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**5<sup>th</sup> Annual Ohio Energy Deregulation**  
**Conference**  
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**Good morning.**

**It's always fun to participate in this conference and to talk with you about electricity deregulation and the changing marketplace for energy. Everyone talks about "change," but in the electric business, the changes we are seeing lately are more like a revolution.**

**You'll probably hear enough about what is happening in Ohio from my fellow panelists.**

**After 50 days, there is not that much different I can add.**

**However, you may be interested in the fact that FirstEnergy expects to reach its 20-percent shopping goal for all classes of customers this year.**

**That's due in part to the Market Support Generation, or MSG, we offered the market. It was quickly claimed by third-party suppliers and aggregators. So, it's essentially no longer available.**

**MSG has, however, been successful in jump starting competition – and it must have jump started some of the marketers, who are now fighting each other over it.**

**FirstEnergy Services, our competitive arm, has also been seeking new customers, both for natural gas and electricity. In fact, I fully expect FirstEnergy Services to have some 350,000 customers by the end of this year – that will be about a six-fold increase since we launched our retail strategy last fall with an aggressive move into the natural gas markets.**

**Despite the success of our MSG program here, retail competition generally is having a tough go of it, and not just in California. For the most part, there are substantial impediments to the development of retail electricity markets, despite what some of the trade press has reported about the past success of a few states.**

**And, the problems are more fundamental than simply providing the time needed for the market to develop.**

**For example, one of the key issues is the disconnect between the wholesale and retail electricity markets. In order for competition to work, there needs to be a better relationship between the two. The retail price of virtually every other competitive product is based, in large part, on the wholesale price. Electricity should be no different.**

**No one benefits when the wholesale market is opened to full competition but the retail market maintains an obligation to serve, which controls not only available supplies, but price.**

**Some have compared that to the government deciding that we're going to change from driving on the right side of the road to the left. You don't get there by phasing the change in and having 18-wheelers switch before everyone else.**

**That won't fly, and until retail prices reflect wholesale activity, including all of our power suppliers, the retail market will be slow in developing. This problem is not caused by a lack of transmission.**

**Wholesale markets are simply not working, and it is not because of transmission.**

**Markets work around transportation systems. In fact, transmission is very much an ancillary issue – one that can be handled with coordination and reciprocity agreements. And, we should be devoting our time to breaking down the barriers between systems, instead of wasting time trying to force any one particular system.**

**One of the major reasons given for trying to create large transmission organizations is to reduce pancaked transmission rates. The story line goes that customers shouldn't have to pay the costs of moving power across two or more systems.**

**Instead, transmission of electricity should be more like sending a letter – and only one postage stamp rate should apply no matter what assets are used in the process or who owns those assets.**

**Great idea. The only problem is that, unlike the post office, different companies own the assets that are being used and should be paid for that use.**

**The fact is that pancaking of transmission charges by utilities can be addressed through reciprocity agreements between systems – but more importantly, pancaking by utilities is strictly bush-league, compared to what some of the players in this business are getting away with. Professional energy**

**traders are adding hundreds of pancaked charges to the price of electricity, without using a single asset in the process.**

**Spiraling wholesale rates are in large part the result of traders literally buying and selling the same kilowatt hour thousands of times, needlessly driving up the market price for power. Instead of a formal regulatory process, we now have traders setting the price and rules for commercial transactions.**

**And, these traders don't take customer complaints; they don't respond to communities needing economic development support; and they don't do business with customers who have credit problems. More importantly, these traders**

**don't answer to regulators for the prices they create.**

**One of the biggest problems in the wholesale market is that supply is very thin. Most existing capacity is already committed to serving native load customers and is not available to the competitive market.**

**In other words, very little capacity, at least here in the East, is uncommitted. And, this won't change for 5 or more years in this part of the country.**

**However, even in states, such as California, where utilities were required to divest their generation, and essentially *uncommit* the**

**capacity, competitive markets are not functioning.**

**You might find it interesting that under regulation, three California utilities owned most of the generation. Under competition, three *out-of-state* utility affiliates control most of it. I guess that's progress.**

**But, California utilities have paid more than 20 cents per kilowatt-hour for power they sold to customers for 5 or 6 cents.**

**So, what else needs to be done for wholesale markets to work?**

**First and foremost, we need new generation to be built in the region. Without adequate supplies you can't have reasonable prices in a competitive market.**

**The good news is that the Ohio Power Siting Board has approved applications for an additional 5,000 megawatts of generation since 1998, and has applications pending for another 8,000.**

**The bad news is that no one knows how many of these plants actually will be built. That's a problem, because just to keep up with growth takes about a few thousand megawatts of new capacity each year.**

**To date, just two new facilities, with combined capacity of 840 megawatts, are operating.**

**Because most of the proposed plants would be natural-gas-fired peakers, high wholesale prices for natural gas will affect how many of these projects actually are completed – and ultimately the price.**

**The market will also now determine whether new plants will be natural gas-fired or coal-fired or some other form of generation. And, no matter what is built, it is clear that new supply is needed, not just to meet growing customer demand, but also eventually to replace aging base load coal-fired power plants – the ones we all depend on seven days a week, nearly 24 hours a day.**

**It's important that the market recognize the need for a balanced portfolio of generating assets – not just low-capital, high- operating-cost natural gas plants – and, the need for an adequate reserve margin.**

**But, I'm not certain how deregulation gets us there, considering that having a balanced generating portfolio or a proper reserve margin would likely reduce the market price of electricity.**

**In any event, we need to send the right economic signals to investors and developers who will build the plants of the future.**

**Regulators and legislators must ensure that there are no unreasonable barriers to development and construction of new facilities.**

**Uncertainty must also be reduced in the area of environmental protection. Increasingly strict regulations have had a chilling effect on development of power plants nationwide.**

**At the same time that supply shortages in California are getting national attention, the U.S. EPA appears intent on prematurely shutting down the existing coal-fired fleet in the eastern United States, even though coal-fired plants help fuel our economy by producing more than half of the nation's electricity.**

**Certainly there is a place in this new, competitive world for environmental regulations, but they should be reasonably and fairly applied and include enough flexibility to allow sufficient time for implementation and development of new emission control technologies.**

**However, if environmental regulations outpace our ability to develop technologies to economically meet them, then we would have no choice but to shut down existing facilities.**

**That would only worsen the volatility we're seeing in the wholesale market. That volatility is a sign that the market is immature and needs time to develop.**

**While we recognized the need for a transition period to ease retail customers into market-based pricing, and every state that deregulated has provided a transition period for retail customers, we need to rethink the flash-out approach to the wholesale market that has allowed uncontrolled wholesale market prices.**

**I've always tried to challenge this group on issues, even though most of the time you haven't taken my suggestions. Today, I'd like to suggest some options for solving many of the current problems in the wholesale market.**

**Now, wholesale suppliers are not going to like my proposal. In fact, you can expect them to fight this at every turn, but as customers, you should demand a change.**

**Actually, the options are fairly simple, but they send a powerful message that we will not allow a dysfunctional wholesale market to jeopardize our economy.**

**For example, we could set a date – say 5 years out – for wholesale markets to be fully based on market prices. In the meantime, the FERC could use cost-based rates for all generating plants, unless the owner could prove it possesses no market power, under any conditions.**

**Or, just as some gas wells were treated differently when that industry moved to deregulation, we could treat existing power plants and new power plants differently.**

**For example, The Federal Energy Regulatory Commission could establish a two-tiered pricing method – where existing plants would charge regulated, cost-based rates for about a 5-year transition period, but new plants would be allowed to charge market-based prices to encourage investment.**

**This would ease the transition to competition, establish more of a relationship between wholesale and retail prices, and offer incentives for investments in new generating plants.**

**And, 5 years would allow sufficient time for new generation to be built, for existing generation to be modified with additional environmental controls, and for perceived and real transmission issues to be resolved.**

**It also would provide the time to develop the systems that would give retail customers the real-world pricing information they need to make informed buying decisions.**

**In effect, wholesale markets need a market development period, so, we can address these key issues.**

**And, we need to use that development time to ensure that all the appropriate safeguards are in place.**

**We can't afford to wait until price caps are lifted, to find out if we have an effective market.**

**Thank you.**