
Electric Power Sector Restructuring-- Back to the Future Again?

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A Decade of Electricity Market Transition With Mixed Results

- Transition to “competitive” wholesale market that began in the early-1990’s has yielded mixed results that, with few exceptions, are net positive
 - Outcomes of this transition are generally predictable
 - markets generally performed as *designed* not as various stakeholders may have envisioned
 - electrons acted in a manner consistent with physical laws rather than market designs
 - politicians acted “politically”
 - Efforts to expand the geographic “footprint” of competitive markets have stalled and some “shrinkage” seems likely
 - The current focus on “hybrid” models seems to involve reversion back to some elements of the older vertically integrated structures
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A Decade of Wholesale Market Transition With Mixed Results (cont.)

- Decisions on retail restructuring were adopted in some jurisdictions with little or no consideration of long term political viability or economic consequences
 - Resolution of obvious design flaws and future political “trainwrecks” was left for another day; the future is “now”
 - Wholesale restructuring had a sufficiently robust foundation and a diverse/committed constituency to survive California meltdown and lesser “bumps”
 - Support for retail restructuring is considerably more fragile; default response to unforeseen (or totally foreseeable) problems has been market intervention and selective reversion to familiar “cost-based” regulatory model
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Expectations Versus Reality

- Early debate on benefits of wholesale competition (especially for smaller retail customers) created unrealistic expectations
 - Timelines for realizing benefits distorted by political and structural factors not internalized into early models of competitive transition
 - Looming exposure in multiple jurisdictions to market outcomes in period of unprecedented volatility
 - Spillover from California debacle still dominates much of the dialogue and in some cases, proposed fixes
 - Pervasive lack of trust between stakeholders limits transferability of successful models
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Where we are...where are we going?

- The current blue (deregulated) versus red (vertically integrated) “colorscape” of the state retail access map is unlikely to materially change in the near future
 - Recent trend has been towards greater consolidation and vertical integration; effects of PUCHA repeal, while significant are probably overstated
 - In theory, the U.S. is roughly evenly divided between blue and red although many blue states are really shades of “purple” where retail access is more theoretical than fact
 - Extreme commodity price volatility combined with residual advantages to incumbent suppliers has limited the price spreads needed to attract new market entry
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Where we are...where are we going?

- No clear “driver” to overcoming political opposition to retail restructuring option in “red” states
 - Widespread distrust of market outcomes has increased over the past several years, notwithstanding all the post-Enron reforms;
 - Financial institutions with few if any “physical assets have emerged as major players in wholesale markets
 - There are substantial legal/practical barriers to turning back the clock in “blue states” even if there was consensus on a specific hybrid or “retro” model.
 - Efforts to re-impose expiring rate freezes or “recapture” stranded cost seems to be the interim “fix” to address market price realities
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Supply-Demand Balances in a Restructuring Market

- The erosion of vertically integrated structure poses substantial challenges to those tasked with forecasting customer demands and planning least-cost supply additions
 - Projected decline in capacity (reserve) margin in most regions over next decade (reflects short-term planning mentality and risk averse resource acquisition strategy by LSEs and PUCs (load growth of 19% versus “committed” supply additions of about 6%))
 - Wild card in supply equation is nearly 50 GW of existing “uncommitted” capacity which is expected to double to more than 100 GW over the next decade; problem of deliverability
 - Supply planning vexed by unprecedented fuel price volatility, environmentally-based portfolio standards and financial difficulties in merchant power sector
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Supply-Demand Balances in a Restructuring Market (cont.)

- Resurgence in coal/nuclear offset by natural gas price/supply volatility concerns...return to portfolio mix typical of the 1960s and 1970s??
 - GHG-based targets for wind/solar, et al. has some characteristics of post-PURPA mandates for renewables/cogen in the late '70s albeit with improved comparative economics
 - Major surprise is the slower than expected uptake on demand side management and distributed generation (<2.5% peak load)
 - Major technological innovations difficult to forecast; emergence of “disruptive” demand side technologies could materially change supply-demand balances
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Supply-Demand Balances in a Restructuring Market (cont.)

- Lack of focus on grid expansion to accommodate changing industry structure (i.e., increased interregional trade, proliferation of merchant generators, loss of incentives to build new lines with emergence of RTOs)
 - New Federal siting authority and financial incentives for merchant transmission *may* be a partial fix for chronic underinvestment in network expansion
 - Need for new planning mechanisms (especially within RTOs) to coordinate supply additions and grid expansion to accommodate congestion, fuel diversity and integrating surge in renewables
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Can Competitive Wholesale Markets Survive Flawed or No Retail Competition?

- In a single word, YES
 - Properly designed competitive retail markets will always enhance the economic benefits of a competitive wholesale market
 - However, even in the absence of retail access and customer choice, workably competitive bulk power markets yield tangible end-user benefits
 - “Virtual choice” provides hedging options to retail customers in any jurisdiction
 - The stealth restructuring scenario: “WalMart” and the inevitability of large customer migration to least cost supply option
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Implications for Regulators: "Primum Non Nocere" (First, Do No Harm)

- Federal regulators can respect the political choices of the states on retail restructuring while continuing to create incentives for greater reliance on markets
 - State regulators can be negative/agnostic regarding the merits of retail competition yet avoid actions which undermine the efficient functioning of competitive wholesale markets at the regional level
 - Commodity-based price volatility and fears of supply shortages are powerful political drivers for reversion to closed, vertically integrated industry models
 - Recent actions in some jurisdictions could jeopardize much of the progress that has been made in wholesale market restructuring
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The Industry Structure Debate: No Agreement on “Optimality”

- While a “more efficient industry structure” was one of the principal arguments for industry restructuring, after more than a decade, the debate over optimal organization is far from settled
 - Clear “winner” is viability of an independent generating sector; T&D sector benefits less identifiable
 - Loss of incentives for new T&D investment and deterioration in reliability frequently linked to move away from vertically integrated model
 - The effects of PUHCA repeal clouded by political resistance to mergers and fears of regulatory “evasion” by utilities freed from SEC oversight
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The Wholesale-Retail Interface

- Default service arrangements (Standard Offer-PLR) for non-core customers are the key determinant of how retail markets impact wholesale
 - Regulators seek to optimize efficiency benefits of exposing end users to real time wholesale prices and political imperative of dampening wholesale price volatility through administratively determined caps
 - Two competing models for default arrangements have evolved
 - auction rights to serve default customers (preferable from a market functioning perspective)
 - request for offers
 - Accurately modeling and forecasting non-core customer loads and preferences are among the major challenges for long term supply adequacy
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Political Equilibrium In Future Wholesale-Retail Market Evolution

- Political drivers of retail market re-design focused on “protecting” retail customers are skewing upstream market decisions; reversion to centralized control
 - Challenge for FERC is to find ways of highlighting adverse wholesale market impacts of State actions while avoiding confrontation and implicit preemption
 - resource planning/portfolio mandates
 - suppression of demand side response (absence of real time pricing) in default service arrangements
 - limits on cost recovery for wholesale purchases
 - incumbent preferences and lack of transparency in auction-RFO implementation
 - constraints on transmission expansion-siting
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Back to the Future (or ‘déjà vu all over again??)

- While the national effort to restructure electricity markets appears to have stalled, progress is really ongoing
 - Need to redefine metrics of “success” in the restructuring debate to conform to a mixed model of competition and regulation.
 - Efficiencies of scale and innovation really do matter—whether supply-side or demand side
 - Price “volatility” is preferable to “predictability” if it provides the needed incentive for CAP-X
 - Even markets that are not fully competitive can provide more efficient outcomes than pervasive regulation
 - Challenge of “reinventing” the coordination and communication mechanisms that were internalized in the old vertically integrated model without undermining competitive benefits of unbundling
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