# McCullough Research

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Dear Fred Kahn, Paul Joskow, *et al*.:

Your 'Open Letter to Policymakers' of June 26, 2006 came to my attention earlier this week. While I share your commitment to competition, I have some doubts about the economics described in your open letter. Like you, I have spent many years participating in the restructuring of the nation's electricity industry. I have also spent more years than I would like to count in the identification and correction, in a few cases, of the many failures of our present system.

Most people are unaware that electricity industry competition originated in the Pacific Northwest in the early 1980s. Peter Johnson, then Administrator of the Bonneville Power Administration, decided to establish an open market in the 3,000 average MW of annual non-firm hydroelectricity. It became so successful that by 1991, FERC approved the Western Systems Power Pool. It possessed freedom of entry and exit. Prices were set by open outcry without the supervision of special governments formed to manage prices and quantities. The tremendous benefits of the free market in electricity eventually created a desire to replicate the Pacific Northwest's experience throughout the U.S.

The system extolled in your open letter has few of WSPP's attributes. In highly centralized, governmentally managed markets, freedom of entry requires vast outlays to be expended on acquiring and managing the requisite specialized tools and personnel. The theory that the success of wholesale electricity market operations requires multiple layers of secrecy by now has received such concentrated support from the nation's Regional Transmission Organizations (RTOs) that transaction data is hopelessly opaque. In many instances, even the most cursory information is classified to protect competition. For example, in the highly controversial auctions in Maryland and Illinois, the participants, the evaluation, and the winners of the bids are secret.

Most transactions within RTOs are prohibited or must be reformulated to comply with the highly stylized formats that have developed. Prices and quantities are determined by arcane computer models, sometimes undocumented and in some cases, barely functional. I find it as no surprise that price controls are very common.

You are correct in pointing out that a major cause of the price increases for electric consumers is the cost of the global wholesale prices of oil and gas. However, your letter does not recognize that even if prices for these fossil fuels had not increased dramatically, the massive transfer of producer's surplus to producers causes hardships for all energy consumers.

For readers outside the profession, producer's surplus is the value above the supply curve and below the line representing the price paid in an efficient market. Traditional regulation assigned this value to consumers by directing that they be paid the average cost of production rather than the marginal cost of production. We have always been troubled by the inefficiencies caused by the incorrect price signals and lack of market discipline caused by traditional regulation. However, it is a bit disingenuous of us to pretend that this tremendous transfer is not a sizeable component of the rate increases facing the ratepayers in Maryland, New Jersey, and soon, Illinois.

Of course, Maryland is the most obvious example in which the burden of enormous, unplanned for rate increases set off a political crisis, the likes of which we have not seen since the Western Energy Crisis of 2000-2001. In Maryland, regulated Baltimore Gas & Electric transferred its generation assets to Constellation, its unregulated parent. For the last five years, the state has conducted auctions where the bidders, the winners, and even the bidding process are hidden from public view. Like something from Gilbert and Sullivan (or more likely, Bertolt Brecht), the same supplier always wins the same auction to serve the same customers - albeit at greatly increased prices. Obviously, competition should mean more than simply reassigning the producer's surplus. Market discipline is best served by a market, not a governmental auction, and an effective choice of suppliers, not the repetitious choice of the same supplier in each succeeding auction.

While we economists conduct our public debate, few people understand that a similar disaster awaits Illinois this summer. Its first-ever state-run auction is being undertaken in such secrecy that even the sign-in sheet for the bidders' conference on June 6, 2006 was classified information. The irony that an official within the Illinois Commerce Commission thought that competition is best preserved by allowing the potential competitors to meet, but shielding their identities from policy makers, the media, and ratepayers is difficult to overlook.

As you know, McCullough Research was instrumental in finding that the massive run-up in prices in California and the West Coast in 2000-2001 was caused by market manipulation. Trading schemes flourished in the artificially managed markets created by California's restructuring. The cultivation of secrecy that allowed Enron, Reliant, and others to perpetrate massive frauds with minimal fear of discovery by state and federal authorities contributed greatly to the severity of the crisis throughout the Pacific Northwest. At the time, some of you signed a letter whose theme was to allow the market to work out the problems. At least one of you argued that if there was a regulatory response, blackouts would result. Reality, however, painted a far different picture. It finally took action by federal regulators before prices fell, production increased, and the California ISO's 125 system emergencies came to an end. Nearly five years later, however, the state economies of Washington, Oregon, Montana, and California still have not fully recovered from the crisis.

If we could eliminate the ponderous bureaucracies of the RTOs and return to an open outcry market, it is possible we could all agree on the benefits to be realized. Would eBay flourish if the rules were arcane, the bidding secret, the participants unknown, the regulators largely absent, and a massive bureaucracy was required to manage each and every transaction? I think you would agree with me that the answer is no.

Unfortunately, I am not sure we can even agree that markets can flourish without the central governmental supervision of the RTOs. I do think we can agree on a simpler prescription. Liberalizing the electricity sector in our nation has been poorly served by the prevailing tendency to cloak markets and their operations in secrecy. If we must assemble thick books of rules and massive bureaucracies to manage the market in electricity, let us at least let the consumers know their suppliers' identities. We will not know whether the dramatic increase in "market" prices is appropriate until we are able to visit the market ourselves to see if the prices reflect the fundamentals of economics or are simply the result of an arbitrary and opaque mechanism.

Yours sincerely, and with my warmest wishes to Fred Kahn,

Robert McCullough