Does Competition *Inevitably* Lead to Lower Prices?

*By Fereidoon P. Sioshansi**

The popular belief is that competition will *inevitably*—and *automatically*—lead to lower electricity prices. The reality is never that simple, nor equivocal. True, competition *generally* leads to improved efficiencies in operations (e.g., power generation), cost reductions in certain functions, the introduction of new—and sometimes improved—services. But its impact on electricity prices is more complicated for several reasons:

- **Large vs. small customers**. The intense pressures to cater to certain large and strategically important customers tends to lead to lower prices and/or offering customized services at little or no cost. Conversely, many small and marginally profitable customers may experience little or no price reductions, end up paying higher prices, and/or suffer service quality degradations. It makes perfect business sense to look after the big customers, but is political suicide. Neither the politicians nor the utility regulators savor the thought of newspaper headlines claiming that residential customers are paying higher bills so the fat industrials can get a break. But that, in a sense, is part of the reality of competitive markets. Larger customers with their high load factors and high-voltage service levels are cheap to serve.
- **Cost attribution and price rationalization**. Another factor further complicating a meaningful comparison of *pre-* and *post-*competition prices is the disappearance of many subtle price subsidies among and across customer classes. Cost allocation and price adjustments, which are a highly important and necessary by-products of industry restructuring, tend to result in significant cost shifts across internal functions and among customer classes. Consequently, some prices rise while others decline even in the absence of any net cost reductions.
- **Risk and return**. The introduction of competition to monopoly functions (e.g., power generation and competitive energy supply) introduces certain risks not previously present. This, in turn, requires higher returns on investment to attract and retain capital. The higher risk premium may partially—or totally—offset the gains in efficiency improvements. Moreover, competitive companies have the prerogative to increase management salaries, pay higher dividends to their investors, make investments in business operations, and/or reduce customer prices.

Combine these three factors, and one can appreciate why it is no easy task to provide a simple answer to the simple question, "does competition lead to lower prices?" The answer turns out to be anything but simple or inevitable. In most cases, the only correct answer is "it depends."

Perhaps because of these complicating factors, politicians in a number of U.S. jurisdictions that have passed restructuring legislation have insisted on *mandated price reductions*. A legislatively mandated 10-15 percent price reduction targeted at small residential customers (i.e., the voters), combined with a price freeze for everyone else, appears to be a popular political formula. It guarantees the support of a majority of the voters, while permitting larger customers to cut special deals with competing suppliers—something they will demand anyway. Some customers are made relatively better off, while nobody is made worse off, a so-called *Pareto superior* solution. Who can argue against such a deal?

Now a report titled, *The Impact of Competition on the Price of Electricity*, conducted by J. A. Wright and Associates of Marietta, GA, supports the notion that legislatively mandated price reductions may be the *only* pragmatic way to guarantee immediate lower prices. The report, which is focused on the 3 competitive markets in California, Massachusetts, and Rhode Island, concludes that the lower prices experienced so far have been the result of legislative mandates, not competitive market forces. The report, however, is not critical of competition. It points out that most of the benefits of competition are yet to come—once the transition period is over and utility's *stranded costs* have been written off.

Moreover, the report points out that, even setting the recovery of stranded costs aside, the costs of transitioning to a competitive electricity market are significant—and tend to be overlooked or underestimated. Finally, there are other subtle costs associated with a restructured market, including more volatile prices.

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International Energy Foundation

The Bahrain conference of the International Energy Foundation approved a series of resolutions pertinent to the coming ENERGEX conferences scheduled for Las Vegas in 2000, Krakow, Poland in 2002, Buenos Aires, Argentina in 2004 and Stavanger, Norway in 2006 summarized as follows:

- ENERGEX'98 achieved the objective of harmonization among energy researchers in all areas of energy. Through a united spirit of cooperation, coordination and communication the results of research in the technical, economic and human dimensions allowed researchers the opportunity and challenge of strengthening and enhancing our capacities and capabilities in responding to the needs of society.
- A prerequisite to the utilization of any form of energy is energy efficiency. This should be emphasized by all in research and in energy policy. This has the added benefit if minimizing environmental degradation and extending energy reserves.
- The action of government is required in order to remove the barriers which prevents the market penetration of renewable forms of energy in the transfer from an oil based economy to a future energy economy. Each nation is encouraged to use their energy resources with due consideration being given to the environment.
- There is a need for development of an environmentally sustainable energy policy which is both flexible and transparent. The development of such should be in concert with government, industry and academia.
- The precise energy resources and technologies which will be viable or even dominate energy use at any given point, cannot be predicted with certainty. The social and economic benefits of developing cleaner, cheaper energy resources are clear.

Those resolutions related to the Foundation are:

- The committee concurs with the Beijing and Seoul Resolutions and encourages the Foundation to proceed in finalizing these resolutions.
- Future ENERGEX conferences should incorporate not only the technical but also the continuation of inclusion of economic, social and environmental dimensions of energy. Specific sections on global climatic change and sustainable development are strongly recommended.
- The Foundation bestows the honour of Fellow to Dr. Eng, Mohammed J. K. Alghatam, President, University of Bahrain, and H. E. Sheikh Essa Bin Ali Al-Khalifa, Minister of Oil and Industry in recognition of their contribution to the global assistance in the fostering of energy technologies among developed and developing nations.
- The Foundation bestows the prestige title of Fellow upon Prof, Obasi, Secretary General, World Meteorological Organization; Dr. M. M. Al-Lababidi, Director of Technical Affairs Department, Organization of Arab Petroleum Exporting Countries; Dr, Anwar Al-Abdullah, Director of Oil and Gas Department, Cooperation Council for the Arab States of the Gulf, Secretariat General; Dr. Michael Lynch, Executive Director, Centre for International Studies, MIT, U.S.A.; Dr. N. Veziroglu, Director, Clean Energy Research Institute, U.S.A., and Dr Ali Sayigh, Director General, WREN, UK.
- The leadership and vision of H. H. Sheikh Isa Bin Salman Al-Khalifa in providing a mechanism for recognition of outstanding scientific contribution at global energy forums with the first presented at ENERGEX'93 in Seoul, Korea, the Foundation recommends that the Sheikh Isa Bin Salman Al-Khalifa Prize be formally integrated in future ENERGEX conferences as a legacy to his global commitment and dedication and that of the State of Bahrain, to energy education and research.

IAEE Awards Announced

The Association has announced the winners of its *Outstanding Contributions to the Profession, Outstanding Contributions to the IAEE* and *Journalism* awards for 1998.

Professor Colin Robinson of the Institute of Economic Affairs in London was selected to receive the *Outstanding Contributions to the Profession* award for his extensive contributions in more than 23 books and monographs and over 100 papers, which address important public policy issues relating to energy.

Dr. Subroto has been selected to receive the*Outstanding Contributions to the IAEE* award. While serving as Secretary General of OPEC, Dr. Subroto participated in the first public dialogue with the International Energy Agency at the IAEE International General Meeting in Honolulu, Hawaii in 1990. He appeared on numerous occasions at other IAEE meetings and provided much support for the organization including serving on the IAEE Council and as a Presidential Advisor.

Toni Mack, Senior Energy Editor for Forbes magazine, and John Jennrich, Editor and Publisher of Natural Gas Week were jointly selected to receive the *Journalism* award. Toni Mack was selected for her outstanding contributions on the strategy of major energy companies in oil, natural gas, electric power, and related areas of energy. Her work has focused on both large and small companies including Exxon, Royal Dutch Shell, PDVSA, Caltex, Enron, Niagara Mohawk Power, service companies, and small independent companies, globally.

John Jennrich was selected for his work and commentaries on the sweeping changes in the natural gas industry including barriers to open market competition, to the benefits of technology advancement and the resilience of the natural gas industry.

"All of the nominees have made a major impact on how industry, government, media, and the public think about energy and energy economics. They are an outstanding group of leaders in energy and energy economics. The Committee thanks the nominees for the privilege of selecting them for the awards and to the IAEE members who were thoughtful enough to nominate them," said Dr. Dennis J. O'Brien, awards committee chairman and past president of the IAEE.

All IAEE members were solicited and invited to submit nominations to the Awards Committee. The 1998 Awards Committee included Lori Cameron, Keichi Matsui and Hoesung Lee, in addition to O'Brien.