

# Spotlight on the RTO Board: Governance

A Discussion Organized by the Harvard Energy Policy Group (“HEPG”)

## The HEPG Framework

Corporate governance is a hot topic. RTOs are not an exception from that discussion. It is hard enough to define roles and responsibilities when there are shareholders and a stock price. California began with a stakeholder board, but has now discarded that model in favor of a board appointed by the state’s Governor. Other RTOs have employed a model in which the directors are independent persons who have no formal connection to any market participants.

### *Questions*

- What should we be learning about governance of a new beast like an RTO?
- To whom, however, do RTO board directors owe their primary duty?
  - Are they fiduciaries for all of the stakeholders?
  - Are they the protectors of the consumers, or the guardians of a broader public interest?
- How are the incentives of the directors aligned with these goals?
- Are the directors a self-perpetuating group, or should stakeholders or regulators have some say in their selection?
- How do stakeholders participate in decision-making under the board?
- What procedural rules guide or constrain the board’s activities?

## What is the Real Question?

During his presidential campaign in 1932, Franklin Delano Roosevelt (FDR) spoke often of the disconnection between the performance of private electric utilities and the public interest. In a Portland, Oregon speech on September 21, 1932, he said:

Speaking in the language of the Navy, with which I was associated for many eventful years, I want at the outset of this discussion to take my bearings, to know my destination, to chart my course. In discussing electrical power, the speaker, like a ship sailing in dangerous waters, must avoid not only unseen shoals and rocky reefs, he must also be on his guard against false lights on the shore. His only protection against all of these dangers is to set squarely and fairly before him the course that he must steer<sup>1</sup>.

He went on to describe the common law's concept of a public utility (quoting Lord Hale<sup>2</sup>) and society's search for a means to assure that services were "... satisfactory and cheap enough while ... making possible safe investment of private capital. Mr. Roosevelt described the "... subtle, deliberate and unprincipled campaign ..." of "misinformation", "propaganda" and "lies and falsehoods" "... bought and paid for by certain great private utility corporations" and his commitment to returning government to its position as a regulator driven proactively by the public interest.

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<sup>1</sup> The speech is available via the Internet at <http://newdeal.feri.org/texts/60.htm> . The speech will be referred to as the Portland Speech for the balance of this paper.

<sup>2</sup> *"The greed and avarice of some of the ferry-boat owners were made known by an outraged people to the King himself, and he invited his great judge, Lord Hale [Sir Mathew Hale], to advise him. The old law Lord replied that the ferrymen's business was quite different from other business, that the ferry business was, in fact, vested with a public character, that to charge excessive rates was to set up obstacles to public use, and that the rendering of good service was a necessary and public responsibility. 'Every ferry', said Lord Hale, 'ought to be under a public regulation, to-wit: that it give attendance at due time, keep a boat in due order, and take but a reasonable toll.'"*<sup>3</sup>



Lord Hale

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The views of former President Roosevelt<sup>3</sup> may help to highlight the nature, duration and scope of the provocation required before government will rise to the challenges presented by reforms that target the electric utility industry. It seems clear that present circumstances suggest that government has again escalated its inquiries about how to best serve the public interest. Examining “a new beast like an RTO” and exploring the topic of governance means that we must consider why our government has commissioned the making of a new beast. Understanding the reasons for the new beast initiative might contribute much to efforts to arrive at governance structures that facilitate desired performance.

One of the things we might hope to learn here is that government reform that targets an entire industry<sup>4</sup> is generally an indication that the industry’s public interest

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<sup>3</sup> In the Portland Speech, FDR described his findings upon becoming Governor of the State of New York:

*When I became Governor, I found the Public Service Commission of the State of New York had adopted the unwarranted and unsound view that its sole function was to act as an arbitrator or a court of some kind between the public on one side and the utility corporations on the other. I thereupon laid down a principle which created horror and havoc among the Insuls and other magnates of that type. I declared that the Public Service Commission is not a mere judicial body to act solely as an umpire between complaining consumer or the complaining investor on the one hand , and the great public utility system on the other hand. I declared that, as agent of the Legislature, the Public Utility Commission had, and has, a definitely delegated authority and duty to act as a the agent of the public themselves; that it is not the mere arbitrator as between the people and the public utilities, but was created for the purpose of seeing that public utilities do two things: first give adequate service; second, charge reasonable rates; that, in performing this function, it must act as agent of the public, upon its own initiative as well upon petition, to investigate the acts of public utilities relative to service and rates, and to enforce adequate service and reasonable rates.*

<sup>4</sup> The word target as used here refers to the electric industry and more specifically the investor-owned, vertically integrated segment of the electric industry. However, it is no coincidence that all owners of communications and energy grid systems are under pressure to reform themselves to better serve the evolving public interest. In the communications industry, Operational Support Systems (OSS) contain the network elements an incumbent telephone company uses to provision services to its own retail customers and competing telephone companies. These services include support for pre-ordering, ordering, provisioning, repair and maintenance, and billing. As part of the process to permit a regional Bell operating company (RBOC) to enter the interLATA in-region long distance market, the Federal Communications Commission (FCC) has required the applicant to demonstrate that it can provide OSS either at the same level that it provides those services to itself or, in the case of services that the company would not provide itself, at a level that would permit an efficient new entrant to compete with the incumbent. As in the case with FERC’s open access transmission tariff (OATT) requirements, the incumbent service provider has the burden to demonstrate that its OSS is competitively neutral. This burden contains design, resource robustness and commercially operational components.

battery has run dangerously low. More pointedly, the plan for a “new beast” is some evidence that there is mismatch between the performance of “great private utility corporations” and the evolving public interest. The mismatch has made reconciliation difficult and the federal government’s preference for muddling along has tested our endurance. We can talk about governance but the real, sometimes hidden, debate is over whether, when and how the old beast can be put down or morphed and retrained so that the public interest can be better served.

## **It Depends**

Like most RTO-related topics, a useful discussion about governance also requires healthy respect for the significance of context. After all, RTOs have a design range that means that they must nimbly and contemporaneously play multiple roles.

RTOs must remedy past anticompetitive behavior<sup>5</sup> and monitor the market to protect against future exploitation.<sup>6</sup>

RTOs must manage reliability in real time.

RTOs must develop and implement commercial rules<sup>7</sup> that will better align our commercial conventions with physical realities.

RTOs must enable an efficient energy market<sup>8</sup> (through the interaction of supply and demand side resources) to fill the gaps between scheduled and actual performance. RTOs must integrate the physical operations with the market.

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<sup>5</sup> On April 24, 1996, FERC issued Order 888 establishing interrelated rules designed to remove impediments to competition in wholesale bulk power markets. In the Order, FERC said:

*The legal and policy cornerstone of these rules is to remedy undue discrimination in access to monopoly owned transmission wires that control whether and to who electricity can be transported in interstate commerce.*

<sup>6</sup> Load pocket problems and the extent of pricing flexibility available to must run units provide motivation for active RTO market monitoring.

<sup>7</sup> The RTO’s responsibilities for commercial rules and the design of energy markets may be a necessary so that capital can be applied to meet our needs. In history, the organization of trade often precedes the organization of industry. Ashley, *Economic History Part I*, page 77.

<sup>8</sup> The energy market should include real time and day-ahead components.

RTOs must bill, collect and pay owners for the use of their assets. RTOs must bill and collect for the services they provide (on a bundled or unbundled basis).

RTOs must publish and manage the flow of information in a way that builds the type of transparency and convenience useful to commerce.

RTOs must implement rules that will allow new supply and demand side technologies to interconnect, reach and dynamically interact with the market through an open architecture network.

RTOs must develop and implement plans that will define the future size and shape of the grid,<sup>9</sup> this responsibility may involve securing site and build performance from transmission owners.

RTOs must satisfy the obligations imposed by laws and regulations applicable to public utilities, prosecute applications for rate increases, and defend themselves in complaint proceedings.

RTOs must manage a process by which stakeholders (a proxy public) have an opportunity to provide input to the independent board on all matters with the possible exception of rates obtainable through traditional regulation.

This is not a comprehensive list of RTO responsibilities. However, this partial list should help to illustrate why the short answer to most of the questions listed above is “It depends”.

The above (partial) list of functions indicates the significant scope of the responsibility that FERC is prepared to delegate to **appropriate** RTOs. Given FERC’s legal status as an agent of Congress, the responsibility that is ultimately delegated must be purposefully related to FERC’s duty as defined by Congress. In this larger context, questions about RTO governance and the role of stakeholders take us necessarily back to the root purpose of Congress’ delegation of authority to FERC. If we focus on individual entities in the chain of responsibility or their respective forms of governance, we may welcome further confusion.

Keeping it simple<sup>10</sup> always has value but questions about RTO governance and the role of stakeholders may have answers that change as the focus shifts

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<sup>9</sup> Planning should be driven by the forward-looking bilateral market (not the spot market).

between RTO functions. Collectively, the questions must be answered so that the RTO functions to fulfill the duties assigned to FERC by Congress. It seems clear that ultimate authority is placed in the RTO board<sup>11</sup> that is ultimately accountable to FERC.

The RTO, like a corporation, is a combination of various interest groups with goals that must be coordinated. Governance is the process by which this coordination is pursued. By looking at the RTO functions separately, it may be easier to determine to whom the duties of care and loyalty are owed and to what degree.

### **What Else Should We Be Learning About Governance of a New Beast Like an RTO?**

Discussions about RTO governance raise many of the same issues that are raised in discussions about corporate governance. The corporate form provides an opportunity to separate ownership of property and control over the property. If separation of ownership and control sounds familiar, these words are part of the design specification that is guiding efforts around the World to use communications, natural gas and electric networks to enable competition where competition can better serve the public interest than regulation. From this necessary attribute of a corporation, we see room for differences in views on the subject of governance.

The RTO, like a corporation, is a vehicle to organize the performance of parties having different interests. Good governance structures give all the participants in the enterprise incentives to work together efficiently and minimize the

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<sup>10</sup> In his Portland Speech, FDR commented about the complexity of utility discussions saying:

*This subject has been discussed so much in complex language, in terms which only a lawyer can understand, or in figures only accountants can understand, that there is a need for bringing it back into the realm of simple, honest terms understood by millions of our citizens.*

<sup>11</sup> MISO'S tariff (Article II.B.1) states that "[t]he management of all the property, business, and affairs of the Midwest ISO shall be vested in the Board." Article III.E states that "[t]he Midwest ISO shall develop appropriate incentives for efficient management and administration and shall file such incentives with the FERC."

costs of coordination and dispute resolution.<sup>12</sup> In some cases, the relationship with a party can be defined through long-term contracts. For example, holders of long-term debt are entitled to payment on specified terms and conditions and transmission asset owners obtain compensation for the use of their assets according to laws and rules applied by the economic regulator. In some cases, these “contracts” obligate payments irrespective of the performance of the RTO.<sup>13</sup>

Some claim that corporate control must be deposited in the shareholders who own the property and the managers selected by the shareholders predicated on the assumption that the shareholders hold residual risk and have, therefore, the most to gain from efficient performance. Placing control in shareholders is viewed by these advocates as the best way to maximize welfare. Some advocates that tilt towards placement of control in shareholders or corporate managers also cite a need for organizational and governance certainty as a means of holding corporate managers accountable for performance.

Others claim that this assumption (that shareholders hold residual risk) is unfounded (particularly for large corporations) due to things like statutory limitations on shareholder liability, risk diversification opportunities presented by a portfolio and the ease of exit from share ownership. The view that shareholders do not hold residual risk usually provides a foundation for reasoning towards placement of control in elements of the larger population such as employees, customers or other stakeholders.

Embedded in these competing positions are fundamental differences in views over the purpose of corporations.

Debates about corporate governance are also often framed in a static context that fails to consider the evolution of the corporate form. Our original notions of corporate governance come from the days of “joint stock companies” (beginning in 1555) that had limited lives and were confined to a specific purpose

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<sup>12</sup> Margaret M. Blair, *Ownership and Control*, at page 244, The Brookings Institution (1995).

<sup>13</sup> Mechanisms like “ZTA” and “SRA” charges have been approved as a transitional strategy to make sure that the change in physical commerce that may take place because of fully functional RTOs does not operate to lower transmission owner’s revenue.

such as a trading expedition, construction of roads or canal building.<sup>14</sup> They are rooted in a time when “*owners managed and managers owned.*”<sup>15</sup> In the real and today world, corporations have the opportunity to exist in perpetuity, the power of shareowners is very diffused, professional managers pull the levers and press the buttons sometimes far removed from both employees and customers, and the corporation possesses a broad range of powers through grants contained in general incorporation laws.

Reasoning used to place and allocate corporate control in the larger corporate governance context can be quite useful as we develop appropriate governance structures for RTOs. But, prudent use of concepts applicable to corporate governance requires an understanding of the historical evolution of corporations, the assumptions relied upon to place control and design governance as well as the tensions between clear assignment of accountability and the variable placement of control depending on who has the most to gain from efficient performance.

### **Where Are the Residuals in the Electric Industry?**

As discussed above, general corporate governance theory suggests that control should be placed with the persons or entities that stand to gain the most from efficient production. Stated in historical terms, the common law deposited control over the corporation in shareholders based on the view (perhaps correct in the beginning) that shareholders receive the residual return and bear residual risk. If shareholders receive the residual return and hold residual risk, logic suggests that maximization of shareholder value will be a proxy for maximization of social value.<sup>16</sup> If we commit to maximization of shareholder value as a proxy for maximization of

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<sup>14</sup> Margaret M. Blair, *Ownership and Control*, at page 207, The Brookings Institution (1995).

<sup>15</sup> *Id.* at 208, citing Alfred D. Chandler Jr.’s, *The Visible Hand: The Managerial Revolution in American Business*, Harvard Business Press (1977).

<sup>16</sup> Maximization of social value requires us to consider the means that are available to create, capture and distribute wealth.

social value, then corporate governance is more likely to emerge with corporate managers accountable mainly to shareholders.<sup>17</sup>

History does not give us a singular notion about governance. As previously noted, the common law had a somewhat different rule for businesses affected with the public interest. The core of Lord Hale's relevant wisdom holds that the duty owed shareholders of a business affected with the public interest is circumscribed by a duty of care and loyalty owed to an indefinite and general public. The ferryboat operator could not charge excessive rates because excessive rates were an obstacle to public use. The duty of care and loyalty owed by ferryboat operators required him or her to render timely and reliable service taking but a reasonable toll. From the beginning then, the total governance picture was different for what we now call public utilities.

Control must be deposited somewhere – otherwise no control exists. A discussion of RTO governance necessarily requires an identification of the place where control presently resides and where we should place control to maximize value to society.

Testing for the best landing spot for control may proceed by accepting the view that RTO control (as with corporate control) should be placed with the persons or entities that stand to gain the most from efficient production. I assume that the persons or entities that stand to gain the most from efficient production are the persons or entities that hold residual risk and are residual beneficiaries of RTO performance.

As discussed above, the modern shareholder does not much resemble the shareholder of our early corporate days because of things like statutory limitations on shareholder liability, risk diversification opportunities presented by a portfolio and the ease of exit from share ownership. In the electric utility industry – particularly the unbundled transmission business – shareholders are even less responsible for residual business and financial risk.

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<sup>17</sup> Margaret M. Blair, *Ownership and Control*, at page 15, The Brookings Institution (1995).

In many states, the business of providing transmission service remains a statutory monopoly protected from direct competition by service area entitlements.<sup>18</sup>

The value of grid property is regarded as superior to the value of customers' property and customers are forced to curtail demand to avoid injury to the grid property. In effect, customers are the reliability providers of last resort. Exculpatory language in tariffs often acts to shield the utility from liability that may otherwise arise from injury proximately caused by a loss of service.

Customers wishing to connect to the grid or developers needing grid interconnection to enhance the value of property under development are often responsible for providing some or all of the capital required by the utility to pay for grid expansion.<sup>19</sup>

Prices are set based on an accounting cost plus formula that ignores (among other things) potential efficiency gains and potential growth in throughput. The rate design and structure are often configured to provide the transmission business with revenue sufficient to recover fixed costs regardless of throughput.<sup>20</sup> Indeed, ratchet mechanisms may require a customer who has ceased operation to continue to pay for allocated fixed costs for an extensive period.

Special automatic price and revenue adjustment mechanisms are often established to rebalance the relationship between cost and revenue for large items over which the utility is deemed to have little control. The cost of fuel consumed to generate electricity is often recovered through such a mechanism. The funding required to support the operation of an RTO may be collected through a rider.

To the extent new technology is applied to significantly reduce costs, taxes are lowered or the labor pool is reduced relative to "test year" assumptions, the

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<sup>18</sup> As FERC's jurisdictional views on electric transmission evolve, the barriers imposed by state-assigned transmission service areas may be lowered by federal rights to interconnect with the interstate grid. Federal rights to interconnect with the grid have been a powerful influence in promoting grid expansion for communication and natural gas networks.

<sup>19</sup> Federal tax law presently treats contributions in aid of construction (CIAC) as ordinary income to the utility and the customers' or developers' payments are often grossed up at the statutory tax rate based on the utility's desire to insulate itself from any federal income tax liability resulting from the CIAC.

<sup>20</sup> As noted above, transmission owners are seeking and obtaining transitional rate features (such as ZTAs) that protect against revenue erosion that may arise from the RTO's elimination of pancakes.

party seeking to lower the utility's prices must carry the burden of proof and persuasion and depend on the utility to provide effective and efficient access to utility-controlled information. The utility's cost of participating in a rate proceeding is a recoverable cost for ratemaking purposes while customers (at least those not supported by the state) internalize such costs.

Utility accounting provides the corporation with special rules related to the deferral of expenses and revenue so that they may be better "matched". These rules often permit capitalization of carrying costs so that the inputs for the cost plus formula provide some protection against the lag between investing capital and obtaining a return of and on such capital.

Bankruptcy code rules give utilities preferences to protect against the debtor's ability to avoid payment while the debtor continues to use service.

To the extent more revenue production certainty is desired, utilities seek and obtain special adjustment mechanisms that operate to maintain revenue at target levels.

Utility businesses often have blanket authority to use the public right of way to construct, operate and maintain their systems and to take (often quickly) private property needed to construct, operate and maintain new infrastructure.

FERC has indicated that a customer seeking to bypass an incumbent electric supplier may be required to pay the incumbent for costs that become uneconomic because of the customer's exit.

Significant financial risks are socialized to some extent by laws that permit utilities to increase rates and revenue through streamlined procedures that allow regulators to act under emergency authority.

Access to the judicial process is often customized to permit utilities to skip levels that are mandatory for the rest of the business community or to permit them to avoid the risks of conflicting court rulings within the area they do business.

Employees, as evidenced by the many reductions in force that have taken place, assume some of the risk of a change in corporate vision, a bad bet by corporate managers or a poor economy. Employees that hold common stock in the

utility through retirement or investment plans may have extra exposure to the business and financial risk of the utility.

Utility profits are often defined for ratemaking purposes through a cost of capital approach that assumes a constant or growing common equity dividend. This assumption helps to reduce the risk that revenues will not be adequate to maintain or grow dividends.

These real world examples from our law and customs that apply to electric utilities indicate that neither utility shareholders nor the managers they choose to lead the corporation are responsible for all residual risk. Indeed, these shareholders and managers often take their piece of the action first through contracts that provide for compensation that is unrelated to the performance of the RTO (at least transitionally).<sup>21</sup> These real world examples also indicate that transmission dependent customers (wholesale and ultimate) have been allocated significant residual risk of failed physical or financial performance by the utility corporation. They also suggest that independent merchant generators may hold some portion of this risk.

Accordingly, the theory that caused corporate control to be originally lodged in shareholders or the managers of their selection suggests that much control over an RTO should be placed in the hands of transmission dependent customers and independent merchant generators. This may be a more compelling observation on matters involving market design, operations and planning than for rates and charges.<sup>22</sup> Transmission dependent customers and independent merchant generators stand to gain most from efficient operation of the grid and will be those most highly motivated to prosecute the campaign for grid efficiency. As in the case of control placed in shareholders of a public utility, the exercise of control by transmission dependent customers and independent merchant generators is limited

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<sup>21</sup> Allowing stranded cost recovery is another means of insulating shareholders from business and financial risk.

<sup>22</sup> As indicated above, the transmission owners' revenue requirements are protected through laws and regulations as well as transition mechanisms that socialize the risk of transmission revenue erosion. In effect, contracts have been written to set the compensation for the use of the transmission owners' assets and to protect their property against waste.

by the larger public interest in assuring that (paraphrasing FDR) services are satisfactory and cheap enough and the commercial context provides a good (not riskless) harbor for investment of private capital.

The logical landing place for control based on theory is also, as a practical matter, where the heavy lifting is being done in RTO land. But for the compelling work of these stakeholders (transmission dependent customers and merchant generators), there would be little hope that electric industry restructuring will produce reliable service, reasonable prices and the societal gains that come from the dynamic efficiency of effective markets.

### **How Do Stakeholders Participate In Decision-Making Under The Board?**

By existing design, the collective interaction of RTO stakeholders (including transmission owners) produces both flowing and stored information that is available for consideration by the RTO's independent board as it charts its course. The RTO board considers this input as it guides the RTO to display the required RTO characteristics and perform the required RTO functions.

In the application for approval of the Midwest ISO, the Midwest transmission owners stated that they would establish an Advisory Committee consisting of fourteen representatives from various stakeholder groups. FERC recognized this Advisory Committee in its order conditionally authorizing the establishment of the Midwest ISO and reiterated the Midwest ISO Advisory Committee's stated purpose:

The Advisory Committee will be a forum for its members to be apprised of the ISO's activities and to provide information and advice to the Board on policy matters of concern to the Committee or its constituent stakeholder groups.

*See Midwest Independent Transmission System Operator, Inc.*, 84 FERC ¶ 61,231, slip op. at 25 (1998), *order on reconsideration*, 85 FERC ¶ 61,250 (1998), *order on compliance*, 87 FERC ¶ 61,085 (1999).

FERC has strongly encouraged all RTOs to utilize effective stakeholder processes, particularly in those situations involving market design or the modification of market structures or protocols that impact all stakeholders. FERC

has even rejected unilateral proposals involving market design measures when stakeholder processes have been circumvented. For example, FERC stated:

We strongly encourage market participants to use the stakeholder process, especially in this type of situation, *i.e.*, where a market participant seeks to modify market measures that impact all participants.

*Consolidated Edison of New York, Inc.*, 95 FERC ¶ 61,216, slip op. at 5 (2001).

The Commission also spoke to the need for RTOs to consult and communicate with stakeholders in order to be responsive to market needs:

Under Alliance Companies' proposal, stakeholders are limited in their ability to consult with each other as part of the stakeholder input process and are potentially subject to confidentiality requirements, in that Alliance will control all aspects of membership eligibility, voting, and the formation of new stakeholder groups, and due to the Alliance Companies' proposal to limit stakeholder communications through mandated confidentiality agreements. The processes that stakeholders can use to communicate and consult with an RTO should be developed in consultation with stakeholders. If RTOs are to be responsive to the needs of the market, there must be a meaningful and efficient process for communication and consultation that serves not only the needs of the RTO, but also the needs of stakeholders. We believe that requiring Alliance to unilaterally propose these processes and having the Commission direct changes in processes based on the comments of stakeholders is not the best way to develop workable processes for stakeholder communication and consultation. We believe that a better approach is for the Alliance Companies to develop an advisory process in consultation with stakeholders, and to describe that advisory process and identify the participants. Only if they cannot will the Commission step in.

*Alliance Companies, et al.*, 94 FERC ¶ 61,070, slip op. at 14-15 (2001).

Additionally, in a subsequent order in the same RTO proceeding, FERC expressed its continuing concern over the lack of an acceptable stakeholder advisory process:

[W]e still have serious concerns over the effectiveness of the stakeholder processes. Stakeholders should have input into aspects of RTO formation necessary to ensure that the RTO develops practices that produce a seamless, well-functioning marketplace. While we do not wish to micro manage the stakeholder process, Alliance must have a useful stakeholder process. Since the stakeholder processes are the key to resolving many of the issues

which are still facing Alliance Companies, Alliance Companies must resolve this issue immediately. We agree with intervenors that there are many significant issues outstanding which need to be resolved in a timely manner.

*Alliance Companies, et al.*, 96 FERC ¶ 61,052, slip op. at 39 (2001).

More recently, and in a complaint proceeding specifically directed at the Midwest ISO, the Commission affirmed the critical importance of seeking stakeholder input prior to the time that issues are presented to the Commission:

More generally speaking, in Order No. 2000, the Commission stated that, where there is a non-stakeholder governing board, as is the case here, it is important that the board not become isolated. The Commission found that both formal and informal mechanisms must exist to ensure that stakeholders can convey their concerns to the non-stakeholder board. We believe that stakeholder consultation facilitates the effective development and management of OATTs and Business Practices, and results in issues being resolved among the parties and thus in fewer and more focused issues being presented for Commission consideration. The Midwest ISO Agreement contains such mechanisms for Midwest ISO and stakeholders to consult with each other, and provides opportunities for stakeholders to participate in a collaborative process in the development of the Midwest ISO OATT and Business Practices. We expect Midwest ISO to utilize this stakeholder advisory process to the greatest extent possible. Likewise, we expect stakeholders to fully participate in the stakeholder process, within the limits of their resources, in order to ensure that their concerns are raised in a timely manner.

*Cargill-Alliant, LLC*, 98 FERC ¶ 61,148, slip op. at 8-9 (2002) (footnotes omitted).

For the RTO to be healthy and adaptive, stakeholders must effectively and timely communicate to the board the individual wants and needs they seek to satisfy through the RTO while mindful of the RTO's obligation to implement suggestions, ideas and recommendations that serve the greater good. When the RTO's performance is not consistent with the public interest or there is no meaningful stakeholder process (as was the case for the Alliance Companies), stakeholders must proceed by presenting issues to state and federal regulators. State and federal regulators are backup providers of public interest.

With all the arrogance attributed recently to Enron, no one seems to notice that even Enron was comfortable working in the trenches with stakeholders.

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Forcing vertically integrated utility representatives to learn to work with stakeholders they previously dismissed as a noise in the background of a conversation with their regulator may also be FERC's way of helping IOUs adapt themselves to the demands of the real world.

There is some evidence that vertically integrated utilities are not sure how to function in the stakeholder-oriented system of RTO governance. This evidence is more obvious when contrasting the performance of utilities that are transmission dependent in real terms (TDUs) with the performance of the load serving of distribution entities (LSEs) that sit under the vertically integrated umbrella of an investor-owned utility (IOU). As the regulator requires all retail load to be served under the RTO's tariff and retail unbundling proceeds (often with transitional price caps), LSEs are transformed into utilities that are transmission dependent (at least in virtual terms). In most cases, TDUs are actively at work promoting efficient balancing markets, active market monitoring, RTO scope and configuration to address market power, the elimination of rate pancakes and so on. In almost no case is an LSE taking positions on these issues distinct from the advocacy position of the vertically integrated firm even though the LSE may hold much of the risk associated with the price of delivered electricity exceeding the price cap. It appears circumstantially that the LSEs are captive to a vision that conflicts with its role as a transmission dependent customer with significant dysfunctional market risk exposure due to price caps or provider of last resort obligations.

FERC's working paper on standard market design indicates that each RTO or other independent entity that operates the grid should have an advisory committee composed of members that include state representatives of retail customers' interests. This requirement seems to be directed primarily at FERC's goal of establishing a better working relationship with state regulators. The formation and operation specifics for these advisory committees may vary by region and RTO. The evolution of FERC's thinking on standard market design will help to shape the role of advisory committees and stakeholders.

## **How Are the Incentives of Directors Aligned with Goals?**

The Midwest ISO just went through a review of director compensation and the Advisory Committee was provided a summary of a report issued by the search firm used by MISO. The report summary includes information about the compensation of directors for market participants. This report indicates that little has been done to align compensation structures for directors with effective corporate performance. MISO's director compensation follows this pattern. Some stakeholders have suggested that this lack of alignment needs to be corrected.

MISO's managers do, however, have incentives built into their compensation structure. The Midwest ISO incentive compensation for officers has two components – a short-term and long-term. In addition, all MISO employees have an annual incentive opportunity. Non-officer employees, depending upon the area, may have department goals as well as the corporate goals. The short-term corporate goals include operating within budget, minimization of errors (inadvertent, settlements and system availability), integration of new transmission owners (SPP for example), reduction in MISO's funding adder, improved grid reliability (reduction in operating limit violations) and meeting with stakeholders (transmission owners) and regulators. Longer term goals include maintaining and improving system reliability, achieving cost reduction measures, development of a robust market for transmission with particular emphasis on a single-market congestion management mechanism and superior customer satisfaction.

RTO foundation documents are generally pretty vague on directors' and managers' compensation. For example, the PJM agreement (Section 9.6) simply says that the directors will set compensation for this population.

## **What Procedural Rules Guide or Constrain the Board's Activities?**

As indicated above, board guidance is provided by the policy goals and other directives established by FERC, the rule of law and the deference the board may show to persuasive stakeholders. Within the RTO, there are the typical articles and bylaws or code of regulations that establish power and duties and define the

process by which performance occurs. In addition, there may be “contracts” with transmission asset owners that deal with their compensation and the duty of care that the RTO must exercise while using their grid assets.

Market monitoring units (MMUs) are receiving much attention these days as an independent source of information on the adequacy of the market and actions that should be taken to address market power. The flow of information from MMUs to state regulators, FERC and stakeholders will serve to guide or constrain the RTO’s performance as well as the performance of market participants.

As the market matures, guidance and constraints will be provided by the market itself. Ultimately, FERC must function to guide and constrain the board’s performance through the operation of procedural and substantive rules established by the market and FERC.

## **Closing**

I end by returning to Lord Hale. It turns out that Sir Mathew Hale presided over a witch trial in the town of Lowestoft in Suffolk, England. It also turns out that he believed in witchcraft and was responsible for the execution of two women as witches in 1664.

I guess this means that people regarded as possessing great influence and intellectual powers can be wrong but it may be unsafe to tell them so in real time. I also suggest that the alleged witches would have benefited greatly by being able to consider a little of our electric industry restructuring experience. Access to this experience may have avoided their premature termination and provided them with the substantial economic gains through recovery of witching costs rendered uneconomic by the reform movement as well as cash incentives to help relieve congestion at the stake.

I hope this paper is useful.