



IssuesLetter

Restructuring and Public Policy

Ten Hurdles to Clear

The electric power industry is on a slow and erratic path toward competition of a much more pervasive sort than was seriously discussed even two years ago. Because the path is slower and more erratic than it needs to be, it is wasteful from a consumer and a societal standpoint. Many individuals and institutions, however, may appear to gain from the delay. This Issuesletter looks at the governmental not regulatory issues associated with increased competition. Restructuring involves major public policy changes that transcend the jurisdiction of any regulatory body and thus pose something of a conflict for regulators. Optimal outcomes will make regulators -- at least traditional regulators -- somewhat less relevant.

At least ten substantial public policy issues are raised in the current debates. While not all are relevant to all jurisdictions, any proposal that does not make provision for most of them cannot be a satisfactory, stable or long-term resolution. Failure to enumerate these issues clearly is itself a substantial source of confusion and controversy. One reason the process is taking so long is sensible outcomes on so many of these topics challenge the conventions of legislators and regulators who must resolve them. Legislators and regulators will be less able to impose policy through monopoly institutions on a case-by-case basis in a world with fewer monopolies and fewer cases.

1. Customer sovereignty

Will future directions in service choice and technology development continue to be driven by monopoly companies and government regulators? Or will electricity services, like telephone and perhaps gas services before them, become market driven, subject to regulation in the form of the broad-based environmental, antitrust, tax, consumer protection and other laws that affect all industries alike?

This question cannot be answered in the affirmative simply by committing to wholesale competition, where all generators compete to sell to a transmission and distribution network, organized along the present patterns of vertical integration, with the monopoly transmission and distribution functions remaining tied to the power plants. If that is the best the FERC and states are able to achieve, they will truly have put the cart(el) before the horse in a particularly crucial sector of the economy.

The most pressing customer sovereignty questions look at the extent to which retail customers and/or their agents will have direct access to sellers of electricity and efficiency services (and how soon) and the extent to which companies owning monopoly assets in transmission and distribution will continue to be allowed to compete in businesses where equal and open access to those monopoly facilities is vital. The abuses that flowed when competitive business was linked to a bottleneck monopoly was a major cause of the AT&T break-up. The same issue is a source of continued scrutiny and difficulty in local gas markets. There is no obvious reason to permit such linkage at the level of the generating stations, and there is considerable cause to insist at

least on separation of intra-corporate transactions and transparency at other levels of the business.

The litmus test is whether all suppliers and all classes of customers are able to deal with each other over a common carrier system of wires, within a reasonably short period of time. Any other outcome is probably politically unstable, despite the short-term appeal of suppressing competition to reduce exposure to overpriced assets. The benefit of customer-driven competition -- its ability bring about technological innovation, organizational efficiency, lower prices and better service -- cannot be suppressed by government once the transition is underway. Efforts to do so will lead to a pattern of false expectations and sudden changes reminiscent of the "pro-nuclear" regulation Wall Street viewed favorably -- to the detriment of investors -- in the 1970s.

2. Environmental regulation

What will become of the substantial levels of environmental protection built into current regulation in many states? Among some pro-competition ideologues, these protections are treated cavalierly, as elitist, liberal pork with which utilities and regulators have been buying popularity at consumer expense.

The federal government has yet to face up to the environmental implications of a competitive electric market. For example, the Clean Air Act Amendments of 1990 created a set of requirements for reductions in emissions that fall, for purely political reasons, more heavily on plants in the Northeast than on a number of the largest, oldest, dirtiest and cheapest plants in the upper Midwest. Given open access, these Midwestern plants will enjoy an unfair economic advantage based on their Clean Air Act exemptions. They may increase their operating hours and sell power more cheaply into regions where plant owners have been required to invest in pollution controls. Prevailing winds will then carry pollutants into the same regions where the cheaper power was sold. This will inevitably lead to more deaths from lung disease, more smog and more mercury pollution in the Northeast. Opposition to this possibility cannot be called elitist.

Existing energy efficiency programs have also built a layer of environmental protection into utility operations in many states. To the extent competition changes the structures that have delivered these programs, it is important to be sure benefits are captured in other ways. It may turn out a competitive market can deliver environmental improvement more efficiently than the current system, but this can only be the case if such improvement -- at least at the levels of protection currently enjoyed -- is a mandatory part of the transition. Otherwise, nothing about a competitive market will protect environmental values. More likely, the reverse can be expected.

Any plan that fails to preserve existing environmental standards and lay a foundation for using market forces to further rather than subvert standards is also unstable and in need of more work.

3. Strandable cost

The terms of this debate are familiar, although the extent to which regulators seem to have swallowed the proposition that utilities have an absolute right of full recovery of every dollar not specifically disallowed as imprudent is surprising. This issue is important, but it is not nearly as difficult from a public policy standpoint as others that are getting far less attention.

4. Nature of regulation

The issue of how regulation should be applied to the remaining natural monopoly areas unsuitable for competition is of real importance. For example, no serious argument can be made that current service territories maximize efficiency, but traditional regulation puts no pressure on such arrangements. Nor does it create much incentive for research on (or commercialization of) improvements in transmission technology -- a substantial source of further savings. Regulation focusing on achieving productivity gains will be crucial in this area. While it is not necessary to spell out the details of such performance based regulation at the outset and while this is not a make-or-break issue by itself, a commission may well want to link restructuring with a move away from cost-of-service price setting.

5. Tax structure reform

States like New York that tax utilities disproportionately will have to reform the aspects of their tax structure that impose anti-competitive burdens on utility plants. In the event of divestiture of utility generation, taxation cannot flow through, and utility tax burdens as high as 1000 times greater than their competitors will not be sustainable. This does not exclude a role for taxation of electric generation, but rather it requires taxation to fall on all sellers in a competitively-neutral manner.

6. Guaranteed access by low-income customers

Acceptable restructuring of the electric power industry simply cannot be accompanied by a wave of disconnections of people without much money. Most states and the federal government now guarantee a reasonable, basic quantity of electricity through a combination of government funding, regulation of disconnection policies and sometimes lifeline rates or other forms of inter-customer subsidy. These programs must be reconfigured in a competitive marketplace -- as they have been in the telephone industry -- to assure a supplier of last resort and a funding obligation that falls fairly on all competitors.

7. Treatment of nuclear power plants

Several serious problems surround nuclear power plants in a restructured environment making it unlikely they can be operated on a deregulated basis.

First, investors may not want to own them if they must really compete. Recent market and pseudomarket tests for nuclear plants here and in Great Britain have not been encouraging, although Britain remains optimistic as to her ability to privatize the better units in the near future. Bids from existing nuclear units in the Northeast lost out to unbuilt, gas-fired plants in New York in 1989-90, and utilities that have closed nuclear units prematurely have not had cause to regret it.

Second, better economic performance and improved safety have, to date, generally gone hand-in-hand, but there is reason for worry if competitive pressure forces plant managers to trade safety for cost. The Nuclear Regulatory Commission is showing increasing concern over this topic.

Third, it is unlikely plants will be able to obtain financing for capital improvements if they are not backed by monopoly customers or the government.

While these points suggest a short but troubled life for nuclear plants under deregulation, the environmental and fuel diversity implications of closing a substantial number of nuclear plants

over the next decade are problematic. Sensible environmental legislation and regulation will allow nuclear power the benefit of its clean air and fuel diversity attributes, but only if it delivers these attributes more cheaply than other sources of energy services.

Of course, some of the nuclear issues should be determined not as "nuclear" but as part of larger resolutions of stranded costs, divestiture and environmental regulation. However, if the nuclear plants cannot (as California seems to have concluded) be moved away from vertical integration with transmission and distribution, some difficult choices among sensible competitive structures, government assistance and nuclear plant closures loom ahead. A case can be made for governmental assumption of decommissioning costs beyond a certain level (since these costs do not increase much with future operation and since their unknown size may be a barrier to finding non-monopoly private owners).

8. Revision of the jurisdictional line between the federal government and the states

The outdated and ineffective wholesale/retail distinction would never have emerged were the jurisdictions being established from scratch today.

The fact that the FERC, Congress, and state policy makers are looking at this issue at the same time provides an opportunity to draw jurisdictional lines more logically.

Whether or not this reform occurs, more serious efforts to create regional regulatory efforts would improve oversight over both the siting and the pricing of transmission. Such an effort will also mitigate the unease many states feel about restructuring plans that, in effect, transfer much state jurisdiction to the slowness, imprecision, industry domination and impulses toward mediocre uniformity that often characterize federal utility regulation of all sorts.

9. Market power

How will federal and state policy define unacceptable market power in the new electric businesses? To the largest practicable extent, anti-trust guidelines should be developed and spelled out from the beginning.

An important aspect of the market power question is the approach taken toward utility mergers. Utility franchise territories are usually the result of decisions made many years ago on grounds having nothing to do with efficiency. Mergers or territorial realignments are clearly a source of savings, but they are also a source of increased market power. The authority to approve mergers gives state regulators the leverage to encourage separation of generation from monopoly bottlenecks; an outcome regulators might otherwise doubt they have the statutory power to press for. It will also be interesting to see whether regulators take the savings claims routinely accompanying merger announcements as a basis for setting future rates.

10. Role of public power

Public power has a mixed history. At its best, it has been a source of visionary innovation and a yardstick against which private companies could be tested continuously. At its worst, it has been a trough of tax-exempt financing through which subsidies have been distributed in ways having little or nothing to do with the real economic interests of the public. As a future competitor in the generation markets, entities with tax-exempt financing present obvious complexities. They may also offer substantial benefits as potential owners or operators of the common carrier monopolies

and in easing aspects of the nuclear transition. The State of Maine is also using tax-exempt financing to reduce its exposure to high independent power contracts, though it may be missing an important opportunity by simply flowing through the resulting rate reductions rather than creating a larger bargain in which some serious restructuring takes place as well.

This is a rapid tour of the items that should be on a checklist for evaluating electric restructuring proposals. Reliability is not on this checklist because it seems to have replaced patriotism as the last refuge of scoundrels. Reliability should not be in serious jeopardy under any responsible outcome. It is being used these days to argue for going very slowly by those who want delay for other reasons.

For contrarians who do not like lists of ten, an eleventh topic might be the extent to which the regulatory agency has assessed its own human and financial resources, regulatory and management processes and sense of mission in light of the very different industry that lies ahead. The skills and the processes essential to traditional rate cases will need to be supplemented and modified if regulation is to continue to perform well. If the telephone industry is any guide, electric regulators are going to have more, not less, to do over the next decade, but they invite exasperated dismissal if they proceed on the premise that they alone need not change.

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