
National Capital Area Chapter

United States Association for
Energy Economics

March 2004

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news

LNG: Back to the Future

Ben Schlesinger- LNG: Promises and Pitfalls

Michael McCall - LNG Storage: Today's Market Solution

NCAC Evening Energy Briefing

WHEN: 5:30 – 8:00 p.m., Thursday, March 18

WHERE: George Washington University Club
1918 F Street NW, Washington, DC
Near Farragut West or Foggy Bottom metro stops; parking on street

SPEAKERS: Ben Schlesinger, BSA Inc.
Michael McCall, Conversion Gas Imports L.P.

Imported LNG is the apparent answer to America's natural gas supply/demand problems. But will it arrive? Some coastal communities oppose tank-based receiving terminals and security and costs are important issues. These issues, and the opportunities for LNG, will be addressed by Ben Schlesinger. One of the alternatives to tank-based terminals is being investigated by Conversion Gas Imports. Michael McCall will discuss this research effort, funded by the Department of Energy, to move the concept of salt cavern-based LNG receiving (Bishop Process) to commercialization. Early indications are that offshore Gulf of Mexico and Atlantic Canada salt cavern terminals could be built at half the cost and twice the size of tank-based terminals. The Bishop Process, if proven successful, has the potential to significantly increase world LNG trade and provide a highly secure, economical and flexible way to expand LNG imports.

Dr. Ben Schlesinger, founding president of BSA Inc., is one of North America's leading independent energy consultants, specializing in gas and electricity marketing, pricing, infrastructure, trading practices, strategic planning, and power plant development worldwide. He has 30 years' experience in managing and carrying out engineering/economic analyses of complex energy issues.

Michael M. McCall founded Conversion Gas Imports, L.P. to commercialize salt cavern based technologies that lower costs and improve security in the receipt, storage and distribution of LNG. He is a logistician with extensive commercial and operational experience in the natural gas and petrochemical industries, in the U.S. and South America, primarily with Union Texas Petroleum.

Logistics for March 18 Event: Join us on Thursday, March 18, at 5:30 pm for networking. A light buffet will begin by 6:00 p.m. with presentations beginning by 6:30 p.m. and ending by 8:00 p.m..

COST: \$20.00 for members and their guests (\$5.00 for student members) and \$25.00 for non-members and their guests. Make checks payable to NCAC-USAAE. **RSVP:** By COB Monday, March 15 to Leslie Coleman by phone (202/463-9780) or email (lcoleman@nma.org). Cancellations after noon Wednesday will be billed.

Highlights of the February Lunch

SPEAKER: Vito Stagliano, Vice President Transmission Policy, Calpine Corporation

The Unending Policy War: Electric Markets v. Franchised Monopolies

Vito Stagliano, Vice President of Transmission Policy for Calpine Corporation, provided for NCAC members an historic overview of electric restructuring and the ongoing tension between the forces of the free market and the continuing pull of franchised monopolies.

Most of the pundits now inhabiting Washington, D.C. don't remember the hard-fought, mostly forgotten Congressional debate that led to the creation of the Energy Policy Act of 1992. Yet that legislation, which passed with substantial bi-partisan support, contained two small provisions that launched what we now know as "electric restructuring."

One provision created a new designation for power producers—the Exempt Wholesale Generators (EWGs). The other provision guaranteed transmission access for EWG power.

Paul Jaskow and Richard Schmalensee laid the foundation for this move toward wholesale power in their 1983 book "Markets for Power." It took a decade to build the political consensus necessary to establish the competitive wholesale generation market advocated by Jaskow & Schmalensee. Since then political consensus has broken down. .

Despite the political reservations, between 1992 and today an entirely new industry of power generators has built more than 150,000 MW of capacity.

In 1996 the Federal Energy Regulatory Commission (FERC) realized it couldn't manage access to transmission on a case-by-case basis, as called for in EAct 92, and consequently issued the landmark Orders 888 & 889 that established non-discriminatory open access under which transmission-owning utilities were required to provide service to others.

By 2000 it was understood that transmission access would be managed by independent operators—Independent System Operators (ISOs) or Regional Transmission Organizations (RTOs). The first area in the country that achieved this new organization was the Northeast, where tight power pools, in operation for decades, lent themselves to this structure. These included PJM Interconnection in the Mid-Atlantic region, ISO-New England and the New York ISO.

California also launched an ISO and an initial market structure, which, notwithstanding laudable aims, proved to be profoundly flawed in both concept and execution. The California structure, which was duplicated nowhere else in the world, remains the point of reference for those who currently oppose both RTOs and related organized markets for power.

Elsewhere in the U.S., many states and utilities were coming together for the purpose of designing ISOs/RTOs and variations of market structures through the end of 2002. Among the organizational initiatives were the Midwest ISO, launched in 1987 and still struggling to launch a

market, the still born GridSouth in the Carolinas and SETrans across the Southeast, which was brought to an end by its sponsors in December 2003. Other RTO initiatives included GridFlorida, SPP in the prairie states, ERCOT in Texas, RTO West, and the halting, and inconclusive effort known as WestConnect.

In 2003 FERC thought it necessary to issue another general rule that would establish coherent, predictable structural rules for RTOs and establish common structures for real time power markets. Its Notice of Proposed Rule—commonly known as “Standard Market Design” (SMD) - created a political furor among State regulators and politicians in the South and the West who perceived it as an extension of FERC jurisdiction into areas historically reserved as purviews of the states.

“As of 2003 we lost most of the momentum gathered up to that point,” said Stagliano. Instead, what emerged from 2003 was a political dialogue, occasionally inflammatory, reviving very old jurisdictional questions between the States and the Federal Government, which had remained muted for a number of decades. The positions of the parties became extreme, with the West and South arguing that vertically integrated utilities were a valid model for delivery of electric service to consumers, and the FERC and other market participants asserting that monopolies are by definition anti-competitive. The opponents of restructured power markets in the South and West stressed two arguments: low power rates for consumers in states that had vertically integrated utilities, and the fear that power generators would build power in the low-cost states and export it to higher-cost regions, thus driving up transmission investment costs for local constituents.

What opponents of SMD did not mention was that, in a fully competitive market, investment in new plants is typically made in order to serve customers locally. To build a plant whose output would be aimed at long distance exports would not be prudent, given the uncertainty and cost of securing transmission service across multiple control areas and price unpredictability in the target market. No banker would finance a merchant plant based on such a model.

Stagliano points to 17,000 MW built in Southern states between 1999-2003, primarily based on the expectations that local, older, highly inefficient and highly polluting power plants would be retired, a competitive wholesale market would be actively established in compliance with existing law, and demand would continue to grow.

In the West, rates are relatively low because of relatively cheap hydropower, managed through Bonneville Power Authority (BPA) and Western Area Power Authority (WAPA)—both of which are federal agencies. But such power is limited and all incremental supply to meet future demand will need to be procured either through economically opaque bilateral deals, or through competitive processes supported by a vibrant, RTO-related wholesale generation market. The Northwest’s powerful Congressional lobby are highly protective of BPA in spite of the fact that it is a federal agency not subject to state jurisdiction, and key to the establishment of competitive conditions in the region.

“FERC is considered the enemy in the Pacific Northwest and in the Southeast,” said Stagliano. He points to efforts undertaken during the latter half of 2003 to insert anti-FERC, anti-SMD language in the energy bill that was making its way through Congress. Even though no energy legislation passed in the last session, the mere introduction of legislation was sufficient to tie FERC’s hands.

The practical reality, according to Stagliano, is that there are 160,000 miles of FERC-jurisdictional transmission lines that are in bad shape, with little capital investment to upgrade the system, at the same time that wholesale transactions have been rising exponentially.

“There is a disconnect between FERC and the states over effective jurisdiction of transmission policy,” said Stagliano. He points to self-interest on the part of native utilities NOT to invest in the grid—both because they can earn a larger return on equity by putting their money elsewhere, and because limiting capacity on the lines serves to ensure service for their native load while establishing plausible deniability of service to others.

“Transmission congestion is now chronic throughout the U.S. system,” he added, “at a cost that is difficult to calculate, but that certainly reaches \$3-\$4 billion a year in costs to consumers.”

In most states there is no way to measure the true cost of congestion. Where there are ISOs, a visible price can be measured everyday. “In the South there is no ‘apparent,’ economically measurable congestion, among other reasons because there is limited or inexistent access to the grid,” said Stagliano.

In addition, a change of political mood has allowed some regulated utilities to return to vertical re-integration. Measures to restore vertical integration has been successful in California, Arizona, Washington, Nevada, Utah, Oregon, Idaho, Louisiana and Georgia, where 2003 procurement processes for electric supplies allow utilities to select themselves to build new plants, to be paid for by ratepayers.

“Utilities have lost the ability to build efficient, economic power plants,” says Stagliano. In addition to \$250 billion in stranded costs that were transferred from utility shareholders to ratepayers in the very first phase of the restructuring process, he believes there is no incentive for utilities to reduce the cost of constructing any plant or system—and every incentive to goldplate.

In recent months, critics of electric restructuring have focused on the ability of operators to manage transactions on the grid. Blackouts increasingly are blamed on the growing energy market, regardless of facts.

“Nothing could be farther from the truth,” said Stagliano, citing the August blackout on the East Coast. The evidence indicates that the blackout was due to inattentive or incompetent behavior on the part of one company, and pointed out that energy trades among utilities have been going on since 1926. He calls the reliability argument to oppose energy markets a “red herring” in the debate.

Conforming to reliability standards is now voluntary. The new energy bill would make that obligatory with FERC in charge of enforcement, notwithstanding the FERC-bashing of last year.

Stagliano provided a thumbnail assessment of electric restructuring efforts in various areas of the country:

--In the Southeast, the SETrans RTO may be dead, but there is a major battle on the horizon, driven by complaints about market power.

--In California, a deeply flawed market structure that sent ripples through the West is being revisited and redesigned. But Stagliano declares that Californians have not “learned much about FERC-State relations” in the process.

--In Texas, the ERCOT market is moving slowly toward Standard Market Design. One way that this manifests is the fact that it is the only area of the country that, through effective and reliable price signals, retirements of old inefficient plants are actually taking place.

--The Midwest continues to struggle, with the emergence of the Midwest ISO (MISO) taking longer than expected. Stagliano predicts that the Eastern states within MISO will benefit

from a market structure based on locational marginal pricing, while states on the Western side of MISO will delay market organization because they fear cost shifting induced by LMP.

The question is how the U.S. can emerge from its “present policy nightmare.” Stagliano believes that there needs to be a jurisdictional truce between FERC and the states. “I have not seen this fight as intense as it has been over the past 15 months,” he noted. “Market players must keep their heads down and continue doing business while federal and state regulators work things out over our collective heads.”

One problem, says Stagliano, is that ISOs are expensive. And it is not efficient for every problem to be argued out by lawyers in front of FERC. He believes there can be a different market structure that can better resolve the issues, and points to the for-profit RTO plan originally brought forward by SETrans as the model.

Stagliano also argues that it is not necessary for a market to be complicated. The most basic market structure consists of an imbalance market and a market for ancillary services. Market power mitigation also needs to be addressed routinely in every region that lacks an ISO/RTO.

“A competitive wholesale market is now in place in a great geographic area of the country,” said Stagliano. “What we need now in areas that lack organized market structures and RTOs, is competitive supply procurement.”

Despite setbacks in some regions Stagliano sees three areas of the country that are moving forward in fashioning electric markets:

--SPP in the Plains states of Oklahoma, Kansas, Arkansas and parts of Missouri.

--GridFlorida is moving steadily forward, under State leadership.

--RTO West has formed a fragile alliance that continues to define regional problems and work toward a Western solution to grid management and market structures.

Generally, it can be said that many states see the cost, but don't see the benefits of an RTO world, said Stagliano, but the momentum towards competition at wholesale and in power generation appears unstoppable.

Upcoming NCAC Events

We've lined up an exciting list of events for this spring. Please be sure to put these luncheon meetings on your calendar!

Friday, April 16 Robert Bradley, Institute for Energy Research, University of Houston
“Energy Alarmism Revisited”

Friday, May 21 Vijay V. Vaitheeswaran, Global Environment & Energy Correspondent,
The Economist
“Power to the People: How the Coming Energy Revolution will Transform
An Industry, Change Our Lives, and Maybe Even Save the Planet”

And don't forget the USAEE Annual Conference, July 8-10 at the Capitol Hilton in Washington!

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National Capital Area Chapter U.S. Association for Energy Economics

- Please check here for membership renewal.
- Please check here for new membership registration.
- Please check here for student membership registration.

Membership registration/renewal for the NCAC/USAEE is expected by the end of the preceding calendar year.

Please return your registration form and check to **Leslie Coleman**—NCAC/USAEE 2003 Treasurer at: **National Mining Association, 101 Constitution Ave., Suite 500 East, NW, Washington, DC 20001**. Phone: 202/463-9780. Email: lcoleman@nma.org.

Full membership dues for 2003 are \$20.00 (students \$10.00). Please make checks payable to NCAC/USAEE.

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