of the power system. Therefore this should be a non-issue for NERC. This assumes that the IA is subject to compliance reviews and audits to ensure compliance to NERC requirements. The IA should be required to comply with the applicable NERC Policies and face penalties if it disregards these standards.

George Bartlett
Entergy

The White Paper does not state whether the Interchange Authority will be independent of the merchant function. Entergy believes that the Interchange Authority will have to be independent. If the Interchange Authority is not independent, then other market participants will not share the market information contained in schedules and tags with the Interchange Authority. The result will be that each market participant will become its own Interchange Authority. As a practical matter, such a result would be unworkable because the Balancing Authority would then have to coordinate with literally hundreds of Interchange Authorities when approving each day's transactions. Therefore, the Interchange Authority will have to be independent.

Response

The Task Force has debated the Interchange Authority "independence" issue at great length and concluded that the Interchange Authority could be either affiliated or independent. The CACTF believes that there are opportunities for both kinds of IAs to exist simultaneously, depending on the need and situation. It is likely that an IA who is affiliated with a merchant would only provide IA services for that merchant. Other merchants would either form their own IAs or use an independent IA.

The IA only knows those transactions that are submitted by PSEs to the IA—the IA can not obtain information on any other Transactions.

The CACTF believes that the Load-Serving Entity should be able to specify which IA the PSE uses in setting up the Transaction. Therefore, if a Load-Serving Entity is not comfortable with using the services of an Interchange Authority that is affiliated with the merchant function, it can specify that the PSE use an Independent IA.

Regarding the Code of Conduct requirement that Ms. Campbell and Mr. Mellinger question, the Task Force believes that Codes of Conduct are necessary for the Interchange Authority function—as well as the other Reliability Functions defined in the Reliability Model—to ensure marketplace trust in the entities who serve these functions. This is similar to the Standards of Conduct that NERC recently required of the Security Coordinators.

Independence – Transmission Service Provider

Raymond L. Vice
Southern Company

Functional Independence of Transmission Functions: Due to FERC requirements for comparable service, it is obvious that the Transmission Provider and the Transmission Operator must be functionally independent of the energy merchant function. The Transmission Owner may be functionally independent but does not have to be. If the Transmission Owner is not functionally independent of the energy merchant function, it cannot fulfill either of the functions of Transmission Provider or Transmission Operator. If the Transmission Owner is functionally independent of the merchant function, it can provide Transmission Provider and Transmission Operator functions.

Linda Campbell
FRCC

Transmission Service Provider: On page 11, under the Criteria and Compliance section, there is no bullet requiring that it "Must be independent of the merchant function". FRCC believes that bullet should be added as is shown with the other independent functions.

Ron Gunderson, Al Boesch, Paul Brune
Nebraska Public Power District

The TSP should not be required to be independent from the Transmission Owners and Operators.

Having the TSP independent from owners and operators does not enhance the reliability of the power system. NERC should focus on what is required for reliability and incorporating independence requirements that are required by FERC to insure a fair and open market. Certainly if the owner/operator is a transco, there should not be any reason for that entity to discriminate when providing transmission service. This is not a reliability issue and therefore independence should not be mandated by NERC. It is simply out of scope.

Response

The Task Force agrees with Mr. Vice's explanation of the Transmission Service Provider/Operator/Owner relationships, and the next version of the White Paper will clarify them.

Regarding Messrs. Gunderson, Boesch, and Brune's comments, please refer to the sections "Independence – General," and "Transco Issues."

We will add the bullet item that Ms. Campbell recommends in the next version of the White Paper.

Attachment 2 – Public Comments on "Independence" from Second White Paper Draft

(Note: the Task Force is still preparing its responses to these comments)

Independence – General

Vern Colbert
Dominion Virginia Power
In the Independence section the white paper states "The Task Force believes that Independence requires physical and corporate separation of reliability functions from merchant functions". We take strong exception to this statement that proposes a separation criteria that is completely unfounded in the present industry. The Task Force's proposal is not only unsupported with facts to defend this position, but it also completely ignores the tremendous changes to infrastructure that even approaching this criteria would require. In short, we strongly believe that the cure proposed (requiring complete physical and corporate separation) would cause more reliability problems than it would propose to cure. Simply put, the industry will not support this part of the model and the white paper should recognize this.

The paper goes on to further state "…the Task Force does not believe that FERC's definitions in Order 888/889 are comprehensive enough to adequately define the relationship between the Reliability Model's various reliability functions…" Here it appears that the Task Force is setting itself above even the FERC who has already established jurisdiction in this area, issued rules, and reconfirmed these rules in its subsequent orders. It is not reasonable for the Task Force to take a position where NERC would issue policies that supercede the FERC or any other federal agency.

Finally, the white paper also proposes that the Balancing Authority, Security Authority, and Transmission Service Provider must meet similar stringent independence criteria from the merchant function. We want to make it clear that we would similarly oppose these independence criteria being extended on the same grounds noted above. The whole premise of the white paper that ultimate reliability can only be achieved by complete independence of all its component parts, needs to be carefully reviewed in light of existing FERC policies and a realistic appraisal of what the industry will support.

Kenneth J. Skrobak
Alabama Electric Coop.

I have concerns over the Independence requirements, as they are currently set up. I don't think that corporate separation should be required for the smaller utilities (e.g. coops and munis) that do not possess market power in transmission or generation.

John G. Mosier, Jr.
NPCC

A fundamental goal of the CACTF effort was to be the identification and separation of those functions conducted within the existing control area which impart commercial advantage. This is still not clearly delineated within the model. Rather than simply segregating those few commercial functions, the unbundling of all control area functions has introduced a more contentious and difficult issue of defining independence between and among the various components of the model. The white paper currently calls for the necessity of "... physical and corporate separation ..." to achieve such independence. This is not necessary to achieve the dual goals of the separation of reliability and commercial interests while maintaining a fair and open marketplace. To the contrary, needless confusion is introduced into the model. For example, the White Paper designates the Balancing Authority as the "provider of last resort," and, in this capacity, is charged to acquire Ancillary Services as necessary to fulfill this responsibility. Yet in so doing the Balancing Authority relies on the marketplace, blurring its perceived independence. It is equally important to realize that the evolution of the marketplace is not at the same point throughout North America. The current structure within North America is largely divided between the cost based operating entity and the market based, or bid based, operating entity.

Charles Yeung
Enron

Independence is Required. NERC's proposed Reliability Model is one approach to provide entities a structure for unbundling of these services and maintain the necessary operational functions to ensure the reliability of the Interconnected transmission system. To move forward with this effort, NERC must now prescribe the necessary independence requirements as identified in the Reliability Model to ensure the unbundling of these functions facilitate the open access and non-discriminatory requirements of FERC's Order 888 and Order 2000.

Enron believes that total independence is essential for the reliability functions: SA, TSP and BA. The IA, since it can be readily substituted, does not require independence from the marketing function. Enron also believes that the retail merchant function of a vertically integrated utility must be separated from the transmission operations functions. Total separation is needed to maintain reliability of the Interconnection in the new marketplace.

Functional separation of transmission operators from the wholesale merchant functions and a code of conduct restricting the pass through of information does not remedy the possibility of discriminatory behavior. Economic or discriminatory decisions must not impact operational decisions. An operator (SA, BA, or TSP) favoring one set of transactions over another (e.g.- affiliated LSE's load contracts over third party's point-to-point service) may not take the most efficient course of action to remedy an operational problem such as a transmission constraint. Most often, the fastest and most efficient means to alleviate transmission equipment overload is by moving generation closest in to the problem. Such decisions should not be impaired by economic influence.

Proposed Action. Enron agrees with many of the CACTF responses to the concerns expressed in public comments on Version 1 and from the first round of industry workshops. However, due to the industry's transition into a RTO structure, Enron urges the CACTF to begin mapping these Reliability Model functions to the structures as proposed by the RTO filings as details of organizations and functions emerge.

The Reliability Model defines the fundamental functions for all reliability/market interface structures. No work has been done yet to match the RTO structures with the Reliability Model. Such a "mapping" will provide a gauge of how the RTO structures meet the reliability and independence requirements.

Enron urges the CACTF and OC to finalize the Reliability Model and its independence requirements in time for a vote by the Board of Trustees at its February 2001 meeting and begin the implementation of these concepts. Enron also encourages the Market Interface Committee and the Operating Committee to take up tasks as appropriate that will involve NERC actively in the RTO formation process from the perspective of the Reliability Model. Any changes to NERC rules to support the implementation of the Reliability Model by the start of the RTO operations must also begin.

Curtis Crum
NIPSCO

Very little discussion is given to state rights versus federal government.

The task force needs to substantiate why independence of all the reliability functions from the merchant functions is required to ensure a viable electricity market, when it is not required for either reliability or the model. Some of the ancillary services provided from the reliability functions are obtained by controlling assets of the market functions.

Edward Scott
FRCC

There needs to be a clear expla nation as to what is meant by physically separated. FRCC recognizes that the independence of the reliability function from the merchant function is a very important issue to the marketplace. However, as stated in the above paragraph the validity of this reliability model does not depend on any one definition of independence. FRCC supports the separation or breakout of the reliability functions as identified. FRCC would recommend that all requirements of independence be removed from the reliability model. The model should focus on the responsibilities of all the reliability functions and leave the subject of independence to FERC and other regulatory bodies. If independence continues to be such a divisive issue, FRCC believes it is better to approve the model without independence requirements than to not have the model at all.

George Bartlett
Entergy Services, Inc.

The CACTF Should Reconsider Its Recommendation to Require Corporate Independence. Entergy commends the CACTF for its frank and straightforward treatment of the difficult issue of independence. From the outset, Entergy stresses that it shares the CACTF's conviction that reliability authorities should remain independent from wholesale merchant functions. Entergy concurs in the CACTF's conclusion that NERC lacks the authority to impose a corporate independence standard that is contrary to FERC regulations. Entergy also agrees that the Reliability Model is not dependent on the corporate independence standard, and agrees that the corporate standard should be considered, at most, a recommendation of the CACTF.

While Entergy appreciates the CACTF's frankness, Entergy requests that the CACTF reexamine the White Paper's conclusion that corporate independence should be recommended. As the CACTF is aware, FERC has considered independence in both of its landmark electric restructuring orders and has rejected it both times. Additionally, the NERC's General Counsel has also rejected corporate independence as the standard required for Security Coordinators. The CACTF should not waste this opportunity to have its voice heard on the independence issue by proposing a rejected standard that finds little support in the industry and even less chance of being implemented.

The second White Paper states that, "[t]he Task Force's recommendations on Independence stems from the Operating Committee's charge to 'accommodate the marketplace' and to 'remove the economic advantages of performing reliability functions.'" In this regard, the CACTF has identified only two such economic advantages – parking and inadvertent interchange. However, as the second version of the White Paper demonstrates, one of the two – parking – is actually not a commercial advantage derived from performing reliability functions and, thus, does not support the CACTF's recommendations regarding corporate independence. The only remaining commercial advantage claimed by the CACTF – Inadvertent Interchange – is really a question of revising NERC standards, not Control Area reliability functions.

The second White Paper also offers the following statement as an additional justification for imposing corporate independence, "[a]greements, Standards of Conduct, and audits are also important, but only physical separation at the corporate level provides the marketplace with maximum assurances that those entities performing reliability functions do not favor one set of customers or suppliers over another." Rather than relying on commercial advantages, the second White Paper appears to rely solely on the notion that "maximum assurance" for the marketplace is the only factor that should determine the degree of independence required for reliability authorities. This approach is short-sighted and the White Paper should clarify whether any other factors were considered in determining the appropriate degree of independence. Specifically, flexibility, effectiveness, and cost are just some of the considerations that improve reliability but are sacrificed (or at least ignored) solely to achieve the "maximum assurance" for the marketplace.

In Order Nos. 888 and 2000, FERC considered all of these factors (assurance to the market, flexibility, cost, etc.) and concluded that independence short of corporate divestiture provides a high degree of assurance to market participants, while also obtaining other equally important goals. With regard to Control Area restructuring, there has been no showing that functional independence would not work, and there has been no showing that it is necessary to secure the highest degree of independence by trading off the lowest degree of flexibility, cost-effectiveness and efficiency. The White Paper should recognize that the extreme degree of independence comes at a cost and explain why that cost is justified here.

In response to comments, the White Paper addresses why the CACTF believes FERC's definition of independence does not apply. The White Paper first states that the FERC orders pertain to Transmission Providers and RTOs, not the root-level reliability functions. However, the White Paper never explains why the two should be treated differently. Moreover, the simple fact that FERC did not define BAs or IAs does not explain why a more stringent standard should be applied to those entities, particularly when FERC has concluded that the functional independence standard is sufficient for the entities that have traditionally performed the functions of the BA and IA (*i.e.*, Transmission Providers and RTOs). Additionally, the White Paper also states that many organizations are not under FERC's jurisdiction. Even if FERC jurisdiction is not a prerequisite for adhering to independence requirements, this does not explain why corporate independence or FERC's decisions should be rejected.[7] In sum, these explanations, at best, are relevant to why NERC can set its own standard; they do not address what that standard should be or refute the substance of FERC's position on functional independence.[1] (The White Paper states that independence from retail merchant functions is no less important than from the wholesale merchant functions. While Entergy disagrees with this statement for the reasons identified in its first comments, this statement of course does not demonstrate that corporate independence is warranted.)

In the final analysis the White Paper's justification for a corporate independence standard rests on one ground and one ground alone: the CACTF's belief that anything short of corporate independence will not eliminate the market's *perception* that reliability functions are being performed unfairly. The White Paper concludes this is sufficient to recommend corporate divestiture, even though: (1) there has been no showing that functional independence will not work; (2) the CACTF concedes that corporate independence is not required for reliability; (3) FERC has addressed the need for corporate divestiture twice and rejected it both times; (4) NERC has also decided not to require corporate independence for Security Coordinators; and (5) the only two commercial advantages identified are irrelevant to Control

[7] The White Paper states that independence from retail merchant functions is no less important than from the wholesale merchant functions. While Entergy disagrees with this statement for the reasons identified in its first comments, this statement of course does not demonstrate that corporate independence is warranted.

Area restructuring. Entergy requests that the CACTF reconsider its decision to recommend a corporate independence standard.

Finally, Entergy also requests that the CACTF clarify the Reliability Model's treatment of Transcos. Although the White Paper states that the Reliability Model will accommodate Transcos, the CACTF's posted responses to the first set of comments state that Transco's that are not corporately independent (*i.e.*, passively-owned Transcos) cannot be Transmission Service Providers. The White Paper should specifically explain whether it is precluding the FERC-approved concept of passively-owned Transcos as Transmission Service Providers and, if so, the basis for its decision.

Stan Mason
SWPA

The CACTF, NERC Operating Committee, and/or NERC Board of Trustees should not be an alternative regulatory forum for FERC. Many, if not all, of the arguments forwarded by market players have been made before at FERC. FERC listened to all interventions and then made rulings. NERC should not, wittingly or unwittingly, become the equivalent of an appeals court for the market when it does not like a FERC ruling.

With this in mind, the CACTF is overstepping its authority to make recommendations on physical and corporate separation of functions. It is obvious the CACTF did not apply its "Independence" yardstick equitably to merchant functions. To insert a merchant or merchant affiliated Interchange Authority function between the Security Authority function and the Balancing Authority function empowers the merchant function to "direct, organize, or execute" a reliability function of interchange scheduling. This violates a core principle of separation of function as defined by FERC.

Peter Steitz
Wisconsin Public Power

Independence of Reliability Functions. Regarding independence requirements, we also addressed this in our August 24 comments. We agree with the task force that independence requires "physical and corporate separation" of reliability functions from merchant functions and that this independence requirement also applies to the Balancing Authority, Security Authority, and Transmission Service Provider functions. The white paper identifies some exceptions to the independence requirement for the Balancing Authority. Specifically, the task force concluded that there may not be a need for a Balancing Authority to be independent:

a. **Where the customer has no choice of energy suppliers** (e.g., the Load-Serving Entity is using its own generation to serve its load). In the task force's view, this might apply where states have not deregulated their electric utilities, or in some cases, do not allow merchant plants to be built within their borders.

b. **When regulatory requirements would prevent such independence.** This may be the case with some municipal, state, provincial, or federal utilities.

c. **In the case of a "generation-only" Balancing Authority** that does not serve native load and where generation is owned by a single corporate entity.

Our position is that independence (corporate and physical) needs to be the goal in any situation where more than one market participating entity operates within a given Control Area. In other words, wherever there are competing Generators, Load Serving Entities, and/or Purchasing-Selling Entities operating within the electrical boundaries of a Balancing Authority, independence needs to be the goal, both corporate and physical.

V. (Wally) Koschik
Manitoba Hydro

In this version of the White paper, the issue of independence is dealt with extensively and there is a waiver proposed for the Balancing Authority, but not for the Security Authority and the Transmission Also the definition of merchant function has been expanded to include the retail merchant function, going beyond even the FERC definition of "Merchant function".

One could argue that independence does not seem to be an essential requirement if it is acceptable to have the requirement waived in some cases (e.g., where legislation does not permit). Certainly the argument for independence is weakened considerably by waivers. In our view, either independence is essential - or it is not justified as a requirement at all.

Furthermore, in Version 1, the case for independence of certain functions was based primarily on two commercial advantages of Control Areas namely, the ability to park and hub and to pay back inadvertent energy in kind.

In this version, the first advantage now appears to be a non-issue and the second is addressed by having NERC adopt a cash payback mechanism such as the one ECAR uses.

The remaining reasons are somewhat vague and one has to ask if there is now any compelling reason.

While we understand the position of the CACTF, our concern remains that NERC is venturing far beyond its mandate of overseeing reliability and trying to write energy policy.

John Blazekovich
ComEd

This is unacceptable

The White Paper states the following (page 7) "However, the Task Force reminds everyone that *the Reliability Model's role is to define operating functions and authorities, not organizations"*

The definition of independence appears to contradict this statement through the requirements of independence NERC is in fact defining organizational structure.

We simply will not accept NERC attempting to take on this role.

Vern Colbert
Dominion Virginia Power

The Task Force correctly states that FERC has already established jurisdiction over this matter, and in-fact has not required separation of the Transmission Provider from the retail merchant function. This subject has been discussed at length in prior comments submitted. We fail to see what the task force hopes to accomplish by continuing to propose a standard that is not within NERC's purveyance. If this white paper is to become anything more than a theoretical debate then it should recognize where the industry is actually at in regulatory requirements, and proceed from there.

Curtis Crum
NIPSCO

(Regarding organizations not under FERC jurisdiction). If they are not under FERC's jurisdiction, why would they comply with any FERC regulations? Why would they adhere to Independence requirements of the reliability functions?

Edward Scott
FRCC

FRCC believes it is important that these exceptions be included for the BA. However, FRCC is not clear as to if the choice is retail or wholesale. FRCC believe that the BA should not be required to be independent until such time as there is retail choice.

Steven C. Cobb
Salt River Project

Isn't it somewhat presumptuous to believe that NERC, through a set of standards, can mandate the divestiture of assets currently owned by corporations?

(Regarding allowing an Interchange Authority to be affiliated with a merchant). In addition, assignment of these (IA) responsibilities to a merchant can cause potential inequities between merchant entities as we have previously mentioned.

The "Merchant" Interchange Authority could use this information for financial benefit. i.e. increase cost to the curtailed customer on a non-constrained path. If the Task Force is willing to disassemble corporations to eliminate the "perception" of improprieties, why not make sure the IA is also independent?

Independence - Interchange Authority

Steven C. Cobb
Salt River Project

In the document it is stated that the INTERCHANGE AUTHORITY service can be provided by a reliability or merchant entity. The concept that drove the CACTF's original charter was to identify and eliminate market advantages inherent to Control Areas. We suggest that allowing a merchant to perform the INTERCHANGE AUTHORITY service provides an opportunity for exploitation. What if certain appropriate parties (i.e. Transmission Provider) are not notified in the approval process so that a transaction can flow without the appropriate reservation.

V. (Wally) Koschik
Manitoba Hydro

To be consistent, the Interchange Authority should be an independent function because it could presumably provide better service for its affiliated merchant both in arranging transactions and in curtailing them when necessary, i.e. it is in a position to game in favor of its affiliate.

Having said that however, independence does not guarantee non-discriminatory behavior, there would still be a strong incentive for an IA to favor its best customers, at the expense of its lesser customers if that furthered its profits. Something beyond independence is required. Perhaps requiring certification would be sufficient but even better would be assigning the functions to the RTOs. Some are already doing this, as we understand it, e.g. the MISO.

The paper points out that the Interchange Authority need not be involved in load-serving entities serving their own load with their own generation.

Does this still hold in situations where load serving transfers, as well as firm point-to-point transactions are flowing though a transmission constraint, requiring pro-rata curtailment? It seems that the process would be awkward if the Interchange Authority were only involved in part of the curtailment process.

Peter Steitz
Wisconsin Public Power

Independence of Interchange Authority. Regarding the independence of the Interchange Authority, we agree that an Interchange Authority may or may not be independent depending upon the relationship of that Interchange Authority with market participants. If an Interchange Authority affiliated with a market participant is providing interchange services to other market participants that are in competition with the Interchange Authority's affiliate, problems could materialize. Market Participants need to be able to obtain interchange services from an independent Interchange Authority, in the event that they lack confidence in the services of a particular Interchange Authority due to its as affiliation with a merchant function.

Edward Scott
FRCC

The IA should only see the list of cut transactions that they are responsible for, otherwise the IA would need to be independent somehow as well.

If the IA is the final authority on what they told the different BA's for scheduling, how can they not be independent? Especially if ramping generators could be favored in any way in certain BA's? How can an IA be automated if it has to verify ramping? What if ramping is different between generators, how does the IA settle that if it's automated?

Could there be any favoritism here? Could the IA introduce bias in BA's is directed to do things? For example. Load following is an ancillary service the BA will provide. If the IA is affiliated with the generator couldn't there be a competitive advantage to allow the BA with that generator to become provider of last resort?

Attachment 3 – Comments on this Report

During the past few weeks, the NERC staff received several comments on this report to the Board. They are included in this section for reference.

Victor Bissonnette
Délégué commercial
TransÉnergie

Don

We did discuss this issue at the last MIC meeting. I will therefore repeat the comments I made during this meeting on the task that the CACTF seems to have undertaken by its own interpretation of its mandate, that is to require "Independence" and to define it for reliability related functions. It seems to me, and I add my voice to that of many others, that this goes beyond the role of NERC. That the CACTF defines clearly some roles (IA,BA,SC) in its reliability model is fine and required by the industry. It should then stress the requirement for those functions to be performed with nondiscrimination and with equity. It is up to the regulators and market participants in each jurisdiction to put this into practice in the manner that best suits each case. In some jurisdictions it will be squarely impossible to comply with a strict "independence" as the CACTF defines it. Furthermore, the CACTF recognizes that such an "independence" is not a determining factor for reliability. The CACTF should then restrict its role to that of defining the Reliability Model, which it has done a good job of, and only insist on a non-discriminatory and equitable performance of some functions, leaving the "how" of this to the relevant authorities.

Victor Bissonnette
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NORTHEAST POWER COORDINATING COUNCIL

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January 18, 2001

Mr. Donald M. Benjamin
Director-Operations
North American Electric Reliability Council
Princeton Forrestal Village
116-390 Village Boulevard
Princeton, New Jersey 08540-5731

Re: NPCC Comments to the Report by the Control Area Criteria Task Force on "Independence Requirements for Organizations Performing Reliability Functions"

Dear Don,

The NPCC Task Force on Coordination of Operation would like to offer the following comments to the proposed direction of control area independence as proposed by the Control Area Criteria Task Force, the key conclusion of which is presented as follows:

"The Task Force recommends physical and corporate separation. The Task Force believes that only physical and corporate separation (Case 4) provides the marketplace with the maximum assurances that the organizations performing reliability functions do not favor one set of customers or suppliers over another. This applies to the Balancing Authority, Security Authority, Interchange Authority, and Transmission Service Provider functions. (There may be exceptions to requiring Balancing Authority and Interchange Authority independence, which we will explain.)"

First the TFCO reiterates its positions as posted through NERC Due Process in its letter of December 8, 2000. With respect to the recommendation that full separation be implemented, the NPCC Task Force on Coordination of Operation believes that such an independence directive goes well beyond the charge of the Control Area Criteria Task Force, the essential focus of which was the identification of those responsibilities in the traditional control area which define a commercial advantage.

The Task Force must also point out existing regulatory conflicts. Throughout North America, there are numerous state and provincial regulatory authorities which govern the structure of the respective electric operations. **Within many of these** jurisdictions, the separation of the operating responsibilities as suggested by the CACTF will not be permitted through laws in place preventing these actions. The inequities within the industry of a partial adoption of total physical and corporate separation are obvious. More importantly, such a partial industry adoption of independence by total separation can only contribute to enormous confusion in operations and ultimately degrade the reliability of the North American Interconnections. Even at the federal level within the United States, conflict appears likely. The concept of the TRANSCO model has been vigorously endorsed and encouraged by the FERC, yet it appears that the CACTF model cannot support the operation of a TRANSCO and physical and corporate separation. Clearly any proposed model for an independent control area function must be able to incorporate the TRANSCO.

Thank you for your attention to these concerns.

Very truly yours,

J. G. Mosier, Jr.

John G. Mosier, Jr.
Director, Operations

JGM:mr
cc: Members, NPCC Task Force on Coordination of Operation
Chairs, TFCO Working Groups
Mr. Edward A. Schwerdt

Howard F. Illian, President
Energy Mark, Inc.

Schaumburg, Illinois
January 18, 2001

Comments on Independence of Balancing Authorities

Introduction:

As an attendee of the first Control Area Criteria Task Force in August of 1999, I have been following the progress of the CACTF through its deliberations. I have not felt the need to comment previously because there was significant input from others that supported my positions on the issues. Unfortunately, the issue of independence has progressed in a manner that is fundamentally flawed. Although these comments might have had a larger influence earlier in the process, I was occupied with other issues and unable to provide comments. Please consider these comments in your deliberations as you proceed with finalization of the characteristics of the new reliability model.

NERC is beginning to come to the realization that effective reliability cannot be maintained from a position that is ignorant of the markets. Unfortunately, in the White Paper, NERC moves from reliability rules that are written in ignorance of the markets to reliability rules that attempt to enforce some preconceived notion of how markets should function. This position is also wrong. Reliability should be enforced from a position of neutrality in the market with full knowledge of how the market operates. The markets must be free to develop as they see fit with intervention from NERC when the reliability rules or lack of rules results in detrimental market function or unintentional reductions in reliability.

I would suggest that there are some unstated underlying assumptions that are detrimentally influencing the recommendations offered in the White Paper.

Balancing Authorities must be geographically contiguous.

Discussion: This assumption is apparent from the following comment taken from the CACTF White Paper. "Our position is that independence (corporate and physical) needs to be the goal in any situation where more than one market participating entity operates within a given Control Area. In other words, wherever there are competing Generators, Load Serving Entities, and/or Purchasing-Selling Entities operating within the electrical boundaries of a Balancing Authority, independence needs to be the goal, both corporate and physical."

When the CACTF separated the functions of the Control Area, it did not question whether the new authorities would have the same geographic characteristics as the old Control Areas. An examination of the geographic characteristics of the new authorities would indicate that the Security Authority, a transmission entity, would need to be electrically contiguous, while the Balancing Authority (BA) does not.

In fact, NERC has developed specific guidelines, guidelines for **Dynamic Transfer**, to address non-electrically contiguous BAs. It is reasonable to assume the customers could have more than one BA to choose from when determining who should perform the final frequency control function for them. This is further supported by many examples on the interconnections where a customer is geographically surrounded by one control area but has been included within another using Dynamic Transfer.

The significant advances in metering and communications technology that have occurred over the last decade have enabled these non-geographically contiguous BAs. The same forces that have driven customer choice of energy supplier will also drive customer choice for reliability supplier where possible.

If the customer has a choice between BAs, then there is no need to require that the BA be independent. In a market, the choice should be that, "**Every customer that has a choice between BAs should have the opportunity to choose an independent BA.**" This criterion is significantly different from the criteria that all BAs must be independent. The criterion that customers have the opportunity to choose a non-independent BA improves customer choice. When customer choice is affirmed, market function is improved.

NERC must look at those reliability functions that should be independent from the Merchant Function to help ensure a viable marketplace.

Discussion: This approach leads to two results. The first, removing the reliability functions from the Merchant Function assures that these reliability functions will not affect the remainder of the marketplace, is stated. Additionally, by removing them from the marketplace NERC insures that the innovation that will improve the marketplace will not affect reliability. In other words, not only are the reliability functions insulated from the detrimental effects of the marketplace, they are also insulated from the beneficial effects of that same marketplace. This is a bad tradeoff. As the market evolves there must be innovation in the ways that reliability is maintained. The path chosen attempts to maintain reliability without exposing reliability decisions to the same forging to which energy market decisions will be exposed.

For Reliability purposes, all customers must be treated the same.

Discussion: This assumption more than any other might be the one that is having the greatest impact on our decision-making. The attempt to treat every customer the same is preventing our industry forward. What we need to realize is that it is acceptable to treat customers differently if it is the customer that chooses to be treated differently. We attempt to set up rules and operating methods that treat every customer the same because we do not want to develop the rates or compensation packages that will enable customers to choose to be treated differently. Interruption is assumed to be involuntary, because we choose to interrupt customers without compensation.

A previous comment stated it correctly with "... the "independence" criteria should not be a substitute for proper balancing policies that include proper economic signals." If fair compensation is offered for load shedding or load balancing participation, the issue of favoritism or discrimination will not arise.

I would suggest that the area of greatest innovation in the electricity markets will be in the commercialization of reliability and the opportunity for the customer to custom fit its reliability needs with commercially offered products.

Control Areas derive economic advantages from performing reliability functions.

Discussion: Two reasons are given for Control Areas deriving perceived economic advantage from performing reliability functions. The first perceived advantage is "Parking and Hubbing." Later analysis revealed that the perceived advantages from "Parking and Hubbing" derive from the transmission functions not the balancing functions. The second perceived advantage derives from the use of inadvertent energy accounting. This perceived advantage derives directly from the balancing function.

Unfortunately, the investigators analyzed the difference between Energy Imbalance and Inadvertent, but they never determined whether a real as opposed to a perceived economic advantage derives from the use of inadvertent within the NERC policies. They did not answer the question: "Are the costs of meeting the responsibilities of a Balancing Authority greater than or less than the savings resulting from managing inadvertent within the NERC policies?" Even if this question had been investigated and it was shown that an economic advantage did result, this should not be a reason to eliminate this economic advantage. The only reason to eliminate the economic advantage should be that the economic advantage would result in decisions that are detrimental to reliability. Therefore, their statement: "The Task Force believes that until NERC's Inadvertent Interchange standards address all three requirements listed above, generators affiliated with a Control Area are afforded a commercial advantage over independent generators," has not been supported with either economics or justification from a reliability position. If there is an economic advantage in being a Control Area, then it is logical to encourage more entities to become Control Areas, and therefore, increase this economic advantage for all.

Alternative Vision:

I have an alternative vision of how the market could work. I would suggest that the reliability functions performed by the balancing authority have a net cost. The Balancing Authority is really a manufacturer of controlled frequency. The BA purchases Frequency Response, Regulation, Load Following and Reserves in the market and mixes these IOS in the correct proportion to manufacture controlled frequency. Therefore, the BA could sell the reliability of controlled frequency to their customers based on how much of the controlled frequency product they use. If there were more than one BA the BAs could compete with one another using both price and product design. Every BA would be required to meet the NERC requirements to maintain reliability. In meeting the NERC requirements, they would insure that their actions have not had a detrimental effect on others. In this alternative view of how the markets could work there is no need for all BAs to be independent, there is only a need for each customer to have the opportunity to select an independent BA to provide service to them.

Conclusion:

I would suggest that most of the work that the NERC CACTF has performed is excellent and should be supported. However, in the case of considering the requirements for independence, the CACTF has limited its vision. As we move forward in restructuring the electric utility industry, we must make decisions that are inclusive rather than exclusive. Every time a decision is made to exclude a participant from a market, that market is potentially weakened. When we make decisions to offer additional players the opportunity to participate in the markets, the market will become more robust. In the specific case of the Balancing Authority, we should choose the inclusive path as opposed to the exclusive path. Therefore, we should only require that customers have the opportunity to choose an independent Balancing Authority rather than requiring them to choose an independent Balancing Authority.

Wayne Lewis
Progress Energy

Don,

Progress Energy has the following comments. Please forward these for consideration by the NERC BOT.

"First, I am not sure NERC has the power to impose such stringent regulations and why they feel the need to go beyond FERC. Second, NERC reasons for extending the requirements of FERC's independence criteria as set forth in Order 2000 are flawed.

In NERC's reason 1 they state that their model applies to all RTOs ISOs, transcos and gridcos. FERCs order 2000 applies to all RTOs, ISOs, transcos and gridcos. The main purpose behind Order 2000 was to have all vertically integrated utilities throughout the nation participating in RTOs by December 15, 2001.

NERC's reason 2 states that their model requires physical and corporate separation. By having a utility transfer control of all of their transmission assets to an un-affiliated RTO is both physical and corporate separation.

NERC's reason 3 states that independence from the merchant function should also include not only wholesale but retail as well. Pursuant to Order 2000, utilities must transfer "control" of their transmission assets to an RTO and in turn the RTO with run the grid. This would certainly cover any discrimination issues that would arise relating to both wholesale and retail merchant functions because the RTO would control the grid. NERC's reason 4 states that FERC does not have jurisdiction over public power. Does NERC have jurisdiction over public power to force them to comply with these standards? FERC states that Order 2000 is voluntary and it is not their intent to make it mandatory. I think NERC should follow this same approach.

I believe that Order 2000 more than adequately addresses merchant discrimination issues and that most if not all utilities will join or form RTOs.

Independence is one of the hallmarks of Order 2000, as stated by FERC: "the principle of independence is the bedrock upon which the ISO must be built with emphasis that this principle must apply to all RTO's, whether they are ISOs, transcos or variants of the two."

In addition to the above comments, I would comment that the two exceptions to the proposed independence requirements are not clear and confusing and too restrictive.

Wayne

Wayne Lewis
Director - System Support Section
---Progress Energy----

Doug Hils
Cinergy

Don,
I commend the extensive work done by the CACTF in drafting the reliability model however I am disappointed that the CACTF disregarded an overwhelming consensus by the industry that corporate independence of the Balancing Authority is neither necessary nor advisable. I think there's some great work here, however the Reliability Model can work within the existing framework of the industry with functional independence as we move toward RTO development.
Thank you,
Doug Hils
Cinergy
Control Area Operations

Peter G. Flynn
National Grid USA

February 2, 2001

Don Benjamin
North American Electric Reliability Council

Re: Independence Requirements for Organizations Performing Reliability Functions

Dear Mr. Benjamin:

National Grid has recently received a copy of a draft report from the Control Area Criteria Task Force (Task Force) entitled "Independence Requirements for Organizations Performing Reliability Functions". We are concerned that the definition of Merchant Function proposed by the Task Force could disqualify from the performance of reliability functions an entity that does not have any economic or commercial interests that would be significantly affected by the performance of such functions. National Grid therefore requests that the Task Force modify its definition to provide that if FERC finds that an entity is not a Market Participant because it lacks any economic or commercial interests that that would be significantly affected by a regional transmission organization's decisions or actions, then FERC's ruling should also govern for purposes of the Task Force's definition of Merchant Function.

As currently written the Task Force's proposed definition of Merchant Function would disqualify every entity engaged in the distribution business in retail access states from performing reliability functions. Every state that has implemented retail access thus far has required utilities to provide "standard offer" or "last resort" service to retail customers that have not yet gone to the market or who are temporarily not served by the market. To fulfill this state-mandated roll, a utility that has divested its generating assets will necessarily have to buy electricity in the marketplace and to sell electricity to retail customers that are eligible for the backstop service. In many cases, pass-through arrangements at the state level will assure that the company does not stand to make financial gains or losses from these transactions.

In light of these state-mandated obligations, FERC properly concluded in Order 2000 that it will apply its independence criterion pragmatically. It reasoned that the facts in a given case might support a finding that a utility that sells electricity subject to state-mandated backstop power supply service may not have any economic or commercial interests that would be affected by an RTO, including the RTO's actions and decisions relating to maintaining the short-term reliability of the grid. (RTO characteristic #4) In those cases, FERC concluded that the facts would support a finding that the utility is not a Market Participant. The decision whether a utility that sells electricity is a Market Participant will be made by FERC on a case-by-case basis. (Order 2000 at 200)

The Task Force should adopt a similar pragmatic approach to the definition of Merchant Function. Specifically, if FERC should find that a utility that sells electricity has no economic or commercial interests that would be affected by an RTO, including the RTO's decisions and actions relating to maintaining the short-term reliability of the grid, then that determination should govern for purposes of the NERC's independence requirement. In short, if FERC finds that such an entity is not a Market Participant, that decision should also govern for the purposes of the Task Force's definition of Merchant Function.

National Grid therefore proposes adding to the Task Force's definition of Merchant Function the same language that appears in FERC's definition of Market Participant: "...unless the [FERC] finds that the entity does not have economic or commercial interests that would be significantly affected by [a] Regional Transmission Organization's actions or decisions". 18 CFR §35.34(b)(2). The Task Force's definition of Merchant Function would thus read as follows: "The generation, selling, reselling, or purchasing of electric energy, capacity, or resources-related services for wholesale and retail customers, unless the FERC finds that the entity does not have economic or commercial interests that would be significantly affected by a Regional Transmission Organizations' actions or decisions."

On a related point, one important theme relating to reliability appears to be absent from the Task Force's draft report. In general, reliability is likely to be higher if organizations responsible for delivering it have appropriate economic incentives. If economic incentives are developed properly, then any unfair discrimination between customers that runs counter to reliability targets would cost that organization money. In this way, economic incentives can further the objective of ensuring the independence of organizations performing reliability functions. This is a point that the Task Force may wish to consider incorporating into its report.

Thank you for your attention to these matters, and I apologize for the tardiness of our comments. Unfortunately, the draft report did not come to our attention until recently. National Grid would be pleased to participate directly on the Task Force going forward if you think that we could be helpful.

Should you have any questions or otherwise wish to correspond with us on this or any other matter, my e-mail address is peter.flynn@us.ngrid.com. You are also welcome to correspond with my colleague Masheed Rosenqvist at mashed.rosenqvist@us.ngrid.com.

Sincerely,

Peter G. Flynn
Vice President
National Grid USA

Attachment 4 – Interconnected Operations Services Independence Issues

The Non-Technical Issues Task Force of the Operating Committee's Interconnected Operations Services Subcommittee developed a proposal to resolve Issue 4 on the independence requirements of the Operating Authority. The MIC approved in July 2000 an interim definition of independence requirements, as narrowly applied to Interconnected Operations Services standards, pending adoption by the NERC Board of Trustees of more comprehensive independence requirements. This interim resolution of Issue 4 is presented below:

Independence of Operating Authority as Related to Interconnected Operations Services Standards. The following standards define the independence requirements of the Operating Authority in the course of specifying, procuring, and deploying Interconnected Operations Services:

1. The Operating Authority shall remain independent from:

    A. IOS Suppliers (including both generation and load), except when acting as a "supplier of last resort" as required by regulatory order; and

    B. Wholesale merchant functions, including power marketers and other entities that sell or broker electric energy.

2. Independence is defined as meeting FERC Order 2000 and Order 2000A independence criteria or independence criteria adopted by other applicable regulatory authorities.

3. ***The independence requirements in 1 and 2 above shall apply to the Operating Authority's conduct of the following activities related to IOS:***

    A. Setting of regional and local requirements for IOS, with the requirement of an open and inclusive process in which stakeholder interests are represented.

    B. Development of IOS procedures.

    C. IOS certification and compliance monitoring.

    D. IOS procurement process.

    E. Decision-making regarding which IOS Supplier to deploy and how much, including real-time deployment decisions.

4. The following IOS functions do not require the Operating Authority to meet the independence requirements in 1 and 2 above:

    A. Implementation and publishing of IOS standards and procedures (e.g. metering, voice and data communications, etc.)

    B. Actual control and operation of IOS Resources.

    C. Arranging for transmission services for IOS.

Attachment 5 – Control Area Criteria Task Force Roster

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