

Restructuring is Not Deregulation: “Regulated” Markets and Competition are Not the Same

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Introduction

There has never been a full political debate conducted concerning the advantages or supremacy of either markets or regulation for meeting energy needs in this country. Consequently, regulators across the nation have mostly combined the two ideas, while not rejecting or preferring either. Cautious politicians also prefer the word “restructuring”, since this gives them more room to hide if recent shifts towards competition/deregulation “fail.”

It is impossible, therefore, to characterize what is now happening in the energy world as either perfect competition or traditional regulation. For example, is it bad regulation or constrained markets saddled with price caps and must-run tariffs that is causing power shortages and threatening reliability? What is developing is a hybrid that combines elements of competition and regulation. Whether this hybrid will be successful remains to be seen.

Much is at stake. Will states that brought competition to retail natural gas consumers roll back reforms and restore regulation? Will broad political support for the short-term benefits of wholesale electric price caps mean that these will

* In the interest of full disclosure, some of our recent clients have interests in these matters. They include Duke Energy, Florida Power and ANR Pipeline Company. Nevertheless, the views expressed are entirely our own and no client has reviewed or approved this paper.

become permanent policies that cause a return of planning and, perhaps, distribution company investment in new rate base generation?

Most experienced hands know that the devil is in the details when it comes to public policy. Few would be surprised that self-serving arguments are being foisted on the restructuring process. The current policies and results are everything but competition and economic efficiency. The jury is still out as to whether or not the net effect will be “good or bad.” More precisely, the question is whether across the nation competitive markets or neo-regulation will rule.

The push to restructure the electric industry and to develop new institutions has tended to push state regulators towards doing something (i.e., letting markets decide) that they are not yet 100 percent comfortable doing. This innate distrust, combined with the inertia omnipresent in government, has caused regulators to develop a hybrid system that is neither fish nor fowl. These hybrids are likely to fail. And when they do, markets and “competition” will be the handy scapegoat. Not only is this blame misplaced, it could cause regulators to stage a full-scale retreat from the brink of actually letting competitive markets determine efficient prices and quantities. If such a retreat occurs, it is not likely that we will again reach this historic point in the near future. Regulation will become more firmly entrenched than ever and competitive markets will not develop. This would be truly unfortunate.

Recent events in California have pushed the competition versus regulation issue to the political forefront. In this paper we will discuss the California Public Utilities Commission's (CPUC) reaction to recent blackouts in San Francisco and

price spikes in San Diego. We will also discuss how these reactions and Governor Gray Davis' recent order to regulators to slash prices in San Diego signal a desire to return to the "good old days" of regulation

Further, there are interesting and troubling events occurring in states that have not yet fully embraced competition. We will discuss two examples where regulators and consumers in states that are still fully regulated are being duped by proponents of what is best described as pseudo competition.

This paper reviews three fundamental errors being made across the nation that are confounding markets, and setting back competition. California offers chilling evidence of the negative effect on competition that these errors can have. Alarming, these errors are serving as examples that are being copied elsewhere. These categories of failures are

- Using administratively set prices (in the guise of price caps and reliability prices), in a market setting, that nullify efficiency and hurt the consumers that are intended to protect
- Encouraging new entry in a form that undermines incumbents and causes regulated consumers to subsidize new entrants and pay more for energy
- Using retail competition restructuring to invite political compromises, not competition, in a new round of special interest neo-regulation

Administrative Prices

“What is the value of reliability?” This is a good regulatory question. The regulatory answer generally sets the bar at a level applicable to all. Recall the general wisdom that regulation provides the same vanilla flavored service to all customers. Pundits asserted that markets would not be so limited, providing many additional services in addition to the traditional plain vanilla offering. Competitive markets and tariff unbundling are supposed to think and act differently than regulated markets. Left alone, competitive markets would offer various new services to customers, including reliability services. Left alone, the historic single reliability service provided in lockstep to all customers would grow into a myriad of new services designed to meet each customers’ specific and unique needs.

In competitive markets, supply shortages naturally will trigger price spikes. This is the normal order and is to be expected. These prices would simultaneously signal the value of new supply-side investments and cause customers to search for substitutes on the demand side. Both responses initially would ameliorate price spikes. They would also work to restore long-run dynamic competitive market efficiency through new investments. Competitive markets recognize that different customers have different tolerances for interruption and reliability. Competitive markets would price various reliability services in response to these differences. This would allow consumers with different reliability needs and sensitivities to respond differently if given choices in a truly competitive market.

However, the burgeoning restructured market and its newly created institutions seem incapable of accepting such competitive outcomes. There is growing evidence that regulators and regulators-lite (e.g., some ISOs) do not trust markets to do their job. There are two recurring examples that drive home this point. These anti-market actions and restrictions deny both consumers and producers the benefits of competition.¹

Price Caps

The first of these anti-market actions and restrictions are price caps. In the several months leading up to the current summer season, the nation has heard the “cry for price caps” for wholesale power to “protect” consumers from high demand and tight supply. Think about this. A price cap ameliorates or even negates the signal for consumers to curtail demand or seek out substitutes. Price caps cause producers to look to other markets in the short-run and to reduce investments in new capacity in the long run. This is exactly opposite what a competitive market would do if left to its own devices. There is not much here for consumers.

Price caps inflate demand and reduce supply at precisely the wrong time. Markets do not work this way. Those regulators and ISOs that are adopting price caps are falling back to a regulated world using administrative fiat to control prices. Unfortunately, this sends the wrong signals. Competition is not

¹ Worse, new institutions such as the California ISO falsely seem to believe that their actions will not have any serious spillover effects outside their immediate jurisdictional concerns. Electric utilities in neighboring states know that they are indeed affected by Cal-ISO pricing policy and terms of service.

supposed to rely on self-serving advertisements suggesting that consumers should not buy a competitively sold product by turning off their air conditioners during hot weather. This is akin to airlines telling people to avoid traveling at Christmas. Price signals should be sent and consumers should make free choices. If most consumers like air conditioning during peak use periods and are willing to pay high prices for this service, a competitive market should allow this to happen. In this way, consumers send signals to investors by paying these higher prices. Producers will take note and enter this market. Consequently, there will be more supply, and prices will drop until the market reaches equilibrium. When price caps are in place, incorrect price signals are sent. Consequently, new supply will not respond and the supply shortage problem that caused regulators to panic will remain unsolved. Price caps today require price caps in the future.

Reliability Payments

A second widespread example of administrative pricing trumping markets is the manner in which ISOs and the Federal Energy Regulatory Commission (FERC) sets reliability rules, terms and prices in electricity markets. The rhetoric for markets here is strong. FERC Order 2000² strongly endorses competitive

² Regional Transmission Organizations, 18 CFR Part 35, Docket No. RM 99-2-000, Order No. 2000, 89 FERC ¶61,285 (issued December 20, 1999)

markets, performance-based incentives and price signals for the purpose of managing congestion and achieving reliable electricity grids³

Unfortunately, the actual regulatory rulings that address congestion relief and reliability lack the intestinal fortitude of FERC Order 2000⁴ Exaggerated horizontal market power concerns are often used to create a buyer monopoly that can and does use its reliability-must-run (RMR) authority to avoid zonal pricing, and to mute any reasonable signal for transmission system expansion. For example, in California, congestion is handled by administrative fiat that “manages” reliability and prevents markets from doing the job that they can best do. All of this causes new generation decisions to be made without the checks and benefits of reasonable and important engineering and economic information. Once again, consumers and producers are not provided with appropriate price signals

The result is a triumph of institutional bullying and hometown refereeing over both sensible coordinated system planning (the old regulatory order) and competitive market price signals (the new paradigm) Regulators in this neo-regulatory regime promise to come roughly close to market answers However, they deliver precisely the wrong relief

³ While emphasizing that it intended to be flexible in reviewing congestion pricing proposals, the Commission re-emphasized that “markets that are based on locational marginal pricing and financial rights for transmission provide a sound framework for efficient congestion management” (FERC Stats And Regs ¶32,541 at 33,742) Again, reemphasizing its comments in the NOPR the Commission stated that congestion pricing proposals should “ensure that the generators that are dispatched in the presence of transmission constraints must be those that can save system loads at least cost, and limited transmission capacity should be used by market participants that value that use most highly” (Id At 33,754-55)

⁴ Recent FERC actions in the northeast may prove this wrong See ISO New England, Inc., Docket Nos EL00-62-000-002, ER00-2052-000, 002, and 003, New England Power Pool, Docket No ER00-2016-000, Central Maine Power Company, et al v New England Power Pool and ISO New England Inc., Docket Nos EL00-59-000 and ER00-2005-000, 91 FERC ¶61,311 California, however, is definitely on a very different page and these comments apply

It is self-evident that some generators are needed for reliability due to their location, regardless of their running cost. With transmission constraints, these units could potentially charge prices based on what the market would bear for transmission. This is exactly what locational rents are supposed to do in the short-run in competitive markets. Left to themselves, markets would use locational price differences to send pricing signals that would bring forth new investments and/or shift demand. This is not horizontal market power running unchecked. It is what happens when networks have capacity constraints that create different zones or markets. Regulators' fear of monopoly power abuse causes them to abandon markets and to replace them with monopoly buyers (i.e., ISOs and RTOs) that, similar to some medical suppliers, set prices and determine need.

The Cal-ISO and FERC have seemingly rejected comprehensive zonal prices⁵ to address reliability and congestion. Worse, these regulators find it reasonable for reliability suppliers to receive regulated prices for the services they must provide. This policy will maintain itself and prove unable to relieve transmission constraints efficiently in either the short run or the long run.

This pricing policy sets the administratively determined prices equal to competitive prices outside of the zone, or relevant location, in which the plants generate electricity. In other words, such reliability pricing schemes (1) ignore

⁵ See for example Pacific Gas & Electric Company, Docket Nos. ER98-494-000, ER98-1614-000, ER98-2145-000 and ER99-3603-000 (issued June 7, 2000). In this case, the Administrative Law Judge was charged with ascertaining the appropriate charges for RMR service at three power plants in the San Francisco, CA area. The ALJ recognized that the RMR plants were a hybrid and that cost based rates for the RMR services were a vestige of traditional cost based ratemaking. Nevertheless, the ALJ noted that RMR status was necessary to mitigate any locational market power the generator might have and that net incremental cost compensation was adequate to reimburse the generator for all costs associated with RMR unit obligations.

the value of location; (2) mask appropriate price signals so that the market will not ameliorate transmission constraints that cause locational pricing differences; and (3) sets price equal to competitive prices that occur outside the relevant geographic market. This is an administrative recipe guaranteeing that congestion will continue. This means that RMR regulation will also continue indefinitely.

The regulatory rhetoric makes it sound like competition has arrived in California. The practice, however, denies sending signals to eliminate transmission constraints. This approach fails to put a reasonable value or price on reliability. Worse, the California ISO policies reject the use of market prices to relieve congestion. While not as efficient as allowing competitive markets to do their work, there are administrative terms and prices that would come closer to a competitive result than current Cal-ISO tariffs. For example, most run units could be dispatched and paid the system lambda of the generator within the constrained zone that clears the market. This could constrain market power, while using intra zonal price differences (i.e., locational marginal cost pricing).

There is also a growing awareness that owning electricity transmission may be very undesirable. This is an additional reason why congestion and reliability relief are unlikely to be addressed in the future. There are three reasons for this conclusion. First, transmission ownership often forces vertically integrated utility companies to accept onerous customer service/distribution operation restrictions and regulatory handicaps in new competitive markets. Second, owning transmission plays into vertical market power fears and supports

strong efforts to force utilities to divest generation assets. Third, a FERC Administrative Law Judge has recently set the authorized Return on Equity (ROE) for transmission assets owned by a utility and operated by an ISO at 9.68 percent.⁶ While the FERC eventually restored Southern California Edison's ROE to the level at which it was prior to the time it transferred operational control over its transmission assets to the Cal-ISO, there is no guarantee that future decisions will not be as draconian as the initial decision made by the ALJ.

Under such circumstances, few investors can be expected to upgrade or expand the electricity transmission grid. With growth, reliability problems and congestion will increase. Existing transmission will become economically scarce and increase in market value. This would normally result in new investments in congested markets. Alas, the current Cal-ISO practices and tariffs mean that there would be insufficient incentive to construct new transmission facilities. This will require a permanent role for price caps on generation, indefinite reliability must-run status, and, in the near future, new priority/allocation schemes to manage the market. Worse, the future perceived failures (i.e., higher consumer prices), will lead to demands to reinstitute comprehensive regulation. With all the anticipated market restrictions already in place, the task to restore regulation will be relatively easy.

The Cal-ISO and FERC are acting like deer frozen in a car's headlights. Only here the car is a fear of locational horizontal market power that causes them to reject meaningful locational market pricing. Fears of ridiculously low returns on equity will prevent new investments that could improve reliability and reduce

⁶ Southern California Edison, Docket No. ER97-2355 et al. (March 31, 1999)

congestion. Fear of or a repulsion to profits seem to have driven regulators to use tariffs and rules that reflect the very regulatory principles that restructuring was supposed to replace. These rules and tariffs also cause new problems that require more regulatory tinkering and solutions. Markets do not require micromanagement, monitoring and endless fine-tuning proceedings. These problems would be eliminated if regulators would trust the market to send appropriate price signals. Until this happens, neo-regulation will reign and markets will be unable to fully develop.

Recent Events in California

Two events have recently roiled the electricity market in California. First, in June 2000, San Francisco was hit with a series of rolling blackouts. Second, San Diego, the first city in California to pay market prices, faced soaring prices that resulted from a combination of extended hot weather, transmission constraints and power shortages. Governmental and regulatory reaction has been swift and predictable. Markets were blamed. Governor Gray Davis called for the CPUC to initiate an immediate investigation into the reasons for the blackouts and price spikes and to devise a solution that would prevent their recurrence.

In response, the CPUC conducted its investigation and on August 2, 2000, released its report to the Governor. The report assesses blame and presents various assessments for controlling the problem. The solutions proposed by the CPUC threaten an end to the competitive market in California.

The Blame Game

The CPUC asserts that the blackouts and price spikes were driven by “hot weather, aging power plant and transmission infrastructure, and dysfunctional bidding behavior in the wholesale power markets .” Then, in classic regulatory fashion, the CPUC report blames past administrations for current problems, alleging that past administrations “traded away the State of California’s ability to project, plan for and act to control electricity supply shortages and wholesale and retail price run ups The federal government now regulates California’s electric system Washington, D C now controls pricing decisions directly at the wholesale level and indirectly at the retail level ” To further spread the blame, the CPUC points a finger at the Cal ISO and Power Exchange, raising serious allegations about conflicts of interest that exist due to the respective Board of Directors structure and the presence of stakeholders who might benefit from higher prices. And the CPUC found sufficient evidence of questionable bidding practices to call for the State Attorney General to investigate statewide bidding practices.

Neither the Governor nor the CPUC seems to get it It is fruitless to assess “blame” for the bumps in the road that occur as we transition from a regulated market to a competitive market It is unrealistic to think that it will not take time for the market to equilibrate once supply and demand come into balance. This will never happen unless and until regulators and politicians allow the market to send appropriate price signals So, is this what the CPUC suggests in its recommendations to the Governor? Unfortunately, it is not As

we discuss below, we fear that the CPUC's recommendations signal the start of a full-scale retreat from competitive markets in California

The CPUC's Recommendations

The CPUC identifies what it considers to be the four separate components affecting electric reliability and prices. It has specific recommendations for each. First, the CPUC asserts that the State must protect consumers from "cartel pricing, collusive behavior, inadequate power plant maintenance and lack of market planning for adequate electricity supplies." The CPUC's primary complaint here is that the Cal ISO and PX are private, autonomous entities that are not accountable to the state or its consumers. The CPUC sees sinister shadows lurking in the corners and concludes that somehow, the Cal ISO and PX are partially responsible for the problems with California's markets. The CPUC wants the State Attorney General to investigate

Second, the CPUC wants policymakers to determine "what constitutes adequate electricity capacity." Additionally, in the short-term, the CPUC wants to focus on reducing electricity demand

Third, the CPUC wants the state and Cal ISO to speak with one voice and demand that the FERC (1) extend wholesale price cap authority, and (2) find that California wholesale markets are not competitive

Fourth, the CPUC wants to "manage retail price problems until a market develops and is fully functional." To that end, it recommends creating a California Energy Council that would "unify State action to resolve energy problems and to perform integrated energy planning."

The Beginning of the End for Competitive Markets in California

To summarize, in response to what it perceives to be a volatile market situation in California, the CPUC wants investigate manipulative pricing practices, create a new regulatory oversight board that will perform integrated planning, institute wholesale price caps, find that no competitive wholesale market yet exists, encourage consumers to use less electricity, and implement state oversight for the Cal ISO and PX. Governor Gray, apparently feeling the political heat, on August 9, 2000 ordered the CPUC to slash electricity rates in San Diego by 50 percent. Some California legislators criticized the action not because it signals a retreat from competition, but because it pre-empted the California legislature, which is also poised to take up the proposed rollback issue. Although the CPUC had earlier in the week rejected mandatory rate reductions, the CPUC President endorsed the Governor's actions. It seems that neither politicians nor regulators in California have the courage to withstand this onslaught against competitive markets.

These actions suggested by the CPUC are ostensibly temporary fixes that will be in place until California's wholesale market can develop. But let's get serious for a second. As we have pointed out above, these are exactly the activities that will prevent competitive wholesale markets from developing. These "fixes" should be seen for what they really are: a full-scale retreat from markets and a return to regulation in California.

While the blame game is played and re-regulation, or worse, is threatened, new retail marketers are not entering California. But they should be.

Available data clearly indicates that in eight to ten months of the year electricity is in oversupply in California, and competitive prices are below the annual average price. Retail marketers should have aggressively pushed a pricing option that would smooth out these big monthly seasonal price differences (about 3 to 1). But, until very recently, they didn't. Instead, retail prices doubled over what they were at a similar time a year ago and summer use in the face of prolonged heat increased dramatically. Seasonal price and use protection would likely be a welcome product in California, where most consumers do not want to play the price swing game and would prefer that others hedge this risk. There is money to be made here.

But instead, California is facing a political and regulatory calamity. Politicians order regulators to provide consumers with 50 percent refunds and threaten re-regulation. Retail consumers in San Diego pay punishingly high electric rates and no one seems courageous enough to discuss lower fall and springtime offsets. New competitive suppliers are still being scared off by all this political uncertainty and ubiquitous attempts to place blame on others. The rest of California's retail customers fear that the worst is yet to come.

Solutions are easy, but the political will to adopt them is hard to find. First, California needs to deregulate its competitive markets fully. Price caps must go. Local reliability payments need to be loosened from the grasp of their current regulatory and parochial interests. Power marketers need to enter the market and offer seasonal price and use protection. Politicians and regulators need to entice and encourage such entry, not deter it. Unfortunately, threats to re-

regulate and nonsensical costly universal telemetry proposals (e g , real time metering) are keeping new competitors out of the market just when they are most needed.

New Entrants and Bad Results In Other States

In competitive markets, new entrants are expected to enter markets when demand is high, supply is short and prices are high. As more supply enters such markets and demand and supply come into equilibrium, prices come down to long run marginal costs.

In competitive markets, higher prices caused by excess demand and/or short supply will send strong price signals to potential new competitive suppliers to enter the market. When left to their own devices, this is how competitive markets function.

In some higher priced states that have not yet restructured, some new entrants are proposing modifications to the existing regulatory systems under the guise of competition. These troubling new hybrid structures promise bad regulatory results. Worse, this form of neo-regulation will continue to expand transition regulation and extend transition periods. Few expect the sun to set on these new regulations.

Two recent examples, one from the electricity world and one from the natural gas world, demonstrate the problems that are inherent in a regulatory/competitive hybrid approach that seeks to encourage entry in a partial regulatory/competitive system. Consider the Florida experience with merchant

plants. Recently several new merchant plants applied to enter the Florida electricity markets.⁷ Florida is a relatively high-priced state that is isolated from the rest of the lower 48 states due to its unique geographic location. Consequently, it suffers from constraints in its electrical transmission system and limited natural gas supplies. Additionally, tremendous growth in Florida is fueling growing demand for electricity. New supply is needed. Merchant plants are anxious to enter the state and prevent incumbent investor-owned utilities from building this needed generation under the traditional cost-of-service regulation that is still in place in Florida.

Florida has only recently begun to explore restructuring its electric industry and remains firmly entrenched in traditional cost-of-service ratemaking. Retail customers are not free to choose their suppliers. However, Florida's relatively high electric prices have proven to be an irresistible magnet to merchant plant owners who see huge profits from being among the first merchant plants to enter Florida's currently protected markets. These new entrants attempt to manipulate regulators by using self-interest arguments implying that the merchant plant owner will assume all the risk of entry. While these arguments may have some merit in a competitive market, in a hybrid market such as the one developing in

⁷ See for example In Re Joint Petition for Determination of Need for an Electrical Power Plant in Volusia County by the Utilities Commission, City of New Smyrna Beach, Florida and Duke Energy New Smyrna Beach Power Company Ltd., LLP, Before the Florida Public Service Commission, Docket No. 981042-EM, In Re Petition for Determination of Need for an Electrical Power Plant in Okeechobee County by Okeechobee Generating Company, LLC, Before the Florida Public Service Commission, Docket No. 991462-EU, In Re Petition for Determination of Need for an Electrical Power Plant in St. Lucie County by Panda Midway Power Partners, L.P., Before the Florida Public Service Commission, Docket No. 000289-EU.

Recently, these cases were abated subsequent to the Florida Supreme Court ruling that the Florida Commission has exceeded its jurisdiction in granting the need petition in the Smyrna Beach Docket. See Tampa Electric Company et al. vs. Joe Garcia, et al. as the Florida Public Service Commission, et al., 25 Fla. Law W. 5294, 2000 Fla. Lexis 772 (April 20, 2000).

Florida where retail customers have no choice and incumbents remain regulated, the merchants seek entry in order to obtain much higher than competitive returns and benefits

These merchant plant owners have sought Florida regulatory approval to be paid administratively set prices based upon the “price stack” or hourly system lambda of the incumbent IOUs’ generators that clear the dispatch sequence. If approved, the prices paid to new merchants would not reflect wholesale competition between competing generators and electricity consumers. There is no such market because the investor-owned utilities are currently regulated under traditional cost-of-service principles. In other words, a joint dispatch approach is used to achieve operating efficiency, while each utility generator effectively is paid a price equal to its individual running costs not a market clearing price. This regulatory practice means that consumers pay the least cost for electricity.

Merchant plant owners seek administrative prices equal to the highest running cost in each hour, much as a market would do. This would yield extraordinary profits in Florida’s non-market hybrid world. These market prices would also greatly exceed the comparable rate-base costs that incumbents would receive if they built these same new units. If approved, consumers would pay more, not less, for electricity under these new merchant plant hybrid restructuring proposals. This is not competition. The only winners are the new entrants that cream skim, avoid competition, and use the state’s fear that, but-for the new merchants, the lights would go out in Florida.

A second troubling example comes from the natural gas side of the energy market. The FERC seems to recognize that in competitive markets, new interstate natural gas pipeline entrants willing to put their investment at risk should not be required to satisfy the old certificate of need regulatory requirements.⁸ This is quite sensible.

However, in Wisconsin, a natural gas pipeline entrant is using this otherwise reasonable competitive proposition to pursue self-interested regulatory rulings that sweeten its deal and harm consumers. The pricing proposals are neither arms-length nor competitive. Instead, they represent vertical market power and affiliated interest abuse.

The story is about as old as recorded regulatory history. In Wisconsin, this proposed new pipeline is partially owned by an affiliate of a natural gas local distribution company.⁹ The new “at risk” regulatory policy would seem to apply. Exaggerated fears of natural gas shortages coupled with a perceived need for more natural gas to fuel new electricity generation has pushed state political leaders to endorse and support this new pipeline entry. This perceived energy shortage fear has seemingly blinded state and federal regulators to the fact that the incumbent pipeline has committed to add new equivalent capacity at significantly lower fixed prices than the new entrant, which is an affiliate of the state’s largest natural gas buyer, and a local distribution company.

⁸ See Certification of New Interstate Natural Gas Pipelines, Statement of Policy, 88 FERC ¶61,227 (September 15, 1999), Order Clarifying Statement of Policy, 90 FERC ¶ 61,128 (February 9, 2000)

⁹ Application of Guardian Pipeline, LLC for Certificates of Public Convenience and Necessity, FERC Docket Nos. CP00-36-000, CP00-37-000 and CP00-38-000, Wisconsin Gas Company, Requests for Approval of Application to Construct and Operate Natural Gas Lateral Line Facilities, Public Service Commission of Wisconsin, Docket No. 6650-CG-194

Similar to retail electric customers in Florida, retail natural gas customers in Wisconsin do not have the ability to choose their natural gas supplier. This lack of retail competition invites new entrants to ask for new subsidies and regulatory protection from competition provided by incumbents. Of course, these requests need to be masked. In Wisconsin, the new pipeline entrant sought administrative or regulatory approval to build a new source of supply in exchange for higher regulated prices that would be paid by captive retail consumers. In Wisconsin, as is Florida, the new entrant makes competitive price claims and avers consumer benefits that are neither factually correct nor based on common sense. Regulators want more supply and energy security. However, they also need to consider other alternatives, especially when the new entrant does not participate in an arms length negotiation with the local distribution company. This is not competition. It is bad regulation.

In the Wisconsin case, the higher priced solutions will inure to the benefit of a vertically connected affiliate. Under strict regulation, this result would not seem plausible. However, invoking the "magical" competition and new entry mantra appear to be all that is necessary to obtain political endorsement and regulatory approval. In this mixed regulatory/competitive hybrid world, new entrants seem able to seek out and obtain outrageous subsidy payments if they play on fears of shortages and play the competitive purposes/free market card. Unfortunately, consumers typically pay more for this subsidy-masking pseudo-competition than they would have paid under traditional regulation.

Special Interests, Compromises and Bad Deals

The various restructuring proceedings and legislative efforts ongoing throughout the nation have brought forth a wide array of special interests seeking to rewrite regulatory history in order to shift the future competitive battlefield in their particular favor. This is where the compromise game is played. The result is a free-for-all where special interests attempt to establish a hybrid paradigm that is neither a market nor regulation. This new hybrid can undermine existing regulation, reducing its effectiveness. At the same time, because no real competitive market is created, there are typically insufficient benefits created to offset the negatives associated with emasculating the existing regulatory process. There are typical three components to this special interest process, which is reasonably similar across the nation.

First, various interest groups come forward to support “mitigation adjustments.” These adjustments can take various forms; but their primary purpose is to reduce stranded cost estimates. In general, mitigation means that considerably less than one hundred percent of a utility’s stranded costs would be recovered. The largest energy consumers push this policy to provide them with a swift and cheap exit strategy.

Undoubtedly, some utility companies have inefficiencies that the market would uncover and weed out. The mitigation process attempts to use regulation and administrative proceedings to accomplish this task. The results have, to date, been typically heavy-handed and designed to implement the results of

actions that regulators allegedly should have forced utilities to take under rate base regulation

Second, many states with nuclear generation experienced the first “prudence” wars in the 1970s and 1980s. These battles were fought in an attempt to prevent utilities from including in rate base all their nuclear power plant construction costs. Restructuring often brings forth a second prudence fight. The same previously addressed and resolved arguments resurface. The result, along with mitigation requirements, is nothing more than an attempt to rewrite the past, reduce current rates, and accelerate the move to competition. Not all bad, perhaps. In practice, however, much of this is irrational, duplicates the past, and is likely to result in adopting offsetting “bads” as self-interested participants seek advantages over incumbents, not common sense solutions.

If these real restructuring purposes were articulated and pursued explicitly, few would question the end result. Instead, regulators and others hide behind “mitigation” and “prudence” shields to pursue their other agendas. This provides clever special interests with an opportunity to seek advantages not available to them under either sensible regulation or real competition. When the inevitable problems surface in the future, there will be no basis for understanding what and why things were done. If regulators/politicians instead explicitly articulate their purposes and rationale, many future problems will be easier to resolve.

Third, restructuring is typically presented as a political process where new entrants need some special protection. Therefore, new entrants argue that incumbent electric utilities need to be heavily controlled and handicapped.

However, this is not how competition works. Under competition, investors take risks with no downside protection or upside caps. The hallmark of most restructuring proceedings around the nation is to seek political and regulatory guarantees and new subsidies. None of this is explicit. Nevertheless, the game is well played and ubiquitous. But make no mistake, it is not competition.

Conclusion

Restructuring is not deregulation. Neither is it competition. Controlling and micro-managing markets and handicapping incumbents is not how competitive markets work. The new institutional norm uses price caps to mask price signals. The new institutional norm also prefers rules to manage congestion rather than encouraging locational marginal congestion prices to internalize congestion and to improve reliability. This also masks price signals. Why should neo-regulation be better than the cooperation between utilities it replaces? The paradigm of markets is not currently the new norm. There is a new regulatory penchant for managing potential problems to the point where these policies become self-fulfilling. It is hard to fathom how this hybrid approach improves upon either the traditional regulatory norm it is designed to replace or upon the competitive markets it seeks to become.

While we have seen the results of this hybrid form of regulation in California, all of this does not mean that things are necessarily going to be worse in the future. That is yet to be determined. Nevertheless, problems such as hot weather and rising natural gas prices are not being internalized by neutral

competitive markets. Instead, special interest dominated institutions are causing more political tinkering with the “market.” Worse may come. Consider that after nearly two decades of significant real gasoline price declines, the first sign of price increases at the pump caused politicians to yell “price gouging” and seek a political solution. Of course, the “solution” we often get is regulation, not competition. Worse, it is regulation without a template of tradition and well understood principles.

Doubtless, when regulators are forced to determine what went wrong in the future, the “blame game” will point to markets. We are seeing this happen in California. This is the wrong answer. Markets work to curtail demand and signal new supply-side investments. If markets continue to be regulated, as they currently are under American-style restructuring, we should expect reliability problems, bad investment choices and higher consumer prices. The task is to recognize that unless the nation truly moves to competition, restructuring is really neo-regulation. And this neo-regulation is not necessarily an improvement over traditional cost-of-service rate based regulation. Nor is it necessarily a step toward relying upon and trusting in true competitive markets. Rather it is an untried and potentially flawed hybrid of traditional regulation and competitive markets.

In the future, when unforeseen problems arise (e.g. power outages and higher natural gas prices), the political process undoubtedly will attempt to blame “markets” and competition. The next phase of energy policy seems certain unless state and federal policymakers truly embrace competition. Regrettably,

the nation seems inevitably headed in a new regulatory direction. When future problems rear their head, this most likely will signal a call for a return to old-style regulation. If this happens, we fear that it will take many years for the nation to once again embrace competitive markets. It would indeed be a shame to come so far only to falter because regulators prefer restructuring and lack the faith necessary to completely embrace competitive markets.