Getting from Here to There: Transitional Competition Issues in U.S. Electric Industry Restructuring

Report from the Hill

Comments of
Alan H. Richardson
President & CEO
American Public Power Association

Presented at the
Third Annual Energy Conference
American Antitrust Institute

January 21, 2003

Thank you for the opportunity to participate in this conference. It has been APPA's pleasure to support the creation and continuation of the American Antitrust Institute and it is my pleasure to join you today.

While my comments are intended to provide a broad overview of what we might expect from the 108th Congress, I can't and won't resist the temptation to editorialize a bit on what I believe should happen, and why.

Let me start with a simple question from the title or theme of this conference, "Getting from Here to There." How are we defining our destination? What is the "there" we are trying to reach? Is it the same "there" that was the vision of Enron? And if so, can we really get there? It isn't too late to ask this question. Indeed, it cries out for an answer based on a sound, critical analysis of what the electric utility industry is, how it operates, and most important, the disastrous events of the last few years that challenge the assumption that we can displace regulation with competition to the extent envisioned by federal and state policy makers.

The November 26, 1992 issue of *Fortune Magazine* carried an article entitled "Power Failure." It noted the demise of the energy trading and marketing companies whose stocks have lost 90 percent of their value in the last year, and the staggering $90 billion of debt that is coming due in the next three years. According to the article, the meltdown was set in motion by "botched deregulation." A major contributing factor (in my mind, perhaps the key factor) was that "electricity was simply different from other commodities. Unlike corn or wheat – or natural gas – it can't be stored." And it concluded with the prediction that "ultimately, the energy industry is likely to go back to its roots: It will be a low-margin business dominated by power generators and local utilities that trade with one another and hedge against volatility….Suddenly, that doesn't sound so bad."

As the program proceeds today, I hope we continue to challenge ourselves to define our destination.

Now, let me turn to the subject at hand, a report from the Hill. Here are the issues I hope to cover in the next few minutes: the larger context for electric industry restructuring; an historical perspective on energy legislation; energy and other issues competing for Congressional attention this year; antitrust issues to watch; concluding comments and predictions. With respect to those issues that relate to antitrust, let me state that I have a broad interpretation of "antitrust" here, where regulation and antitrust in the U.S. have been threads in the same garment of consumer and investor protection from monopoly abuse.

Electricity Restructuring Legislation in the Broad Context of Energy Policy

Electricity legislation is obviously part of a much larger legislative picture. In the last few years, and particularly during the last Congress, it was but one element in the broader debate on national energy policy issues. None of issues were resolved and many were extremely controversial. These included drilling in the Arctic National Wildlife Refuge, corporate automotive fuel efficiency standards (CAFE), hydroelectric licensing reform, greenhouse gas

reductions (GHG) and renewable energy portfolio standards (RPS). Three of these five – CAFE, GHG reductions, and RPS – were issues advanced by the Democratic majority in the U.S. Senate. With the change in control of the Senate, these issues won't disappear but they are unlikely to be incorporated into a broad energy bill as was the case last year.

Electricity restructuring issues were also extremely controversial. The electricity title of the Senate energy bill last year contained a few positive provisions that modestly expanded FERC's merger review authority to cover transfers of generation facilities as well as utility holding company mergers, and new conditions regarding how FERC should permit electricity wholesale sales at market based rates. Such review was to include an examination of market power problems and availability of reserves. It also authorized the repeal of market based rates on a finding that they did not meet the statutory standard of "just and reasonable." The House bill did not address electricity formally, but House Republican conferees made offers to the Senate during the conference committee last fall that included such items as repeal of FERC's merger review authority and an expansion of FERC's authority to direct utilities to join regional transmission organizations (RTOs).

An issue in the Senate bill that was not controversial, unfortunately, was the repeal of the Public Utility Holding Company Act of 1935 (PUHCA). I'll have more to say on that in a moment.

FERC regulation also crept into the debates on electricity restructuring near the end of last year, and recently this issue has taken center stage as the Senate struggles with the omnibus appropriations bill. Last summer, the Federal Energy Regulatory Commission proposed a new rule that would implement a standard market design (SMD) for wholesale electricity markets throughout the country.

The SMD proposal was extremely controversial. So controversial, in fact, that there were efforts in both the House and Senate to prohibit FERC from spending any money to complete the rulemaking proceeding. There was also discussion of an amendment to the comprehensive energy

bill to vacate the FERC proposal. Both efforts failed primarily because the vehicles to which such amendments would have been attached – the energy appropriations bill and the comprehensive energy bill – were not enacted. The issue, however, has not gone away and regional opposition, particularly in the Pacific Northwest and the Southeast, continues to mount.

The FERC SMD proposal contains some very good elements, including in particular its recognition of the problems of undue discrimination for access to transmission. This is, in fact, the corner stone of the proposal. It also has some very problematic elements such as the manner in which it proposes to deal with transmission congestion and pricing. As we meet here today, there is a heated debate in the Senate over whether Congress should pull the purse string closed and prohibit the use of funds by the Federal Energy Regulatory Commission to act on the proposed rule on (SMD).

Historical Context

Typically, Congress addresses key economic issues on a 10 to 15 year cycle. This has certainly been the case for electricity. President Carter's National Energy Policy Act was passed in 1978. Elements of that act began the drive for electric utility deregulation.

In 1992, Congress enacted the Energy Policy Act. That Act contained a provision to promote wholesale competition through the creation of a new category of owners of electric generation – exempt wholesale generators (EWGs). These entities were defined as "non-utilities." EWGs were exempted from regulation under PUHCA whether they were owned by utilities, utility holding companies or an entity with no relationship whatsoever to the utility industry. Further, FERC was authorized to permit EWGs to sell wholesale power at market-based rates where these EWGs were operating outside of the parent utility's service area. I'll return to the consequences of this exemption and what they might mean in the future in a few minutes.

So, if you look only at the calendar, it would appear that we are due, once again, for Congressional action on energy and electricity issues. Of course, the calendar doesn't calculate political dynamics. While the issues might be ripe for Congressional action, whether and how they might be considered is another matter.

Congressional Agenda

Energy policy is but one of many issues for the Administration and the Republican controlled Congress. The top priority domestic issue for the Administration is an economic stimulus or economic recovery plan, take your pick. Whatever its title, the Administration's multi-billion dollar proposal would result in a huge loss of federal revenues through various tax cuts, thus increasing the federal deficit and decreasing the availability of funds to be used for other purposes (adequate FTC and DOJ budgets, for example). Health care and drug benefits are also on the agenda, as is "tort reform" with attention already focused on limits on medical malpractice awards. Environmental issues, including the President's Clear Skies Initiative, might also garner some political attention. From a political perspective, the Administration may want to do something to enhance its environmental record although that is not at all clear at the present time. In addition to these issues is the prospect of war in Iraq.

Comprehensive energy legislation, to include electricity restructuring, appeared to be high on the agenda of both the Administration and Congress last month. House Majority Leader Tom Delay (R, TX) was predicting that he would have an energy bill on the President's desk within six months. Today, for a number of reasons, the relative priority of energy legislation may be slipping.

First, two high-priority energy issues for the Administration, ANWR drilling and reauthorization of the Price-Anderson act, can be handled through means other than a comprehensive bill. ANWR, for example, could be (and some are predicting will be) included in a budget reconciliation bill. This would render it filibuster-proof and allow it to pass the Senate by a simple majority.

Second, electricity restructuring remains highly controversial while the constituency most avidly pursuing restructuring – the energy marketers and traders and the independent power producers – is fighting for its very survival. There is no groundswell of public opinion clamoring for deregulation (in fact, if anything, probably the reverse is true). Looking forward to the 2004 elections (and everyone in the Administration and on Capitol Hill is looking forward) there seems to be little political gain from acting on electricity matters (but a lot to lose if they get it wrong). Thus members of Congress might be content to take a pass.

Finally, the SMD issue could become moot if, within the next day or so, Congress decides to prohibit the expenditure of funds for FERC to continue to move forward with this rulemaking proceeding. If it does so, that issue, which is yet another driver for consideration of electric industry restructuring legislation, would be taken off the table. Congress might be content to take a pass and just let FERC handle this issue.

Antitrust Issues to Watch

PUHCA Repeal: Let me begin with the most dangerous proposal on the horizon, stand-alone repeal of the Public Utility Holding Company Act. After an exhaustive FTC review of the ways in which utility holding companies abused investors and consumers, Congress enacted PUHCA in 1935. PUHCA was created to remedy a number of problems, including: lack of investor information; incorrect valuation of assets and earnings; improper pricing of inter-affiliate transactions; no relationship between a company's expansion and operational efficiencies; and subsidiaries and affiliates in different states, making effective regulation difficult and enhancing opportunities for utility holding companies to siphon funds from customers of the operating electric utility in order to shore up failing ventures elsewhere.

Ironically, these problems define our industry today. The reasons they exist can be traced in part to the EWG exemption from PUHCA in the Energy Policy Act of 1992 and in part to the failure

of the Securities and Exchange Administration to enforce PUHCA for almost two decades. These problems include: lack of access to and transparency of market information; siphoning of funds from operating electric utilities to prop up unregulated business ventures; extension of credit from the operating utility to the holding company parent to deal with liquidity and debt problems; and the transfer of generation facilities from unregulated subsidiaries to the regulated electric utility at terms favorable to the holding company parent. There is insufficient time to elaborate on this, but for those of you who are interested, I would refer you to an excellent article in *The Wall Street Journal* on December 26, 2002 by Rebecca Smith entitled "Beleaguered Energy Firms Try to Share Pain with Utility Units."

PUHCA should be modernized. It should also be enforced. It should not be repealed. However, that doesn't seem to square with Congressional intent. At the moment, there is little opposition to repeal of PUHCA. The SEC has advocated repeal for two decades, and throughout that time has been extremely lax (some might say negligent) in exercising its PUHCA responsibilities. On Capitol Hill, it has been characterized as an antiquated New Deal statute with little modern day relevance. One of the foremost advocates of repeal is the Oracle of Omaha, Warren Buffett who claims to have $10 to $15 billion to invest in the electric utility industry. That is a tempting offer at a time when the industry is suffering from both a liquidity and a looming debt crisis and policy makers are asking where will the money come from to maintain and expand the industry's infrastructure. Repeal was supported on a 19 – 1 vote of the Senate Banking Committee in 2001 (Sen. Debbie Stabenow, D, MI was the lone dissenting vote) and included in the Senate-passed version of the comprehensive energy bill last year. It hasn't yet been put to the test of a vote in the House. If it were, it would probably pass.

If repeal were proposed within the context of a larger electricity restructuring measure, there would at least be a chance that FERC's authority to deal with issues currently within the purview of the SEC under PUHCA could be enhanced. Stated differently, the damage from PUHCA repeal might be mitigated to some extent through other means, but only within the context of a broad energy bill that addressed electric industry issues. However, if the energy bill together with

electricity restructuring legislation is pushed off the agenda for reasons I have mentioned, then stand alone repeal becomes a very real prospect, while the opportunity to mitigate the damage essentially disappears.

FERC Authority to Protect Consumers: Limited enhancements of FERC's authority to deal with market power problems were, as I mentioned, included in the Senate energy bill last year. But these were advanced by the Democrats, including in particular then-chairman Jeff Bingaman. They were not widely supported by Senate Republicans, and were opposed by the Republican House conferees. In fact, last year House conferees offered proposals to weaken or eliminate existing FERC consumer protection provisions, including its review of utility mergers. It does not appear that the 108th Congress will act to enhance the ability of FERC to protect consumers and prevent the abuse of market power. In fact, I believe we will need to fight just to protect the status quo.

Last year, there was also some support for expanding FERC's authority in the area of market information transparency and credibility. Information transparency is, of course, critical to the proper functioning of any market. But proposals for transparency are met with complaints regarding the need for confidentiality lest competitors (or heaven forbid regulators or consumers) find out what is going on.

It would also be helpful if Congress were to provide explicit directions to FERC regarding when and how to permit wholesales power sales at market based rates and when to withdraw that permission in the face of market power problems that are producing unjust and unreasonable rates. Through painful experience in the past few years, people are coming to understand that a simple HHI analysis does not uncover the potential to exert market power. Electricity is an essential product that can't be stored. The entity holding the last increment of generating capacity necessary to meet a peak load, no matter how small in terms of total generating capacity in that market, can exert market power and produce unjust and unreasonable rates. (This "pivotal supplier" problem was examined in an article by Seth Blumsack et al. in the November

2002 issue of *The Electricity Journal* entitled "Market Power in Deregulated Electricity Markets: Issues in Measurement and the Cost of Mitigation.) While Congressional action in this area would be useful, I don't expect to see it in this Congress.

Other Issues to Watch: Time is short, so let me tick off a few of the other issues that should be on your radar screen as you track the course of the 108th Congress and FERC:

- Adequate appropriations for the Department of Justice and the Federal Trade Commission.
- Interactions between the Department of Justice and the Federal Energy Regulatory Commission.
- Commodity trading and accounting practice rules changes.
- Natural gas price indices and price manipulation.
- Potential calls for antitrust exemptions due to security or reliability coordination rationales.
- The unknown factor.

Conclusion

As I warned at the outset, these comments have been a mixture of my view from the Hill as well as my views about the Hill. I hope my comments have been interesting and informative and contribute in some way to laying a foundation for the outstanding speakers to follow as well as to the overall success of the program.

I would like to close with an observation and a prediction. First, the observation.

However we define "there" in "from here to there" I hope it encompasses the concept of just and reasonable rates. For at least the next few years and probably longer, the application of the "just and reasonable" standard for electricity rates must not be abandoned. Just and reasonable

standard for monopoly service, despite being centuries old, is not at all an outdated concept. The public policy rationale was described in Franklin D. Roosevelt's Campaign Address on Public Utilities, delivered in Portland, Oregon, on Sept. 21, 1932.

During the reign of King James, ferrymen enjoyed monopolistic positions and were able to charge whatever the traffic would bear. The citizens were outraged, King James took notice and asked for Lord Hale's advice. As recounted by FDR, "The old Lord replied that the ferryman's business was, in fact, vested with a public character, that to charge excessive rates was to set up obstacles to public use, and that rendering of good service was a necessary and public responsibility. 'Every ferry,' said Lord Hale, 'ought to be under a public regulation, to wit: that it give attendance at due time, keep a boat in due order, and take but reasonable toll.'"

Industries change over time. Ferry boats lost their monopolies as roads were constructed. Certainly the electric utility industry has changed as well. However, its fundamental characteristics – a real time product that is absolutely essential, can't be stored, is generated in an oligopolistic market in which even the smallest participant may be able to manipulate the market at certain times, and finally is provided to buyers by monopolies – remain unchanged. So long as this is the case, the just and reasonable principle must be the benchmark.

I will close with only one prediction beyond the speculative "might happen" events sprinkled throughout the body of my comments. The 108th Congress will offer significant challenges to those of us committed to protecting the interests of consumers from those who have and are allowed to abuse market dominant positions in the electricity industry.

Thanks again for the opportunity to be with you this morning.