

## ***Progress on Point***

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### **Electricity “Restructuring”: What Went Wrong**

by Thomas M. Lenard<sup>\*</sup>

Current efforts to introduce competition in the electricity industry are not living up to their promise.<sup>1</sup> If this is the case, and I believe it is, the question is “what went wrong?”

The promise of electricity “restructuring” was straightforward.<sup>2</sup> Sixty years of cost-based rate-of-return regulation had raised costs and prices above competitive levels. There was widespread agreement among economists and others that wholesale power markets had become workably competitive. Competition could be introduced in all parts of the industry except the wires sectors—transmission and distribution—which retained natural monopoly characteristics. Introducing competition would enhance efficiency and lower prices to consumers, as it had in other industries where competition had replaced regulation.

The world was divided neatly between progressive, right-thinking people who believed in competition and retrograde troglodytes who defended the evil utilities that wanted to retain their monopolies. There are some people who still see the world in those terms, but a diminishing number, because trying to bring competition to electricity markets has proven to be very hard, indeed. This difficulty is reflected in the policy landscape, which is not a pretty sight.

After a decade of trying, we have failed in the two policy areas that are key to obtaining the benefits of competition: developing a transmission policy that is

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<sup>1</sup> For three very recent views of this, from different perspectives, see Joshua Z. Rokach, *Taking the Fork in the Road: Retooling Electricity Policy*, Elec. J., Jul. 2004; Lester B. Lave, Jay Apt, and Seth Blumsack, *Rethinking Electricity Deregulation*, Elec. J., Oct. 2004; and Peter VanDoren and Jerry Taylor, *Rethinking Electricity Restructuring*, Cato Institute Policy Analysis no. 530, Nov. 30, 2004.

<sup>2</sup> See Michael K. Block and Thomas M. Lenard, “Deregulating Electricity: The Federal Role,” The Progress & Freedom Foundation, April 1998.

supportive of competitive markets, and developing the demand side of the power market.

The most obvious symptom of our failure to develop and implement a sound transmission policy is the failure to attract the investment capital needed to support the new demands of a competitive wholesale market or even to support the normal growth of the market. This is partly because transmission is an inherently difficult issue. For example, an efficient transmission pricing regime needs to be able to achieve multiple objectives: efficiently allocate available capacity; reduce congestion; provide incentives for investment; and cover embedded costs. We do not appear to be very close to achieving such a regime.

With respect to the demand side of the market, the issues are not conceptually difficult, but they are politically difficult, because policy makers are reluctant to expose consumers to the vicissitudes of the market.

Both transmission and the demand side of the market are important to alleviating the two major concerns associated with competition: reliability and market power. With respect to the latter, the earlier consensus that wholesale markets are workably competitive has, to a significant extent, eroded—as indicated by the numerous market power proceedings underway at the FERC. Thus, one of the major premises for the move to competition and the associated restructuring is now an open question. Again, this is reflected in the policy arena:

- After a decade of trying, Congress has failed to enact electricity legislation (although it probably will keep trying).
- In the absence of Congressional action, “competition policy” has been driven by FERC, which (as discussed below) has not had a consistent policy. The current FERC has been very aggressive in pursuing its particular vision of electricity “competition,” which, to say the least, is quite controversial.
- In the wake of actual and perceived policy failures associated with the California energy crisis, the Enron collapse, and the 2003 Northeast blackout, the introduction of competition at the state level has slowed dramatically.
- And, there is increasingly the view that, whatever its failings, the regulated vertically integrated utility model—perhaps with some updating of the regulatory scheme—might well have been better than what we now have, which bears little relation to competition. In any event, it would be difficult to do a benefit-cost analysis showing that the new regime—assuming one could define it well enough to do such an analysis—is better than the old.

In sum, we seem to be stuck in a place where it’s difficult to go back and unclear how to go forward.

Given the physical and economic characteristics of electricity markets and the balkanized legacy regulatory system, introducing competition was always going to be difficult. But it could have been done better had we not taken a wrong turn after FERC

Order 2000. (The subtitle of this story is the old Washington adage “personnel is policy.”)

The precursor to Order 2000 was Order 888, which required utilities to provide open access to their transmission networks. At the same time, FERC and many states were encouraging utilities to transfer control of those networks to non-owner Independent System Operators (ISOs). It was amazing how little controversy this idea—separating ownership from operational control of billions of dollars of economic assets—generated at the time. But, eventually, it did generate some concerns and these were reflected in Order 2000, which recognized that the ISO represented a very unusual, untested economic model. The incentive structure of the ISO was unknown—whose interests did it represent?; what objective function would it try to maximize?—and therefore its behavior was unpredictable.

As a result, Order 2000—while it formalized FERC’s commitment to the concept that transmission should be managed by regional entities (now called Regional Transmission Organizations (RTOs), introducing some new nomenclature)—was written to permit significant flexibility in how the RTOs were designed. In particular, Order 2000 explicitly allowed for Transcos—profit-making transmission companies operated by their owners—and, indeed, the Transco appeared to be FERC’s preferred model at the time. The Transco model avoids the incentive problems inherent in the ISO structure because it does not separate ownership from operational control.<sup>3</sup> Its objective would be to maximize profits, presumably subject to some regulatory constraints. At the time Order 2000 was issued, there were major ongoing efforts to form for-profit Transcos—most prominently, the effort of the Alliance companies representing transmission systems in Illinois, Michigan, Ohio and Virginia.

Had it been allowed to play itself out, Order 2000 could have represented a major positive step. But, the change of leadership at the FERC in 2001, from Curt Hebert to Pat Wood (both Republicans), was accompanied by a significant shift in policy direction to a much less flexible, more prescriptive approach.<sup>4</sup>

An early indication of this came in December 2001 when FERC denied the application of the Alliance companies to be an approved RTO. This was an effort that had been underway for four years and had already received conditional FERC approval. At the same time, FERC approved the Midwest ISO to be the RTO for the Midwest and ordered the Alliance companies to find ways of joining the Midwest ISO.

This of course was all prelude to the “gigaNOPR”—FERC’s 600-page Standard Market Design (SMD) notice of proposed rulemaking—a document that would have made Gosplan proud. In contrast to Order 2000, the SMD proposal provided very little flexibility. It proposed to design power markets and institutions at a level of detail virtually unprecedented in our economy and mandated the transfer of all transmission

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<sup>3</sup> See Thomas M. Lenard, *Getting the Transcos Right*, Elec. J., Nov. 1998.

<sup>4</sup> The shift in FERC policy is discussed in Thomas M. Lenard, *FERC’s New Regulatory Agenda*, Regulation, Fall 2002.

assets under FERC jurisdiction to non-owner, non-profit entities now called Independent Transmission Providers (ITPs). (If you have a problematic concept, give it a new name.) For-profit Transcos (such as the Alliance companies had tried to form) were not allowed.

The SMD proposal did little or nothing to improve incentives for transmission investment. Instead, it relied on cumbersome planning processes. Prospective investors were required to go through multiple regulatory venues and gain multiple regulatory approvals to obtain permission to undertake investments whose returns were subject to significant regulatory risk in addition to normal business risks. Virtually all investment decisions—for both transmission and generation—were under the control of planning processes and institutions mandated by the NOPR. For generation, FERC also proposed to rely on regulatory planning with a controversial long-term resource adequacy requirement—such a requirement being necessary to offset the effects of the proposed price-cap policies which would be a disincentive to investment.

In sum, SMD was a new centralized regulatory regime, not obviously better than the old one. Even the Department of Energy, a strong supporter of SMD, could only produce net benefits of \$1 billion in its benefit-cost analysis, surely within the margin of error for a \$230 billion industry.

Congress was disturbed enough about SMD to include a provision in the energy bill remanding the proposal to the FERC for reconsideration, prohibiting the Commission from finalizing any SMD proposal before the end of 2006, and requiring the Commission—if it wanted to pursue a SMD—to put out a new NOPR. This provision will likely continue to be part of an energy bill, when, as expected, it is taken up in the new Congress.

Even without passage of a bill, FERC has had to pull back from SMD in large regions of the country, but its basic policy approach is the same:

- Transmission is viewed as a platform for other businesses rather than a business itself, and there doesn't seem to be any productive approach to the problem of insufficient investment in new capacity.
- The approach to reliability is new mandatory regulation rather than some more fundamental improvement in the incentive structure that would yield greater reliability. The absence of a functioning price system on the demand side makes any reliability goal much more difficult to attain.
- In the current FERC view (espoused in the Wholesale Market Platform White Paper), wholesale markets are not able to fix themselves when broken—the FERC has a comparative advantage in that area.<sup>5</sup>
- The RTOs—entities like MISO and PJM—are emerging as a new type of regional regulator—with less accountability than traditional regulators—incorporating major elements of SMD.

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<sup>5</sup> See Comments of Thomas M. Lenard and Anthony G. Schuster on FERC's "Wholesale Market Platform" White Paper, Docket No. RM01-12-000, August 14, 2003.

On the positive side, FERC has been sufficiently constrained so that it is not able to force the new model everywhere. So, to the extent that the new market design is not optimal for all time and every place—as the FERC apparently believes—at least it will not be in place everywhere.

And, if there is another change of personnel at the FERC, it still may be possible to shift policy to get back to the more-modest, less-prescriptive path the agency was following under Order 2000—a path that is more consistent with competition. There is no reason to believe we know how to operate a new centralized regulatory system for the electricity sector any better than the traditional regulatory system has been operated.

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