For Distribution

Remarks of
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Federal Energy Regulatory Commission

"Electricity Reform In Crisis: The Way Forward"

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I.

Thank you once again for allowing me to visit with you. With its recent study of the Nation's electric transmission system, aptly called High Tension, CERA has made a useful contribution to our collective understanding of what the future may hold for this critical network industry. In the seven months since I spoke to CERA about Order No. 2000 implementation, developments in the energy markets and among utility corporate families have often been dramatic. However, they do not necessarily reveal which of the bulk power

scenarios CERA has studied is the more likely to occur. One can see in current events potential for markets to go in any of the three directions, although I view two of the three as representing the partial failure of public policy in general, and RTOs in particular.

Since May, the Commission has largely finished a major round of collaborative processes that we expected would foster better RTO applications under Order No. 2000. The Commission invested considerable staff resources in this work because we think it is our job to help reform, not just dictate its terms. I believe that, whatever the outcome in the area of RTOs, the Commission and its staff now have a far firmer grasp of the industry's needs and apprehensions, the regional economic dynamic behind these proposals, and who can be depended on to advance its policies and who, regrettably, cannot.

Despite the varying quality and weightiness of the RTO proposals, nothing expended by the market participants or the Commission in <u>any</u> of these discussions has been wasted, in my view. Indeed, the process has advanced the national discussion about the future of regional transmission networks far beyond what might have been anticipated from a voluntary compliance regime and far beyond what I expected two years ago when I began talking about RTO formation.

Yes, the progress has been agonizingly slow. Yes, there are proposals that may not warrant rehabilitation, or even life-support. Yes, I find many of the plans reflect the myopia and risk-aversion of transmission owners and some hesitation or resistance by states more than they reflect any effort to open up real regional negotiations or to comply with the letter of Order No. 2000. So, I persist in some of my original skepticism about the practicality of voluntarism in this area. And not all the signs are

good. The Midwest ISO appears to be shrinking, not growing. Proposals from the Southeast each embrace only a few entities. The Southwest is more or less formless at this point. In New England, collaboration on an RTO that has support from more than transmission owners is just beginning. Perhaps the Commission must choose a different course now that the "Year of the Carrot" is about concluded. The opportunities to make good decisions and good investments are still tremendous.

I must nevertheless emphasize that I am firmly persuaded that the RTO effort as a whole has been (and will continue to be) a success, particularly in demonstrating how divergent parties in an increasingly competitive environment can, through good faith and hard work, fundamentally rethink how to operate the network upon which they will all ultimately depend for market access. It will be the model for how this Commission and the states and the industry move through

this difficult time of change. But it must produce results.

For a variety of additional reasons, however, this may not yet be the season to be jolly! The energy crisis is only deepening in California as natural gas and electricity supply problems become manifest and give rise to other market dysfunctions. The Governor of California, who is under tremendous pressure from his constituents to get a grip on the continuing price and reliability crisis in that state, lit the Capitol Christmas tree in Sacramento two nights ago and then turned it off for reliability reasons, with the following holiday wishes: "We're going to send FERC a picture of the tree going dark." I see in that a perfectly understandable level of frustration with a market that is capacity-starved, poorly structured, and conceivably manipulated, but where neither quick solutions nor culprits are easy to come by.

For several months, the events in California have largely filled my time as well. They have dominated the Commission's agenda and clearly influenced much of the country's feelings about the changes coming in this key industry. True, there has been news of positive competitive developments here and elsewhere, but those tidings of even moderate joy have been drowned out. With the Congress stalemated on how to move the electric industry forward, with renewed questions about the benefits of throwing over regulated monopolies for competition, and with the current anxieties about how to ensure reasonable energy prices tomorrow, let alone five or ten years from now, the Commission finds itself in an uncomfortable position. It is being looked to for sure-fire remedies to reliability and pricing problems that are (at least for now) often beyond its legal authority and its traditional range of responsibility. I will return in a moment to what I think our posture must be under these circumstances,

but I can assure everyone that we will not be satisfied to say simply "retail markets are not my job."

It is fair to say, in any event, that the triumphalism exhibited by companies or legislators, who until recently may have thought they could unilaterally concoct from economic theory and political willpower a market of their liking, has been significantly more muted. The sobering realization that we are likely to have a long restructuring road before us happens just as the euphoria seems to be draining from the economy generally and consumer confidence begins to fall. Perhaps the silver lining in the Nation's current economic cloud is that, as the economy cools down, energy demand growth may be effectively dampened. Public policy-makers and energy market participants could use this as a moment's respite and an opportunity to achieve for electricity what Mr. Greenspan wants for the economy as a whole -- a "soft landing."

It is readily apparent, however, that electric restructuring must continue to accommodate the technological, economic, operational, and even corporate changes in the industry that simply will not and cannot be ignored and the needs of the digital economy as a whole. Yet, despite its importance, this may be a protracted effort. Speaker Hastert recently characterized the inability of the 106th Congress to conclude its business in a way that sounds to me just like restructuring. Borrowing from Thomas Hobbes, the Speaker reportedly said, "this can be solitary, poor, nasty, brutish, and short. Or," said the Speaker, "it can be solitary, poor, nasty, brutish and long."

II.

The electricity business clearly needs competition to iron out its inefficiencies, to induce new investment, and to encourage and permit consumers of power to respond to price signals from the wholesale

supply side. But, this transition to competition risks, not only prolongation, but becoming a harbor for compromises, special deals, and idiosyncratic practices as parties battle for advantage or jurisdiction, or as they try to insulate existing investments from risk. Splitting the difference between regulation and competition –- as we must at a moment of transition –- we should not also re-balkanize markets to take care of specific companies or groups or locales. It will defeat the purpose. In other words, we should make this a struggle to establish a coherent vision of 21st century power markets and try to avoid the chaos and uncertainty that will frighten consumers and public officials alike, delay the economic benefits of competition and bigger markets, and make RTO development, retail access, and all the activities in between appear riskier than in fact they are. In Commanding Heights, Dan Yergin put his finger on the real challenge for us: "Will confidence in market systems be reaffirmed, or will it be eroded? And

confidence, after all, is the heart of the matter . . . Yet, there is nothing guaranteed about the results. Volatility and risk are inherent. If confidence is to be well grounded, it requires a realistic assessment of what can go wrong."

As Californians now realize, they failed to realistically assess the risks of what they were doing, when they adopted AB 1890. All the post-hoc rationalizations about the detrimental reliance of the state on the Commission's powers to protect consumers or the trust of prior state administrations that has supposedly been betrayed by the "feds" cannot explain that away. Ratepayers there were unjustifiably exposed to wholesale market volatility. That it was an appalling shock and inequity is beyond question. Now, let's deal with the problems that got us here.

The economic pain of current energy markets,

which continues in California even today, is just one unfortunate symptom of the failure of all of us to size up the risks, including the risk of undersupply that was created by the failed regulatory regime of the past, and prepare to overcome them. It is also an indication that we have not sufficiently and effectively integrated retail and wholesale electric power restructuring. And, that difficulty persists and not just in California. The immediate rhetorical manifestation of that disjunction is in the Governor's recent comment, in a letter to me, which stated: "I want you to do your job and to let me do mine." Very well. But, even if one assumes that California and the Commission have precisely and appropriately identified their respective roles and functions in this newly dynamic environment –- and I doubt that we have —- we still seem to be pursuing different goals and timelines and techniques. Our current California proceeding should be a chance to come together.

The challenge before us now is, first, to employ cool heads to find good answers and, second, to work in tandem toward a shared vision of the interstate electricity marketplace that works well for everyone. I realize –- who wouldn't? –- that there is a certain disconnect between the political perspective and the gestalt of the regulator. Yet, I believe state and federal agencies can move forward, and operate upon, a single and progressive vision of the market and achieve a level of public confidence that the outcome will be a good one.

The Commission has begun to paint that picture in Order No. 2000 and, although the Congress has yet to meaningfully participate, we can shoulder the task of reform together. In the final analysis, we have the same job -– to utilize existing assets, and employ the best regional solutions for the benefit of consumers. Easier said than done –- but doable!

III.

It is all too easy to learn the wrong lessons from events like those in California. Fear of the justified anger of consumers may panic us into doing the wrong things, if we take the wrong lessons from what we have seen. The wrong lessons are easily identified: 1) Competitive markets don't work and competition won't improve rates or services. 2) States can control their own energy and design their own exclusive markets. 3) Retail markets are separate from wholesale markets. 4) We just need to get the bid structure for a spot market right then everything else will be fine. We can make the market rules as complicated as they need to be to take account of historical interests and special circumstances. 5) If at first you don't succeed . . . go back to old-style regulation.

Here are some of the right lessons: 1) We need to get markets functional as quickly as possible. A long and contentious transition is in no one's interest.

2) We have to figure out how to protect consumers from market volatility without damaging the functionality of the market. That takes care and expertise. 3) We need to get regional institutions in place and working, because the electricity markets are regional, and to provide transparency, efficiency, and liquidity -- and therefore equity -- in every jurisdiction the market reaches. 4) Market power can be an ugly thing and we, as regulators or market participants, ignore it at our peril. 5) We need flexible institutions. Legislating all the details is impossible. 6) Because it's often too easy to create market rules that lead to inefficiency and bad conduct and virtually no one knows enough to design the perfect market, we need to provide a level of flexibility to allow the market institutions to correct themselves. 7) Lastly, either give customers real choices that are sufficient to let them protect themselves, or be darned sure to protect them yourself.

There is more attention to the notion of competitive electricity markets in California than there has ever been –- including while the legislation was being enacted. That attention creates political energy that, even if sometimes negative, is important. Restructuring drags when no one pays attention. Now, people want solutions! Some of the most important things that we can do are not the things that most people will recognize as dramatic, but many of them are the very solutions that we have known from the beginning needed to be done, but were too politically difficult.

Sorting out the jurisdictional issues is one of these kinds of things, for example. The development and planning of electricity markets on a regional, rather than a state-by-state, basis is now a matter of economic necessity. But, it has always been seen as politically difficult. Now may be the time when we can get it done. If states fear a loss of control over

currently-bundled transmission, they can participate with the FERC in regional regulatory institutions ("RROs"), which could perform critical RTO oversight. We simply have to get beyond the retail/wholesale split for determining what is the state's and what is federal. We have to get beyond the turf fights that in part have led to the circumstances that we are in. We also need to get all transmission under the same framework of open access rules, whether those facilities are publicly-owned or investor-owned. Network industries require uniformity to operate efficiently and sufficient independence from market interests to be fair. It's that simple.

IV.

The Commission is often reported these days as caught off guard, stressed out, surprised by the political heat coming in its direction, or ready to equivocate about its basic objectives in order to make problems disappear. Don't believe everything you read!

These difficult times find us hard at work formulating changes for California, examining the merits of RTO proposals and current ISO operations, and investigating markets for conduct that manipulates price in discriminatory or otherwise unlawful ways. We must take market power seriously and, for that reason, I have asked our staff to conduct unannounced on-the-ground audits of plant outages and bidding behaviors where needed.

Going forward, there are some very difficult decisions. I hope the Commission opts for policy choices that enhance and improve the federal role, that foster collaboration but not by disabling states from doing their important job or at the expense of creating a "hodgepodge of distrust, subsidies, incentives, and handicaps that is likely to fail and lead opponents to go searching for a scapegoat." (Cicchetti & Long, Public Utilities Fortnightly, Oct. 1, 2000, p. 42). Given the difficulties and the opportunities of the

moment, we cannot afford to stay on the sidelines as reform evolves willy-nilly.

At bottom, this is all about whether, when it comes to providing ample amounts of this essential and ubiquitous commodity -- electric power, the Commission and, by implication, the Congress are able or willing to protect the interests of interstate commerce. This is, of course, a matter of enormous commercial importance. It will impact the American quality of life. But it is also, in the final analysis, a Constitutional issue of the first order. For, if the operation of the industry, whose current infrastructure is that of a vast interstate network connecting remote sellers and buyers and giving even small consumers access to diverse energy options, is impeded -- even for reasons that in seem crucial to the short-term economic interests of a state, I believe economics and the law tilt heavily in favor of the larger interest of the region, if not the Nation.

Because electricity consumers everywhere share the same interest in reasonably priced and reliable service, however, it need never come to a state-federal conflict. That's what gives me confidence that RTOs will succeed; indeed, they have become the necessary prime ingredient in whatever the industry is likely to evolve into, even assuming California and other states put their distinctive fingerprints on the nature of the regional market. Almost anything one can say at a moment of crisis risks sounding like a platitude. Nevertheless, state and federal public policymakers need to keep their eyes on the ball in situations like this, working for a competent solution to the problems we face jointly.

Thank you.