

Barriers to Entry and U.S. Wholesale Power Markets

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Impediments to Competition?

- “Competition has elsewhere encouraged efficiency and innovation better than regulation.
- That electricity must be consumed when produced is no different from other time-perishable commodities like airline seats, hotel rooms, movie seats and advertising time on television. No barrier there.
- The solution is to improve market rules and market oversight.”

Branko Terzic, Former FERC commissioner
New York Times letter to the editor, 21 Nov 06

Impediments to Competition?

- The question of whether to stay the course on deregulation or restore aspects of traditional regulation “would have to ...
- ... take into account, above all, the extraordinary and in some respects literally unique characteristics” of the industry.

Alfred Kahn

Relevance of industry characteristics to competitiveness

	<u>Not Very</u>	<u>Somewhat</u>	<u>Very</u>
<u>Capital intensiveness</u>			<input checked="" type="checkbox"/>
<u>Financial capital requirements</u>			<input checked="" type="checkbox"/>
<u>Scale economies</u>			<input checked="" type="checkbox"/>
<u>Lumpiness of investments</u>			<input checked="" type="checkbox"/>
<u>Location of facilities</u>			<input checked="" type="checkbox"/>
Technology		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Product durability			<input checked="" type="checkbox"/>
Sunk costs			<input checked="" type="checkbox"/>
<u>Substitutes</u>			<input checked="" type="checkbox"/>
Seasonality			<input checked="" type="checkbox"/>
Product differentiation		<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Vertical integration			<input checked="" type="checkbox"/>
<u>Number of sellers and buyers</u>			<input checked="" type="checkbox"/>
<u>Mobility of resources/ Asset specificity</u>			<input checked="" type="checkbox"/>
Foreign competition			<input checked="" type="checkbox"/>
Network industry			<input checked="" type="checkbox"/>

Evidence: Consumer Benefits?

“There is growing evidence and convincing studies that show that consumers have saved billions of dollars in energy costs as a result of competitive markets.”

“Open Letter to Policymakers,”
Compete Coalition, Washington,
D.C., June 26, 2006

Evidence: Consumer Benefits?

Generally:

- Concluded “that the methodology used in [the] studies consistently fall short of the standards for good economic research.”
- “In particular, despite much advocacy there is no reliable and convincing evidence that consumers are better off as a result of restructuring of the U.S. electric power industry.”

John Kwoka, *Restructuring the Electric Power Sector: A Review of Recent Studies*, Nov. 2006

Evidence: Consumer Benefits?

Specifically in regard to the “Open Letter ...”:

- “... Existing studies do not support that proposition.”
- “Indeed, ... there is no credible and convincing economic evidence that consumers have been made better off by electricity restructuring.”

John Kwoka, *Restructuring the Electric Power Sector: A Review of Recent Studies*, Nov. 2006

Evidence: Consumer Benefits?

Specifically in regard to the “Open Letter ...”:

- “The unsupported conclusions of these studies should not serve as the basis for further ill-defined ‘deregulation’ or ‘competition’ solutions to the present difficulties in electricity markets.”

(Emphasis added)

John Kwoka, *Restructuring the Electric Power Sector: A Review of Recent Studies*, Nov. 2006

Evidence: Company Profits

	ROE (%)		Cash Flow to Equity (%)	
	<u>2005</u>	<u>5-Year</u>	<u>2005</u>	<u>5-Year</u>
Exelon	19	18	33	33
Constellation	13	13	28	25
PSGE	14	16	27	24
PPL	16	20	32	50
Allegheny	10	-1	30	11

Evidence: Company Profits

Summary of Stock Holding Period Returns (%)

	<u>10 yrs.</u>	<u>5 yrs.</u>	<u>3 yrs.</u>	<u>1yrs.</u>
<u>Regulated</u>	10	9	9	12
<u>S&P 500</u>	7	5	10	15
<u>Exelon</u>	22	27	30	26
<u>Constellation</u>	13	22	19	11
<u>PSGE</u>	19	13	20	4
<u>PPL</u>	17	18	23	15
<u>Allegheny</u>	7	3	60	49

Evidence: Prospective Profits

	<u>Year</u>	<u>ROE (%)</u>
Exelon	2008	22
Constellation	2008	17
PSGE	2009	22
PPL	2010	23
Allegheny	2010	26

Warren Buffet on Electric Utilities

- Investing in electric utilities is “not a way to get rich, it’s a way to stay rich.”
- “Most of deregulation was a mistake” because, in a deregulated market, “generators have a clear incentive to reduce power reserves.”
- Owners of generating assets want the market to be tight
- “The last thing in the world an unregulated operator wants is excess capacity.”

Source: *Platts Electric Utility Week*
20 November 2006

PJM Market Power Indicator

PJM's Use of Price-Markup Index (PMI)

PJM estimated 3.9 percent for 2005

Important conceptual issues and application of the formula aside ...

5 Regions

8-25 %

8-19 %

6-15

8-26

7-17

Economic Analysis v. Value Judgments

Why are concerns about impediments to competition and evidence on restructuring ignored or dismissed?

Economic Analysis v. Value Judgments

Do Policy Recommendations rests on:

A commitment to the competitive market as an ideal, and consequent belief that any step in the direction of the ideal is desirable;" or on

Economic Analysis and Empirical Evidence?

Final Thoughts

- Threshold question is not about markets v. regulation, as such; rather it's about competition v. monopoly.
- "Imperfect information, imperfect capital markets, imperfect competition: These are the realities of market economics – aspects that must be taken into account."

Final Thoughts

- “The advocates of deregulation say it was not done perfectly.
- They would have us compare an imperfect regulated economy with an idealized free market
- ... Rather than an imperfect regulated economy with an even more imperfect unregulated one.”

Joseph Stiglitz