

**REMARKS OF
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Distinguished Guests, Ladies and Gentlemen:

Good morning. I want to thank the Gas Industry Standards Board for the invitation to speak to you today.

During my service with the Clinton Administration at the Department of Energy, I addressed a meeting of the Council on Foreign Relations regarding the role of Middle Eastern petroleum in sustaining the economies of industrialized nations, including that of the United States. At the conclusion of my remarks, a bespeckled gentleman asked me whether the Administration had ever examined the role of our increasing defense requirements in maintaining our domestic energy security. The questioner was Robert McNamara, former Secretary of Defense in the Kennedy and Johnson Administrations. I answered: "Mr. Secretary, while I have heard incidental references, there has been no ongoing inquiry at this time to my knowledge." He rejoined: "Well, Mr. Secretary, it is long past due for the American public to have that discussion." I concurred.

This colloquy illustrated our country's heightened vulnerability owing to our dependence on imported petroleum. Last week's tragic events -- occurring in part literally blocks from where I live -- gravely reminded us of that fact, and may well finally prompt that overdue discussion. But this morning I want to highlight a different type of vulnerability -- that related to economic and market alterations affecting our electric grid. And that concern likewise warrants our immediate attention.

Our country has financed and constructed an electric infrastructure that is second to none. But significant changes in market structure and physical power dispatch have transformed how we utilize the grid. New generation is no longer being constructed primarily for local end-use. Transmission is no longer being devoted exclusively -- or in some cases even predominantly -- to serve "native load". Lagging transmission investment, surging numbers of wholesale power transactions, and thinning reserve margins in some parts of our country have made increasingly difficult the physical and economic management of the grid.

In the generation sector, the movement to market pricing has meant vulnerability to price risk. The choice of natural gas as a preferred fuel resource -- at least for now -- has made our power generation needs ever more dependent upon gas as a reliable and affordable source of supply. But gas prices are influenced by the cyclical economic supply and demand forces of the oil patch as the most recent escalation and volatility in gas prices over the course of last

year has demonstrated. This has required closer management and calibration of fuel price risks through hedging instruments and forward contracting arrangements.

Today: Energy Restructuring at a Crossroads

Almost a decade has passed since our country enacted federal legislation to allow economic market decisions, rather than command-and-control regulatory directives, to dictate the construction and financing of new power generation. This was followed by federally ordered, non-discriminatory open-access requirements for power transmission in interstate commerce to ensure that all sources of power could serve growing market loads. Competitive wholesale power markets were established and began to flourish.

While that occurred, the states debated the merits of embracing reforms in retail power markets. Some market participants were impatient with the slow pace of decision-making, urging that Congress preempt the states to mandate nationwide competitive retail markets by a common date. Others – myself included – argued to the contrary that states ought to be the sole arbiters of their economic fate, urging that they be permitted to fill the role of becoming learning “laboratories” of change.

Currently, about half of our states have already opened or are at various stages in the process of opening their retail markets to competition.

This past year, in California and the western power region, we saw what happens when you combine poor market design, an uncertain environment for generation investment, and extraordinarily unlucky weather: power prices failing to maintain affordable levels, utilities failing to remain solvent, and responses by political leadership failing to maintain public confidence.

Already voices are clamoring to rethink the wisdom of unleashing the forces of competition. Some have called for a slowing of the pace, a halt to, or even reversal of decisions to adopt competitive retail markets. Others have proposed that certificates to sell into markets be accompanied by a Miranda warning. Like driving and drinking, a volatile mix of politics, high power prices, and angry constituents do not offer a basis for reasoned decision-making.

In the meantime, federal regulators are caught in the crossfire of this debate. First harshly criticized for acting too *slowly* to remedy western regional power price spikes, the Federal Energy Regulatory Commission has now become the target of those opposed to its recent efforts to merge the various Regional Transmission Organizations. Why? For acting too *quickly*!

Lessons Learned

What can we learn from this?

Lesson 1: If things go sour, many political leaders don't really care whether the energy sector has an optimal mix of market and government control, or frankly, whether there is a market at all. They could care less whether you make money. What

they want is reliable, affordable power for their constituents. This is true even among many of those elected officials who proclaim to be free-market advocates. If they must choose between those who want to make money and those who have the votes, I'll put my bet that they go with the voters every time.

Do I agree with this? No. Do I accept this as a political reality? Yes.

Lesson 2: Contrary to what some here may believe, political leaders are actually more knowledgeable now than at any prior period in our nation's history concerning how the electric system works. This is true because in virtually all of the states that have adopted, or have been examining, retail market restructuring, legislatures have invested a great deal of time to discern how the system works and what other states and countries have done. This was certainly true here in Texas. It has also been true to some extent in certain western states -- although there I think they may have *reversed* the deliberation and decision stages.

But the knowledge held by political leaders doesn't mean that they will necessarily make the correct market and policy decisions. For that they must rely on others -- such as those assembled in this room -- to advise them on what works and what doesn't. In any event, having our leaders better understand this industry is, in my view, a positive milestone -- and one that offers opportunities for the right decisions.

Lesson 3: Fix what we can. States will continue to exercise independence in determining the direction, scope, and pace of retail market competition. But abundant opportunities to make headway in other aspects exist. Specifically, whatever reforms are adopted for those markets, an absolute essential at this time is a functional, competitive wholesale market. We must resolve differences over how to plan, transport, integrate, and interconnect additional wholesale power generation into the grid if our expectations of affordable, reliable power are to be realized. If we can't timely resolve these questions, nothing else will matter at the retail level because wholesale power markets will fail to provide the platform for any meaningful type of competition.

Task One: Fix the "Seams"

Further, in those pending or currently open retail markets, the need is ripe for improvements. As regulatory reforms to the grid were introduced, state policymakers were permitted to customize the design and structure of their respective markets. As I stated previously, I was an early advocate of a "Heinz 50 Variety", state-directed approach to retail restructuring.

Now, we are at a juncture to ask whether the goal of achieving robust, sustainable wholesale and retail markets can genuinely be achieved absent some measure of standardization or harmonization of business practices beyond those adopted within individual states. Arguably applicable primarily in state-to-state retail markets, standardization may also have merit to address the differences, or "seams", between wholesale and retail markets, among regional wholesale markets, and finally at the interface of natural gas and electric markets.

There are many and varied viewpoints on this subject, and how we get there -- or even if we **should** get there -- still falls short of a full consensus. However, we ought not forget that markets require certainty for a competitive environment to grow and flourish. Thus, the sooner we progress in achieving an “end state” -- thereby providing at least **relative** certainty -- the better our prospects for sustaining a market. “Pending” status is not a preferred precondition for financing and starting a new business.

If you conclude it preferable that business practices be standardized and enforced by those who must abide by them, rather than through government prescription, then the private sector must take the initiative to fashion both the necessary organizational and procedural structure. I applaud the Gas Industry Standards Board for your leadership and advocacy in this regard, and for your willingness to be part of a larger, comprehensive energy standards-setting body for both the gas and electric industries.

Task Two: Reform Transmission Oversight . . . And Perhaps More

As I indicated before, the transmission sector has undergone a dramatic transformation. No one can dispute that much of the grid is now being used to facilitate regional transactions in interstate commerce. But questions still center on which institutions should control or oversee these transactions, and how limited or expansively these “regions” should be defined. Moreover, because statutory responsibility for overseeing the various components of transmission has remained fundamentally unchanged for many years, some propose to realign the federal-state balance in the interest of modernizing institutional oversight.

We are thus now immersed in a debate over the proper jurisdictional role between states and the federal government over the planning, siting, and pricing of transmission facilities used for retail services. Let me recite to you an excerpt from an article published in **Public Utilities Fortnightly** and authored by a state public utility commissioner:

[A] . . . significant policy activity concerns the increased need for greater, ongoing working relationships between states. This need arises from jurisdictional challenges imposed on states at the federal level . . . Efforts to meet this need have spawned federal and state proposals to create regional authorities or compacts to address problems . . . [such as] transmission pricing and siting. A clear trend exists for regional resolution of many seemingly intractable jurisdictional and policy disputes.¹

Those words were not written last week, last month, or last year. They were written **eight years ago** -- by me. I was not clairvoyant. Rather, I was only echoing the “clear trend” for regional issue- resolution at that time. Thus, the Great Debate now joined over state versus federal transmission jurisdiction is not new.

Within this context, when I hear certain states advocating the unequivocal retention of their existing transmission jurisdiction, I am struck by a sense of **déjà vu**. I made those same arguments several years ago. This is not surprising. States are not inclined -- nor should they be expected -- to surrender their authority willingly. But much has changed since those days

¹ R. Gee, *Managing the Dynamics of Change*, **Public Utilities Fortnightly**, November 1, 1993 at page 36.

before anyone heard of a “regional transmission organization”, or when “customer choice” was still called “retail wheeling”.

Calls are now being heard from the Bush Administration and from both sides of the aisle in the Congress for federal preemption of states over siting of new transmission capacity, or at minimum for a federal jurisdictional backstop if states are unable to resolve siting questions. Whether any of these measures ultimately will be enacted is speculative. But it does demonstrate the risk states run in appearing to oppose measures couched in terms of reforming the law to reflect how the market currently works and in advancing the broader national interest.

While I understand the states’ traditional reluctance to share decisions such as siting with other authorities, collaboration among states and between states and the federal government on other matters affecting the electric utility industry or other regulated industries is not unprecedented. Let me share two personal experiences. While a Texas utility commissioner, I recall negotiating with other state commissioners over terms of the joint system operating agreement Texas and other states entered into with the Gulf States Utilities holding company (now Entergy) whose subsidiary utility companies were distinct jurisdictional entities of each of the states.

Through participation in this system operating agreement, the states of Texas, Arkansas, and municipalities in Louisiana were able to ensure that ample generation capacity at reasonable costs were afforded to all states where the utility subsidiaries of the holding company were situated, notwithstanding the state-specific location or costs associated with particular power plants. A key participant in this process was the Federal Energy Regulatory Commission, the entity whose approval was required to render the agreement effective. While we did not always concur, we understood the need to forge a commonly acceptable regional outcome, and agreed more often than not.

A second instance of successful state-to-state and state-to-federal cooperation can be illustrated by the Regional Bell Operating Company Joint Audit undertaken by all five state regulatory commissions in the entire service region of Southwestern Bell Telephone Company (now SBC Corp). Texas represented the largest market segment of this region. This collaborative audit, conducted with the assistance of the Federal Communications Commission, was aimed at finding whether the methodologies of the entire company properly costed and allocated expenses to each of the company’s respective states where service was provided. It successfully identified instances where the company’s accounting practices could potentially lead to rate overcollection.

These two instances are not isolated events. Rather, they show that when the need arises, states and federal authorities can work cooperatively to overcome provincial obstacles to meet objectives serving a broader set of interests. While the issue of transmission siting authority is certainly laden with a highly charged, emotional element, I am also convinced that there may be workable schemes offering the means for a mutually satisfactory resolution.

On a concluding note, and at risk of introducing more complexity, allow me to suggest that perhaps the time is ripe for the states and our federal government to broaden discussion to address whether to reapportion jurisdiction over not only transmission but also other components and services integral to a competitive electric industry. This inquiry could benefit all sides by revealing how the introduction of new structural and market components could require further rethinking of the jurisdictional role of each beyond their traditional oversight missions. It is plausible that, in the end, such an inquiry could enable states to *gain* in advancing the interests of their local constituents, while still being consistent with a broader national interest. At least, that is my hope.

So, the question I leave you is not whether we *ought* to resolve these and other questions, but *when*. To paraphrase Secretary Robert McNamara: "That discussion is long past due."

Thank you very much.

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