ECONOMY & POLICY

Deregulated U.S. Energy Markets Are Set for a Tough Summer

COMMENTARY By Ed Hirs May 31, 2022 11:36 am ET

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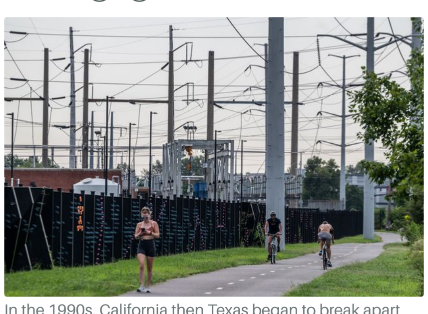

In the 1990s, California then Texas began to break apart the vertically integrated utilities, writes Ed Hirs.
Andrew Caballero-Reynolds/AFP via Getty Images

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The forecast for summer is hot weather and possible blackouts in America's deregulated electricity grids. That's according to the summer reliability assessment released by the North American Electric Reliability Corporation, the federal grid overseer. In other words, consumers should expect the same outcome they receive with any monopoly: less service and higher prices.

The Federal Energy Regulatory Commission and state regulators have driven us to this predicament with their evangelism of "deregulated" electricity markets. It is as if FERC and state regulators are working for the companies and not for their employers, the public.

In the old days, electric utilities were integrated from the generator—sometimes including even the coal mine—to high voltage transmission lines, local wires, and customers' meters. Recognizing that these were natural monopolies, state and local authorities began to regulate the rate of return earned by the utilities. The total cost of providing that electricity was divided by the number of kilowatt hours for the day to determine the cost per kilowatt hour. A regulated profit was then added to the cost. The process and outcomes were predictable. The Dow Jones Utility Index reflected the fact that utilities offered lower risks and stable returns for investors. The regulated utilities worked with state regulators to determine where to build new facilities. Reliability was the goal. In some areas of the country, generators were added even though they would only be needed during the hottest of August days or coldest of January nights, but the utility owners were compensated whether or not the units ran.

In the 1990s, California then Texas began to break apart the vertically integrated utilities. Generator owners bid into the market to sell their electricity. They were not paid unless they generated power. This so-called electricity-only market is akin to paying only those ten New York Yankees who take the field for a night's game. Those on the bench get nothing.

Transmission and local distribution of electricity to consumers remain regulated.

The laudable premise at the time of deregulation was that noneconomic generation plants would drop off the grid. New transmission facilities would better utilize the generators that remained and wheel power across the nation. To facilitate this activity, the regional operators implemented locational marginal pricing, or LMP, based on the optimization techniques of linear programming models. It is the same technique that the Soviet Union used for its centrally planned economy. It blows up today just like it did for the Soviets because it does not account for the cost of capital or bad weather.

The regulators believed that higher LMP prices across points in the grid would signal a profit opportunity to generators and transmission companies. Investment would follow to capture that high price. It hasn't. Regulators still express surprise that the generators are smarter than the algorithms. Companies will not add capacity just to guarantee lower prices. It is better to wait for prices to spike and enjoy the windfalls.

The deregulated electricity markets underinvested in their electricity infrastructure. The lack of reliable generation in Texas resulted in an outage of more than 52,000 megawatts during the February 2021 freeze. That is more electricity than California has ever used in a day. Hundreds died. Economic damages are estimated to be more than $100 billion from the outages. The Electric Reliability Council of Texas, ERCOT, and its regulator the Public Utility Commission charged the consumers for billions more that will be paid off by Texans for years, at the direction of Gov. Greg Abbott.

FERC will be on the lookout for market manipulation in the natural gas and electricity markets they regulate this summer, Chairman Richard Glick said recently. It is exactly the behavior that FERC's policy encourages.

At national conferences, states consider the lessons of California and Texas as they contemplate fully abandoning rate of return regulation for their electric grids. What are their options for maintaining reliability?

California has exposed the conceit that grid operators can rely upon neighbor grids. The recent heatwaves have also hit the states California relies upon for backup power, as noted in the NERC report. NERC also forecasts that ERCOT's neighbor, the Mid-Continent Independent System Operator, is in a more precarious situation this summer. Constructing interconnections between these two faltering grids would be laughable for both. It is fair to repeat that there was not enough electricity available across the entirety of the U.S. to have saved Texas in the February 2021 freeze. It was cold next door, too.

Grid operators and regulators continue to admit more wind and solar generated electricity to their grids. Because the fuel cost is zero, these resources bid into the grid markets at prices lower than the legacy natural gas, coal, and nuclear plants. Under electricity-only schemes, the legacy plants can look forward to declining run time in the future. They will drop off the grid just as they have done in California and Texas. This is not a matter of renewable energy versus legacy energy; it is a matter of governance and rate of return. Appointees of multiple Texas governors admitted every renewable energy resource to ERCOT and did so without considering market dynamics.

The solutions in California and Texas differ. California's grid operator has contracted to buy 5,000 megawatts of new natural gas generators to stabilize the grid. Diablo Canyon Power Station, the only U.S. nuclear plant beside an active fault line, may remain open. In recent meetings of the Public Utility Commission of Texas and ERCOT, the commissioners and staff have touted "new products" that are coming to market. Given that an electron is still an electron, and there are not enough of them during bad weather, one wonders what they mean.

Commodities traders can barely contain their glee. Public employees at FERC and at agencies in California, Texas, and other deregulated states have played right into their hands. Wall Street withholds capital. Rich consumers buy home generators. Poor consumers wonder why no one cares.

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Conversation

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By Nicholas Jasinski Follow Updated May 31, 2022 / Original May 29, 2022

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U.S. stock and bond markets will be closed Monday for Memorial Day. A handful of major companies report later this week, with the economic-data highlight being jobs Friday.

HP and Salesforce.com will report on Tuesday, followed by Chewy, GameStop, and Hewlett Packard Enterprise on Wednesday. CrowdStrike Holdings, Hormel Foods, Lululemon Athletica, and Okta will be Thursday's earnings highlights.

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