

ELECTRIC DEREGULATION: A COMPLETE AND COSTLY FAILURE FOR CONNECTICUT

Good Afternoon,

Thank you for inviting me to speak about Electric Deregulation. There are many people throughout the country discussing the failure of deregulation -- the failed economics of deregulation and the failure of federal policies to promote competition.

I am here to speak to you about the failure of deregulation in my state -- the State of Connecticut -- the causes of this failure and the cures I am advocating.

The first step in addressing any problem, of course, is acknowledging you have a problem. In Connecticut we have a serious problem -- it is now crystal clear that electric deregulation has become a complete and costly disaster.

Connecticut can serve as a cautionary tale to those of you from states that have not yet been lured down the path of deregulation.

I want to share with you some sobering statistics. As you all know, electricity is not a luxury, but a necessity of modern life. The safe, reliable and affordable provision of electricity is absolutely critical to the public's health and safety. In addition, reliable and affordable electric service remains a cornerstone of our economy. Electricity is an essential commodity fueling businesses and creating jobs for our citizens.

Lets look at the facts in Connecticut.

- Since January 2003 electricity rates in Connecticut have nearly doubled (90% higher).
- As of January 2007 Connecticut's two investor owned utilities -- CL&P and UI -- composite average rate is more than 18 cents per kWh.
- Connecticut has catapulted to the state with the second highest electricity costs in the nation, just behind Hawaii -- an island geographically isolated from its fuel sources. Source - Electric Power Monthly with data for November 2006.
- Connecticut rates are more than double the national average, which according to the most recent Department of Energy -- Energy Information Agency Report is 8.83 cents per kWh. Source - Electric Power Monthly with data for November 2006.
- As a result, Connecticut's economy is struggling: losing businesses because of our staggeringly high energy costs. Connecticut's residents -- especially those on fixed or limited incomes -- are scraping to pay their bills.

Remarkably, the officials at the Federal Energy Regulatory Commission (FERC) -- as well as the regional grid operator ISO New England -- remain in denial over this failure and the consequences of the failed deregulation.

- All we hear from FERC and ISO is "stay the course". They say the current system is working and that our incredibly high rates are "price

signals” that someday will spur the market into building new nuclear and coal plants, which will lower rates.

- Our businesses and residents cannot wait 10 – 20 – or 30 years to see if FERC and ISO’s theory of “market signals” will work.
- Our rates are already at unsustainable levels and they are continuing to climb at an alarming rate.
- Businesses are leaving because they can’t afford to stay and we can’t compete against the 48 other states where power prices are lower -- particularly, those states that FERC and ISO are not using as guinea pigs to test their grand economic theories

How did we get here?:

The catastrophe that has become electric deregulation is primarily attributable to FERC and ISO New England. Particularly, locational market pricing (“LMP”), the manner in which it has been imposed by ISO, the ISO’s promiscuous use of ratepayer subsidized reliability must run (“RMR”) contracts, and its newly approved “forward capacity market” (“FCM”), which provides ratepayer subsidized windfalls to all generators. Lets look at each of these issues:

Locational Market Pricing

- Under ISO-NE market rules, the most expensive generating units set the clearing price for all generating units -- the so-called “marginal clearing price.” In Connecticut and New England, the highest cost generators are natural gas and oil units. These units have much higher operating costs than the state’s nuclear, hydro or coal plants. While the concept of a “marginal clearing price” may be appropriate for other, simpler commodities markets, it has been an abject failure in wholesale electricity markets. Why?
- In Connecticut, two-thirds of the total electricity consumed is produced by low variable cost nuclear, coal and hydro units. Under the current market rules, however, 100% of our electricity is priced as if it was generated by high cost gas and oil plants.
- To put that in perspective, Connecticut’s nuclear plants alone provide nearly 50% of the power consumed in the state. A recent Nuclear Energy Institute report showed industry average production costs for electricity to be 1.66 cents per kWh. By comparison, natural gas fired plants average more than 7.5 cents per kWh -- five times the cost of nuclear generated electricity. Under FERC’s failed policies, however, customers do not see any benefit from the low cost nuclear power, but, instead pay rates based on the fiction that all electricity is generated by high cost natural gas.

- The premise behind a “marginal clearing price” is that a high market clearing price will incent the entry of a flood of new low cost generators to take advantage of available profits, thereby lowering costs to consumers. According to the theory, if expensive gas plants are setting the marginal clearing price, lower cost generators will enter the market and eventually displace the high cost gas plants, reducing costs to ratepayers. This theory, however, is severely flawed and has cost Connecticut consumers dearly
- First, there are significant practical hurdles in siting new nuclear, coal or hydro units. These include legitimate environmental concerns. No new nuclear units have been constructed in the United States in over 30 years. We can’t construct new rivers in Connecticut for more hydro power. Clean coal technology is still years away
- Second, even assuming we could site new nuclear or coal plants, it would take decades to construct sufficient capacity to displace gas as the “marginal” units

Reliability Must Run Contracts.

The signs of market failure are everywhere. One of the most obvious signs is the increasing proliferation of so-called reliability must run (“RMR”) contracts. These contracts allow plants that are earning less than an 11% return on their equity to be reregulated by FERC and earn profits guaranteed by ratepayers. The result is a bizarre hybrid market where low cost generators earn exorbitant profits and high cost generators are fully subsidized by ratepayers

- Nearly 50% of Connecticut’s installed capacity is high cost, unable to compete in ISO’s “market,” and is operating on some form of ratepayer subsidy. Many of these plants are brand new highly efficient gas plants. ISO and FERC have given these plants subsidies so they can earn a guaranteed return on equity of about 11%.
- Connecticut’s low variable cost generators -- its nuclear and coal plants -- are allowed under ISO’s “marginal clearing price” rules to charge the same rates as the high cost units. As a result, these low cost units are earning extraordinary windfall profits.
- Very simply, there is no competitive market and no effective regulation. High-cost generators have opted out of the “competitive market” in favor of RMR regulation to receive cost-of-service compensation far above what they would receive in a competitive market, while low variable cost generating units charge whatever the market will bear, collecting profits far in excess of their cost of service
- Under either a competitive market or a regulated market consumers would be poised to receive either the benefits of competition among all generators or the

benefit of cost of service pricing for both high and low cost generators. Under the system existing in Connecticut, consumers receive nothing but price increases.

Forward Capacity Market

Despite these extraordinary profits and ratepayer funded subsidies, FERC and ISO have just approved a new ratepayer funded subsidy for all generators, rich and poor alike. This is the so-called “forward capacity market” (“FCM”).

- The FCM is intended to provide incentives for energy companies to build new generation.
- Included in this FCM, however, is an \$800 million giveaway to Connecticut generators and a power industry already awash in cash. Generators will receive \$800 million without any requirement to build power plants. These ill-conceived and irrational charges will further burden already stressed businesses and consumers, while failing to add a single megawatt of electricity
- Worse still, the windfalls are not targeted to financially distressed generators to construct new generation needed for reliability. The green rain falls on rich and poor alike. This relentless rain of rate increases threatens to drown our economy, and must stop
- The best that anyone can say about FCM is that it is better than LICAP -- but that is not good enough.

What Can We Do?.

- The time has come for a change. We can't afford to keep doing what we are doing.
- Each state faces its own unique set of challenges to take back control of its energy future. In Connecticut, I have initiated a strategy that combines state legislative action, action at the FERC and action in the courts.
- Connecticut is now in the midst of its 2007 legislative session. The general outrage over skyrocketing electricity rates has pushed energy reform to center stage. I am urging the legislature to adopt my proposals for: (1) a centralized state electricity authority; and (2) a windfall profits refund to return to ratepayers a portion of the excessive profits made by generators under FERC's failed market design.

Attorney General's Plan for a Connecticut Electric Authority.

- I believe the state must take an active role -- stepping in where the market has failed -- and working for the consumer rather than the generators. Our only hope is for the state to take back some measure of control over its energy future rather than simply continuing to be at the mercy of the current failed federal energy regime. We have to put our "thumb on the scale" to get the new generation we need, where we need it, and in a way that our ratepayers get every cent of the price benefits new plants offer.
- My plan will ensure that our system is reliable, safe and affordable, by directing state funding on a targeted basis towards necessary resources and ensuring that customers receive the full benefit of these resources. My plan includes the following:

1 Electric generation and conservation plan

The state should develop a ten-year electric generation and conservation plan to establish the optimal, least-cost mix of electric generation resources, including baseload, intermediate and peaking resources necessary to reduce or stabilize electric rates of all customers.

2 Peaking plants

Certain electricity plants only operate during times of peak electricity usage. Under FERC rules, these peaking plants control the overall pricing of electricity on the spot market during their use. Controlling the pricing of electricity from the peaking units will lower the cost of electricity. Peaking plants should be purchased by the Connecticut Electricity Authority or returned to and operated by Connecticut utility companies, subject to rate regulation to control the prices charged during peak usage.

3 Baseload power plants

The state shall solicit proposals for building baseload power plants identified in the generation and conservation plan. As an incentive to build such plants, the state may enter into long-term purchasing contracts with the builder. These contracts must include all electric products from the power plant, including capacity, energy, air emissions and renewable energy credits. The plants must operate to benefit ratepayers.

Attorney General's Plan for Windfall Profits Refund.

As noted above, a number of low variable cost generators are earning windfall profits -- paid for by Connecticut ratepayers -- based upon unfair FERC

and ISO market rules. Those rules allow low cost nuclear and coal generators to sell their electricity at prices as if they burned expensive oil and gas, resulting in extraordinary overcharges to Connecticut consumers and businesses. Low cost generators are allowed to make extraordinary profits without doing anything new or more efficient. The windfall profits refund -- 50% of all earnings above a 20% return on equity -- is intended to recapture for ratepayers a portion of the extraordinary overcharges they are currently paying

The Windfall Profits Refund could reduce Connecticut ratepayers bills by \$500 million to \$1 billion a year, providing immediate relief for all ratepayers.

Attorney General's Section 206 Complaint at FERC.

In addition to proposing state legislative reform, I have filed a complaint with the FERC seeking to stop these grossly unfair and ruinous pricing rules. I was proud to be joined by business leaders -- the Connecticut Industrial Energy Consumers ("CIEC"), the Connecticut Municipal Electric Energy Cooperative ("CMEEC") and the state Office of Consumer Counsel ("OCC").

- In our Complaint, we sought to terminate the "market based rate authority" for all the generators in Connecticut until such time as the FERC can certify that the wholesale electricity market is workably competitive. The complaint seeks to have the FERC place all in state generation on cost-of-service compensation. This would save Connecticut ratepayers approximately \$1 billion a year.
- The FERC rejected our complaint on the basis that "we hadn't proven our case" -- however, FERC denied our request for a hearing which, of course, we needed to prove our case. I have sought rehearing on FERC's Catch-22, denying us due process

Attorney General's Appeal of Forward Capacity Market Settlement.

As noted above, the FERC has also approved the forward capacity market settlement. That settlement provides for \$5 billion in so-called "transition payments" to generators throughout New England. \$800 million would be paid by Connecticut ratepayers. These transition payments serve absolutely no legitimate regulatory purpose -- they represent a pure windfall. Despite the fact that the stated purpose of the settlement was to increase the construction of new capacity in New England, not one new megawatt of new capacity will be created by these payments.

The FERC has exceeded its jurisdiction under Section 201 of the Federal Power Act ("FPA"), 16 U.S.C. § 821 in approving a forward capacity market. The FERC has violated its obligation to protect consumers in approving windfall transition payments that serve no legitimate regulatory purpose.

I have joined with the Massachusetts Attorney General, Martha Coakley, to appeal this decision to the United States Court of Appeals (DC Circuit). We are committed to overturning this illegal and unfair decision

The original promise of electric deregulation has turned into a nightmare. FERC's failed pricing policies have punished Connecticut's consumers and its economy. Action can and must be taken to protect consumers. To those of you who have not yet embarked on deregulation, great care must be taken to protect your consumers from FERC's false promises.