



**“You Got To Be Careful If You Don’t Know Where You’re Going,
Because You Might Not Get There” [Yogi Berra]**

A Presentation By:

**Dr. John A. Anderson, President and CEO
Electricity Consumers Resource Council (ELCON)**

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First, I appreciate the opportunity to be with you today. We, as large industrial electricity consumers that quite often cogenerate, and you, as suppliers and operators of combined heat and power facilities have much in common.

I have titled my talk today: “You Got To Be Careful If You Don’t Know Where You’re Going, Because You Might Not Get There.” The great worldly philosopher, Yogi Berra, pointed this out a many years ago and it certainly seems to capture the present conditions in the electric utility industry. No one seems to know where they are going and thus we probably will not get there.

What I will try to do today is to offer some insight into the future of the electric industry – especially as it might relate to the CHP business. What’s in store for you and us. This is a difficult task. Again, as Yogi Berra said, “It’s *always* difficult to make predictions, especially about the future.”

As an economist, I begin by observing that on the one hand, things are looking great.

Financial services executives are saying that “demand for power is growing, the next power plant and transmission grid ‘build-cycle’ appears to be under way in response to sagging reserve margins, and there is plenty of public and private money available for investment.”

A GE Capital Markets/Energy Financial Services partner was recently quoted as saying that “we see [electric sector] sales and purchase opportunities for years to come.”

And a managing director of Lehman Brothers recently said: “Development money is available ‘perhaps as never before.’ ”

But, as all good economists will say, on the other hand, there are storm clouds far closer than on the horizon that I believe will result in some significant change— and it might not be the kind of change that either you or we really want.

Let me try to explain.

BACKGROUND

I start with a little background.

Certainly, there were real problems with the old, traditional, cost-of-service regulation. As Yogi said, "If the world were perfect, it wouldn't be." Well, the electricity world certainly wasn't perfect – far from it.

Regulation produced high and significantly differing prices. Many of the ELCON members knew that under regulation, their competitors paid multiples of 3, 4, or even more than they did for electricity.

There was little product innovation. As an example, electric meters in use today are of the technology that was first used in the early part of the century – the 20th century that is!

Utilities had a very strong bias toward traditional, utility-owned generation and real hostility toward any form of non-utility generation. In fact, it was very difficult to economically justify non-utility generation, including CHP, before PURPA.

And on top of this, there was no customer focus. The regulators were the customers. And the regulators often did not have the customers' interests as their main goal all of the time.

These problems were well recognized, and the movement to restructure began. One of the first efforts to bring some competition into the electric industry involved the enactment of the Public Utility Regulatory Policies Act of 1978 (PURPA). PURPA did

stimulate a lot of non-utility generation. Many industrials finally found it possible to justify CHP to meet at least a part of their electricity needs. Many of you finally found markets for your products. But this was only the first step in restructuring – and it was quite limited.

While PURPA certainly helped, there was much more that needed change. And the change had to be structural.

ELCON's ADVOCACY FOR RESTRUCTURING

Recognizing that much more needed to be done, we at ELCON began an advocacy to promote competition in electric industry in the early to middle 1980's. We thought that introducing a healthy dose of competition into the industry would:

- Create market discipline on electricity prices
- Produce technological innovation, new products and services
- Incent new supplies, giving consumers a number of options
- And finally bring a customer focus

The restructuring effort most certainly has brought about a tremendous amount of change – but it hasn't brought us either real competition or the other benefits we expected would come with competition. Instead of real competition, we got several very undesirable changes.

First: we got large, bureaucratic and far too expensive Independent System Operators (ISOs) and Regional Transmission Organizations (RTOs). While the concept of independent grid management is terrific, it is undermined by the continued joint ownership of generation and transmission that allows the exercise of market power. Further, the very large structures of ISOs and RTOs require consumers to pay large sums for organizations that are not producing enough consumer benefits to justify the costs. And we found out that making changes beneficial to consumers to the ISOs and RTOs was nearly impossible – the governance structures were stacked in favor of the generators and incumbent utilities against the consumers – even though consumers pay all of the costs

Second: we got “locational marginal prices” – or (LMP) prices. While LMP certainly is theoretically intriguing, it also brings with it a host of practical problems. All too often the “market” price is set by gas-fired generators, yet that single price is paid to all generators that are dispatched. Today, these prices barely compensate the marginal generators for their energy costs, yet they provide tremendous infra-marginal revenues for the depreciated coal and nuclear unit owners and remove any benefits to consumers from fuel diversity.

Third: policy makers became very concerned about possible price volatility in LMP regimes. So they implemented price caps and bid mitigation plans that made it even less profitable for the marginal generators. And even worse, an LMP pricing scheme with price caps and bid mitigation does not assure resource adequacy. Marginal generators

only recover their variable costs. But any new generator must have a reasonable chance of recovering both fixed (or capital) costs as well as their variable costs if it is to actually be built. Thus, the LMP pricing scheme became a disincentive to build either generation or transmission as removing constraints that are currently benefiting asset owners reduces prices and takes away the benefits of the constraints.

In an attempt to address these concerns, policy makers began adding new revenue streams such as capacity payments they said would incent new generation or transmission – all in the name of resource adequacy. Unfortunately, these revenues streams did not result in new generation, although they did significantly over-reward those generators that are already receiving the infra-marginal revenues in the energy payments and raised significantly the arguments against restructuring. As a specific example, consumers have been required to pay capacity payments in New York for more than two years, but absolutely no new generation has even been proposed, much less built, other than the very recently announced repowering of some old generators by the New York Power Authority – hardly the result of the capacity payments.

And **Fourth:** on top of all of this, the so-called “markets” did not result in a customer focus. To generators, the “customers” now are the ISOs and RTOs. The ISOs and RTOs operate both the transmission system and the “markets.” Not only is this bad policy (I ask: Would it make sense for United Airlines to be both the air traffic controller at O’Hare Airport – as well as being allowed to sell seats, but only on United flights?), it also means that suppliers have absolutely no need or desire to meet with those pesky

customers – just dealing with the ISO or RTO market is all that is needed. Generators have no desire to negotiate any contracts that are at price levels other than the expected future LMP prices, plus a very significant risk factor, plus an adder for administrative costs. Since such contracts completely eliminate any consumer benefit of fuel or generator diversity, they are of only very limited value to consumers. Thus, today's markets are moving toward over reliance on spot transactions – sort of like California in 2001. Not a good sign!

So what we have gained is simply a new form of regulation. It certainly is not competition. Instead of regulators trying to limit cost recovery to prudently incurred costs plus allowing a fair rate of return, regulators, ISOs and RTOs are drawing their own “demand curves” trying to establish a level of capacity payments that will incent enough new generation to assure resource adequacy. From a consumer's point of view, this new form of regulation is much worse than the old regulation.

OPPOSITION DEVELOPS

ELCON was patient for a considerable period of time. We knew that the transition to competition would take some time – and probably would not be smooth. We continued to express our concerns and fought for change. But the changes that did occur represented movement in the wrong direction from a consumer point of view. Regulatory patches were put on top of regulatory patches, rather than taking the difficult, but necessary, steps to fix the underlying structural problems.

Then, a few other factors complicated the situation. Natural gas prices increased – and increased substantially. Instead of finding gas for \$2.50 to \$3.00, prices went substantially above \$10.00. This had a devastating negative impact on many manufacturers – especially chemical companies that used natural gas as a feedstock. But it also hurt all electricity consumers in Organized Markets as the clearing price, quite often set by gas-fired generators, increased yet again electricity prices for everyone.

Further, intense opposition to restructuring came from areas of the country that had chosen not to restructure – especially the Southeast and Northwest. The political opposition grew substantially to FERC’s proposal to require “Standard Market Design” – or SMD – basically creating Organized Markets everywhere. By the time Congress passed the Energy Policy Act of 2005, the opposition effectively had stopped the movement to SMD – or, for that matter, to additional Organized Markets. There is even a provision in the Act that prohibits the use of LMP in the Northwest!

And to add to the problems, the Energy Policy Act brought with it substantial changes to PURPA. As I mentioned earlier, PURPA brought the first real competition to generation. It opened markets – your markets – that otherwise would remain closed.

The EPAct 2005 basically said (at least I thought it said) that where the owners of CHP facilities face real competitive electricity markets, the mandatory purchase and sale provisions of PURPA should go away.

We certainly agree with this theory. We don't think we need, nor should we have, regulatory protection where truly competitive markets exist.

However, FERC has interpreted this EPCRA provision as saying that any CHP facility in any of the Organized Markets automatically meets the EPCRA provisions. FERC thus proposed, in their Notice of Proposed Rulemaking, to automatically exempt any utility in the Organized Markets from the mandatory purchase and sale provisions of PURPA.

Of course, we strongly opposed this proposal – and I know that John Jimison and some of the USCHPA members also have been active in this opposition. While we have heard some encouraging feedback from some folks at FERC, we are still awaiting the Final Rule. Only time will truly tell.

ELCON finally said enough is enough! We issued a report a little more than a year ago titled “*Problems in the Organized Markets.*” It was met with substantial opposition and pushback. Many said that we no longer supported competitive markets. Others said that we simply opposed the higher electricity prices caused by high natural gas prices. But the bottom line is that, to date, we have not been very successful in achieving positive results.

But lately, the opposition to the Organized Markets has begun to grow.

- The CATO Institute issued its report “***Rethinking Electricity Restructuring***” saying that if you can’t deregulate every aspect of the industry, maybe doing nothing is better than doing something.
- The industrial electricity consumers in PJM issued a white paper concluding: “End-use customers are becoming increasingly frustrated by their increasing electric costs. With the existing mismatch between price expectations and realities and generators continuing to press for additional revenue streams, PJM must question whether PJM markets are working properly.”
- The American Public Power Association (APPA) issued a paper titled “***Restructuring at the Crossroads.***” That paper, among other things, seriously criticized the RTOs as big, expensive disappointments that do not produce benefits to justify their costs.
- The Progress & Freedom Foundation wrote a guest editorial in the ***Electricity Journal*** questioning the value of FERC’s Standard Market Design and the RTOs and ISOs that are already in existence.
- Nobel Laureate economist Vernon Smith wrote an op-ed piece in the ***Wall Street Journal*** that pointed out the many flaws in today’s Organized Markets and called for significant change – including substantially more demand response, and
- Carnegie Mellon Professors Lave and Apt (along with graduate student Blumsack) authored an article in the ***Electricity Journal*** that concluded that, unlike consumers in other deregulated industries, industrial electricity consumers in the Organized Markets saw no price benefits and, in addition, residential

consumers: "... are bracing for the expiration of mandated rate reductions and price caps." Little did we know how right these authors were!

But, even with this wide ranging opposition, change that would benefit consumers was not in sight.

Then, an even more significant thing happened. Residential customers – whose electricity prices had been reduced and frozen at the start of restructuring – began facing rising – sometimes significantly rising – electricity prices as the price caps expired. These consumers were mad – mad as hell – and they made their feelings well known to policymakers.

State politicians took notice – and took actions.

- The Delaware governor issued an order seeking to blunt the expected rate hikes that exceeded 100% for some customers
- The Connecticut AG proposed legislation that included a windfall profits tax and allowed the state to build generation
- The Virginia legislature considered legislation to extend the capped rates
- Nine U.S. House members called for hearings on the rising costs of RTOs
- Several utilities proposed – and received – permission to drop out of RTOs
- Then, New England experienced what I call the "New England Electricity Tsunami"

- Every New England Governor, regulatory authority, consumer advocate, and member of the U.S. Congressional Delegation actively and aggressively opposed the New England ISO's proposal for a locational capacity payments that would cost New England consumers nearly \$15 billion
- But it was approved by FERC anyway – although the implementation was postponed for a year
- Then a very long and acrimonious settlement process was conducted that resulted in a so-called settlement that was opposed by parties that represent more than half of the total load in New England
- We must stay tuned as the saga is not yet over
- And most recently, Maryland became the “poster child” of opposition:
 - The Governor demanded actions to reduce the rate increases predicted to be 72% in BG&E's service territory.
 - The legislature passed several bills with what appeared to be veto-proof margins to: (1) fire all of the PUC commissioners, (2) give the legislature the authority to block the proposed merger of Constellation Energy and FP&L, and (3) called for the return of \$528 million that had been collected from consumers under the guise that power plants that had been transferred from BG&E to a Constellation affiliate were not worth much – but turned out to be ATM machines for Constellation.
 - The Governor vetoed all of the bills.

- The legislature had only one day to overturn the vetoes. After a terribly acrimonious session, they adjourned at midnight without overriding any of the vetoes.
- Very recently, the Governor announced a plan to partially postpone the rate increases. But rather than calming the storm, this has raised the already high political heat even higher. The Legislature is considering a special session and electricity has become the major political issue for the fall elections.

And how have the ISOs, RTOs and generators reacted to this significant push back throughout the Organized Markets? They retained consultants who drafted so-called “studies” that purport show that consumers really are benefiting. And they asserted that the price increases are really only the result of high natural gas prices. They argued that consumers should just recognize this fact and accept it. On top of this, some of the larger generators with fleets of coal and nuclear units that were either obtained at less than book value or have been depreciated through captive consumers’ payments are reporting record profits.

I refer to a couple of recent examples:

- Cambridge Energy Research Associates claimed that: “US residential electric customers paid about \$34 billion less for the electricity they consumed over the past seven years than they would have paid if traditional regulation had continued.”

- And Global Energy Decisions concluded that consumers realized \$15.1 billion in value from wholesale electric competition in the 1999–2003 study period.

I ask a rhetorical question: How do you think these assertions are being received in Maryland today?

Given these conditions, I assert that today's current electricity market structure is not sustainable. Clearly, as Yogi Berra said, "We made too many wrong mistakes." I believe that change is coming, we just don't know when and how.

While we don't know when or how, we do know that there is growing pressure to try to turn the clock back and return to cost-of-service regulation. As examples:

- The Delaware legislature called for the implementation of "integrated resource planning" – an old regulatory concept.
- Several states that required the sale of all generation from the previously vertically integrated utilities, are now allowing – if not requiring – those same utilities to begin building and buying generation.
- One of the many options Maryland is considering is a legislative mandate to return to cost of service regulation – with a completely new commission overseeing the regulation.

While I certainly have serious problems with today's Organized Markets, I also have substantial problems with an attempt to move back to cost-of-service regulation.

First, I do not believe that there is any reason to think that COS regulation today would be any better than it was in the past – and that is not a compliment.

Second, even if we wanted to move back to COS regulation, the path would be terribly difficult and fraught with problems. Many state laws have been enacted that tie the hands of many entities – including regulators. These laws would have to be changed. A lot of generation has been sold. Can it be returned at prices that bring benefits to consumers without resulting in a “taking”? Many contracts have been signed. Can these contracts be amended, modified, or changed or will the sanctity of contracts prevail? At a minimum, it seems that going back to COS regulation would take a long time. And the process would be very messy, at best.

A much better solution seems to be to fix today’s problems. We know that will not be easy. But it seems better than retreating – if it can be achieved.

But fixing today’s problems will be very difficult. It is always hard to change an institution once it has been created. And those with the resources – the suppliers – don’t want these changes.

ELCON listed six “Essential Preconditions” in our report of last year that we said were necessary, but not necessarily sufficient, to fix the problems. These six conditions include:

1. **Fix today's ISOs and RTOs.** They are too costly. They do not bring enough benefits to justify the costs. And the governance in each is weighted far too heavily against consumers.
2. **Get rid of the so-called "capacity markets."** First of all, capacity payment schemes are not markets – they are simply and completely regulation. And they are not any better than the regulation of old. Further, the only product or service in the electric industry with sufficient liquidity to be a commodity is energy. Energy-only balancing (or spot) markets should be recognized as another primary objective of wholesale restructuring. However, this market should be only a very small fraction of the total transactions. By far, most of the transactions should be in long-term bilateral contracts.
3. **Eliminate the barriers of entry to price-responsive loads.** We cannot have real competition with only a supply side of the market. And that is the way it is today. Demand response is a critical condition for real competition.
4. **Mitigate market power.** Market monitoring is a critical function for any market. There are several factors that contribute to market power. However, we believe strongly that, as long as we have vertical integration in the electricity industry, some entities will have significant market power. FERC must do a much better job mitigating market power if we are ever to have real competition.
5. **We must have adequate transmission infrastructure.** There is a lot of congestion today throughout the transmission grid. We know where this

congestion is located. We don't need new studies or other factors to identify it. The LMP prices in today's Organized Markets are supposed to incent new transmission investments to mitigate the congestion. Unfortunately, what we have learned is that the LMP prices actually have become a disincentive to new investment. This problem must be fixed.

6. **And finally, we must find a way so that federal and state regulators work with each other – instead of against each other.** The fact that consensus does not exist among state regulators with respect to necessary steps for restructuring has prevented a rational market structure from evolving. We must have cooperation if we are going to have rational and functioning competitive electricity markets.

It is interesting that in over a year since we released our study, I have not heard one person say that these conditions are invalid. Yet, we are not seeing any movement towards their implementation. This is not encouraging.

If my assertion is correct – that the status quo is unsustainable – and that change is coming, it seems to me that it is time for various stakeholders to think clearly and carefully about where they want to go. Remember, as I opened my remarks today, I quoted Yogi as saying “You Got To Be Careful If You Don't Know Where You're Going, Because You Might Not Get There.” Said slightly differently, if you don't know where you are going, you **won't** get there – and even if you think you know where you want to go, you might not get there without a lot of thought, luck and help.

We at ELCON are looking for help. We still believe that a healthy dose of competition would bring great benefits to the electric industry. We are trying to identify those who will help us get some real competition in the electric industry. We believe that this is a critical time. If we don't get our current restructuring effort going in the right direction, it might reverse itself and go back to regulation. And those that keep issuing studies saying that consumers really are benefiting when consumers are saying, and saying very forcefully, that they really don't like the current conditions are actually hurting, rather than helping, the restructuring effort. I do **not** think scrapping the move to competition is good for any of us. But it might very well happen.

In concluding, I remind us that Yogi also said "If I didn't wake up, I'd still be sleeping." Unfortunately, I am not optimistic that, collectively, we will wake up in time to make the necessary changes to keep the movement toward a competitive electricity market alive. Too many stakeholders may still be sleeping. And that is sad.

Thank you for the opportunity to be before you today.