ELCON

TODAY'S ORGANIZED MARKETS – A STEP TOWARD COMPETITION OR AN EXERCISE IN RE-REGULATION?

What is ELCON?

The Electricity Consumers Resource Council (ELCON) is the national association representing large industrial users of electricity. ELCON was an early proponent of competition in wholesale and retail electricity markets.

Does ELCON still support competition in electricity markets or does ELCON now support a return to cost-of-service regulation?

Large industrial electricity consumers have believed for many years that cost-of-service regulation produces limited benefits for consumers. Under cost-of-service, utilities have an incentive to increase their capital expenditures but have little incentive to seek more efficient, lower-priced generation options or pursue innovative product offerings. There is little (or no) customer focus, because, in truth, the utilities see the state public utility commission, not the actual power users, as the customer.

ELCON continues to believe that "true" or "real" competition in wholesale and retail electricity markets has the potential to bring significant benefits to consumers and to the overall US economy. The potential benefits include competitive prices, innovative products, and a customer focus. The problem is that, perhaps with the exception of (present day) ERCOT, the so-called organized markets lack the necessary structure to promote "true" competition at a wholesale level.[1] And states that have tried to implement competitive retail markets have often included structural flaws (price freezes, politically driven stranded cost awards to generators that don't reflect economic realities, etc.). Those flaws, coupled with poorly functioning wholesale markets, have not provided the necessary foundation for effective competition at the retail level.

ELCON is advocating changes so that truly competitive markets can be achieved. Without such changes, competitive markets cannot bring the desired benefits to consumers.

Why do some stakeholders and policy makers believe that ELCON has given up on competition?

Some view any criticism of the organized markets as equivalent to a criticism of competition. ELCON members strongly disagree with this premise. Since they do not believe that the organized markets are in fact truly competitive, ELCON members believe that our criticism of

[1] ELCON is primarily focusing on three FERC-approved "markets" in this paper: NY ISO, ISO NE and PJM.

those markets is not a criticism of competition but rather an appeal to correct the problems and move on to new market structures that actually promote true competition. Unfortunately, some market participants who are profiting from today's flawed market structure use our criticism to suit their own purposes.

Have electricity markets become more competitive? If not, what conditions are necessary to increase competition?

Today's restructured electricity markets are very different than the markets of fifteen years ago (roughly, before the Energy Policy Act of 1992), but they are not necessarily more competitive.

Truly competitive markets cannot exist without at least the following necessary conditions (without regard to priority):

- **Prices must be established through an interaction of supply and demand:** Unfortunately, demand has very limited opportunities to influence prices in today's organized markets. ISOs and RTOs estimate the level of demand and then simply dispatch enough generator bids to meet the estimated load. Except in isolated instances, consumers cannot react to high prices by reducing consumption. True competition cannot be achieved without an active participation of demand interacting with supply.

- **New capacity must be "incented" through market forces – not administrative re-regulation:** Capacity "markets," both those already implemented and those proposed in the organized markets, are inconsistent with true competition. In fact, capacity markets aren't markets at all – they are simply a form of regulation. ISOs and RTOs administratively determine a "price" (which consumers pay to both new and existing generators) that the ISOs and RTOs hope will stimulate enough new capacity to assure resource adequacy. Unfortunately, not only are capacity markets anti-competitive, they simply do not work. While they take billions of dollars from consumers, they have not been demonstrated to "incent" any necessary new generation.

- **Market entry and exit should be determined by market forces:** Market forces must be allowed to discipline inefficient suppliers. However, increasingly it appears that, if high-cost generators claim they are necessary for system reliability, they will be propped up by a variety of financial mechanisms and revenue streams. Regulators have thus created their own problem. Regulatory support systems in fact negate the market forces attempting to force efficient construction and operation of generation assets. This creates disincentives for potential new entrants to invest in more efficient facilities.

- **Consumers must be able to hedge future prices with long-term bilateral contracts:** We will never have truly competitive markets until there is considerable liquidity in forward markets and both buyers and sellers are motivated to negotiate long-term bilateral contracts. Such contracts would provide price certainty. Unfortunately, today's organized markets discourage such contracts since most generators know that they can simply sell into the spot and day-ahead markets and earn very significant returns. The bilateral contracts that continue to exist are mostly "legacy" contracts left over from the sale of generation assets and the imposition of rate stabilization programs. A major problem is that today's organized markets have implemented a bidding system relying on a single-price auction that applies to all generators. In general, this allows generators to receive a price that is determined by the highest cost generating unit (usually gas in today's markets) operating at that time (the "generator on the margin"). This eliminates the benefits of fuel diversity since the low costs of efficient baseload coal and nuclear facilities are never passed on to consumers, but rather produce windfall profits for the owners of generation. Optimally, locational marginal pricing (LMP) would be limited to small balancing markets, consistent with the views of many academics (e.g., Frank Wolak) who have observed that the most competitive markets make very little use of spot markets.

- **There must be an adequate transmission infrastructure:** Generators must be able move power from the source to the load. Unfortunately, the present transmission system is characterized by a number of significant congestion points. While advocates of LMP pricing asserted that it would "incent" the construction of new generation or transmission to mitigate the constraints, the facts simply do not support such claims. Nodal pricing actually creates a greater disincentive to build, as the congestion often protects a high-cost generator from low-cost competition and thus provides sustained profits. Further, today's "financial transmission rights" (FTRs) in place of physical transmission rights simply do not adequately protect consumers from the very significant congestion costs of the transmission constraints. In addition, the joint ownership of generation and transmission encourages discrimination and gaming and should be discouraged if not eliminated.

- **Market power must be mitigated:** Suppliers with local market power can "game" the markets at the expense of consumers. The larger the number of "nodes" in an LMP environment, the greater the opportunities for the exercise of local market power because there simply are fewer suppliers at each node. The market monitoring units of the organized markets are paid for by the very markets that they monitor. This creates a potential conflict of interest. Competitive electricity markets require truly independent market monitors that are not advocates of any particular market design.

- **Finally, and in conjunction with all the above conditions necessary for competitive markets being met, wholesale price caps and bid mitigation measures may be relaxed:** Politicians often say that consumers must be protected from price spikes and volatility. In reality, the way to avoid price spikes is to (1) ensure an adequate supply of efficient, low-cost generation, (2) ensure an adequate transmission infrastructure, and (3) effectively utilize demand response. Attempts by regulators and policymakers to avoid price spikes by implementing administratively determined price caps, automatic bid mitigation procedures, etc. actually reduce the market incentives that should dampen market forces that would prevent such price volatility (although price caps may serve a legitimate purpose until "true" markets are established). Price signals can and should serve as the primary means to incent investment. After other necessary conditions have been achieved, price caps and other mitigation measures may be relaxed.

Are industrial electricity consumers alone in pointing out flaws in the Organized Markets?

No. As price freezes and fixed price contracts expire, residential electricity consumers in many states are becoming quite vocal in their opposition to restructuring. While Maryland may be the poster child of this backlash, significant opposition also has been expressed in Connecticut, Delaware, Illinois, Maine, New Jersey, Pennsylvania, Rhode Island, and Virginia.

Other stakeholders, including municipal and cooperative utilities, have also voiced their concerns about the flaws in the organized markets, as have observers in the academic and think tank communities. The daily media in the affected areas, as well as the ***New York Times***, have published analytical articles highlighting the market inefficiencies. ELCON believes that unless the problems with the organized markets are fixed, and fixed soon, political pressure will result in substantial attempts to return to regulation.

What should be the next steps?

There is general recognition among ELCON members that, due to inherent flaws, the present structure and operation of the organized markets have been very costly and burdensome to consumers. ELCON members do not believe this should necessarily mean a return to cost-of-service regulation, although that approach is favored by stakeholders in some states. Policymakers, regulators and other stakeholders must work together to actually implement truly competitive electricity markets – rather than to re-regulate and call it competition – so that the markets can provide benefits for all consumer classes.

ELCON offers the following observations:

- **States that have not yet restructured should not do so:** Roughly two-thirds of the states have not yet restructured or have begun the process but are not past the point of no return. They have the opportunity to wait until a wholesale market structure develops that can support retail competition and actually bring demonstrated benefits to consumers.

- **Today's organized markets must be fixed:** Today's organized markets are not competitive, are anti-consumer, and are likely to remain that way. As long as some (mostly utilities, generators, and the ISOs and RTOs themselves) continue to assert that restructuring has brought competitive markets and benefits to consumers, we will never seriously address the problems that consumers encounter on a daily basis. Moreover, as long as the governing structures of the organized markets are skewed to benefit suppliers, ELCON does not believe that the problems will be self-correcting. Simply "staying the course" will only extend harm to consumers. The irony is that consumers -- the ones who pay all of the bills and the entities for whom markets are designed to benefit – at best get only 20 percent of the total vote in any of the organized markets. Unless and until the governance is changed to allow consumers, at a minimum, to stop the implementation of elements that they know are harmful to their interests, necessary changes will not be made. Since the consumer opposition to the rising electricity prices is rising and rising substantially, ELCON strongly recommends that serious steps be taken to correct the governing structures and market flaws as quickly as possible. These steps must at least incorporate the seven necessary conditions listed above.

- **If today's organized markets cannot be fixed, explore all options including a return to traditional regulation:** If today's organized markets – which are not a step toward competition but in truth a new form of regulation – are the best we can ever expect, large industrial electricity consumers are prepared to explore all options, including a return to regulation based on cost of service. We recognize that in states where local distribution companies have sold their generation this may be especially difficult and will take considerable time and effort. Our preference would be that the existing markets be fixed.

12/04/06