

Testimony

**Testimony of
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Federal Energy Regulatory Commission
Before the Committee on Governmental Affairs
United States Senate
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Mr. Chairman and Members of the Governmental Affairs Committee:

Thank you for the opportunity to appear before you today. The state of retail and wholesale electricity markets in the West has been headline news on a daily basis for the last six months. California's experience has been in the forefront, but clearly, the problems – as well as the solutions – are regional in nature. Indeed, it is a tragedy for everyone in the West, and a matter of grave national importance.

I should take this opportunity to emphasize something that I stated during my confirmation hearing. My appointment to the Federal Energy Regulatory Commission did not arise because I have all the answers. I can offer no panacea. Unfortunately, that has not changed since I was sworn in last week. I am committed to working with you, your colleagues in the House of Representatives, the State of California, market participants, consumer groups, environmentalists, and other interested groups to arrive at solutions.

Over the past year, I have been constantly aware of the very divergent experiences that my home state,

Pennsylvania, has had with its markets from the experiences of California. During this time, I have been repeatedly asked what made Pennsylvania's market different. Both California and Pennsylvania have been high-cost states, that moved to de-regulated markets. I would first like to briefly comment on what could possibly account for the the different results, and then discuss what I see as possible lessons that we can use in the future.

Many factors have resulted in differences between Pennsylvania and California, including sustained economic growth in California and other Western states that has caused demand to exceed supply. This imbalance has been exacerbated by California's internal policies on generation siting and environmental restrictions, which have led to few, if any, additions to generation. The region is highly dependent on hydroelectric power, which, when combined with one of the most severe droughts experienced by the Northwest region in history, has led to a reliance on relatively more expensive replacement power. California is also dependent on imports from other states in the region, with as much as 20 percent of its peak demand being met through imports. As the drought has affected the entire region, this reduced the amount of supply available for imports to California.

In short, the net affect of all these factors is that supply is insufficient to meet demand. If I may borrow a statement of Commissioner Wood, when you have insufficient supply, the supply and demand curves meet in funny places.

The inadequacy of the transmission grid has also contributed to these problems. There has been very little transmission enhancement to support the economic boom in the West, and the increased demand associated with it. Again, difficulties in siting and environmental restrictions are associated with a failure to enhance,

upgrade, and enlarge the regional transmission grid. The siting of transmission facilities subject to multiple state and local entities is complex and subject to delays. For the most part, the region itself is not represented, so local concerns predominate. I would emphasize that the interstate transmission grid is truly regional in scope and operation and we must work toward a regional approach to planning and siting.

The lack of transmission infrastructure enhancement and regional cooperation with regard to transmission siting, upgrading, and operations, has resulted in significant constraints in California's grid. Accordingly, even if we can add new generation resources quickly, it is still not clear that these resources could be directed toward load in the most efficient manner, given current transmission constraints. Generation and transmission must be linked, if we are to succeed in addressing these problems. This is true with regard to gas infrastructure development as well.

I am frequently asked to address the "failure" of regulation which some contend is evident from California's experience. As a preliminary matter, I would like to emphasize that while I do not necessarily agree with all the decisions made in California, I heartily applaud the state and its lawmakers for initiating retail restructuring and for doing so at time when there were few, if any, models. In the long term, the welfare of the American consumer will be significantly increased by the development of workably competitive electricity markets, and California was among the first states to understand this concept and work to achieve it. Pennsylvania learned from California's experience, and has devised a different model. Texas moved even further and improved on what had gone before. I do not say this to criticize California, but only to emphasize that there are different approaches to deregulation, and we must be responsive to differing regional circumstances.

It appears, in retrospect, that California's market design lacked the necessary flexibility to respond quickly when there was insufficient supply. To make matters worse, natural gas is a major fuel source, and its prices have escalated substantially. California also required divestiture of utility generation assets and forced its utilities into the spot market, a volatile market of last resort. This reduced the utilities' opportunities to manage their business and for procuring power supplies from all possible sources, including on a long-term basis, a critical component of a workably competitive market. Once natural gas prices rose, and supplies fell, there was simply no means by which the utilities could develop supply portfolios that "managed around" the increasingly volatile spot market.

Pennsylvania, however, had a significantly different environment. First -- and perhaps most importantly, Pennsylvania's deregulation operated against a supply surplus. The resource generation fuel mix was not subject to weather-related shortages, as hydroelectric power is. While the regional grid has some import capabilities, imports are not essential to meet demand.

In addition, to adequate supply, the ISO that controls the grid in Pennsylvania's region ensure that the grid operates in an independent fashion. There is substantial regional planning, which not only ensures that generation supply would keep pace with demand, but also eases transmission siting problems and reduces uncertainty with respect to generator interconnection procedures. While local issues and debate are not eliminated, regional planning better manages this issue by allowing a certainty of process and solid engineering approaches to grid enhancement. This, in turn, helps attract investment, a critical feature to maintaining competitive markets. The ISO also manages a well-designed, market-based congestion management system, that, by allowing parties to "buy their way through" constraints, allows them to pay their true

economic price for use of the grid. This kind of market-based response to constraints also helps attract investment.

Pennsylvania's market design was designed to encourage all participants into the competitive market. While there were mandatory rate cuts, the bulk of Pennsylvania's market design focused on creating incentives for consumers to enter the market, as well as suppliers. To achieve these goals, Pennsylvania's market supply requires consumers to explore options in the market in order to achieve the full extent of possible savings. Also, Pennsylvania did not restrict utilities from using market-based tools to protect themselves against market volatility and did not require generation divestiture. The utilities were free to make such decisions as part of their individual business plans.

I should add that Pennsylvania had the decided advantage of launching competition only after the regional ISO has up and running. The ISO performed test runs of the regional energy commodity market before Pennsylvania's deregulation initiative started. Over time, additional markets have been created, and are now operating, which provides for competitive approaches to power supply, including delivery to ultimate customers. None of this would, however, would be successful unless the ISO is truly independent, operationally sound, and operates a significant portion of the region.

Moreover, the ISO that manages Pennsylvania's grid performs a market monitoring function, which did not exist at the time that Pennsylvania launched its program. However, it soon became clear that monitoring is essential to ensuring that developing electricity markets have the opportunity to mature and remain healthy. It is clear from Pennsylvania's experience that the ISO must have adequate access to all necessary market data, and understand how to interpret, and respond to, such data.

Market monitoring plays a critical role in ensuring workably competitive markets, and resources should be devoted to its development.

These are some of the key differences that I see between California and Pennsylvania. One thing that they do have in common, however, are limited demand response programs. For the most part, consumers in both states still see one average price for their power. California has recently significantly increased its prices, and has seen a substantial reduction in demand. While that is an important step, consumers are still blind to pricing and cannot react on a real-time basis. Because it is estimated that demand response of very small proportions can have a real effect on market prices, demand response programs are a necessary component of a successful transition to competition. I am aware of several experimental demand response programs that have achieved promising results. As the marketplace becomes more familiar with these tools, and demand for the technology increases, investment will begin into this area, and better results will be achieved. Customers are smarter than we give them credit for. They will use the tools that we give them. We must work to bring these and other new technologies to market quickly.

I would now like to focus attention on what lessons I take from my experiences in Pennsylvania, and my understanding of the differences between California and Pennsylvania. First, I strongly believe that a comprehensive, regional approach is the key to solving our current problems, preventing future problems, and achieving our goal of competitive, seamless markets. We must focus on both the electric and gas markets. We must involve the states and other federal agencies and departments. To that end, as an agency, we should better communicate with regional stakeholders and improve regional coordination to develop a more comprehensive and permanent solution to today's energy problems. The ISO that has been a factor in Pennsylvania's transition to

competition is a regional grid operator, which has enhanced its ability to create solutions to regional supply problems. As I discussed earlier, the ISO is active in regional transmission planning, a key component in long-term transmission constraint relief. This is just one example of how important a regional approach to problem-solving can be in the maturation of energy markets.

I intend to explore such creative approaches as the development of regional oversight committees, which can work with the existing regional coordination councils and other similar entities, including state regulators, to better assist the development of workably competitive markets across the country. I believe that the Commission can structure itself to better understand, and respond to, state and regional concerns. It is clear from both the California and Pennsylvania experience that regionally-based solutions are critical to preventing, or solving, supply and demand imbalances.

Second, I believe that the Commission must commit itself to effective market monitoring, both monitoring that it performs itself and that performed by ISOs or RTOs. An ongoing market monitoring program is necessary to plan and decide strategically to ensure that our decisions promote competition and efficiency in energy markets. Market monitoring is also necessary to assist the Commission in carrying out its regulatory responsibilities in an environment of rapidly changing markets.

I intend to explore creative approaches to ensure an effective market monitoring program. One possibility is to tap the resources of other entities, public and non-public, that are experienced in market monitoring, such as the Federal Communications Commission, the Securities and Exchange Commission, the Federal Trade Commission, and the New York Stock Exchange. Senior managers from these entities could provide input on

what data is needed for effective market monitoring, how to best use the data, and how to respond rapidly and decisively when the data indicates that problems are developing. We can benefit from the "best practices" of these entities in strengthening our market monitoring function.

I believe that the Commission must have timely and reliable data and information to have an effective market monitoring program. This is area where better communication with regional stakeholders and improved regional coordination may lessen the burden and cost of data collection for both the Commission and the energy industries.

Third, I am also a strong advocate of truly independent, operationally strong ISOs and RTOs, whose scope is as broad as possible. One of the key lessons I take from the experiences in California and Pennsylvania is that workably competitive markets are more likely to develop and remain healthy when the grid operator is independent, is able to engage in effective market monitoring, and can plan on a regional basis, both with respect to transmission and generation. Moreover, the grid operator must have sufficient flexibility to rapidly respond to changes in the market as they occur. Anything else cannot achieve our goals of a transition to competition and deregulation.

I also learned from my tenure in Pennsylvania that regulators must act rapidly and creatively to ensure the successful development of competition. For example, Pennsylvania used alternative dispute resolution to settle all of its deregulation-related proceedings, thereby avoiding prolonged, expensive litigation. While we may not be able to settle all the deregulation-related proceedings pending at the Commission, I believe that we must actively explore the possibility of expanding our reliance on alternative dispute resolution, particularly with respect to proceedings involving

deregulation. Moreover, this Commission must maintain open lines of communications with stakeholders, and keep an open mind with respect to their suggestions and concerns. Stakeholders bring to the table invaluable experience that regulators cannot readily duplicate, and we should not deprive ourselves of that resource. No one person or entity knows all the solutions to the problems we have encountered in the developing markets, and we must tap all the resources we can to ensure that we move to workably competitive electricity markets as soon as possible.

Finally, I want to comment that we are all challenged with the task of transforming ourselves to respond effectively to the demands of transitional markets. We are creating the road map in the middle of the trip. I want to commend the staff, as well as my colleagues, for their enormous commitment and hard work. We may need new tools and we may need new skill sets, but I have found a strong desire to learn and a willingness to embrace change. Those are essential to making the system evolve successfully.

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