

# Plugging in the International Northeast

## A Model for the Electricity Market of the Future

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When reflecting on a model for future electricity markets, there are many issues and complexities to consider. Just as we cannot at once turn everything over to competitive markets and their economic characteristics, nor can we simply walk away from regulation. We must be committed to understanding historical frameworks that led to present complexities, and accept that these complexities will take time to resolve.

Competition and open markets have long been a fundamental underpinning of our economy. The U.S. Supreme Court in enunciating the economic case for competition in the Northern Pacific Railway Company Case (1958) used the following language to describe the intent of the Sherman Act (1890):

“[It] was designed to be a comprehensive charter of economic liberty aimed at preserving free and unfettered competition as the rule of trade. It rests on the premise that the unrestrained interaction of competitive forces will yield the best allocation of our economic resources, the lowest prices, the highest quality and the greatest material progress, while at the same time providing an environment conducive to the preservation of our democratic political and social institutions.”

This is a powerful endorsement of competitive principles, yet in this country today there are few industries that conduct business in the “unfettered” manner contemplated by this language. To a greater or lesser extent, there are rules and regulations that apply to all businesses. Electricity is no exception, and we can all agree that this industry has long been heavily regulated.

In part, this is because electricity is fundamentally different than any other commodity. It comes with a unique set of physics and characteristics. Unlike other commodities, it cannot be stored in a practical and efficient manner. Electricity is produced and transmitted with these characteristics in mind. In our society today, the critical services that electricity powers make it nearly as essential as basic resources such as food, air and water.

It is difficult in today’s political climate to advocate a pure market oriented approach to every issue and crossroads in the development of competitive and efficient market design and structure for electricity. While at FERC, I was a strong advocate for establishing a robust wholesale market. It was my view at the time, that a robust wholesale market was a necessary precursor for States that chose to move to retail access to do so successfully. And for States that chose to remain in the existing regulatory regime, a robust wholesale market would benefit their consumers as well. Today, I continue to endorse, and strongly advocate, that same point of view.

Absent a broad move to retail competition, the following concepts, in my opinion, have been proven to be an outstanding substitute for pure market response and reliance.

- formulary rate plans,
- performance based rate plans,
- rate of return incentives,
- accelerated depreciation,
- demand response initiatives,
- and environmental enhancement incentives.

In practical application, these concepts have brought about a positive impact in the marketplace, whether we are talking about necessary market development, or whether we are talking about efficiency gains and benefits. They are an interim step on the path to a competitive marketplace. A belief in competition is clearly a choice to move toward these concepts, and away from traditional regulation. Technology and competitive alternatives can and will forge the new path for customer choice, and provide rewards for innovative industry response in a transforming market.

Using the movement toward competitive markets as a catalyst, industry responded by planning and building production capacity that utilizes fewer, mostly larger, generating plants, pools reserves, and locates plants closer to fuel sources. While this is a natural strategic conclusion, the business decision assumes that current transmission assets and capacity are able to support the direction chosen by entities developing capacity.

These strategic decisions and business opportunities in the generation arena have driven the development of production capacity available to developing competitive markets. Market development deficiencies in the transmission and transportation components of the business have manifested themselves because incentives and business opportunities have not been fostered or enhanced. The point is not intended to force a determination of whether transmission capabilities must come first, or whether production capabilities must come first. The argument is that each must work in tandem and on parallel paths in order to efficiently develop the competitive market and to mitigate the difficulties and friction in the developmental stages of the energy markets.

Incentives through formulary rate plans and performance rate plans achieve the intended results. The results are designed in a fashion to reward incremental milestones of infrastructure investments, efficiency gains and production capacity investments.

Incentive plans create measurement tools and determine performance targets for system operations, reliability, and pricing (generation and transmission). As the formulary and performance measurements reach certain predetermined levels, rewards for progress are finite and known, and accrue to the proactive market participant in a timely manner. It is the measurement features of any plan, when well conceived and designed, that encourage the type of conduct and investment to inure to the benefits of the consumer.

In the present political arena, it is the consumer/voter who must realize a favorable experience in the movement toward competitive markets. Without widespread support for the development of the energy markets, progressive ideas are stalled, and the risk of reversion expands to unacceptable levels.

The same incentive philosophy is true with respect to determining an appropriate return of equity as a means of rewarding businesses commensurate with financial risk inherent in the market. Such should be adequate to provide confidence in the financial entity, result in the ability to sustain creditworthiness, and be attractive to capital investors.

It is clear that market-based mechanisms are an excellent solution in other areas of the energy business. Demand response is being utilized and developed in many states in order to address the energy needs

during peak periods or during periods of high energy costs. Business decisions and opportunities are available in certain regions that allow incentives to those that have consumption and production flexibility.

The same is true for industries that pursue environmentally sound practices in the production and consumption of energy. Environmental credits are a reasonable source of incentive to shape and mold business conduct and to provide a market advantage to advancing technology. Environmental analysis as well as economic analysis is becoming a critical component of the business decision-making process. Environmental benefits that can be used to achieve substantial support in the business and political arenas have been shown to reach the bottom line and prove to be an excellent driver in forming the business models of the future.

As awareness of environmental advantages and benefits are embraced by the consuming public, the willingness of the consumer is evidenced in the market response and revenues of the most favored corporate participants. Premiums are definitely being paid for environmental consciousness.

So when will competition come and what will it look like? Prior to California, many States were on a glide path that would have already brought them to retail open access. Needless to say, we're not there yet. What happened?

When you look at any jurisdiction, or region, and try to decide if it's ready for competition, you can't just look at electricity. And even with electricity you can't just look at distribution or transmission or generation. You have to look at all facets of the industry.

California is a prime example. They thought they had abundant capacity because all of the states around them had excess energy. As long as there was sufficient rain and snow they did because of the hydropower. When there was less rain and snow they had less hydropower so they had to rely more on natural gas. That's fine as long as you can deliver it to where it was needed, but California could only get it to the border. They didn't have the pipes to move it around the state so it wasn't available to burn and make electricity. Competition does not serve the consumer well when there are scarce resources. Deregulation didn't work in California because California wasn't ready for competition.

Some markets are more prepared to deregulate than others. All will be ready when they make the right decisions. This is why the current debate over RTOs and Standard Market Design is so essential. It is critically important to get the rules right, to lay a foundation that will provide clear guidance to all market participants, build on successes, and yes, allow for appropriate financial incentives to attract investors willing to finance the necessary infrastructure expansions.