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Panel on "Today's Challenges in Strengthening Bilateral Markets"
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Introduction

Mr. Chairman and Commissioners:

Thank you for the opportunity to testify on behalf of the Electric Power Supply Association at today's Conference on Competition in Wholesale Power Markets. EPSA is the national trade association representing competitive power suppliers, including generators and marketers. These suppliers, who account for nearly 40 percent of the installed generating capacity in the United States, provide reliable and competitively priced electricity from environmentally responsible facilities. EPSA members participate in both organized markets and so-called "bilateral markets."

We commend the Commission for convening this series of conferences at a critical time for the future of wholesale power markets and the retail customers they serve across the country. EPSA particularly appreciates the Commission's reasoned decision to extend the scope of these conferences to *all* regions of the United States – those with organized markets and those that lack the pro-competitive structures organized markets provide. Given the fundamental differences between these two regulatory structures, the challenges and appropriate reforms for each region are different in many respects. EPSA also agrees with the Commission's determination to discuss issues at this conference regardless of federal and state jurisdictional lines, since so many issues do not fall neatly on only one side of those overlapping lines. EPSA respects the important role that both federal and state regulators play in determining and implementing electricity policy.

Power Generation Is Not a Natural Monopoly

The nation is one year shy of the 30th anniversary of the beginning of a series of three federal laws that, over time, allowed for increasing degrees of wholesale power competition. The inescapable and incontrovertible conclusion from the implementation of these laws is that the generation of electricity is no longer and never again will be a natural monopoly that justifies exclusive franchises for generation accompanied by traditional rate regulation. What began with PURPA in 1978 was accelerated in the Energy Policy Act of 1992 and reaffirmed in the Energy Policy Act of 2005. These statutes were enacted with bipartisan support in the Congress, signed into law by presidents of both political parties, and implemented by you and your predecessors irrespective of party affiliation.

Wholesale Competition Is Lacking In "Bilateral Markets"

EPSA wholeheartedly agrees that wholesale power competition is the law of the land, that it is settled national policy after nearly a decade of debate that preceded EPACT 2005, and most importantly, that it is the right policy for consumers, the economy and the environment. Accordingly, wholesale power competition should be promoted to the fullest regardless of the retail regulatory structure in a given state or region. However, robust wholesale competition is <u>not</u> the reality in the wires or on the ground in too many of what are being called "bilateral markets." Wholesale competition does not mean very much if power generators and marketers do not have access to consumers and the transmission to serve them. Competitive suppliers have invested tens of billions of dollars in generation resources in "bilateral markets" in reliance on federal and state statutes and policies, and on the expectation that they would be vigorously enforced. We welcome today's dialogue and earnestly hope that it will be the start of an expedited effort to address the considerable challenges that remain before it is too late.

Today's Challenges in "Bilateral Markets" Are Largely Yesterday's Challenges

This afternoon's panel has been asked to address "Today's Challenges in Strengthening Bilateral Markets." Today's challenges are in many ways the same as yesterday's challenges. In truth, some regions of the country, particularly the Southeast, probably do not even qualify as "bilateral markets." A region dominated by monopsony buyers who can use their control over transmission to unfairly crowd out generation from unaffiliated sellers is more "unilateral" than "bilateral." In addition, some regions are hardly what one normally thinks of as a "market" – which requires multiple buyers and sellers free from the influence and distortion of unmitigated market power.

This Commission unanimously put its finger on the source of these challenges earlier this month in the final rule issuing Order No. 890 in the Open Access Transmission Reform Proceeding The Commission stated then, as it did in Order No. 888 before it, that "[i]t is in the economic self interest of transmission monopolists, particularly those with high-cost generation assets, to deny transmission or to offer transmission on a basis that is inferior to that which they provide themselves." [paragraph 423.] Federal appeals courts and the Supreme Court have also recognized this inherent conflict in the structure of vertically-integrated utilities which own both transmission and generation. Despite efforts to address these inherent conflicts in recent years, challenges remain and must be addressed to make these challenges yesterday's news, not today's imperatives.

Today's "Bilateral Market" Challenges In A Nutshell

The Commission's agenda for this panel captures the list of the most important challenges very well – (1) transmission access, (2) regional coordination and planning, (3) competitive procurement for new resources, (4) risks to consumers of rate base investments, (5) price transparency, and (6) integration of remote resources.

EPSA Is Hopeful Order No. 890 Will Tackle Transmission Access and Planning

One of the major challenges is the chronic lack of non-discriminatory transmission access in "bilateral markets." EPSA commends FERC and its dedicated staff for the recent issuance of the final rule on Order No. 890, which recognizes that, a decade after Order No. 888 was written, transmission access remains a major barrier to achieving the wholesale competition Congress intended and that all consumers deserve. Order No. 890 is an important milestone that has the significant potential to substantially improve transmission access. As the Commission has acknowledged, many of its most important provisions – such as those on Available Transfer Capacity (ATC) and regional planning, among others – depend on subsequent actions by NERC, NAESB and market participants to fully implement them. Vigorous FERC oversight and enforcement to the fullest extent of the law, including use of EPACT 2005's civil penalty authorities, will be required to achieve Order No. 890's significant potential.

When it comes to non-discriminatory transmission access, FERC should adopt a "three strikes and you're out rule" – Strike One was the need for issuance of Order No. 888, Strike Two is the need for Order No. 890, and Strike Three will come if transmission owners in bilateral markets avoid, evade and filibuster yet again. At that point, should it come, the Commission should not hesitate to exercise its authority to go beyond mere functional unbundling and instead institute the RTO-style structural reforms that have worked elsewhere to ensure non-discriminatory transmission access to wholesale competitors and customers in "bilateral markets."

EPSA is also heartened by the provisions of Order No. 890 on regional coordination and planning. The Commission's final rule recognizes the reality that in most parts of the country electricity flows across state lines on a regional basis. Accordingly, planning should take into account all available resource options on a region-wide basis by following the nine fundamental principles described in the final rule. Planning should address the future uses of the grid necessary to serve all transmission customers.

Competitive Procurement and Rate Base Risks Are Pressing Challenges

With transmission access, and regional coordination and planning being addressed under the Commission's watchful eye as Order No. 890 is implemented, the most pressing challenges today are two sides of the same coin: competitive procurement and the risks to consumers of rate base investments. EPSA commends the recent announcement by FERC Chairman Kelliher and NARUC President Kerr resuming the joint federal-state dialogue on competitive procurement. We look forward to working with Commissioner Spitzer as the designated FERC liaison and with the designated lead state commissioners (Chairman Jeff Hatch-Miller of Arizona and Commissioner Stan Wise of Georgia) as the task force undertakes its activities.

Need for New Power Generation is Clear

The need for new power generation and associated infrastructure has become evident over the past year or so. The critical point to stress today is that the enormous costs and other risks associated with making these investments are only now emerging, at the very time that some are attempting to revert back to the days of shifting those risks to captive ratepayers through rate base investments.

The level of future power generation investment needed is on an unprecedented scale, even with aggressive efforts to implement demand response, efficiency and conservation to reduce that level. The evidence includes record peak demand on very hot days nearly nationwide last summer, to recent record peak winter demand in many areas just weeks ago. These records were not just eclipsed at the margins, but shattered – with projections of new, even higher records to come. These are not merely temporary or one-time events. We have to start planning and building now to meet projected future demand that starts just around the corner but will last for decades to come.

Need for New Generation is Greatest in "Bilateral Markets"

The amount of new generation necessary has been documented in a number of recent reports, including NERC's Long Term Reliability Assessment issued late last year and the Energy Information Administration's Annual Energy Outlook 2007. According to EIA, the greatest demand growth will occur in what we are terming "bilateral markets" on this panel: "The largest amounts of new capacity are expected in the Southeast (FL and SERC) and the West (NWP, RA and CA). In the Southeast, electricity demand represents a relatively large share of total U.S. electricity sales, and its need for new capacity is greater than in other regions."

The critical policy questions revolve around who will build and operate these new plants in "bilateral markets." That will determine how risks and rewards will be allocated among investors and consumers. Which structure best serves consumers – the market-based approach successfully employed in the most recent build out of generation that started in the mid-1990s, in which almost all of the new generation was built by competitive suppliers deploying more efficient new innovative technologies largely at their own risk, or going back to the model when overruns were paid for by captive ratepayers?

The basic laws of economics remain the same – to a great extent, who pays and how they pay will largely influence how much is paid. If a company recovers investment on a so-called "cost based" (or cost-plus) basis, there is less incentive or inclination to be disciplined about costs, largely because costs are merely passed through, and profits in fact rise with higher costs. Further, innovation suffers if the builder recovers costs before the plant is successfully deployed to generate power.

On the other hand, if payment is based on whether the plant is constructed on-time, on-budget, and only if the plant is actually generating power or providing capacity, there is every incentive to control costs, manage risks, and seek out and successfully deploy new, innovative power technologies to operate the plant most efficiently.

In the competitive wholesale market, economics rule and profits are earned. Competitive suppliers are paid for performance – or they are not paid. In the rate regulated regime, politics can trump economics and profits are seen as an entitlement largely divorced from performance over the multi-decade life of the project. During the "good old days," rate-regulated utilities were paid if they could persuade the regulator that costs were "prudently incurred" regardless of the economic outcome over time. I ardently hope that federal and state policymakers will ultimately resist the misguided, misinformed calls for a return to rate base regulation without competition. However, that will not happen unless competitive procurement becomes the law of the land and the actual practice in each state before these massive investments are made.

Generation Costs and Risks Are Rising

Competitive procurement is so important precisely because the risks to consumers of rate base investments are as high as or even higher than ever before.
The real news is not that so much new generation is necessary, but that the costs and risks associated with doing so are rising and climbing higher. Earlier this month, an analyst at Cambridge Energy Research Associates (CERA) told its annual conference that the required capital expenditure budget for the power industry is $800 billion over the next fifteen years – an amount equal to the entire industry's current net plant value - with $275 billion of that total in power generation.

Since the U.S. will be building power plants at the same time as other countries, including China, India, and Brazil, constructions costs are rising steeply for power generation worldwide, and indeed for all forms of capital intensive infrastructure. The costs of engineering, procurement and construction contracts (EPC) lead the way but are not the only source of upward cost pressure. Standard & Poor's recently listed rising costs as second on its "Top Ten Credit Issues Facing U.S. Utilities" issued January 29, 2007:

> Companies that are building new plants must confront rising raw material costs. Recent reports indicate that the cost to build a greenfield coal plant has climbed above $2,500 per kilowatt, at least 50% higher than five years ago. Factoring in the prospects for cost overruns, a baseload plant sized at 640 MW of capacity easily exceeds $1 billion dollars. Difficulty entering into engineering, procurement, and construction contracts with guaranteed prices that shield utilities from cost overruns requires active management of the construction process. Another challenge is the shortage of skilled labor, which threatens the schedule and in-service date. Other operating expenses are also rising, including the cost of routine maintenance as well as the highly documented explosion in pension and health care costs that grips corporate America.

Similarly, *The New York Times* (Saturday, February 17, 2007) under the headline, "Rising Price of Electricity Sets Off New Debate on Regulation," discussed a recent example of a utility seeking to rate base two 800 MW pulverized coal plants (not IGCC plants), the estimated price tag for which jumped from $2 billion as recently as last September to over $3 billion and climbing. Even a non-math major like me knows that a percentage rate of return on $3 billion in allowed costs yields much higher profits than that on $2 billion. Other public utilities announced similar expected cost overruns in late 2006 and more such announcements are sure to follow. If costs for proven technologies are rising, imagine the future actual cost curves for the new technologies which are expected to make up an increasing percentage of new power plants.

Despite its shortcomings, there are those clamoring for a return to predominant or exclusive use of rate base investments. However, policymakers acting as stewards for consumers should resist these calls. For example, Dominion's CEO spoke to NARUC last week about "creative rate-making approaches" including higher authorized rates of return on equity, recovery of investment in large-scale projects as work is done rather than waiting until the projects are in service, and advance approval of projects. These so-called "financial incentives" in fact turn the traditional link between risk and reward upside down; if they are successful, their rewards will actually rise as risks are lowered because they will face less competition – in fact, virtually none at all.

The full implication of Dominion's proposal is evident from an interview with the company's CFO in yesterday's *Wall Street Journal*. He is quoted as saying that a utility should obtain exclusive rate base investments not only to obtain from ratepayers a return of capital spent on a failed project, but a profit on failed investments as well. If this is "Back to the Future," we know how the movie ends and who will be left holding the bag.

In its "Top Ten" report referenced earlier, S&P said, "Rising costs leading to the potential for strained regulatory and political environments make it that much more important to secure preconstruction approval for long lead time, large ticket projects." Translated, this means some utilities are seeking issuance of virtual blank checks <u>before</u> the rising costs are evident. However, at that point it will be too late: the project will be underway, and, as happened in decades past, reluctant regulators will be forced to approve higher costs to complete the project. Imagine the "strained regulatory and political" reaction, to use S&P's description, and against whom it will be directed, if the plants experiencing post-approval rising costs were given a green light without passing a competitive test to determine the best deal for consumers.

Others speak in coded terms like "regulatory certainty." "Regulatory certainty" in this context really means the regulator is being asked to shield the utility from the costs and other risks of these power generation projects. Make no mistake about it – this type of "regulatory certainty" is a zero sum game as any such deal for rate base utilities and bondholders is the result of shifting risks to current and future consumers.

Those who seek certainty for themselves know full well that it will be at the expense of consumers. Simply said, it is impossible to provide the requested certainty any other way given the uncertainties inherent in new power plant investments today. In its Annual Energy Outlook 2007, the Energy Information Administration described several reasonable sets of assumptions about the many economic and other variables that impact the number of new power plants that will be needed, when and where they will be needed, what type of fuel should be chosen, how much the fuel will cost over the life of the project, and what technology is best. The outcomes for the study period between now and 2030 vary widely. Furthermore, the EIA analysis does not take into account future policy changes on matters such as climate change – which raises the uncertainties and risks ever higher.

For example, one of many key variables involves assumed rates of economic growth. In AEO 2007, the difference between how much new generation is necessary between now and 2030 could be "only" 191 gigawatts in the low growth case to almost 400 gigawatts in the high growth case. This is a potential swing of 100 percent. Aside from the amount of new generation actually needed over time, the mix of fuels and technologies is highly sensitive to multiple variables that cannot be divined with much precision today. Yet, investment decisions must be made starting now, begging the question of who will bear how much of the risks for these multiple, inherent uncertainties. Rate basing these investments shifts the risks of under investment, over investment and poorly timed investment to consumers.

Similarly, a comparison between the different projected outcomes of various case assumptions in the 2007 EIA Annual Energy Outlook with those in recent preceding years shows vastly different outcomes over the next several decades in which these power plant investments, once constructed, will determine the extent to which power is affordable, reliable and environmentally responsible. For example, in just the three years between 2004 and 2007, EIA shifted from predicting a majority of natural gas-fired plants to a majority of new coal plants over the planning period – but this could change again as variables change.

Policy Alternatives for New Generation

Against a backdrop of such starkly vivid uncertainty, the policy alternatives are as clear as day and night – either shift most of the uncertainties and risks to present and future consumers without any tools to address them, as pure rate base investments would do, or allow competitors (whether utilities or non-affiliated competitive suppliers and marketers) to assume and manage those risks.

The answer for power generation should be identical to the answer in the private and public sectors: competition in lieu of an overt or de facto utility self-build on the basis of an exclusive franchise. As far as I know, every state has a law that simply says if a good or service is to be procured over a certain amount (usually a nominal figure well under $100,000) then the good or service must be competitively procured. When the Pentagon, or some other federal or state agency, fails to do so, the media drops a front-page headline, political outrage follows, and even criminal prosecutions are brought. If the CEO of a publicly traded company purchased goods or services for the company from a relative on a no-bid, non-competitive basis, and paid them whatever it cost – plus a guaranteed rate of return – shareholder suits would be brought and the Securities and Exchange Commission might not be far behind.

Competitive Procurement in "Bilateral Markets" Today

Despite the compelling case for competitive procurement, only about a third of the states have competitive power procurement rules in place. To be sure, many states (those in organized markets) already tap competitive market forces through the vibrant wholesale markets that serve those regions. However, even in those relatively few states in "bilateral markets" with competitive procurement rules on the books, utilities find ways to escape them. Sadly, the trends are largely, but not entirely, heading in the wrong direction just as competitive power procurement is needed most.

On the positive side, last year Oregon adopted an excellent set of rules. However, while Utah also adopted good rules, a recent request for an "emergency waiver" is troubling, to say the least. Similarly, Dominion originally sought this year to repeal Virginia's competitive power rules on the books since 1990 in the same legislative package that would eliminate retail competition before it even got off the ground, accelerate the expiration of retail rate caps, and lock in a legislatively determined formula for its future rate of return on new power investments (taking away the discretion of state regulators) – all in the name of protecting Virginia ratepayers.

Georgia has had good competitive procurement rules on the books for years – rules that were touted by an attorney for Georgia Power on a NARUC panel just last November. More recently, Georgia Power filed a request with the state commission to exempt new baseload coal and nuclear plants from these rules. In Michigan, the misnamed "21st Century Energy Plan" recently sent to the governor by the chairman of the state commission rejected competitive procurement on spurious grounds, including a misrepresentation of EPSA's comments on the impact of purchased power agreements on utility credit ratings.

Other states hold some form of competitive procurement but utilities then change the terms of the procurement being sought after competitors have expended tens of millions of dollars to comply (Colorado). Still other states disregard the availability of power from competitive suppliers, whether from the regional wholesale market or from in-state independent generation, even when the competitive supplier's project is many years down the road toward completion, the state's needs are imminent, and the utility awarded the rate base project is still at the starting gate. This was done in Nevada recently, even to the point of excluding the affected independent power supplier from the relevant regulatory proceeding.

Who is Afraid of Competitive Procurement?

One is compelled to ask the simple question – "Why are some utilities afraid of competitive procurement?" If their plan for meeting the needs of retail customers is the best option, after taking all other options into consideration, then – and only then – they should prevail. If, on the other hand, opposition to competitive procurement, evasion of existing rules, and exemptions for certain types of plants is wielded as an anti-competitive club against unaffiliated generators seeking nothing more than the opportunity to propose a less costly alternative to the utility's self-build plans, then there must be a remedy. Absent a remedy, robust wholesale power competition in "bilateral markets" is more of a mirage than a reality. If the source of that remedy is not this Commission, or state regulators and legislators, then the time will come to seek redress from Congress, the judiciary, and ultimately the court of public opinion.

As to how to implement competitive procurement, time is of the essence. Governors, state legislatures and state regulators must act quickly. The federal-state task force must proceed broadly and swiftly. We are encouraged by public comments by Commissioner Spitzer in his role as the designated FERC liaison to the task force with NARUC that he will proceed expeditiously. To make the most of the task force, it should produce a set of best practices as well as model legislation and regulations. States in bilateral markets should require and implement competitive procurement before the next build out of generation is launched.

Standards of Conduct and Competitive Procurement

This Commission will have an opportunity to send an important signal – one way or the other – when it acts on the pending NOPR on Standards of Conduct. EPSA has serious concerns about the NOPR and how it deviates from what FERC is seeking to achieve in Order No. 890; our comments to be filed in that docket will elaborate on those concerns. For present purposes, the important point is that <u>if</u> the Standards of Conduct are to be relaxed for integrated resource planning and competitive procurement, then this Commission should use its authority to the fullest in clearly defining in a pro-competitive manner what specific types of IRP and competitive procurement qualify for relaxed Standards of Conduct – and which do not.

Arguments Against Competitive Procurement Are Myths

Those who oppose obtaining power generation through a competitive mechanism raise several myths that are easily refuted. The first myth is that only rate base utilities can and should build new base load coal and nuclear plants. The fact is that competitive suppliers are already operating a fuel diverse fleet of coal, natural gas, nuclear and renewables facilities. Furthermore, the track record of improved efficiency at facilities transferred from rate base to competitive status is a major benefit of competition. New coal and nuclear plants should be built by those with a recent track record in successfully managing the development and operation of capital intensive, technologically challenging facilities.

The second myth revolves around the ability to finance new generation. I am confident from discussions with EPSA member company senior executives and experts in the financial community that ample capital is available to competitive suppliers if regulators will just allow them to compete to serve load. To be sure, there will likely be a mix of financing mechanisms – some more like the merchant financing used in the past decade, and others based to some extent on purchased power agreements. Different companies have different business models and the strategies will vary among them and by region. No other state should follow the misguided path chosen by Virginia on the basis of false claims that only rate base treatment will bring about new base load power plant investments.

The third myth is a natural segue to the challenge of price transparency listed on the agenda for this panel. The time has come to call a halt to the charade of arguing that higher rates in restructured states and lower rates in "bilateral markets" are evidence that restructuring has not worked, justifying rate base investments by default. The proof is in the recently issued FERC State of the Markets Report for 2006. The report concluded that "Price patterns were fairly similar across the United States, rising in 2005 and falling in 2006 in almost all regions for both on-peak and off-peak deliveries. Regional 2006 declines in on-peak power prices consistently ranged between a quarter and a third of 2005 prices, except in Minnesota where the 2006 decrease ranged from roughly 15 percent to 30 percent." [page 15.] Spot prices went up by the same percentage range in the Northeast and Southeast from 2004 to 2005, and down within the same range in the two regions from 2005 to 2006 (see Table 15). The report went on to note that, "Prices rose to very high levels at some times during heat waves in both bilateral and RTO markets, as is typical for electric power markets. " While the report further stated that "In general, RTO and bilateral markets both produce prices that largely reflect the cost of fuel for marginal units," the report noted that "RTO markets provide far more information than other markets, especially about the locational value of the commodity." To be more specific geographically, the report stated that "In the Southeast, bilateral markets have few liquid trading points (into-Entergy is a partial exception) and little transparency." [page 20.]

Integration of Remote Resources

Successful integration of remote resources will naturally follow as a very beneficial consequence of addressing the other challenges on today's agenda. For example, many EPSA members are major players in developing new renewable resources along with other no-carbon and low-carbon technologies. Transmission access is critical to tie these important sources of power generation with the loads to be served. This will be greatly facilitated by Order No. 890 in general, including the regional coordination and planning principles and processes.

Challenges Between Organized and "Bilateral" Markets

For organizational ease, today's conference consisted of separate panels on "organized markets" and "bilateral markets." As noted earlier, EPSA members operate in one of the other or both of these systems. In actuality the separation between the regions is not as cut and dried as the descriptive labels might suggest. Power does flow between "organized" and "bilateral" markets. In fact, those who argue most vocally against "organized markets" are not shy about taking commercial advantage of trading into them when it suits their purposes. EPSA commends FERC for scheduling the upcoming seams conference. EPSA continues to believe that further steps are necessary to bring about greater transparency in dispatch procedures.

Critical Importance of Contract Certainty in All Markets

Finally, transactions in "bilateral markets" as in organized markets are grounded in commercial contracts and in the certainty of those contracts. Contract certainty enables bilateral contract markets to achieve the lowest possible prices for consumers without the need for sellers to add risk premiums due to the fact that their contracts may be modified. For that reason, EPSA is keenly interested in and acutely aware of how regulators and the courts view the certainty of such contracts. The investments necessary to power the future at reasonable cost to the consumer depend on investing parties being able to rely on contract provisions for the term of the contract. FERC needs to continue focusing on efforts that can facilitate certainty of contracts. This is especially true in bilateral markets.

Conclusion

In conclusion, EPSA again commends the Commission for holding this conference on wholesale power markets. The stakes for these and other deliberations have never been higher and they continue to grow every day. Failure to swiftly address the challenges we and others identify in "bilateral markets" as the nation embarks upon the largest single set of investments in electricity generation, transmission and distribution in its history will be costly – extremely costly – for decades to come. If policy mistakes are made today, they will be difficult to reverse tomorrow once multi-decade, multi-billion dollar projects are underway without the benefit of robust competition to deliver the greatest value to consumers while protecting the environment and facilitating long-term investment.