

Retail Competition: A Failed Experiment, or an Essential Reform Just Beginning?

A presentation by:

Dr. John A. Anderson
Executive Director
Electricity consumers
Resource Council (ELCON)
Washington, D.C.

At the:

Harvard Electricity Policy
Group
September 27, 2002
Cambridge, MA



1

ELCON Has Long Advocated Retail Competition in Electricity

- ELCON put “retail wheeling” on the agenda for public debate
- We said then, and still believe now, that the potential benefits of competition are many – and very significant:
 - Lower prices
 - Technological innovation
 - Customer focus



2

Unfortunately . . .

- States that have decided to “restructure” actually:
 - Either deregulated monopolies or simply transferred “monopoly power” to other entities (in generation divestiture) rather than introduced competition to electricity
- The results have been very predictable:
 - Deregulation of monopolies increases prices, stifles innovation, and negates customer focus



3

LESSONS LEARNED FROM “DEREGULATION”

- The “restructuring” experiments we have seen to date demonstrate clearly the failures of “deregulation”
- The problems are many
- My remarks are organized as follows:
 - What went wrong?
 - What needs to be done?
 - Will FERC’s SMD solve the problem?



4

What went wrong?

- Major flaws included:
 - Centralized power exchanges or pools with single-price auctions
 - Gaming behavior of suppliers and load serving entities – and the lack of appropriate market monitoring
 - Flawed markets for capacity
 - Generation divestiture & the absence of vesting contracts



5

What went wrong? (Cont.)

- Major flaws included (Cont.):
 - Retail rate freezes
 - Provider of last resort (POLR) service
 - Too much focus on market designs and not enough on eliminating barriers to competition and mitigating market power
- The bottom line -- markets cannot be “designed” by committees or political compromise



6

What went wrong? (Cont.)

- Some of these factors, by themselves, are relatively benign, but in combination with other factors create serious financial or reliability consequences.
- All regions of the country are at least partially vulnerable to some or all of these factors.
- Many of these factors were the result of political compromises intended to protect stakeholders from the consequences of restructuring (e.g., rate freezes, stranded cost recovery & POLR).



7

What went wrong? (Cont.)

- Some market structures are more vulnerable to gaming and the exercise of market power of suppliers:
 - Such structures create greater risk of market failure.
 - Centralized exchanges with uniform-price auctions, or centralized pools with optimized dispatch provide fertile ground for gaming and the exercise of market power
 - The experiences in both the UK and California highlight this fact
 - Such structures should be avoided – or monitored VERY closely



8

What went wrong? (Cont.)

- Market designs that maximize the use of forward contracts in bilateral markets, are more resilient to potential market power
- The bottom line:
 - States created badly flawed retail “markets”
 - FERC created wholesale markets with inadequate market rules and monitoring
 - Market monitors are very important – but were ineffective
 - They must be given benchmarks for judging particular transactions as illegal



9

What went wrong? (Cont.)

- Both supply and demand must be (but were not) integrated within the same market:
 - Restructuring efforts to date have almost exclusively focused on wholesale-only markets as the initial market structure
 - This is a critical mistake and poses the greatest risk of market failure
- There is no “market” without a real demand response



10

What went wrong? (Cont.)

- Market design should abide by time-tested economic principles and not political influences:
 - This is an essential lesson from California – as well as many other states – and countries
- The bottom line: The California and Enron debacles focused attention away from getting it right – to getting somebody!



11

What needs to be done?

- Maximize the use of forward markets with bi-lateral contracts and tradable transmission rights
- Establish **markets** for price-responsive customer loads
- Maximize the use of all available resources including QF and other distributed generation capacity and market power mitigation
- Assure ongoing market surveillance
- Enforce short-term reliability on a nondiscriminatory basis
- Create an appropriate, but limited, transition period



12

What needs to be done? (Cont.)

- In addition, we must be assured of:
 - Adequate natural gas infrastructure
 - Adequate new generation and fuel supply
 - Adequate transmission capacity
 - Large, independent RTOs



13

What needs to be done? (Cont.)

- Short-term markets are inherently volatile and risky, but that is their function in competitive markets:
 - Market designs should not encourage or force short-term markets (e.g., day-ahead or day-of exchange or pool-based markets) to be the dominant market.
- Forward bilateral contracts in markets are necessary to cultivate competitive behavior and protect consumers from supplier market power.



14

What needs to be done? (Cont.)

- Markets—not programs—for price-responsive customer loads should be established under the auspices of each FERC-approved RTO or ITP:
 - Markets for customer load response must be efficiently integrated with the other RTO real-time markets, standardized, and coordinated across inter-RTO boundaries
- The bottom line: Demand should be treated the same as supply



15

What needs to be done? (Cont.)

- Industrial cogenerators and small power producers (QFs) have become a significant resource in almost all regions of the country:
 - Yet, these plants operate under restrictions that are not imposed on traditional utility resources for the obvious reason that QFs compete with utility resources
- QFs and other small power producers need fair and nondiscriminatory new generator interconnection rights



16

What needs to be done? (Cont.)

- Regulators and antitrust agencies must take all necessary remedial actions to eliminate market power:
 - The emerging dominance of a few large suppliers creates a vibrant opportunity for gaming and the exercise of market power
 - Demand must be engaged to check the growing ability of any supplier by itself, or with other suppliers, to profitably maintain prices above competitive levels – especially if regulators and antitrust agencies are unwilling to take appropriate actions



17

What needs to be done? (Cont.)

- Regulators and antitrust agencies ... (Cont.)
 - Market rules must be established that clearly spell out the forms of behavior that are not either just and reasonable or in the public interest
 - Market monitors could then much better differentiate between legal and illegal activities



18

What needs to be done? (Cont.)

- Effective market surveillance functions in both retail and wholesale markets are essential:
 - Independent market monitors are needed – especially in the transition
 - These monitors must evaluate the progress of competition and to recommend necessary midcourse corrections to market design, the stranded cost recovery mechanism, POLR, or other market rules
 - Very few state restructuring activities included adequate market monitoring and surveillance
 - Market monitors should be agents at FERC – not to ISOs, RTOs or ITPs



19

What needs to be done? (Cont.)

- Markets during a transition period should never be confused with the real thing:
 - Arguably, the transition period requires greater regulatory oversight and activism than before or after the transition.
- All else equal, transition periods should be brief:
 - This minimizes opportunities for gaming of the initial market structure (with potential loopholes) by incumbent or new market participants.



20

Will FERC's SMD solve the problem?

- Some form of SMD is a necessary, but far from sufficient, condition for **retail** competition
 - This certainly is not surprising since FERC doesn't address retail issues
 - However, since it is impossible to have a vibrant retail market without a fully-functioning wholesale market – and *vice versa* – the SMD is a very positive step in the right direction



21

What's good about the SMD NOPR?

- The SMD NOPR proposes to:
 - Establish a single tariff
 - Require "Independent Transmission Providers" (ITPs)
 - Emphasize the use of bilateral contracts
 - Require the ITPs to establish and operate both day-ahead and real-time markets
 - Require four large RTOs and eliminate rate pancaking



22

What's good about the SMD NOPR? (Cont.)

- The SMD NOPR proposes to (Cont.):
 - Require the inclusion of the demand-side in the market
 - Allocate transmission rights (or the value of the rights) to load
 - Emphasize the importance of market power mitigation
 - Offer great guidance regarding ITP/RTO governance



23

How should the SMD NOPR be improved?

- The SMD should:
 - Carefully define certain terms like "load" (which should not include LSEs)
 - Create a clear distinction between "transmission" and "distribution"
 - Draw a bright line between "in front of" and "behind" the meter – and require equal treatment for each
 - Clarify that all existing contracts are not grandfathered forever



24

How should the SMD NOPR be improved? (Cont.)

- The SMD should (Cont.):
 - Assure that bids in the LMP system reflect marginal costs – and take appropriate action where they are not so based
 - Assure that truly liquid and transparent forward markets develop
 - Foster a “consumer focus” that results in bi-lateral contracts – rather than an over-reliance in the spot market
 - Not result in yet another layer of regulation



25

Observations and Conclusions

- Negative experiences in CA, and in other states (and countries), demonstrate clearly a **failure of regulation** – NOT of competition
- All too often, states deregulated monopolies or simply divested monopoly power from the former utility to some other entity
 - They did not create competition



26

Observations and Conclusions (Cont.)

- The failure of regulation certainly has slowed the movement to restructuring:
 - This may be good
 - It is far better for consumers to have no restructuring – than to have bad restructuring



27

Observations and Conclusions (Cont.)

- FERC's SMD proposal is a very positive step in the right direction
 - However, much more needs to be done before end-use consumers actually see the potential benefits of retail competition in electricity
 - Specifically – We will not have retail competition that brings consumer benefits as long as states implement programs that favor the incumbent utilities and other producers
- If history is any indication (and I am certain that it is) this will take time – probably a lot of time



28