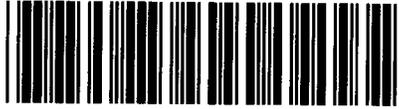




Control Number: 40000



Item Number: 529

Addendum StartPage: 0



2013 OCT 28 AM 10:29

There and Back Again: The High Transition Costs of Electricity Regulation

Consumers will Start Paying for a Capacity Market before Old Regulatory Costs are Paid Off

by Kristin Cavin &
Bill Peacock

Findings

- Texas electricity consumers are still paying off the \$11.6 billion price tag for transitioning away from previous regulation.
- The PUC is considering imposing \$3 to \$5 billion in new annual charges on consumers to pay for the cost of moving the market back toward increased regulation.
- Moving to a capacity market would turn the clock backward to where consumers—rather than investors—are forced to bear the costs of uneconomic generation.
- The higher cost of moving away from competition underscores the inefficiency of whatever type of capacity market Texas might adopt.

This is the seventh in a series of papers examining the debate over the reliability of the Texas electricity market.

Introduction

Just as Texas consumers are beginning to see some slight relief from paying off the \$11.6 billion price tag for transitioning to today's competitive electricity market, the Public Utility Commission of Texas (PUC) is deliberating whether to add another \$3 to \$5 billion in annual payments in order to move back toward regulation. The new market structure the PUC is considering, a capacity market, resembles the antiquated regulated market that Texas left over a decade ago in that much of the cost of new generation is borne by consumers instead of investors. Moving away from competition is never a good idea. The fact that the costs of doing so dwarf the costs of moving to competition proves this point and exposes how inefficient a capacity market is compared to the competitive market.

Stranded Costs: The Price of Moving to Competition

The thriving Texas competitive electricity market in existence today, housed on the grid known as the Electric Reliability Council of Texas (ERCOT), was once served by five incumbent utilities: Central Power and Light, Houston Lighting and Power, Texas-New Mexico Power, Texas Utilities, and West Texas Utilities.

These companies operated under the old rate-of-return model of electricity regulation. They would build new generation and make other upgrades to the grid under the supervision of the PUC and in turn receive a more or less guaranteed return on their investment. Most of the investment risk under this system was placed on consumers rather than the investors. This led

to a very inefficient market with high consumer prices.

In an effort to reduce prices, the Texas Legislature passed legislation in the late 1990s to move to a competitive market for both the retail and generation businesses. In accordance with the new statutes, most of the incumbent utilities spun off their generation, transmission and distribution, and retail businesses into three distinct entities. The generation and retail businesses opened to competition from new entrants in the market, whereas the transmission and distribution business remained a regulated monopoly, with its rates for wires-and-poles service still set by the PUC.

This restructuring left the incumbent utilities in the situation where their sizeable investment in generation assets, for which the PUC had previously assured recovery, would now face the price-cutting forces of market competition. So whether a company divested its generation assets or held on to them, it was possible in many cases that the revenue from future generation would be less than the revenue guaranteed by the PUC. This was especially the case when generation had to be sold by certain dates under the planned divestitures.

The Legislature recognized that the PUC had essentially approved costs for generation assets with book values that were greater than market value—also known as deadweight or uneconomic generation. As the Texas Supreme Court noted in *CenterPoint Energy*, the Legislature “understood that the costs of these assets likely

continued

| Costs of Transitioning to Competition | | | |
|--|------------|------------|-------------------------|
| Company | Start Date | End Date | Securitized Balance |
| AEP - Texas Central Company (Fmr. Central Power & Light) | | | |
| TC1 | 12/31/2001 | 1/15/2016 | \$797,334,897 |
| TC2 | 10/12/2006 | 10/21/2021 | \$1,696,620,385 |
| TC3 | 3/14/2012 | | \$800,000,000 |
| Total | | | \$3,293,955,282 |
| AEP - Texas North Company (Fmr. West Texas Utilities) | | | |
| CTC | 6/1/2007 | 5/31/2008 | \$1,491,049 |
| Total | | | \$1,491,049 |
| CenterPoint Energy (Fmr. Houston Lighting and Power) | | | |
| TC1 | 10/24/2001 | 8/9/2013 | \$740,000,000 |
| TC2 | 12/16/2005 | 12/16/2019 | \$1,493,747,264 |
| TC3 | 2/12/2008 | 2/12/2023 | \$506,268,100 |
| TC5 | 1/19/2012 | 1/19/2026 | \$1,695,000,000 |
| CTC | 9/13/2005 | 9/13/2019 | \$570,017,821 |
| Total | | | \$5,005,033,185 |
| Oncor (Fmr. Texas Utilities) | | | |
| TC1 | 8/28/2003 | 8/28/2018 | \$1,840,797,221 |
| TC2 | 7/30/2004 | 7/30/2019 | \$1,300,000,000 |
| Total | | | \$3,140,797,221 |
| Texas New Mexico Power | | | |
| CTC | 12/1/2006 | 12/1/2020 | \$159,647,567 |
| Total | | | \$159,647,567 |
| Grand Total | | | \$11,600,924,304 |

Source: Public Utility Commission

Note: "TC" means "Transition to Competition." "CTC" means "Competitive Transition Charge."

would be recovered in a regulated environment, but might well become uneconomic and thus unrecoverable in a competitive, deregulated electric power market. The Legislature called such uneconomic assets *stranded costs*.¹ (Texas Supreme Court 2004, emphasis added) The law called for the companies to be compensated for these costs.

In addition to the stranded costs, there were three other costs of moving to competition as part of the restructuring process for which a company might be compensated: wholesale clawback costs, retail clawback costs, and final fuel reconciliation costs. The wholesale clawback reconciled the differences in the PUC's projected wholesale price of power with the actual wholesale price. The retail clawback reconciled the difference between the price to beat and the actual retail price. The fi-

nal fuel reconciliation reconciled fuel prices and retail prices prior to retail competition.

Except for the stranded costs, it was possible that the "costs" might even be beneficial to the companies. The determination of these costs and which companies should be awarded how much was the subject of significant regulatory and legal wrangling over a period of years. Several cases wound up in the Texas Supreme Court. Table 1 shows that when all the litigation eventually came to an end, the costs totaled more than \$11.6 billion.

Since 2001, consumers in competitive markets have been paying for these costs through nonbypassable "transition charges" on their electricity bills. The maximum period over

which the charges can be collected is 15 years. To date, only two sets of the charges have been paid off—the most recent in August of 2013. For the first time, Texas consumers are finally able to enjoy the competitive market having paid off some of the transition costs. The next pay off date, though, isn't until 2016. The last of these charges won't be paid off until 2026.

While there has been some disputes over the necessity of this process and whether the PUC could have lowered the price tag for these costs, this \$11 billion was the price tag of moving Texas away from regulation and into competition. While the competitive market will always provide the most optimal prices and services for consumers generally, eliminating the inefficiencies of government regulation always comes at a cost. Nevertheless, the costs have been worth it. Texas' competitive electric market brought billions of dollars of new investor-owned generation, an abundance of affordable, reliable electricity, consumer choice, and new businesses and jobs.

A Capacity Market is a Return to Uneconomic (and Expensive) Generation

At the same time the costs of transitioning to competition are beginning to expire, the PUC is considering imposing new charges on consumers to *pay for the cost of moving the market back toward increased regulation*. It appears as if this will take the form of a capacity market and add an additional \$3 to \$5 billion annually to consumers' bills—much more than the transition costs of moving to competition. Under Texas' current competitive electric market model, the electricity generators who took over from the incumbent utilities are only paid for the electricity that they sell. By contrast, a capacity market, as under consideration by the PUC, would force consumers to pay generators simply for the generating capacity available, whether or not the consumers actually need it. Consumers would pay for this capacity on top of the costs for the electricity they do use, essentially paying generating companies twice.

Bibliography

- CenterPoint Energy, Inc. v. Pub. Util. Comm'n*, 143 S.W. 3rd 81, 82 (Tex. 2004).
 Hunker, Kathleen. 2013. *The Texas Capacity Market: The Push for Subsidies*. Texas Public Policy Foundation.
 Ed. Kiesling, Lynne L. and Andrew Kleit. 2009. *Electricity Restructuring: The Texas Story*. American Enterprise Institute.
Texas v. Pub. Util. Comm'n of Tex., No. 08-0421, 2011 Tex. LEXIS 230 (Tex. June 24, 2011).

There is no reason to move to a capacity market, especially just as consumers are beginning to see some slight relief from the \$11 billion price tag of leaving regulation.

In the antediluvian regulated model, regulators permitted the incumbent utilities to recover the costs of generation from consumers. With consumers paying for generation that had not been demanded by a market, a tremendous amount of uneconomic generation costs accumulated over time. This is the same deadweight generation that consumers are still paying for today. A capacity market would return Texas back to a model that supports uneconomic generation and add the \$3 to \$5 billion in annual costs of doing so on top of the \$11 billion that Texans are already paying.

Conclusion

The Foundation's recent research has shown that Texas' competitive, energy-only market is working quite well and that there is sufficient existing and planned generation to provide Texans a reliable and affordable supply of electricity well into the future. There is no reason to move to a capacity market, especially just as consumers are beginning to see some slight relief from the \$11 billion price tag of leaving regulation. The competitive market has ensured that consumers are not exposed to the risk of paying for generation that is uneconomic and inefficient. Yet the PUC is considering a return to a regulatory structure that would transfer much of the generation risk from investors onto the backs of consumers and force them to support uneconomic generation at a cost of \$3 to \$5 billion a year. Moving to a capacity market would turn the clock backward, reversing many of the benefits gained from the years of effort and billions of dollars invested in the competitive market. ★

About the Authors

Kristin Cavin is a research associate in the Foundation's Center for Economic Freedom. She previously worked for the Public Utility Commission of Texas.

Bill Peacock is the vice president of research & planning and the director of the Center for Economic Freedom at the Texas Public Policy Foundation. He has been with the Foundation since February 2005.

Bill directs the research of the Foundation to ensure its accuracy, integrity, and application of free market principles to the issues facing Texas and the nation. His own research focuses on economic freedom and growth, property rights, civil justice, and regulatory issues.

Bill has extensive experience in Texas government and policy on a variety of issues, including economic and regulatory policy, natural resources, public finance, and public education. His work has focused on identifying and reducing the harmful effects of regulations on the economy, businesses, and consumers.

About the Texas Public Policy Foundation

The Texas Public Policy Foundation is a 501(c)3 non-profit, non-partisan research institute. The Foundation's mission is to promote and defend liberty, personal responsibility, and free enterprise in Texas and the nation by educating and affecting policymakers and the Texas public policy debate with academically sound research and outreach.

Funded by thousands of individuals, foundations, and corporations, the Foundation does not accept government funds or contributions to influence the outcomes of its research.

The public is demanding a different direction for their government, and the Texas Public Policy Foundation is providing the ideas that enable policymakers to chart that new course.

