



AEI Panel on Electricity Deregulation

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Introduction:

I emphasize at the outset that ELCON was perhaps the first and strongest advocate for electricity restructuring. Our members know competitive markets – and know them well. They operate in competitive markets throughout the world. They truly believed, and still believe, that real competition in the electric industry would bring significant net benefits to consumers – both small and large. Real electricity competition would be expected to bring discipline to artificially high prices, stimulate technological innovation, incent new products and services and force a customer focus – while reducing (but not eliminating) regulation.

Unfortunately, the electricity restructuring we have actually experienced has not brought real competition to the electric industry. That is a real shame as the opposition throughout the world from nearly all entities on the load side is strong and growing.² And the results of the opposition will probably be more regulation rather than a movement towards real competition.

¹ The views are of the author's only.

² See: "Electricity Restructuring: A Review of Efforts around the World and the Consumer Response," John A. Anderson, *The Electricity Journal*, April 2009, Vol. 22, Issue 3.

AEI's Question #1:

Why is the process of restructuring and institutional change so different than in other infrastructure industries?

I offer 10 Consumer Insights of Restructuring (NOT Deregulation which has not occurred)

1. Principal/Agent Problem: Utilities really were in control of regulation and had access to all the data. Regulators feared losing control of utilities (which they never really had). Restructuring increased this problem. The transition to so-called competitive markets (which of course are not competitive) was killed by too much meddling by regulators who did not understand what they were doing. As a vivid example, there was far too much interference by state legislators (such as: price freezes, stranded cost recovery, legislating outcomes, etc.).
2. Vertical Integration: Vertical integration creates a lot of economic efficiency regardless of the form of regulation. Unbundling destroyed those efficiencies but did not eliminate the market power of incumbents (because joint ownership of essential facilities continued) or remove barriers to entry and thus did not offset the losses with gains from competition. Laissez-faire orthodoxy created impression that markets can always correct themselves. However, we should know by now that they can't – or at least they don't.
3. Unilateral Market Power: The ability to exercise unilateral market power is almost impossible to eliminate in network industries, certainly in the power industry, which has unique physical features (e.g., the instantaneous need to balance supply and demand, the lack of storage, etc.). Predominance of short-term markets exacerbated this problem (in part because adequate regulatory safeguards were not, and still are not, in place.) For fear of blackouts, regulators/legislators were either unwilling or unable to rein in large utility holding companies who were also skilled lobbyists. In essence, they faced entities that were “too important to fail.”
4. Lack of Transparency with Respect to the Options: The high degree of technical/engineering complexity made the debate more vulnerable to laissez-faire assertions. The winning solution, locational marginal pricing or LMP, was even more opaque. It was based on a deterministic “model” from Operations Research, not market theory. Restructuring was oversold given key policymakers' level of comprehension, and the trendiness (at the time) of promoting markets.

5. Lack of Intellectual Leadership: The debate was dominated by lawyers and lobbyists—many of them hired by Enron – which then over-simplified the issues and took ideological positions based on theory rather than on realities.
6. The Demand Curve: We can never have real competition with a one-sided market. And residual market power and the bifurcated federal/state regulatory structure (“federalism”) prevented the successful integration of price responsive demand in the market. Demand response may not have been able to compensate for the inefficiencies of unbundling, but it was never given a fair demonstration.
7. Ill-Defined Product: Traditional regulation did a better (or certainly more efficient) job pricing the different forms of generation (peaking, load following and base load). The single-price auction format of RTOs mispriced the distinctly different values of these products. The value of fuel diversity, which was captured under a regulatory regime, was lost in restructuring.
8. No Competitive Long-Term Funding Mechanism: A market structure never emerged that was capable of financing long-term investments—FERC tried to jury-rig various capacity payment mechanisms and ended up simply handing out bribes. Advocates of restructuring assumed that regulators were imperfectly informed about a regulated utility’s cost opportunities and demand patterns and were incapable of effectively enforcing cost minimization on the utility (which they probably were). However, the far from perfect ISO/RTO markets are no better and probably less capable than the far from perfect regulators.
9. Just and Reasonable Standard: The Federal Power Act doesn’t require competition, it only requires “just and reasonable” wholesale electricity rates. There is no requirement or test for productive and/or allocative efficiencies or other such metrics in the FPA. In other words, the “markets” produce J&R rates if FERC says they are – and it is nearly impossible to successfully challenge FERC in the Courts which almost always give deference to the Commission.
10. False Expectations: Finally, there simply does not seem to be a potential for significant long-term cost reductions in electric supply. Short-term efficiency gains in generation and grid operation, which most certainly have occurred such as lower heat rates and greater dispatch efficiencies, are trivial for an industry of this size and importance. Besides, most short-term gains could have been accomplished with command-and-control measures (e.g., larger power pools). This point may have been lost on advocates of restructuring. Almost all incremental technologies are very, very expensive and some will only be developed with federal loan guarantees or other socialized solutions creating more moral hazard issues.

AEI's Question #2:

What is the current “state of play” of state and federal electricity policy?

I offer 5 Hazards:

1. Moral Hazards in Wholesale Markets: The wholesale electricity markets shift enormous amounts of risk to consumers. From a consumer perspective restructuring replaced many local monopolies with large regional monopolies. FERC policies provide financial backstop to holding company decisions which now appear to be “too important to fail”.
2. Underegulation or Un-Deregulation: States that restructured (except perhaps Texas) are attempting to put the toothpaste back in the tube but with total exasperation. They cannot reclaim divested generation at their previous prices so any return to vertical integration will take decades and multiple election cycles.
3. The Empire Strikes Back—Many state regulators seem to feel vindicated that the deregulation experiment was an abject failure and are now back in full “command and control” mode. They are overcompensating for the “lost decade” and desperately trying to save the world from global warming without any regard for the economic consequences of their actions. The regulatory future appears to be one without anything even resembling any form of cost-benefit analysis, much less least-cost planning or integrated resource planning.
4. Federal Power Grab: Federal regulators seem to be increasing their jurisdictional reach with large non-profit ISOs and RTOs and *de facto* federal control of deregulated generators (formerly under state control). All has been reaffirmed by the federal appeals courts. Arguably ISOs and RTOs are the oddest entities ever created by government in the name of capitalism and free enterprise (deliberately or not). Their markets certainly are not competitive. FERC changes the reasons for creating RTOs (or ISOs) about every two years to suit the current political conditions. The sitting Commission appears to use ISOs and RTOs as implementers of climate policies and as a way to de-energize the American economy.
5. Monopolies Get Monopoly Rents: Federal regulators (and to a lesser extent Congress) are resorting more to the use of so-called “incentives” to coerce responsible utility business behavior. As we all know, utility holding companies retain large service territories and represent a very large economic presence in state or congressional districts and have substantial public affairs outreach programs.

AEI's Question #3:

How can electricity policy at the federal and state level evolve along with changes in our policy objectives and with innovation and technological change?

I leave you with 2 observations:

- Electricity policy (if there ever was one) has completely changed focus and direction. The electricity restructuring debate is dead and has been supplanted by carbon alarmism (although some renewable entities now seem to want Standard Market Design to help integrate large quantities of variable generation).
- It is not clear if policymakers in the United States are capable of an honest public dialogue and debate on complex technical issues without resorting to politics. Perhaps we will find out when we see the outcome of the current FERC Docket on ISO/RTO metrics.