

COMPETITION IN THE ELECTRICITY INDUSTRY?

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Thank you, Alex.

In your original letter inviting me to participate in this session you wrote “We would like to ask you to consider talking about how competition affects investment in the power sector.”

That’s what I intend to do.

For the benefit of some if not all of the audience I would like first to spend a few minutes on some historical facts that bring us to where we are today.

When I first became engaged with the electric power industry, some 40 years ago, the consistent inexorable growth of demand for electricity was about 7% annually. While the pace of growth has declined significantly to some 2 – 2.5% per year, it is still unabated and as a result new supply, and the ability to deliver it to the ultimate users, requires significant ongoing investment.

As explained by Russell Tucker of the Edison Electric Institute, end use providers (read electric utilities) have three main choices as to how to acquire new sources of power supply:

(1) build them,

(2) contract for power with a purchase power agreement (PPA), either from a merchant (read non-regulated) generator, or from another utility with excess capacity, or

(3) buy an existing plant – a relatively new option – either completed or under construction – from a wholesale market supplier, either independent or affiliated.

Virtually all of the state regulatory bodies require their regulated utilities to provide some form of resource plan or data proving that the option chosen to meet supply requirements is the one providing the least cost, as the cost will ultimately be borne by the utility's customers.

It's more complicated today than it was years ago. Both options 2 and 3 are relatively new, and largely the result of legislative and regulatory actions including the Energy Policy Act – or EPAct – passed in 1992, which permitted the formation of exempt wholesale generators outside a utility's regulated portfolio as well as FERC Order 888 in 1996, which required transmission owners to provide open access to their lines.

These developments - combined with the ability to site environmentally friendly units and relatively quickly complete the construction of such gas-fired units with high efficiency - at what was then competitively priced natural gas, led to the rise of merchant generation.

The generating entity assumed the financial risk of building the power plant in order to have the opportunity to sell its power in the open market at market-based rates. As a result, utility purchases from these merchant generators became a more significant factor in resource planning.

The third option – purchasing existing plants (or those under construction) - was little used since there weren't any for sale during times of low reserve margins - which persuaded the merchants to build still more generation.

However excess generating capacity now exists in many parts of the country, where the construction of new plants outpaced the growth of demand. In addition, some plants were built on “spec”, or without long-term purchase power agreements or other forms of assurance of a market for the plant's output.

As a result of the over-build, the increased cost of natural gas and the reduced, or in some cases, non-existent spark spreads in the last few years, the market value of new combined-cycle gas-fired generating units declined to a level significantly less than the original cost of these units, thus wiping out billions of dollars of capitalization of the merchant generators, pushing some into default or bankruptcy and forcing some to sell their assets at distressed prices, providing a potential new least cost option for some utility buyers.

All right – now we are pretty much up to date. Just a month ago FERC hosted a technical conference on public utilities acquisition and disposition of merchant assets. A former colleague of mine, Peter Kind – now with CitiGroup Global Markets, Inc. – noted that if public utility access to these asset sales was impeded, as some have suggested, then the market for generation assets would be still more distressed than at present. Kind also noted that contracts for the output of such units are deemed riskier than ownership, resulting in the decision to buy (at prices below cost) rather than build. Sounds like Economics 101 to me.

While a merchant in distress might offer to enter into a long-term PPA, credit concerns of the purchaser may well result in unfavorable terms. FERC is, in fact, now planning to examine electric credit worthiness standards – more conferences and more attempts to “get it right.”

Back, finally, to the original question of how competition might affect investment. I feel that it is important to consider the status of U.S. and state electric policy in order to address this question.

Generation is overbuilt and inadequate transmission exists in parts of the country.

Natural gas, the presumed fuel of choice and the fuel for most generation added by merchants, appears to be in short supply even while its price is at historical highs.

Various regulatory bodies are providing greater scrutiny over market and market participants' behavior.

Mandatory, enforceable reliability standards are contemplated.

Environmental standards are requiring many utilities to retrofit existing facilities and substantial cost. Mandatory renewable portfolio standards are being enacted state by state.

Although 17 states have engaged in some form of restructuring and enabling of competitive markets, the remaining states appear to believe that they need to lock the barn door before the horse escapes and strong disagreements among regions about wholesale competition are now being openly discussed. Most of the Southeast and Northwest oppose federal interference with their planning, siting and resource adequacy while the Northeast, Mid-Atlantic and Midwest appear to favor wholesale competition.

State regulatory bodies appear to me to want to determine and defend their views on reliability, native load priority, resource planning and adequacy, pricing of transmission expansion, allocation of costs of existing transmission and determination of rates for bundled retail transactions.

Combine these divisions with the controversy in Congress over potential comprehensive energy legislation, the previously mentioned bankruptcies and collapse of the merchant and energy trading sectors and the inability of the involved parties to determine what the wholesale market will finally look like.

The result, in the view of the financial community, is uncertainty. Uncertainty over the details of future energy markets and the speed (or lack thereof) of achieving whatever form is to take shape, and the result of these uncertainties is a significant increase in risk to the investor.

In my opinion, the basic question is: Can competition be made compatible with the development of new generation and transmission? Unfortunately, I believe the answer is: “To be Determined”, with the determining factors likely to be decided by future legislative and regulatory action or inaction.

Remember the three R’s of elementary school? I would suggest a new set of R’s – that Risk Requires Return.

Higher rates of return, while clearly needed at a time when the potential of billions of dollars of rate increase applications are already upon states to decide are, by themselves, inadequate. Accelerated cost recovery would help, together (in some states) with a clear statutory basis for cost recovery. It would also be desirable to restrict future Commissions from undoing previous Commission’s commitments.

One of the most interesting pieces of state legislative action in recent years was the enactment in Iowa of H.F. 577, which provides for binding determination of ratemaking principles for proposed generation investments prior to significant expenditures. (A similar process is also provided for investments in environmental improvements to existing coal-fired generation.) It is the utility’s option to pursue this special ratemaking avenue and to propose specific ratemaking principles. The Commission (the Iowa

Utilities Board) then reviews the utility's proposed ratemaking principles and accepts or modifies them, and if the Board's principles are not acceptable to the utility the utility is not required to pursue the project. If the utility accepts the Board's principles, and proceeds with the project, the adopted ratemaking principles are binding on all future regulators by way of the statute.

Similarly, Indiana, Kansas and Wisconsin have enacted statutes designed to encourage utilities to make much needed infrastructure investments.

I want to change gears for just a moment now to review with you some of the results of a survey entitled "The Outlook for the North American Power Industry" as conducted by Navigant Consulting and EEI's *Electric Perspective* magazine and reported in the May/June issue of the magazine.

The respondents to the survey were primarily utilities (83%), although technology developers (6%), municipal operators (3%), state and federal agencies (3%) and attorneys and financial executives (4+%) also participated.

The survey found that the five most critical issues to be resolved in the next five years were #1 - regulatory uncertainty (72%), #2 - system reliability (67%), 3 - aging physical infrastructure (56%), 4 - transmission siting (46%) and #5 - financial performance (43%).

I would be so bold as to suggest that if the number one issue of regulatory uncertainty is solved the other issues will be vastly reduced in importance if not eliminated.

In conclusion, what I suggest is that there is a crying need for regulated utilities, those who regulate them and the state legislatures to update and renew what has for years been known as the "regulatory compact", in order to

recognize the now combined operating model of competition and regulation and the risks associated with such a model.

Years ago, when I first entered the business, it was explained to me that regulation was a substitute for competition.

If indeed we are to have competition, what we need is not more regulation. We need to consider what the addition of competition means to regulation, and how utilities are to attract capital required to provide safe, reliable and reasonably priced service to their customers.

Thank you for your attention.