Insight

Independent Agency Rules Would Further Distort Markets

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EXECUTIVE SUMMARY

- Despite the Trump Administration’s focus on deregulation, poorly designed regulation continues, particularly from independent agencies.
- Two examples of these poorly designed regulations, from the Surface Transportation Board (STB) and the Federal Energy Regulatory Commission (FERC), show how that even when there is some evidence that regulatory action may be warranted, design matters.
- STB’s attempt to increase the number of shippers that can challenge freight railroad rates would be unfairly advantageous to shippers and make railroads less able to make the investments necessary to improve technology implementation.
- FERC’s effort to deal with state-subsidized electricity production resources would double down on government intervention in the market and ultimately lead to a reversion to a cost-of-service model that disincentivizes innovation.

INTRODUCTION

Even during the Trump Administration, with its focus on cost savings and deregulation, poorly designed federal regulatory proposals continue. This fact is particularly true at independent agencies, whose rules are not reviewed by the Office of Information and Regulatory Affairs to ensure consistency with the administration’s priorities.

This analysis examines two ongoing regulatory efforts from two independent agencies, the Surface Transportation Board (STB) and the Federal Energy Regulatory Commission (FERC). It finds that though regulatory intervention may be warranted, these regulatory efforts as currently structured will have the effect of limiting innovation and growth in their respective industries.

STB: Final Offer Rate Review

After the railroad industry struggled with decades of financial issues due to government rate regulation, Congress partially deregulated the industry in the 1970s and 1980s. In order to ensure that certain shippers with limited transportation options were not subject to unfairly high rates, the STB was given the authority to litigate rate complaints and award relief in cases where a shipper could show the railroad had market dominance and the rate it was being charged was unreasonable.

In the decades that followed, relatively few shippers challenged rates. According to a report from a Rate Reform Task Force (RRTF) established by the STB, shippers argue the time and expense of bringing challenges remains too great, despite previous streamlining efforts, to make a challenge worthwhile and increase the amount of relief that could be awarded in the STB’s simplified methodologies. The RRTF recommended to the STB that it

create a baseball-style arbitration system, called Final Offer Rate Review (FORR), to make rate challenges more accessible, particularly to smaller shippers. Based on that recommendation the STB in September 2019 proposed a rule adopting FORR.

Here is how FORR would work, according to the STB. At least five days before filing a complaint, the complainant (the shipper) serves a notice of intent to file to the defendant (the railroad). Once the complaint is filed with the STB, there is a 21-day period for discovery. Five weeks after the date of the complaint, both side file their arguments on whether the railroad has market dominance, an analysis of what rates would be reasonable, and their final rate offer. The STB then deliberates over the next 100 days and chooses the final rate offered by one of the two sides. It would not independently determine a maximum lawful rate or develop a solution somewhere in the middle of the two offers. The theory behind this approach is that each side will be conservative in their final rate offers, so as to not appear extreme.

While there may be a need to provide smaller shippers with a more affordable way to challenge rates, the STB's proposed FORR rule overcorrects to the clear detriment of railroads. Setting aside questions about the legality of STB's proposal, there are three main ways FORR would harm railroads from a market-intervention perspective.

The first is that the shipper has little to lose in bringing a challenge. Complaints will only occur after a railroad has established a rate. Thus, the railroad is unlikely to offer a rate to the STB that is above the established rate for fear that the STB will consider it unreasonable. In the worst-case scenario for the shipper, the STB will side with railroad's offer, which is just the challenged rate. No harm done, in the shipper's view, as the potential savings if the STB sides with shipper will be considerable. Because there is little to lose, there could be a considerable increase in the number of rate challenges. Railroads could find themselves a defendant in several of these cases, which means they would have to set aside resources to devote to challenges.

The second way FORR would overcorrect for the current situation is that, by law, there is greater scrutiny on the reasonableness of the railroad's "offer" than the shipper's. During deliberations, the STB needs to determine whether the railroad's proposed rate is reasonable. If it is not, even by a small margin, then the STB is to side with shipper's proposed rate nearly regardless of how small it may be. While the STB has said it will be cognizant of a railroad's revenue adequacy, FORR prioritizes expedition in lowering rates over revenue adequacy.

The third way has to do with the expedited timeframe proposed by the STB. While there is an interest in shortening the process to make it less costly on shippers, this timeframe gives the shipper another advantage. It can take as long as it needs to develop a claim, including coming up with its market dominance analysis and rate reasonableness methodology, then serve notice to the STB that it is initiating a rate challenge. The railroad gets only five weeks to develop their defense. This short timeframe increases the likelihood that the shipper will present the stronger case before the STB.

By making it increasingly likely that railroads would lose revenue on some services, even below what is needed to meet investment and operational needs, the STB's FORR rule would have the consequence of inhibiting railroads ability to invest in infrastructural upgrades and innovations. Rail networks are privately maintained and improved, meaning that losses in revenue will affect the ability of companies to invest in their networks. It would also hurt their ability to invest in technological improvements that increase safety.

FERC: Minimum Offer Price Rule

In December 2019, FERC issued an order directing the PJM Interconnection, a regional transmission organization that coordinates wholesale energy movement in 13 states and the District of Columbia, to submit a minimum price floor for electricity in its capacity market from resources that receive, or are eligible to receive, state subsidies.

Put another way, FERC is ordering PJM to set its Minimum Offer Price Rule (MOPR) at a rate high enough to prevent subsidized energy from being unfairly cheap against energy from non-subsidized resources. The MOPR is a price floor below which electricity in a capacity, or future energy, market cannot be sold. FERC's concern is that subsidized electricity, particularly from renewable resources that would not be competitive in a capacity market absent subsidies, distorts the market. Since capacity markets commit resources to provide power three years into the future, the impacts of resources artificially lowering their price can linger.

FERC is correct that state subsidies distort the market by allowing capacity from subsidized resources to be sold at a price below its cost to produce. Its remedy, however, amounts to a doubling down of government intervention into the PJM electricity market. As the R Street Institute's Devin Hartman explains, "Other markets and subsidy payments interact with capacity markets and will continue to shape the resource mix regardless. Thus, the MOPR adds to subsidies, which will result in an artificial surplus of capacity."

The pain of the MOPR will be ultimately felt by consumers, who will face higher prices. In his dissent of the order, FERC Commissioner Richard Glick predicted the order would lead to "a multi-billion-dollar-per-year rate hike for PJM customers, which will grow with each passing year."

One major factor in the economic harm FERC's order is likely to cause is the broad definition of a subsidy. The MOPR defines a state subsidy in part as any "direct or indirect payment, concession, rebate, subsidy, non-bypassable consumer charge, or other financial benefit" that stems from a state government, including any actions resulting from a process mandated or sponsored by any subdivision or agency of a state government. The benefit must also pertain to procurement of or generation of electricity sold in a capacity market; support the construction, development, or operation of a new or existing resource; or allow a resource to clear, or sell its capacity at or below the highest price paid by PJM to ensure future commitments, an auction. This broad application would cover the vast majority of the resources in PJM's coverage area.

FERC attempts to address this by exempting many existing resources, even those that clearly rely on subsidies. This policy has the effect of maintaining the existing mix of electricity sources, a bias that limits innovation in the electricity supply in PJM's region.

While some had anticipated FERC to rehear some of its December 2019 order to address some of the potential problems, the Commission denied a rehearing in April 2020. As a result, PJM plans on implementing its proposed MOPR once it is formally accepted by FERC. A likely result is that this MOPR will set a precedent that will expand beyond PJM and into other regional transmission organizations.

The ultimate effect of the MOPR is likely a return to cost-of-generation pricing whereby states lock utility companies into charging consumers what it costs to generate electricity. The substantial downside of this model is that electricity providers have no incentive to upgrade technologies and develop innovative new alternatives. Once again, consumers stand to lose the most in this scenario.

Conclusion

The lesson from these two regulatory examples is that design matters. While there may be evidence that regulatory intervention in these respective markets is needed, both approaches would further distort markets rather than correct market failures. The evidence suggests that STB and FERC should reconsider the current structure of their regulatory intervention.