

January 25, 2002

FLORIDA'S ENERGY 2020: IS IT DEREGULATION OR MUSICAL CHAIRS?

By LYNNE KIESLING

Industry observers generally perceive Florida as downright hostile to changes in the electricity industry.

The Florida state government has embarked on a long-term electricity study called Florida Energy 2020. The stated goal of this project is legislative change to create the potential benefits of electricity restructuring while phasing in these changes over a three-year transition period. The Energy 2020 Study Commission released its final report in December 2001, laying out proposals for the "deregulation" of Florida's wholesale electricity market.¹ The commission recommends some changes that would foster competition and create consumer benefits, but they are few and far between. The report seems more interested in managing and controlling change than in striking a balance between change management and using market processes to unleash productive creativity in electricity and bring the benefits of choice to Florida's consumers. The recommendations resemble musical chairs more than true deregulation.

Even before the California electricity crisis accelerated last summer, Florida was not moving assertively toward electricity competition. In fact, industry observers generally perceive Florida as downright hostile to changes in the electricity industry. This perception is largely based on Florida's denial of the construction of merchant power plants, which are plants built with no obligation on the part of retail customers to pay for the output of the facility.

It appears that Florida is unique among states in its statutory prohibition against the construction of merchant plants. ... Thus, Florida's wholesale market is basically closed to a large segment of potential competitors in the wholesale market.²

Such a legal and regulatory environment stifles competition in the wholesale electricity industry.

Electricity Deregulation in Florida

According to the *Retail Electricity Deregulation (RED) Index*, published by the Center for the Advancement of Energy Markets, Florida is a laggard in pursuing competition. In the most recent *RED Index*, published in July 2001, Florida had zero points out of a possible 100, because the state had taken no action beyond establishing this commission. (Pennsylvania ranks highest with 66 points and Texas has 65 points.)

Consumers have not pressured for deregulation of Florida's wholesale electricity industry. The state's average residential rate ranks 15th in the country at 8.1 cents per kilowatt hour. These relatively low rates do not tell the whole story, though. The *RED Index* reports that the average annual residential electric bill is \$1,086, third highest in the country. More importantly, the percent of average per capita income paid for electricity in Florida is 3.1 percent, second highest in the country. Only Louisiana residents pay a larger share of their income for their electric power.³ Perhaps if more Florida residents realized this fact, they would push for more assertive electricity industry deregulation.

Rather, the impetus to change has come from external pressure, most notably from the Federal Energy Regulatory Commission's (FERC) orders to pursue regional transmission organizations (RTOs). RTOs are consortia of transmission owners (usually electric utilities) that will operate their transmission grids as a single regional system. FERC hopes to use RTOs to promote open access to transmission for independent generators and power marketers, and to coordinate the use and construction of transmission assets by region. The Energy

By concentrating on wholesale “deregulation” and a slow process on top of that, the commission drastically diminishes the possible benefits to consumers and entrepreneurial suppliers.

2020 interim report, issued in February 2001, opened by stating that FERC's initiatives, which have prompted three Florida utilities to form the RTO GridFlorida, have spurred the state to consider wholesale electricity deregulation:

It is becoming more and more clear that federal policies are succeeding in pushing the electric industry toward a more competitive market structure. To the extent that the generation segment of the industry can be competitive, Florida's policymakers should examine Florida's laws and policies to facilitate a smooth transition to a competitive market.⁴

Florida 2020's Proposals

Florida is considering only wholesale market deregulation; under the current proposal, consumers still will not have the power to choose their electricity generator. The sole focus on the wholesale market severely limits the benefits of competition to both Florida consumers and to innovative suppliers. In Pennsylvania, Ohio, Maryland, the District of Columbia, and Texas, retail electricity markets have opened to competition, with consumers able to choose their provider (although not their distributor—the local incumbent utility still provides distribution services). This choice, not guaranteed low rates, is the real benefit to consumers of deregulation. In all of the above-named areas, innovative energy suppliers have presented consumers with a variety of electricity choices, including green power (the generation of electricity using renewable resources such as wind and sun). Of course consumers expect to pay more for green power because its generation costs are higher. But if they care deeply about how the electricity is generated, retail deregulation unleashes the opportunity to find such a supplier in the market and for such a supplier to profit from selling clean, green power. Innovation and creativity like this does not arise in a regulated environment, and Florida's retail electricity environment will continue to be regulated. By concentrating on wholesale “deregulation” and a slow process on top of that, the commission drastically diminishes the possible benefits to consumers and entrepreneurial suppliers.

Among the changes the commission recommends are the following highlights, both positive and negative.

- ***Changing the determination of need statute to lower barriers to entry (+)***

The determination of need statute, one of the most anticompetitive pieces of legislation in the industry, requires regulators to approve the construction of additional power plants to serve Florida consumers. This statute has stifled the entry of independent power producers into the Florida wholesale electricity market, to the detriment of consumers. Such changes would reduce or eliminate (depending on the details) the ban on merchant power plant construction, which would help competition in Florida's wholesale market. Independent power producers, particularly those from out of state, face substantial barriers to entry because of the need determination statute.

- ***Changing the way investor-owned utilities (IOUs) acquire energy (+)***

The commission recommends energy acquisition through bidding, bilateral contracts (between individual buyers and sellers), and/or spot market contracts (for immediate or next-day needs). Allowing bilateral contracts without having to go through a particular government agency (originally forbidden in California's legislation) would decentralize the energy trading process and serve as a check on the market power of participants. One feature of California's legislation that created problems was the requirement to trade through the state-created faux market of the Power Exchange, not through any bilateral contracts. Instead, a more open, decentralized system of trading, such as that proposed for Texas, would help electricity markets thrive.

- ***Requiring IOUs to sell generating capacity to independent generators (-)***

The proposal recommends that IOUs divest their power plants. Mandatory divestiture contributed to the financial insolvency of California's IOUs and to the market power that the generators were able to exploit, so Florida should approach this policy with caution. A policy like Texas's, where an incumbent IOU can retain only 20 percent of the generation capacity of its service area, is less likely to create market power for generators, but still creates entry opportunities for generators. Florida's proposal may mitigate some of the California market power in the three-year transition period, though, by requiring IOUs to enter longer-term

A more integrated approach that introduces wholesale and retail competition in tandem, as has been implemented in several other states, would bring real choice to consumers, not just a shuffling of chairs within the industry.

contracts to decrease IOU reliance on spot market contracts during that time. The fact remains, though, that all of these requirements amount to telling the utilities what to do, which is simply a different form of regulation.

• ***Protecting consumers from rate fluctuations (-)***

The commission recommends a three-year rate freeze for IOUs. "If, for some reason, wholesale prices do begin to fluctuate, the proposal calls for a base rate freeze as a fail-safe mechanism to protect consumers."⁵ Unlike California, the commission recommends inclusion of a fuel adjustment clause so the IOUs may pass on fuel costs to customers. The report does not go into detail on this adjustment clause, but if it allows the IOU to recoup all of any fuel cost increases from consumers, the IOU has little incentive to manage its fuel price risk.

• ***Implementing demand responsiveness and real-time pricing (RTP) (+)***

RTP uses computer technology to enable consumers to monitor their electricity consumption and to see the price they are being charged. Being able to charge consumers different prices during the day would improve efficiency, since the cost of producing electricity varies widely according to the time of day. The commission recommends that Florida explore such programs and implement them as they become cost-effective. Prices are a powerful incentive for consumers to conserve and to allocate resources efficiently. The electricity industry, through its historical rate-of-return regulation, has not used this tool, with regulators using the argument that electricity demand is inelastic. Inelastic, yes; totally unresponsive, no. Last summer San Diego residents did curtail their power use when their rates increased, only to increase their use again after successful lobbying to reintroduce retail caps. In the RTP programs in Georgia and Washington state, consumers have shifted their use away from peak hours based on the prices they face. In an industry like electricity, where shaving demand in peak hours changes long-run investment decisions regarding peaker plants versus regular plants, exploiting demand responsiveness could change the development of the industry. RTP also reduces the production of high-cost electricity, which would reduce prices to all

consumers, not just those who face real-time prices.

Summary

Electricity industry restructuring is complex and hence policy proposals will rarely be ideal. The Energy 2020 report makes some constructive recommendations—eliminating the need determination statute, one of the most anticompetitive pieces of legislation in the industry, is a big improvement. The emphasis on demand responsiveness also highlights one of the most effective ways to introduce efficiency. However, the report's proposals are actually far from ideal. Although the commission has worked assiduously to avoid California's pitfalls, the slow speed and tentative nature of its proposals are unlikely to generate the benefits that are possible through a more integrated deregulation.

The focus on wholesale competition over a three-year phase-in severely limits the possible benefits of competition. A more integrated approach that introduces wholesale and retail competition in tandem, as has been implemented in several other states, would bring real choice to consumers, not just a shuffling of chairs within the industry. Integrating wholesale and retail competition would also reinforce the point that the actual benefits of deregulation are choice, not guaranteed low rates, because it would enable removal of the retail rate cap. The rate cap runs counter to the objective of demand responsiveness and real-time pricing, and the commission will have to resolve those inconsistencies if they intend to deliver real deregulation in Florida's electricity industry.

Endnotes

¹ Items associated with the Energy 2020 Study Commission are at www.myflorida.com/energy.

² Florida Energy 2020 Study Commission, Interim Report, Proposal for Restructuring Florida's Wholesale Market for Electricity, February 2001, p. 5.

³ Center for the Advancement of Energy Markets, Retail Electricity Deregulation Index, July 2001, pp. 94, 150. CAEM's website is www.caem.org.

⁴ Florida Energy 2020 Study Commission, op. cit., p. 2. Note that since the interim report was issued, FERC has changed its approach to RTOs, and has forced GridFlorida to join with other regional transmission owners to form an RTO covering the entire Southeast region.

⁵ Ibid, p. 19.

Lynne Kiesling (lynnek@rppi.org) is Director of Economic Policy at Reason Public Policy Institute and Senior Lecturer of Economics at Northwestern University. Her analysis of electricity restructuring in various states is available at www.rppi.org/ps281central.html, and on the consumer education website of the Texas Public Utilities Commission, www.powertochoose.org.