

## An Open Letter Concerning Electricity Markets

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Congress, and the Federal Energy Regulatory Commission, are currently facing difficult choices concerning the future of energy markets. There are, for example, elements in recently proposed legislation that would restrict or constrain the FERC's efforts to pursue national market designs, and other elements that favor an outright return to vertical integration under traditional regulation. For the reasons outlined below, Congress should resist the temptation to trade the opportunities inherent in broader and more effective markets for the expensive comforts of the past.

Ever since the passage of the Energy Policy Act, FERC has been facing the problem that electricity markets have outgrown state boundaries. FERC's effort to implement Standard Market Design is the latest, and the most coherent, effort to find a way to capture the benefits of a more broadly integrated and geographically more extensive electricity market.

Where markets are larger, the overall efficiency of the system is improved to the benefit of the country as a whole. Larger markets permit the capture of the benefits of dispatch over a larger set of available resources; take advantage of load smoothing available when areas with different climate and demographics act in concert; increase fuel diversity and security; and reduce the opportunities for the exercise of market power. Moreover, advances in information technologies now permit "real time" control, trading, and monitoring in much larger electricity markets than was possible a few years ago.

Once electricity markets spill over state boundaries, as they have and will continue to do, there is a fundamental and difficult political and institutional problem: how do you match the constituency of the political entity making decisions about a market to the geographic scope of the market? Individual states are simply too small and inevitably too parochial to govern a multi-state market. Moreover, even if states develop market structures that, standing alone, would work well for their constituents, so long as

each jurisdiction makes its decisions separately there will be inevitable differences that will make the full and enduring operation of an integrated market encompassing many states difficult or impossible.

This suggests the need for a referee with the authority to ensure, not just recommend, consistency. In the absence of intermediate entities (i.e. multi-state bodies with teeth), the overall benefits to be achieved in the electricity sector are likely to be realized only if FERC, and not each individual state, has the responsibility and authority to make and enforce market rules.

Thus the FERC Standard Market Design (and White Paper) proposals are entirely logical responses to the problems that emerge in the shift from localized central planning models for electricity production and sale to market-driven allocations of resources for some -- though importantly not all -- aspects of the system. The premise of SMD is that you cannot operate a geographically broad market successfully with competing sets of rules. It seems intuitively obvious that standardization is vitally important to capturing the substantial benefits to the country as a whole that are available from larger markets. (Indeed, the recent blackout is a sobering reminder of the importance of coordination and clear policy in electricity transmission, and of the risks to that system inherent in diffuse authority.)

This is not to say that states should be asked to abdicate their role in protecting consumers. It means instead that, where differences among states in siting, resource planning, market rules, and reserve margins (to name some of the more important issues where the states have had the paramount role in the past) prevent the achievement of important efficiencies, only FERC currently has both the resources and the appropriately national perspective to resolve those differences. FERC efforts cannot be fairly seen as a nefarious power grab from Washington: SMD is the logical consequence of the technological developments (such as Information Technologies) that have made larger markets possible and of the market-opening principles of the Federal Power Act.

FERC should be encouraged to resolve, promptly, the issues raised by this inevitable and positive move to larger markets. The issue of how the benefits are shared is obviously important: left to its own, there is a real chance that an expanded market will produce huge benefits for customers in some areas, but actually increase the prices

for others. The FERC thus needs to look for ways to smooth the transition to a system of more efficient and more averaged prices (or, more precisely, prices that vary from place to place based on the characteristics and locations of their generation and transmission capabilities rather than accidents of political history). In this regard, there is some interesting work being done in the Northeast, in which the Maine PUC is participating, to see if this issue can be resolved in the context of the integration of the New York, New England and PJM markets.

The SMD debate, seen in broad perspective, provides an opportunity to re-evaluate the role of electricity pricing in the competition -- or mutual support -- among states. Giving states the primary market role means that some will do very well, and some less well, based on factors ranging from natural resources to regulatory competence to historical levels of federal project support. There may be greater benefits for the country as a whole, however, if prices converge across the country to an overall level that is below the current (and any future) average of Balkanized prices. Should wide variations in pricing continue to divide us, or should we collectively seek the lowest overall cost (which I believe the broad and harmonized market envisioned by the FERC is designed to achieve) and find a way to share the benefits? The answer that best serves the nation is self-evident. Those who oppose the basic principles in the FERC's SMD proposal should be compelled at least to articulate how similar benefits can be achieved another way or why they should not be sought. A retreat to reliance on individual state authority -- whether under the guise of "deference" to state commissions or otherwise -- is a wholly inappropriate response to our paramount need to use our energy resources efficiently.

In this debate, we should not expect a state that now benefits from inexpensive federal power projects to leap to the idea that markets should be expanded and standardized in a way that might require that cheap power to be shared: for such a state, it's hard to answer the "if it ain't broke don't fix it" homily. On the other hand, my views are admittedly colored by the unhappy experience Maine -- and some other New England states -- had in using the PURPA central planning model. It was a noble idea that failed because, as we discovered too late, even the best combination of regulatory and utility talent is unlikely to be able to match the efficiencies, and predict accurately the vagaries,

of the marketplace. We should, however, all welcome the opportunity to see whether the kind of standardization proposed by the FERC can increase the efficiency and reduce the cost of satisfying our electricity needs for the country as a whole. If it can, then there should be a heavy burden on those who argue that we should delay or oppose implementing the market that FERC envisions.

In the assessment of the relative support for FERC's efforts among commissioners and those in the market, we should recognize that the terms of the public debate are asymmetrical: those who are favorably disposed in principle to the thrust of the proposed rule may disagree with one or more of its general aspects and likely several of its specifics. Thus, while opponents can be clear and effective in denouncing the entirety of something that for some reason they dislike (issuing impassioned calls to arms), those open to the proposal are likely to be restrained in their support until the details that concern them are worked out. It should be revealing that much of the support for FERC's efforts comes from areas, like New England and the mid-Atlantic, where commissioners have real experience with real markets.

In conclusion, congress and other policy makers should support FERC's efforts to achieve the geographically broad and workably competitive wholesale markets in electricity that will produce, for the country, substantial gains in efficiency and savings to consumers. We can no longer afford the often hidden cost of regional and local differences that prevent achieving those savings. Congress should avoid diverting FERC's effort, and allow the FERC, in concert with other commissions and all the affected market participants, to focus on implementing geographically broad and effectively competitive wholesale electricity markets.