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Working Party No. 2 on Competition and Regulation

Self Evaluation Exercise on Implementation of Regulatory Reform Recommendations

---United States---

30 May 2004

The attached document is submitted by the delegation of the United States to the Working Party No. 2 of the Competition Committee FOR DISCUSSION under Item IV of the agenda at its forthcoming meeting on 30 May 2005.

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Implementation of regulatory reform recommendations

1. The OECD Background Report on Regulatory Reform in the Electricity Industry for the U.S. was completed in 1998. At that juncture, the OECD report saw significant progress toward increased competition in the sector, but considerable uncertainty concerning non-discriminatory access to transmission services, policy tensions between the states on the prospects for effective retail competition, and policy tensions between the federal sector regulator (FERC) and state regulators and legislators. At that time, other outstanding issues included stranded costs, transmission pricing and siting, price responsive demand, and existing market power. While many of these issues remain active today, the U.S. has seen improvements and FERC has implemented policies consistent with the recommendations made in the OECD's background report.

- The report recommended the following (overview of status in parentheses):

- Regional pacts to address problems that are common at the regional level, but which vary considerably between regions (some regional groups are at the early stage of formation; FERC has been encouraging state regulators and other agencies to form regional committees to which FERC would look for advice and input on such regional transmission organization (RTO) matters as transmission cost allocation, congestion management and resource adequacy; such committees have been formed in two RTO regions and a third is now in progress)

- Real-time pricing (several states with retail competition have recently required real-time pricing for large commercial and industrial (C&I) customers, some traditional utilities have real-time pricing programs, the Energy bill encourages states to offer real-time rates; FERC encourages the RTOs and independent system operators (ISOs) to accommodate price responsiveness, but this is largely a state matter; some RTOs are developing approaches that allow large retail customers to bid consumption reductions to wholesale reserve markets)

- Improved hedging opportunities for buyers and sellers (many have developed including some regular exchanges)

- Experimentation with locational marginal pricing (widely implemented in RTOs)

- Improvements in calculations of available transmission capacity (some improvements, partially obviated by RTO formation)

- Competition advocacy by the antitrust authorities (ongoing; in addition to the antitrust authorities, FERC policies also encourage competition in wholesale markets)

- Refinements in merger and anticompetitive conduct methodologies (revised; however, the application of competitive analysis such as that used by the competition agencies continues to be developed; it is unclear whether additional improvements to alleviate methodological and investigative problems, *e.g.*, FERC's lack of civil investigative demand authority, can be accomplished without additional legislative change)

- Consideration of FERC transmission siting authority (in the Energy bill; the Department of Energy is developing a program to identify and designate national interest transmission bottlenecks)

- Required divestiture of generation from transmission in the same area (RTOs largely substituted for transmission companies (Transcos); some Transcos now forming)

- Divestiture and transmission remedies for existing market power (some states ordered this as part of stranded cost assessment process; many utilities did so voluntarily; forced divestiture to solve market power problems is still rare; FERC has required this as a condition for one merger; FERC has also strengthened its approach to affiliate transactions to help avoid *de facto* rebundling of transmission and generation, which have been unbundled to some degree)

- Improved connection rules for independent generators (largely completed)

- reduced entry impediments for new, independent generators (some improvements, shift toward combined cycle gas turbine alleviated several entry impediment issues; California and other states have improved entry approval procedures to reduce delays in siting decisions; continuing commitment at federal level to coordinate and streamline the permitting process)

- Focused policies to avoid transmission discrimination (RTO formation is primary remedy; revived interest in refinement of behavioral rules against transmission discrimination).

2. There are several general observations about implementation of this list of recommendations that can be made. The first observation is that nearly all of them are still active policy issues. Only the question of stranded costs has really faded from the policy debate (because of general agreement that stranded costs would be collected and paid to the relevant utilities; much of this revenue has, in fact, been collected). The question of connection rules is close to being resolved. The second observation is that some progress has been made on most of these topics. The third observation is that the degree of progress varies greatly by region of the country. Progress has been modest in the SE and NW and these areas have been vocal in opposing many federal level regulatory reforms. The fourth observation is that any progress is somewhat remarkable in view of the tumultuous events that have rocked electricity markets in the U.S. in the intervening years. These include the California energy crisis, the run up in natural gas prices, 9/11 security concerns, two major black outs, and the bankruptcies of Enron, Dynegy, and others. The fifth observation is that pending energy legislation before Congress deals directly with several of these policy concerns. There has been progress in many areas, but it has been slow and uneven.

Roadblocks to implementation

3. Aside from the events listed above, implementation of reforms has been slow in part because of the active political resistance of utilities and others in the SE and NW. The SE area of the country has low electricity generation costs and a few very large, vertically integrated utilities that own most of the region's transmission facilities by themselves, and generally is cool to reform efforts. Opposition in the NW stems in part from concern that improved transmission access will undermine the historical economic development advantages of the area based on low cost hydro-electric power (much of it generated by Federal government generators).[1] When the events in California significantly raised energy prices to consumers and independent suppliers appeared to be in part responsible, regional opponents of reform, even in other areas of the country, were able to halt the momentum for reform generally. FERC's efforts to develop and implement a standard market design for wholesale markets based on independent system

[1] The President's budgetary proposals would remove much of the ability to keep hydro-electric prices in the region at below market levels. Opposition to this element of the budget is intense.

operation and locational pricing in spot markets were stalled by this opposition.[2] Several states postponed or reversed pending retail competition programs.

4. Another major roadblock was the pricing of provider-of-last-resort (POLR) service that often accompanied efforts to collect funds to pay stranded costs. In most states, these rates were set administratively and fixed for significant periods of time. When wholesale prices rose (unexpectedly), POLR prices were not adjusted. This both made entry by independent generators unattractive and put the POLR service providers (the distribution utilities) in financial distress. Most of the transition periods in these states are now ending. Most such states have elected to continue POLR service, but to let its price be determined through competitive procurement processes. Some states have decided to make POLR service for large C&I customers be real-time pricing.

5. Another obstacle to reform has been the exit of some of the firms that lead much of the initial push for reform. The remaining voices for regulatory reform have been less well organized and less well funded, leaving the opposition to reform in a stronger position.[3] In short, reform has many strong opponents but not many powerful champions.

Impact of the OECD Recommendation on Reforms

6. Over the past decade or so, FERC has adopted policies to encourage competition in wholesale electricity markets and has sought to improve needed coordination with and among the states. FERC looks to the experience of OECD members and the recommendations of the OECD to inform U.S. policies. FERC commissioners and staff meet and exchange views with their counterparts and market participants from OECD members and other jurisdictions. FERC's policies have been consistent with the OECD's regulatory reform recommendations.

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2 The pending energy legislation precludes implementation until 2007. Chairman Wood will leave FERC at the end of his term in June 2005.

3 The state of regulatory reform in Texas is informative. In contrast to other states one of the ironies of the current state of regulatory reform is that Texas, the largest state in the South, has become a model for regulatory reform. Unlike all other states, most of Texas is regulated at both the wholesale and retail levels by a single regulator; the state's the state's sector regulator Public Utility Commission. Texas is the only state to proceed with thorough regulatory reform after the California crisis and indications are that the reforms have been effective. Both the Chairman of FERC and the legislative leader in the House of Representatives are from Texas, as of course, is the President.