VISIT THE CITY OF BOOKS powells.com

USED • NEW • RARE • OUT-OF-PRINT

http://www.salon.com

salon.com

To print this page, select "Print" from the File menu of your browser

What if you deregulated a market, and no one cared?

Even in the states where electricity deregulation has supposedly worked, there's little choice for consumers and scant savings.

- - - - - - - - - - - -

By T.M. Sell

May 24, 2004 | Eric Levis probably knows the ins and outs of electricity deregulation better than his neighbors. As the press secretary for the Pennsylvania Public Utilities Commission, it is his job to know about the new realities of the electricity service environment. But despite all the promises of shiny new markets for power, Levis doesn't shop around.

He did when the program first kicked into high gear in 2000, buying his electricity through an online brokerage that has since gone the way of many other dot-coms. At first, he saved a little money, but no more.

"I returned to PP&L [Pennsylvania Power & Light]," Levis says. "I don't think there's anybody who's offering lower prices."

Therein lies the frayed wire of electricity deregulation, or restructuring, if you prefer the current euphemism. The promise of ending good old home-style regulated electricity service was that an open market would invite

lively competition and drive prices down. But that's not exactly how it's working out. It turns out, there just isn't much money to be made competing for the residential consumer. And it also turns out, the utilities are now arguing they need to set *higher* prices before there's real competition.

In Pennsylvania, electricity restructuring hasn't been the disaster it was in California, but neither has it been the bright shining light its supporters have been promising for decades. And with California's current governor hinting that his state should try the power dance once again, it might be time for a look at what has happened there, and elsewhere.

After California, some states concluded that electricity deregulation was a public policy disaster equivalent to the introduction of New Coke. Others pressed ahead. Among the latter, Pennsylvania became the poster child for supposedly successful restructuring.

Like most of the 16 other states (and the District of Columbia) that decided to pursue restructuring, Pennsylvania had above-average costs. Former utility commissioner John Hangar, who ended up leading the fight for Pennsylvania's plan, says he was first intrigued by the 1992 Energy Policy Act, which began the deregulation of wholesale electricity sales.

"We concluded that Pennsylvania was going to be in the market, of which the wholesale foundation was going to be competitive," Hangar recalls. And by 1998, at about the same time as California was beginning its adventure, Pennsylvania citizens became free to choose who would sell them electricity.

Pennsylvania's plan had similarities to California's: Electricity consumers large and small were to be sprung free from having to buy power from their traditional suppliers; rate cuts and caps were ordered into place; and electricity firms that owned plants that appeared to be worth less than what they cost to build got to walk away risk free by being allowed to stick consumers with the bill in the form of so-called stranded costs. (Studies that tout consumers' savings under restructuring don't always appear to take into account stranded costs -- which may have reached $200 billion nationwide, according to one study.)

Electricity is different, we are often told, except when it's not. Despite all the hoopla of letting the markets run free, Pennsylvania spent thousands of dollars in taxpayer money to persuade taxpayers to shop around.

It appeared to work. By 2000, 22 percent of the state's residential electricity customers were buying electricity from someone other than their old utility. While a chunk of those shoppers had been randomly assigned away from Philadelphia's PECO Energy (in one of the many Byzantine deals regulators across the country have worked out with individual utilities), the achievement was the national high-water mark of residential retail-electricity competition.

"It was not so much forcing them to shop, as it was basically getting a foothold in the market for new entrants," says Sonny Popowsky, Pennsylvania's state electricity consumer advocate.

But a funny thing happened on the way to the market. In Pennsylvania, California and elsewhere, firms once eager to sell power to homeowners started pulling out.

Early on, Pennsylvania, like most of the other restructuring states, had a number of firms jump into the market to sell power to anyone. Enron, for example, bought Portland General Electric and a host of generating properties to pursue just this line of business.

But the market quickly dried up and the suppliers went home. New Power, one of Enron's many stepchildren, went bankrupt, and other firms packed it in when they realized there was no money in wooing customers who don't buy much power.

Power providers left the residential market for a number of reasons. Supporters of restructuring say that the rate cuts and caps enacted by most states drove prices too low to encourage competition; in other words, if prices

had been higher, there would have been more competition. This is a strange argument, given that competition was supposed to drive prices down.

State governments had tried all kinds of tricks to get people to shop, including "shopping credits" to give consumers a discount for switching providers, but at the same time often failed to follow through. Shop, but don't shop too much, they said, putting in place limits to switching too often; no more than once every three months in Connecticut to once a year in Massachusetts. Other states even allowed utilities to charge exit fees to customers who fled them.

But the biggest reason for the lack of real competition, critics say, is that there's simply no money to be made in selling residential electricity at competitive prices. Firms that rushed into the power-supply business rapidly discovered that a high-cost, low-margin business with customers who use very little of your product won't pay the bills, let alone turn a profit. And residential customers buy all of their power at the wrong times -- morning and evening off-peak periods.

Eugene Coyle, an economist who specializes in resources such as electricity, and who produced a report on deregulation for the American Public Power Association last year, calculated that it would take eight years to recover the marketing cost of winning one residential customer -- using the industry's own figures on what those costs would be.

Today, in all the deregulated states, there isn't much of anybody who's offering any electricity at any price to the great mass of consumers, unless they're factory owners or an aggregation of customers with enough leverage to work a deal. While deregulation has meant savings for large customers, residential customers appear to be saving money only where states have mandated rate cuts, and all of those rate caps are eventually scheduled to expire. Most residential customers in the 17 actively deregulated states aren't shopping for power, and few energy suppliers are trying to serve the residential market.

Defenders of restructuring say it's still been a net gain, and not just for big businesses that buy a lot of electricity.

"You've got to pay attention to the benchmarks," says John Hangar, now president of the lobbying group Citizens for Pennsylvania's Future. He notes that in 1996 Duquesne Light customers in the Pittsburgh area paid 8 cents a kilowatt hour just for power (not counting distribution costs). Now they pay about 6 cents. And Duquesne, having been sharp enough to unload its nuke plants on another firm when power prices were high in 1999, is no longer sticking its customers for stranded costs.

"Lower prices in the wholesale market have flowed through to the customers," Hangar says. "The competitive price for power in Pennsylvania is below what it was before."

But even some advocates of deregulation say lower prices are not inevitable, or even desirable. Jamie Wimberly, president of the Center for the Advancement of Energy Markets (an avowedly pro-market think tank), in Washington, D.C., says restructuring may not in fact mean lower prices, especially for retail residential consumers, and he doesn't think that's necessarily a bad thing.

"This focus on prices is probably the wrong focus," says Wimberley. "That's not really what competition is about. What competition promises is more efficient markets, better allocation of resources.

"You might end up paying more" in a restructured electricity market, he says. "There's an equal chance that you see the prices and you can respond to them. You can see what you're paying for and you can make your own decisions."

In other words, when prices spiked, you could instantly conserve. But Wimberly acknowledges that people aren't very likely to turn off their refrigerators when they see electricity prices rise. What he hopes is that a more open market will encourage trends such as distributed generation (that fuel cell in your backyard).

"People will have more choices than just getting their electricity from their local utility," Wimberley says. "Maybe they self-generate or they're in some sort of aggregation program."

But even when deregulated states have marginally lower prices, that doesn't mean that the market is really competitive or that the "free market" is setting prices. More than 90 percent of Pennsylvania's ratepayers, for example, get electricity from default providers, typically their old-line utilities, still very much in business. Retail power prices in Pennsylvania and elsewhere are now largely set by negotiations between power providers and the state. Duquesne is seeking rate hikes that will raise prices to consumers by more than 20 percent by 2008, although the company maintains that it still will be charging less than it was before restructuring.

That's not so surprising, says company spokesman, John Laudenslager. "Until you get to a market situation, where the markets are robust, you're going to negotiate a price and a contract" with the state and the citizens.

Another improvement, Hangar says, is that the PJM power pool -- covering Pennsylvania, New Jersey, Maryland and parts of Northern Virginia -- has an independent board in place to keep the market, such as it is, functioning.

"You need to put in place rules for the market," Hangar says. "All healthy markets have rules. It's not survival of the fittest."

Perhaps the biggest gain, Hangar says, is that power producers are now ostensibly on the hook for their own choices as to what generating assets to build and operate. In theory, at least, there should be no more stranded costs, no more nuclear debacles. You screw up, you're on your own.

"My message is that you have to be vigilant," Hangar says. "After the transition [to restructuring] there's an important role for regulation and regulators.

"Restructuring done right drives both the left wing and the right wing crazy," he adds. "The left wing can't stand the idea of the market being right. The right wing says, Get the government out of the way -- they're the enemy."

Others are not nearly so sanguine about restructuring. Roger Odisio, a former economist for the Federal Energy Regulatory Commission, notes that elsewhere, Hangar has been among the many arguing for *higher* rates so as to encourage competition.

"This 'solution' has nothing to do with competition," says Odisio, who lives in Philadelphia. "It would create monopoly rents [prices above costs] and perhaps create a rivalry among a few suppliers to capture them. This is the opposite of what [deregulation] advocates told us originally -- that there would be a competition that would lower rates."

Odisio says his former employer has been committed to deregulation since the 1980s without paying attention to what really drives the industry.

Deregulating the wholesale electric market lets the big dogs wrestle with each other and could put some limits on prices. On the other hand, a deregulated wholesale market has led to buckets of indictments and convictions for energy traders who conspired to rig prices offered to California.

"They talked about these wonderful efficiencies," Odisio recalls. "It's just a textbook view of the world that had no reality to it whatsoever. I don't think it's too surprising that you didn't have too many firms competing and that they wouldn't take too long to rig the market."

Economists for whom the supremacy of markets is not an article of faith ("It really is a religion for some of these guys," says Coyle) point out that what deregulation promised was a dizzying array of new products and

services. But never mind that the quality of the basic product -- electricity -- doesn't vary a bit from kilowatt to kilowatt. Most small customers aren't likely to want to take the time to shop for separate vendors of billing, metering and risk-management services (precisely the kind of thing promised by advocates in the 1990s). Nor are many firms going to want to spend the money to enter such markets.

Where there is competition, it's from so-called green power firms, who offer some mix of juice from hydro, wind and solar facilities. They charge a premium so that you can imagine that your power comes from a windmill turning gracefully atop a windswept hill (odds are, it doesn't). It may be one of the few things Odisio and Hangar have in common: They both buy green power.

The result is a system that isn't really deregulated but that does play into the hands of the big utilities.

"What the utilities charge is still regulated," says Sonny Popowsky, Pennsylvania's electricity consumer advocate. "They can't charge whatever they want."

So the onus is still on the state utility commissions to protect residential consumers' interests, which is possible so long as they have the resources to be able to tell when utilities are being reasonable or just blowing smoke.

Historically, they haven't. Utilities sought and got state-level regulation early in the 20th century, as a means of avoiding battles with big-city political machines and forestalling local efforts to create publicly owned utilities, which, then as now, charge less for power.

For much of the 20th century, state commissions were unloved and underfunded and could do little more than say "OK!" when utilities asked for rate hikes.

That was fine as long as power prices were falling. But by the 1970s, generation technology had reached a plateau and a number of utilities started investing in nuclear power plants. One could argue all night about nuclear safety, but what's undeniable is that nuclear plants are very expensive.

As electricity rates began to rise, consumers started putting pressure on state legislatures to do something. Revitalized state commissions began to just say no to the demands from utilities for higher rates, and as a consequence utilities began to push for deregulation.

Now that the rate caps that came with the political deals that made restructuring possible are beginning to come off, the future is hazier than ever.

In Maryland, the Republican chairman of the utility commission in April fired his top nine staffers, including the leading engineer and accountant, a development that probably won't help regulators there sort out utilities' rate requests.

Other states still hope for competition. In Rhode Island, the price is simply raised every year in an attempt to encourage shopping.

"That was set by statute to increase up through 2008, to [get to] a level that would encourage competition," says Terry Mercer, assistant administrator with the Rhode Island Division of Public Utilities. "It [competition] hasn't materialized."

The one state where restructuring could be working is Maine, where the state simply aggregated its residential customers and took bids on their behalf. As a group, Maine's citizens could be an attractive piece of business. At least the transaction costs would be lower for the power suppliers negotiating the contracts.

"Before restructuring, we were getting overall regular price increases," says Phil Lindley, an analyst with the Maine Public Utilities Commission. "Our total price remains lower today than it was in 1999."

Ohio has had some success with aggregating, and organizations such as the Rhode Island League of Cities have aggregated to get themselves a better deal. But the Maryland Legislature, under pressure from private utilities, recently turned down efforts to allow communities to do the same. This is, after all, America, where we tend to favor competition, except when it applies to us.

Critics also point to another potential problem of a market-based electricity system: reliability. Under the old system, plants that will supply power during periods of peak demand could be built into the rate base and made economically feasible.

"We're about to throw all that away for a slogan," says utility consultant Merrill Schultz. Under the new system, Schultz and others point out, there's a positive disincentive to have a plant that may operate only on a few cold mornings a year. First, you can't charge people for it when it's not operating. And second, the mere presence of such plants ought to tend to depress the price of electricity. In a purely profit-driven market, nobody wants that.

"It's not very profitable to sink a couple of hundred million dollars into a power plant unless you have customers you can count on to buy from you," Odisio says.

Meanwhile, big chunks of the country say their disaster plan is to import power from Ontario. Last summer's power meltdown ought to at least call that notion into question.

FERC spokesman Bryan Lee says the answer is regional power pool planning, which would make it easier for states to push through new transmission lines, among other things.

For all its faults, the old, regulated system had its virtues. People got power, and utilities were profitable, and reliability, considered over the whole system, was outstanding.

Merrill Schultz, who did most of his work in the West, watched the California debacle with much dismay, and he worries it will be repeated. The emphasis in the industry has gone from public service to competition.

"I was fooled by the precipitous change of proud independent operators into greedy marketers," he says. "All those people did whatever they could to make big bucks and no longer cared about reliability or performance."

\- - - - - - - - - - - -

About the writer
T.M. Sell is a professor of political economy at Highline College in Des Moines, Wash. He is the author of "Wings of Power: Boeing and the Politics of Growth in the Northwest."

Sound Off
Send us a Letter to the Editor

Related stories
From Enron to Cheney to California
Golden State politicians are on the warpath after a leaked memo reveals Kenneth Lay's instructions on how the White House should handle last year's electricity crisis.
By Anthony York
02/01/02

Enron, we hardly knew ye
Ironically, only one thing could have saved the now-imploding corporate poster child for deregulation: Tougher regulations requiring more financial "transparency."
By Andrew Leonard
11/09/01

The deregulation debacle
Who's responsible for for California's electricity crisis? Everyone.
By Anthony York
01/30/01

Reproduction of material from any Salon pages without written permission is strictly prohibited
Copyright 2004 Salon.com
Salon, 22 4th Street, 11th Floor, San Francisco, CA 94103
Telephone 415 645-9200 | Fax 415 645-9204