BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

GRIDFLORIDA COMPANIES

PREPARED DIRECT TESTIMONY OF

C. MARTIN MENNES, LEE G. SCHUSTER, AND GREG RAMON

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Q. Please state your names and occupations.

A. There are three persons presenting this testimony jointly on behalf of Florida Power & Light Company, Florida Power Corporation, and Tampa Electric Company (the "GridFlorida Companies"). Our names, employers, and positions are:

1. C. Martin Mennes – Vice President, Transmission, Operations and Planning of Florida Power & Light Company.

2. Lee G. Schuster – Manager, Network Reliability, Florida Power Corporation.

3. Greg Ramon -- Director of Transmission Policy and Analysis, Tampa Electric Company.

Q. Please describe your involvement with the development of GridFlorida.

A. Each one of us has been significantly involved in the development of GridFlorida, collectively or individually being deeply involved in developing the governance, planning, operations, and market design proposals that have been addressed by this Commission.

Q. What is the purpose of your testimony?

A. We will describe the market design principles the GridFlorida Companies propose to adopt for GridFlorida and why it is prudent for the GridFlorida Companies to develop detailed market rules and a transmission tariff that incorporate those principles. We also will explain the GridFlorida Companies' proposal for developing the detailed market rules and tariff, including Commission review.

Q. Please provide an overview of the market design principles the GridFlorida Companies propose for GridFlorida.

A. The GridFlorida Companies propose to develop a market design structure for GridFlorida that would include the following characteristics:

(1) Congestion management and energy markets that are based on financial rights and locational marginal pricing ("LMP") concepts.

(2) A voluntary day-ahead market and a real-time market, with mechanisms to protect against undue reliance on the real-time market. The availability of these two markets sometimes is referred to as a "multi-settlement system."

(3) Payments of market clearing prices calculated on a "nodal" basis. Market clearing prices would be paid by and to purchasers and suppliers, respectively, in both the day-ahead and real-time markets. Each GridFlorida Company proposes that a substantial portion of its gain on sales in the GridFlorida energy markets be allocated to its retail customers.

(4) Mechanisms to ensure resource adequacy. These mechanisms, which would be consistent with the Commission's planning reserve requirements, would allocate capacity requirements on an individual load serving entity ("LSE") basis.

(5) Allocation of financial transmission rights to existing users to protect those users, to the extent possible, against increases in congestion costs. This would include an annual re-allocation for new resources and to reflect native load growth.

(6) Market power mitigation measures to provide safeguards against abuses of market power.

(7) A hierarchical control system, wherein existing control areas may be maintained, but GridFlorida would be responsible for the short-term reliability and overall performance of the system.

We believe that each of these market design principles is an integral part of an overall market design package intended to achieve the ultimate goal of benefitting peninsular Florida's retail customers through reliable, equitable, and transparent wholesale markets and congestion management. Mr. Rossi, in testimony he is providing on behalf of the GridFlorida Companies, explains many of the technical and operational mechanics associated with this integrated market design proposal.

Q. Would this proposed new market structure supersede bilateral markets and arrangements in Florida?

A. No. The new markets for GridFlorida would be designed around, and be consistent with, bilateral markets. LSEs could continue to serve load in peninsular Florida with power from their own generating resources or from resources they purchase on a bilateral basis through voluntary arrangements. The market design proposed for GridFlorida would supplement the existing structure in peninsular Florida with energy markets and a congestion management system that would send transparent price signals to users of the grid.

Q. How is the remainder of your testimony organized?

A. The remainder of our testimony is organized as follows:

First, we will explain why it is prudent to adopt a financial rights/LMP/multi-settlement model. We also will explain why "balanced schedules" need not be included in such a market structure, but why a mechanism must be in place to ensure against undue reliance on the real-time market.

Second, we will explain why it is prudent to adopt a market clearing price approach for GridFlorida.

Third, we will explain the GridFlorida Companies' market power mitigation principle, and why it is prudent to develop a market power mitigation scheme consistent with this principle.

Fourth, we will explain why it is prudent to adopt the GridFlorida Companies' proposal regarding the allocation of financial transmission rights to existing users of the grid, including an annual re-allocation for native load growth.

Fifth, we will explain the GridFlorida Companies' resource adequacy principle, and why it is prudent to include a mechanism to help ensure resource adequacy.

Finally, we will describe the GridFlorida Companies' proposed next steps regarding the GridFlorida proposal, including the GridFlorida Companies' proposal for additional Commission review of a detailed market design structure and detailed market power mitigation measures.

I. A Financial Rights/LMP/Multi-Settlement Model is Prudent

A. Financial Rights/LMP/Multi-Settlement

Q. Please provide a general explanation of a financial rights/LMP model with day-ahead and real-time markets.

A. The purpose of a financial rights/LMP model with multi-settlements is to establish an integrated and transparent system for buying and selling power, resolving congestion on the transmission system, and allocating costs to those market participants that cause such costs. Mr. Rossi provides a more detailed explanation of this market structure, but the following are the general characteristics of such a market design model:

- Market participants may sell and purchase power in a voluntary day-ahead market and a real-time market.
- Energy prices in both GridFlorida markets (*i.e.*, not including power sales and purchases in the bilateral market) will be calculated on a nodal basis. In the absence of congestion between two nodes (and assuming losses are

not included in calculating LMPs), those nodes will have the same market clearing price. Congestion will cause price divergence between affected nodes as generation patterns are changed to relieve the congestion.

- A market participant that schedules between resources and loads will pay to GridFlorida the congestion costs between its sinks and sources, equal to the difference between the market clearing prices at those nodes.
- The results of the day-ahead market will be financially binding. If a buyer or seller does not produce or purchase according to its day-ahead schedule, its imbalance will settle at the real-time price.
- A market participant will not need a transmission right to schedule service.
- Financial rights will be available to hedge against congestion costs. A holder of a financial right will have a right to receive a payment from the Regional Transmission Organization ("RTO") equal to the difference between the market clearing price at the point of withdrawal specified in the financial right (*i.e.*, a specified node) and the point of injection specified in the financial right (*i.e.*, a different specified node), as determined in the day-ahead market.
- The holder of a financial right will not need to schedule service between the source and the sink to obtain a payment right.

Q. Please explain why the GridFlorida Companies propose to adopt a financial rights/LMP/multi-settlement market structure.

A. Three important goals can be satisfied by adopting a financial rights/LMP market design with day-ahead and real-time markets. First, such a market design would provide transparent price signals for the energy markets administered by the RTO and for congestion management. Second, such a market design structure should help minimize the time and cost associated with implementing a new market design structure. Third, such a market structure should help attain the Commission's goal of maintaining GridFlorida as a Florida-specific RTO.

Q. Why do you believe that an LMP/financial rights/multi-settlement model provides transparent price signals?

A. The market design structure proposed by the GridFlorida Companies–a LMP/financial rights/multi-settlement model--includes a number of components that work in tandem to produce transparent price signals. We believe that this type of market structure has proven to be successful in both the Pennsylvania-New Jersey-Maryland Interconnection ("PJM") Independent System Operator ("ISO") and the New York ISO ("NYISO"). On the other hand, other market designs have not been as successful.

As Mr. Rossi explains more fully in his testimony, LMP is an energy pricing mechanism that prices energy at each node on the grid based on the price to serve load at that location. When there is no congestion, the nodal prices will be the same (assuming losses are not included in the nodal prices). When there is congestion, the nodal prices will differ due to the fact that more expensive generation will need to be used to serve load in the congested area. Nodal energy

prices, which are used both for the pricing of energy purchases and sales in the RTO spot markets and for pricing congestion associated with schedules to deliver power across the grid, thus reflect system conditions.

Further, financial rights will be available to market participants to provide hedges against congestion costs. Because a financial right is not required to schedule service, however, a market participant that is willing to pay congestion is able to schedule service even if it does not have such a right. That customer will be responsible for the costs it causes.

The day-ahead market is available for willing buyers and sellers to transact on an economic basis. The day-ahead market is a centralized market that is in addition to the bilateral market. In the day-ahead market, sellers may submit bids to sell power, and an LSE will be free to seek to purchase as much of its power as it desires. The RTO will clear the market based on the supply bids and demand bids, and charge the resulting nodal prices to purchases and sales in that market.

Finally, in real-time GridFlorida will operate the system to resolve all deviations from the day-ahead market (*e.g.*, load in excess of the amount scheduled by an LSE to be served by self-schedule, bilateral purchase, or day-ahead spot market purchases) using least-cost, security constrained dispatch.

Q. What is the basis for your conclusion that the proposed market design structure should help minimize the time and cost associated with implementing a new market design?

A. Financial rights/LMP market designs coupled with two-settlement systems have been implemented or are being considered by many ISOs and RTOs throughout the country. The two most prominent examples are two that we already have mentioned--PJM and the NYISO. Further, the SeTrans RTO, Midwest ISO, ISO-New England, and the California ISO are in various stages of considering or implementing such a structure. Because this structure is becoming more wide-spread, obtaining and implementing software and developing detailed operating and other protocols for it should be relatively straightforward and cost-effective.

Further, because it appears that this basic market design structure will be adopted in a number of regions throughout the country, difficult seams issues may be minimized in implementing GridFlorida. Again, limiting such issues should ease implementation of such a structure in peninsular Florida.

Finally, because many market participants already will be familiar with LMP/financial rights/multi-settlement systems, that approach has the potential to be relatively user friendly, making training easier.

Q. Do you expect these benefits to be limited to the start-up of GridFlorida?

A. No. Market designs have evolved over time in operational ISOs, and they likely will continue to evolve in the future. As more experience is gained with the markets, some relatively minor operational changes to market design software and systems likely will be warranted, as will changes to more basic aspects of the market rules. Using a market structure that is compatible with other regions of the country will allow GridFlorida to benefit from the experience gained in other

regions, and to utilize software and other systems changes that other regions adopt and that would be appropriate for peninsular Florida.

Q. Does this mean that you are proposing to adopt the PJM or New York detailed market rules, or any other particular set of market rules?

A. No. The point here is that detailed market rules have been established in those ISOs, have been changed over time to address specific issues that have arisen, and have proven over time to be effective. They thus provide important lessons that can be used when developing detailed market design rules that are best for peninsular Florida.

Q. Why do you believe that the market design structure proposed herein will help maintain GridFlorida as a Florida-only entity?

A. We believe that concerns about seams issues have been major driving forces behind calls to limit the number of RTOs in the country, including calls for only one RTO for the southeastern United States. While such calls have not been as common recently as they were in the past, if major seams issues result in market distortions or perceived market distortions, we believe that there will be additional pressures in the future to merge GridFlorida into a larger RTO in the southeast. This will put GridFlorida as a Florida-only entity at risk, and could raise a number of jurisdictional issues. Inter-regional transactions should be more practical if GridFlorida utilizes the same basic market structure as other ISOs and RTOs, which should decrease pressure on merging GridFlorida into another RTO.

B. Mechanism to Ensure Against Undue Reliance on the Real-Time Market

Q. In the principles you listed above, you state that the GridFlorida market design should include a mechanism to protect against undue reliance on the real-time market. Please explain what you mean by mechanisms to ensure against undue reliance on the real-time market.

A. When we state that mechanisms should be in place to ensure against undue reliance on the real-time market, we mean that mechanisms should exist to ensure that adequate resources will be available in real-time to ensure reliable operation of the system.

Q. Why do you believe a specific mechanism should be adopted to ensure that adequate resources are available to GridFlorida for reliable real-time operations?

A. The GridFlorida Companies are adopting a market design structure that permits LSEs to serve their loads by self-scheduling their own resources, through bilateral purchases of power, or through a voluntary day-ahead market. However, notwithstanding the availability of these options, there may be some LSEs that, rather than responsibly planning to meet their loads prior to real-time operations, would attempt to rely heavily (*i.e.*, lean) on the real-time market for that purpose, or would attempt to obtain at the last possible moment the supplies necessary to serve their loads. These LSEs may believe that they can obtain an economic advantage by taking such an approach, or there may be other reasons for doing

so. Regardless of the reasons, there can be significant operational concerns that arise as a result of LSEs waiting until the last possible moment to procure the supplies essential to meeting their loads, or not obtaining such supplies and instead relying on resources being available through the real-time market.

Specifically, once it becomes operational, GridFlorida will be responsible for the short-term reliability of the grid. A basic tenet of reliable utility operations is ensuring that sufficient resources--either loaded and serving load, spinning but unloaded, or available on a quick start basis--will be available to serve load on a real-time basis, while maintaining adequate operating reserves that are available in the case of an unplanned event such as the unexpected loss of a transmission line. If LSEs rely heavily on the real-time market to serve load, rather than procuring resources for that purpose, there is a real risk that adequate resources will not be available. Further, LSEs waiting until the last minute prior to real-time before obtaining resources can make it difficult for the RTO to reasonably plan the operating day unless a mechanism is developed to allow it to address such situations. We believe that it is absolutely essential to ensure that adequate resources are scheduled in a timely manner that will be needed to operate the system reliably. We thus believe that a specific mechanism to ensure the availability of sufficient resources in real-time should be adopted to ensure that an LSE's purchase decisions do not adversely affect reliability.

Q. Does this mean that balanced schedules must be required, *i.e.*, that each LSE should be required to purchase or otherwise schedule energy prior to real-time operations in sufficient amounts to serve its expected load?

A. No. Requiring balanced schedules is one way to avoid over-reliance on the real-time market. That is why a balanced schedule requirement was included in earlier GridFlorida proposals.

However, we believe that mechanisms other than balanced schedules should be developed that will better provide LSEs with flexibility in serving their load, provide the RTO with assurances that sufficient resources will be available in real-time, and that will allocate the costs of making such resources available to those entities that cause such costs. For example, it may be possible to provide the RTO with a right, prior to real-time operations, to arrange for additional resources when it does not believe that sufficient resources otherwise will be available for reliable real-time operations. The GridFlorida Companies thus are not proposing to include a balanced schedule requirement as part of the GridFlorida market design structure. Instead, the specific mechanism to ensure against undue reliance on the real-time market and the needed availability of adequate resources would be developed along with the other detailed market design rules.

Q. Please explain further your statement that the cost of ensuring that sufficient resources will be available for real-time operations should be allocated to the entities that cause such costs.

A. This really is nothing more than the basic and long-accepted principle of cost causation, *i.e.*, the principle that those who cause costs should be responsible for those costs. Ultimately, there is a cost to ensuring that sufficient resources will be available for reliable real-time operations; suppliers should not be required to stand ready to serve load during real-time operations without being compensated for doing so. The GridFlorida Companies believe that the money to pay those suppliers should come from entities that purchase energy from the real-time market, or entities that make purchase decisions after expenses have been incurred to ensure resource adequacy, as it is those entities that ultimately caused the costs.

Q. How will reliability must run ("RMR") units be treated in the GridFlorida market?

A. RMR units generally are defined in existing ISOs as generating units that the ISO requires to operate the system under certain, specified operating conditions. The treatment of RMR units will need to be addressed as part of the detailed GridFlorida market design. When addressing those units, it will be necessary to ensure that the treatment of those units is consistent with the overall market design and consistent with the need to ensure reliability. The GridFlorida Companies do not believe, however, that RMR contracts should be used on a regular basis to serve load in the real-time market. Rather, the bilateral and spot markets should be the main source of energy.

II. The Proposal To Utilize Market Clearing Prices is Prudent

Q. Please explain why the GridFlorida market design should include a market clearing price approach.

A. We believe that payment of market clearing prices is an essential component of the market design package the GridFlorida Companies are proposing. The entire LMP structure is built around, and assumes the payment of, market clearing prices, and we believe that the benefits of such an approach would be lost were an alternative pricing structure adopted. Further, as Mr. Rossi explains, alternative pricing structures can lead to distorted bidding by suppliers, which can distort market outcomes. We thus believe that retail customers in peninsular Florida are best served by a market design structure that includes payment of market clearing prices.

Q. But would not those customers be subject to higher costs as a result of implementing a market clearing price approach, versus a pay-as-bid approach?

A. As Mr. Rossi explains, whether prices to customers are higher or lower under a market clearing price regime than a pay-as-bid regime would tend to turn on whether suppliers tended to guess high, *i.e.*, tended to submit bids that exceed the market clearing price that would occur under a market clearing price regime, or tended to guess low, submitting bids that would be below the market clearing price that would occur. A conclusion in this regard thus cannot be stated unequivocally. However, as Mr. Rossi also explains, ultimately the inefficiencies

in generation dispatch that result under an approach other than a market clearing price approach can be expected to harm retail customers through higher energy costs.

Further, each of the GridFlorida Companies believes that a substantial portion of its gain on sales in the GridFlorida energy markets should be allocated to its retail customers. This not only will provide retail customers with significant protections against higher costs, it can prevent wealth transfers between retail customers. Under a pay-as-bid approach, energy prices may not reflect the true market value of the energy being purchased. Thus, under such an approach one set of customers effectively may be able to utilize another set of customers' resources at less then the value of those resources. This transfers wealth from the second set of customers to the first.

Q. What would happen to the portion of the gain that is not allocated to retail customers?

A. The small portion of the gain that is not allocated to retail customers would be allocated to the applicable GridFlorida Company. This will provide an incentive for participation in the real-time market by the GridFlorida Companies.

III. <u>The GridFlorida Companies' Market Power Mitigation Principle is Prudent</u>

Q. Do the GridFlorida Companies propose to adopt market power mitigation measures that will apply to the GridFlorida markets?

A. Yes. The GridFlorida Companies believe that market power mitigation measures should be adopted for the GridFlorida markets to protect against abuse of market power.

Q. Have the GridFlorida Companies developed those market power mitigation measures?

A. No. Like the other detailed aspects of the GridFlorida markets, the GridFlorida Companies have not developed the detailed market power mitigation measures that should apply for GridFlorida. However, the market power mitigation mechanisms must be consistent with the market design structure, and thus the GridFlorida Companies believe that the market power mitigation mechanisms can be developed only when the market design details have been developed. We explain below the GridFlorida Companies' proposal for developing these details.

Q. Is it the GridFlorida Companies' intent to have market power mitigation and market monitoring procedures in place before implementation of the new market design?

A. Yes.

IV. The GridFlorida Companies' Proposal Regarding the Allocation of Financial Transmission Rights to Existing Users of the Grid is Prudent

Q. Why do the GridFlorida Companies believe that financial transmission rights should be allocated to existing users?

A. This principle is based on the belief that those entities that have rights to the system prior to the implementation of GridFlorida, either through existing

contracts or as native load users, should receive similar rights through a direct allocation of rights. We do not believe that those entities should be required to obtain such rights through an auction process, which is the alternative to allocation that some entities have suggested. Absent an allocation, existing users could face an inappropriate allocation of congestion costs.

Q. Please explain the basis for your statement that under an auction process existing users could face an inappropriate allocation of congestion costs.

A. We believe that this risk arises for two basic reasons. First, because competitive electric markets are immature, it may be hard for LSEs to determine the level of congestion costs that likely will occur on a long-term basis between two points on the system. LSEs would not be well positioned, particularly initially, to determine the appropriate amount to bid for financial rights. LSEs thus may not obtain financial rights because they bid too low, subjecting them to congestion costs, or they may obtain rights but pay more than the congestion costs they are hedging against. Second, a full auction process for transmission rights can be extremely complicated. This can place undue risks on existing users if they have to purchase financial rights in an auction, as a lack of understanding of the complicated rules can result in an LSE not acquiring the rights it desires. Ultimately, this would place Florida retail customers at risk for additional congestion costs.

Q. What do you mean when you state that existing users should be protected "to the extent possible" against increases in congestion costs?

A. This caveat reflects the fact that there may be instances where all of an LSE's desired financial transmission rights to serve all existing uses cannot be granted. As Mr. Rossi explains, the number of financial rights that can be issued must be simultaneously feasible, that is, the system must be able to handle the simultaneous flows that would be associated with all of the financial rights that are issued. Thus, an LSE may not receive all of the financial transmission rights that it believes are necessary to protect it fully against congestion costs, especially where congestion costs are incurred today to serve its load. To the extent an LSE is causing congestion costs today but not fully incurring those costs, it will be subject to greater congestion costs than it pays today. It is important to note that this does not necessarily reflect an increase in the total amount of system-wide congestion costs, but rather a better allocation of such costs to those entities that cause them (consistent with the cost causation principle), but may not be paying them today.

Q. What will happen to financial rights above those that are allocated to existing users?

A. Additional financial rights would be made available pursuant to auction procedures. Any qualified entity that desired those additional financial rights would have an opportunity to bid for those rights.

Q. Have the GridFlorida Companies developed the allocation methodology or auction rules for GridFlorida?

A. No. The GridFlorida Companies believe those processes should be developed as part of the detailed market design development.

V. The GridFlorida Companies' Resource Adequacy Principle is Prudent

Q. Why is it appropriate to include a mechanism designed to ensure resource adequacy in the GridFlorida market design?

A. A sound market design structure must ensure that adequate resources will be planned for and available to serve load when needed, and that each LSE is allocated an equitable share of the cost of ensuring the availability of such resources. Including a resource requirement that meets these goals will help achieve both reliability and reasonable market prices. The GridFlorida Companies thus believe that a resource adequacy mechanism should be developed for GridFlorida.

Q. Do the GridFlorida Companies propose to develop a mechanism that would supplant the Commission's planning reserve requirements or its authority over planning reserves?

A. Absolutely not. To the contrary, the GridFlorida Companies believe that the Commission should continue to set the reserve requirements for peninsular Florida. An LSE-specific requirement would be established for GridFlorida, helping to ensure that one LSE cannot unduly lean on another and obtain an advantage in the market. Further, GridFlorida would administer the requirements and enforcement mechanisms associated with satisfying resource adequacy standards.

Q. Why do you believe that a resource adequacy requirement can help maintain reliability and reasonable market prices?

A. As we already have explained, to help ensure reliability adequate resources must be available to serve load on a real-time basis. We also believe that insufficient availability of resources can lead to very high energy prices, a result that was seen in California. The resource adequacy requirement will be specifically designed to help ensure that adequate resources are planned for and available for reliability and to maintain reasonable energy prices.

Q. How would the proposed LSE-specific requirement be enforced?

A. The specific resource adequacy requirement enforcement mechanism will need to be developed. However, the GridFlorida Companies believe that such a mechanism should be designed to be consistent with the rest of the GridFlorida market design, should be forward-looking, and should be developed to help ensure that resources will be available when GridFlorida needs them. As we mentioned, the goal of such a resource adequacy mechanism ultimately will be to ensure that adequate resources will be available to serve load in Florida reliably, with an equitable allocation of costs.

VI. Proposed Next Steps

Q. Have the GridFlorida Companies developed a proposal for developing detailed market rules and market power mitigation rules for GridFlorida?

A. Yes. For the reasons we have explained, and the reasons explained by Mr. Rossi, the GridFlorida Companies believe that the market design principles described

herein provide a prudent basis for developing detailed market rules for GridFlorida, and that those principles can be approved as such. The GridFlorida Companies also recognize, however, that the principles described herein are just that--principles--and that a significant amount of detail will need to be developed to implement those high level principles. The GridFlorida Companies thus have developed a proposal for developing the necessary market design and market power mitigation detailed rules.

Q. Please explain how the GridFlorida Companies propose to proceed.

The general principles described herein must be included in detailed market design and market power mitigation language for inclusion in the GridFlorida transmission tariff or other protocols. After the Commission issues an order addressing the market design/market power mitigation principles, the GridFlorida Companies propose to develop that detailed tariff and protocol language with input from stakeholders. The GridFlorida Companies propose then to provide that detailed language for Commission review. Following such Commission review, the GridFlorida Companies would make a comprehensive GridFlorida filing with the Federal Energy Regulatory Commission ("FERC").

This approach provides a number of benefits. First, it recognizes the desire of additional stakeholder input as the detailed market design and market mitigation rules are developed. Second, it recognizes the need for additional Commission review of the detailed rules, and the need for a subsequent filing at FERC. Finally, it recognizes that ultimately it is the GridFlorida Companies that

are responsible for filing the detailed GridFlorida rules and obtaining approval for those rules.

Q. Does this conclude your testimony?

A. Yes.

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the Prepared Direct Testimony of C. Martin Mennes, Lee G. Schuster and Greg Ramon has been furnished by Electronic Mail(*), Overnight Delivery(**) or Hand Delivery(***) and by United States Mail this 19th day of September, 2002, to the following:

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