

Demand Common Sense

Roger D. Feldman

Co-chair, Project and Structural Finance Group

Bingham Dana LLP (Washington Office)

By the time this article is published, it will be time for post mortems on the “great energy legislative fix” of 2000. One may have a certain confidence that however substantial or modest or non-existent that fix may turn out to be, it will be at best amelioratory and likely addictive (i.e., necessitate more fixes to come).

The reasons are simple: Deregulation is not as great a thing in the electric industry as it has been (at least by some key criteria) in other formerly regulated industries. To the extent deregulation is going to be made to work, the key lies in the substantial physical revamping and upgrading of the grid on a national basis and emphasis on demand management breakthroughs. While the best aspects of the proposed legislation would create a better regionally based infrastructure to oversee “reliability,” it at best offers an improved long-term institutional approach to a market that is physically discontinuous.

A key data point which supports this observation is the great price cap war currently raging. Regulator after regulator in the Deregulated States of America now has sought to address the summer shortage and price spiking phenomenon by one of the most ancient of means: fiat, California has been the most visible battleground.

There, the godfather of that state’s mother of all deregulation bills—paradoxically surnamed “Peace”—now wrestles with the ISO over whether it should have price control power. The debate is framed in classic economic terms—but unfortunately without reference to the unique characteristics of the commodity in question.

It runs like this: distorted markets produce unjust and unreasonable pricing. Would-be suppliers are diverted to more attractive markets. The prospects of shortage and rationing are induced. The wraith of reregulation is unleashed on the land by pusillanimous populists.

To which the aforesaid populists respond by arguing that California’s so-called deregulation which effectively preserved incumbent utilities’ market shares—thereby permitting stranded cost recov-

ery—is not a true deregulated “open market” at all. They then go on to challenge deregulation as being supported on the flawed premise that raising prices now somehow will lead to lower prices.

They further point out that this proposition represents the abandonment of the rationale for deregulation when it was originally proposed: that it would lower prices, because, that is simply what competition necessarily does.

Insight into the merits of the argument may be gained from a recent article. “Electricity Restructuring: Deregulation of Reregulation” appeared recently in *Regulation*, a publication of the generally pro-free market Cato Institute. Focusing on consumer price response to market price signals as the likely best source of the beneficial efficiency desired from industry deregulation, it reaches the following empirical conclusion which lies at the crux of the debate described above:

“Thus far in the United States, real time consumer price response has not developed *either* in regions that have restructured or in those that have remained under traditional regulation... (T)he need for price responsive demand is *made greater* in a less regulated environment.” (emphasis added)

The article then emphasizes the potentially adverse effects of deregulation unaccompanied by consumer price signal response. While electric generation may have become a commodity (and one that has been underdeveloped in recent years), it is a commodity marked by a high cost of storage; for which there is a need to balance supply and demand on a second-by-second basis; and for which (at this stage of technology development), end use consumer demand price observation and response capability is minimal.

The result is a situation where producers can, at certain times, command extremely high prices (particularly as reserve margins shrink). This is because the electric good is not storable to defend against vulnerability, and because market demand cannot shift to other willing suppliers. Under these circumstances, there are times when even firms with small market share can exercise significant power. Concentration measures suitable to measure market power in other industries may well not be suitable to electric power.

Moreover, the “free trade” scenario which is supposed to accompany deregulation, i.e. power flowing competitively among markets, is a partial fiction. Analyses of prices under “free trade” and “regulated trade” in the Northeast, in order to determine if interregional power

movement will respond to deregulated market opportunities, is revealing. Application of optimal computer flow (OCF) algorithms produce conclusions like the following: in a scenario where more power is freed up in ECAR and PJM to be made available to NEPOOL*, nevertheless calculated NEPOOL prices actually may rise as a result of the operation of transmission constraints.

This analysis in Regulation suggests that the great price cap war ought to be understood by regulators to suggest a need for a larger number of more specific demand side oriented solutions than are being proposed in the “comprehensive” standards presently being proposed on the Hill. Some recent examples illustrative of the directions which, if properly coordinated and writ large, might begin to address the difficulties electricity deregulation has presented, include the following:

- PJM’s initiative to make it easier for distributed generators to hook up to the grid and to encourage large users to generate on-site during peak demand periods (the Customer Load Reduction Pilot Program);
- Proposals by EEI to encourage investors to enter the transmission business (e.g. risk adjusted returns on equity to attract capital to profitmaking incentives to encourage transmission operators to reduce congestion);
- Emergence of an e-commerce web clearinghouse end-to-end load management service for utilities and aggregators to sell to commercial and industrial customers, e.g. sell excess on-site generation and curtailed load to utilities, retail energy service companies and aggregators when prices spike.

Measures like these will enable the industry to get beyond rhetorical battles of “freedom of choice” versus “people power.” Electricity is a sophisticated commodity; facilitating meaningful market demand response to price signals is the key to common sense.

We should demand common sense.

* ECAR—East Central Area Reliability System
PJM—Pennsylvania/New Jersey/Maryland System
NEPOOL—New England Power Pool

ABOUT THE AUTHOR

Roger D. Feldman is co-chair of the Project and Structural Finance Group of the century-old, 325-attorney law firm of Bingham Dana LLP, which has closed several merchant plant transactions, and currently is in the process of advising several others. He is also a principal in the Bingham Consulting Group, LLC, a wholly owned strategic and public affairs planning affiliate of the firm and has participated in ground-breaking project finance and securitization projects for the US Department of Energy in that context.

With over 30 years of practical legal experience, public service as deputy administrator of the Federal Energy Administration and on the Environmental Protection Agency's Financial Advisory Board, and Washington editorship of the *Merchant Power Monthly* (previously *Cogeneration Monthly*) and *The Construction Business Review*, Mr. Feldman brings significant capabilities to energy project transactions of all types. He is a graduate of Brown University, Yale Law School and Harvard Business School.

Bingham Dana LLP, Suite 800, 1120 20th St. NW, Washington, DC 20036, (202) 778-6150, fax 6155.