



**“A DISCOURAGING WORD”
(OR TWO, OR THREE, OR FOUR)
ABOUT ELECTRICITY RESTRUCTURING IN
TEXAS, PENNSYLVANIA, NEW ENGLAND
AND ELSEWHERE**

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SHRINKING BENEFITS, INCREASING CONCERNS

As the Federal Energy Regulatory Commission (FERC) continues to struggle to sort out the mess that occurred in West coast electricity markets almost three years ago, it is rushing to impose wholesale spot markets on the generation and transmission of electricity in the two-thirds of the nation that does not want to have anything to do with restructuring. Congress continues to move to give deregulation a boost, by threatening to repeal the Public Utility Holding Company Act, which was a bulwark against market abuse, and expand FERC's ability to deregulate interstate markets and preempt state regulation. To deflect the objections of the overwhelming majority of states to a forced march to deregulation, proponents of deregulation trot out the alleged success stories of restructuring.¹ We are told that everything is great in Texas, the home state of the Federal Energy Regulatory Commission (FERC) Chairman, Pennsylvania, the home state of another of the FERC Commissioners, and New England. A close look at the facts makes it clear why many in the restructured states are having doubts² and virtually every state in the West and the South is steadfastly resisting FERC's standard market design (SMD).

Deregulation was sold to policymakers in the mid-1990s with a questionable set of claims about huge price reductions – as much as 40 percent – that would result from market forces. Last year when the FERC went looking for efficiency gains in restructuring, it could project gains of only 3 to 5 percent.³ Even these small gains have been challenged as being too large,⁴ with an analysis done for regulators in the Southeast having trouble finding any gains at all.⁵

RISING PRICES IN TEXAS

Texas consumers have experienced repeated price increases under deregulation. According to the Texas Office of Public Utility Counsel, Texas regulators have already approved \$1.7 billion in rate increases to residential and small business customers who stick with their traditional utility.⁶ As much as half of that increase is not justified by rising costs.⁷

The problem is that the state of Texas sets the price of electricity just like the FERC proposes to price it in the spot market nationally. It pays the utilities the highest prices it can find in the market – the price of natural gas – for all the electrons produced, even though about half of the electrons are produced by coal and nuclear power plants, which do not burn natural gas to generate electricity.⁸

Prices have been rising relentlessly in Texas for both default utility service and the service offered by competitors, so there are no consumer benefits from competition. In fact, the only things rising faster than prices in Texas are consumer complaints – they quadrupled in the second year of restructuring.⁹ It should come as no surprise, then, that few residential customers have switched in the context – 93 percent are served by their old utility.¹⁰

SCARCITY PRICING MEETS RESISTANCE ELSEWHERE

In technical economic terms, what the Texas default price system does, as the FERC spot market does, is transfer all the scarcity rents in the electricity markets to the producers. In layman's terms, the FERC is determined to ensure that consumers pay the highest price,

regardless of the cost of service, in effect, transferring dollars from consumers to sellers. The Chief Economist of the Office of Markets, Tariffs and Rates, at the FERC makes no bones about the agency's desire to increase the prices enjoyed by generators:

O'Neil argued that the SMD's relatively laissez-faire attitude on market pricing of electricity is the best way to assure an efficient market with "appropriate" scarcity pricing.

"The idea is to try to create a market where suppliers, and to some extent, buyers do not have to exercise market power in order to get a marketplace that's efficient," he said. "A new innovation is a demand curve for reserves which says that when markets are get tight, the market itself will move the price up so that the generators playing in these markets do not have to withhold in order to drive the price up. So, we won't go on witch-hunts trying to find these people who have been withholding."¹¹

Because the agencies implementing restructured markets are so concerned about giving incentives to generators, they set lenient market power tests and price caps at extremely high levels.¹² The abuse that these caps allow was underscored by the Attorney General of Massachusetts, who pointed out that the "threshold on peaking units costs of 8-9 cents/kwh – a price that generators in NEMA could charge without any regulatory oversight even if the actual cost of production of that power is only 4-5 cents/kwh."¹³

SCARCITY PRICING FOR TRANSMISSION SERVICES: THE OTHER SHOE THAT FERC WILL DROP ON CONSUMERS

FERC's SMD does not stop at proposing spot markets for generation that would allow prices to rise. It would also push transmission pricing toward a "whatever-the-market-would-bear" approach.

The adoption of a market-based locational marginal pricing (LMP) transmission congestion management system is designed to provide a mechanism for allocating transmission capacity to those who value it most.¹⁴

The Attorneys General of Massachusetts and Connecticut recently discovered the wonders of scarcity pricing for transmission services, much to their dismay. When the New England ISO proposed to switch from cost based pricing of transmission to scarcity base pricing, they discovered that rates could rise for a substantial part of their constituency and there was little to prevent the sellers' abuse of market power. As the Massachusetts Attorney General put it:

The concepts underlying a standard market design are certainly not new, but I am deeply concerned about the recent projected rate increases for the metropolitan Boston/Northeast Massachusetts Area (NEMA) – apparently at least 14.2 % -- and the failure of the ISO-NE's proposal to address the realities of market power in that area.¹⁵

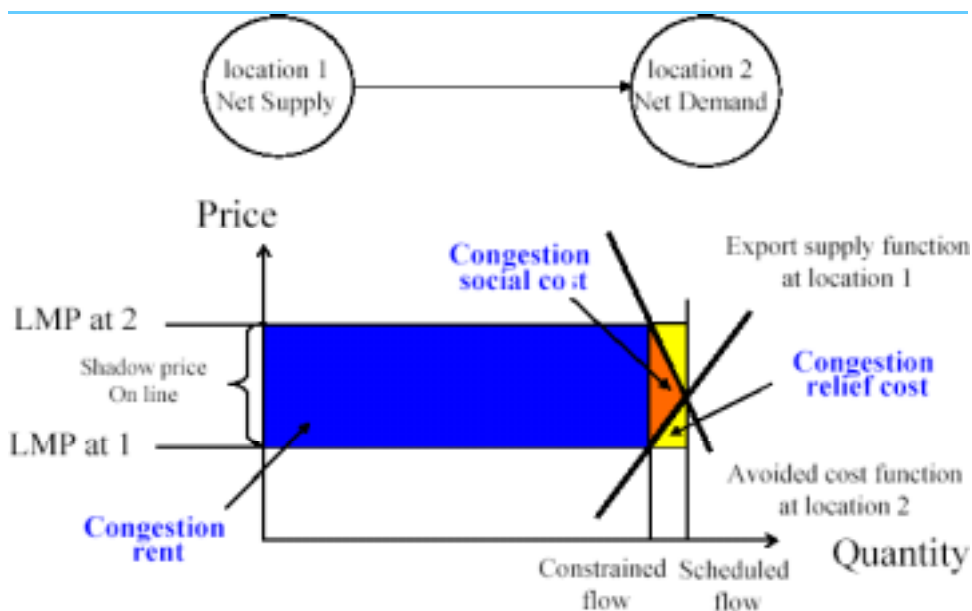
Observing the problems with deregulation and the pricing of transmission the legislature in Virginia recently passed a prohibition on the transfer of transmission assets into a regional transmission organization that relies on scarcity pricing.¹⁶ Several states and utilities that have

led the charge for deregulation promptly petitioned the Federal Energy Regulatory Commission to assert its jurisdiction and preempt the state action, essentially federalizing the national transmission grid.¹⁷

TRANSMISSION IS A HIGHWAY, NOT A MARKET

The transmission grid is the highway system for electrons. It is a shared system in which the costs and benefits are difficult to allocate. Moreover, because the public perceives transmission facilities to have substantial environmental, health and land use impacts, transmission lines are difficult to build. They are scarce, bottleneck facilities in the electricity system for social reasons, not economic reasons. The economic costs of building transmission facilities are far lower than the public's perception of the total cost they impose on society.

Under the current system, when congestion develops, the cost turns up in the price of electricity because electrons from low cost units cannot be transmitted over congested facilities. The actual cost of operating the "wrong" units (out of merit plants) is paid by the public in the price of electricity, but that price is far lower than the price FERC would impose on the public. Instead of paying only for the out of merit costs, under FERC's approach all electrons sold subject to the constraint fetch the highest price the market will bear, again transferring scarcity rents to generators and transmission owners (as the following Exhibit shows).



Source: Original from Oren, Shmuel, "Market-based Congestion Management," *Public Utility Commission of Texas Public Workshop on Congestion Management*, Austin, January 13, 2003; as discussed in Belk, Brad, "Texas Round-Up: Two-Stepping to De-regulation in Texas," *Gulf Coast Power Association*, March 3, 2003.

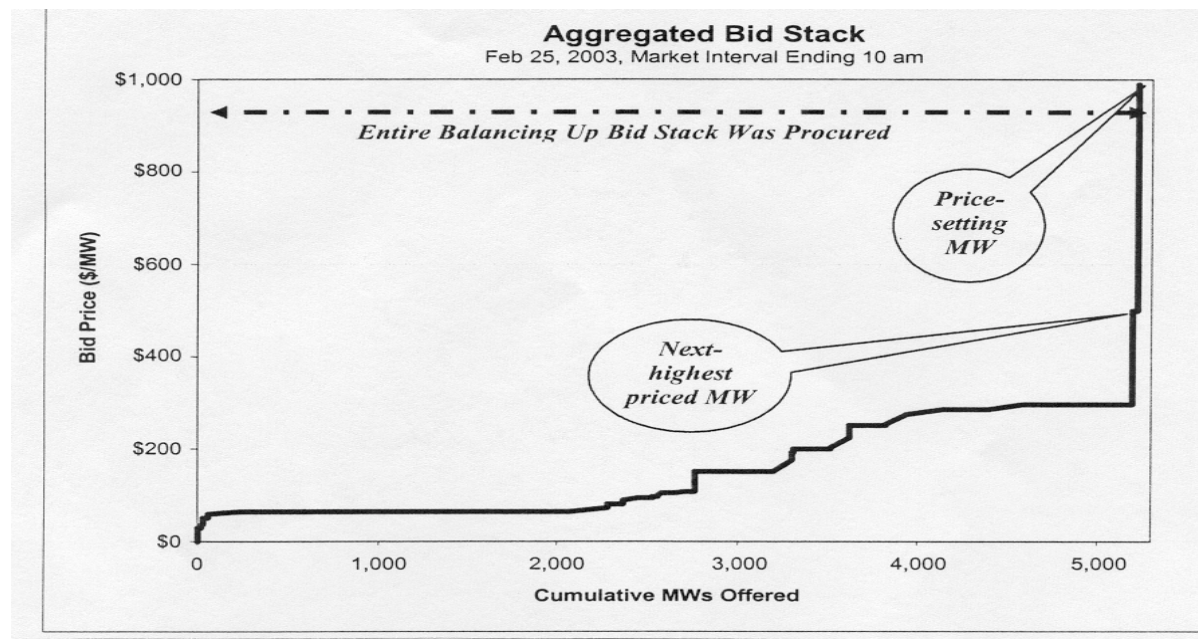
The difference between the two approaches is substantial, as some analysts recently discovered in Texas. One estimate for Texas, which is being pressured to move to scarcity pricing, indicates the price of congestion would almost quadruple, from just under \$248 million per year to over \$950 million.¹⁸

These congestion rents are transferred from consumers to producers (both generators and transmission owners) in an effort to induce investment. However, the intention to invest in either transmission or generation may quickly run into the constraints of social concerns. Worse still, owners of bottleneck facilities have little incentive to invest in facilities to overcome constraints, since the greater the constraint the higher the prices they can receive. In the short term, the result is a pure windfall. Depending on the strength of social concerns and the resistance of transmission owners, the rents become permanent. In both cases, the wealth transfers far exceed the efficiency gains.

MORE MARKET MANIPULATION

As the Massachusetts Attorney General suggests, the problems of market manipulation have not been solved in the FERC SMD proposals. They are still plaguing real world markets.

Texas, which has a state-only grid that is not under FERC jurisdiction, offers a good example. The Market Oversight Division of the Texas Public Utility Commission s investigating yet another incident of price manipulation, an apparent case of the most common forms of abuse, “hockey stick” bidding. It is so named because bidders who see tight markets put in very high bids for a small amount of electricity.¹⁹



Source: Market Oversight Division Staff Report, *Analysis of Balancing Energy Price Spikes During the Extreme Weather Event of February 24-26*, Public Utility Commission of Texas, March 3, 2003, p. 5.

As the Texas Public Utility Commission put it:

Hockey stick bidding as described here, while allowed under the ERCOT market rules, does not usually lead to market outcomes that are indicative of the cost of the service being provided. Rather this strategy provides a near-zero risk

opportunity for bidders to occasionally “hit the jackpot” and realize huge profits while load serving entities (bracket) and their customers (bracket) are unexpectedly hit with expenses that are orders of magnitude in excess of those typically seen.²⁰

Because they know the market is tight, the sellers can be confident that even the high price will be paid. Because the system pays the highest price for all electrons sold in that hour, the cost to consumers is very high. Initial estimates are \$18 million in two days of abusive trading.²¹

The merchants were careful to stay just below the state's \$1000 bid cap, so the market cleared at \$990. This is a preview of the FERC standard market design that calls for a similar cap of \$1,000.²² As early as 1998, Enron was defending prices in the \$10,000 to \$25,000 range,²³ so a \$1,000 cap might seem to provide consumer protection, but when that cap is ten, twenty or thirty times the actual cost of production, it provides little comfort to consumers.

The regulators keep promising to fix things, but the problems grow deeper and deeper. Even the most basic ingredient for a market to work, honest information, is missing. Confidence in the ability of energy markets to function has been so deeply shaken that a group of the largest corporations in the nation has asked the government to take over the gathering and reporting of price data.²⁴

LITTLE REAL COMPETITION, LITTLE REAL CONSUMER CHOICE

If competitors in deregulated markets demand huge price spikes to function, as the examples above suggest, there should be little wonder why very few consumers have switched. Competitors simply cannot consistently offer lower prices to consumers in a volatile wholesale market and retail competition continues to stall in the “best” states like Texas, Pennsylvania, and Ohio.

In Pennsylvania retail competition has been imploding.²⁵ After peaking at just over 500,000 customers who had voluntarily switched, the number has now been cut in half. Pennsylvania has assigned almost as many customers by a negative option, as have chosen voluntarily to switch.

In Texas, consumers suffer under price increases imposed by incumbents and competitors alike, while also experiencing a marked decline in service quality, resulting in a four-fold increase in consumer complaints. With the prospect of saving little and the risk of new problems with switching service and receiving accurate bills, the vast majority of residential customers has stuck with the default service, known as the “price to beat.”²⁶

In Ohio concerns are growing about restructuring:²⁷

As Ohio begins its third year of retail electric competition, the Ohio Consumers' Counsel (OCC) sees continuing cause for concern about the health of the state's electric marketplace and the potential long-term risks for Ohio's residential electric consumers.

When Ohio's retail electric market was opened to competition in 2001, the Public Utilities Commission of Ohio (PUCO) certified 38 suppliers to sell electricity to all customer classes. By the end of 2002, just 2 suppliers were actively marketing to the state's residential customers. Now, as we enter the third year of what is for most Ohio consumers a temporary five-year "market development period," the OCC is increasingly concerned about the lack of meaningful retail competition in Ohio.

Ohio's retail electric marketplace is at a critical crossroads. In 2003, the state must address a number of tough issues:

- What happens if there are few or no competing electric suppliers when the market development periods end?
- What price protections will consumers have when the current rate freeze disappears?
- What state actions will be taken to break the logjam over regional transmission issues that threaten both the reliability and affordability of electricity for Ohio consumers?

Deregulation in Canada, once hailed as a success, has also failed to produce the promised benefits.²⁸ The Ontario government has expanded its 4.3-cent electricity rate cap to include industrial customers using 250,000 kWh per year or less. The government also ordered refunds for those companies that have paid more than the cap amount since last May. The provincial government introduced the 4.3-cent (Canadian) price cap last fall, making it available to households and to businesses using less than 150,000 kWh a year. The government said that move protected 98% of Ontario's electricity customers. The latest action safeguards remaining customers by extending the cap, providing a regular rebate and offering greater certainty around energy costs.

MORE MISLEADING CLAIMS FROM DEREGULATION ADVOCATES

These failures do not stop the defenders of deregulation for continuing to make bogus claims in support of restructuring. A recent analysis of a group headed by one of the commissioners who implemented deregulation in Pennsylvania, shows the lengths to which deregulation ideologues will go to mislead policymakers.²⁹

It proposed a scorecard for electricity pricing. Its approach was simple, and simple-minded. States in which prices had gone up in the previous six years lost points, regardless of what the initial price was, or why prices had increased. States that had lowered prices got extra credit. The objective was to prove that deregulation is good for electricity consumers. The scores just don't add up.

Deregulation states, which had started with the highest rates, got high grades. Regulated states, which had started the period with low rates, got low grades. States where merchant manipulation of markets had raised prices so much that policymakers decided to re-regulate also got low grades. For example, among the regulation states that received a D were Idaho and Washington, which were tied for the second lowest residential rates in the nation, at 5.4 cents per kWh. Pennsylvania got an A, with residential rates that were almost twice as high (9.7 cents). Residential rates in

Pennsylvania were tenth highest in the nation, exactly the same ranking it had before restructuring.

Half of the states that were awarded grades of D were afflicted by and are still suffering from the massive fraud and market manipulation perpetrated by energy traders in the Western market. In most of the states that got high grades, price caps are still in place and virtually all rate reductions were achieved because regulators or legislators ordered them to be lowered, not because electricity markets work to create lower prices for consumers.

This is the ultimate hypocrisy of restructuring. Analysis of the restructured states makes it clear that consumer gains were not a function of the market, but were the result of regulatory ordered changes. Yet, deregulation advocates complain bitterly about price caps that produce the consumer savings. When states move to protect their consumers from rising prices, competitors vacate the market. For example, Connecticut, an 'A' state, recently lost its last competitive company serving residential customers, who complained that

it could not operate profitably in Connecticut because of regulations controlling the rate suppliers can charge consumers. It also cited the overall lack of a competitive electric market in the state for its decision to cease operations.³⁰

CONCLUSION

Disregarding the mounting problems with deregulation in the so-called "successful" states, the FERC and Congress are charging ahead with restructuring, seeking to impose it on the three dozen state jurisdictions that understand the risks it poses to consumers. This is a case where the cure is substantially worse than the disease.

The recent FERC actions in the California cases make it more obvious that the FERC should slow down.

- Three years after the fact, the full extent of the manipulation and abuse has not been explored.
- The proposed fines and settlements are a small fraction of the astronomical increase in prices and the FERC has failed to deal with long-term contracts that the state signed at the point of a gun.
- With the one price auction FERC adheres to every Megawatt receives the highest price in the market, even when they are bid at a low price, and the FERC has no authority recapture the windfall and return it to consumers.
- FERC does not have a convincing plan for preventing the abuse of market power, and continues to downplay the problem.
- The SMD fails to deal with windfall profits that would result from its scarcity pricing of transmission services.

The stampede to restructuring has stopped in the states; it should stop at the FERC, too.

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