

--Distribution Copy\*--

Uncertainty and Volatility:  
The Utility Executive's Dilemma

Remarks By

Erroll B. Davis, Jr.  
Chairman, President, and CEO, Alliant Energy  
And  
Chairman, Edison Electric Institute

To The  
2002 ELCON / PGC Seminar October 11, 2002, Arlington, Virginia

Good morning, and welcome to the Washington, D.C. area.

Your conference theme, "Uncertainty and Volatility: The Energy Manager's Dilemma" certainly reflects the times. I am reminded of the ancient Chinese curse, "May you live in interesting times." These are truly "interesting times."

Your theme also captures the feeling of the many changes and uncertainties surrounding all of us today in business, in the economy, and certainly in the energy sector.

Uncertainty and volatility in energy markets make your jobs as energy managers more difficult. They affect your ability to plan, to manage costs, and to meet your company's goals.

But, as they say, I share your pain. I assure you that utility executives are not crazy about uncertainty and volatility, either. They make our jobs harder, as well. And that's putting it mildly.

But I come from the "glass half full" philosophy of life. I strive to see the good in everything.

So I've been thinking about what could possibly be good about the uncertainty and volatility that we all face. What's so great about this confusion and chaos?

I sought help from the best and brightest of business minds. And I found Tom Peters, who said, "If you're not confused, you're not paying attention."

Not bad. Clearly the present confusion we face has our attention. But I wasn't satisfied leaving it there.

---

\* This text was prepared on October 9, 2002.

So I looked back to the founder of the electricity industry, Thomas Edison. Edison said, “Restlessness and discontent are the first necessities of progress.”

I felt as if I was getting warmer. We are discontented and we are looking for progress.

But I wanted reassurance from someone who had truly lived it, from someone who had worked in the trenches of uncertainty and volatility, from someone who had learned to win even in the most trying and chaotic of times, from someone who knew how to get the job done no matter the obstacles. And I found that someone in General Douglas MacArthur, who said, “There is no security on this earth. Only opportunity.”

There we have it: from uncertainty, we get opportunity. Because of all the difficulties and problems they cause us, uncertainty and volatility compel us to resolve them, to move toward certainty and stability. And in the process, we are given opportunities to change the system, to make things better for everyone, customers and utilities.

Of course, you don’t have to agree with my “glass half-full” philosophy to know that there are tremendous opportunities before us right now to improve the generation and delivery of electricity. Congress is at a crucial point in consideration of new national energy legislation. The Federal Energy Regulatory Commission (FERC) is proceeding with the most significant rulemaking ever to hit the electricity industry. And Wall Street is demanding that companies of all kinds rapidly make changes in the way they do business, particularly in the reporting of financial information.

Today our country is at a crucial crossroads, facing a host of difficult challenges. Let’s take a look at those challenges, and how we are approaching them as opportunities to make the system better.

Investment in electricity infrastructure is simply not keeping pace with the growing demand for power or with the increasing demand for use of the transmission grid to serve competition.

Between 1995 and 2000, U.S. electric demand increased by almost 14% (13.8%), while total electric generation additions rose only 5.4%. The Energy Information Administration projects that 355 gigawatts of new electric generating capacity will be needed by 2020 to meet both growing demand and to offset plant retirements. To help put these numbers in perspective, 1 gigawatt of capacity produces enough electricity to serve 250,000 average homes. Consumption of electricity is expected to increase 45% by 2020 – if we can in fact produce it.

On the transmission side, the growing demand for use of the grid is pushing the grid nearer and nearer to its limits.

Originally built to serve local communities and interconnect neighboring utilities, the grid now is being asked to operate as a super-highway to allow a broad range of energy products to be delivered in the energy marketplace over vast regions of this country. The number of transactions where electricity was sold from one region to another has skyrocketed. In 1995, there were 25,000 such transactions. In 2000, there were two million.

More and more, this system is congested – unable to meet the growing requests to move power. And the problem is getting worse. Between 1998 and 1999, transmission congestion was up 40%. Between 1999 and 2000, it was up 140%.

Both DOE and FERC have completed studies showing that transmission congestion is enormously increasing costs to electricity customers. The FERC study found that transmission bottlenecks cost consumers in parts of the U.S. more than \$1 billion over the past two summers alone.

Without action now, these problems will only get worse. And, they will hinder your company's ability to both operate and grow.

I know that in some respects I am preaching to the choir. What I hope to impress upon you, however, is the tremendous nationwide magnitude and urgency of the problem, and the need to find the right solutions and find them now.

Billions of dollars for investment are needed, particularly in transmission. A recent study shows that just maintaining transmission adequacy at its current level might require an investment of about \$56 billion during the present decade. Yet that's only about half the transmission needed for new generation during the same period.

Improvements in transmission infrastructure are necessary not only to help efficient markets; they also increase reliability and national security – key areas of concern in this post-September 11 world.

There are ways to manage transmission congestion, and these are being used on an increasing basis. But rather than just manage it, we need to alleviate congestion. Building new generation and expanding the use of demand-side programs are good tools. But they will not do the job alone. Only by building additional cost-effective transmission, competitive with other alternatives, will we achieve a robust market, lowering costs to consumers such as you here today.

Well, you should probably now ask, “Since we need it, are you investing?”

Sadly, the answer is “No” – a resounding “No.” At a time when the transmission system is nearing the limits of its capacity, investments in transmission have been declining. Transmission investments in 1999 were less than half of what they had been in 1979.

There are several reasons transmission investment is not keeping pace:

1) The integrated utility model – the way transmission historically has been funded – is simply not working. In many cases it is not providing rates of return or other incentives sufficient to encourage the level of investment needed; and there is increasing uncertainty over cost recovery issues. No longer are we willing to risk large amounts of capital in a sometimes arbitrary regulatory process.

2) Electricity markets are becoming increasingly regional. Old structures and relationships are changing – but new ones are not yet fully developed. We are still in a transition period. And, capital is scarce in times of uncertainty.

3) The current federal tax code is impeding progress. The code imposes stiff tax liabilities on utilities that sell or spin-off their transmission assets. This clearly raises concerns about the viability of such new options as for-profit Transcos for transmission investment.

4) The procedures for siting and permitting new lines remain long and are always contentious. And there is no certainty that the necessary approvals ultimately will even be obtained. Rational investors in today's markets don't have to wait and will not wait for multi-year proceedings to determine if they will even be allowed to make an investment.

5) The obstacles to investment have been exacerbated by the tremendous upheaval in financial markets and the loss of investor confidence. Both are significantly increasing the cost of investment capital.

So, in spite of the tremendous need, investors are not investing. Energy policy remains incomplete. The marketplace is filled with uncertainty. Clearly, we must turn these trends around, and we must do it quickly. And our industry is committed to doing just that.

What must we do? Maintaining our electricity infrastructure at the world-class level that your companies need and deserve requires action on three fronts.

First, we must restore confidence among investors and the investment community, so that they will once again want to invest.

Second, we need a comprehensive national energy policy that sets a clear direction for the future and provides the incentives to get us there.

Third, we must ensure that the rules of competition still being written are done so and applied in ways that provide the flexibility and incentives needed to ensure a strong, reliable system.

Let's look at each of these areas.

These are both difficult and trying times for us all in the financial marketplace.

The four pillars of investor confidence have been literally shattered.

1) Management has lied, stolen, and cheated. 2) Auditors can no longer be trusted. 3) Analysts have been working for investment bankers instead of the investors. And because of these actions by some, the fourth pillar of confidence – credit markets -- are in chaos. We are facing a liquidity crisis of major proportions.

This is not an easy time to invest. No one wants to lend, at least at reasonable rates. Yet we must invest. Our infrastructure demands it.

That, ladies and gentlemen, is the Utility Executive's Dilemma – my dilemma!

The electric utility industry has been characterized throughout its 100 years or so by honesty and integrity. We are adamant that this hard-earned reputation will not be squandered because of the actions of a few, most of whom are relatively new to the industry.

Our industry has taken aggressive steps toward fixing problems that have affected wholesale trading caused by accounting irregularities. EEI's members strongly believe illegal actions should be punished to the fullest extent of the law. We support the ongoing investigations by FERC and others.

At EEI's annual meeting in June, its Board of Directors passed a resolution reaffirming its commitment to integrity and to the highest standards of ethical conduct. The resolution affirms that EEI and its members will work diligently with other stakeholders to reinforce corporate governance practices; to improve critical financial and accounting practices; and to promote sound and ethical trading practices.

We have developed and are implementing an aggressive Action Plan to realize these resolutions.

Our present focus is in four areas:

--#1. Promote improved financial disclosure practices.

--#2 Work with a broad group of industry participants to develop standardized ways to establish valuation, measure risk exposure, and disclose risk concentration and credit quality.

-- #3. Develop a business model for energy trading that will reduce risk, increase market liquidity, and have a proper level of management controls.

-- #4. Direct a program to educate policymakers, consumers, and the financial community on the strong, positive value of competitive generation, energy trading, and risk management.

We have moved quickly to make good on our word.

Several weeks ago, we expanded outreach to the Securities and Exchange Commission and to Wall Street analysts and credit rating agencies. There is a tremendous need to educate regulators and others about how our industry works, and to identify the right ways to move forward. We have met with SEC senior staff to create a dialogue on financial disclosure as well as emerging issues. In late June, we sponsored the first of a series of seminars for Wall Street to focus on financial disclosure issues. Additional forums are scheduled for November and December.

We've activated a high-level team to focus on financial disclosure issues and to develop enhanced voluntary disclosure methods.

We're also benchmarking the very best practices in disclosing and reporting financial information.

We're working with the Commodity Futures Trading Commission to redefine and improve energy trading.

We're working with the Committee of Chief Risk Officers to develop guidelines on energy trading, liquidity and capital resources, and risk sensitivity measurements.

We've drafted a standard master netting agreement to mitigate credit risk. This will be completed very shortly.

We're working with NASDAQ, the New York Stock Exchange, the SEC, and other policymakers to develop new corporate guidelines to implement the Sarbanes-Oxley Act, one of the first new pieces of legislation in this area.

The new law establishes an independent board to regulate the accounting industry; and provides more funds to root out fraud and new tools for enforcement. It also requires companies to disclose changes in their financial conditions or operations on a current basis. It prevents executives from benefiting from inside information. EEI supported this legislation.

I recently completed media tours in New York City and Washington, D.C., talking with major newspapers and financial media about our work to assure investor confidence. More tours are anticipated for the future. We feel certain that we can regain our footing and assure confidence among investors and Wall Street.

The second wider step in building our infrastructure is the implementation of a comprehensive national energy strategy.

Without comprehensive action, we will continue to pit fuel type against fuel type; conservation against production – all to the detriment of the economy, the environment, and our quality of life.

EEI is working very aggressively to advance a national energy strategy that would help promote investment in generation and transmission infrastructure.

We advocate tax incentives, as well as research and development funds to accelerate development of new technologies – clean coal, renewable, and the next generation of nuclear.

We also must fix the process for siting and permitting new power plants and transmission lines. As one Member of Congress so eloquently put it, “It shouldn’t take longer to permit a power plant than it took to win World War II” – yet under today’s system, that is often the case.

We support access to additional domestic sources of oil and natural gas. We support expansion of a safe pipeline infrastructure as a means of ensuring that our country maintains its fuel diversity and decreases its reliance on foreign supplies. This is critical to ensuring the reliability of electricity and the security of our nation.

Many of these provisions are under consideration in energy legislation currently before a House-Senate Conference Committee.

A third step necessary to building our infrastructure is getting the rules of wholesale competition right, so that we have the incentives to build the system and the flexibility to maximize its use.

I appreciate that both your companies and EEI have been deeply involved in the restructuring of the electricity industry since passage of the Energy Policy Act in 1992 and implementation of FERC Orders 888 and 2000. It is interesting to note, however, that the drive to increase competition in the industry first came to the public’s attention with the recent, dramatic problems in California. Many people think that federal restructuring caused those problems, but that is not the case. And, in spite of the fingers being pointed today at some energy traders, they did not create the situation either. Some have exploited it, but they did not create it.

California’s problems were caused by not building enough generation and transmission to meet the demand, and then using a faulty market design that made matters even worse. The state had chosen to rely on power imports rather than to build. Then it designed a system that precluded utilities from writing long-term contracts and instead required them to buy imported power daily on the mercurial and expensive spot market.

The rest, of course, is history. Consumers experienced blackouts. Businesses were tremendously disrupted. One electric utility went bankrupt; another implemented drastic restructuring. And California issued \$12 billion in bonds to buy its way out of this situation. Tremendous instability permeated California’s energy market. That instability then spread to neighboring states.

We would hope that this experience is not repeated again, in California or elsewhere. But when you have policies that don't permit plants to be sited or transmission to be built, you will inevitably have problems when demand starts to outstrip supply.

As you know, FERC's new rulemaking on Standard Market Design (SMD) is an effort to improve the operation of wholesale markets so consumers can reap enhanced benefits. As FERC moves forward, it is critical we get the rules right to ensure this goal is truly met. None of us here today can afford to get it wrong.

Earlier this year, EEI members engaged in an intense and constructive dialogue about the design of the SMD. In July, we adopted principles on standard market design to serve as the benchmark against which we would evaluate the NOPR and guide EEI's response to it.

We believe the goal of a Standard Market Design should be to establish an efficient and robustly competitive wholesale electricity marketplace for the benefit of consumers. This can be accomplished through the development of consistent market mechanisms and efficient price signals to induce efficient investment in productive transmission facilities and demand response activities. You also must have assurance of fair and open access to the transmission system for all participants.

The following are important elements of our principles.

We want the rule to promote the continued development of regional transmission organizations (RTOs).

We want to see transmission pricing that promotes reliability and adequate infrastructure development. It must also provide access to all potential users.

We want a market design that provides flexibility for business models for electric transmission companies within RTOs and incentives to stimulate expansion. These business models should include independent, for-profit transmission companies.

We also want to see a consistent set of standards to constrain market power abuse.

EEI supports a planning process that has appropriate support and cooperation from state public utility commissions; one that identifies needed upgrades and expansions of the transmission system; and one that affords transmission owners responsible for planning within their footprint the first opportunity to build.

We also believe strongly that there must be a role for state utility commissions and regional reliability authorities in ensuring long-term supply adequacy.

Lastly, we believe an SMD should promote demand response programs that coordinate wholesale market activities with state and utility programs.

FERC's SMD proposal includes much that is consistent with our principles. EEI supports the overall framework for competitive markets set forth in the NOPR. We support the use of day-ahead and real-time energy markets and the use of a financial, rather than a physical, priority means to mitigate transmission congestion. We also commend FERC's market-based approach to demand response.

We do have concerns, however. We are concerned with some aspects of the FERC NOPR and believe that in some respects it will not work, in practice, as FERC intends.

First, we are concerned that every region cannot accomplish all that the SMD NOPR proposes within FERC's extremely ambitious timeframes.

Second, we are not convinced that the SMD NOPR, as now written, provides the necessary incentives to construct new transmission. It requires a stakeholder-selected board to oversee all regional transmission operations. Our reading suggests that transmission investors would have no control over the management of their assets. The proposed transmission tariff also imposes significant new outage liabilities. The process FERC envisions may, in fact, duplicate, rather than build upon, existing efforts. We fear all of these changes would make it extremely difficult to attract investment in new transmission.

Third, it affects important state interests, but yet, appears to provide an insufficient framework to foster essential state cooperation needed for regional institutions to work effectively. This feature alone has caused a fire-storm of resistance at the state level.

Lastly, and very importantly, it does not apply to government and cooperatively owned utilities, which operate one-fourth of the nation's transmission and generation but as much as 70% in some regions. You cannot have a standard market without all the participants.

We are very concerned that years of litigation over these issues could delay needed investment and improvements in our energy infrastructure.

Constructive solutions are readily available. We believe FERC should focus first on getting day-ahead and real-time regional energy markets up and running. It should clarify its transmission pricing and transition rules. It should eliminate the barriers to transmission enhancements, and take affirmative measures to encourage needed transmission construction.

Since planning and resource adequacy issues have traditionally been addressed at the state level, states must have a greater opportunity and more time to participate in fashioning regional approaches. Government and cooperatively owned utilities must also be required to participate in a Standard Market Design. As I said earlier, you cannot have a standardized market without all the players.

Congress can help by affirming FERC jurisdiction over all utilities. Also, where existing approaches for siting critical transmission do not work, Congress must provide FERC backstop authority for siting of transmission.

EEI is committed to working constructively with FERC and the states to address these concerns. In fact, we are rapidly becoming an honest broker between the states and FERC.

In concluding, let me say that I have described to you today an ambitious agenda – and an environment where the need for capital is greater than ever, and the costs of not acting are greater than ever. It is an environment in which uncertainty must be resolved, quickly, yet we must take the time get it right. We must use the opportunities we have now to further restructure the system to meet our collective needs, or we will be leaving open the door to litigation and greater uncertainty in the future. That serves the interests of no one.

What we as a nation do now will set the direction of the future. We must ensure that a strong, vibrant electricity system is there for your companies and for your families.

With the issuance of the FERC SMD NOPR, the train has left the station. The precise destination, and how we're going to pay to get there, however, is not yet fully defined. Not everyone will agree on the best course to take on the many issues to be decided. But that is the beauty of our country's democratic process: it gives everyone a chance to be heard. We are glad you are active participants in the process, and we look forward to constructive dialogue as FERC moves forward. Again, this meeting is an excellent example of thoughtful consideration of the issues, and I appreciate the chance to address your group and learn from you.

I believe, and I hope, however, that all of us can agree on the overarching goal: to build the infrastructure needed to ensure reliability, to provide service to customers, to build a strong economy, and to secure our country.

And in these times that are filled with uncertainty and volatility, I encourage us all to remember how great and strong our country truly is. Even with turmoil in energy markets, the lights have stayed on. Even with corporate scandals, thousands of businesses like yours continue to provide the jobs and turn out the products that are the backbone of our economy. Even the most despicable terrorist attacks have not broken our spirit.

America is strong because her people are strong. America is strong because there are those, like you here today, who choose to work with vigor and dedication, and to participate in shaping the electric industry of the 21<sup>st</sup> Century. I salute you for your commitment. And at EEI, we pledge that we will work our hardest to see that your needs are met – both now and in the future.

#