



## **Improving Michigan's Electric Utility Industry**

Testimony to the Michigan Senate Energy and Technology Committee

September 24, 2015

*Presented by,*

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Good afternoon, Senators. Thank you Chairman Nofs for allowing me to testify before you today. And thank you, Larry, for the introduction.

As Larry mentioned, I recently partnered with the Michigan Conservative Energy Forum to produce a White Paper called "Improving Michigan's Electric Utility Industry." I've had the pleasure of meeting with several committee members to discuss it personally, and I would look forward to the opportunity to meet with each of you. Because what you are doing here is important – and critical to Michigan's future.

The electric utility market in Michigan has defining characteristics that set it apart from a market-based economy. Most important is that it developed as a regulated monopoly, thus creating certain inefficient incentives for both producers and consumers. Because of the barriers to entry imposed by regulation and the monopolies themselves, electric utilities do not respond to the marketplace in the same way companies in a competitive market do.

In most cases, government intervention in a market is not the most productive course. However, I contend that the electric utility industry as structured today can be improved by government activities that require the providers and distributors of electricity to be more responsive to consumer demand and that move the industry towards competition.

My paper – and we’ve distributed copies to all your offices, as well as a copy of this testimony to you today – deals at length with how we got here, but Senators you, of all people, do not need a history lesson on this.

Because, while the details of Edison versus Tesla and the “current war” are interesting, the main point is that it became economically efficient to have large generating facilities for electricity. Also, recognizing it was probably a bad idea to have lots of different electric lines distributing power from various companies, the electric utility market became a regulated monopoly.

While it was long held that electricity was a “natural monopoly,” innovations have resulted in the ability of the industry to become competitive, and the theory of regulation has developed to point out the inefficiencies in the incentives of companies that are regulated monopolies.

We must always remember that these firms did not gain their market position by outcompeting other firms, but rather through government regulation itself. Thus, I want to be clear that in no way am I accusing Michigan’s utilities of being bad actors. Rather, I believe they are behaving exactly how they are incentivized to behave – and that’s where the legislature comes in, and why I am here today.

A fundamental point of economic theory is that people and firms respond to incentives. It is important to think through the incentives of regulated monopolies, such as the electric utility industry, and determine whether the result will be an efficient allocation of resources and what actions can be taken to improve these incentives.

First, because the regulated monopoly has governmentally imposed barriers to entry, the economy is burdened by a misallocation of resources. Resources remain in their current use or are unused instead of flowing into the industry that earns monopoly profits.

Second, there is a reduction in entrepreneurial activity and innovation, as it is not possible to capture the benefits of innovation without access to the market. Entrepreneurs need access to customers to innovate – and this is particularly true when it comes to renewables.

Third, regulated monopolies are subject to what Nobel Laureate economist George Stigler termed “regulatory capture.” Regulated companies have strong incentives to craft favorable regulation, while the general public has little or no incentive to be informed.

Fourth, because utilities are awarded rates based upon the concept that they will be able to recover their costs including an authorized rate of return, combined with the inability of their customers to seek other providers, there is a dampened incentive to produce electricity in the most cost efficient manner, or to adopt new technologies.

Fifth, when regulatory barriers exist, valuable resources are required for an entrepreneur to overcome those barriers. For example, an independent power producer may face significant legal costs and delays in getting a fair price from monopoly utilities who control access to customers – time and money it could otherwise have used to create jobs or otherwise more productively.

Sixth, it is difficult for the average consumer to estimate the benefits and costs of actions that reduce electricity usage, and there is little incentive for the utilities to encourage their customers to conserve electricity since that would reduce their revenue. Utility control of customer metering information makes it difficult for other businesses to market services to conserve electricity.

Seventh, the generation of electricity must be capable of meeting peak-load demand. If consumers are provided an incentive to move their usage to off-peak load times, resources used up to provide electricity will be smaller and more efficiently used, but the utility may be less well off financially.

The need for improvement can be readily seen when comparing the retail price of electricity in Michigan to surrounding competitor states – in 2014 prices here were highest in the region. Notably, prices have risen substantially more in Michigan than surrounding states since the passage of 2008 legislation severely limiting retail choice.

Reducing the cost of electricity would reduce expenses for most industries and services, as there are few that do not use electricity. Reducing what economists refer to as the marginal cost of production would increase the supply of goods and services, both lowering prices and increasing jobs.

One would think that higher rates means better service. But based on current data, in exchange for higher rates Michigan utilities do not clear higher bars for service, reliability nor environmental standards.

There are several approaches that legislation and regulation may take to improve the incentives and thus the performance of Michigan's electric power industry.

First, expanding retail choice would alter the incentives of the existing utilities as they would have to compete. The added supply of electricity would put pressure on the utilities to improve their production and reduce rates or face the loss of their customer base. It's beyond the scope of my testimony to consider how competition should be established. However, an obvious mechanism would be to increase the limit on the market share that was put in place in 2008.

Second, because there is little incentive for a utility to provide access to another generator or a wholesaler to the line to their customer's home or business, one approach to change the incentives would be to structurally separate the ownership of generation from the ownership of distribution, in the same way that transmission was separated from generation.

Third, just as some consumers would rather purchase organically-grown vegetables even if the cost of these vegetables is greater than those grown conventionally, there are consumers that would rather purchase energy that is produced from renewable sources. There already exist renewable energy certificates that consumers may purchase supporting the production of renewable energy. But one could consider allowing consumers to specifically purchase power generated by renewable sources.

Fourth, as previously mentioned, entrepreneurs have reduced incentives to take on the risk of innovating in the generation of electricity from renewable sources such as solar power, or other cutting-edge methods like co-generation and waste-to-energy, as they may not have access to a final consumer. Requiring the utility that distributes electricity to the customer to purchase alternative power at an economically efficient rate would lead to innovations in power production that will lead to lowered costs throughout our economy.

Fifth, electric utility generators have little incentive to encourage their customers to reduce electricity usage or to consume at times when energy costs less to produce. There are several ways to change this incentive. One is to require utilities to set rates that reflect the added cost of production. Second, reducing energy consumption - even in off-peak periods - can reduce the costs of owning facilities needed to generate electricity, since base load plants are significantly more expensive than peaking plants.

The current structure of Michigan's electricity industry results in inefficient use of resources, higher prices for electricity, and reduced economic activity due to the misaligned

incentives of both producers and consumers inherent in the current regulated monopoly structure. Michigan's economy could be improved and consumers would benefit from introducing a fully competitive industry. However, within a regulated market, our energy market can be improved through regulations properly aligned incentives. Given the high price of electricity and relatively poor performance of Michigan utilities compared to its surrounding competitor states, in a regulated market it is the responsibility of the Legislature and Michigan Public Service Commission to fully address these issues by passing incentives for better performance.

Again, thank you Senators for allowing me to testify today. I'll now turn the microphone back to Larry Ward.