Preliminary response to the EIA report

Will Electricity Competition Increase Northwest Electricity Costs? ? Part II

This paper is written in response to recent headlines declaring that prices in the Pacific Northwest could increase if a competitive retail electricity market is created. The headlines were prompted by the recent release of a preliminary analysis by the U.S. Energy Information Administration (EIA). That study was based on a model of competitive electricity markets, and concluded that electricity prices are likely to increase in the Northwest under competitive markets. These concerns have been expressed for some time here in the region and were addressed in an earlier paper from the Council "Are customers of Northwest utilities likely to pay higher rates due to competition?"

This paper addresses the EIA study specifically. Higher electricity prices as a result of competition are a possibility the region needs to consider, but it is not at all certain. To a significant extent, the EIA study?s conclusion is the result of technical and, more importantly, policy assumptions made in their analysis. Moreover, the analysis addresses only one aspect of the effects of competition. The potential longer-term benefits of competition are given little attention. This paper addresses three issues related to the EIA study and retail competition: (1) The paper raises some important technical concerns about the EIA analysis and its assumptions. (2) It discusses the policy assumptions implicit in the EIA analysis and the implications for regional electricity restructuring policy. (3) It distinguishes the short-term electricity price effects that are the subject of the EIA study from the longer-term reasons for encouraging competition.

In summary, our conclusions are:

1. The EIA analysis incorporates a number of technical assumptions that would lead to an overstatement of the competitive price of electricity.
2. The EIA?s conclusion that electricity prices (or, more accurately the cost of electricity to consumers) would go up in the Northwest under competition (and down in many other parts of the country) is largely the result of a policy assumption. That assumption results in shifts of the benefits of existing low cost generation and the costs of existing high cost generation from consumers to owners. Such shifts are not a given and, in fact, are contrary to the restructuring policy decisions that have been made around the country.
3. The EIA analysis pays little attention to the long-term benefits that many believe will result from competition. In the long run, competition should lead to greater innovation in electricity services, greater system efficiency, and, ultimately, lower power costs than would be the case in a protected monopoly environment.

Technical Limitations of the EIA Study

Although not the main point of this paper, there are reasons to believe that the results of the EIA study overstate the likely competitive price of electricity. This would result in overestimation of the short- and medium-term prices that could be expected in a competitive electricity market and also overestimation of any increase in price that might be experienced by Northwest consumers. The reasons are listed below:

- The estimated cost of a new combined-cycle combustion turbine, which tends to become the

marginal new power source and set electricity prices, is one third higher in the EIA study than in the Council?s power plan. If anything, the Council?s estimates have been criticized as being overly conservative (i.e., higher cost).

- EIA?s estimates of competitive electricity prices in the Northwest are more than double the prices that have been typically observed in the competitive market at the California/Oregon border since that market has existed. Comparing the EIA?s estimates of competitive market prices for the California/Southern Nevada Power Area with other estimates for that area show the EIA estimates to be from 1 to 2 cents/kwh higher. [See the LCG Consulting Report]
- The EIA study assumes average water conditions in the Pacific Northwest, but does not consider purchases of firm or secondary energy from Canadian power markets. Northwest electricity exports to Canada were assumed to double, presumably reflecting the return of the Canadian entitlement, but because Canadian energy markets were not modeled, the possibility that the power could be remarketed in the Northwest is not reflected.
- The report underestimates the rate at which new, lower cost electricity generating plants may replace older plants by assuming no early retirement of existing generation.

We cannot, at the present time, assess accurately the extent to which the EIA analysis overestimates market prices but we believe it does. The Council will be undertaking analyses in the coming months that should provide better estimates of the West Coast and Northwest markets.

Policy Assumptions and Their Implications

Regardless of these arguments about the specific results of the EIA study, there is a great deal of uncertainty about future competitive electricity prices. It is possible, even likely, that for many Northwest utilities future competitive market prices could be above current costs. That does not mean, however, that the existing customers of that utility have to experience higher total electricity cost as a result of competition. That is a policy choice for legislators and regulators. To a large extent, the EIA study?s conclusion that the Northwest would experience higher costs as a result of competition (and the conclusion that the other parts of the nation would experience lower costs) is the result of implicit policy assumptions made by the EIA. Those assumptions have to do with the treatment of stranded costs and their mirror image, competitive "windfall profits."

Stranded costs occur when utilities cannot recover their fixed costs of *existing* generation at competitive market prices. Much of the restructuring debate has been on the question of stranded costs. In virtually all cases, regulators and/or legislatures have decided that when markets are opened up to competition, utilities are entitled to recover most or all of their stranded costs from their existing ratepayer base ? their distribution customers. [In contrast, all the costs of new resources in a

competitive market are the responsibility of the owners. The owners bear the risks of new resource decisions.] The policy rationale is that when those investments were made, the utility owners had a reasonable expectation that their monopoly customers would pay those costs. The EIA analysis, however, ignores this policy reality. Consequently, in those areas with high cost existing resources, the EIA analysis finds competitive prices to be significantly less than the average costs that would be charged in a monopoly environment. That is because those average costs include the stranded investment and the competitive prices do not. It is an "apples and oranges" comparison. The lower competitive prices are the result of shifting existing fixed costs from the distribution customers to the owners.

Wind fall profits can be created when utilities with low cost resources, who had previously been constrained to selling their power at average cost based rates, are allowed to sell that power at market rates. This is the situation that could exist for several utilities in the Northwest. This issue has not yet been fully engaged because restructuring has been advancing more rapidly in areas with high cost generation. When it is engaged, the parallel with the recovery of stranded costs should be evident. If it is reasonable policy for the distribution customers to pay a significant share of the stranded costs of high cost utilities, an equally reasonable and symmetric policy would be for distribution customers to

receive a significant share of the windfall profits from existing low-cost resources. The EIA analysis ignored windfall profits as it did stranded costs, and consequently their market prices are higher than current average costs in areas where the consumers are currently enjoying the benefits of existing low cost resources. The effect is to shift benefits of existing generation from consumers to the owners.

While one reaction to the possibility of increased prices is to postpone or limit competition in the region, this response would have serious drawbacks. Delaying retail competition is likely to allow large electricity users to capture any available low-cost electricity leaving captive customers with higher costs. It would also delay the longer-term benefits of consumer choice that are the real goal of restructuring.

There are better policy responses available to the region for dealing with the risk that competitive market prices could be higher than current average costs. In its latest power plan and in other places, the Council has urged that the region?s utility regulators develop *symmetrical* transition cost recovery methods that include the possibility of both stranded costs and windfall profits.. Stranded costs and windfall profits are simply mirror images of one another. During some transition period, distribution customers of utilities should share symmetrically in responsibility for paying stranded costs or benefiting from windfall profits.

Developing stranded cost/windfall profit policies would be a positive activity for regulators and legislatures in the region. Delaying retail competition is only likely to result in policies being dictated at the national level, cost shifting among consumers as customers with market power get market access, and a delay of the long-term benefits of competition.

Short-term Versus Long-term Effects of Competition

Electricity prices will be affected by the change from regulated pricing to market pricing. This change was described in the Council paper referenced above, and would be the immediate short-term effect of

deregulated electricity generation. It is important to understand that such short-term changes in electricity prices do not represent real gains in economic efficiency. Absent policy action on transition costs, any immediate reduction in price would just be a shift in costs from consumers to owners of electricity generation. Losses suffered by electricity generation companies and their stockholders would about equal the gains to consumers. In areas where prices increase, the opposite would be true, consumer?s losses would equal increased profits for owners of generation capacity. Stranded cost/windfall profits policies simply mitigate for all or some part of this transfer by adding a charge, or providing a credit, to the price of electricity. For example, if full sharing of windfall profits were the policy, and electricity prices increased, the consumer?s cost of electricity would be unaffected because the price increase would be offset by a windfall profit credit on the consumer?s bill.

The EIA study primarily addresses these short-term effects of competition on electricity pricing. Likewise, most of the regional discussion about the possibility of increased electricity costs has focused on this short-term concern. In the areas of the country that have high electricity costs, these potential short-term price reductions could be large. While the current competitive pressures, even in this low cost region, tend to indicate that there may be some short term price savings available, such benefits, if they materialize at all, will be certainly be smaller for this region than for many others.

In the longer term, there are more fundamental reasons to encourage competition in electricity markets. The Comprehensive Review report put it this way:

> **The goal of the Comprehensive Review Steering Committee recommendations on retail markets and consumer choice is to encourage a more efficient power system, lower electricity costs, increased product choice and greater product innovation for all consumers.**

The Comprehensive Review goals of greater efficiency, increased product choice and innovation will lead to lower electricity costs over time. However, these longer-term benefits of competition are more difficult to quantify and have not been as prominent in regional analyses and discussions. Nevertheless, the benefits of increased efficiency, innovation, and product choice have been significant in other industries that have been opened to increased competition.

These long-term benefits, as well as the shorter-term cost reductions likely to occur in most parts of the country, have been driving the national debate on restructuring. It was a widely held perception during the Comprehensive Review that restructuring was likely to happen at the national level and that this region needed to determine the best way to position itself for the changing industry. Simply ignoring the changing electricity industry is not an option for this region. Implementing restructuring policies that are appropriate for the realities of this region is the only option.

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