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Q&A on the Texas Electricity Market

by Bill Peacock
Vice President of Research & Director, Center for Economic Freedom

Findings

- There's a strong correlation between increased use of electricity (and energy in general) and the increased health and wealth of a society.
- Texas' world-class electricity market has pushed electricity prices today as low as 7 or 8 cents per kWh, compared to the pre-competition, inflation-adjusted price of 13 cents in 2001.
- Abandoning competition and adopting a capacity market could cost Texas consumers as much as $4 billion annually.
- Texas should act to improve market reliability and increase new investment, but we should do so by moving away from, not toward, more regulation and intervention.

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

Q: Why is electricity so important?
A: The wealthier we are, the more electricity we use. Not because we are wasteful, but because it makes us better off. Increased use of electricity allows us to have better machines for manufacturing, better equipment to provide us health care, better gadgets to help us communicate and live our lives. There's a strong correlation between the use of electricity (and energy in general) and the health and wealth of a society.

Q: If using electricity is so good for us, why do some people want us to use less?
A: Environmentalists want us to use less because they think generating electricity from traditional fuels is destroying the planet. Many regulators and policymakers share this view; others want us to use less because they fear the consequences if we run out of electricity. In both cases they ignore the many positive benefits of increased energy use.

Q: So to make us use less electricity, they are making it more expensive, right?
A: Everywhere you look that is happening. Energy efficiency programs across the country aren't about being efficient like most people think of it—getting more for less money. Instead, they are about getting less for more money. Renewable energy mandates are making electricity much more expensive because wind, solar, and biomass just can't compete with uranium, coal, and natural gas.

This has even happened in Texas. Texas' energy efficiency programs increase electricity costs by more than $100 million per year, and the state's renewable energy credit program adds about $70 million a year. On top of this, the state will spend close to $7 billion to transport wind energy through its CREZ program. All of this is factored into the price of electricity.

Q: But don't we want to become more energy efficient?
A: Without a doubt energy efficiency is a good thing. The good news is that we have been getting more energy efficient for centuries. But the bad news is that environmentalists and regulators have turned the meaning of energy efficiency upside down. Energy efficiency is not about making electricity more expensive so we will use less of it, it is about making electricity less expensive so we can use more of it. It is also about making equipment use electricity more efficiently so it lowers the overall cost. For instance, with lower electricity prices and more efficient manufacturing process we can make more computer chips for less cost. So the price of everything from cell phones to health care drops.

Q: Despite our challenges, Texas has become more energy efficient as our electricity prices have trended lower. How did this happen?
A: Competition. Back in the 1990s, Texas joined a lot of other states in trying to get cheap electricity out of cheap natural gas—even the most liberal politicians recognized that government couldn't make that happen. That's why states like California, Maryland, and even New York tried to make it happen. But most states didn't make it. Some, like California, couldn't bring themselves to actually let competition work, and so the mess they created collapsed on itself. Others, like Maryland, balked when prices started going up and abandoned the experiment. Some, like Pennsylvania, had some success. But no one made it all the way except Texas. The resulting competition has forced Texas market participants to become more efficient.

Q: What's been the result of competition?
A: Billions of dollars have been invested in new generation. So we have plenty of electricity, a large surplus most of the time—that's why prices are so good. Consumers can go on the web and shop for dozens of plans from dozens of providers. You can pay spot prices or lock in lower rates for a year or two. It can

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actually be a bit overwhelming—just like buying a new cell phone, but people have figured it out. Prices have dropped as well. Texans in the competitive market can buy electricity for as low as 7 or 8 cents per kWh, compared to the pre-competition, inflation-adjusted price of 13 cents in 2001.

Q: So if things are going so well, why are some people talking about changing the system?

A: While competition has driven prices down, it can also be hard on corporate profits. So there has been a push to abandon competition for a couple of years now, since lower natural gas prices and a more efficient market started eating into electricity generator profits. Also sparking the debate was the record heat and drought of 2011 that strained our electricity supplies to the limit.

Behind the push are policymakers nervous about running out of electricity, regulators who don't believe an electricity market can operate without their help, generators seeking to boost their profits, and consultants who stand to earn millions of dollars in fees from implementing a new market structure.

Though we survived 2011 without any interruptions in service, the thin reserve margins that summer opened the door for generators to begin the push for subsidies through a capacity market, in which generators get paid for their generation capacity—regardless of whether consumers need it. There is no evidence, however, that capacity markets can actually improve reliability. But there is plenty of evidence that they make electricity more expensive.

Q: How does a capacity market differ from the existing electricity market?

A: Texas' current electricity market is an energy-only market. This means that electricity generators are paid only for the energy—or electricity—they sell. And generators bear all the risks of investment in the generation plants they build—they either turn a profit or they don't. Consumers pay only for the electricity they buy. And prices are based on competition, i.e., supply and demand in the market.

In a capacity market, however, generators receive capacity payments regardless of whether their capacity is needed, and consumers pay for capacity on top of their electricity costs, whether or not they need the capacity. The role of competition in setting prices is significantly diminished, and a lot of the risk of new investment is shifted from generators to consumers.

Q: Will a capacity market make electricity more expensive?

A: Adopting a capacity market will increase electricity costs in two ways. Designing and implementing a capacity market will cost money. While no one knows what the cost of this will be, in 2010 Texas implemented a new nodal market at a cost of over $500 million. Implementing a capacity market could see similar costs. Though the nodal market was expensive, at least it was designed to save consumers money by reducing congestion costs. Unfortunately, that will not be the case with a capacity market. Once it is up and running, capacity payments to generators are estimated to be $4 billion or more annually—on top of what consumers will be paying for the electricity they use.

Q: But don't we have to do something to improve reliability and new investment in generation?

A: Yes we do, but we have to first understand that concerns over reliability and profitability are overstated. Concerns about future shortages are based on projections that overstate demand and understate supply. While some companies struggle to turn a profit, others have announced hundreds of millions of dollars in new investments in generation.

We also need to understand that to the extent the Texas market is having problems, it is largely because of growing intervention in the market by policymakers and regulators—who now seem bent on creating more problems. So while Texas does need to act to improve the market, we should be moving away from, not toward, more regulation and intervention. We should eliminate overregulation of wholesale prices, eliminate renewable energy subsidies, promote market-driven demand response, change bid structures and ancillary markets, and generally reduce the ability of the PUC to interfere with the market.

Q: When will we find out if Texas stays with competition or adopts a capacity market?

A: With the recent appointment of a third commissioner, the Public Utility Commission of Texas (PUC) appears ready to move forward rapidly on this issue. It has set October 8 as the date for a workshop on this issue. It could be that many of the decisions determining the future of the market may be made at that time. The PUC is taking public comments on this issue through September 23 on its Proceeding to Ensure Resource Adequacy in Texas, Docket # 40000.

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900 Congress Ave., Suite 400 | Austin, Texas 78701 | (512) 472-2700 phone | (512) 472-2728 fax | www.TexasPolicy.com