

COMPETITIVE BIDDING IN THE ELECTRIC POWER INDUSTRY

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ABSTRACT

Competitive bidding is certainly not a new mechanism used by regulators to secure resources for their retail customers. Actually, the original processes and experiences were developed during a period of traditional, tight regulation of vertically integrated utilities. Since then, wholesale markets have become increasingly more competitive. This article explores the opportunities, challenges and issues associated with competitive bidding for wholesale power resources.

INTRODUCTION

Prior to the restructuring of wholesale power markets in 1996, traditional methods of securing supply-side generation resources were comprised of a regulated, vertically integrated utility constructing new generating plants subject to a need determination that in many instances, was the result of a longer-run planning process. Some variations of this traditional approach existed prior to 1996 and included rudimentary competitive bidding processes. These processes, however, had little initial success owing to the fact that non-utility generation development was relatively new with only niche sources of generation that were typically PURPA-based applications.

There have been considerable structural changes in both wholesale and retail markets since the late 1980s and early 1990s when the tradi-

*Public Utilities Regulatory Policies Act of 1978 (or "PURPA") promoted the use of electricity from industrial cogeneration as well as other types of small power and renewable applications.

tional resource acquisition paradigm co-existed with early competitive bidding requirements. A unique combination of factors exists today, which is creating renewed interest in competitive bidding. These factors include:

- Significant development of competitive (non-utility) generating assets throughout most of the U.S.;
- A significant amount of older, less efficient, utility-owned, gas- and oil-fired generation that could be retired to make way for more efficient generation;
- Development of market institutions and regulatory processes that can facilitate robust, competitive wholesale power markets;
- A lack of new, regulated, utility-constructed generation facilities over the past decade; and
- Reticence on the part of state regulatory commissions to experiment further with retail electricity competition.

So, for states that have not, and do not want to, move forward with retail choice, their regulators have the ability to take advantage of some market forces without compromising captive ratepayers. This article explores the opportunities, challenges and issues associated with competitive bidding for wholesale power resources.

CHANGES IN WHOLESALE AND RETAIL MARKETS FACILITATING THE NEED FOR COMPETITIVE BIDDING

Change in the wholesale markets began in 1996 when the Federal Energy Regulatory Commission (“FERC”) promulgated Order 888, opening the electric power transmission grid to open and non-discriminatory access. However, the regulatory changes and opportunities created by Order 888 were not enough to immediately stimulate any expansive development of competitive power generation. Competitive generating resources would not be developed until later, when the market sent a number of easily recognizable signals, via considerably outages and high

past decade, regulatory uncertainty associated with cost recovery and competition have provided strong disincentives for traditionally regulated utilities to construct new power generation facilities.

The strong economic growth during the mid to late 1990s, coupled with the ever increasing digital (and electric) economy and the advance age of the existing regulated utility power generation fleet, has placed a number of regulated utilities in a position where they need to secure new generating resources for their customers.

Fortunately, many utilities were able to meet their needs for generation resources through relatively short term purchases from liquid and active wholesale markets. However, regulators, as well as many utility competitors, are becoming increasingly frustrated with this year-to-year reliance on spot market purchases and are placing pressure on utilities to make longer term commitments.

Regulators, particularly those in states that are not moving forward with electric restructuring, are at a crossroads. On the one hand, regulators have the option of moving to embrace and facilitate the use of competitively developed wholesale power generation. Alternatively, they may choose to move back to the old days of utility-generation development and the regulatory-intensive planning paradigms and approval processes.

The recent interest in competitive bidding over the past several years by a number of states (i.e., Louisiana, Florida, and Arizona) indicate that at least some state regulators are willing to give the wholesale market a chance under various terms and conditions. In these states, the key challenge was to identify the terms and conditions for securing new resources from competitive bidding and distinguish new rules from those of the past.

PAST EXPERIENCES WITH COMPETITIVE BIDDING

Until recently, the terms and conditions for competitive bidding rules were promulgated close to a decade ago. Unlike the current proposals to use competitive bidding as a means to secure all (or most) future generation resources, past policies were usually associated with refining the procedures for limited purchases required under PURPA. Under PURPA, regulated utilities were required to purchase electricity from "Qualifying Facilities" ("QFs") at buyback rates set upon "avoided

costs.” Many state regulatory commissions recognized the problems of administratively determined avoided costs,² and turned to competitive bidding as a means of letting the market reveal what the true costs of non-utility generated electricity.

One of the first competitive bidding rules was adopted in 1984 by Maine. Under that rule, Central Maine Power Company (“CMPC”) issued the first-ever Request for Proposal (“RFP”) for QF capacity after the recognition that its administratively-determined avoided costs rates were overly attractive for many cogeneration projects. To assure that only the amount actually needed was built, CMPC issued a RFP for the 100 MW it was seeking. As a result, only the lowest bidders would be able to supply the utility with additional capacity. The success of this process led the utility to continue the use of the competitive bidding process when any type of capacity addition was needed.

By the late 1980s, several states realized that competition drives bids lower, and allowed independent power producers (“IPPs”) to participate in the competitive bidding process. FERC also encouraged IPP participation in its 1988 Notice of Proposed Rulemaking (“NOPR”). In many cases at the state level, regulators included opportunities for demand side management (“DSM”) projects to compete for the RFP resource under solicitation. Competitive bidding for all resources, in fact, became a hallmark of integrated resource planning (“IRP”). Thus, competitive bidding facilitated a process by which all resources (supply and demand) could bid to serve additional utility resource needs.

By 1990, bidding rules were in place, being developed, or under consideration in 21 states. The other 29 states had either deferred action or taken no action at that point. By mid-1991, over 50 utilities had issued at least one RFP for generating capacity from qualifying generation facilities. [4] These rules represented a move away from the over-priced generation that utilities built in the late 1970s and 1980s, as well as some of the costly PURPA-related resources secured under administratively-determined buyback rates and contract terms. These rules, in many ways, represent the early development of wholesale markets that set the groundwork for competition later outlined in the Energy Policy Act of

*For instance, if administratively determined avoided costs are set too low, there could be an uneconomically low level of cogeneration resources. Likewise, if administratively determined avoided costs are set too high, an uneconomically high level of cogenerated electricity could be developed.

1992 (“EPAAct”) and realized by FERC’s Order 888.

However, despite these past experiences, there are a number of differences between the competitive bidding practices of the past and today. These differences include:

- Many competitive bidding practices were developed years ago for cogenerated (“QF”) power and usually did not recognize IPP power (as it is known today), as well as a vibrant wholesale commodity (trading) market.
- Many of the earlier developed rules set some preferential and special contract terms to promote nascent non-utility generation that was primarily associated with QF power, and in some instances (particularly in the early 1990s) IPP-provided electricity. The goals of these preferential terms were first, to promote energy efficiency, and much later, more competitive energy markets. These preferential terms are unneeded today because most major IPPs have the ability to finance, develop, and maintain competitive generating projects that were questioned over a decade ago when the industry was still in its evolutionary phase. Hence, issues associated with “front-loading” of contracts, and verification of financial performance, may not be as critical as it was a decade ago.¹
- Most competitive bidding rules were written in a pre-Order 888 environment. They do not appreciate, or even recognize, a host of important transmission issues that reflect today’s wholesale market.
- Competitive bidding practices, particularly those in the Northeast and California, included a number of regulatory agendas that, at

*This is not to suggest that reviewing the financial performance of a potential bidder is unimportant. However today, several of the major IPPs in the U.S. are of considerable size and financial diversity. The IPP industry of today is relatively mature, compared to its portion over a decade or a decade or more ago. The credit problems that are pervasive throughout the IPP sector of the energy business today have less to do with its relative size or newness, and are more associated with perceptions of these companies’ bad investments, management practices, financial transparency, and business decisions.

least at this point, have not been as pervasive as years past. These agendas include establishing “adders,” set asides, and even externality credits for certain types of generation resources, like wind, solar, and other renewable power, that encouraged the development of resources that are above traditionally-measured cost.

- Many competitive bidding practices were done in the context of IRP-type proceedings. Competitive bidding, however, does not have to be part of a comprehensive IRP process to be successful.
- In the past a number of competitive bidding processes could be characterized as “search processes” to establish values for utility cost recovery that are consistent with the market. As such, the degree to which these RFPs were taken seriously is questionable. Today, many Commissions are adopting competitive bidding practices to genuinely secure least cost resources, and not as a means to “test” the market.

ISSUES ASSOCIATED WITH COMPETITIVE BIDDING

A number of important issues have arisen in state regulatory competitive bidding rule proceedings to date. Many of the issues and topics debated in these proceedings have surrounded methods to bridge older competitive bidding and planning practices with today’s fast moving and highly competitive energy markets. Another set of important issues under debate at the state level is associated with reconciling competitive bidding processes with the needs of a captive retail customer base.

Some of the main topics that have been debated in the competitive bidding process to date have included such issues as:

- Expedited Treatment of Resource Requests;
- Bid Evaluation Criteria;
- Detailed Filing Requirements;
- Affiliate Participation in the Competitive Bidding Process; and
- Neutral Third Party Administration of Competitive Bidding Process

Expedited Treatment of Resource Requests

In the past, prior to restructuring, there typically was not a large sense of urgency in expediting competitive bidding processes. In many instances, these competitive bidding processes were part of a larger resource planning process that covered several years and was updated annually. These processes differ today in large part due to the fact that utility generating capacity has been limited in past years (creating some sense of urgency to the resource acquisition process), and the fact that wholesale markets move quickly. Opportunities that exist today may not be available tomorrow. Furthermore, long, dragged-out competitive bidding processes could serve as a disincentive to some competitive firms that would prefer to see a quick resolution to their offers.

The problem with creating an expedited competitive bidding regime is that it potentially conflicts with detailed analysis of both the need for new generation and the source of generation selected from the competitive bidding process. Of particular concern to competitors is that an unnecessarily expedited process could offer incumbent utilities an advantage in selecting resources that it finds more favorable (i.e., an affiliate bid, a self-construct option, a repowering option).

Bid Evaluation Criteria

While cost is an obvious factor in evaluating competitive bids, it is by no means the sole consideration. Other relevant factors that can be considered include: flexibility, diversity, reliability and credit worthiness, and reputation and past experience of the offerer. Competitive bidding rules need to clearly identify and explain each of these criteria and their relative weight in the bid evaluation process.

While the criteria, and their relative weights, can change over time, they should not change within any single competitive bidding processes. Changing the evaluation criteria and their respective weights during the course of a competitive bidding process can ultimately result in an inefficient outcome. Potential bidders could become disillusioned with the process, its independence, and its objectivity. As a result, bidders may decline from participating in the processes thereby limiting the scope of options for regulators.

Detailed Filing Requirements

One of the particular challenges in developing an efficient competitive bidding process is identifying the degree of information disclosure

that will be required by both parties to the process (i.e., utilities and competitors). Many on the competitive generation side of the business would argue that the degree of functional separation between a utility's competitive generation business and its regulated business could be improved. In such instances, the utility holds a competitive informational advantage over independent generation.

Even in the situation where there is a clear separation between a utility's regulated operations and competitive generation, it is still the case that regulated generation competes with independent power. In a competitive bidding process, detailed filing requirements put competing parties in the position of potentially revealing competitively-sensitive information.

Affiliate Issues

As noted earlier, utilities can, and in many instances do, compete with independent generation. In theory, there are a number of forms of competition that can occur during a competitive bidding process. These include:

- F1: Utility Competitive Affiliate versus Independent Generation
- F2: Utility Regulated Generation versus Independent Generation
- F3: Independent Generation versus Independent Generation
- F4: Utility Competitive Affiliate versus Utility Regulated Generation

Again, in theory, all of these forms of competition should be healthy and result in efficient competitive outcomes. However, in reality, the outcome could be inefficiently skewed given the concerns about the degree of separation between a utility's regulated and competitive generation operations. The potential competitive advantages afforded from this affiliate relationship can be numerous and extend beyond the informational advantages discussed earlier.

State regulators have to grapple with how to deal with this problem in a competitive bidding process. These regulators generally face two potential remedies in minimizing or eliminating affiliate abuses. First, regulators can simply prohibit affiliates from participating in the competitive bidding process. Unnecessarily limiting affiliate competition also runs the risk of potentially harming ratepayers by limiting the scope of the market, competition, and lower cost resources. Second, the regulatory commission can allow affiliates to participate, provided they subject

themselves to a pre-defined set of approved affiliate codes of conduct. In most instances, states are opting to facilitate the latter, as opposed to the former method of minimizing affiliate abuses.

The more difficult potential abuse in any competitive bidding process, however, is associated with the potentially anti-competitive advantages the utility confers on its own regulated operations as both a competitor to independent power and an evaluator of competitive bids submitted by these providers.

Third Party Administration of the Bidding Process

In some of the more recent regulatory proceedings addressing competitive bidding, parties have recommended that a third party administrator be responsible for overseeing and ultimately delivering a final bid to the regulatory commission. The purpose of involving a third-party administrator is based upon the belief that it will bring a degree of objectivity and complete information disclosure to the process that will be respected by all participants.

Attaining neutral and objective information can be particularly important if the turning point in the resource acquisition decision is associated with more subjectively determined factors such as flexibility, deliverability, and reliability. Third party administrators have no stake in the outcome of the process and would be able to provide regulatory commissions with unqualified recommendations, removed from the financial outcome of the decision, about potential bids.

Proponents argue that the use of a third-party administrator will result in securing the most cost-effective resources for ratepayers. The use of an outside independent body could potentially reduce litigation costs associated with protests and actually increase planning flexibility that could be impacted by protests questioning the utility's objectivity in the resource review process. At minimum, the use of a third party administrator will effectively reduce one whole area of protest – that the utility manipulated the process. Arguments and protests, to the extent they arise, will rest solely on the objective criteria that was presented to the regulatory commission by the third party administrator.

CONCLUSION

Competitive bidding is making a resurgence as a regulatory means of securing future generation resources. The fact that numerous states

have not, and probably will not, move forward with retail competition increases the probability that competitive bidding could be used more frequently in the future. In many instances, utilities have not constructed electric power generation facilities in over a decade, while their independent counterparts have been on a construction spree over the past three years.

Regulators now have the option of meeting existing and future load growth in one of two different manners. One includes securing these resources from the competitive market while the other would see a return to past practices of utility need determination and planning processes. Given the plethora of existing and uncommitted merchant generation whose output is already looking for a home, it seems likely that regulatory commissions may have to start considering competitive bidding and the possible adoption of rules on how their regulated utilities will secure resources from the market.

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