

# Maryland Policy Report

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No 2019-01

January 30, 2019

## NO, THE ABELL FOUNDATION DIDN'T FIND THAT “DEREGULATION DIDN'T SAVE PAYERS”

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**BY THOMAS A. FIREY**

The headlines were eye-grabbing:

- “More Utility Competition Was Supposed to Drive Down Prices, But Many Marylanders Are Paying More for Energy”<sup>1</sup> (*Baltimore Sun*)
- “Study Finds Deregulation Didn't Save Payers”<sup>2</sup> (*Maryland Reporter*)
- “Deregulation Ushered in Higher Energy Rates”<sup>3</sup> (*Maryland Reporter*)

The *Sun* article, the *Reporter* summaries (of news reports appearing elsewhere), and other descriptions<sup>4</sup> of a new policy report would lead readers to conclude that the report shows Maryland's 1999 electricity market restructuring has saddled consumers with higher electricity bills than they would have received under the state's old regulations. Problem is, that's *not* what the study finds.

The cited study is “Maryland's Dysfunctional Residential Third-Party Energy Supply Market: An Assessment of Costs and Policies,”<sup>5</sup> written by independent

journalist Laurel Peltier and energy policy analyst Arjun Makhijani and published last month by Baltimore's Abell Foundation. It's a well-done and important analysis (though I have a few quibbles with it that I'll discuss below) that should provoke concern and policy changes at the state Public Service Commission and perhaps in the General Assembly. But the report should not prompt policymakers to reverse course on opening up Maryland's electricity and natural gas markets to supplier competition because—well, because that's not what the report's about. Rather, it's about how one type of restructured energy provision is producing far lower energy rates than another type of provision.

### WHY DEREGULATION OCCURRED

In the 1990s, Maryland electricity consumers—along with consumers in Northeast states and California—were experiencing soaring electricity rates. (Note: This analysis will focus on the electricity market. A similar story played out in natural gas—at least until fracking changed everything.) As a result, manufacturers in those states were relocating elsewhere, taking with them good-paying jobs that politicians hate to lose from their districts.

Why were rates so high in the Northeast? As I explained in some detail in a 2010 paper,<sup>6</sup> the answer lies in previous energy regulation, adopted in the early 20th century. Back then, policymakers believed that networked energy like electricity and natural gas were most reliably and cost-effectively supplied by giant utilities. The utilities would handle all phases of production and delivery and would build large generating plants and distribution grids that would capture economies of scale. They believed these industries would evolve into natural monopolies in which a single provider would control generation, transmission, and distribution for all consumers in a large market area. That would allow the utilities to charge “supra-competitive” prices—prices with profit levels higher than what would be accepted by price-competitive energy providers.

Policymakers wanted the returns-to-scale efficiencies they believed these utilities would achieve, but they didn't want the monopoly pricing. So they adopted legislation and regulations that sanctioned monopoly status for area utilities, but required the utilities to receive approval from government public utility commissions (PUCs) before changing their rates or expanding their facilities. The PUCs made their decisions based on the utilities' costs, both fixed (e.g., costs for power plants and power lines) and marginal (e.g., fuel costs), as well as considerations of future consumer demand and developments in the industry.

That all sounds good in theory, but it removed from utilities the risk of making poor decisions about their facilities. So, when Northeast utilities—with the PUCs' blessing—made heavy bets on nuclear power plants and those plants wound up being much costlier to maintain

than expected, Northeast utility rates rose. (California's problems were different—the state didn't go in heavily on nuke—but rates there also suffered from the embrace of this sort of regulation.)

### ENERGY MARKET RESTRUCTURING<sup>7</sup>

The energy market restructuring that swept state capitals, including Annapolis, in the late 1990s was intended to address this problem and provide the high-rate states with lower-priced electricity produced by competing energy providers. Typically, states required utilities to separate their generating operations from their distribution operations, and the now-distribution-only utilities to purchase the lowest-priced electricity from competing power providers to deliver to utility customers. (The generation–distribution separation was intended to prevent any pricing mischief by

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the utilities.) This is referred to as “wholesale restructuring” because utilities bought power on competitive wholesale markets, though states usually also let large commercial and industrial consumers buy power directly from that market (with the power delivered via the regulated utility). Because wholesale energy prices were well below rates in Maryland and the Northeast states, consumers in those states soon benefited from the restructuring.

Over time, many states also implemented “retail restructuring,” letting residential consumers purchase energy directly on the open market (again, with the power delivered via the regulated utility). However, those consumers could continue to have their utility purchase low-priced power for them in an arrangement commonly called “standard-offer service” (SOS).

Overall, *wholesale* regulation and SOS have been very successful: rates fell and have stayed significantly below what it's believed they would have been under traditional regulation. However, *retail* regulation—well, it's complicated.

### WHAT THE STUDY FOUND

In the Abell study, the authors compared SOS rates to rates paid by residential consumers who chose to buy energy on the retail market. The authors found that, in most cases, SOS produced considerably lower rates. Troublingly, few of these consumers were aware of this price difference, believing they were getting a better deal than SOS. Even more

troubling, many of them were low-income. Some of them were receiving public energy assistance, which means that taxpayers were sharing in the higher rates.

Why would these consumers pay higher rates? In some cases, they deliberately chose to do so: they purchased electricity generated by solar panels and wind turbines because they wanted to promote the environmental benefits of those energy sources. The Abell authors (rightly) have no concerns about those arrangements.

However, the study persuasively argues that other consumers chose retail power providers as a result of deceptive marketing practices that convinced the consumers they would be paying much lower rates than SOS. This should concern policymakers. In the next section, I'll discuss some policy recommendations the report's authors make to combat these practices.

Concerning Maryland's 1999 market restructuring, the Abell study does *not* compare regulated rates to deregulated rates, as the news headlines suggest. Rather, the study compares one type of restructured energy provision for residential consumers—standard-offer service—to another type—retail purchasing—and finds that SOS delivers considerably lower rates than those paid by most consumers in the retail market. This shouldn't be surprising. The utilities handle SOS by conducting “reverse auctions” (meaning energy providers “win” by offering the lowest prices), and the energy providers price-compete heavily in order to win these large contracts. This is a success of the 1999 restructuring: it has produced a strong wholesale market that appears to be yielding much lower rates than what would have been paid by Maryland and other Northeast state consumers under traditional regulation.

Speaking personally, I purchase my home's electricity and gas through SOS. It is possible to get lower rates by direct-shopping—and I've done it in the past—but it takes considerable time and effort to monitor and conform to the details of the various energy contracts. Generally speaking, for most consumers, if they're only concerned about price and reliability as well as convenience, I don't know why they would retail-shop for themselves instead of relying on SOS.<sup>8</sup>

## RECOMMENDATIONS AND COMMENTARY

I share the Abell authors' concerns about deceptive marketing practices by some energy providers and third-party marketers operating in the retail market. To combat those practices, the authors offer a number of policy recommendations, some of which I support and some of which concern me. Let's look at them.

**Aggregating third-party supply.** One recommendation is that some government-designated entity should act as a buying agent for all consumers who want third-party supply, or at least low-income households that want such power provision. This seems unnecessary to me because

SOS already provides this function. Marylanders would likely be better served by a government effort to publicize the benefits of SOS.

**Prohibit variable-rate contracts.** The Abell authors are concerned about variable-rate contracts: contracts whose power rates change over time. The authors charge—correctly, I believe—that some power providers trick consumers by offering low “teaser” initial rates and then “resetting” those rates to levels higher than SOS.

I agree that deceptive teaser rates are a problem, but there are legitimate—and welfare-enhancing—reasons for variable rates. When any sort of supplier offers a fixed price for a product whose cost can vary over time, the supplier must set its price at a level that should cover future cost increases. To compensate for this risk, the supplier will include an implicit risk premium in its price to consumers—which means a higher price overall to consumers.

Moreover, an increasing cost typically indicates that the resource cost is increasing. Transmitting that higher cost to consumers in the form of higher prices benefits consumer welfare because the higher prices encourage conservation. That, in turn, should result in overall lower prices for consumers. Prohibiting variable prices to con-

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sumers would prohibit this beneficial price signal, which would perversely alter consumer decisions by encouraging more consumption when resources are stretched and discouraging consumption at times when resources are slack.

Instead of prohibiting all variable rate contracts, policymakers could prohibit one specific type of price variation: “teaser” rates that reset to a higher rate, as well as the use of one-time, up-front inducements like gift cards and sign-up credits. This should address many of the deceptive pricing practices that concern the Abell report's authors. However, policymakers should keep in mind that this could harm some consumers: those who make use of the initial savings and benefits from these up-front inducements.

**Prohibit early-termination fees.** The authors also argue against early-termination fees for energy contracts, arguing that such fees lock-in consumers to contracts that they ultimately decide are undesirable, especially if those contracts include variable rates. No doubt, some of these contracts

are unfair. However, in other cases, early termination fees have consumer benefits.

Energy costs often experience an annual cycle, with higher costs at certain times of the year and lower costs at other times. Consumers who sign one-year, fixed rate contracts receive a de-facto discount during the high-cost periods and pay an offsetting premium during the low-cost periods. Some consumers prefer this type of contract because they value the stability of a fixed price. For these contracts, the early-termination fee acts as a commitment device to ensure that consumers don't defect when the cycle enters a low-cost period, thereby undermining one-year (or longer) contracts. It's puzzling that the Abell authors recommend prohibiting these fees, which improve the efficiency of fixed-rate contracts, when they also recommend prohibiting variable-rate contracts.

**Require utility bills to state what the comparable SOS bill would have been.** The authors suggest that "utility bills should prominently and clearly state that the customer saved Y dollars or paid X dollars extra during that month by being on third-party supply" as compared to SOS. I think this is a good proposal, though the information requirement should also note longer-term savings or expenses. Variable-rate contracts, for instance, may have a higher rate in a given month but still save money over a long period of time.

**Prohibit individual third-party contracts, unless for 100% renewable supply.** As noted above, some retail-market consumers choose to pay higher rates in return for environmental benefits. The Abell authors would prohibit third-party individual purchases *except* for providers designated as providing "renewable" energy. However, as I've argued elsewhere,<sup>9</sup> power sources designated as "renewable energy" are not necessarily environmentally beneficial. It would be odd for policymakers to prohibit individual retail purchasing because of price deception but carve out an exception that allows deception on environmental benefits.

**Information-gathering.** The Abell authors recommend the Maryland Public Service Commission (the state's PUC) collect and publish aggregate local-level data on consumer energy billing, as well as provide individual-level data to the

state's Office of Home Energy Programs (OHEP), in order to expose deceptive energy marketing practices. Also, OHEP would monitor for the effect of such practices on taxpayer-subsidized energy assistance programs. I believe these are good proposals, provided there is reliable data security.

**The PSC should investigate deceptive business practices.** The Maryland PSC issued a report in 2014 describing worrisome energy market practices that could deceive consumers. The authors recommend a follow-up to that report, as well as enforcement actions under Maryland consumer protection laws. I believe this is a good proposal.

## CONCLUSION

As stated above, the Abell Foundation study on the retail residential energy market in Maryland is well-done and important. Though I have concerns about some of the authors' policy recommendations, I agree with their overall concern about the harm of deceptive marketing practices in retail energy markets, and especially the effects these practices can have on both the poor and the public fisc. The best way to do this is through public information about the benefits of standard-offer service.

However, it is important to not misunderstand this report as showing that Maryland's previous energy market structure was better for consumers than the current structure. The report does not pursue that question, and there is ample policy analysis showing restructuring's benefits.

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1. Scott Dance. "More Utility Competition Was Supposed to Drive Down Prices, but Many Marylanders Are Paying More for Energy." *Baltimore Sun*, Dec. 7, 2018.
2. *Maryland Reporter*. "State Roundup." Dec. 19, 2018.
3. *Maryland Reporter*. "State Roundup." Dec. 7 2018.
4. See, e.g., Denise Koch, "Report Finds Third-Party Energy Providers Have Been Costing Marylanders More, Not Less, For Their Gas, Electric," *CBS Baltimore*, Dec. 20, 2018.
5. Laurel Peltier and Arjun Makhijani. "Maryland's Dysfunctional Residential Third-Party Energy Supply Market: An Assessment of Costs and Policies." Abell Foundation, December, 2018.
6. Thomas A. Firey. "The Maryland Electricity Market: A Primer." Maryland Public Policy Institute, Sept. 8, 2010.
7. I use the term "market restructuring" because "deregulation" is inaccurate. The restructuring didn't end regulation of energy providers, but rather shifted it from the regulation of vertical monopolies to the regulation of monopoly utility distributors and competitive energy producers.
8. One important caveat: At least one state, Pennsylvania, uses the term "standard-offer service" to refer to a different sort of provision than the SOS described in this report—though Pennsylvania also offers an SOS-like option. Consumers who are interested in signing up for the SOS I describe should take care not to get tripped up by peculiar state labels.
9. Thomas A. Firey. "Md. Renewable Energy Mandates: Corporate Welfare Disguised as Environmentalism." *Baltimore Sun*, Sept. 28, 2017.

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