

Gulf Coast Power Association
Spring Conference Keynote Luncheon Address
Friday, April 3, 2009
Approximately 30 minutes followed by Q&A

Thank you, John [Stauffacher, GCPA Executive Director].

It is a pleasure to be here in Houston to help celebrate GCPA's 25th anniversary with you.

As John mentioned, I celebrated my own anniversary this year – 25 years as a utility CEO.

This means I have been around long enough to see some good ideas succeed, some bad ideas fail, and many failed ideas re-invented and presented as new.

As I think back on that time, I am struck by all the changes we have seen.

And based on my visits to Washington, I am certain that more changes are coming.

However, to get too far into what may come in the future risks losing sight of our many accomplishments to date.

Given our respective anniversaries, I thought I'd share my personal views on utility regulation in general and competitive electricity markets in particular.

Competition is a fundamental principle for Exelon.

Just as it is a fundamental faith for you here in Texas.

You have one of the premier markets in the country and certainly much to be proud of.

I am reminded of Winston Churchill's quip that democracy is the worst form of government except all the other ones that have been tried.

And based on my experiences at the three companies I have headed, I think the same can be said of the competitive model.

So let me briefly take you through my personal odyssey – or to borrow a title from Douglas Adams, "The Hitchhiker's Guide to Utility Regulation."

I began my career at a small utility called Central Maine Power.

It may be about as far from Houston as you can get.

When I took over in 1984, we were in the waning days of the rate-based model in New England.

That model had favored building coal-fired and nuclear baseload generation with low operating costs and high capital costs that could be recovered over the life of the unit.

It worked reasonably well during a period of predictable load growth and declining generation costs.

But in the 1980s load growth was less than expected, natural gas and oil prices were lower than projected, and in the wake of Three Mile Island nuclear costs were far higher than expected.

All of these factors meant dramatic increases in retail rates.

And, all across New England, the regulatory bargain was broken and nuclear costs were disallowed as imprudent or uneconomic.

CMP, which had more than its total book equity invested in 6% of the Seabrook plant, was ordered to sell its stake at 15 cents on the dollar and “share” the loss with its customers.

The Seabrook investment nearly bankrupted CMP and did bankrupt the company who bought our stake at such a deep discount.

And our experience was hardly unique – nationwide after-tax write-offs totaled over \$17.5 billion.

After this debacle, a new regulatory model was born – Integrated Resource Planning.

The PURPA/IRP model was designed to “fix” the problem with the rate-based model – construction cost overruns incurred by monopoly utilities.

The “solution” was to forecast the utility’s “avoided costs” over a 20 year period, estimate how much new generation would be required, and sign fixed price long-term contracts at a “discount” to avoided cost.

In theory, this would shift the risk of construction and operations from customers to suppliers.

But in practice, this was no better for customers than the rate-base model.

In Maine, the same regulators who were burned by Seabrook insisted on using the estimated cost of Seabrook II as the proxy for PURPA avoided costs.

As Charlie Monte, my executive vice president, observed: "They took the worst thing we ever did and required us to repeat it!"

The initial Maine PURPA contracts for wood burning power plants rose to more than 14 cents per kilowatt-hour before they were settled out.

The same pattern played out in Massachusetts, where I served as CEO of New England Electric, and in New York, Connecticut, and Pennsylvania.

Ultimately, when the transition to competitive markets came, stranded costs from PURPA contracts were often greater than those associated with rate-base constructed generation.

In the Southeast, they were about 40% of stranded costs.

In the Northeast, they were about 50%.

In California, they were almost 75%.

The combined aftermath of the failures of the rate-based and IRP models led to the development of the competitive model.

I joined Unicom, a predecessor to Exelon, in 1998, immediately after passage of the Illinois restructuring act.

The Illinois law sought to create a competitive generation sector, one that would shift the risk of generation decisions, construction cost overruns, and operational failures to shareholders and away from customers.

In the ten years since the law was passed,

Over 9,500 MW of gas-fired generation was built in Illinois;

Exelon's nuclear units were up-rated by over 900 MW;

And our nuclear units in Illinois have improved their capacity factor from 47% in 1997 to over 93% today.

To the average customer, that means we have almost doubled the effective output of our fleet without building a single reactor and with improved safety.

So with the history now out of the way, let's turn to the future – and in that future I believe that competitive markets will be needed more than ever before.

Competition will discipline us as we make the massive investments needed to improve our energy infrastructure.

The Brattle Group, working off of data from DOE's 2008 Annual Energy Outlook, estimates that

We will need to build 219 GW of new generation at a cost of almost \$700 billion;

And we will need to spend another \$300 billion on improved transmission;

You can waste billions in this business very quickly – though none of you need me to tell you that.

You also don't need me to tell you that in this economy, that is the last thing we can afford.

Competitive markets are the best mechanism we have to make sure we act efficiently.

And while all of us in this room may not share the same views on federal climate change legislation, we can all agree that organized markets can help us as we adapt to a lower carbon economy.

Over 70% of wind generation has been built in competitive markets despite the fact that only 44% of wind energy potential is found in these areas.

And competitive markets also help to promote energy efficiency – such as the over 1,200 MW of demand response resources added in New England as of the end of 2007.

There are those who argue that competitive markets are part of the problem, not the solution.

They argue that competition is responsible for higher energy prices for consumers.

They sometimes point to Illinois.

But today, Illinois residential customers pay only 6% more than they did before rates were cut and frozen for ten years as part of restructuring

And their rates are below the national average.

Indeed, data from the Energy Information Administration indicates that price increases are roughly the same for states in RTOs versus those that are not.

This would seem to imply that the cost of fuel – particularly natural gas – is far more responsible for cost increases than competition is.

And neither competition nor cost-based regulation can protect consumers from the global fluctuations in energy markets.

Some argue that no one will build generation in competitive markets.

But Illinois' experience belies that myth also.

And Texas has built over 41,000 MW of new generation in ERCOT since restructuring.

It is remarkable to me that some regale the good old days of stable, command-and-control regulation.

I lived those days and they were far from good or stable.

The history of the last 30 years, fairly remembered, makes clear that central planning efforts using the customers' money – whether done by utility executives, regulators, or even legislators – have not produced economic results.

The overall scorecard for competition shows both wins and losses.

Competitive markets received a vote of confidence from President Obama several weeks ago with Commissioner Wellinghoff being named Chairman of FERC.

Chairman Wellinghoff has been outspoken in his support for competition, declaring in 2007 “Competitive markets are the only way to provide consumers with just and reasonable prices and the lowest total bill.”

But at the same time, support for markets is not a popular sentiment in this economy.

In Connecticut, the House and Senate will consider a bill to create a state authority to own and operate generation facilities.

In Maryland, the governor is demanding and the legislature is considering requiring utilities to build generation in rate base and generally prohibit the building of new merchant generation.

In my opinion, the cure for the sins of AIG is not the policies of the German Democratic Republic, nor is it a return to the utility monopoly industry of the 1980s and 1990s.

But those of us who support organized markets should not be lulled into a false sense of security that falling energy prices will reduce the enthusiasm of those who want to return to past, failed models.

Undeniably, Texas's experience should be counted on that scorecard as a win.

Texas's experience is not unlike that of Illinois.

There is the 41,000 MW of new generation I mentioned previously.

Approximately \$5 billion in new transmission investments are on the drawing board as part of the CREZ build-out.

Texas has had tremendous investment in renewable resources – particularly wind.

Though it may have had too much success, since the effect of wind power on around-the-clock power prices can discourage baseload investments in coal and nuclear.

And I have heard that some new wind investments have even begun to erode the economics of existing wind projects.

And finally, polls show that Texans overwhelmingly support competition – with almost 80% of consumers in favor.

Texas is one of the premier competitive markets in the country.

Policymakers and regulators here understand this business and the challenges we face.

ERCOT is a well-designed and operated market.

And the planned transition to nodal wholesale market design – while bumpy in its implementation – will bring increased efficiencies and clearer price signals to the market.

Exelon is a proud participant in Texas since our entry into ERCOT in 2000 – owning both output from long term power purchase agreements and generating assets.

As many of you know, we are contemplating building a new nuclear plant a few hours from here in Victoria.

We have submitted our license application to the NRC and are preserving our option to build.

The success of the Texas competitive market is a major factor that led us to explore Texas as a potential site for a new plant.

We know that competitive markets don't succeed without the addition of new generation assets.

We also know that competitive markets require that you analyze these projects with sharp pencils to make sure that the economics work – and we will continue to do that.

And it goes without saying that in today's challenging economy with today's gas prices, one must have a very sharp pencil indeed.

Increased size and scale help companies like ours make the investment that markets like ERCOT need, particularly now given the economic recession and tightening financial and credit markets.

I have long been an advocate for consolidation in the utility industry.

This desire for size and scale motivate Exelon's bid to acquire NRG.

And NRG's presence in this market and its assets in Texas greatly add to its attractiveness.

For instance, actually building a new nuclear plant – even here in Texas – given today's economy will be a very difficult challenge for anyone.

But there is a better chance of getting it done through a combined Exelon and NRG than by either company on its own.

We are hopeful that we will complete the NRG acquisition later this year and will participate in GCPA's next Spring Conference in an even larger way.

Being in Houston, I should also comment on NRG's proposed acquisition of Reliant's retail business.

Exelon believes that consumers' power to choose a retail electric provider is an essential component of competitive markets.

But because we have not been able to conduct due diligence on NRG, our knowledge of the NRG-Reliant combination is limited.

Nonetheless, given the announcement that Reliant's retail business may become part of NRG and given our support for retail electricity markets, we will certainly evaluate how all the pieces fit together in our proposed transaction.

Finally, let me say that despite the documented successes of Texas's experience with electricity competition, several bills have been introduced in Austin that threaten harm to both the competitive retail and wholesale markets.

Regulatory certainty is critical to maintaining the success Texas has seen.

It is my hope that state lawmakers resist the urge to tinker too much with a market that clearly works.

In 1921, the journalist Lincoln Steffens went to the Soviet Union and returned to say “I have been over to the future, and it works.”

Through my 25 years as a utility CEO, I have been through the past – through the monopoly model and the centrally planned model – and it didn’t work.

Competitive markets may not be perfect, but the experience of Illinois, Texas, and elsewhere tell us that they are, as Churchill might have described them, the worst model except for all the other ones that have been tried.

Organized, competitive markets are our future and are the best option for our customers.

But they will only thrive if they are vocally and vigilantly defended.

We must constantly remind folks what we tried under traditional regulation, where we failed, and why we came to restructure the markets in the first place.

I want to express my appreciation to GCPA and all of you for your support of these ideals and the Texas competitive power market.