



Consumer Federation of America



Publisher of Consumer Reports

THE FEDERAL RESPONSE TO THE 2003 BLACKOUT: TIME TO PUT THE PUBLIC INTEREST FIRST

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**Subcommittee On Oversight Of Government Management,
The Federal Workforce And The District Of Columbia
Committee On Governmental Affairs, United States Senate**

SEPTEMBER 10, 2003

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE,

My name is Dr. Mark Cooper. I am Director of Research at the Consumer Federation of America (CFA).¹ I also appear today on behalf of Consumers Union.² We have been deeply engaged in the debate over electricity restructuring and deregulation for almost two decades. I have submitted to you a list of appearances I have made before Congress and Federal Agencies, as well as state regulatory commissions, on this issue. I have also submitted the studies and analyses of the faltering efforts to deregulate electricity, which we have conducted since 1997, soon after the first radical restructuring laws were passed in a couple of states. Every six months for the last twenty years we have been cautioning policymakers not to experiment with electricity or treat it like any other commodity.

I greatly appreciate the opportunity to appear before you today to present the residential ratepayer view of the federal role in the ongoing troubles of deregulated electricity markets. It is about time that the voice of the little guy and gal, the people who pay the bill, is heard on this matter. It is about time that you get the perspective of local jurisdictions that have had the good sense not to go down the road of electricity restructuring and deregulation or have decided to change course after being badly burned by deregulation and restructuring. Two-thirds of the states have figured out that deregulation is a road to ruin. It is time for federal authorities to change course too, or at least to pause for a substantial period while they rebuild the physical and institutional infrastructure of the electricity grid.

ELECTRICITY RESTRUCTURING DOES NOT ADD UP FOR RESIDENTIAL CONSUMERS

In the wake of the massive blackout in the Northeast, government officials and industry experts are calling for a massive upgrade of the transmission system that will cost between \$50 billion and \$100 billion. The annual carrying costs for such a capital outlay are certain to be in the range of \$10 billion to \$25 billion, or even more if the merchant model being pushed by the

¹ CFA is the nation's largest consumer advocacy group, a non-profit association of 300 pro-consumer groups, with a combined membership of 50 million, founded in 1968 to advance the consumer interest through advocacy and education.

² Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide consumers with information, education and counsel about goods, services, health, and personal finance; and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of *Consumer Reports*, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports*, with approximately 4.5 million paid subscribers, regularly carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

Federal Energy Regulatory Commission (FERC) is pursued. Many experts are beginning to admit that a substantial part of the upgrade costs are caused by the need to support the increased strains on the system that occurs in deregulated electricity markets. In contrast to these huge costs, the Department of Energy conducted a study earlier this year using extraordinarily optimistic and unfounded assumptions but still projected less than \$1 billion of efficiency gains from implementation of FERC's Standard Market Design. FERC's own study found equally meager gains, while studies by other regulatory commissions question whether even those small benefits are realistic.

A consumer does not need a degree in electrical engineering to see that these numbers do not add up. If the costs outweigh the benefits, why should we bother? At a minimum, policymakers should inquire as to what it would cost to run a reliable system without the added demands on the system and associated costs of supporting deregulated markets.

Frankly, with the discovery of massive infrastructure costs needed to support deregulation and the run up in natural gas prices, there is no chance that deregulation will produce benefits for the vast majority of residential consumers. In the northeast and mid-west where regulators did a miserable job of protecting consumer interests in the 1980s and 1990s, it was possible to use regulatory mechanisms to hold consumers harmless during the early phase of deregulation, but those days are gone. Consumers now face huge price increases as the dash to gas-fired generation in the past decade will flow through to the electricity meter and meet up with the excessive capital costs of deregulated markets.

ELECTRICITY IS A UNIQUE AND VITAL SERVICE, NOT JUST A COMMODITY

This is not the first time that the electricity market has thrown a curve at deregulation. In fact, restructured electricity markets have lurched from crisis to crisis – the price spikes of 1998, the outages of 1999, and the California meltdown of 2000-2001. All of these events share a common cause – electricity is different from any other service or commodity.

Historically, the uniquely American approach to delivering this vital and difficult service was to allow private companies to own both transmission and generation and provide service in exclusive territories, subject to public interest obligations. The integration of generation and production fostered coordination and effective management of the network. Exclusive territories lowered the risk and costs associated with long-term inflexible assets. Public interest obligations, such as the obligation to serve all customers at just and reasonable rates, protected the public from the abuse of monopoly power while preserving companies' incentive to invest in the network.

This pragmatic approach was certainly not perfect, but it achieved a critical balance between public and private interests. In the past decade, policymakers lost sight of these fundamentals and deregulation upset that balance, particularly for the transmission system. De-integration quickly turned into disintegration.

Electricity has no substitutes. It is not storable. It is essential to health, safety and the economy. It must be delivered under incredibly demanding conditions through an extremely capital intensive infrastructure.

It was blatantly irresponsible for Federal and state authorities to rush ahead with deregulation without the necessary physical and institutional infrastructure to support the

markets they were trying to create. It would be grossly negligent for Congress to allow restructuring to continue without taking a long pause to repair the damage that has been done to consumers and the electricity infrastructure.

RESTRUCTURING AND DEREGULATION MAKE IT MORE DIFFICULT TO ENSURE RELIABILITY

Make no mistake about it; deregulation and restructuring have increased the stress on the transmission system. There are numerous economic and operational mechanisms through which electricity restructuring and deregulation increased pressures on the nation's electricity transmission network:

- ? A dramatic increase in the number and complexity of transactions, which the system was not designed to support.
- ? Difficulties of coordination and planning as competition and contracts replace vertically integrated operational and administrative decisions.
- ? Deregulation short-circuited utility incentives to invest in transmission because the private interests of facility owners came into conflict with the shared, public nature of the transmission grid and created a disincentive to spend on maintenance because of profit pressures and the perceived competitive disadvantage associated with spending on a system shared with potential competitors.
- ? Increasing needs for excess capacity to cope with market manipulation problems that plague electricity markets and to dampen price spikes that result from trying to treat electricity like a commodity, all of which must be paid for with the higher cost of merchant finance.
- ? Failure to account for the social and environmental constraints on increasing transmission capacity and to provide a framework for comprehensive planning that integrates alternative approaches, like energy efficiency and local (distributed) generation (such as co-generation).

Given the massive costs of deregulated markets that are now coming into view and the meager gains that such markets appear to promise, not to mention a track record of market manipulation, price volatility and lack of consumer choice, it may be a lot cheaper for the handful of states who have deregulated to go back than to force the majority of states down the problem riddled road toward deregulation.

THE GRID IS BASIC INFRASTRUCTURE: A HIGHWAY, NOT A MARKET

Transmission facilities are critical infrastructure of a modern society and digital economy that must be dedicated to promoting the public interest. They are part of a shared system in which the fate of each user and producer is tied to the behavior of others. The fundamental problem with transmission is not inadequate economic incentives to invest; utilities were willing to do so before deregulation the problem is public resistance to the building of additional transmission lines for environmental, health and safety reasons. The social cost of transmission facilities is far greater than their economic costs. For this reason, scarcity of transmission in the economic sense is likely to be a permanent part of the industry landscape.

Moreover, the benefits of shared transmission facilities that support the overall network are difficult to align with private calculations of costs and benefits. The problem is both geographic, determining which benefits accrue to which areas, and intergenerational, recognizing that different parts of the system may benefit differently from the same investment across time. Today's investment to serve a long distance transaction may be a core part of tomorrow's system serving native (local) load. The shared nature of facilities makes it more difficult for private investors to recover their costs and to overcome the social resistance to the siting of facilities. The shared nature of facilities across jurisdictions makes it more difficult to reconcile competing interests. Such public investment is best carried out within the framework of a comprehensive plan. Yet, integrated resource planning is harder to implement in the deregulated model, if it is not abandoned altogether.

We take the primary lesson of the decade of deregulation to be that we need to restore the balance of public and private interests in the electricity sector. Society cannot rely on private actors to ensure that adequate investments are made in vital public goods, such as the electric transmission grid. The transmission system is a highway, not a market, and should be developed under a public interest model in which the primary purpose of all participants is to ensure reliability and protect the public. The obligation to serve, which transmission utilities properly bear, must be matched with a duty to build. Bribing merchants to provide these vital public goods, such as through "incentive" payments, unbridled expansion into non-utility businesses, and the auctioning of transmission capacity to the highest bidder, will be particularly expensive.

These lessons have been clear for quite some time. Federal authorities simply seem unwilling to get the message. Two years ago, in the midst of the last crisis of electricity restructuring and deregulation, in testimony I entitled "The Federal Role in the Deregulation Tragedy," I offered the following conclusions about transmission:

The failure to recognize the important role of the continuing monopoly in transmission resulted in the under-regulation of the wires segments of the industry. The transmission wires are the highways of commerce over which electricity flows. This is a highway system, not a market, which constitutes an essential, bottleneck facility with virtually no redundancy and never likely to support head-to-head competition. One of its primary inputs is right-of-way, which relies on governmental power of condemnation. The biggest obstacle to the expansion of transmission capacity is a social externality – public concern about ugly wires and local health effects – not inadequate economic incentives. Proposals to let the marketplace solve the wires problem are not likely to succeed, since given the market power that the wire "owner" would possess and the non-market barriers to expanding capacity, profit maximization would only result in the abuse of market power and the creation of artificial scarcity rents.

The right model for transmission is a public or private entity imbued with the public interest and dedicated to ensuring that this essential facility fulfils its public functions – ensuring reliability and supporting nondiscriminatory market transactions in the widest area possible to achieve economies of coordination and maximum competitive effect. It must be independent of market participants and directly accountable to public authorities for achieving those goals. Transactions must be standardized and transparent, with the creation of an exchange in which all rates terms and conditions can be identified. Brokers must

be subject to rules that are similar to those applied to financial transactions like stock sales.

We offered similar advice to the Congress last year in a report entitled “All Pain: No Gain:”

Rather than rushing ahead with restructuring and deregulation, Congress and FERC need to step back and fully understand the implications of the abuses, operational disruptions, and the financial crisis that has occurred in the electricity industry. Congress must restore simplicity and transparency to the industry. The first goal must be to reinforce consumer and investor protections. A comprehensive review of the national transmission system should be conducted. Effective mechanisms for planning and expanding the grid should be demonstrated in reality. Institutions for managing the grid and overseeing trading should be transfigured before moving forward.

I could go back two decades and the message would be the same. I understand the pressures to do something in the wake of the blackout, but when it comes to electricity, doing just anything will not help. You have to do the right thing, or you will make matters worse.

WHAT FEDERAL AUTHORITIES SHOULD NOT DO

Policymakers could have eased the transition to competitive generation markets by recognizing the physical and institutional infrastructure that would be needed to support greater competition, but they did not. Perhaps they realized that presenting a true picture of the difficulty of electricity deregulation would have made it impossible to sell to the public. Whatever the reason behind the underestimation of the difficulties of deregulation, the build-up of problems now makes the implementation of competition a much riskier proposition. Not only has the inadequacy of institutions and facilities grown, but public confidence in the process has also been eroded. Congress needs to start solving the problem by stopping the deregulation train.

Do not repeal the Public Utilities Holding Company Act (PUHCA). Congress does not need to allow utilities to diversify into non-utility businesses and form huge multi-state holding companies by repealing PUHCA to solve the reliability problem. This would subject the utility industry to less oversight, by allowing utilities to play a shell game with their assets and increasing FERC’s responsibility, which has so far been completely unable to deal with the manipulation of markets in the west and with the misreporting of energy prices.

Do not allow the FERC to impose its complex “Standard Market Design” on the nation. Regional transmission organizations that are dominated by industry and preempt local accountability while forcing utilities into markets that allocate transmission resources to the highest bidder, with no assurances that transmission is presently adequate or that additional transmission capacity would be built or adequately maintained, are a prescription for disaster.

Do not rely on industry self-regulation for reliability. The proposal to move from voluntary *self-regulation* to mandatory *self-regulation* misses the point. The problem is not the voluntary part; it is the *self-regulation* part. The industry will simply not regulate itself sufficiently, especially in a market-oriented system, to protect the public. The private interests of the large players will always come first.

Do not create private transmission monopolies. Transmission services are a natural monopoly and part of a shared network. Transferring control to unregulated private parties will simply allow them to abuse captive customers and shift costs onto the backs of ratepayers throughout the system.

WHAT FEDERAL AUTHORITIES SHOULD DO

Federal authorities should devote all of their energy to promoting the public interest, not the profits of merchant generators and transmission owners, by studying, strengthening and managing the interstate transmission system. **Any interstate transmission organization must be based on fairness and public accountability.** We must create new institutions that can reconcile the interests of the states and include representation of consumer interests. Interstate compacts or federal state-joint boards are a possibility.

Fairness requires that an interstate transmission organization embody a process for fair representation of all interests affected by transmission projects. Local consumers and citizens must not be excluded from the process. **Accountability** demands that local officials who get the phone calls when the lights go out must be in a position of authority. Standards must be set by responsible authorities and be mandatory, with stiff penalties for failure to comply. Industry self-regulation will not do. Public accountability also requires **transparency**. The competition between the FERC and the DOE, and the army of private consultants muddying the picture of what happens on the transmission grid, is unacceptable.

The obstacle to expanding transmission is not inadequate economic incentives; the obstacles are environmental, public health, and safety concerns. Even if economic incentives were a problem, **the solution is not to increase incentives; it is to lower risk.** The cost of bottleneck, infrastructure facilities are much lower when they are funded through a utility finance model. Utility investments in transmission facilities will easily attract capital if policy makers restore their traditional quality of stable, dividend paying investments.

Congress should require a framework for **comprehensive planning that considers all alternatives.** It should **get serious about energy efficiency**, like mandating higher minimum standards for air conditioners, which would reduce demands on the grid at its most vulnerable times, hot summer days. It could also **give a boost to local (distributed) generation**, which has the double benefit of adding generation resources to the system while not using long distance transmission lines, whose failure triggered the recent blackout.

Unfortunately, both the House and Senate bills that are being reconciled in conference violate virtually every one of these consumer “Do’s” and “Don’ts.” The fact that the Congress has failed to act in the past several years is actually a good thing for consumers because Congress has never once come close to passing legislation that would do the right thing. Now is the time to focus on the real problem, restore accountability and oversight over the industry and put the public interest first.