TEXAS PUBLIC POLICY FOUNDATION
PolicyPerspective

January 2013
Center for Economic Freedom

Sunset Recommendations Would Increase Regulations on Texas' Electricity Market

Analysis of the Sunset Advisory Commission's PUC Staff Report

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Key Points

- The Sunset Commission's Staff Report recommends the quadrupling of the Public Utility Commission's fines and restricting due process for Texas businesses.
- The Staff Report recommends this increased government intervention in the Texas electricity market even though it offers no examples of any problems in the market that need addressing.
- The Sunset process today is more about increasing the size and scope of government than it is making it more efficient.

Introduction

The Texas Sunset Advisory Commission's Staff Report on the Public Utility Commission of Texas portrays the state of the Texas electricity market in a negative light—in contrast to its findings about the Texas telecommunications market. The Staff Report thus recommends two significant increases in government intervention in the electricity market: 1) quadrupling the PUC's administrative penalty authority to $100,000 per violation per day, and 2) authorizing the PUC to issue emergency cease-and-desist orders.

The problems with the Staff Report are twofold. First, the Staff Report mischaracterizes the state of Texas' electricity market. For instance, its assessment of the market differs significantly from that of Potomac Economics, ERCOT's Independent Market Monitor, which found "that the ERCOT nodal wholesale market performed competitively in 2011."

Second, the Staff Report presents no evidence of misconduct or violations within the electricity market to justify its recommendations. The lone example of a "problem" with the market included in the Staff Report was a disruption of service caused by an extreme cold weather event—not by market misconduct.

In fact, the evidence today as Texas struggles with the issue of reliability overwhelmingly supports less intervention by government—not more. The increased fines and emergency cease-and-desist authority proposed in the Staff Report will increase reliability problems by creating even more regulatory risk within the Texas electricity market—which is one of the main problems the market faces today.

Calls to "fix" Texas' electricity market with more government intervention won't help—in fact, they will make electricity more expensive for consumers, reduce competition, and harm current efforts to increase reliability. It would be most unfortunate if the Staff Report's recommendations contributed to the demise of the world's best example of competition in electricity markets. If we let it work, Texas' world-class energy-only electricity market will power our future.

Analysis of Sunset Staff Report Recommendations

Issue 1 in the Staff Report is, *"PUC Lacks Regulatory Tools Needed to Provide Effective Oversight and Prevent Harm to the Public."* Two common themes run throughout the discussion in Issue 1 with regard to the Texas electricity market. First, it is based on theoretical, rather than actual, market conduct in the competitive market. Second, it is based on the invalid premise that increased regulation of the Texas electricity market is necessary to improve its operations.

The complete lack of evidence in the Staff Report of any substantive violations or problems in the Texas electricity market is astonishing—particularly at a time when the primary challenge facing state policymakers is maintaining reliability.

> **Sunset Recommendation 1.1** *Increase PUC's administrative penalty authority to $100,000 per violation per day for electric industry par-*

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ticipants' violations of ERCOT's reliability protocols or PUC's wholesale reliability rules. **Foundation Position: Oppose**

The Staff Report's attempt to justify its recommendation to quadruple the PUC administrative penalty authority does not comport with actual conditions in the Texas electricity market. For instance, Potomac Economics, the Independent Market Monitor for the ERCOT Wholesale Market, reports:

> Overall pricing outcomes from the nodal real-time market have met expectations for improved efficiency. … The nodal market has also enabled the higher utilization of transmission facilities… Three areas where the nodal market implementation led to unanticipated outcomes were identified and quickly resolved in 2011. … In summary, we find that the ERCOT nodal wholesale market performed competitively in 2011.

The Staff Report tries to overcome its mischaracterization of the market by pointing to the February 2, 2011 extreme cold weather event which led to a series of rolling blackouts in the state:

> The failure to live up to the terms of such an agreement can be serious, as seen on February 2, 2011, when extreme cold weather and an inadequate response by several market participants contributed to an energy emergency alert at ERCOT, resulting in rolling blackouts statewide to avert what could have been a major disaster had the entire grid failed.

In this example, the Staff report attempts to paint the February 2 event as one in which there were illegal actions by market participants where higher fines might have led to a different outcome or been appropriate punishment.

However, here again the Staff Report's findings contrast with the Independent Market Monitor, as well as by the actions taken by the PUC after the event. The Independent Market Monitor found:

> Although a wide range of actions were undertaken by generation resource owners in preparation for the extreme weather conditions, it is clear from the unprecedented loss of generation capacity on the morning of February 2nd that many of these preparatory efforts were unsuccessful. This experience will serve to produce lessons learned and specific areas for improvement in the areas of generation resource weatherization and coordinated extreme weather planning. Overall, although the scope and magnitude of the generating unit outages on February 2nd was absolutely unprecedented, we do not find any evidence that indicates that any of the outages were the result of physical withholding.
>
> Another measure to provide additional insight related to this finding is the relative profitability of market participants during these events and how it correlates with unit outages. Although an assessment of profitability in isolation is insufficient to draw conclusions related to market manipulation or market power, increased profitability is the primary motive associated with resource withholding strategies. Hence, a negative correlation between resource outages and profitability would provide increased confidence in the finding that the outages were not the result of market manipulation strategies or market power abuses.

The Independent Market monitor concluded, "These wholesale market pricing outcomes were consistent with the ERCOT energy-only market design."

In other words, even though unprecedented cold weather stressed the system in ways that were completely unanticipated, the system worked as planned, and the events of February 2 are unlikely ever to be repeated. If they ever are, it will be the "lessons learned and specific areas for improvement in the areas of generation resource weatherization" that will keep Texas from again experiencing rolling blackouts, not the increased fines recommended by the Staff Report.

The Staff Report also attempts to justify its recommendation to increase fines by claiming that a 2010 PUC decision "limits PUC's ability to assess a meaningful penalty for reliability-related violations." However, in truth the decision placed no restrictions on the ability on the PUC to enforce reliability standards. While the PUC staff had in the past attempted to view "certain reliability violations … as multiple violations per day," those efforts have generally not been successful because, as the Commission's 2010 decision makes clear, the PUC did not have this authority in the first place.

> **Sunset Recommendation 1.2** *In limited circumstances, authorize PUC to issue emergency cease-and-desist orders to electric industry participants.* **Foundation Position: Oppose**

The Staff Report's recommendation granting the PUC emergency cease-and-desist authority will not have any beneficial effects on the electricity market or the public. In fact, the result will be to further increase regulatory risk in the market and harm efforts to increase the reliability of the system.

As with its Recommendation 1.1, the Staff Report provides no evidence of any problems that would be solved by emergency cease and desist authority. Instead, it offers conjecture:

> A regulatory agency should be able to stop unlicensed or harmful activity immediately. PUC's current authority relating to electric industry participants does not meet this standard. To stop an action, PUC first must issue a notice to the alleged violator and provide an opportunity for a hearing before issuing a cease-and-desist order. By then the harm may have been done.

The Staff Report offers no evidence of any harmful activity in the past that should have been stopped. On the contrary, it notes that the PUC has only used its current cease-and-desist authority once since FY 2007. Surely if there were harmful activities by market participants that needed to be stopped "immediately" the PUC would have pushed forward with its current cease and desist authority despite its alleged shortcomings.

Nor does the Staff Report offer any support for why its supposition (that a "regulatory agency should be able to stop unlicensed or harmful activity immediately") should be a standard by which the current regulatory apparatus of the PUC should be judged. There is no discussion of what harm might be avoided by the adoption of such a standard, no mention of the fact that any activity immediately stopped under such a standard would only be alleged to be "unlicensed or harmful," and no analysis of the costs to market participants (producers and consumers) of 1) wrongfully stopping what later turns out to legal behavior and 2) the regulatory uncertainty caused by the "standard" generally.

As noted above, the PUC already has cease-and-desist authority. The Staff Report is recommending *emergency* cease-and-desist authority, apparently, because under current law the PUC must "issue a notice to the alleged violator and provide an opportunity for a hearing before issuing a cease-and-desist order."

In other words, the Staff Report finds that requiring the PUC to present evidence of a violation in a court is "harmful to the public." The Staff Report's answer to this allows the PUC to prohibit a business from engaging in any commercial activity it alleges to be "unlicensed or harmful" without providing any evidence of a violation. This leaves businesses unable to defend themselves until they have lost a significant amount of money, customers, etc.

Conclusion

Staff Report Recommendations 1.1 and 1.2 will result in a significant intrusion by regulators into the Texas electricity market and a curtailment of due process for market participants. If there were problems with anti-competitive behavior or other illegal activities in the market today one might be able to build a credible case for these recommendations. But this is not the case. Instead, these recommendations are simply solutions in search of a problem—a problem that doesn't exist. The Foundation recommendations that Staff Report Recommendations 1.1 and 1.2 not be included in the final Sunset Commission Report on the Public Utility Commission of Texas. ☆

[1] Potomac Economics, 2011 State of the Market Report for the ERCOT Wholesale Electricity Markets, Independent Market Monitor for the ERCOT Wholesale Market (July 2012) xxviii ff.

[2] Sunset Advisory Commission, *Staff Report on the Public Utility Commission of Texas* (Dec. 2012) 13.

[3] Potomac Economics, 2011 State of the Market Report, 21-22.

[4] Sunset Advisory Commission, Staff Report, 15.

About the Author

Bill Peacock is the vice president of research and director of the Texas Public Policy Foundation's Center for Economic Freedom. He has been with the Foundation since February 2005.

Bill has extensive experience in Texas government and policy on a variety of issues including, economic and regulatory policy, natural resources, public finance, and public education. His work has focused on identifying and reducing the harmful effects of regulations on the economy, businesses, and consumers.

Prior to joining the Foundation, Bill served as the Deputy Commissioner for Coastal Resources for Commissioner Jerry Patterson at the Texas General Land Office. Before he worked at the GLO, Bill was a legislative and media consultant. He has also served as the Deputy Assistant Commissioner for Intergovernmental Affairs for then-Commissioner Rick Perry at the Texas Department of Agriculture and as a legislative aide to then-State Rep. John Culberson.

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