Myths & Realities of Competitive Electricity Markets

Myth: Electricity restructuring has failed because retail rates are rising – not dropping – in regions with competitive electricity markets.

Reality:

Electricity rates have been rising throughout the country, not only in restructured states. 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 the hurricanes in 2005, and insufficient domestic production. The push for cleaner, more reliable and efficient power plants drive costs higher as well. Despite this pressure, if one takes into account price increases over the same time-frame in other consumer goods like food, housing and health care, electricity price increases are mostly modest by comparison. In addition, wholesale prices actually declined last year in some regions.

Electricity rates are not rising because of the competition brought about in those states that restructured electricity. Many of the states that introduced retail competition incorporated rate freezes that kept rates unchanged for a period of years even as the input costs for generating electricity increased dramatically. These artificial price freezes are not sustainable in the face of these economic realities, particularly when they have been in effect for many years.

Make no mistake – retail customers in states that do not allow customer choice have experienced higher rates 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. Recent reports by several state utility commissions document that prices in competitive markets are lower than what would have been the case in a rate-regulated environment had those states not restructured.

Myth: Rates may be increasing across the country, but the worst increases have been in restructured states.

Reality:

Not so.

In most of the states that restructured to increase competition, political agreements were made to cap rates for a certain period of time and, in some cases, actually roll them back. As a result, many customers in restructured states have been paying below market rates in recent years despite increases in the input costs for generating electricity. As these rate caps expire, rates are catching up and starting to reflect current market prices that are being driven by significantly higher fuel prices. In spite of this, public reports show that even when current prices are adjusted for fuel increases, customers have saved billions of dollars as a result of competitive markets and restructuring. Some state regulatory commissions have taken a variety of steps to phase in these rate increases so customers do not experience a large increase all at once. Finally, requiring utilities to supply power at below market rates keeps competitors from entering those markets. By contrast, states without such restrictions, such as New York and Texas, have markets with multiple competitors selling to consumers.

Myth: Advocates of competition promised better prices for consumers and that there would be many companies fighting to supply customers in states that restructured. Those companies have not made the investments to provide customers the choices they were promised.

Reality:

There are, in fact, many competitive suppliers fighting to serve customers, and studies have repeatedly shown that there have been lower costs resulting from competitive reforms. In a number of cases, that competition is occurring at the wholesale level. Electricity distribution companies have more options than ever before. They can run their own plants, or buy from a wide range of power suppliers – a fact that may be unknown to most retail electricity consumers. In Illinois, New Jersey and Maryland, for example, a dozen or more electricity suppliers participated in state-supervised auctions, fighting for the right to help meet consumer power needs.

Many states have successful competitive programs for retail consumers. A small business or farm in Texas, for instance, may choose to buy electricity from any one of a number of quality companies, who can offer a range of products and services (including "green" or "clean" power options). Where the electricity prices were artificially reduced or frozen by regulation, competition generally has not yet fully evolved. These artificially low prices have kept away alternative retail suppliers to the traditional local utility. However, once price freezes end, there is a greater incentive for more competitive suppliers to enter the markets. The rapid switching to alternate suppliers, particularly by commercial and industrial customers, in states that recently lifted rate caps is proof of this point. The same goes for the high retention rate of end-use customers already served by competitive retail suppliers.

Myth: A return to cost-based rate regulation is more practical given competition's failure.

Reality:

States chose to restructure in the 1990s for the very reason that cost- or rate-based regulation was failing. The goal of policymakers at the time was to ensure affordable and reliable electricity for consumers. That objective remains today. As it does elsewhere in the economy, competition keeps costs as low as possible, drives innovation, and produces the benefits customers are seeking. This is also true for telecommunications services, the advent of discount department stores, or the reforms in the automobile industry in the last quarter century. The fact is that we need more competition, not less. Cost-of-service rates encourage power plant operators to inflate costs and run power plants inefficiently, which saddles consumers with over-priced electricity.

Before restructuring, many power plants were running at only a fraction of their capability. There were massive cost overruns on the construction of new power plants – evidence of this exists today in non-restructured regions like the Southeast. There was little incentive for utilities to save money because everything was bankrolled by the captive customer who had no other choice. Many of these captive customers were the businesses – small and large – that create jobs and build the economy.

When electricity suppliers are allowed to compete to sell their product, the customer wins. If a customer could only buy their car – a critical investment for many – from one company, the result would be higher prices, poor – or no – choices, and ultimately, an unhappy customer. When prices are controlled by regulation and based on whatever costs are deemed "prudently" incurred – plus an administratively determined profit margin – traditional utilities are rewarded for charging more, not less.

Myth: While we cannot completely "put the genie back in the bottle," we should, at the very least, return to cost-of-service rates for the generation of electricity; after all, it seems to work well in the Southeast.

Reality:

In the Southeast, rates have been historically lower than in some other regions because much of the electricity is generated by very old power plants with relatively modest environmental controls and better access to a range of fuel resources. These factors, not vertically-integrated utilities regulated under "cost-of-service" rates, gave this region an advantage over regions that have tougher environmental requirements and newer power plant investments. Whether this advantage will remain in the future is an open question for the Southeast as the cost of fossil fuels rises, and as the power plants in the region are required to install expensive pollution control equipment to meet tougher federal Clean Air Act regulations.

Even in the Southeast, there is ample evidence that increased competition would provide benefits to consumers. For example, in many Southeast states, highly inefficient and costlier natural gas-fired generation continues to be operated by vertically-integrated utilities, while state-of-the-art units built by competitive suppliers, that could save precious natural gas resources and consumers' money, are idled by poor power procurement policies and discriminatory transmission practices.

Myth: Competitive companies can go bankrupt, yet regulated monopolies seldom do. This proves that competitive companies are poorly equipped to provide the public with electricity, an essential commodity.

Reality:

One of the most important benefits of competitive markets is that they shift investment risks away from captive ratepayers to competitive power suppliers. Competitive companies are more disciplined because more is at risk for them if they fail. For one thing, competitive power suppliers are not paid unless their power plants generate power or provide capacity, and their plants do not run if their output is not priced to beat their competitors. By contrast, rate-based utilities are paid regardless of whether their plants run efficiently or run at all. Rate-based facilities have incentives to drive up rates to earn a profit on those higher costs.

Competitive suppliers focus on managing all of the risks associated with producing power. Competitive companies that filed reorganized their affairs continued to operate and supply power to customers, and in almost every case, are now strong financially. Corporate executives may lose their jobs, but the good news is that the customer wins because suppliers bear the risk. Those competitive suppliers that have been reorganized emerged from bankruptcy as stronger competitors. By contrast, when financial difficulties strike rate-based utilities, captive ratepayers or taxpayers are burdened with the cost. Over the last thirty years, these consumers have paid tens of billions of dollars for utility mistakes. Competition is better for consumers.

Myth: Competition was supposed to shift the risk away from consumers. But now generators want "capacity payments" in addition to what they receive for the power they generate. These payments are just another guaranteed rate of return like the system that competition was supposed to replace. What's worse, now they're saying even capacity payments aren't enough to get them to build new coal and nuclear plants at a time when we need to diversity our fuel sources away from natural gas to generate electricity.

Reality:

In a fully competitive market, power generators would only get paid for the electricity they produce. However, rather than fully embracing competition, every wholesale market today has one or more forms of "market mitigation" – a fancy term for artificial limits on prices regardless of underlying supply and demand. If prices are held artificially low for a period of time, particularly as operating and capital costs for new plants increase, investment in new facilities will not be made, and even existing plants may not be able to be maintained. Therefore, a capacity payment is needed to compensate a power generator for some of the fixed costs of the power plant that stands ready to generate electricity as needed to meet consumer demand. This is especially important for plants that are desperately needed to keep the lights on during the hottest summer or coldest winter days but run less the rest of the year.

Competitive suppliers already operate a diverse mix of coal, nuclear, renewable, and gas-fired power plants. These companies are also developing new coal, nuclear and renewable plants and expanding existing facilities. Whether they are built by a competitive supplier or a vertically integrated monopoly utility, coal and nuclear plants require billions of dollars to construct, take a long time to build, and may not work as predicted when new technologies are deployed. In markets where wholesale prices are artificially limited, capacity payments may be the only way to ensure that needed, fuel-diverse power plants get built – on time and without regulatory guarantees that force customers to pay for bad investment decisions.

Myth: To build new IGCC coal gasification or nuclear power plants built in our state, the best approach would be to help a utility finance this project with state bonds or other ratepayer and taxpayer incentives.

Reality:

Hardly. When the nation relied on utilities to build all the new power plants in a given area 20 years ago, billions of dollars in "stranded costs" were created. It has been proven time and again that competition can get those plants built and operating more quickly and more cost effectively. Competitive suppliers own and operate nuclear, coal, natural gas and renewable power plants. Any state that desires a specific resource mix should decide what type of incentives to offer and then invite all developers to compete to build new plants with those incentives. Just as consumers would comparison-shop before buying a car, anyone seeking a new power plant should recognize that head-to-head competition is the best way to ensure that customers get the best deal and are not burdened with cost overruns or poorly operating plants. The "right plant" should be constructed at the best cost.

Myth: We don't need to build more power plants. The lights are on today, so we should focus on conservation, transmission and the plants that we have today.

Reality:

This is a false choice. Electricity demand is projected to substantially increase over the next decade even with greater conservation. The U.S. economy has become remarkably energy-efficient in recent decades. However, electricity remains the lifeblood of the economy, powering homes, factories, hospitals and the information age. As the economy grows and the population expands, new power plants will be needed to meet these demands and replace aging power plants that use too much fuel and have higher emissions.

Just as financial advisors recommend that consumers diversify their financial assets, we need a diverse mix of new generation plants using a variety of fuels, as well as more conservation, more energy efficiency, and more investment in transmission. We also need greater efficiencies and higher output from existing power plants. Competitive suppliers have proven they can run existing plants better than before

competitive markets were introduced. Lastly, competitive markets bring more transparency to retail prices. Often, rate-based regulation leads to hidden costs and confusing bills that hinder effective conservation policies.

Myth: All competition has brought is more natural gas fired power plants, when what the nation needs is more coal and nuclear generation. Competitive markets seem to be permanently biased toward construction of a gas-fired plant.

Reality:

Competitive electricity suppliers are the most fuel diverse generators in the business. Nearly 40% of the electric generation capacity in the U.S. is competitive and more than two-thirds of this output is from coal, nuclear and renewable power plants.

During most of the past 15 years, natural gas has had cost and environmental advantages that made it preferred by new power plant developers – whether in competitive markets or under rate-based regulation in states that did not restructure. When natural gas prices have risen significantly, there has been a steady shift to interest in alternative resources such as coal, renewables, and nuclear energy. Competitive markets have helped this process by creating fundamental new opportunities for investment in fuel diversity. Coal-fired power plants that are built at the mine (mine mouth) can rely on new regional markets to obtain access to distant customers. High technology renewable power developers can implement national strategies appropriate to the resource (e.g., wind). Larger company balance sheets, better nuclear plant management and environmental considerations are opening the door to the first new nuclear investment in a generation. Lastly, competitive generators have an excellent record of true technical innovation. Whether it is gas, coal or renewables, our companies are on the cutting edge when it comes to efficiency, cost-management and better pollution control.

Some natural gas-fired power plants that were built recently are, in fact, not running today – idled by high gas prices. If these unused power plants are owned by rate-regulated utility companies, customers are paying for them anyway. If these plants are owned by competitive firms, the customers are not. Once again, for cost-plus businesses, good investment strategies and ideas are not required. In competitive markets, they are.