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Interview

Energy

Electric Industry Restructuring Stalled, True Competition Hard to Find, Says **ELCON**

John Anderson has spent the past 25 years trying to restructure the U.S. electric industry, and he is pretty sure that the large end-users he represents are not benefiting much more than they did under traditional regulation.

Anderson is president and chief executive officer of the Electricity Consumers Resource Council, known as **ELCON**, a trade group formed almost 30 years ago by large industrial buyers of electricity.

Major manufacturers have been one of the original drivers of the ongoing effort to restructure the \$220 billion U.S. electric industry and introduce competition into the last monopoly of the energy business.

Lately, Anderson is given to blunt and uncharacteristically pessimistic assessments.

He told a Houston energy conference a few weeks ago that "there is less consumer focus in this current market than we had under traditional regulation."

He sees the development of regional transmission organizations, or RTOs, which are supposed to coordinate transmission across broad regions, as "expensive disappointments that are hard to justify, especially given the paltry benefits for consumers."

In an interview Feb. 23 with BNA, Anderson said it is time for a serious discussion "about what is good and isn't good for consumers," stressing that he is not suggesting turning back the clock to traditional regulation.

ELCON represents large companies including Air Liquide, Anheuser-Busch, BP, ChevronTexaco, DaimlerChrysler, DuPont, General Motors, Intel Corp., and Procter & Gamble, Weyerhaeuser, and others that use as much electricity as many cities.

The watershed year for the restructuring movement came in 2000-2001 with the California electricity market meltdown and accompanying Enron Corp. scandals.

"When you have a very sensitive and highly political restructuring going on, and you have two very large negative issues hit, the pushback was even greater than I thought it was going to be," Anderson said. "The falloff was very significant."

"It seems to me we're just stalled," Anderson said. "We're in this very difficult, stalled state What we have now is restructuring without true competition."

New Playground

About 16 states have moved toward some form of choice at the retail distribution level and probably will not reverse themselves, Anderson said, but in 2000, approximately 25 states announced plans to move toward more competitive retail markets.

California again may be the "bellweather" state, Anderson said, and is being watched closely to see if it will embrace a proposal by Gov. Arnold Schwarzenegger (R) to allow large customers to shop around for their electricity suppliers and to encourage utilities to sign long-term contracts.

At the height of the energy crisis, California signed high-priced, long-term contracts worth about \$26 billion to ensure adequate supplies, which will take the state more than a decade to pay off.

The poor response to retail choice plans in most states "indicates there's not a lot of opportunities to save money," according to Anderson.

The PJM Interconnection, a Pennsylvania-based power pool created in 1927 to serve the Mid-Atlantic region, is internationally renowned today as the premier U.S. restructured market. The pool, restructured as an RTO and greatly expanded, now controls the movement of electricity in all or parts of wholesale markets stretching from Illinois to Tennessee.

However, **ELCON** believes the new rules are stacked in favor of the existing utilities and other generation suppliers.

Also in the interview, John Hughes, **ELCON** vice president for technical affairs, said the restructured markets that have emerged in PJM have "nothing to offer customers" and represent "just a new playground for big suppliers to make money."

New Baby Bells

Anderson gives the Federal Energy Regulatory Commission high marks for opening the wholesale electricity market to more competition with several landmark orders, including Order 888, which established nondiscriminatory, open-access rules for transmission in 1996.

However, the RTOs that are emerging today are not what **ELCON** envisioned.

"We're calling them the reinvention of the Baby Bells on the electric side," Anderson said.

They have become "big bureaucracies," with 500 employees or more, and "are costing tremendous amounts of money," Anderson said.

The startup costs, when utilities turn over their transmission operations to the RTO, are reasonable, he said. This is known in FERC-ese as "Day One." But costs "skyrocket" when energy trading begins and market-based rates kick in, known as "Day Two," Anderson said.

Anderson expects the same thing will happen when the Midwest Independent System Operator begins its energy trading markets on April 1. The Midwest ISO was approved by FERC in 2001 as the nation's first RTO.

Large industrial customers are in a unique position of consuming as much power as some cities, but they are treated as retail customers subject to state laws. Anderson would like to see companies able to buy at the wholesale level as cities do.

Large industrials find that utilities and merchant generators do not have to negotiate directly with large customers in the RTO world, Anderson said, as long as the generators "bid in" the lowest price and beat their competitors. "The supplier does not come to the customer and say, 'What do you need?'" Anderson observed.

In addition, **ELCON** members do not believe they are getting the lowest generation prices possible under a popular methodology, known as locational marginal pricing, or LMP, that started in PJM and has spread to New York, New England, and the Midwest.

LMP is supposed to be a way of sending price signals that show where transmission congestion exists, which would lead to the building of more transmission.

In reality, according to **ELCON**, LMP is an artificial accounting mechanism that has become a way for utilities to pass through volatile fuel costs to the customer, shifting another risk to the consumer. "It is a poor substitute for a real market," Anderson said.

Some of the nation's largest manufacturers have told Anderson that their electricity bills for plants in PJM and New York are higher than in the South, where restructuring has been blocked by powerful vertically-integrated utilities such as the Southern Company and Entergy Corp.

Companies also say they find more predictable prices in the Southern system than they do in the so-called "organized markets" of PJM and New York, Anderson said.

The shift toward spot markets in PJM for daily and hourly pricing has created more volatility and put more of the risk on the customer, Anderson said. Companies find that long-term contracts in PJM are not really competitively priced, he added.

Buying Electricity

Paul Williams, a consultant with Liberty Energy Group in Philadelphia and a former fuel buyer for a major industrial firm, told BNA that he doubts he has saved any money in the deregulated markets where his plants were located.

Williams said he would be hard pressed to show that electricity costs for his plants in New York, PJM, Texas, and California were any lower than operations in the regulated markets of the Southeast, on the Tennessee Valley Authority system, or in Indiana.

Until last year, Williams was an energy buyer for MG Industries, an international manufacturer of industrial gases, which was bought by Air Liquide. His former company spent \$70 million a year on electricity, which accounted for more than half of its production costs for producing hydrogen, nitrogen, argon, and other gases used in a wide range of services from steelmaking to medicine.

To accurately compare electricity costs, differing fuel mixes for generation have to be taken into account, Williams said, and it is also true that rising natural gas prices, now in the \$7 per million Btu range, have a bigger impact on deregulated markets.

"A lot of end-users don't grasp that the wholesale market is the driver of costs," Williams said. "If you want retail choice in your state, you better get the wholesale markets right, otherwise you're being thrown to the wolves."

Williams is advising his clients to sign long-term contracts where possible and when it fits their business model. "I push people to lock energy prices up. Take energy volatility off the table," Williams said.

In his industrial gas business, Williams favored five-year to seven-year contracts.

Currently, electricity prices are closely tied to natural gas, which sets the marginal price in most markets, Williams said.

Williams advises his clients to "buy the dips" in energy prices and "lock in a profit margin that matches your sales."

In Williams's view, regulators still need to work on the wholesale markets. "If retail markets are stalled, it's OK in my book, until wholesale is addressed," he said.

In another example, a fuel buyer for an energy-intensive industrial firm, who asked not to be identified, told BNA that he has seen relatively stable prices over the past decade at his plant in Indiana, a state that has not adopted retail choice, but prices have risen dramatically at his plant in Maryland, where market-based rates have been implemented.

At the time the factories were built, power costs were low at both sites, the buyer said. Both plants are served primarily by coal-fired generation.

Power costs at the Indiana plant have risen only 12 percent, from 3 cents per kilowatt-hour in January 1995 to 3.4 cents in January 2005, he said. In contrast, electricity costs at the Maryland plant have jumped 88 percent, from 3.8 cents in 1995 to 7.2 cents per kilowatt-hour in January, he said.

ELCON Solutions

Anderson believes there are four conditions necessary for competitive markets to succeed.

The first would be much larger RTOs than currently exist. Several years ago, Anderson shocked FERC officials by recommending only three RTOs: one for the Eastern Interconnect, which would manage the transmission grid from the East Coast to the Rocky Mountains; a second for the Western Interconnect, which encompasses the Rockies to the Pacific Coast; and a third for Texas, which operates its own statewide grid.

ELCON was an early supporter of RTOs, Anderson said, but added, "We're just not seeing the results We're frustrated." The costs have become "astronomical" and they're not leading to the building of more transmission, he said.

Under the current RTO regime, utilities retain ownership of their transmission systems but turn over operations to an independent entity.

A second goal would be to convince regulators to approve "energy-only markets," which means abolishing the capacity markets used in PJM, New York, and New England that are theoretically supposed to show generation constraints and stimulate the building of new generation.

Utilities are getting "multiple revenue streams," Anderson said, from charges for LMP, the capacity market, reactive power, and ancillary services that when combined, are greater in some instances than what is allowable under the "prudently incurred cost" of generation under traditional cost-of-service ratemaking.

To get rid of the capacity markets, Anderson said he is willing to raise the "bid caps" on how much generators can get for their power sold into the power pools. But politicians would have to be willing "to take a lot of heat" when prices spike, Anderson said, until enough transmission is built.

"Name another commodity market that has a capacity aspect to it. I can't think of any," Anderson said.

ELCON's third recommendation is promoting a robust "demand response" market.

Currently, PJM estimates what its load will be for the next day, ensures enough that generation is available, and then sets a market clearing price at the cost of the highest unit, which usually is more expensive natural gas-fired generation.

Anderson wants to move beyond traditional interruptible contracts and experimental programs, which are popular but have no impact on price.

Anderson would like to see a demand-response market in which suppliers take bids from customers that promise to cut demand by a certain amount at a specific price.

Hybrid Markets

"It highlights probably the biggest reason why competition is failing in this country," Hughes said. "We insist on operating a hybrid market. The old, regulated market has not gone away."

There is a state-federal jurisdictional problem with demand-response programs on the scale that Anderson envisions.

Under current law, retail customers are state jurisdictional, and wholesale customers are under federal jurisdiction. Allowing large customers, or an aggregate of small customers, to deal at the wholesale level would remove them from state control. "There are states that don't even want to talk about it," Anderson said.

The impact of allowing large companies to negotiate directly with PJM in a demand-response market would be "unbelievable," Anderson said.

The fourth condition is elimination of market-power abuses, perhaps the toughest of all to achieve.

Market power issues should have been one of the first priorities addressed by FERC in the restructuring effort, but it has become one of the last, according to **ELCON**.

FERC took a stronger stance last year, rejecting market-based rate filings for six major utilities in December, saying the companies have too much market dominance over energy prices in portions of their service areas. FERC applied its new market power "screens" that the agency adopted in April 2004, which sets out tests to determine undue market power.

Still, the current LMP markets are subject to market-power abuses, and it is not clear that FERC will be able to resolve the issue, according to **ELCON**.

Long-Term Contracts

Anderson favors a market design based predominately on long-term contracts, which he believes would be less susceptible to market manipulation than spot markets.

He cites the current United Kingdom electricity market, which underwent a fundamental change in 2001 to a commodity market that emphasizes forward and futures contracts and includes an active bilateral market in which buyers and sellers are matched.

The new UK model is referred to as "new electricity trading arrangements," or NETA. The program replaced a pool arrangement in which suppliers bid into a single-priced auction that set a pool price for all generators. Critics said the pool model was dominated by a few large generators.

In addition, U.K. generators face more of the risk associated with forecasting and balancing loads, Anderson said.

Uncertain Future

ELCON sees few "pro-consumer provisions" that benefit both large and small customers in the energy bill currently being debated in Congress, Anderson said.

The trade group has problems with several provisions in the electricity title, including repeal of the Public Utility Holding Company Act, which restricts ownership of electric and gas utilities. **ELCON** also opposes language that would give rate incentives to utilities as an inducement to build more transmission lines.


A few extra basis points on rates will not outweigh the revenues collected by utilities that operate high-cost generators near well-known transmission bottlenecks, Anderson said. "They have no incentive to build more transmission," he said.

Two independent transmission companies in Michigan and Illinois have had no problem in obtaining capital and building new transmission, according to Anderson.

The trade group does support federal "backstop" siting authority to approve new transmission lines if states fail to act.

It is unclear how much further FERC can push electric restructuring. The backlash in Congress from members in the South and Pacific Northwest have restricted FERC Chairman Pat Wood's ambitious plan to create a "seamless" national grid and more competitive markets.

Wood's own future has been cast in doubt as well. His first term ends June 30, and a number of industry sources question whether he will be reappointed by President Bush. Wood has not yet said whether he will seek renomination, according to FERC spokesman Bryan Lee.

Anderson sees today's restructuring effort "muddling along" for a year or more, but he believes a complete turnback is not possible. There have been fundamental changes in the electric industry, Anderson said, adding, "If nothing else, enough generation has been sold to where we cannot go back to vertically integrated utilities." 

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