



# COMPETE

Electricity Competition **IS** the Public Interest

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## SPEAKING TO THE BENEFITS OF ELECTRICITY COMPETITION

### Understanding Electricity Rate Increases

- Electricity rates have been rising throughout the country. These increases are largely a result of rising costs for the fuel used by generators to produce electricity. In fact, fossil fuel costs have increased over 150 percent since 1999.
- Fuel costs are rising due to global demand for fossil fuels, the impact of supply interruptions from last year's hurricanes, and insufficient domestic production.
- Despite this pressure, if you look at price increases over the same time-frame in other consumer goods like food, housing and health care, you will find that electricity price increases are mostly modest by comparison. Electricity rates are not rising because of competition.
- Make no mistake -- retail customers in states that don't allow choice have been hit with much higher costs as well -- often in the form of an automatic increase on their bill. In these states, steady increases over a number of years have been passed through to consumers. These regular, smaller price hikes can add up to dramatic changes in price over time. For example, during the period 2000-2005 the following electricity rate increases occurred in regulated states:

Oklahoma	46.7%
Colorado	43%
Georgia	37.4%
Louisiana	67.3%
Mississippi	53.1%

- In most of the states that restructured to increase competition, political agreements were made to cap rates and, in some cases, actually roll them back, for a period of time. As a result, many customers in restructured states have been paying below market rates in recent years despite increases in the cost of generating electricity. As these rate caps expire, rates are catching up and starting to reflect market prices that are being driven by very high fuel prices.

### Going Back to State-Supervised, Cost-Based Rate Regulation Would Be a Mistake

- The goal of all policymakers should be to ensure reasonably priced and reliable electricity for consumers. Competition keeps costs as low as possible, drives innovation, and produces the benefits customers are seeking -- because the customer calls the shots. This is true whether you're talking about telecom services, the advent of discount department stores, or the changes in the automobile industry in the last quarter century. It is also true for electricity.
- It's easy to forget what the world was like before competitive forces took hold. Consumers demanded the right to choose their own energy supplier, recognizing that competition

imposes maximum downward pressure on prices, and that they were paying more for electricity commodity services than would be the case in a competitive market. There was less incentive for utilities to save money than there is under competition, and no opportunity for captive customers to choose a lower cost provider. Many of these captive customers were the businesses -- small and large -- that create jobs and grow the economy.

- When electricity suppliers are allowed to compete with each other to sell their product, the customer wins. If you could only buy your car – a critical investment for many – from one company, the result would certainly be higher prices, poor choices and unhappy consumers.

### **Competition Shields Customers From Risk**

- One of the most important benefits of competitive markets is that they shift risk away from customers and toward the shareholders of competitive companies and those that lend them money. Regulation fails to create all of the incentives that would otherwise exist in a competitive market to improve efficiency, which leads to unnecessarily high generation demand for input fuel, adverse environmental impacts, and higher costs to consumers.
- Competitive suppliers focus on managing all the risks associated with producing power. Some competitive companies made bad investment decisions, in a few cases filing for bankruptcy to reorganize their affairs. What is important to understand is that, even when competitive companies reorganize, the power plants they developed continue to operate and supply power to customers.
- Those competitive suppliers that have been reorganized emerged from bankruptcy as stronger competitors, and the costs and losses incurred were borne by investors – bondholders, lenders and stockholders. By contrast, when financial difficulties hit rate-regulated utilities, captive ratepayers or taxpayers are hit with the cost. While this may make sense under the traditional “regulatory compact” for natural monopoly services, there is no need for consumers to bear this level of risk for the costs associated with all existing electricity generation or retail sales of electricity commodity services in a competitive market. Over the last thirty years, consumers have paid hundreds of billions for utility mistakes. Competition – even with the risk of bankruptcy that confronts all businesses in a marketplace – is a better deal.

### **Economists Agree: Competition Benefits Consumers**

- This summer, eight leading economists, including George Mason University Professor and Nobel-Laureate Vernon Smith, and Alfred E. Kahn of Cornell University, issued an open letter to policymakers, saying that

among economists, it is almost universally accepted that well functioning competitive electricity markets yield the greatest benefits to consumers in terms of price, investment and innovation especially when regulated alternatives are no longer warranted. And, despite currently high electricity prices in many regions, driven by very high fuel input costs used to generate electricity, we are confident that well structured markets and robust competition are providing substantial benefits to electricity consumers.

The letter was also signed by Paul L. Joskow (*Massachusetts Institute of Technology*), William W. Hogan (*Harvard University*), Peter Cramton (*University of Maryland*), Howard J. Axelrod (*Energy Strategies, Inc.*), David W. DeRamus (*Bates White, LLC*), and Gary Hunt (*Global Energy Advisors*).

- In a November 2006 *Public Utilities Fortnightly* article, Dr. Axelrod, David DeRamus (*Bates White*), and Collin Cain (*Bates White*) offered a similar assessment, noting that
 

despite the headlines, our research – and that of several others – has shown that wholesale competition has been successful, especially in markets in the eastern United States, and will foster lower, more stable electric prices over the long term than a retreat to traditional rate regulation.<sup>1</sup>

### **Consumer Savings by the Numbers**

- A 2005 study by *Cambridge Energy Research Associates*<sup>2</sup> found that competition resulted in \$34 billion in savings for residential customers across the country over seven years compared to what would have been paid under traditional regulation. Among the study's findings:
  - Real prices were 16% lower during the seven years of the electric restructuring era than during the previous seven years of the regulated era;
  - Many of the expected gains from introducing more competitive pressures into the power business resulted in greater efficiencies, more innovation and cost discipline;
  - Significant savings were also derived from restructuring having reallocated and shifted the cost of the most recent overbuild of power generating capacity away from ratepayers to investors who held the market risk
  - From an economic perspective, the success of electric restructuring should be judged by a wide set of criteria, including how well power prices line up with production costs and provide proper price signals .
- A 2005 study by *Global Energy Decisions, Inc.*<sup>3</sup>, found that competition in the eastern United States resulted in \$15 billion in savings to consumers from 1999-2003 due to greater plant efficiencies, innovations and cost discipline.
- In March 2006, the *New York Public Service Commission (PSC)* issued a staff report<sup>4</sup> for the time period 1996-2004. The report found that real electricity prices resulting from competitive markets dropped an average of 16 percent for New York residential customers and between 14.7 and 17.7 percent for commercial and industrial customers.
  - The report commented that 4,200 MW of efficient new generation capacity had been added since utilities had divested their generation facilities and that, unlike investments by regulated utilities, "ratepayers are not at risk for cost overruns or inefficient operations."
  - After taking a look at other states, the staff report concluded that customers in retail competition states generally "fared better than the average residential customer in states without retail access."
- A 2005 study by *Energy Security Analysis, Inc.*<sup>5</sup> found that wholesale electricity customers have saved more than \$500 million a year as a result of the expansion of PJM into the

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<sup>1</sup> "The Fallacy of High Prices," *Public Utilities Fortnightly*, November 2006, page 55.

<sup>2</sup> *Cambridge Energy Research Associates, "Beyond the Crossroads, The Future Direction of Power Industry Restructuring," October 2005.*

<sup>3</sup> "Putting Competitive Power Markets to the Test," *Global Energy Decisions*, July 2005.

<sup>4</sup> "Staff Report on the State of Competitive Energy Markets: Progress to Date and Future Opportunities," *New York Public Service Commission*, March 2006.

<sup>5</sup> "Impacts of the PJM RTO Market Expansion," *Energy Security Analysis, Inc.*, November 2005.

Midwest and Southeast; and that the liquidity and diversity of the expanded PJM will yield savings to electricity consumers of \$700 million to \$1.4 billion per year.

- *ISO-New England* reported in 2005<sup>6</sup> that with market operations beginning in 2000, adjusted wholesale prices of electricity in New England declined by 11 percent from 2001-2004 (after adjusting for the increase in fuel prices). This reduction saved \$400 million per year for the wholesale market. In that same period New England saved an additional \$300 million each year by reducing generation uplift costs, decreasing requirements for regulation services and improving generation availability rates.
- An September 2006 report prepared for the *New England Energy Alliance*<sup>7</sup> revealed a number of benefits stemming from the restructuring of the New England electricity market, including:
  - *Improved operating performance of power plants* – since wholesale restructuring, plant availability has increased by 8%, avoiding the construction of up to five, 400 Megawatt generating facilities.
  - *Reduced emission rates* – while electricity generation within the region increased 25% between 1998 and 2004, associated sulfur dioxide emission rates decreased by 56%, nitrogen oxide by 57% and carbon dioxide by 22%.
  - *Consumers have cumulatively saved between \$6.5 to \$7.6 billion between 1998 and 2005*, based on projections of where prices would have trended in the absence of restructuring.
- In February 2006, the *Public Utility Commission of Texas* issued a staff report<sup>8</sup> that found that customers in Houston and Dallas could have realized savings of \$1,450 and \$800 respectively since January 2002 by switching to the lowest-cost supplier. The report also noted that “even customers who did not switch to a competitive rate have benefited from the introduction of retail competition” from benefits “such as a variety of service and pricing options and efficient mechanisms for promoting renewable energy and energy efficiency.”

The report noted the benefit of investment in efficient generation, which it said would not have occurred to the same extent in a fully regulated environment.

- According to the report, if retail competition had not occurred, new investment in power plants would have been required to meet the needs of Texas electricity customers, but the level of investment would have been much lower; and the improvement in overall power plant efficiency would have been much more modest.
- The implications for electric rates are that more natural gas would have been consumed to meet customers’ needs under continued regulation, more aging and inefficient plants would have remained online, and customers’ rates would have reflected these higher costs.
- Competitive forces resulted in the replacement of older power plants with new, efficient plants, making a major contribution to the reduction of emissions from the electric industry and progress in meeting national air-quality standards in the Houston-Galveston and Dallas-Fort Worth areas.

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<sup>6</sup> “Progress of New England’s Restructured Electric Industry and Competitive Markets: The Benefits of ISOs and RTOs,” *ISO New England*, April, 2005.

<sup>7</sup> “A Review of Electricity Industry Restructuring in New England,” *Polestar Communications and Strategic Analysis (for the New England Energy Alliance)*, September 2006.

<sup>8</sup> “Electricity Pricing in Competitive Retail Markets in Texas”, *Public Utility Commission of Texas*, February 2, 2006.

- Competition also provided an efficient mechanism for meeting goals for renewable energy and energy efficiency, which have contributed to reducing emission.
- Prior to restructuring, customers were locked into paying for new plant construction, repair, or updates, even if subsequent technologies or changes in fuel or energy markets made the investments uneconomic. In the competitive Texas market, the private sector bears the financial burden of new plant construction; the result has been an extraordinary level of investment in new, highly-efficient generating facilities throughout ERCOT.
- The *U.S. Department of Energy*<sup>9</sup> determined that wholesale markets saved consumers an estimated \$13 billion annually. “On average, wholesale power transactions reduced generation costs, in the aggregate, by approximately \$370,000 per hour in the East and by more than \$1,000,000 per hour in the West. These savings translate directly to lower prices for consumers.”

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<sup>9</sup> *National Transmission Grid Study, U.S. Department of Energy, May 2002, page 16.*