

Plugging in the International Northeast

Recovering from Setbacks in Electric Competition Policy

Ken Malloy

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Most would agree that the revolution in natural gas markets over the last 20 years has been a resounding and unqualified success. Nevertheless, most would agree that a similar attempt in electricity markets has not yet proved successful. Why the difference and how do we get back on track?

We take the modern gas industry largely for granted. It seems little remembered these days in how much crisis the gas markets were, from around 1983 to around 1985.

There was a serious debate in Congress about whether the phased deregulation scheduled to take place on January 1, 1985, under the Natural Gas Policy Act of 1978 would result in a fly-up of gas prices and thus whether phased gas deregulation should be reconsidered. The Fuel Use Act of 1978 prohibited the use of natural gas in electric generation. You still needed a certificate to import gas from Canada. There was still a genuine debate as to whether gas resources were plentiful or in short supply. Policy relating to marketer access to pipelines was in a state of turmoil, to put it nicely. Take-or-pay debate was de rigueur. Major companies were bankrupt or teetered on bankruptcy. Many states still had a moratorium on new hookups. Frankly, gas markets then were in worse shape than electric markets now.

The Federal Energy Regulatory Commission took a series of market-oriented actions between 1983 and 1992 that gave us the modern gas industry. (They were not a moment too soon. Where would we be today if we still could not use gas in electric generation?) In 1989 congress accommodated FERC's world-view with a plan for wellhead decontrol, after earlier eliminating the consumption constraints of the Fuel Use Act.

Prior to 1992 and the issuance of Order 636, the gas industry was generally regarded as chaotic and crisis ridden. After 1992, the industry was increasingly regarded as an efficient, innovative, technology-rich, modern industry. Indeed, it is not too much a stretch to argue that the revolution in gas markets was one of the most profound success stories in both network restructuring and energy policy. (Some argue that today's high/volatile gas prices are an indication of failure. On the contrary, they are an indication of success. Few disagree that prices are driven by the need to achieve supply-demand equilibrium. Dynamic equilibrium is the quintessential characteristic of robustly competitive markets, i.e., the reason for the reform of gas policy.)

Reconstituting the Competitive Electric Movement

Regarding the current state of electric competition policy, there is surprisingly strong agreement on nine propositions:

1. In the last several years, competitive electric policy has suffered significant setbacks.
2. The setbacks have crippled the historic supporters of competitive electric policies.
3. The supporters of electric competition made serious mistakes but have learned some valuable lessons from their mistakes.
4. The United States is currently stuck in the middle of a transition between the traditional model for regulating utilities and a competitive model.
5. The uncertainty created by being stuck in the middle is untenable and unsustainable over the long-term.
6. This uncertainty creates significant risk for the nation, consumers, and many companies.
7. Current policy proposals, e.g., the national energy legislation, will not resolve and may significantly exacerbate the problem.
8. The goal of pursuing a competitive electric policy is still a worthy goal.
9. There is currently no obvious path to achieve the goal of competitive electric markets. There is no vision, no leader, no strategy, and limited funding for where we should go from here.

In light of the dramatic recent setbacks, most discussions of “where do we go from here” turn into exercises envisioning a set of more modest policy changes at either the state or federal level that would achieve nirvana. This focus is misplaced. The competitive electric advocacy movement is disorganized and in crisis and disarray. We need to take a step back, rethink our tactics and strategies, and then reemerge with a more mature understanding and set of recommendations. We should postpone many of our individual efforts and rather substitute effort to develop a cohesive strategy. Below is a seven-part framework that provides my recommendations on how we should proceed.

Vision

Proverbs 29: 18 says “Where There Is No Vision, the People Perish.” We have been very confused about our vision for the future of the electric industry. Our vision so far seems to be saving customers a penny per kilowatt-hour. This is a profoundly unexciting vision on which to predicate the blood, sweat, and tears that will be necessary to transform this industry. Far more exciting is a vision predicated on a revolution in products and services that are more commensurate with the 21st century consumer’s lifestyle, integrated with other network flowing content goods. At 4, my daughter had her own list of icons for her preferred Web sites on our computer. She understood control, self-determination, immediacy, and the role of information for decision making better than most of us do. At 7, my daughter demands broadband. When she is 30, will she accept the limitations inherent in the monopoly model? Is it really too much to ask to have a vision that is 20-plus years in the future? Something as simple as a company giving me notice before turning off any of my aging mother’s flowing content services is a service I would appreciate and be willing to pay for. Right now, no single company can perform even so simple a service.

We must be clear about where we want to go and why.

Policy

We need tried-and-true policy prescriptions grounded in reliance on “right” prices and market reliance, not stale, self-interested, least common denominator proposals. Coming up with such policy recommendations will require both maturity of judgment and sacrifice of short-term objectives.

Leadership

No individual or company has yet come forward to fill the niche formerly occupied by Enron and Ken Lay, and Jeff Skilling. The reaction to mere mention of those individuals is all that needs to be said in order to understand the reluctance of many corporate officials in being associated in a very public way with leadership and the competitive electricity movement. Nevertheless, without academic, nonprofit, consumer, political and corporate leadership it is clear that we will not make progress.

Strategy

No football coach expects to be successful without first having a playbook that contains all of the potential actions that might be taken in order to achieve success on the field. It is understood that each player will have a role in carrying out his part of the playbook. Some will have big roles some minor roles. While there is obviously a role for individual initiative in carrying out the coach’s expectations regarding the playbook, chaos and ultimately defeat follow if each player decides to go that player’s own way.

The advocates of competition have no playbook. Thus, none of us knows what role we should be playing in order to achieve success on the playing field of electric competition. We need a bold action plan that supporters can follow, not a let-a-thousand-flowers-bloom approach.

Organization

Perhaps the most pernicious legacy of Enron’s collapse is the organizational chaos left behind. Several difficult years have left the trade associations that advocate competitive electricity policies in a weakened condition. No company has jumped to the front of the line to take the place of Enron, perhaps fearing an intense level of scrutiny of its corporate practices. For whatever reason, the large think tanks, foundations, and universities have not provided the intellectual leadership on this issue that they provide on other issues. There is no coalition that is broader than corporate self-interest that would allow former secretaries of energy, governors, Nobel laureates, environmentalists, consumers, generators, utilities, and others to participate in the advocacy and support of competitive electricity policies.

We need effective organizations similar to the type that exist in other reform strategies, such as the consumer and environmental movements

Outreach

The public relations problem that the advocates of electric competition have in restoring confidence in its integrity and the efficacy of its policies is only slightly better than the challenge Saddam Hussein would face in convincing Iraq to vote for him in next year’s election. We need a

foundation of education, consensus building beyond the business-as-usual players, and a restoration of credibility to those whose support is essential.

Funding

Enron reputedly spent upwards of \$50 million a year in the advocacy of competition in the energy industry. Admittedly, much of that was self-interested to Enron's corporate objectives. *Nonetheless, that funding* represented a significant commitment of financial and personnel resources to competition policy. No company will come forward with that level of commitment anytime soon. Thus, it seems inevitable that we must organize much more effectively. No single organization will dominate the funding of the movement like Enron. We need a mechanism for pooling and deploying funding to accomplish the needed reforms.

Why Competitive Electricity Markets?

Why should we even care about reconstituting the coalition in favor of electric competition? There are five reasons to transition from the monopoly model to the competitive model.

Freedom/Choice

The central tension of the 20th century was over central planning versus capitalism. Wars have been fought to preserve/enhance freedom and choice. Completely apart from any other benefits, there is a philosophical principle that freedom and choice should be preferred over coercion and monopoly.

Rational Economic Decisions

Consumers respond rationally to the signals they see regarding prices and consumption. Monopoly regulation sends consumers distorted price signals that lead consumers to take economically irrational actions: over consume at the peak, under consume in the off peak, prefer consumption to conservation, etc.

Milton Friedman observed in *Free to Choose*¹ that the price of pencils is affected by world oil prices. More consumers would burn wood for heating to avoid high heating oil prices, and this would put upward pressure on wood. This would result in higher priced pencils and greater use of pens (substitution). The point is that command-and-control prices for goods that compete with oil are irrational when oil markets are volatile. Just as the market for pencils would be distorted if pencil prices could not fluctuate with changes in competitive inputs, so also are electricity markets distorted when they cannot respond to changes in markets in competing goods.

Notice that the goal here is not lower prices but rather to set "right prices," prices consistent with achieving supply and demand equilibrium. There is no doubt that as markets adjust to competitive forces that some customers will pay lower prices, though it is difficult to fully understand in advance all these adjustments. Moreover, some customers will pay higher prices because of these adjustments. Overall, average prices will likely be lower because facilities will be used more efficiently, but it is a mistake to argue that all prices, at all times, for all purposes, for all customers will be lower.

Innovation in Products and Services

Today's U.S. consumer is very different from consumers of the past. Consumers are increasingly affluent; computer-savvy; lead more complex, specialized lives; have more options for the use of their time; and are very busy. Consumers will demand flowing content services for our homes and businesses consistent with these consumers' lifestyle choices. I don't drive the cheapest car or use the cheapest computer, why do I want the cheapest flowing content products and services?

Recently, I became very angry when I had to use my phone to call an airline company to cancel a reservation and get special credit because of a SARS-related conference cancellation. Was I happy that the airline had a special policy that did not penalize me for a cancellation (I could have bought insurance to hedge against such an event)? No. I was ticked that they did not have a process online for me to do so. I bought my ticket on line; why shouldn't I be able to cancel it online and get the SARS credit? What was once an above-and-beyond service is now expected and even resented if it is not provided. How much longer will consumers be satisfied with flowing content services provided by monopolists that are simply not likely to be at the top of the class when it comes to innovation?

Technology Deployment

Regulation retards effective technological deployment; markets enhance it. Regulated monopolies are beholden to the entity that sets rate of return. Technology deployment thus gets caught up in the political process, with almost uniformly sorry results. As part of the response to the oil crisis, the National Energy Act in 1978 set us on a course of relying on the three-legged stool of coal, conservation, and nuclear. This seems pretty silly in hindsight. Government making wise technology choices is an oxymoron. Regulation retards effective deployment of technology by making regulators and utility executives risk averse, by blessing the wrong technologies for political reasons, and by rewarding failure. Markets are impersonal, support calculated risk, and reward entrepreneurship in effective technology deployment.

Environment

While transitioning from monopoly to competition may cut both ways with regard to impacts on the environment (maybe coal and nuclear plants will be used more intensively), the environment will undoubtedly be improved because of competitive electricity markets. The most profound environmental impact will be that consumers will have greater incentives to purchase energy-efficient products in order to avoid peak prices. Additionally, there will be less need for generation facilities as consumers seek to avoid peak prices. Overall, it can be expected that all energy facilities will be used more efficiently, thus negating the need for some new facilities otherwise built under regulation. Some consumers have shown a propensity to purchase green products to support their lifestyle choices. Most important, however, if dramatic changes in environmental policy necessitate changes in the energy production, consumption, and delivery industries, you can bet that a flexible, responsive, innovative industry structure will accommodate such changes better than the alternative.

Troubled Waters

With a fairly strong case in favor of transitioning to a competitive electricity policy, it is fair to say that the goals of such policy have not been realized in the initial decade of implementation. In short, we screwed up.

The major disasters are well known. Events in California continue to be affected by the impact of their well know energy problems. (Would Arnold be governor today without the electricity crisis?) The collapse of Enron has left a bitter aftertaste that will spoil appetites for many years. The meltdown of the trading sector will have impacts for several years to come, that are even now underappreciated. Lastly, the Blackout of 2003 colors our perception of a policy that relies on markets not regulators.

One can make, and I have made, arguments that is unfair to blame deregulation for all (or any) of these calamities. Nevertheless, it cannot be denied that it the attitudes of many consumers and policy makers have been negatively affected by the close proximity of these events to competitive electricity policy.

In addition to these major above-the-fold events, there have been a series of minor setbacks that affect attitudes toward the electricity competition:

- Ontario price caps
- Volatile natural gas prices
- FERC's delay and missteps with Standard Market Design Rulemaking
- Sluggish economy
- September 11 and its diversion of attention to security
- Global Crossing and World Com
- Decline of Pennsylvania's retail market
- Failure of so many retailer marketers
- Consumer Reports article on deregulation

Despite the setbacks, there has been some good news. The quality of FERC appointments has been very high, but there have been delays in confirmation. FERC continues to be committed to the development of competitive wholesale markets, despite the opposition of many parts of the country. PJM (Pennsylvania-New Jersey-Maryland reliability council) and Texas continue to mature and provide laboratories for understanding the impact of different policies. The North American Energy Standards Board continues to put into place the nitty-gritty governance structure that will be necessary to promote standards for gas and electric wholesale and retail markets. Gas markets, despite their volatility, continue to be a success story in terms of innovation and non-crisis oriented response to rather dramatic changes in supply and demand. Georgia's gas market, despite its rocky start, is now in the fifth year of 100 percent of its retail customers buying gas from a competitive supplier. Somewhat cynically, crisis provides context and motivation for leadership and action: people are worried and will respond to coherent strategy if one is developed.

Thus we have our job cut out for us. We, the advocates of competition, have made some mistakes. We need a period of reflection, followed by confession, request for forgiveness, genuine contrition, and eventually redemption.

Post Mortem

Let us begin with reflection. There are differences between natural gas, telecommunications, interstate highways, airports, Microsoft, movie theatres, and lots of other network facilities with limited access to bottleneck facilities. Nevertheless, let us start with the premise that it makes sense for society to apply a consistent set of policies to network facilities, including electricity, that result in competitive conditions for the inputs and outputs to that network. Why, then, has it

proven so difficult to implement these policies for electricity? What follows is my best effort to understand where we (advocates of competition in the electric industry) went wrong over the last decade in applying a fairly well understood template to another network industry.

Federalism

The nature of the federalism issues was dramatically different for electric than for natural gas. In natural gas, FERC had plenary jurisdiction over the entire wellhead and wholesale infrastructure. Because the industry was not vertically integrated, the line of demarcation between federal jurisdiction over pipelines and state jurisdiction over distribution activities was well understood. (That is not to say that there were not some debates relating to federalism in gas policy reforms.)

Electricity on the other hand poses far more challenges in the federalism arena. The fact that many utilities are vertically integrated means that states have control over a much more significant percentage of the industry. The fact that FERC does not have siting authority for wholesale electric facilities the way that it does in gas gives states much more power in the regulatory relationship. Given these differences, it is surprising that advocates of competition for electric did not understand how much greater these differences would be as barriers to the effective implementation of policy.

Ignorance/Dishonesty

Electricity competition was sold on the basis that it would lower prices. There were referenda in both California and Massachusetts where the case was made in the most public way possible that prices would go down because of the implementation of competitive electric policies.

While it is certainly true that prices will change rather dramatically because of competitive electric policy, it is simply not true that all those price changes will be in the direction of high to low. Some prices, especially peak prices, will go higher than consumers have typically seen and maybe higher than they are comfortable with, hence the motivation for consumer change in behavior. During periods of supply/demand disequilibrium due to the inevitable timing issues in bringing major facilities online will result in higher prices during certain periods. Rather than selling electricity competition based on rational electric rational economic decision-making it was sold on a basis that was either gross ignorance or outright dishonesty. When the initial competitive reform attempts resulted in higher prices, consumers felt deceived and betrayed. This backlash may be the most serious impediment to the future success of electricity competition policy.

How does this differ from what happened on natural gas? There is little question that gas prices were a significant part of the problem in the early 1980s. While advocacy of gas competition policy was predicated largely on rationalizing economic decisions, it is surely the case that gas prices were perceived nationally as higher than necessary and that prices would decrease because of competitive price reforms. Indeed, the immediate experience after these reforms were implemented was a very low price environment for more than a decade. In that sense, one could argue that we were luckier on gas than electric.

Disorganized

Enron was the undisputed leader of electricity reform policy. They adopted both a lone-wolf attitude and scorched-earth tactics. There were many other companies and organizations that supported competitive electric policies but for the most part we played roles at the periphery of

Enron's advocacy. Because of Enron's dominance, there was no cohesive organization to competitive electricity movement. Thus, as a result of Enron's demise, we should not be surprised that there is not an immediate infrastructure of influence capable of taking over in the vacuum left by Enron.

Neither a single company nor a single sector of the industry dominated the coalition that favored competitive gas policies. Ironically, Enron found its growth opportunity in the mid-to-late 1980s because of the implementation of competitive gas policy.

Diversity

The advocates of gas competition only had to be successful in three policy arenas. They certainly had to be successful at FERC and the executive branch (including the Department of Energy), and they at least had to be successful in preventing Congress from taking any action that would have been inconsistent with competitive policies. (Indeed, it helped that in certain areas Congress cooperated and took action consistent with competitive gas policies.)

The advocates of electric competition, on the other hand, were required to argue state-by-state, RTO (regional transmission organization) by RTO, for reform policies. The lack of centralized decision-making resulted in an amazing diversity of models of competition. While such diversity is often argued as one of the strengths of states as laboratories of change, given the nature of network industries, the need for integration, and the need for scale in order to achieve success of competitive markets, this diversity was crippling.

Overreaching

In the gas area, attention focused on the federal players for the decade of the 1980s. It was well understood that policy would have to change at the federal level before it made sense that policy changes at the state level were needed or appropriate. Thus, there was no simultaneous demand for federal and state policy changes to bring about competitive markets. (States were of course involved in the debate at the federal level and eventually in accommodating to changes made at the federal level. However, their cooperation was not, however, absolutely necessary to effective implementation of policy.)

During the mid-1990s, there were simultaneous demands for both wholesale and retail electric changes, as well as for retail changes on natural gas. This simply bit off much more than could rationally be handled by the advocates of competition. Because these battles had to be fought on so many different fronts, it stretched too thin the resources available for effective implementation.

Mixed Motives

In the gas area, there was the obvious standoff between the advocates of competition and the opponents of competition. While there were many subsidiary issues that had to be resolved in order to implement effectively gas competition policy, this did not significantly affect the direction of policy.

In electric, on the other hand, much of the change in policy was actually predicated not on the desire to promote competitive markets but rather to achieve a wide variety of other objectives:

- States and the federal government were vying for control of the two functions that will remain regulated (transmission and distribution).

- Many utilities used the deregulation initiative to seek compensation for bad investments (“stranded” costs) and to get illicit competitive advantages in place as part of the deregulation program.
- Some larger customers (mostly industrial) used deregulation as a pressure point for getting cheaper long-term contracts from utilities.
- Small customer advocates (mostly residential) demanded that regulated prices be reduced and price caps be put in place for extended periods.
- Environmentalists insisted that reform include public benefits charges and renewable portfolios.
- Governors and state legislators saw it as either economic development or a payoff to politically powerful interests (mostly utilities and industrial customers).
- Congress could not overcome the tension between a Republican obsession with command-and-control supply and a Democrat fixation on command-and-control conservation. Neither party has a strong interest in competitive policy.

Short-Term Focus

The advocates of electric competition adopted a short-term, quick-fix approach to achieving political victories. Again, the referenda in Massachusetts in California are instructive. Rather than take a decade to educate consumers on the complex benefits of relying on competitive market forces for electricity, the advocates went for quick victory.

The advocates of competition often adopted the silver bullet approach to advocacy. Rather than adopt a strategy that would result in competitive energy markets over a decade, there was often the demand that an action be taken in a given state in a six-month period in order to achieve some immediate, though imperfect success. This is understandable given the half-life and financial challenges of many companies in the competitive arena, funded far more thinly than the utility advocates they were facing in many venues. Nonetheless, it helps explain the situation circa 2004, stuck halfway between the monopoly model and the competitive model, garnering the disadvantages of both in the advantages of neither.

In the gas arena, perhaps because we had been fighting these battles since the 1954 Phillips Petroleum decision, it seemed well-understood that a decade or more transition would be necessary to move the industry from its monopoly policies to a competitive paradigm.

Complexity

Few would disagree that electricity is a far more complex commodity/industry than either the gas or the telecommunications industry. Advocates of competition severely underestimated how this complexity would undermine the effective advocacy of policy change. Legislators and consumers, indeed even many state regulators, were ill-prepared for the complexity involved in electricity policy changes.

Technophobia

When the book is written on the history of electricity policy reform 25 years from now, the main story will be about the transformation that technology made in moving from a creaky monopoly industry to an efficient, innovative competitive industry. Nevertheless, the advocates of competition were often obsessed with price-reduction mindset rather than a technology-inspired

message. Telecommunications possibly provides the best contrast. While it is certainly wonderful to make as many local and long-distance calls as desired for \$49, the whiz-bang nature of fax, cell phone, Internet, and digital technology is what truly makes telecommunications policy reform exciting. There is a singular inability it seems to paint as exciting a picture of technology change in electricity.

In gas, it seemed easier to develop a technology message relating to 3-D seismic, natural gas vehicles, and cogeneration to a more sophisticated decision maker.

Selfishness

Again, largely driven by the financial considerations and the need for short-term gains in order to maintain business objectives, the advocates of electric competition were much more selfish in their advocacy. It was not well-understood that there was a need for long-term, major readjustments in market mechanisms and institutions that required short-term sacrifice. It seemed that on gas there was greater leadership and statesmanship. (Though, interestingly, the beneficiaries of gas reforms have put very little effort into providing leadership on electric competition unless they also have corporate interests in electric. Statesmanship is now about caring about your grandchildren, not your immediate corporate bottom line.)

Conclusion

We have broken up telephone, natural gas, airline, trucking, and railroad monopolies over the last 25 years and consumers have received spectacular benefits in terms of price and technological, product, and service innovation. I know that I will hear carping about how even these deregulation policies were not perfect and we get squeezed like sardines on airlines, called at dinner by long distance telephone companies, and natural gas prices are higher. Nevertheless, believe me, you would not want to trade the good for the bad.

We have had enough time to lick our wounds and ruminate on what happened. Only a few years ago, it seemed inevitable that the tide in favor of competitive electricity markets would sweep across not only the United States, but North America and eventually the world. Alas, as a former deputy secretary of energy argued to me, “We’ve lost that sense of inevitability.” It is time to internalize the lessons of our past failures, maturely and sacrificially develop a vision and strategy for the future, and then commit the resources both financially and personally to implementing a coherent framework for the future of competitive energy markets.

Ken Malloy is a founder and CEO of the Center for the Advancement of Energy Markets (CAEM). It is an independent, nonprofit, Washington think tank founded in 1999 to promote market-oriented solutions to the energy challenges that confront the nation. It established an affiliate in Canada in 2001. Comments can be sent to kmalloy@caem.org.

NOTES

¹ (1990). New York: Harvest Books.