BEFORE THE
ARIZONA CORPORATION COMMISSION

Workshop on Retail Electric Competition) Docket No. E-00000A-02-0051

Comment of the
Federal Trade Commission

January 26, 2009

The Federal Trade Commission ("FTC") appreciates the opportunity to submit this comment to the Arizona Corporation Commission ("ACC") in connection with the ACC's consideration of whether retail competition in electricity is in the public interest (including an evaluation of the potential risks and benefits of retail competition). The FTC wishes in particular to bring two relevant documents to the attention of the ACC: the 2007 interagency *Report to Congress on Competition in Wholesale and Retail Markets for Electric Energy* and the FTC's December 2008 comment on dynamic pricing to the Pennsylvania Public Utility Commission ("PA PUC").[1]

---

[1] The FTC is an independent agency of the United States Government responsible for maintaining competition and safeguarding the interests of consumers, both through enforcement of the antitrust and consumer protection laws and through competition policy research and advocacy. The FTC often analyzes regulatory or legislative proposals that may affect competition or allocative efficiency in the electric power industry. The FTC also reviews proposed mergers that involve electric and natural gas utility companies. In the course of this work, as well as in antitrust and consumer protection research, investigation, and litigation, the FTC applies established legal and economic principles and recent developments in economic theory and empirical analysis.

The energy sector, including electric power, has been an important focus of the FTC's antitrust enforcement and competition advocacy. *See*, *e.g.*, Deborah Platt Majoras, Chairman, Federal Trade Commission, Opening Remarks at the FTC Conference on *Energy Markets in the 21st Century: Competition Policy in Perspective* (Apr. 10, 2007), *available at* http://www.ftc.gov/speeches/majoras/070410energyconferenceremarks.pdf. FTC merger cases involving electric power markets have included DTE Energy/MCN Energy (2001) (consent order), *available at* http://www.ftc.gov/os/2001/05/dtemcndo.pdf; and PacifiCorp/Peabody Holding (1998) (consent agreement), *available at* http://www.ftc.gov/os/1998/02/9710091.agr.htm. (The FTC subsequently withdrew the *PacifiCorp* settlement when the seller accepted an alternative acquisition offer that did not pose a threat to competition.)

The FTC's competition advocacy program has produced two staff reports on electric power industry restructuring issues at the wholesale and retail levels. FTC Staff Report, *Competition and Consumer Protection Perspectives on Electric Power Regulatory Reform: Focus on Retail Competition* (Sept. 2001), *available at* http://www.ftc.gov/reports/elec/electricityreport.pdf; FTC Staff Report, *Competition and Consumer Protection Perspectives on Electric Power Regulatory Reform* (July 2000), *available at* http://www.ftc.gov/be/v000009.htm (compiling previous comments that the FTC staff provided to various state and federal agencies). The FTC staff also contributed to the work of the Electric Energy Market Competition Task Force, which issued the aforementioned *Report to Congress* in the spring of 2007 (*available at* http://www.ferc.gov/legal/fed-sta/ene-pol-act/epact-final-rpt.pdf). In addition, the FTC has held public conferences on energy topics, the most recent of which was the above-referenced *Energy Markets in the 21st Century* on April 10-12, 2007 (conference materials *available at* http://www.ftc.gov/bcp/workshops/energymarkets/index.shtml). Other programs have included the FTC's public workshop on *Market Power and Consumer Protection Issues Involved with Encouraging Competition in the U.S. Electric Industry*, held on September 13-14, 1999 (workshop materials *available at*

The Electric Energy Market Competition Task Force's *Report to Congress* described retail competition's mixed track record. Based on the nuanced picture that it presented concerning retail choice programs' current performance, the *Report* made specific recommendations to states that choose to proceed with retail competition. The *Report* observed that when "provider of last resort" ("POLR") rates reflect wholesale costs, efficient consumer choice between the regulated utility and entrants is more likely. Similarly, the FTC's comment to the PA PUC on dynamic pricing described how rates that reflect wholesale costs (through the use of real-time or dynamic pricing) empower ratepayers to solve system problems – for example, by reducing consumption in response to higher prices during scarcity conditions – and allow them to save money by shifting usage to periods when electricity costs are lower.

Background on the *Report to Congress* and the Comment to the PA PUC

Report to Congress. The Energy Policy Act of 2005 required a task force (comprising representatives of the FTC, the Department of Justice, FERC, the Department of Energy, and the Department of Agriculture) to report on competition in wholesale and retail electricity markets. In April 2007, the Electric Energy Market Competition Task Force issued its *Report to Congress* – a document that reflected the Task Force's receipt of substantial public comment.[2] Chapter 4 of that report described the state of retail electric competition in the United States and offered "observations on what appears to work well . . . in retail customer choice programs."[3] Appendix D to the report described in detail the programs (and their results) adopted by seven states situated in organized wholesale electric markets. We hope that these case studies will inform the ACC's deliberations.

---

http://www.ftc.gov/bcp/elecworks/index.shtm); and the Department of Justice and FTC Electricity Workshop, held on April 23, 1996.

The FTC and its staff have filed numerous competition advocacy comments with the Federal Energy Regulatory Commission ("FERC") and the states concerning electricity restructuring initiatives. *See, e.g.*, Fed. Trade Comm'n, Comment Before the Federal Energy Regulatory Commission on Wholesale Competition in Regions with Organized Electric Markets (Apr. 17, 2008), *available at* http://www.ftc.gov/be/v070014b.pdf. Moreover, the FTC staff participates in preparing United States Government filings before international competition organizations regarding energy policy matters, and the FTC and the Department of Justice also participate as United States delegates in a number of international organizations (such as the Organisation for Economic Co-operation and Development). As part of the latter process, the FTC staff contributes to the United States' "country reports" on competition topics. *See, e.g.*, United States Department of Justice and Fed. Trade Comm'n, "Note by the US Department of Justice and US Federal Trade Commission," OECD Roundtable on Energy Security and Competition Policy (Feb. 21-22, 2007), *available at* http://www.ftc.gov/os/2007/02/WD200725OilGasUnited%20States.pdf. When requested by the Department of State, the FTC staff also contributes to comments by the United States on proposed regulatory reforms in other nations.

[2] Electric Energy Market Competition Task Force, *Report to Congress*, *supra* note 1.

[3] *Id*. at 103; *see generally id.* at 84-108 for the relevant discussion.

Certain conditions in Arizona differ from those that faced the seven states analyzed in the Task Force *Report*. Unlike those states, Arizona is not a part of an organized wholesale power market, and utilities in Arizona control a much larger proportion of in-state generation than is the case in the retail choice states that the Task Force studied. Accordingly, before it reopens retail competition, the ACC may wish to ascertain whether retail entrants can access competitive generation sources that will be available at prices reflecting real-time costs.

Dynamic Pricing Comment to PA PUC. The FTC's December 2008 comment to the PA PUC described the merits of retail prices that reflect real-time fluctuations in the wholesale cost of generating the marginal unit of power.[4] The FTC also urged the PA PUC to consider approaches – such as improved pricing and demand response programs – that "involve customers in addressing the power systems' most pressing problems."[5]

Policy Implications

The 2007 Task Force *Report* and the FTC's 2008 dynamic pricing comment to the PA PUC both emphasized the importance of having retail prices better reflect the wholesale cost of power than is now the case. The Task Force *Report* stated that the price charged for POLR service "must closely approximate a competitive market price if it is to provide economically efficient incentives for consumption and supply decisions and thereby maximize welfare. This price will vary over time as supply and demand change. . . . When POLR prices are below competitive levels, even efficient alternative suppliers cannot profit by entering or continuing to serve retail customers."[6] Many states capped incumbent utility prices below the cost of buying and delivering power from the wholesale market, which made it unattractive for competitive power suppliers to offer power to retail customers served by incumbents whose retail rates are capped below cost.

The FTC's recent dynamic pricing comment to the PA PUC observed that customers make wasteful choices when, for example, they can buy power to run their clothes dryers at 10 cents per kilowatt-hour during daytime periods of extreme scarcity – when those kilowatt-hours of energy may cost the utility $1 each[7] – particularly when, as is generally the case, the utility is able to obtain a kilowatt-hour of energy at night for much less than $1 (and, indeed, less than 10 cents). The comment thus encourages "dynamic pricing," which is a collection of approaches – including real-time pricing and

---

[4] Reply Comment of the Federal Trade Commission submitted in "Energy Efficiency and Conservation Program and EDC Plans: Reply to Comments on the Staff's Implementation Plan for the EE&C Program of November 26, 2008" (Dec. 17, 2008), *available at* http://www.ftc.gov/os/2008/12/V090001papuc.pdf.

[5] *Id*. at 2.

[6] Electric Energy Market Competition Task Force, *Report to Congress*, *supra* note 1, at 104-05.

[7] The relevant costs should include the construction and maintenance of peaking generators that are used only during scarcity periods. During the handful of hours when demand hits its peak level for the year or the decade, the scarcity cost of building and maintaining the electric system capacity needed to handle only that peak demand far exceeds fuel costs and other variable costs.

critical peak pricing – that allow retail prices to change on short notice in response to fluctuations in wholesale prices. Scholars and regulators have found that having customers pay the real-time price of power can provide significant benefits, including reducing the cost of providing electricity by 5 to 10 percent;[8] reducing customers' bills; undermining generators' efforts to exercise market power; avoiding or postponing the need to add generation, transmission, or distribution facilities; and increasing system reliability.

Both the Task Force *Report* and the comment to the PA PUC also suggested that real-time pricing that adjusts retail prices at least hourly – based on temporal fluctuations in generating and other costs – can send the most accurate price signals to guide customers' decisions about when (and in what quantities) to consume power, as well as about whether a competitive entrant offers a better product. Both the report and the comment, however, acknowledged that the complexity and volatility of real-time prices may make them unattractive to some customers. Both documents also offered practical commentary about how to capture many of real-time pricing's advantages in rates that are simpler or that reduce utility bill volatility.[9]

Rate designers confront tradeoffs between offering accurate – yet complex and volatile – prices that allow customers to achieve the greatest savings and offering simpler, less volatile dynamic rates that offer smaller potential economic efficiency gains. These tradeoffs, together with the diversity of customer needs, create opportunities for competitive retail firms to profit by creating innovative, customer-friendly, dynamic retail pricing. If a retail firm develops a dynamic pricing or demand response program that reduces costs, it can profit by splitting those savings with customers. Competitive retailers have the flexibility – and potentially have incentives – to solve challenges to the implementation of dynamic pricing.[10] Various types of firms – ranging from traditional investor-owned utilities to companies that specialize in retail demand response – have brought dynamic pricing to customers, so experience suggests that retail customer choice is just one of several viable ways to deploy dynamic pricing.[11]

---

[8] *See* Severin Borenstein, "The Long-Run Efficiency of Real-Time Electricity Pricing," 26:3 Energy J. 93 (2005); *see also* Severin Borenstein and Stephen Holland, "On the Efficiency of Competitive Electricity Markets with Time-invariant Retail Prices," 36:3 RAND J. Econ. 469 (2005).

[9] For more discussion of the level of bill volatility that real-time prices create and the effectiveness of simple risk management strategies that maintain the right incentives, *see* Severin Borenstein, Center for the Study of Energy Markets, Univ. of Cal. Energy Inst., Working Paper #155, "Customer Risk from Real-Time Retail Electricity Pricing: Bill Volatility and Hedgability" (2006) (also published at 28:2 Energy J. 111 (2007)).

[10] Our dynamic pricing comment to the PA PUC described these implementation challenges in detail.

[11] Although Chapter 2 of the Task Force *Report* provided references that discuss the degree to which retail entrants have delivered innovative dynamic pricing, we will not currently dwell on that topic or on policy interventions meant to enable entrants to do so.

Conclusion

If the ACC decides that the benefits of retail competition in electricity outweigh the costs,[12] the Electric Energy Market Competition Task Force's *Report to Congress* includes recommendations about how to increase the likelihood that retail competition will work well. In any event, regardless of what the ACC decides about the eventual role of retail competition in Arizona, we encourage the ACC to examine dynamic pricing as a means to address a wide variety of electric system problems.

[12] The retail competition policy issues for small customers are significantly different from those for large customers. Commentators have observed that large and medium-sized commercial and industrial customers benefit from firms' provision of total energy management services, including not only energy sales but also efficiency consulting, risk management, unified billing across dozens of facilities, and opportunities to profit by reducing use when wholesale power is scarce and expensive. For further discussion of the case for retail competition for small customers, *see* Paul L. Joskow, "Why Do We Need Electricity Retailers? or Can You Get It Cheaper Retail?" (MIT Working Paper, rev'd Feb. 13, 2000), *available at* http://econ-www.mit.edu/files/1127. Joskow – an MIT economist and a leading expert on electricity economics – argued that relatively low switching rates, and the limited ways in which retail firms can add value, counsel against offering competition (at least for small customers). In "Why We Need Electricity Retailers: A Reply to Joskow on Wholesale Spot Price Pass-through" (Aug. 22, 2000), *available at* http://www.econ.cam.ac.uk/dae/repec/cam/pdf/WP0008.PDF, Stephen C. Littlechild – a Fellow of the Judge Business School at the University of Cambridge and formerly Britain's Director General of Electricity Supply – claimed that the market (and not the regulator) should set the right price. *See also* Catherine Waddams Price, "Spoilt for Choice? The Costs and Benefits of Opening UK Residential Energy Markets" (Feb. 2004), *available at* http://www.ucei.berkeley.edu/PDF/csemwp123.pdf. In this study – one of several that Price has done concerning British residential switching choices – the author found that residential customers often switched to the wrong retail suppliers, given their demand patterns.