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
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

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?
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

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
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).

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
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

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
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!

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
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

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.
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

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
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

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
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

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.
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

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
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

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
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 bilateral contracts – rather than an over-reliance in the spot market
  - Not result in yet another layer of regulation

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
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

- 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