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Thank you for this opportunity to discuss wholesale power markets. Thank you to CERA for sponsoring a conference on the important topic of restoring trust and confidence in our energy industries. Trust building is nearly as important now as trust busting was a century ago.

The nation is faced with two important questions regarding the policy framework for the U.S. electric power industry: “Should we continue to rely on the market for wholesale power supply”? I believe the answer is yes, which prompts the second question: “What regulatory platform is required to support markets and provide benefits and protections to customers”?

There should be little disagreement today on whether we should continue to rely on markets for wholesale power supply. Markets have earned our support. Markets have performed well in wholesale power for all the same reasons they have served customers of other industries and made our economy and our nation so strong. Markets put investment risk where it belongs, with investors, not solely on the backs of captive customers. We should not lose sight of how market forces have already brought electric and natural gas customers billions in lower energy costs.

Yet, our support for markets must not be based on blind faith. California will be a constant reminder that poorly designed markets can fail miserably. Ideology alone will not capture the benefits of competition while preserving customer protections. Rather, the nation was moved to pursue wholesale power markets due to the realization that customers were not being well-served by cost-based regulation. Twenty years ago, with the publication of Markets for Power, Paul Joskow and Richard Schmalensee advocated neither a completely free market nor a fully regulated industry, but a mixture of regulation and competition. They wrote: “Successfully managing a

system that mixes competition and regulation is complex and requires that regulatory institutions, industry structures, and arenas of competition be designed carefully to complement one another.” The authors knew then that electric supply, demand, and the transmission grid could only work on an effective market platform. The lack of storage, free flow across state and company boundaries, and the need for a central grid operator to maintain instantaneous reliability are permanent features of electric power systems everywhere that must be accounted for.

John McMillan’s recent book “Reinventing the Bazaar: A Natural History of Markets” describes the evolution of markets from the non-transparent bazaars of Marrakesh to stock exchanges to eBay. He concludes, “Markets do what they are supposed to do, only if they are well structured. Any successful economy has an array of devices and procedures to enable markets to work smoothly. A workable platform has five elements: information flows smoothly; property rights are protected; people can be trusted to live up to their promises; side effects on third parties are curtailed; and competition is fostered.” In electricity, it is impossible to achieve any one of these goals without a coherent set of rules. To avoid market failures and assure that customers benefit from markets, we cannot simply “let” markets work. We must make markets work.

But markets aren’t the end game. They are the facilitator of the end game, which is reasonably priced, reliable service for customers. Let’s look at the evidence.

According to the Department of Energy, wholesale power markets are already saving customers \$13 billion per year. As another measure, in the mid-1990s the policy debate was what to do with \$200 billion in uneconomic costs if the utilities were exposed to limited competition. These “stranded costs” are still being recovered in customers’ rates.

By far the most economically significant issue is investment risk. Most of the dollars coming out of customers’ wallets goes into generation investment. Stranded costs incurred under the old system were all placed on captive customers. During the 1970s, generation investments led to rate increases of 100 percent for industrial customers and 37 percent for residential customers in real dollars. As a result of our national policy to rely on markets, investors now bear the risk for the quantity, timing, and location of generation investments – but customers bear the reliability risks

of inadequate investment. This is the first economic downturn where the stranded costs of excess capacity have not resulted in increased rates for captive customers. The same is true for cost over-runs. Uneconomic investment can still happen from time to time, but it happens a lot less when investors pay for them. It is a historic moment for America's energy customers.

Prices are down since restructuring began. Wholesale power prices in most regions are very low now (relative to input costs), due in large part to competition and overcapacity.

The availability of generating units in well-functioning restructured markets increases. In the Mid-Atlantic and New York, availability has increased approximately 5 percent due to competitive pressures. On a national scale this would be like getting about \$15 billion of capacity built for free to serve customers.

Generation has improved as cleaner, more efficient technology has penetrated the market. We are beginning to witness an effective form of environmental policy: the retirement of old dirty units due to market pressures, not political or regulatory edict. It's happening right now in the competitive Texas power market I had a hand in setting up, and should spread to other regions.

The Western energy crisis caused unacceptable harm to ratepayers and the western economy. It demonstrated the consequences of poorly designed wholesale markets and flat retail rates. Mandatory spot market purchases, other poor design features, combined with inadequate infrastructure and opportunities for manipulation doomed the California market and infected the entire Western market. It is a significant event in the evolution of markets in this country.

Despite this experience, I remain convinced that customers are best served by moving forward to complete the overly long transition from regulation to competition. The real question should be: "what regulatory platform is required to support markets and provide benefits and protections to customers?" This is the question we have been working on collectively in our unprecedented outreach process at FERC we began in the shadow of 9/11. This is the task President Bush continues to charge FERC with in his Fiscal 2004 budget request, which states, "It is clear that market crises can

erupt quickly...And the FERC is acting to provide a much more stable long-term platform for electricity markets.”

This is the goal a bipartisan FERC has been pursuing through its open access and regional transmission policies. It is the question addressed by last year’s CERA report, “Energy Restructuring at a Crossroads: Creating Workable Competitive Power Markets,” which advocates moving past the era of “experimental deregulation” to embrace best practices and dispense with failed methods.

[Choosing this platform is tremendously important. At a recent Congressional hearing on FERC’s oversight capabilities, Paul Joskow said, “The absence of a coherent national policy governing electricity sector restructuring, wholesale and retail competition, and effective market monitoring and enforcement, supported by compatible federal legislation, is a serious impediment to achieving good performance for the sector. The lack of clear national policy mandates no doubt reflects the lack of consensus about the merits of industry restructuring and competition and how best to get from here to there.” America’s energy customers need a consensus on the merits of wholesale industry restructuring and a clear policy mandate, or platform, through which we can make these markets work. FERC’s recent Standard Market Design and Regional Transmission Organization efforts provide such a platform.] *

Market decisions must be informed by experiences across regions. In the Northeast and Texas, as well as in other countries, independent monitoring reports consistently confirm that prices have been competitive and efficient. These markets have benefited from significant generation and transmission investment because the platforms provide investors with clear rules, and predictable rates and rewards for their investments.

Other regions have no market or markets that are still dragged down by problems and inefficiencies. Artificial “seams” between the many islands of the grid hinder customers’ supply choices. There are tollgates along each road, yet the electrons go only where physics dictate. A customer might get transmission service only to have it taken away through “Transmission Loading Relief” because there is no effective way to prevent one utility from overloading its neighbor’s system. New entrants bringing competitive supply and new technologies have trouble assessing opportunities because access is difficult and there are no transparent prices. Small customers and

utilities and competitive suppliers are all disadvantaged because they have no spot market to sell into or buy out of every hour that they have an excess or shortage of power. There is no platform to support demand side participation in the market without an independent grid operator and transparent prices. New generation has been poorly located in regions that do not provide locational price signals and do not allocate transmission costs and transmission property rights on a fair basis. And despite a crying need for new infrastructure, little new transmission backbone has been built in the country beyond the bare minimum.

FERC has undertaken an unprecedented outreach process to determine how this platform should be designed. We have studied regional situations and differences, different state and regional laws, regulations, and culture. Parties from all over the world have offered their insights to this policy discussion. We have talked to utilities across the street, and regulators around the world. We've heard from publicly-owned utility/co-op managers and new competitive power plant developers. Customers – big and small – have discovered where FERC is (a refreshing relief for this former retail regulator). We have been clear to all that we need a platform that ensures just and reasonable rates for wholesale transmission and power sales. Since issuing the proposed rule in July, we have explored the details of market platforms and mechanisms through workshops and through several RTO filings proposed by market participants in each region, so we're looking at what really works, not just what sounds like a good idea.

This review has shown me that successful power markets have certain core design features in common. These include:

- Independent grid operator
- Long term bilateral contract market
- Voluntary short term spot market with transparent prices
- Regional transmission planning
- Locational price signals
- Transmission rights
- Mitigation rules to ensure generator bids reflect costs and scarcity not market power.

A platform designed with these core features serves customers better over the long run than any other platform. Experience in the U.S. and abroad confirms that. I have seen no evidence of any physical or technical

impediment to implementing this platform in any region. This platform works in power systems around the world. It works in hydro-based systems like Scandinavia, South America and New Zealand. It works with long lines and urban congestion grids. It works with thermal- and stability-limited systems. It respects treaties, contracts, and various forms of state regulation. It is essentially what has already been developed by parties in each RTO including those developing in the West and South. Importantly, this core design does leave plenty of room for regional variation. Since we proposed the rule in some detail last July we have learned from states and regions where they believe changes are appropriate. We have responded to many of these concerns in RTO development dockets.

In those dockets, we concluded that it was critical for certain functions to be done to make wholesale power markets work, but not as critical that they be done the same in every part of the country. These include:

- Transmission planning institutions and the RTO's role in supporting those institutions
- Resource adequacy approaches
- Timing and sequencing of evolution
- Mitigation rules
- RTO Governance
- Detail market protocols

These are important issues that must be addressed thoughtfully. Addressing these differently does not interfere with the core design platform we need to make markets work for customers.

My colleagues and I plan to summarize and integrate our revised views on market design in a white paper due this April. We will seek public comment and visit with members of Congress about it as they continue work on the President's energy bill.

The benefit-cost studies of RTOs and Standard Market Design confirm that this market design serves customers best. These studies have all found that this market design yields net benefits to customers. However, they all narrowly focus on short term operations and fail to count the substantial benefits that markets bring in the form of better long term investment. We know from the gas and other industries that balanced competition brings these benefits to customers, and the core features of standard market design are required to support competition.

A platform based on these core design features includes a strong customer protection plan. It checks generation market power through mitigated prices when necessary. It solves transmission market power through structural separation between transmission owners and generators. It promotes and protects physical and financial contracts, including existing explicit contracts and native load service. On the infrastructure side, it encourages and eases new generation entry into the market, incents new transmission construction, and facilitates demand-side bidding into wholesale markets to check supplier market power.

It is clear that these proactive measures are the only effective way to protect customers. Refunds after the fact clearly do not provide a stable platform for market participation and investment in the long run. A platform based on these core design features provides the framework the nation needs to support investment and growth. It provides clear rules and known rewards for investment.

The Commission believes that this is the right platform to support power markets. I have challenged critics to put forth a workable alternative, but I have heard none offered. I do not believe there is one.

Most of the challenges we have heard go less to the features of the market than to the underlying question of whether competitive wholesale electric markets can meet everyone's need for reliable, affordable power. I believe strongly, based on the evidence, that well-designed markets do this far more effectively than the traditional alternative. Every region of the country relies on wholesale markets for much of their needs. There is disagreement about HOW and WHEN to get to a market with these core features in every region. That is a worthwhile debate to have and we can work with each RTO on this. But there is little dispute that if we are to continue benefiting from wholesale power markets, the core features of standard market design form the best platform to serve customers.

We are looking at the issue of how much detail must be in this rule, and which issues are part of the core set of features as opposed to a set which can be developed regionally. We have already issued RTO orders approving features consistent with these core design principles with a commitment that adoption of the ultimate market rule will not overturn those regional implementation decisions.

[So we stand here today at a crossroads. Do we continue with competitive reforms to assure that wholesale markets work better in the interest of customers? Or do we turn back to the failed experience of cost-of-service regulation? The answer is clear. We need to support a national platform for competitive wholesale power markets that contains a set of core design features that have been proven to work. This is what the nation needs. This is what customers deserve.] *

As I mentioned to a group last night, one of my favorite monuments in Washington, DC, is the obscure Teddy Roosevelt memorial. It has a great statue of our century-ago trust-busting President surrounded by four obelisks of his great quotes. One that struck me said: “Order without Liberty and Liberty without Order are Equally Destructive.” Having tried both approaches in power regulation and found them wanting, our country is ready for the third alternative – Liberty with order. I hope you will join with us in working to put that platform firmly in place.

Thank you.

* *[Text in brackets not spoken.]*

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