ENERGY BAR ASSOCIATION
MID-YEAR MEETING

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P R O C E E D I N G S

Thanks to the Bar Association for inviting me to speak. Over the last 20 years, I probably have spoken four or five times at this event. Fortunately, the planners don't remember at all what I had to say on those occasions and neither do I, so we're on equal footing. I can assure you while I was in Congress working on energy policies that I only supported good policy. I always opposed bad policy. And if you buy that, you must be really new to Washington.

One caveat about my speech: Resources for the Future is an independent and nonpartisan research organization – a think tank. It strives for the highest quality economic analysis of public policy issues, especially on resource policy, and in particular on energy and climate these days. Let me be very clear, however, I'm not here to speak from that analysis. I'm here to do the softheaded political speculation based on my previous experience in Congress, and you can be assured I've got lots of experience with the softheaded part of it.

Our folks have been deeply involved doing analysis and providing technical assistance to the Regional Greenhouse Gas Initiative when it was being developed, including how to design the auction system being undertaken in New

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England and the implementation of AB32 in California. They're very active on Capitol Hill, not as advocates but simply analyzing the different design options under the cap-and-trade system. And we have a major energy project underway, trying to do a comparative analysis of different energy strategies in terms of their outcome for energy security issues as well as for carbon dioxide emissions. But I was not hired to do the *thinking* at this think tank; I was hired to clean out the tank today!

I'm going to fly at about a 50,000-foot level to describe where we are. Then I'm going to bring the plane down a little to engage in some speculation about where they are on Capitol Hill with the Climate Energy bill. And then we'll open up to questions, and you might be able to pin me down to actually answer something more specifically. We'll see how well my skill can keep us from getting to that.

Let me suggest what is obvious to most people. If we look at what is happening now in this country and indeed around the world, there's much doubt that we're at a time of incredible change and uncertainty, especially in the energy sector, more so than any of us have ever seen in our lives. In Washington especially, we always come up with these melodramatic statements that "the time is now." You've heard all those speeches. If you haven't, you haven't had the pleasure of being on Capitol Hill very much or you haven't been watching cable television, where melodrama rides high. But, in fact, in this case, it really is true; we are at some major turning point. One individual described it this way recently, which captures that notion. He said, "It's not just a time of change, but a change of times."

If we just look at the last five years in the energy sector, what we see are some very dramatic changes over the last 25 to 30 years. Energy prices just shot through the roof and then they fell down, and then they went back up – in particular oil and natural gas. These shifts were radical – unexpected by industry, by academia, by government. They were not predicted, except by a few outliers who, of course, for one day became "the experts" and were invited to testify everywhere because they luckily happened to strike on what occurred. But by and large, these swings were unexpected, and that's a very important lesson for us in making policy or in deciding on investments.

When prices rose, it energized our energy markets unbelievably, changing investor behavior, changing consumer behavior, and changing behavior throughout the system of production. We saw investments in the private sector rush into alternative fuels to oil in particular. We saw new technologies coming more rapidly into the market, many of which had been developed over the last 30 years but never could make it into the market. And, of course, one of the most profound changes for us in the United States, were the high prices that helped to stimulate in natural gas the experimentation that was going on with shale gas which proved that they can actually get that gas out of rock.

Today it is very widely accepted that this will mean a long-term gas supply of – long-term meaning 25, 30 years – for the United States. And so unless we're wrong about that, this really is going to be one of the things that most dramatically shifts what happens in our energy markets.

You only have to think back a few years ago when the presumption was that domestic gas supply was in decline. We were no longer going to be able to get more gas supplies out of Canada, so if we didn't get that gas pipeline from

Alaska, or we didn't get L&G in place, we were going to be in a shrinking gas market in this country. Now, of course, gas producers are saying we may even turn some of those terminals around and regasify and sell it abroad, which will be interesting when Capitol Hill gets that one. And of course, we saw consumer behavior change causing a decline in driving for one of the rare moments in American history. And certainly, if you were General Motors, Ford, or anybody producing cars, you saw a shift in buying habits.

Now, in addition to energizing our markets, these radical shifts in prices energized our politics. Over the last five years we have witnessed an unbelievably active intervention by governments in the energy markets. The federal government, state governments, even some local governments have gotten into the act and are aggressively reshaping those markets with government policy. Indeed, we saw the resurrection of a lot of old policies. We saw the resurrection of some old energy lawyers! We even saw the resurrection of some of us recovering politicians. Our day finally came again.

The lesson: price really has power in energy markets. And, when it moves rapidly we really do see shifts in behavior. I'm not saying that price is the be-all and end-all. But when people make policy without taking price into account, they are making a big mistake.

So that's one lesson out of this period. The other lesson is, as I said, we did not expect these turns of events. And people who get themselves on their religious high horse about a particular technology or a particular fuel often find themselves getting thrown from that horse when they discover that other things happen in the marketplace that are not anticipated. No planning operation at the federal level or anywhere else is going to be able to anticipate all that will happen, so you've got to create policies that will work over an unexpected future.

Let's turn to what happened in policymaking over those last five years. With the 2005 Energy Act and the 2007 Energy Act, it's safe to say that we saw more government intervention into the energy markets than since the Carter era. And remember, the 2005 Act is from a Republican president, a Republican House, and Republican Senate. So this is not a bunch of left wingers that came up with the idea we ought to try to intervene in the marketplace.

The point I'm trying to make is something we learned back in the '70s but gets lost: people think they can sustain their theoretical principles or ideological position about markets but in fact they don't operate that way. We go back and forth as to how much to utilize the market and how much to intervene in the market.

If you just look at those two statutes, we had major intervention with a plethora of tax subsidies – things, by the way, that the Reagan administration never would have supported. We had the reinstitution on a broad scale of loan guarantees for a variety of technologies. We had mandates as to what you could or could not do in the marketplace: You must buy ethanol. You have to raise fuel economy standards in autos. You have to ban incandescent light bulbs. So you just don't see today all the handwringing you had about four years ago: "Oh my, we don't have an energy policy. What will we do?" We have dozens of energy policies now. The question is: Can we make them work together?

One of our biggest uncertainties came when Hurricane Katrina hit Wall Street. That led to some profound changes that probably none of us would have

believed. The leadership in government and the financial system, it appears as an outsider, were in a total panic over what to do. They simply could not see where this thing was headed, and so they took radical actions that – if you'd asked anybody in this room three years ago would have been taken in America – I'll lay you odds the person would have been expelled from the organization for having thought that. The United States government made a massive shift of public capital – borrowing it – into the private capital markets. That meant that you and I became involuntary owners of General Motors. It just isn't the kind of thing that true-blue Americans do. But we're all true – and we're all blue, quite blue – about the finances.

So, we first saw a very significant shift in public opinion about government and about the marketplace. Clearly, people felt quite distressed at what markets did to their own wealth base and to their own communities and their own jobs. And so they lost confidence in the marketplace and they turned to government for action not because they love government or because they trust it; because it was the only option available. And indeed in the face of a deep recession, we had another resurrection with John Maynard Keynes coming back into the picture. Even Republican economists were arguing in the newspapers that maybe we had to have the federal government prime the pump.

As a result, things shifted very significantly – intellectually, politically, and economically in this country. The new administration responded with a major stimulus package that went through Congress in record time. And it was unprecedented in multiple ways. In the size of dollars involved, this was certainly the largest. Some of these new members of Congress have no idea. I bet in my 20 years on the Hill I didn't have as much discretionary voting on a sum of money as they had in one week. And they'll never get it again, by the way. You may give thanks for the deficit that it won't happen again.

Second, though, a major portion of that money was focused in the energy sector, obviously trying to accelerate clean energy supplies, trying to accelerate energy efficiency in a variety of ways in the economy, and trying to upgrade the transmission system, partly for renewables, partly for the smart grid. That had never been a strategy in the past, any effort to prime the pump, certainly the three recessions I went through when I was in Congress.

Third, and what's a really interesting development, is it was somewhat coordinated internationally with major foreign governments. And, indeed, you can actually go online and find out the comparison with the stimulus packages in China, in America, in Germany, and there are some similarities. Of course, the big question for us, with these tax incentives and these investments coming into play, and clearly having an impact in the energy markets, is when those expire, when the money dries up, will the private sector be able to sustain those activities? While one hopes that will be the case, we really don't know the total answer to that.

Looking ahead, there obviously remain two very broad uncertainties that the energy sector faces. The first is: where are these market prices headed? And, in particular, oil governs so much and influences so much, it is sort of the $64,000 question. We seem to be in a range of about $70 a barrel of oil at the moment. It had gone up to $140, obviously, last July, and then dropped to $40 a barrel. By the way, it was only about six months to less than a year ago that

conventional analysts were saying, well, the proper range is about $40 - $45 a barrel. Where it will probably settle into? Maybe around $60 a barrel.

The only thing we can say with some degree of certainty is that when the world economy recovers and begins to grow, the pressures on the world oil market are going to grow as well, and, therefore we're likely to see prices at least remain at the strong level or even higher. Of course, they can fluctuate up and down. And when they go down, our past history shows that we withdraw investment, we withdraw consumer interest in efficiency, we withdraw government policy, and we step back to a wonderful world of low energy prices. I'm not sure we'll get that opportunity again, but that is one of the uncertainties.

The second uncertainty is the big one before us in the U.S. Congress right now, and indeed around the world, is the Copenhagen question: How much and how aggressive are we going to be about carbon dioxide and the other greenhouse gas emissions? How seriously are we going to try and with what speed are we going to try to transform the energy sector based on the climate issue? And we can get into some specific questions on that if you'd like in a moment.

That leads me to make some speculation about where this is headed in the U.S. Senate – and this is strictly speculative. I'm not willing to bet a nickel of my own money on what I'm about to tell you. You can bet client money if you wish. I doubt that you'll bet your own. I'm going to do this very crudely. In a number of circles on and off Capitol Hill, the conventional wisdom is that this is going nowhere, that you simply cannot get this. You have such competing and compelling issues on the agenda. You have a very unsettled American population about the economy, and so politicians are very nervous about taking any actions that impose cost. And, of course, you have the 60-vote hurdle, which, by the way, is not in our Constitution.

Well, let me suggest to you the counter-argument as to why there's still a likelihood that this will become law within this congressional term. And again, this is speculative.

The first is, the real choice before Congress and the American people right now, and the business community and the various interests, is whether you're going to craft a new architecture for regulation of carbon dioxide through the legislative process *or* you're going to seek to piece together the pieces of the Clean Air Act as they exist now, without amendment and build a regulatory regime. It's not a do-nothing. It is a choice between which of these options you choose. And I realize when you look at either one of them, you may not want to make that choice, but life's full of tough choices.

Most analysts feel that the route of using the Clean Air Act amendments which, as you know because of *Massachusetts v. EPA*, is now a very likely proposition. It's probably not the smartest way to get reductions, or the smartest way to get innovation over a long period of time, or the smartest way to get the least-cost reductions over the next decade. The fact is, if we can ever design and implement a carbon tax or a cap-and-trade policy that gives the market more flexibility, we're likely to do a better job of it.

Certainly, our experience with the SO_2 cap-and-trade system is a very positive precedent, but it's also a limited experience from which to do a massive scale-up of that policy for carbon. So I don't say one leads to the other, that you

automatically win by going that direction, but I'm willing to put my chips on trying.

Moreover, that this legislative process has a lot of design room to creatively build coalitions, more than many kind of policy arenas allow for. Obviously, the very fact that they're using cap and trade with the allowance system means you have something to distribute and something of longer term value to various participants in our economy. It allows the ability to address some central concerns, whether it's for low-income people, whether it's for regions of the country, whether it's for explicit industries facing international competition.

Of course, this is not just about cap and trade and CO_2. This is a bill that deals with a broad range of energy issues, coherently packaged as a comprehensive bill. Historically, most people in Washington don't discern between comprehensive and coherent. But here we have the opportunity. You might be able to get a whole host of incentives for nuclear power negotiated in this legislation. You might be able to get something on offshore drilling. You might be able to get something on smart grid or six or seven other things your clients are interested in. On most of these issues people will recognize this may be the only opportunity to actually win in this congress without a radical shift in American politics.

Let me go to a question of political strategy that is only starting to emerge – and it is a critical question of whether the legislation goes forward, and that is finding some way to interest to center-right leadership that wants to advance and wants to make a deal. Henry Waxman did an incredibly effective job in legislating and putting things together in the Commerce Committee, but one has to remember that working with him was Rick Boucher and John Dingell. And one should never forget how important that was. This really should be known as the Waxman-Boucher Bill, because what it meant was, various participants in the House could look to Rick Boucher or John Dingell as representing their interests.

We haven't yet seen people in the Senate step up to do that. Obviously, it was kind of a breakthrough when Lindsey Graham came out publicly. We don't know how that's going to develop. People who want the legislation passed hope that it's going to actually stimulate some competition for other senators wanting to play a larger role as well. Maybe, when they get health care off the table, that will happen. Maybe some of the Democratic centrists will begin to play that role. That could make a big difference.

Let me just conclude on this speculation with two more points. One that just astounds me is continually missed. I was asked by *The Economist* this last week about increasing speculation that if they don't get it done this year, it's all over. 2010 is an election year, and you know they can't get anything done in an election year. To that I say: False, false, false.

Just look back at the record. Show me any major piece of legislation on energy or on the environment, or something that passed before the election year, that got done before we got into an election year. It just hasn't historically happened. Complex legislation rolls out that way. In 1978 by a one-vote margin, the rule passed on the energy bill with a big majority of Democrats in the Congress – on the energy bill for President Carter. We were three weeks out from the election. So don't buy that. There's still plenty of time.

One more comment about why people ought to be interested in getting this done. Over the next decade, hundreds of billions of dollars are going to be invested in the United States on energy infrastructure and related activities. It would be a lot better from an economics point of view if we had some clear pattern of where we are headed on this. And some of that is going to be delayed if we don't have laws and regulations in place. So it does matter in the economy, not just from the cost-imposed side, but also into getting some certainty on regulations.

One assertion I hear is that without an architecture in place on this, we are going to have food fights over carbon all around this country: in Congress, in the Administration, in the regulatory agencies, at the state regulatory level. You're going to see citizen action step up. The resources of the activists in this country on this issue right now are appropriately focused on getting this legislation and getting some policy into place.

If the Congress fails to act, make no mistake about it, millions of dollars are going to go into advocacy that will say, your project may be a natural gas project, which is a whale of a lot better from a carbon point of view than coal, but it emits carbon dioxide, and so we are against it in our backyard. And you can pick anything you want, and there's carbon dioxide associated with it.

The point is we have no logic and no way to argue, in the regulatory system or anywhere else, that this molecule of carbon dioxide is a bad one, and this other molecule is an acceptable one. But it will be a lot easier to have those fights if we have a policy framework. And if you don't think this can have an impact, all you have to do is review what happened over the last three or four years on new coal plant applications in this country. Many were abandoned. It's accurate to say that none got through the regulatory process without some kind of deal being made; that is, it was not just because it was the low-cost option that it survived the regulatory process. It had to show it with either a higher efficiency or upgraded the technology, or that they were going to close down other coal plants, or they were going to negotiate – they were going to institute an active program to ensure energy efficiency.

Well, let me close and just simply say that given all of these contingencies it is easy to spread the gloom of uncertainty, but let me make one confident prediction. And that is that certainly for the rest of our lifetimes there will be a need for energy lawyers. And I suspect these meetings will go on, and I hope to be invited back yet another time. Thank you very much.

QUESTION:

We're all getting gray, and there are a lot of young-uns here who don't remember the good old days of natural gas. I personally want to thank you for the leadership you showed in 1989 in shocking the Bush Administration, because I was in the Department of Energy at the time, briefing them on the gas deregulation. And all of a sudden, you came out with your bill and paved the way for what I hope you regard as the role of natural gas as having demonstrably approved by the change in policy.

MR. SHARP:

Oh, yes. The price control regime on natural gas was an enormous problem for us in this country, which was partially solved in 1978, but that didn't get us to free markets. The shocker came – I was at a press conference about what we were going to do that year, and I shocked them by saying, "Well, maybe it's time to deregulate old gas." And John Dingell the year before had said, "We would deregulate old gas over my dead body," and he's got a big body!

But the fact is, from a consumer point of view, it was almost irrelevant at that point. Had we done that 10 years earlier, it would have made a difference to consumers, but it didn't at that point. So I don't look on it as the greatest achievement as you do. We were right to get out of the pricing. One of the most interesting things is that in all that run up of natural gas, oil prices and everything, gasoline, obviously, over the last four years, I don't think anybody on Capitol Hill recommended price and allocation controls – not even the socialists!

And it was stunning, because if you remember in the '70s and '80s, the continual worry of the people who had supported price deregulation was that the minute the politics got tough, the Congress would get weak-kneed and retreat. So sometimes we learn, and we learned that there are lots of down sides when the prices go up for lots of people, and you have to address those, but price controls is not the way to do it.

QUESTION:

You hear on the international plane, dealing with the carbon regulation, proposals by various countries will reduce our carbon emissions 20 percent from 1990, 14 from 2005 and so forth. My question is, how do you see all of that coming together on the international front, coming up, perhaps, with some kind of structure or agreement? And how do you see that affecting U.S. legislation as it moves forward?

MR. SHARP:

That's the Copenhagen question. With countries making kind of different diverse proposals, some for intensity targets, some for absolute targets, is there a way that that can actually come together, and if it does, how does that impact us?

The expectations were that you could actually get to a binding agreement at Copenhagen, and they were dashed; this is typical in politics. Then suddenly when you start to look at what's happening, it's remarkable how many countries are stepping forward and actually saying, "We're going to act."

The Chinese a year ago would never have put even a figure on the table. But like us, like others, they are itching to make commitments, which suggests to me we are going forward with this – despite a few e-mails out there among a few scientists. That is not going to stop unless it's broadly endorsed by the global community.

What really matters is what these nations do internally, and then their commitments come in conjunction with that. The Bush Administration did two very smart things, and the current administration is smart to continue. One,

they've got separate negotiations going under what we originally called the major emitters. And nobody liked that term, so now they call them major economies. Nobody wanted to 'fess up. You had to 'fess up to be in. If you were a big emitter, then said it's better to 'fess up as a big economy.

So to have this negotiation among the big economies instead of among the 200 or so parties that we now have at the United Nations, this was smart. But even more significant was the effort of some regional and bilateral negotiations. What we're seeing is among some of the big players, starting to work this out.

It's not the way some people visualized it 10 years ago: Aha, we'll get this big top-down agreement, then we all go back home, and we will implement the agreement. We're doing the opposite. We're trying to see what reasonable policy we can agree to, and how does that work with the others. That's not as clean logically, but it's about human beings and nations and real world. And so these things are piecing together. It appears the end agreement is going to be, essentially, the developed nations: Europe, Australia, Canada, United States, Japan. We will commit to some absolute target numbers. President Obama has given a range, a provisional number he's put on the table, wisely so for political reasons back home. And the Chinese and others are going to give intensity arguments or a commitment to policies. And what we're going to want from them is simply some method of finding out if they did it. Four years from now, can we tell whether they're doing what they said? Are they making progress? And they're going to want that from us. Do we have a monitoring system and do we keep the pressure up?

This legislation will not pass on Capitol Hill without some kind of provision of retaliation in it. In other words, if China or India or other nations don't have a workable carbon-reduction program, then at some point products from those nations are going to face some carbon requirement, which is essentially a tariff.

QUESTION:

You're more bullish on legislation next year than many commentators I've heard, but you've got a great background from which to make that prediction.

MR. SHARP:

Well, I like to be contrarian, and everybody was in gloom. And I always found in the legislative process, almost always we couldn't achieve anything until it was pronounced dead by the journalists.

QUESTION:

In that spirit, what are the top five measures that will perhaps make a bill less pure, but that will be necessary to get 60 votes?

MR. SHARP:

If I knew that, they would call me up and ask me to organize the negotiations! The top five are whatever somebody steps forward to say, I'll vote for the bill if you give me X. That's where we are. And what you've got to get is somebody to step forward and say that. For example, an interesting thing from the nuclear industry is they have a list of several things. They're not too greedy, actually, as to what they're asking for. What they've got to deliver – and they know this is a problem – is a senator or senators who will step forward and say I'll vote for that bill if it has these provisions in it. And we aren't there yet, and whether we can get to that point is the real issue.

Obviously, the nuclear issue's one; offshore drilling is another. People have been talking about these for so long. But what will be interesting is to watch the creativity. I thought it was very significant that Max Baucus, who had been expressing a lot of skepticism about doing anything, suddenly says, look, I've got an idea of how to handle this dispute over whether you go to a 20 percent or you go to a 17 percent early goal on emissions. It's a two-tier system possibility. Well, that's a political compromise that he's putting forward. I believe we will see others who understand they can make a contribution, they can win some things. They can actually be the leaders on important policies, which most of them aspire to be at some point in their careers, and really do something. And by the way, these people are going to have to go home at some point and answer to their children, "What did you do in the war, Daddy?" And these are issues that will really matter for future generations.

Thank you very much.