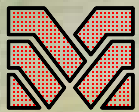


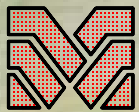
# Night of the Living Dead: When Infrastructure Is Not The Answer

Robert McCullough  
McCullough Research  
June 5, 2001



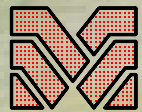
# When Infrastructure Is Not The Answer

- A Little History
- Harvard's Love of Governmental Intervention
- Vampires, Zombies, Nightwalkers, and Ghouls
- Dumping Harvard and Following Market Solutions
- Useful Sayings



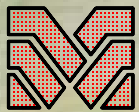
# A Little History

- The Problem In A Nutshell
- Changing Markets
- Established Special Interests
- Legislative Spaghetti

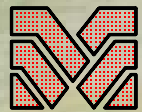


# The Problem In A Nutshell

- At the turn of the century Sam Insull invented trusts, utilities, stock manipulation, pyramiding of control, and the Securities and Exchange Commission
- He wrote the laws, established the Commissions, and founded the utilities
- Ultimately, he implemented a ninety year cost plus structure that left North America with the best (and most costly) electric infrastructure in the world

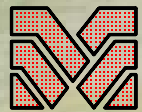


# Our Founder - Sam Insull



# Changing Markets

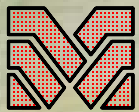
- Jimmy Carter's 1979 law, the Public Utilities Regulatory Practices Act, allowed free entry into bulk power generation
- Competition quickly reduced the costs of generation by a factor of three
- The resulting measuring stick effect made traditional regulation look very expensive





# Established Special Interests

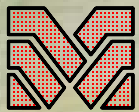
- Insull's regulatory scheme created a series of special interests
- None of these would exist in a normal market
- California is an extreme
  - Hispanic Energy League
  - Lesbian Wind Association
- Unfortunately, even more staid states have spawned numerous special interest groups from the Gray Panthers to Green Peace





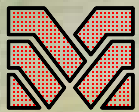
# Legislative Spaghetti

- Each state has attempted to placate a variety of different groups
- Environmentalists have received largely symbolic funding for a variety of ultimately worthless pursuits
- Business has gotten some access
- Homeowners have gotten rate guarantees
- Utilities get market pricing guarantees
- The result in every state has been to bring far, far too many cooks into the kitchen



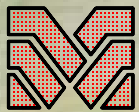
# Is FERC Helping?

- Yes and No
- On the yes side, they fired the ISO Board in December
- On the no side, they eliminated and now have resuscitated the short term administered market
- They have asserted an authority they are unwilling to use
- For the April 26th order, the document reads better if you staple the dissent to the cover.

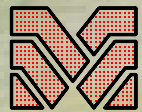
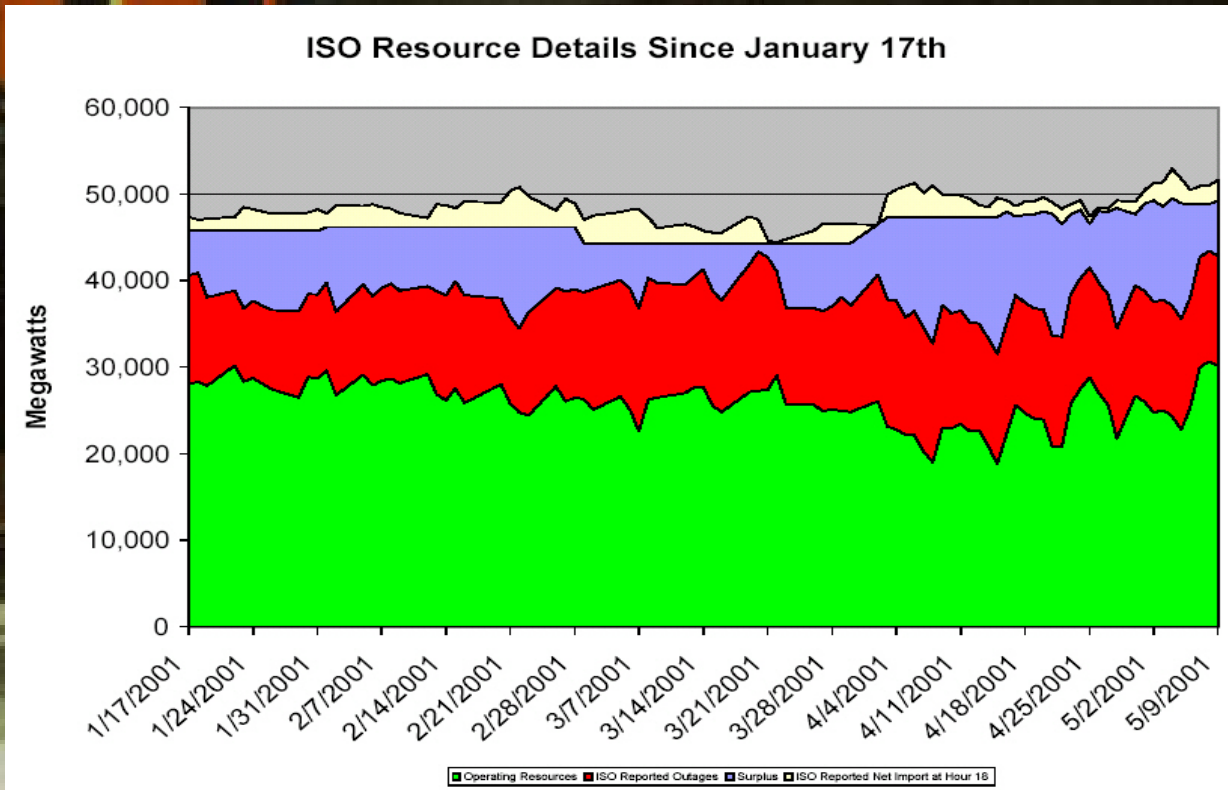


# Last Month's "Emergencies"

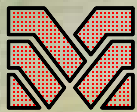
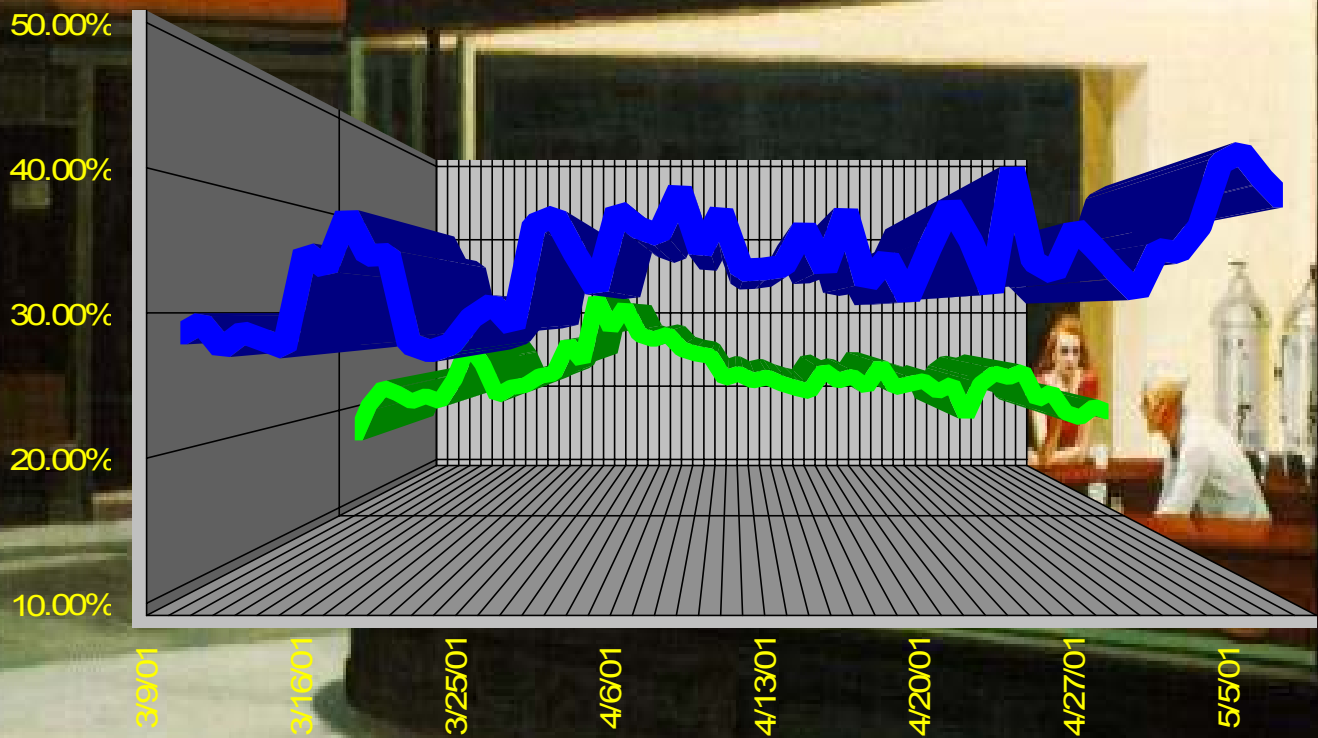
- May is a period of low loads in both electric resistance heating and cooling areas
- The California ISO announced blackouts several days last month
- The problem was not loads (as they announced) but outages



# Loads and Resources



# Relative Outages



■ Big Five ■ All Others

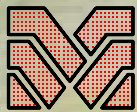
# Villain and Victim



**Professor Hogan:  
Lucius N. Littauer  
Professor of Public  
Policy and  
Administration at the  
John F. Kennedy School  
of Government, Harvard  
University**



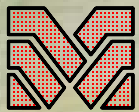
**Professor Fessler  
Emeritus Professor of  
Law  
University of California  
at Davis School of Law**





# Villains and Victims

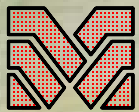
- Professor Hogan believes (to this day) that markets must be guided and managed by government
- Professor Fessler believes (he has been understandably silent since may 22nd) that prices cannot be measured accurately without Professor Hogan's mechanisms
- Their unfortunate common understanding of the world set California down the path to administered markets, mandated secrecy, inefficiency, and ultimately blackouts



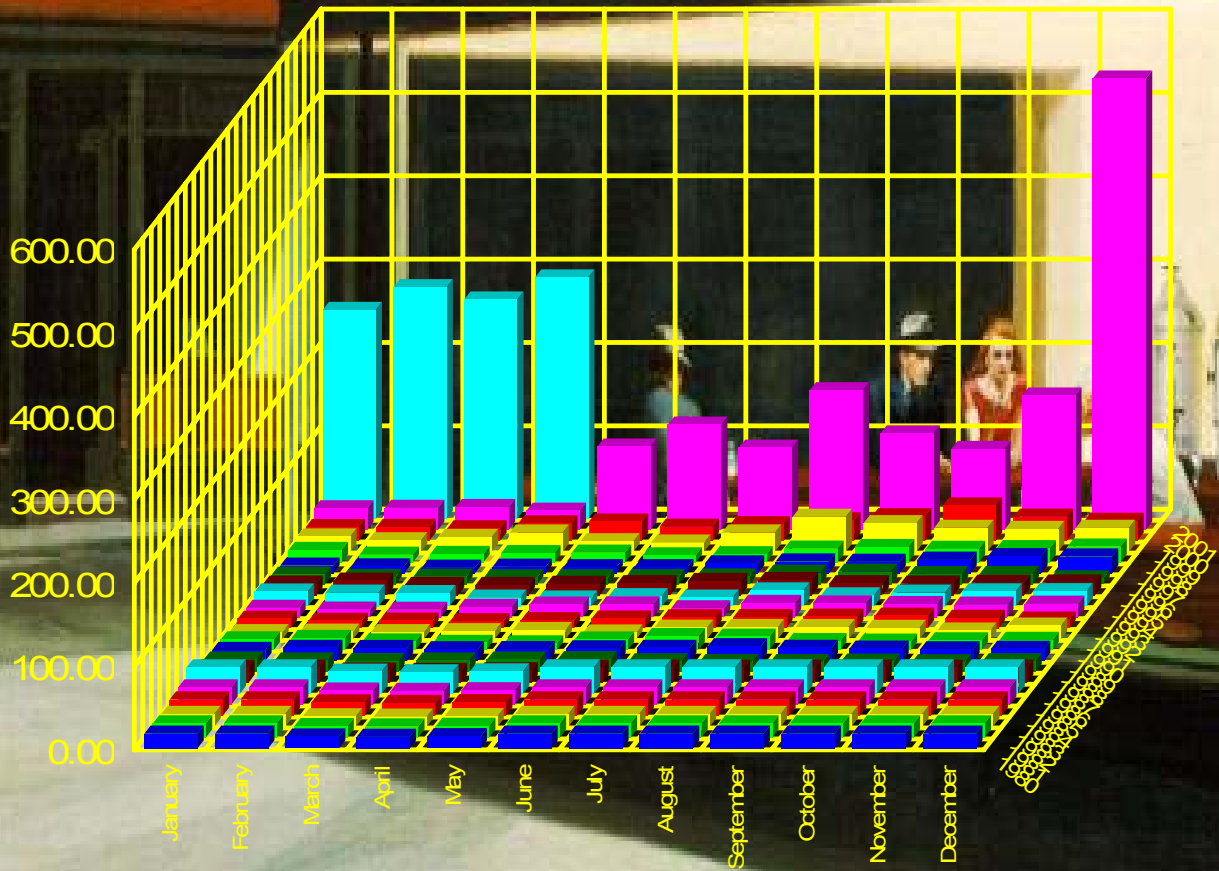


# Twenty Years of Efficient Markets

- Since 1980 the West Coast has enjoyed an active wholesale market
- FERC ratified the market in 1987
- California's deregulatory scheme was a step backwards from competition

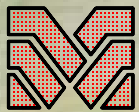


# Twenty Years At Mid-Columbia



# One Year of Inefficient Markets

- Since May the ISO has taken direct control of markets every few days
- Since November, the ISO has taken direct control almost every day
- The primary "market" if this term can be used is the bilateral daily negotiation between Williams, Dynegy, Reliant, Duke, and Southern
- The regional market has suffered from the massive level of governmental intervention

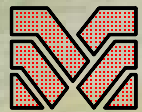




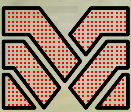
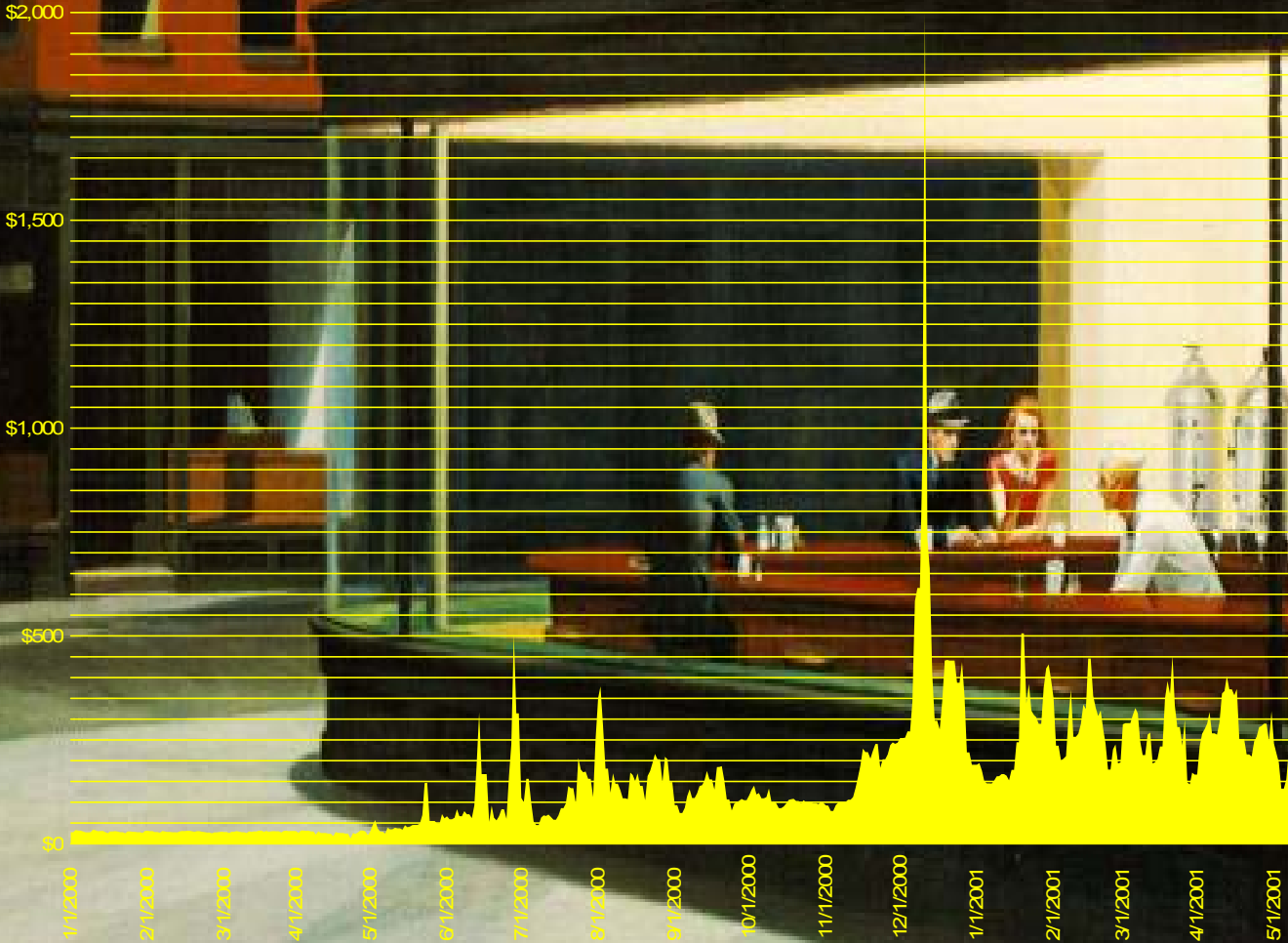
\$1,900/  
MWh

# May 22, 2000

- Pricing changed on May 22nd
- There are almost no explanations for the shift

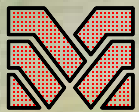


# Current Prices



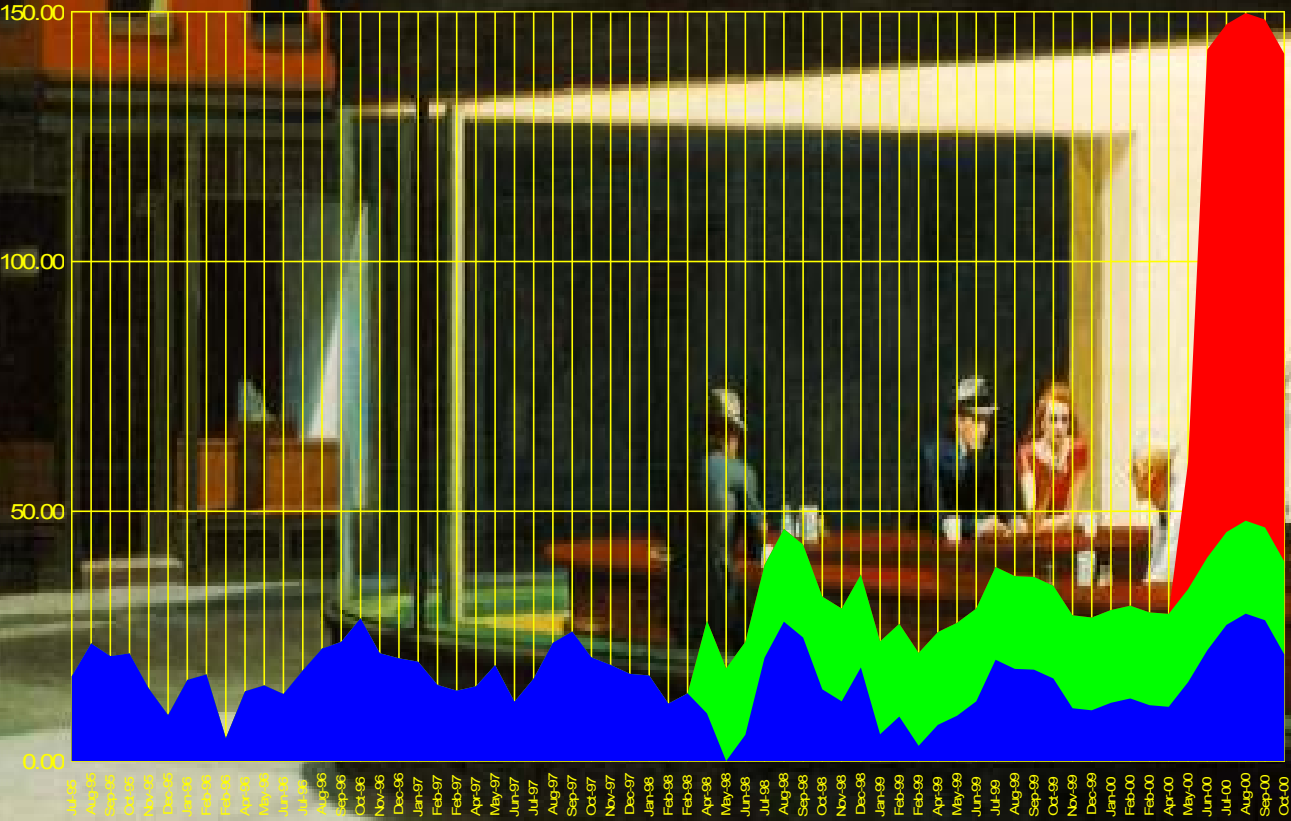
# Calculated Refunds

- **On-Peak: 101.6 mills +/- 23.2 Mills**
- **Off-Peak: 48.4 mills +/- 11.6 Mills**
- **Refunds appropriate from May 22nd through October 31st**
- **Additional data will continue to refine estimates on a month by month basis**

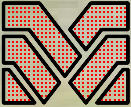




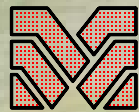
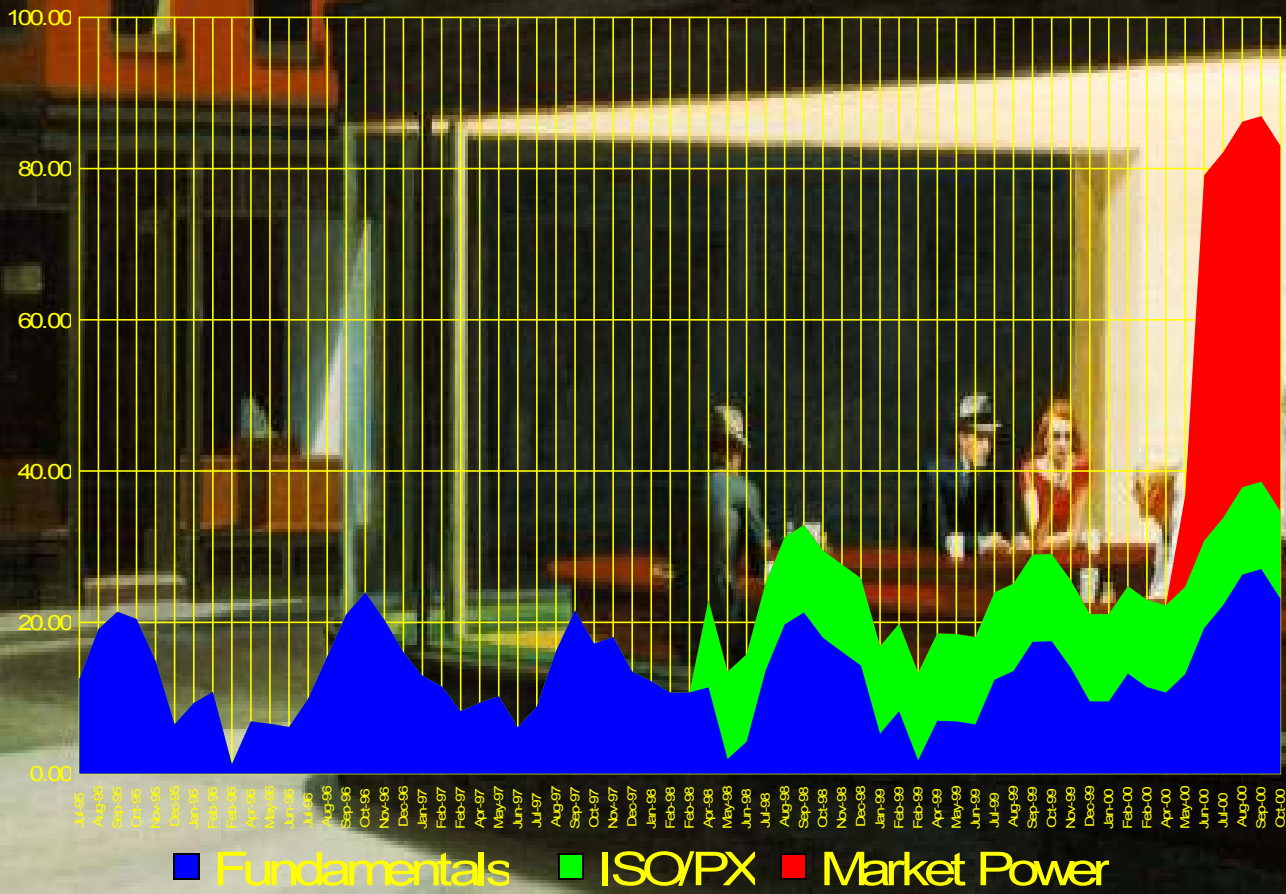
# On-Peak Price Impacts



■ Fundamentals ■ ISO/PX ■ Market Power

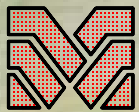


# Off-Peak Price Impacts



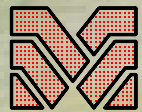
# Harvard's Love of Governmental Intervention

- AB-1890
- California's Structure
- The Role of Secrecy



# AB-1890

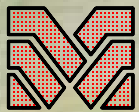
- **AB-1890 was neither engineered nor inspired -- it was a disaster designed by a committee**
- **The primary plan was the creation of two new state agencies -- the ISO and the PX -- to administer California markets**
- **Customer choice was an early and inadvertent casualty -- eliminated by the formulas designed to recover stranded costs**



# California's Structure



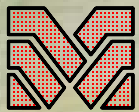
Prices





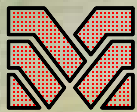
# The Role of Secrecy

- **Secrecy was a central tenet of the California experiment**
- **The logic was that cost recovery required "transparent" pricing (Dan Fessler), "transparent" pricing required administered markets (Bill Hogan), the absence of competitors required secrecy of bids and outcomes**
- **The result was that market manipulation and management failure became obscured by the mantle of competition embracing secrecy**
- **Simply stated, secrecy in areas of central public policy importance is neither required nor desirable**
- **Increased secrecy will bring additional government controls in order to avoid widespread blackouts**



# Vampires, Zombies, Nightwalkers, and Ghouls

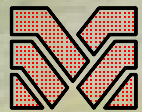
- Vampires -- "RTOs and ISOs"
- Zombies -- "Utility Sales Forces"
- Nightwalkers -- "Energy Partnerships"
- Ghouls -- "Market Redesign"





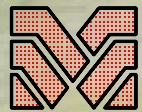
# Vampires -- "RTOs and ISOs"

- Governmental agencies seeking to help you move your power have proved expensive, largely incompetent, and very, very complex to deal with
- If you want to move power, find alternative paths



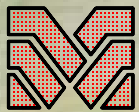
# Zombies -- "Utility Sales Forces"

- Nothing more painful is to see one of your friends roused from the dead and assigned to your account
- The appropriate steps to take are:
  - Fill the mouth with salt
  - Sew the mouth shut
  - Place a stake through the heart
  - Rebury at a crossroads



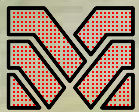
# Nightwalkers -- "Energy Partnerships"

- Enron and a number of other parties are offering the gullible "energy partnerships"
- The most successful partnership of this type was the one offered to the three little pigs by the wily fox
- Every one of these programs has failed and not been renewed



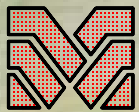
# Ghouls -- "Market Redesign"

- Flowgates
- Bidding rules
- Second price auctions
- Scheduling coordinators
- Just say no



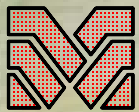
# Dumping Harvard and Following Market Solutions

- Professor Robert Michaels recommends following the gas model -- no centralized administered markets, no transmission authorities, no forced retail access
- Simply follow the gas model -- users who want access can procure it
- Basically, Professor Hogan is simply wrong



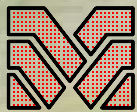
# Useful Sayings

- Products and Services
- If You Can't Explain It, You Don't Understand It
- A Collar Is An Article of Apparel
- Derivatives? Not Now, I Am Working
- Transparency Is Too Dark For Me
- We Give Good Meeting
- No You Can't Pester Me For Data You Won't Understand





**Products and Services**





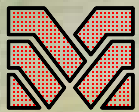
# If You Can't Explain It, You Don't Understand It

- Only Zen masters educate through confusing the student
- If they cannot explain the deal in one page, they do not understand it
- Quick check, if they are inexplicable and wear a loin cloth -- ok. Otherwise, cut the meeting short and move on



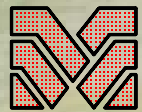
# A Collar Is An Article of Apparel

- You can always detect a newcomer to electricity because he wants to educate you about collars
- Say no -- you will save an hour of a confused and virtually irrelevant lecture



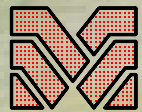
# Derivatives? Not Now, I Am Working

- We have participated in thousands of megawatts of sales and negotiations and have never found a situation where a derivative is relevant to an end-user transaction
- Energy derivatives are the moral equivalent of automobile lease arrangements



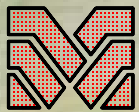
# Transparency Is Too Dark For Me

- The failure rate of complex market mechanisms is very, very high
- After twenty five years of complex negotiations, I estimate that the useful life of an agreement diminishes by one year for each formula

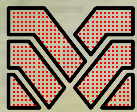
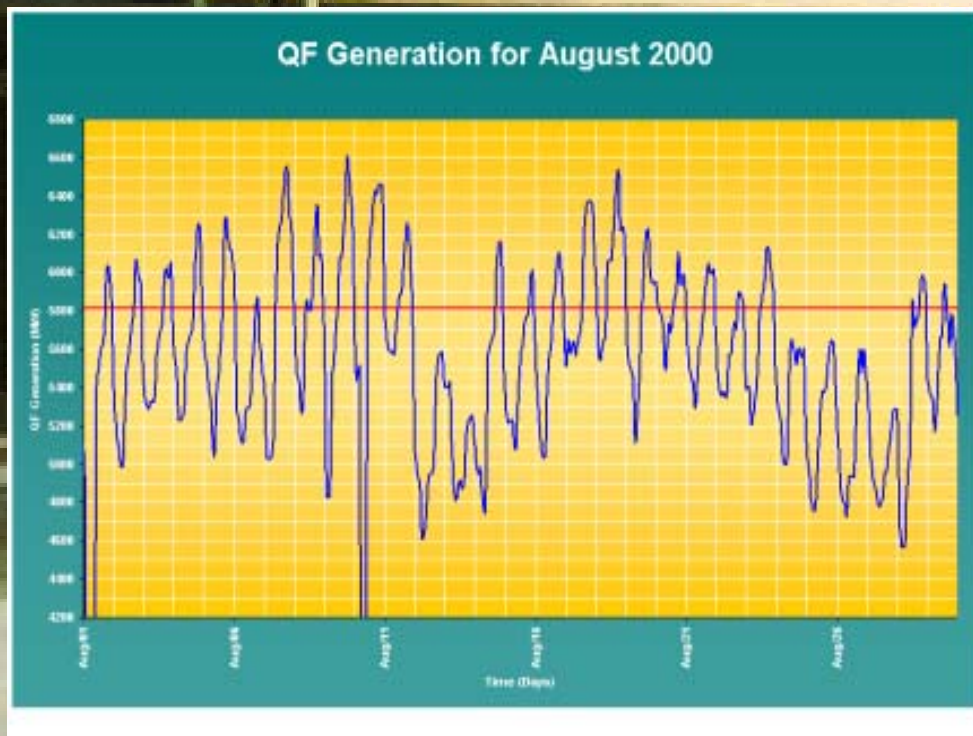


# We Give Good Meeting

- This aphorism describes the desire of many vendors to "bond" with purchasers
- The result is often embarrassing and can be downright awkward at times
- Meetings are not the goal of the process



# No, You Can't Pester Me For Data You Won't Understand







McCullough Research

[garrettcraw@mresearch.com](mailto:garrettcraw@mresearch.com)

503-771-5090

