



Consumer Federation of America

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## **ELECTRICITY MARKETS: THE FEDERAL ROLE IN THE DEREGULATION TRAGEDY**

Statement of  
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On behalf of  
Consumer Federation of America<sup>1</sup>  
Consumers Union<sup>2</sup>  
Subcommittee on Energy and Air Quality,  
House Energy and Commerce Committee's Subcommittee  
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Mr. Chairman and Members of the Committee,

I am Dr. Mark N. Cooper, Director of Research for the Consumer Federation of America. I greatly appreciate the opportunity to appear before you today to offer the views of the Consumer Federation of America and Consumers Union on deregulated electricity markets.

I have submitted for the record three CFA analyses of the real world performance of electricity markets since the beginning of restructuring. They do not present a pretty picture, but they come as no surprise to us. From the start of the electricity deregulation debate over 15 years ago we have warned policymakers that the fundamentals of electricity service – “the physics of electrons and the economics of electricity” – make it virtually impossible to create orderly retail markets that will benefit residential consumers.

We have an open mind about the wholesale generation market and aggressively supported the Energy Policy Act of 1992. Unfortunately, in years since that Act became law policymakers made two fundamental mistakes. State policymakers pushed deregulation from the wholesale market into the retail market and federal policymakers failed, totally, to create an open and vigorously competitive interstate market. These mistakes are the root cause of the chaos in electricity markets across the country today.

Electricity is a vital commodity in a vulnerable market. It cannot be economically stored, has no substitutes and requires perfect, instantaneous balance. The rigorous real-time physics

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<sup>1</sup> The Consumer Federation of America is the nation's largest consumer advocacy group, composed of over two hundred and forty state and local affiliates representing consumer, senior-citizen, low-income, labor, farm, public power and cooperative organizations, with more than fifty million individual members.

<sup>2</sup> Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide consumers with information, education and counsel about goods, services, health, and personal finance; and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of *Consumer Reports*, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports*, with approximately 4.5 million paid subscribers, regularly carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

of the electricity network make it susceptible to highly disruptive accidents. Surplus generation and transmission capacity are not generally available and take long lead times to build. Inelasticity and weather-sensitivity of demand make electricity prone to severe peaks and programs to rapidly shed load have not been developed.

Premature deregulation led to profit maximization that tightened electricity markets by reducing supplies, limiting reserves, eliminating back up requirements, undercutting conservation programs, and preventing facilities from being built. The small number of suppliers and the tendency for electricity product and geographic markets to be highly restricted in time and space make the exercise of market power and the implementation of gaming strategies that drive prices up easy to execute. Price spikes produce such huge windfalls that suppliers exhibit an OPEC-like (backward bending) supply curve, in which supplies are reduced, not increased, as prices rise.

Ignoring warnings about the existence of market power and capacity constraints, the Federal Energy Regulatory Commission (FERC) irresponsibly deregulated the wholesale market. Federal policymakers should never forget that FERC fought for control of California markets and deregulated them over the opposition of many in California. In California and elsewhere, FERC rubber stamped industry rules for operating the grid that are prone to manipulation and abuse. FERC's voluntary approach to forming regional transmission organizations has failed to produce nondiscriminatory access. FERC allowed a wave of mergers to concentrate generation markets, rendering them more vulnerable to the abuse of market power. FERC made matters much worse by refusing to exercise responsible oversight authority until very recently, when the abuse became just too blatant to ignore any longer.

Managing the complex set of real-time transactions necessary to physically and financially clear electricity markets raises transactions costs and has resulted in institutions that are plagued by manipulation and gaming. California's market institutions may appear to have been particularly flawed – including split markets for various types of energy and transmission, an auction that paid all producers the highest price allowed, a lack of reserve requirements, and a ban on long term contracts – but there is an ongoing debate about how important these factors were in comparison to the underlying problems of market power and the nature of the commodity. Markets with different institutions have suffered similar problems, albeit not as severe as California's.

The inevitable result of greed, irresponsibility and mismanagement of a vital commodity in a volatile market is a dramatic run up in price and a massive, unjustified and economically inefficient transfer of wealth from consumers to producers. In one week in 1998 in the Midwest, \$500 million changed hands. Well over a billion dollars of rents was collected in California before the summer 2000 problem and billions more are being litigated for the summer's debacle. The California Independent System Operator has asked for over \$500 million in refunds for last December/January. Over \$70 million was collected in spike costs in New York City in one day. The New England power pool experienced price run-ups and PJM has been afflicted with dramatically rising capacity charges.

Competition has recently collapsed in the places like Pennsylvania and utilities there are seeking to bust their price caps, just as in California. This in spite of the fact that restructuring in Pennsylvania was supposed to be easy because of high prices at the outset, excess generation capacity, and location in the middle of a long standing power pool, well-endowed with transmission assets.

To the extent residential ratepayers have benefited from restructuring, it has been a result of rate reductions mandated by regulators not driven by market developments. In fact, a good case can be made that, given market conditions, consumers would have saved as much or more under effective regulation, without exposing them to price spike risk. Under the best of circumstances, for residential consumers, electricity restructuring was a solution to a high cost problem that has not worked very well, under the worst of circumstances it threatens to make them much worse off.

Consumers now face claims that larger reserve margins, higher capital costs, and faster depreciation are necessary to make the market work, in addition to new transaction costs resulting from the creation of new market institutions. Gone are the fanciful claims of 40 percent savings that were used to sell electricity restructuring to the public. Rather than bring dramatic new innovation and efficiency to the market, many of the entrants seem to have based their business models, and policymakers based their projections of consumer savings, on the ability to sell electricity powered by cheap natural gas. When cheap gas disappeared, so did the benefits of electricity restructuring.

Consumers resist effort to force price spikes into their bills, and rightly so, because a large part of the market price run up is caused by artificial scarcity, abuse of market power and the pure stupidity of poorly designed markets. Until utility industry institutions demonstrate that they have wrung the inefficient and unjustified rents out of the system, consumers are unwilling to bear the burden of dealing with legitimate scarcity problems. This resistance is reinforced when they discover that the solutions now proposed are to use mandatory economic dispatch in transmission, long term contracts in supply, and vigorous interruptible and conservation programs on the demand side. In other words, after wasting tens of billions of dollars, we find that the old system works better.

I have been all across the country educating state policymakers about what went wrong, and here in Washington I will focus on the large role that failed federal policy played in this tragedy.

The failure to recognize the important role of the continuing monopoly in transmission resulted in the under-regulation of the wires segments of the industry. The transmission wires are the highways of commerce over which electricity flows. This is a highway system, not a market, which constitutes an essential, bottleneck facility with virtually no redundancy and never likely to support head-to-head competition. One of its primary inputs is right-of-way, which relies on governmental power of condemnation. The biggest obstacle to the expansion of transmission capacity is a social externality – public concern about ugly wires and local health effects – not inadequate economic incentives. Proposals to let the marketplace solve the wires problem are not likely to succeed, since given the market power that the wire “owner” would possess and the non-market barriers to expanding capacity, profit maximization would only result in the abuse of market power and the creation of artificial scarcity rents.

The right model for transmission is a public or private entity imbued with the public interest and dedicated to ensuring that this essential facility fulfils its public functions – ensuring reliability and supporting nondiscriminatory market transactions in the widest area possible to achieve economies of coordination and maximum competitive effect. It must be independent of market participants and directly accountable to public authorities for achieving those goals. Transactions must be standardized and transparent, with the creation of an exchange in which all rates terms and conditions can be identified. Brokers must be subject to rules that are similar to those applied to financial transactions like stock sales.

The generation market must be demonopolized before it is deregulated. FERC should reconsider market-based pricing for markets that have not been found to be effectively competitive. Ownership limits should be established and additional mergers should be denied until effective market structures are defined.

Aggressive policies to discipline abuse of market power should be implemented. It is critical to monitor closely the supply, bidding and pricing behavior of generation entities even in markets where divestiture and/or open access have taken place. The basic supply and demand conditions in electricity markets may be so severe, that market structures that are traditionally defined as competitive will break down situationally.

Abusive conduct must be identified, investigated, eliminated and punished. Much closer market scrutiny than has occurred in the first few years is necessary. Law enforcement must be proactive, rather than reactive. It may be necessary to turn law enforcement over to agencies that have no stake in the day-to-day operation of the industry. It may also be necessary to identify a broader range of practices that are per se illegal, or at least trigger heightened scrutiny and to have a broader range of disciplinary measures to reflect the especially vulnerable and volatile nature of the commodity. Triggers for heightened scrutiny should be based on well-known structural conditions that are believed to increase the likelihood of the exercise of market power. Any entity that has engaged in market tightening behavior and later profited from actions that exploit the tightness should be subject to greater scrutiny.

Consumers express a strong commitment to reliability and an aversion to price shocks. This is the baseline against which "competition" will be judged. The most obvious means for preventing the overheating of markets is to have adequate reserve margins. However, in a competitive market, it is not clear that any supply-side entity has an interest in carrying excess capacity. For firm residential and small business customers, it may be more important to develop programs that let them enjoy stable prices without sending utilities plunging into markets to avoid blackouts. Proposals to build peaking reserves at stabilized prices become attractive if markets are going to be extremely volatile. Distributed generation and interruptible industrial load could provide a source of reserves on which utilities could rely to prevent price spikes. Aggregators could provide these functions.

Having experienced repeated spikes, policymakers should also implement a series of circuit breakers to prevent the sort of abuse that has occurred. The most obvious circuit breaker is a price ceiling or cap that simply does not allow trades to take place at prices above a certain level. Caps on wholesale prices that are uniform throughout the relevant interstate market – most likely intertie-wide -- should be set to protect consumers from wild price swings and to prevent energy suppliers from forum shopping and pursuing beggar they neighbor behaviors.

My advice to state policymakers has been simple. Forty-seven of the lower forty-eight states are interconnected in the interstate grid and few have adequate generation resources to stand alone. They are dependent on a well-functioning interstate market and should not restructure retail markets until federal authorities demonstrate they can actually produce open, efficient, competitive interstate markets. Given the track record of the past decade and the current attitude of federal regulators, it is unlikely this will happen any time soon. Retail competition was always a dubious proposition for residential ratepayers. In the face of the failure of interstate markets, it is no longer just a disaster waiting to happen, it is a disaster that is actually happening in markets across the country.