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# Standard Market Design in Wholesale Electricity Markets: Can FERC's Proposed Structure Adapt to the Unknown?

*The SMD proposal focuses on wholesale markets and transmission in isolation, not on ways to encourage a more market-based retail approach. As long as it remains so supply-focused, policy will be like one hand clapping, leading to potential overinvestment in transmission and costly future revisions of institutions.*

*Lynne Kiesling and Brian Mannix*

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## I. Introduction

Fifteen years ago Vernon Smith wrote of electricity markets:

Replacing the entrenched regulatory regime, after 80-odd years, with a competitive regime will require regulators to be forward looking, politically bold, and cognizant of the disciplinary value of competition.<sup>1</sup>

Today the Federal Energy Regulatory Commission, and many of the state regulatory commissions, can look back with considerable pride at what they

have accomplished. Deregulation of electric power generation has proceeded, perhaps not as quickly as in some other industries, and not without some missteps, but with a deliberate and sustained pace. Competition is now deeply entrenched in the nation's power generation system, and it has made that system more efficient, more adaptable, more resilient, and more reliable. Much of this progress has been driven by technological innovation and also by economic developments outside the industry, but to a

considerable extent it is the product of hard work and innovative thinking within the regulatory commissions themselves, at both the federal and state levels.

FERC's current Standard Market Design (SMD) proposal is an important—although not final—step in the evolution of electricity markets. It recognizes that, in power generation, competition is now the primary guarantor of “just and reasonable” rates. It seeks to protect and promote that competition by proscribing anticompetitive practices, especially those that take the form of “undue discrimination” by vertically integrated transmission operators. It seeks to expand the scope of competition by erasing the “seams” between different geographic jurisdictions, as well as smoothing some of the seams between wholesale and retail markets. And it seeks to unmask the price signals for transmission investment that will alleviate the troublesome bottlenecks in the existing infrastructure.

These goals are laudable, and many of the features of the proposed SMD are welcome. In our view, however, the current proposal also suffers from several serious flaws.

**A. The SMD is too prescriptive and too quick to impose uniformity for its own sake**

More uniform national, and even international, “ground rules” will provide a better

foundation to facilitate exchange and competition, and to encourage investment in new capacity where it is needed. On the other hand, flexibility and variability in market design provide the raw material for evolution and experimentation, both by regulators and by market participants. By locking in a single, detailed, and inflexible market design, the SMD may inadvertently choke off further progress.

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Regional variation in market design has created “seams,” transaction costs, and other anomalies that seem desirable to eliminate. But regional variation in market design may also have accommodated legitimate differences in local conditions. And while variation allowed California to walk off a cliff, it has allowed other states, and the Commission, to draw important lessons from that experience.

The proposed rule identifies numerous problems—some theoretical, some anecdotal—in existing markets and asserts that the SMD will fix them. A search

of the preamble for “eliminate(d)” and “(re)solve(d)” reveals dozens of problems that will be made, by rule, to vanish. The mixed record of recent experience with market design fails to dent the confidence with which the SMD is proffered:

In the years since the ISO [independent system operator] markets have been operating, dozens of market design flaws have been identified, . . . No region has been exempt from market design flaws of one type or another. . . . Only standardization of electricity market design will solve these problems. Our goal is . . . to raise the quality of all electricity markets simultaneously.<sup>2</sup>

Unfortunately, standardization also means that *unintended* consequences of the SMD will affect all electricity markets simultaneously. Good intentions do not prevent errors, unanticipated abuses, or assumptions that turn out later to be misplaced. For this reason, the Commission should proceed with caution. The proposed SMD may appear to be superior to all the others only because it is, so far, untried.

Detailed rules run the risk of regulatory path dependence and lock-in. The new institutional structure in the SMD should be simple, flexible, and *reversible*, with clear and credible phase-out provisions as technology evolves and market-based retail pricing expands. Robust institutions that will stand the test of time and create value for consumers must be able to adapt to the unknown.

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