UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

State Policies and Wholesale Markets Operated by ISO New England Inc., New York Independent System Operator, Inc., and PJM Interconnection, L.L.C.	Docket No. AD17-11-000

PRE-TECHNICAL CONFERENCE STATEMENT OF
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I appreciate the opportunity to participate in this extremely important technical conference. I am representing today large US manufacturers who are dependent on an adequate and affordable supply of electricity to maintain their global competitiveness. ELCON was an important driver of electric industry restructuring that began over twenty years ago. Notwithstanding problems that continue to plague the organized wholesale electric markets, we continue to support and advocate a greater role for competitive market forces in the supply and delivery of energy, capacity and ancillary services. Our objective is well articulated by Commissioner Donna Nelson of the Public Utilities Commission of Texas (PUCT), "You protect competition; you don't protect individual competitors." I have three main points to offer the Commission and its staff:

1. If left unchecked, efforts by the owners of merchant generation to extract ratepayer-funded subsidies will result in the collapse of competition in the organized markets and possibly even the re-regulation of the energy markets. These efforts often are actively aided and abetted by states seeking to pick winners and losers in resource adequacy determinations. The subsidies are, by definition, intended to directly interfere with the pricing outcomes of the organized markets by preventing uneconomic resources from exiting the market. By artificially retaining uneconomic assets, price signals discourage new merchant investments that otherwise might be made.

2. FERC has a responsibility under the Federal Power Act and *Hughes v. Talen Energy Marketing* to reject state actions that improperly influence prices in the federally regulated wholesale markets. In rejecting the Maryland and New Jersey subsidies for new capacity, the Supreme Court held that "States may not seek to achieve ends, however legitimate, through regulatory means that intrude on FERC's authority over interstate wholesale rates, as Maryland [and New Jersey have] done here." Past precedents, the Court added, made clear that "states interfere with FERC's authority by disregarding wholesale rates FERC has deemed just and reasonable, even when states exercise their traditional authority over retail rates or, as here, in-state generation."

3. FERC should immediately begin a formal inquiry to rationalize the capacity and energy market constructs with the long-term financial needs of different operational categories of electric generation.[1] We strongly oppose any attempt to solve this problem via negotiated settlements in ISO or RTO stakeholder processes.

Make no mistake, a greater role for competition means a lesser role for regulation—especially regulation at the state and local levels. ELCON support for open-access competition beginning in the late 1980s and early 1990s was a direct outcome of the gross mismanagement of the US electric industry's nuclear plant construction program. Billions of dollars in cost overruns were allocated to and recovered from retail customers for a resource that was once considered "too cheap to meter." Ten years later billions of dollars more were extracted from retail customers in the form of non-bypassable "competitive transition charges" (also known as stranded costs). Now a third round is underway and retail customers are being forced to subsidize not just selected nuclear generation facilities but also uneconomic coal-fired and in some cases natural gas-fired plants.

I dispute that a compelling case has been advanced to date for forcing customers to subsidize uneconomic generation facilities. Some of these plants have always had questionable economics. In general, states required utilities to divest their major generating facilities—including all their nuclear plants—in the course of restructuring the power sector

[1] For example: base-loaded, cycling and peaking generation.

that was primarily under the tutelage of FERC. States knew what they were doing. Retail customers were expected to benefit from this unbundling because the risk of developing, operating and maintaining generation facilities would be shifted to separate merchant entities. Many of these entities were the unregulated affiliates of the original owners of the divested assets. In return for the divestiture and elimination of risk, the plants' original owners were lavishly rewarded with stranded cost recovery. Divestiture was supposed to shield customers from economic and operational risks being assumed by the willing purchasers of the generators. Now, through a round of state-sponsored subsidies, such risks are again being imposed on captive customers.

During the early days of the organized markets, electricity prices were generally high as a result of high natural gas prices. The nuclear plants in particular earned their owners very high profits, which flowed to the sole benefit of their shareholders and irrespective of customer impacts. Those owners loved the markets and the competition. Now that the pendulum has swung in the opposite direction, certain owners of nuclear and other generators are abandoning any faith in the markets and seeking regulatory redress. Their business model is the higher of market or regulation, which is the worst of all worlds for customers. When market prices are high, customers pay those high prices. When prices are lower, customers are being forced to pay surcharges in the form of out-of-market subsidies with the intent of preventing uneconomic facilities from leaving the market. This does not bode well for customers because most of the proposals involve long-term contracts that will expose customers to future cost inflation—given that cost deflation is a non sequitur in this industry. That is the problem as I see it. I recognize that it is more complicated but our responses to the questions posed to this panel by FERC staff should clarify that.

ELCON Responses to Four Questions Posed to the Panel

1. *Are there certain types of state policies that can be readily integrated into wholesale markets as opposed to pursuing state policies outside of the centralized energy and capacity markets? Are there certain types of state policies that can be readily integrated into centralized capacity markets, as opposed to centralized energy markets, and vice versa? Please explain.*

ELCON Response: During the restructuring era, some states ordered the divestiture of generation for the purpose of unbundling the vertically integrated utility functions. Other states gave utilities the option to divest. The merchant generation and marketing entities that were created were legitimate participants in the wholesale energy, capacity and ancillary services markets as those markets evolved. Many states have also sanctioned the participation of certain demand-side resources in the wholesale markets. Demand response is perhaps the best example. FERC is presently considering an appropriate mechanism for aggregating Distributed Energy Resources and allowing such resources to trade in the wholesale markets. FERC has shown a willingness to work with the states to properly integrate state policies in the wholesale markets. But, because of the market design and the need to mitigate potential exercises of market power, such willingness cannot be open-ended and the reach of states must be limited. State policies cannot be allowed to undermine the competitiveness of wholesale electricity markets.

2. *If state policy objectives cannot be achieved through the wholesale markets and states choose to provide support outside of the markets, what are the implications for wholesale market outcomes and market participants' ability to make long-term decisions?*

ELCON Response: Two outcomes are deleterious to competitive market operation. First, price formation is distorted. There is no point in having competitive markets if efficient pricing is not respected. Prices are also the mechanism for picking winners and losers and thus the second outcome is inefficient entry and exit. State policies that intend to subsidize uneconomic power plants (whatever the fuel type) are keeping uneconomic plants from exiting the market. This is a drag on the overall efficiency of the market and we would argue always does more harm than good. The uneconomic plants need to cut costs or be replaced by assets developed and operated by owners and managers more competent at competitive business. The needs of US manufacturers are not met by the uncertainties and inefficiencies created by a distorted market. Competitive power markets were created because we can and should do better than command-and-control regulation.

3. *Please explain whether wholesale energy and capacity markets can value or select additional attributes to respect state policies.*

ELCON Response: This is code for attempts to selectively internalize externalities. When regulators second guess the markets and do not like the outcomes, they often reach for this dubious economic gimmick to tilt the balance more in their favor. State policies that force customers to subsidize selected nuclear plants, for example, are typically based on a purported need to retain a certain environmental attribute (*e.g.*, zero carbon emissions). But the same policy ignores entirely all other environmental considerations—positive or negative—associated with nuclear power. For example, nuclear plants have certain unique safety issues and, as a matter of national policy, we are far from handling the societal costs of spent fuel storage. Selecting some externalities (and rejecting others) for internalizing is nothing less than cooking the books and bad policy.[2]

4. *What are the implications for wholesale market outcomes and market participants' ability to make long-term decisions of a hybrid approach where some state policies are achieved through the wholesale markets and some are achieved through out-of-market actions? Similarly, what are the implications of addressing state policy objectives through the capacity market versus through the energy market?*

ELCON Response: A hybrid approach is not sustainable because it incents rent seeking behavior. All consumers are benefiting from low-cost natural gas that has been achieved by the so-called "Fracking Revolution." As expected, this has created losers who are not going quietly. State regulators and policymakers are ill-equipped to pick winners and losers in large regional and national markets (not to mention global markets). The markets need to be allowed to work. States are not without policy tools for dealing with the dislocations associated with uneconomic assets. On the other hand, states may have reason to argue that the organized markets do not properly incent all categories of electric generation. For example, the volatility experienced in some capacity markets is certainly not reassuring to long-term investors. But, we should not destroy the market to save it. It is imperative that FERC initiate an inquiry to rationalize the capacity and energy market constructs with the long-term financial needs of different operational categories of electric generation. This must be done without any attempt to reach a foregone conclusion by selectively internalizing one or more externalities. Continuation of the status quo will only increase regulatory uncertainty, stall investment in new generating resources and debilitate the US economy in general. US manufacturers are fearful that this may be the outcome if FERC does not take decisive action to the contrary. ###

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[2] *See* Electricity Consumers Resource Council, *Profiles in Electricity Issues: Externalities*, Number 16, October 1991. Download.