



Market liberalization: Five seductively simple steps to making it work



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ABSTRACT

The terms deregulation and market liberalization have almost become dirty words in energy circles in the US and EU after failed experiments in both areas. However, the lessons of these experiments can be used to devise a theory of five principles needed for successful electricity market liberalization, providing policymakers and legislators with a crucial checklist to be consulted before designing such measures.

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1. Introduction

Creating a theory of how to make market liberalization work brings challenges. These begin with the very term, which is rarely used in the U.S. Consequently, when most U.S. listeners hear “market liberalization” they equate it with “deregulation,” the Californian electricity crisis, the Enron trading scandal, and, inevitably, they switch off. A similar problem arises in the EU, where the term is frequently used but rarely discussed in any detail. Consequently, most European listeners equate “market liberalization” with any measures designed to loosen network-bound markets from monopoly control. Negative associations like the UK rail privatization crisis (Martin and Thatcher, 2002) and the Russia-Ukraine gas disputes (Lochner, 2011) follow; and again, inevitably, they switch off. This bias did not just appear. It grew from the scarcity of literature evaluating market liberalization, along with the abundance of literature lamenting the consequences of deregulation (its predecessor) (Cudahy, 1993).

2. So what is market liberalization?

Market liberalization rose from the ashes of deregulation, a movement initially driven by the idea that the unregulated operation of competitive markets worked to further stability and socially beneficial economic outcomes. As noted by Richard D Cudahy, deregulation regarded intervention in markets as generally undesirable and disruptive of the natural equilibrium that markets tended to achieve when undisturbed (Cudahy, 2009a). Although deregulation dominated theory and practice for a long

time; by 2002 (following the monumental market failures in California and the Enron collapse) its popularity had waned and the general underlying faith in the markets had been replaced with a penetrating mistrust (Cudahy, 2009b).

Then, along came market liberalization. An easy way to think about market liberalization is as the love-child of regulation and deregulation, with some characteristics of both parents. Like advocates of regulation, market liberalists accept the idea that some intervention (from the state or other external agents) is necessary for the achievement of “benign results.” Like deregulists, market liberalists advocate the removal of direct state control from potentially competitive markets. The underlying aim is to free potentially competitive activities from monopoly control. This is achieved by introducing measures designed to remove the structures which support the dominance of monopolies over these activities (Directive, 1997). In the electricity sector, two activities are considered to be potentially profitable: producing electricity and supplying it to consumers. Transporting electricity (which requires ownership and operation of networks) is not. As a result, electricity market liberalization measures usually aim to introduce competition to electricity production and supply.

As a large number of measures can be described as market liberalization methods, it is easy either to condemn such measures without placing them in context (Pielow et al., 2009) or to criticize the broad concept without examining its methods of implementation. Either action is a mistake. A return to traditional cost-of-service market regulation is not feasible. To quote John Rowe (former chairman and CEO of Exelon Corporation, a utility holding company headquartered in Chicago), “There is not going to be any putting of the genie back in the bottle . . . [w]e discredited the utility monopoly a long time ago (Cudahy, 2002).” In this article I don’t advocate going back. Similarly, I don’t try to make the case for

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market liberalization. This has already been done by experts on both sides of the Atlantic.

Instead, I extract lessons from earlier U.S. and EU restructuring experience, to devise a theory of how to make it work, by identifying the five principles needed for successful electricity market liberalization. The theory is crucial for the following reason: it provides legislators and policymakers with an essential checklist of “what is required to liberalize markets successfully” to be consulted before measures are designed and adopted. Thus, if a principle is absent, this can be recognized as a weakness before it ever poses a problem. It can then be addressed using one of the methods outlined in this article. Alternatively, where a solution is not available, an alternative course of action can be taken.

3. The theory

3.1. Principle one: there must be consensus and clarity on uniform liberalization methods, requirements, and realistic, achievable objectives.

For any journey proposed by a group to be successful, three simple elements are needed: a clear destination, a clear path to that destination, and agreement on the path and the destination. A successful journey to achieving market liberalization objectives also requires these elements. Here, the destination is to achieve realistic goals. The term electricity market liberalization is too vague to be a goal in itself. While this general principle might seem apparent, one of the reasons why the market restructuring (attempted from the 1970s in the U.S. and from the 1990s in the EU) hit so many speed bumps was that one or more of these elements (clear destination, clear path or agreement) were missing.

Economic and legal analyses demonstrate that, in both regions, restructuring began without at least two of these three core elements. The U.S. lacked a clear path and consensus on this path. While there was clarity and consensus on what were realistic aims (to reduce wholesale price disparities between states and electricity market inefficiencies) (White, 1996), market restructuring was an ad hoc affair which began with the Public Utility Regulatory Policies Act 1978 (Public Utility Regulatory Policies Act 1978, 2013). This created “qualifying facilities,” a new class of power producers permitted to receive special rate and regulatory treatment. The Energy Policy Act 1992 followed to enable an additional class of power generators, “exempt wholesale generators,” to enter the market (Energy Policy Act, 1992). Later, the Federal Energy Regulatory Commission (FERC) Orders 888 (Anon., 2017a), 889 (Anon., 2017b), 890 (Anon., 2017g), and 2000 (Anon., 2017d) introduced further measures designed to facilitate the development of competition in the wholesale market. While these measures also paved the way for retail restructuring, retail markets remained subject to state regulation. This has led to a patchwork of independent and affiliated ownership of power production across the U.S. and fragmented retail and wholesale markets.

Almost from the outset, Joskow criticized the absence of a clear, uniform path to achieve restructuring’s aims, and disagreement between FERC and U.S. states on its overarching requirements (Joskow, 1997). In 2005, he noted the link between the apparent failure of deregulation and the lack of agreement on the necessary wholesale restructuring requirements, and stated:

FERC found itself at war with many states in the Southeast and the West as they resisted its efforts to expand wholesale market and transmission institutions that it had identified as being necessary to support efficient competitive wholesale markets in all regions of the country (Joskow, 2006).

Across the Atlantic, the EU’s restructuring efforts omitted each of the three core elements. There, restructuring began in earnest in

1996 with the adoption of the first electricity liberalization directive (Anon., 1997). This was later followed by the second electricity liberalization directive in 2003 (Anon., 2003) and the third electricity liberalization directive in 2009 (Anon., 2009). The first electricity liberalization directive took seven years to finalize due to protracted negotiations and bitter arguments over its ambit (Boltz, 2013). As a result, it was vaguely drafted and the EU’s restructuring policy lacked: a clear path (i.e. clarity and consensus on uniform restructuring methods and requirements) and agreement on its targeted destination (i.e. on tangible, realistic objectives to be achieved). Unsurprisingly, it did not achieve its elusive objective (to create a competitive electricity market). In 1998 Hancher outlined one reason for its failure:

[EU] Member States are given a substantial degree of choice in how they go about introducing more competition into their electricity markets. Indeed that margin is so substantial that it would seem possible for the determined anti-market countries to avoid introducing any meaningful degree of competition at all (Hancher, 1998).

From these early experiences a principle emerges: for market liberalization to be successful there must be consensus and clarity on uniform methods, requirements, and the realistic objectives to be achieved. Of the five principles outlined in this article, this is the most difficult to achieve. As legislation and policy are usually the result of compromise, achieving clarity can be difficult. However, it is not impossible if the following steps are taken. Where legislation/policy is the result of compromise on an agreed path, the destination should be re-evaluated to reflect this compromise. Where legislation/policy is the result of compromise on destination, the path should be re-evaluated to ensure it takes the correct path. Applying this principle should help protect against unrealistic expectations and perceived failures. It should also prevent the introduction of ill-designed law and policy (preceded by inadequate groundwork and analysis).

3.2. Principle two: the control of monopolies/former monopolies over lawmaking designed to implement change should be limited and reduced

Change is difficult. In any drive for change, there are winners (i.e. those who benefit) and losers (i.e. those who lose something). The winners will inevitably be “for change” and the losers, inevitably “against change.” With market liberalization, electricity monopolies are clearly the losers. They stand to lose assets, money, and power. So it’s logical for them to try to lessen these losses as much as possible. For this reason they should not be in control of designing the instruments of change. For this reason their input into instrument design should be reduced if market liberalization is to be successful. Admittedly, limiting the influence of electricity monopolies is more difficult in Europe than in America. The interesting question is why?

Before the restructuring efforts of the 20th century, American and European electricity markets shared a central characteristic. They were both dominated by monopolies which operated in charge of each electricity activity (from generation/production of electricity, to transport of electricity along high-voltage transmission lines, to transport of electricity along lower-voltage distribution lines, to supply to domestic consumers). There was one key difference though. In Europe, national governments owned these monopolies (Anon., 2015). In other words, those seeking to effect market change (and design the instruments of change) (Anon., 2017f) are also those with the most to lose. This is a serious conflict of interest: a conflict which has consistently resulted in weak liberalization measures (Hancher, 2016).

This problem of involving those with vested interests, but preventing them from blocking effective change taking place, is not

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