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FINANCIAL TRANSMISSION RIGHTS: IMPLEMENTATION ISSUES

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Overview

After FERC's Order 888, pricing of transmission service and a design for rights to use transmission facilities has become one of the core issues in the newly deregulated electricity markets in U.S. Some regions (such as PJM, New York, and New England) have adopted market mechanisms involving locational pricing of electricity, coupled with financial transmission rights (FTR). In this paper we will explore some issues that may arise in the application and implementation of FTRs.

Results

Although FTR markets serve several important roles in deregulated electricity markets, there are some issues that may arise in their application and implementation.

First, the performance of FTRs depends heavily on the performance of energy markets. If energy markets do not function properly (such as some generators having significant market power), then FTRs will not necessarily provide appropriate signals for investment in generation and transmission. From the perspective of investment in generation and transmission, the dependence of FTRs on energy bids may yield false signals to the market. Similarly, distorted FTR prices introduce an additional uncertainty for market participants when deciding how much to hedge against locational price differences.

Second, implementing FTRs may lead to substantial wealth transfers. Although Load Serving Entities (LSEs) with grandfathered transmission rights are the initial recipients of FTRs in some regions (such as PJM and New York), substantial wealth transfers are likely as the markets develop. Once the transition period is over, some LSEs may sell off their FTRs with the expectation that the locational price differences are not going to be significant. But the uncertainty and volatility in wholesale markets may then leave those LSEs exposed to high transmission payments. The wealth transfers can also occur from LSEs located in higher price regions to LSEs in lower price regions.

Third, FTRs may enhance suppliers' market power in energy markets. A generator with market power may have enhanced incentives to manipulate energy prices if that generator also holds some FTRs. A dominant generator with the right set of FTRs can obtain supra-normal profits not only from higher payments for its generation, but also from higher FTR receipts.

Conclusions

FTR markets are still in their infancy and so we have witnessed only the initial kinds of transactions they may arise. We have raised the above issues regarding FTRs not out of any desire to merely carp at the mechanism, but rather to provide a "heads up" to policy makers. We believe that FTRs and their related instruments represent the best way to deal with the issue of transmission congestion in deregulated electricity markets. However, as with any market mechanism, they can be abused by some, they can in combination with other asset holdings exacerbate problems within a market, and, like practically everything human beings invented may have many unintended consequences. Policy makers should consider monitoring the development and behavior of the FTR markets, just as they have the other components of the electricity, minimize the problems that may arise.

References

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