Comments Of The Indiana Utility Regulatory Commission
To The
Federal Trade Commission
Regarding
"V010003 -- Comments Regarding Retail Energy Competition."

Indiana's experience with retail competition is currently limited to a pilot program offered by Northern Indiana Public Service Company (NIPSCO) that was approved by the Indiana Utility Regulatory Commission (IURC) under the Alternative Regulatory Plan (ARP) statute. This program is only available to NIPSCO's gas customers and is not available to its electric customers. More generally, the IURC's State Utility Forecasting Group (SUFG) located at Purdue University has, over the past few years, conducted assessments of some of the financial benefits and costs associated with retail competition in the electricity sector. Thus far, the SUFG's analysis has been inconclusive as to whether retail competition would provide significant reductions in electricity prices even assuming a competitive regional wholesale market. The SUFG's analysis also suggests that, for various periods of time, the direct financial benefits may be negative. These preliminary conclusions are, in large part, attributed to Indiana's traditional access to low-cost coal.

While we will offer some observations concerning this limited program, Indiana law may not permit the IURC to order retail competition so our brief comments will primarily address some of the ramifications for Indiana resulting from retail competition in surrounding states (particularly Ohio) as well as wholesale competition as it affects Indiana. The emphasis will be on the implications for the electric markets but, to varying extents, it is relevant to the gas markets since certain Indiana utilities have gas operations in other states that permit retail competition.

Certainly, one of our greatest concerns is that companies that have operations in both regulated and unregulated markets will have every incentive to move costs away from "competitive" markets and to states, such as Indiana, that are characterized as "regulated" markets. Profits, in contrast, would move in the opposite direction. For Registered Public Utility Holding Companies that have operating companies in states that now have retail competition as well as Indiana, the IURC has "Operating Agreements" that govern transactions among the holding companies' various operating affiliates. These Agreements are coming under increasing pressure to be responsive to the ramifications of retail competition. At the same time, the IURC has an abiding concern that there be adequate safeguards to protect the customers of the holding companies' operating affiliates. We are also concerned with the structure of the markets and the attendant implications for reliability, economic efficiency, and a variety of unintended consequences emanating from competition in surrounding states.

In Ohio, for instance, retail rates are frozen as a result of that state's move toward retail electric competition. Ohio's retail rates were frozen prior to the extreme run up in natural gas prices and the utilities are not able to pass on the increased fuel costs to their Ohio customers. This provides an incentive for utilities that operate in both Indiana and Ohio to shift costs, where possible, to Indiana consumers.

There is, now, considerably greater certainty regarding the cost implications of environmental compliance – including unit specific costs associated with NOx reduction. As with increased fuel costs, the inability to increase retail rates in Ohio that result from environmental compliance provides an incentive for the utilities to shift environmental costs to their affiliates in Indiana. In some cases, a utility will have some discretion regarding the selection of generating resources for environmental upgrades. That is, to the extent allowed by the EPA, a utility would have an incentive to try to maximize its "ratebaseable" investment in Indiana and avoid any investment in environmental compliance costs in Ohio.

To gain inroads into competitive markets, there is an incentive for utilities that operate in both competitive and regulated markets to alter dispatch practices and allocate the cheapest power purchases and fuel to the consumers in competitive markets. To the extent that a utility could sell excess generation into a tight market, they could reap profits and not share those with their affiliate that operates in regulated markets. Having an Operating Agreement governing how benefits and costs associated with joint economic dispatch are to be shared among the various operating companies is intended to limit this type of behavior.

The Ohio law also requires utilities to relinquish a certain amount of load during the transition period or be subjected to greater shopping credits to induce customers to select alternative suppliers. This new load uncertainty creates added incentive for costs and revenue shifts. The reserve margins (or capacity margins), for instance, should be greater in Ohio due to the inherently more volatile load requirements – especially if the remaining load has a lower load factor than it's current mix of customers or in relation to its affiliate's load requirements in Indiana. Notwithstanding the rationale for a higher reserve margin in Ohio, there would be an incentive for the companies to maintain higher reserve margins for Indiana customers and permit their Ohio customers to "lean" on generating capacity located in Indiana.

To the extent that an incentive exists for higher reserve requirements in regulated states, this will necessarily skew capacity addition decisions of utilities that operate in competitive and regulated jurisdictions. It is a certainty that utilities subjected to a rate freeze in Ohio will make every effort to avoid investing in new capacity in Ohio. On the other hand, the opportunity to recover their investments and earn a rate of return in Indiana provides a powerful incentive to build all capacity in Indiana. At the extreme, it is possible that the reliability and economic benefits of the new capacity would inure primarily to customers in Ohio. In most cases, it is likely that consumers in Indiana will also benefit from the additional capacity and an effort would be made to determine the extent of benefits relative to the costs in a Certificate of Need proceeding but it will be exceedingly difficult to ascertain if, and to what extent, Indiana consumers will be subsidizing customers in Ohio.

It is also possible that a utility affiliate could construct a "merchant" facility and sell power to its regulated affiliate at above "market" rates. While the IURC still has authority to approve this transaction, particularly with an enforceable Operating Agreement, detection of an arrangement that would result in the regulated company paying higher than market prices is made more difficult by the absence of a well-defined wholesale market with transparent prices.

There is a possibility that other purchased power decisions could be also skewed for utilities that operate in both competitive and regulated markets. We believe that the utilities have a greater incentive to purchase power on the "spot" market for consumers in competitive markets because it is, for most hours of the year, lower cost. At the same time, we would expect utilities to either build generating capacity or to purchase generally more expensive longer-term contracts for customers in regulated markets. During periods when the spot market has higher and more volatile prices, the utilities could take power from longer-term contracts ostensibly purchased for their consumers in regulated markets to insulate their customers in competitive markets from price volatility associated with greater reliance on the spot market. We don't believe that this is a theoretical construct but, rather, there are some indications that this situation may have occurred in the natural gas markets this year.

Joint and common costs, such as the administrative costs associated with operating both the regulated and competitive entities, will also have a tendency to flow to regulated markets. In many cases these will be relatively small but persistent patterns of cost shifting. At the other extreme, adverse financial situations affecting one or more affiliates could have significant adverse affect on the financial structure of the entire company and its ability to acquire favorable financial treatment. The history over the past twenty years is replete with instances where the financial distress of an unregulated subsidiary results in financial harm to the regulated enterprise and its customers.

Recognizing that many of the transactions will be minor but routine while others will be complex and extreme, it will be extraordinarily difficult to prevent, monitor, detect and remedy the improper shifts of costs and revenues under the best of circumstances. Unfortunately, state commissions are rarely in a serendipitous position of being faced with the "best of circumstances" due to funding and legal limitations. Even if staffing, access to information from interstate companies, and other practical considerations could be overcome, state regulatory commissions often do not have the legal authority to act as an enforcement agency for matters generally regarded as in the realm of "antitrust." Safeguards, such as Codes of Conduct and Affiliate Rules or system Operating Agreements, are unlikely to be panaceas to protect Indiana consumers against the abusive actions of utilities because of the overwhelming incentives and the corresponding lack of disincentives even if detected. Certainly, we have no confidence that the industry will police themselves. There have been allegations that the "Chinese Walls" erected to prevent affiliates in competitive markets from having access to competitively valuable information have been porous.

With regard to specific observations about retail market design or implementation flaws, we would briefly like to discuss customer participation. Our limited empirical evidence from the NIPSCO retail competition experiment is generally consistent with the experience of states that permit retail competition. In the NIPSCO program, a lack of competitors that are unaffiliated with NIPSCO or its subsidiaries has limited the competitive options for customers. For residential customers, the choices have been limited to only one or two firms that were not affiliated with NIPSCO. Certainly, NIPSCO's relatively low rates has preempted competition but there were, particularly in the initial stages of the program, concerns about NIPSCO's rate design as a barrier to entry. In part, this was due to the quarterly Gas Cost Adjustment

(GCA) that provided a difficult target for competitors due to its unpredictability. Competitors, for instance, had difficulty in offering a "guaranteed" discount due to the uncertainty of the GCA. In response, the IURC granted NIPSCO's request to move to a monthly GCA to more accurately reflect the price of gas at any given time and allow a better opportunity for competitors to compete.

Concerns about utilities operating in competitive and regulated markets seem certain to be manifested in the pricing of transmission services. The retail rate freezes, for instance, have been cited as a rationale for efforts by transmission owning utilities to recover greater revenue from transmission services. The ability to recover extraordinary revenues from transmission services seems to be abetted by recent decisions of the Federal Energy Regulatory Commission (FERC). Traditional ratemaking practice requiring rates to be predicated upon ratebase has been replaced by the FERC's allowing utilities to recover estimates of revenues lost as a result of providing open-access related services to the market. The FERC, in a further effort to promote open-access and advance their Regional Transmission Organization (RTO) policies, has even allowed bonus rates of return on top of the generous treatment of lost revenue.

For retail competition to be successful, it is imperative that the wholesale markets be robustly competitive. The Indiana Commission is very concerned that the noble efforts advanced by the FERC to promote Regional Transmission Organizations seem to be deteriorating. For this reason, we strongly urge the FTC to carefully scrutinize the RTOs, and agreements among RTOs, in the Midwest for anticompetitive attributes. The potential for anticompetitive practices are of deep concern to the IURC since it seems that Indiana is likely to be split into two RTOs with a "horseshoe" of Alliance RTO members around Indiana members of the Midwest Independent System Operator (MISO). This horseshoe threatens to isolate the Indiana MISO members and make them susceptible to suffering anticompetitive practices. Because of our concerns, the IURC believes that a resolution of "seams" issues is of paramount importance. Based on this Commission's involvement with seams issues such as "congestion management," we are very pessimistic that these can be resolved on a voluntary basis and even more pessimistic that this can be done by the December 15, 2001 deadline for RTOs to be operational. Based on our involvement with the MISO, it appears that some market participants prefer protocols that they believe will allow them to manipulate the market. Some entities that participated in the seams debates have suggested that they prefer "chaos" in the markets. It's telling that even the three relatively homogeneous northeastern RTOs are having extraordinary difficulty in resolving seams issues.

Indiana is at the "crossroads" of interstate natural gas pipelines. Indiana also benefits from a generally robust electric grid. At the intersection of pipelines and electrical transmission, Indiana is experiencing a boom in construction of "merchant" power plants. Unfortunately, the proximity of pipelines and wires may not result in an optimal location for the grid and there are no countervailing financial incentives to site facilities in areas that will benefit the grid. Certainly, there is little incentive for vertically integrated utilities to assist developers in selecting an optimal site for generation (or other alternatives) to relieve constraints. In fact, there may be disincentives to assisting power plant developers since a vertically integrated transmission-owning utility may be able to exercise market power as a result of their unique capability to resolve a transmission constraint. In the longer-term, we hope that RTOs and well-designed congestion management protocols that impart accurate price signals to relieve congestion will result in the proper incentives for efficient siting of generating units and other measures to relieve constraints. Of course, the RTOs ability to perform this task is at risk if it does not have the requisite control and independence.

As Indiana and the nation places an ever-increasing reliance on natural gas to replace coal-fired generating units and to meet increasing demands for electricity, there is a growing concern that market power could be exerted in both the electric and natural gas markets. The concern is heightened for those utilities that have both electric and gas operations where actions by one operation could favor its affiliate to the detriment of non-affiliated entities and consumers. On peak winter days for instance, strategically located gas utilities might be able to manipulate the gas and/or electric markets by withholding gas supply or unused pipeline capacity. Increased demand for electricity during this circumstance may necessitate greater use of gas-fired generation - particularly if coal piles are frozen, certain other generating units are off-line, and/or if certain transmission facilities are out of service. The ability to manipulate the gas and electric markets is enhanced by fundamental changes in the operations of the natural gas markets (e.g., increased demand for gas especially during the summer, reduced injections of gas into storage during the summer months, the potential failure of gas infrastructure to keep pace with the burgeoning demand for gas) as well as long-standing defects in the gas markets that limit price transparency and communication on a timely basis.

One of the "casualties of competition" is competition. The IURC is very concerned that the increasing regional concentration within the electric (and natural gas) industry, resulting from mergers and acquisitions, will diminish real competition. Indiana law, for instance, does not give this Commission authority over mergers involving transfers of stock. Notwithstanding public pronouncements by the FERC that they will protect states that have little or no jurisdiction over mergers, their mandate and that of individual states are not consistent and the respective definitions of "public interest" will not always correspond. The problems associated with mergers in the electric markets are exacerbated by the absence of well-designed wholesale power markets that include truly independent RTOs and entities to establish market- clearing prices, such as power exchanges, heighten our concern for the ramifications of mergers and acquisitions.

Another casualty of competition is information disclosure. As utilities (and other entities) try to position themselves for an increasingly competitive market, there is increasing evidence that entities are unwilling to provide information even if there is little or no competitive value to the information. This hyper-sensitivity toward providing information certainly affects information that is essential to effective monitoring of markets and pursuing any abusive action. This trend has severe implications for the competitive viability of retail and wholesale markets.

In conclusion, despite the IURC's limited direct experience with retail competition, we are very concerned with the experiences of other states in both the electricity and natural gas markets. Regardless of whether

[i] TRANSMISSION LOADING RELIEF (TLR): TLRs increased dramatically during the summer of 2000, relative to the summers of 1998 and 1999 (see Table), even though weather conditions were relatively mild in 2000. The trend of increased TLR events is perhaps the most important transmission issue in the Midwest to date. In order to geta more complete understanding, the Electricity Division of the IURC analyzed the data available on TLR events. This analysis includes the following Reliability Councils, ECAR, MAPP, MAIN and SPP. The future ramifications of these events become even more important if, as expected, the FERC allows three Illinois utilities to leave the MISO to join the Alliance RTO. The Alliance RTO would then form a "horseshoe" around Indiana that could create an opportunity for firms to engage in abusive behavior. It is imprative, therefore, that so-called "seams" issues (e.g., congestion management, communication, planning, transmission capability calculations and curtailment procedures be resolved.

Region	1998	1999	2000	2000 Amended*	Monthly Totals**	Region total
ECAR						
June	13	8	51	51	72	
July	4	24	102	[redacted]	90	
August	4	15	66	66	85	
Total	21	47		179		247
MAIN						
June	40	10	31	31	81	
July	25	3	92	[redacted]	81	
August	21	12	75	75	108	
Total	86	25		159		270
MAPP						
June	0	0	5	5	5	
July	0	0	12	[redacted]	8	
August	0	0	0	0	0	
Total	0	0		13		13
SPP						
June	0	4	27	27	31	
July	0	6	18	18	24	
August	0	4	11	11	15	
Total	0	14		56		70
All Regions	107	86		409		600

*Table: TLRs for levels 2 and above for Summers of 1998– 2000 * Amended by IURC staff after consulting FERC staff* ** Monthly table based on 2000 amended column.

The IURC's analysis started with a description of the TLR procedures and data provided in the FERC report, entitled: 'Investigation of Bulk Power Markets – Midwest Region', published November 1, 2000. Further data was gathered to clarify the possible reasons behind this continuous increase. In this table, only the TLRs on level 2 or above are included. These are the TLRs, which actually have an effect on transmission and accessibility of the transmission system. Also, when a TLR escalated in level while it was active, it was only counted as one occurrence. When FERC analyzed this data, it found that these TLRs were highly concentrated on a few flowgates. For example, only 5 flowgates in ECAR accounted for 41% of all TLR events in the region.

In order to get a better understanding of the TLR data, the raw data was analyzed. This analysis is the beginning of the explanation of the significant increase in the number of TLR events and led to an adjustment of he numbers applicable to July 2000, see highlighted numbers in column 5. This adjustment was necessary because during the compilation of the report by FERC, different data sources were used and different rules were applied. FERC also noted that the raw data from NERC is now checked more accurately and updates are requested if data is missing. Therefore the 2000 data is more accurate than the data gathered for 1998 and 1999. This might have made the increase larger but it can't be the sole reason for this significant increase.

The lack of accurate information and adequate remedial measures for TLR events that are inappropriately invoked, appears to have created an atmosphere of skepticism among market participants, who question whether transmission providers have any incentive not to use TLRs to favor their own generation It also indicates a lack of confidence in the power market in the Midwest. The perceived lack of clarity in the current rules and procedures, as well as the allegation of specific instancesof discrimination, harms the liquidity of the market by hindering the ability of market participants to rely on transmission access. As a result, market participants seem to have become risk-averse, eschewing long-term deals for short-term transactions.

Some market participants have suggested that the increased incidents of TLRs, in many instances, are the result of noncompetitive behavior by vertically integrated transmission providers to benefit their affiliates. For security coordinators who are affiliated with a vertically integrated utility there exists a mixed incentive to enforce reliability on the grid and to maximize power sales profit for the IOU. Their ability to engage in anticompetitive behavior can also occur because of "definitional" differences and ambiguities. There are, for example, different ways to calculate the capacity ratios, like Available Transmission Capacity (ATC) and the Total Transmission Capacity (TTC) on access and availability, whichraises questions about whether a transmission owner is manipulating his factors to the benefit of an affiliated power producer or to squeeze excess revenues for his transmission service.