

## Q&A on the Texas Electric Market

by **Bill Peacock**

Director, Center for Economic Freedom

The following research, available on the Foundation's website, was used in compiling this Q&A:

*Competition in Texas Electric Markets: What Texas Did Right and What's Left to Do*  
by Robert Michaels

*Competition in Texas' Electric Market*  
by Bill Peacock

*Electric Competition*  
by Bill Peacock

*Growing Competitive Electricity: Why Texas Must End the Price to Beat*  
by Robert Michaels

900 Congress Avenue  
Suite 400  
Austin, TX 78701  
(512) 472-2700 Phone  
(512) 472-2728 Fax  
[www.TexasPolicy.com](http://www.TexasPolicy.com)

**T**he battle over electric prices and the deregulation of electric markets has not let up since Hurricane Katrina's disruption of natural gas supplies in the Gulf caused natural gas—and thus electric—prices to increase significantly.

The legislative debate over the wisdom of deregulation continues, particularly in light of Kohlberg Kravis Roberts & Co.'s proposed buyout of TXU. In fact, the Texas Senate has passed three bills to address this issue that are now before the Texas House of Representatives.

The following is a look at the debate and what needs—or doesn't need—to be done to ensure competition and consumer choice in Texas' world class electric market.

### ***Is the Texas retail electric market working?***

The Texas Public Policy Foundation just released a comprehensive study of the Texas electric market. Dr. Robert J. Michaels, professor of economics at Cal-State Fullerton, concluded that "Texas is competitive electricity's greatest success story in the United States, if not the world."

"Furthermore," wrote Michaels, "competition has brought substantial benefits to Texas in only a few years, both in absolute terms and relative to other states. Innovations planned for 2009 will further improve investment choices and power pricing, and institutions put in place by the Texas Public Utility Commission can sustain competitive markets into the future."

As of December 2006, 76.7 percent of residential customers had made an observable choice in electric providers. This includes 36

percent that switched to a competitive retail electric provider (CREP) and 40.6 percent that are still served by affiliated retail electric providers (AREPs) but have 1) chosen a different price plan, 2) moved into an area and chose the AREP, or 3) switched back to an AREP. The December figure was 21 points above last March.

Competition at the retail level is quite dynamic and performing well. Texas has the best functioning retail electric market in the U.S., if not the world.

### ***But hasn't deregulation or market malfunction caused prices to increase?***

Electricity prices in Texas have certainly increased since deregulation began. According to the U.S. Energy Information Agency, the average retail price in Texas, adjusted for inflation, is up about 23 percent. It is about 17 percent higher than the current national average. The highest rates are about 50 percent higher than the national average.

However, these prices need to be seen in context. Texas, which is heavily dependent on natural gas for electric generation, weathered a significant increase in natural gas prices. Natural gas prices today are almost 200 percent higher than in 2001. When compared to other states that rely heavily on natural gas, prices here are in the middle of the pack. Average prices in Texas are lower than in New England, the Mid-Atlantic coast, and California. Rates in Houston and Dallas are comparable to almost every other major city. Rather than being the cause of high prices, it seems that deregulation has allowed us to avoid some of the impact of higher natural gas prices.

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**TalkingPoint:**

Texas got electric deregulation right where other states got it wrong because we set general rules for the market and allowed competition to work within those rules, without attempting to manipulate prices or other aspects of competition.

In the most competitive electric market in the country, prices are not too high because of deregulation or problems with the market. They have risen largely as a result of voluntary agreements between buyers and sellers in the face of significant increases in the price of natural gas. The average customer can choose from over 50 plans offered by 17 or 18 providers. There is no market power in the Texas retail electric market that could keep prices artificially high. In addition, today's prices reflect consumers' preferences about reliability, customer service, and innovation. Many consumers place significant value on these factors, which were not accurately reflected in the regulated rates prior to 2002.

***Many states seem to have failed in their efforts to move to electric deregulation. What did Texas do right?***

Texas got electric deregulation right where other states got it wrong because we set general rules for the market and allowed competition to work within those rules, without attempting to manipulate prices or other aspects of competition. The details of what would be sold to whom and how it would be priced were left to the ingenuity of buyers and sellers.

***Are there "fixes" to the retail market being considered by the Legislature that would undermine the principles that have led to our success?***

There are several provisions under consideration that call for micro-managing competition and the workings of the marketplace, violating the principle that allowed Texas to make a successful transition to electric competition. They include:

***Organization and Ownership***

Before deregulation, most Texas utilities were vertically integrated, and recent studies suggest there may be good economic reasons for that. Additionally, for decades the PUC has been able to review but not deny changes in ownership. The

market is working well, and there are no flaws in the Texas market that should lead the Legislature to further interfere with the ownership or organization of market participants. Yet there are proposals that would allow the PUC to deny any ownership changes that it finds not to be in the public interest.

Under current law, the PUC must be notified of any mergers and acquisitions of utilities. Furthermore, the PUC currently has the ability to "disallow the effect of the transaction if the transaction will unreasonably affect rates or service." In essence, they can take into account any debt loading that they consider improper and deny regulated transmission companies the ability to pass those costs onto customers.

In addition, as the current debate is proving, the PUC will always have significant input into any proposed deal. Proposed changes to PUC rules will enhance this ability in the future. Changing the rules at this point is unnecessary, would add instability and uncertainty to a market where reliability is at a premium, and would create unnecessary impediments to efficiencies and value enhancements sought through market-based organizational and ownership models.

***Consumer Privacy and Competition***

Those who are concerned that there is not enough competition in the market have proposed that certain providers must share customer information with competitors. This is harmful to consumers from a privacy and competitive standpoint. It would lessen competition in the market by allowing competitors to gain access to information and customers that they would otherwise have to gain through competitive measures such as lowering prices, marketing, investment in capacity, etc.

***Market Share***

The retail market share of certain AREPs is used as evidence by some of the validity

of their concerns about the lack of competition. At least two approaches have been offered to deal with this. Both involve fining AREPs tens or even hundreds of millions of dollars until they increase their market share outside of their home service areas and/or decrease their market share within their home service areas. These are harmful proposals that stem from the false premise that government can determine market share allocations better than buyers and sellers. It also assumes that some consumers want to switch electric providers, but are somehow being kept from doing so. Given that Texas has the most mature, sophisticated retail electric market in the U.S., it is unclear what data exists to support such assumptions. In fact, the data seems to point the other way. To the extent the Legislature wishes to encourage consumers to switch, there are voluntary, educational measures that the Legislature could support.

#### *Customer Switching*

As already noted, there is the notion that Texas electric customers are helpless and must be pushed along in order to make good decisions for themselves. So proposals have been made that allow the PUC to use ballots and even customer slamming to “assist” residential customers of an AREP in the selection of a CREP. The one survey that is used to support this contention is used out of context, not being compared to consumer attitudes relating in the selection of phone, video, or Internet service providers. While consumer balloting was used during the AT&T breakup, that involved an immature market—today’s electric market is much more advanced. To the extent the Legislature decides to do this, the effort should apply only to customers who have shown no observable choice, and should ensure that no government slamming of consumers occurs.

#### *Price Caps*

Perhaps no proposal would be more damaging to the market than the imposition of

price caps. One such proposal would allow the PUC to conduct a study to determine the reasonableness of retail electric rates and to reduce rates determined to be found “unreasonable.” In an unregulated market like we have in Texas today, every price is determined through a voluntary transaction between producers and consumers. A price cap provision would allow regulators to impose their opinions of what is a reasonable rate in place of the opinions of consumers and producers. Furthermore, it would create great regulatory uncertainty for investors in a market where significant investment in generation is needed to maintain reliability. Retail price caps are exactly the problem that caused deregulation in California and Maryland to fail.

#### ***What about the wholesale market? Don't the allegations against TXU prove that something needs to be done?***

The Foundation’s new study looked at several measures of wholesale competition and determined that the market is functioning well, though there are improvements that can be—and in fact are already being—made.

Indeed, the wholesale market has produced extremely healthy levels of generation capacity with more planned to come online as older plants are retired.

The reported abuse of market power in the small balancing energy market is not directly associated with the percent of installed generation capacity in the state or in a region. If there are problems, they are more likely to be associated with thin markets, heavy congestion, startup costs, minimum run times, and ramping rates.

Yet there are proposals that would limit ownership or control of generation facilities under all circumstances in a way that would lead to uncertainty in the market, an inability to invest based on economic and financial signals, and ultimately a reduction of investment in generation capacity in Texas.

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#### **TalkingPoint:**

Competition has brought substantial benefits to Texas in only a few years, both in absolute terms and relative to other states.

A better approach to dealing with market power abuse would be to add a day-ahead market, nodal locational marginal prices, and congestion revenue contracts. These provisions would make the Balancing Market more liquid by reducing the problem of non-bidding into the market. Many of these are already in the works. The implementation of a day-ahead energy market and nodal pricing is scheduled 2009. Texas is also investing billions of dollars in transmission capacity to help relieve congestion. All of these measures would be more effective in dealing with market power, and are much more compatible with the operation of a free market, than market-share mandates. Additional provisions such as enhancement of enforcement/remedies for abuses in the market and disgorgement of profits earned would also address this issue without unduly interfering with the market.

***What impact would increased regulation of the electric market have on Texas consumers and the economy?***

Many of the proposed regulations would undermine the framework that has led to the creation of the nation's best electric market. They would instead mandate how, when, and where market participants compete with each other, and deny consumers the ability to make choices for themselves.

KKR is one company that understands this, having committed to staying in the Texas electric market for the long term only under the "current regulatory system." Other businesses

in this and other industries are likely to feel the same way. The result could be harmful to the Texas economy.

Texas' job growth rate is twice the national average. Much of that can be credited to deregulation in various markets that has created an affordable, reliable supply of electricity and a business climate second to none. If we turn our back on deregulation in the electric market, Texas jobs are in jeopardy.

Despite widespread efforts to deregulate electric markets throughout the country, Texas is one of the few states that made it all the way through a full transition from regulation to markets. California, Maryland, and others have pulled back short of success.

Now that Texas has achieved this success, opponents of deregulation see an opening to undo what they couldn't stop in 1999. Many of the same groups who opposed deregulation in the first place are now in support of the provisions of these bills.

Over the last decade, Texas has been the national leader in the move toward limited government. This has included deregulation of the electric and telecom markets, plus tort, tax, budget, and health care reforms. Re-regulating the electric market now would put such gains at risk. ★

**About the Texas Public Policy Foundation**

The Texas Public Policy Foundation is a 501(c)3 non-profit, non-partisan research institute guided by the core principles of individual liberty, personal responsibility, private property rights, free markets, and limited government.

The Foundation's mission is to lead the nation in public policy issues by using Texas as a model for reform. We seek to improve Texas by generating academically sound research and data on state issues, and recommending the findings to policymakers, opinion leaders, the media, and general public.

The work of the Foundation is primarily conducted by staff analysts under the auspices of issue-based policy centers. Their work is supplemented by academics from across Texas and the nation.

Funded by hundreds 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.

