

# The War of Rules and Certainty

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# The Setting



- Last Major Round of Generating Plant Construction in late 1980s
  - Utility Cost Overruns and Inability to Manage Large Projects
  - Regulatory Inability to Create Effective Cost Control Incentives
- Competitive Wholesale Markets Established in Northeast US and West Coast to, Among Other Things, Address These Problems

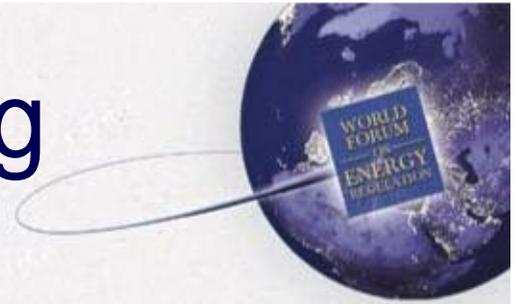
# The Dilemma



- Competitive Wholesale Markets Are Operated by a Regional or Statewide Operator; and Are Complex:
  - Economically Sound Market Rules Are Required
  - Relative Newness of Markets Require Periodic Modifications
- Changes in Market Rules Produce Winners and Losers, and Can Undermine Confidence in the Mechanism (Rules vs. Certainty)

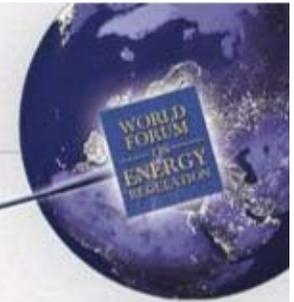
# Implications of Modifying Market Rule

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- Generation Plants: Long Term Commitment of Capital
- Investors Willingness to Commit Capital Dependent on:
  - Expected Cash Flows
  - Likely Volatility of the Cash Flows
  - Regulatory Uncertainty

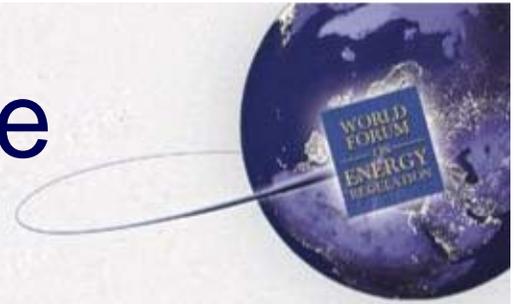
# Traditional Regulation



- Risks Limited by Near Certain Cost Recovery
- Prior to Competition, Utilities Recovered All Costs Through Rates to Monopoly Customers
  - Rate Case Process Could be Contentious; Basic Principle is Recovery of All Prudently Incurred Cost
  - Investment Grade Financing Was Typical
  - Investment Grade Still Typical for Remaining T&D Assets

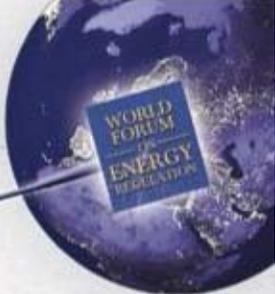
# Generators In Wholesale Markets

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- Cost Recovery Uncertain
- Business Risks
  - Plant Efficiency
  - Input Costs vs. Market Prices
  - Value of Capacity and Other Services
  - Weather and Economic Conditions
- Financial Risks
  - Extensive Use of Debt Leverage Further Narrows Margin for Error

# Changes in Market Rules

The logo for the World Forum on Energy Regulation, featuring a globe with the text 'WORLD FORUM ON ENERGY REGULATION' overlaid.

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- Direct Impact on Current Market Participants
  - Direct Impact on New Projects Seeking Financing
  - Ability of the Market as a Whole to Attract Future Investment Versus Markets in Other Regions
  - Sometimes Necessary to Correct Market Design Flow

# Conclusions



- Regulatory Environments with Changing Rules Make it More Difficult to Attract Capital; Even “Insignificant” Modification Send Signals of a Willingness to “Change the Rules”
- A Workable Market System with Predictable Results and Remains in Place Over an Extended Time Period, Creates Certainty and Instills Confidence for Investors

# Conclusions

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- The Quest For a Perfect Market Mechanism Must Be Managed Carefully to Avoid Creating Added Uncertainty
  - Regular Process Conducted Periodically
  - Open Process With Stakeholder Input
  - Benefits of Moving Toward Perfection Versus Potential Costs