

THE ENERGY BAR ASSOCIATION

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The View From The Trenches

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I. INTRODUCTION

The description of this panel in the program states that competition in the electricity industry should result in improved service and lower prices.

It then poses the question: What are the prospects of that promise being achieved?

The promised benefits of competition have been put into question by the serious problems that are being encountered as deregulation of the electricity industry proceeds. These problems have been extreme in California and have been sufficiently serious in other parts of the country, including New York, to raise doubts as to whether the promised benefits of competition will be realized and, more fundamentally, whether deregulation of the electricity industry is really feasible.

II. TRADITIONAL REGULATION

For about 100 years, there was a consensus that the provision of electricity is a natural monopoly, best provided by vertically integrated utilities. That consensus was codified in state and federal legislation which provided, in effect, that the public interest requires that electricity service be subject to state and federal regulatory control. An extensive system of rules were developed by regulatory agencies and the courts. Under these rules, assets owned by utilities

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were considered to be held in trust for the public. A utility's rate base was determined by the amount of capital it invested in assets to provide service to the public, not the economic value of those assets.

The utility was entitled to recover its investments, a reasonable return, and its expenditures to provide service to the public, provided that its decisions and actions were prudent.

Regulation provided significant benefits to the public for many decades.

The regulatory support for their investments provided utilities with access to huge amounts of capital at relatively low cost. That capital was used to support the development of an electricity industry infrastructure that was considered to be the best in the world.

A clearly defined rate base and regulatory control over the utility's allowed return provided protection to consumers from excessive prices, and provided regulators with strong leverage to ensure that the quality of utility service was high.

Regulation, however, also had significant weaknesses. Rate of return of regulation virtually eliminated any incentive for utilities to make extraordinary efforts to reduce costs. The use of original investment as a rate base decoupled

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the utility's return from the actual economic value of its assets, and passed through to ratepayers the economic benefits or burdens of utility investments.

Regulation also reduced the discipline of the financial markets over utility investments. The capital markets paid more attention to whether an investment would be recoverable under regulatory rules, than whether the assets to be created would have sufficient economic value to support full capital recovery.

Deregulation of the industry promised:

- market incentives for the efficient provision of electricity;
- investment decisions based on the economic value of the assets to be produced, with the risk of those investments borne by the investors, not consumers;
- competitive prices that would provide a sound basis for investment and consumption decisions; and
- incentives for the increased use of technology and financial mechanisms to reduce costs, control risk and provide a wide range of new services to consumers.

III. NEW YORK EXPERIENCE

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The New York Model

In New York State, as in other parts of the country, a consensus developed among state regulators, the utilities and other interested parties that the generation and supply sectors of the industry could be subject to effective competition and that deregulation of those sectors would be in the public interest. Based on policy guidance from the FERC and the New York PSC, the Member Systems of the New York Power Pool developed a model for competitive electricity markets in New York State. It probably is the most complete and sophisticated model to be implemented thus far in the United States. It includes:

- an Independent System Operator (“NYISO”) to coordinate the transmission system and to administer various competitive markets;
- a two settlement process, including day-ahead and real-time markets;
- ISO administered markets for energy, certain ancillary services and installed capacity;
- Locational Based Marginal Cost Pricing (“LBMP”) to price energy and transmission usage costs during periods of congestion; and
- Transmission Congestion Contracts (“TCCs”) to allow parties to fix the cost of transmission congestion in advance.

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Experience Under The NYISO

The NYISO markets certainly have experienced problems that are more numerous and more serious than the NYPP Member Systems had expected.

Those problems were partially the result of the complexity of the model that was introduced as an integrated whole, rather than sequentially; partially the result of design flaws that reflected our inability to anticipate all of the circumstances that the model would have to address in the real world of a competitive market place; and partially the result of an ISO that was not prepared to act with the necessary urgency when problems arose during its first year of operation.

The design flaws and other problems affecting the NYISO markets have been discussed at length both within the NYISO and at FERC. While problems remain, particularly with respect to inter-ISO transactions, it is fair to say that most of the significant problems are being addressed and, if not totally resolved, significant progress is being made.

Equally important, the NYISO governance process is working reasonably well. The governance of an ISO is a real challenge. It is a challenge to allow a large number of parties with differing interests to have a meaningful say in the development of NYISO policies and procedures, without having the NYISO

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process grind to a halt. It also is a challenge to have an unaffiliated and independent board of directors, with the ultimate responsibility for the NYISO, to be accountable, in some form, to the market participants whose interests are directly affected by the NYISO's actions.

While there has been tension between the NYISO board and staff and the market participant committees with respect to their roles and relative responsibilities, we have been able to work through most of those issues. And, despite extensive debates and frequent disagreements among market participants, the discourse is civil and there is a general understanding among market participants that they must work together if they are to provide meaningful guidance to the NYISO board and staff and if the NYISO is to be successful.

IV. FUNDAMENTAL ISSUES AFFECTING ELECTRICITY MARKETS

Aside from design flaws specific to the NYISO model, there are several general characteristics of electricity markets that threaten the realization of the promised benefits of competition. These include:

- legal and regulatory barriers to the addition of new supply;
- the lack of significant price responsive load; and

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- an unusual vulnerability of electricity markets to the exercise of market power.

While these industry characteristics were known when the competitive markets were designed, I do not believe that the extent to which they would affect prices in a competitive market was fully understood. This may have been partly due to the general belief, at least in New York, that there was sufficient capacity so that these weaknesses would not be a major concern, at least in the near term.

Barriers to the entry of new supply and the inability of load to respond to high prices create the potential for prices to rise beyond levels that would be expected in a workably competitive market. In addition, the absolute necessity to maintain the reliability of the system as a whole, and within specific locations, provides opportunities for the exercise of market power that do not exist in other industries, and were not fully appreciated.

The ISO's have market mitigation programs in place to detect and mitigate prices that are determined to be the result of the exercise of market power, and price caps in certain markets have been requested and approved by FERC. It is not clear, however, how effective these measures are in mitigating market power in an industry that is so vulnerable to the exercise of market power, and in ways

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that we probably still do not fully understand

V. ACHIEVING THE BENEFITS OF COMPETITION

Whether the promised benefits of competition are achieved will depend on a number of factors.

First, the public must have a more realistic understanding of the benefits that can reasonably be expected from competitive electricity markets. Contrary to what they may have been led to believe, competition does not promise immediate price reductions or a permanent lid on prices. While in the long run, competition should provide significant benefits, it also may mean more volatile prices and, at certain times and under certain circumstances, prices may be higher than they would be under regulation. If the public and elected officials have unrealistic expectations about competition, competition may be deemed a failure and a consensus may develop that political intervention is needed, even though the competitive markets are working effectively and are providing the price signals needed to guide efficient investment decisions and consumer responses. In this regard, it may be advisable to have utilities or other load serving entities assume on behalf of retail consumers the responsibility for managing the risks and volatility of the competitive electricity markets

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Second, non-market based barriers to the addition of new supply must be reduced, and a significant segment of consumers must have the ability to refrain from purchasing electricity when it is in their economic interest not to consume or to turn to alternative sources

Third, FERC must accept and diligently exercise its responsibility to protect consumers from the exercise of market power, either directly or through authorized ISO programs. It is worth noting that the wholesale electricity market has not actually been deregulated. There is no federal legislation that declares that the wholesale electricity market shall be left entirely to competitive forces and directing FERC to withdraw from the field. FERC retains a statutory obligation to ensure that wholesale electricity prices are just and reasonable. FERC has determined, administratively, that its statutory responsibility to ensure just and reasonable prices can be fulfilled by allowing prices to be established in the competitive electricity markets. FERC, therefore, is obligated to ensure that wholesale prices, in fact, are the result of competitive markets.

In my view, the most certain way to undermine the deregulation of the electricity industry is for the public and elected officials to become convinced that suppliers are taking advantage of the special vulnerabilities of the electricity markets and that FERC and the ISOs are unable or unwilling to protect the public from exploitive pricing.

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Fourth, changes in the structure of the NYISO and other RTOs should be allowed to evolve with the active involvement of all market participants, and should not be mandated by FERC. Currently there is a debate as to whether FERC should order the merger of the three ISOs in the Northeast. In my view, such an action would be ill advised for several reasons. First, because the consequences and impediments to such a merger have not been fully identified or analyzed. The geographic boundaries of the three ISOs are not arbitrary. They reflect the three pre-existing power pools that were designed to operate as integrated and coordinated systems with limited ties to the neighboring pools. While a merger of the three ISO may eventually be the best course of action, it should not be undertaken until the impacts of such a merger on reliability and competitive markets are well understood. The ability of a single Northeast ISO to effectively maintain reliability and efficiently dispatch resources has not been sufficiently analyzed and certainly has not been demonstrated.

Second, we still have a lot to learn about the operation of competitive electricity markets and the best way to administer them. As we go forward, the full range of structural revisions to the ISOs, including mergers or the adoption of a fundamentally different model, should be considered. This process should not be cut short by FERC. All of the market participants whose interests are at stake should play a meaningful role in determining how the structure of the ISOs should evolve.

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In addition, FERC mandated merger of the ISOs will almost certainly result in extensive litigation concerning the right of FERC to issue such an order and the adequacy of the basis for its decision.

CONCLUSION

The promised benefits of competition are very substantial, and achievable. To ensure that the promise of competition is realized, market participants, the ISOs and the FERC must recognize that we are still in a transition period and that we are still learning how to deregulate the electricity industry. They should proceed deliberately, but carefully. And, most important, it must be understood that there continues to be a special responsibility to protect electricity consumers from exploitation during this transition period. The development of a justified public confidence in competitive electricity markets is essential in the transition to competition is to be successfully completed.