Electrical Industry Restructuring in a Nutshell

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January 19, 2000

"Restructuring": What is it? Why are we doing it? How is it going? Who's in charge?
What follows is a brief summary of a legislatively defined process of limited deregulation of the electric power industry. The summary is intended to inform the reader, not to steer opinion one way or another. At this stage in a sequence of events that is only partially predictable, given the diverse array of variables at play in the political economy of states, the nation, and the world writ large, conclusions are difficult to draw; no one can say with confidence or conviction that Montanans will enjoy--or *not* enjoy--the economic benefits that restructuring is intended to deliver.

What is it?

The electric power industry has for decades been composed primarily of investor-owned utilities. These firms have been predominately vertically-integrated monopolies that produce and deliver electric power to consumers large and small, operating under pricing and quality of service rules fashioned by state legislatures and, to a lesser (but not insignificant) degree, the federal government. Until now, electricity rates charged to customers have been determined by negotiations between investor-owned utilities and regulatory authorities. Rates have been calculated to provide both affordable power to different classes of customers and to ensure utilities a sufficient return on investment.

Restructuring entails the introduction of competition into (so far) the generation component of electricity production, with a corresponding decrease in regulatory control. Restructuring can also modify or eliminate other traditional aspects of utilities, including their exclusive franchise to serve a given geographical area (aka their *service territory*), assured rates of return, and vertical integration (i.e., utilities can be ordered to functionally separate different components, or divest themselves of generation assets, in order to allow competitive market conditions to materialize.)

Even though the process set in motion by Senate Bill 390 and subsequent legislation in Montana is often referred to as *deregulation*, restructuring is the preferred and more technically accurate term. The industry consists of three major components: **generation** (the actual production of electricity, at hydroelectric dams, through the combustion of coal or natural gas, or by other means); **transmission** (the movement of electricity from the source of generation to a transfer station), and **distribution** (the poles and wires that deliver power to homes, businesses, schools, hospitals, etc.). Under SB 390 and similar laws in other states, only the generation segment of the industry is being deregulated. So far, transmission and distribution are still generally regarded as natural monopolies (since, for example, duplicating poles and wires and building parallel transmission networks would be redundant and costly), and as such, the case for continued regulation of these components remains strong. To date, no state has pursued a course of full-scale deregulation, although there are think tanks and theoreticians who argue that this would generate much greater economic and environmental benefits than partial deregulation.

Restructuring is a nation-wide (and even global) trend. To date, 25 states have passed bills or issued

final regulatory orders. Various studies and investigations are going on in the remaining states. The British government pioneered electrical restructuring, and the province of Alberta has gone further than other Canadian provinces. In the United States and Canada the process is being guided primarily by states and provinces rather than federal authorities. There are several bills pending in the U.S. Congress that would *require* restructuring for the country as a whole, but so far Congress and the Clinton Administration have deferred to the states, which possess regulatory authority within their respective boundaries, and it is likely that those states that have already passed their own laws will be grandfathered, wholly or in large part, into a federal regime.

While there is not a genuine national electricity market, owing to regional grids with technical barriers to trans-grid exchanges, there is a high degree of market integration across the West. For example, Pacific Northwest utilities (including Montana Power) have sold large quantities of power to California. Alberta, British Columbia, and the northernmost states of Mexico are also part of the western region.

Why do it?

The premise and expectation underlying state restructuring laws is that competition between different suppliers of electricity will bring benefits to consumers that they would otherwise not enjoy in a regulated environment. Such benefits include: new sources of energy, environmentally-friendly power, technological innovations that lead to new products and services, and downward pressure on prices. The price and service effects of deregulation of the airline, railroad, and telecommunications industries provide strong (though not always convincing) evidence that competitive markets work the way that academicians suggest they will.

The driving force behind restructuring was, by most accounts, the federal government's decision to deregulate electricity markets at the wholesale level (where large suppliers meet the demand of very large sellers and resellers of electricity). The Energy Policy Act of 1992 and subsequent policy directives from the Federal Energy Regulatory Agency (Orders 88 and 89) set this process in motion, and also supplied the logic for further reductions in regulation at the retail level, meaning purchases of power for direct consumption by large industrial enterprises, smaller businesses, and the remaining array of customer classes, from school districts and government agencies to individual households and apartment units.

Large energy users, primarily industrial customers of investor-owned utilities, were the first to seek freedom of choice, and in most cases are the first in line to achieve it. For companies whose productive processes require very large amounts of electricity and whose profitability is contingent on the careful management of input costs, the ability to shop for competitive prices is (or at least promises to be) a major improvement.

The combination of relatively low natural gas prices and major improvements in the efficiency of gas-fired turbines has cut the cost of generating electricity, sometimes to levels below the cost of existing facilities. It has also spawned new opportunities in the electricity market, as evidenced by the growing number of merchant power plants in areas of high demand and increased investments in fuel cells, wind

turbines, and other types of renewable energy technologies.

Montana was one of the first states in the West to undertake partial deregulation of this critically important industry, and it remains the only state in the Pacific Northwest region to have gone forward with what be called full bore restructuring. In the Pacific Northwest and the Upper Midwest, two distinct regions, Montana stands out--for the moment--as an anomaly. The proximate causes and consequences of Montana's early foray are debatable. Montana Power Company pushed for SB 390 because they were watching several of their large customers with wholesale-scale loads leave the MPC system, leaving the company with the prospect of having to serve the remaining customer base under unfavorable regulated rates. Montana's electric cooperatives, which serve approximately half the state's customers, and operate primarily in the rural areas of central and eastern Montana, supported restructuring so long as they retained a right to opt in or out of retail competition.

The twin facts that Montana has enjoyed relatively low electricity prices in the past--owing in part to the state's ample supplies of hydroelectric and coal resources--and that Montana's population is relatively small and dispersed--spread across a huge territory, with no significant metropolitan concentrations of consumers--make for somewhat difficult circumstances for standard economic theories to prove out. Time will tell. In the event that effective competition does not materialize by July of 2002, then the PSC is authorized to extend the transition period for another 2 years. Meanwhile, the Transition Advisory Committee is authorized to recommend further legislation to enhance competitive conditions.

How is it going?

In the middle of the transition period, many Montanans find themselves in a bit of a muddle. The first phase of the process has been complicated by unexpected turns of events, the most important of which was Montana Power Company's decision to sell its generation assets. This was followed by a protracted period during which the details of MPC's sale to PP&L Global were negotiated and finalized. The torpid pace of the transaction caused the PSC to hold MPC's transition plans in abeyance. Pilot programs and customer education efforts slowed. Arguably, there is no real incentive for suppliers of electricity to serve Montana's residential and small commercial customers until MPC's stranded costs have been hammered out.

The 1999 Legislature passed two bills (SB 406 and HB 211) that were not entirely consistent with SB 390, the main legal platform for restructuring. The implementation of these legislative measures has raised seemingly obscure issues and considerations to the fore. Senate Bill 406 enabled the creation of a Montana Electricity Buying Cooperative that could aggregate customers' demand in MPC's service territory and thereby constitute a significantly sized block of purchasing power. However, the same bill prohibited the Cooperative from purchasing poles and wires. This restriction, in combination with the Bonneville Power Administration's requirement that an applicant for its lowest-priced electricity (called preference power) MUST own a distribution system, may cause the MEBC to not be commercially viable.

HB 211 allowed cities and towns to become licensed suppliers, but they too appear to be in a

disadvantageous position with respect to access to the least expensive electricity in the region. In order to qualify for BPA's preference power, a municipal utility must demonstrate a *bona fide* obligation to serve its community, as evidenced by being licensed and designated by the Public Service Commission as a default supplier. At the time of this writing, the PSC has not finalized rules governing default supplier designation; moreover, the Transition Advisory Committee has requested that the Commission hold off on these rules until much later in the transition period--which would be too late for the City of Missoula or any other local government to have a shot at obtaining preference power, as it is expected to be fully subscribed via multi-year contracts by September of 2000.

It appears as if the importance of Bonneville's electricity supply, and the scope of its influence on market conditions in Montana, was generally underestimated in the crafting of SB 390. Whatever the case, issues related to BPA reveal that there are serious rifts between different groups in the state. The TAC and others have voiced their frustration with the federal agency's decisionmaking processes, and believe that the issue of default supply has been raised out of sequence, before competitive conditions have been reached. At the same time, other groups point to the internal contradictions in laws passed by the same legislators in two successive sessions, and wonder aloud about the TAC's own consistency of purpose.

This is not to paint too bleak a picture. There are positive, measurable results of the transition to competition. For example:

- Large industrial customers have been able to choose their electricity suppliers since July, 1998. All but 4 of 18 such customers have exercised choice, and number of them have obtained cost savings of 5 to 10 percent. Others have taken a cautious approach, owing to uncertainties surrounding the stranded cost issue. Reportedly none would opt to return to regulated supply service.

- After a year of experience, Montana Power Company reports that approximately 25 percent of their 1998 retail electric load has "moved to Choice". This does not mean that a quarter of MPC's customers have exercised choice, but it does indicate that many of their larger customers were quick to seize the opportunity to select a supplier. Three years remain in the transition to full-scale customer choice, and suppliers as well as some MPC customers are exploring what the company calls "the new energy frontier".

- MPC customers are now receiving "unbundled" bills, showing what they are paying for electricity supply as distinct from various transmission, distribution, and transition charges. This information will better enable consumers to make informed choices.

- Glacier Electric Cooperative opened its system to competition in July 1, 1999. Flathead Electric will do so in 2000, and has formed a for-profit affiliate, Northwest Energy Inc., to serve former customers of PacifiCorp, whose distribution system Flathead purchased.

- The Public Service Commission has crafted licensing rules for suppliers, and is working on rules

for the designation of default suppliers. To date, 24 companies have obtained licenses to sell power in Montana, although only 4 have indicated an interest in serving residential and small commercial customers.

- The PSC has also finalized rules concerning consumer protection in a restructured industry. Key provisions of the rules include requirements that suppliers obtain a consumer's written authorization and provide a service contract detailing the terms and conditions of service before implementing a switch of suppliers.

- MPC's sale price for its generation assets $757 million exceeded the estimated book value, so the company has proposed a 4 percent rate cut over the next 3 years. (In recognition of this voluntary price reduction, MPC will argue that the PSC ought not consider the rate provision in SB 390 as a cap, and therefore require further price reductions.) The sale price at closure effectively negates two types of stranded costs (*generation and regulatory assets*), so MPC customers are only facing one remaining type (*qualifying facilities, or QFs*) of transition charges that will soon appear on their power bill.

This is an admittedly simplistic and incomplete accounting of restructuring activities to date, but it should help the reader gain a sense of what the process looks like, and how progress toward complete customer choice is measured.

Who's in charge?

There is no central authority governing the restructuring process. A number of states are balking on going forward, most notably those in the Pacific Northwest, with a history of cheap electricity. The Congress has yet to play its hand. Regional, national, and global market forces are at work, and business decisions do not conform to any certain logic. The observable pattern of mergers and acquisitions is indicative of a further consolidation in the energy industry--a veritable concentration of power--but at the same time, the emergence of merchant power plants (i.e., new, free standing, and mostly gas-fired production facilities) and periodic announcements of technological breakthroughs in the various subfields of electricity production signal a diffusion and diversification of choice.

In Montana, under the provisions of SB 390, the governance of restructuring is shared by the Public Service Commission and a multifaceted Transition Advisory Committee (TAC) that combines legislators, executive branch appointees, representatives from industry, labor, and consumer groups, and which is funded entirely by contributions from the private sector. These authoritative bodies don't reign supreme--their deliberations and decisions are influenced by external factors, including the behavior of private sector entities and that of federal bodies, such as the Bonneville Power Administration. In short, the TAC's job is to monitor the transition to competition as set forth in state law, and the Commission's job is to craft and enforce implementing rules.

The TAC was created by Senate Bill 390 in the 1997 Legislature. The Committee is composed of 24 members, 12 of whom have voting privileges and are Montana legislators--six from each house. The

voting membership is bipartisan; i.e., there are equal numbers of Republicans and Democrats. In addition, there are 12 nonvoting advisory representatives that embody a cross section of groups interested in the process of partial deregulation of the electrical industry.

The TAC must meet at least quarterly, and may meet as often as necessary (within budgetary constraints) to conduct its business. Senate Bill 390 set forth a number of functions and duties of the TAC that are ongoing. These items are codified in 69-8-501 et. seq., MCA, and include an annual report to the governor and legislative leaders on the transition to effective competition in the electricity supply market. The annual report for 2000 must evaluate pilot programs and must include legislative recommendations (if appropriate) about the best means to encourage customer choice and market access for smaller customers, and about consumer protection from anti-competitive practices. The report for 2000 will also address the larger and more controversial issue of determining what "effective competition" means in the Montana context and whether current laws and policies are adequate to help bring effective competition to fruition.

The TAC must also deal with legislation passed in the 1999 session. As mentioned above, SB 406 enabled the creation of a non-profit, tax exempt buyer's cooperative to obtain low-cost power from federal and other sources for residential and small commercial customers. The bill also requires the PSC to issue rules governing how a supplier (or suppliers) will be licensed to meet the electricity needs of those customers who do not exercise choice during and after the transition period. This task was completed by December 1, 1999, as specified in the statute. The additional rulemaking function, over which the PSC may excercise some discretion (to act in the public interest), deals with how one or more *default suppliers* will be chosen. Under SB 390, the incumbent utility, Montana Power, will remain the default supplier through 2002 unless the PSC's rules allow another entity to serve the same purpose.

HB 211 allows cities and towns to become local default suppliers, provided they obtain a license from the PSC. HB 337 implements the Universal System Benefits Programs formulations resulting from the TAC subcommittee's work last interim. (USBPs are public purpose programs such as low income energy assistance and investments in energy conservation that were established under regulation, and then continued, under SB 390, as a feature of restructuring. HB 337 delegated the task of issuing implementing rules to the Department of Revenue.)

The TAC performs oversight and evaluation functions in connection with these and other issues that are integral to the restructuring process. The Committee is required by statute to meet at least quarterly. In the 1997-98 interim following passage of SB 390, the TAC met as a whole 9 times. (Subcommittees met more frequently.) In the 1999-2000 interim, the TAC is scheduled to meet 6 times. For example, the Committee met in Helena on September 24 and November 5, 1999, and plans to convene again on February 17, April 21, June 23, and September 8, 2000. The TAC must dissolve on the date that full transition to retail competition among electricity suppliers is completed or December 31, 2004, whichever happens first.

Conclusion.

As the restructuring process continues to unfold, two contending scenarios are beginning to materialize on Montana's economic horizon. The first is the worst--although by no means the most probable. It's a situation in which residential and small commercial consumers have no real choices to make because nobody really wants to serve their needs on a competitive basis. Incumbent distribution utilities would be able to obtain supplies at a competitive rate in the regional market, but their customers would have nowhere else to go for electricity. The prices that the vast majority of Western Montana customers would have to pay would be determined many miles away, in population centers that are already accustomed to paying considerably more than we do now. Cost-saving innovations and new products might never be developed or shared in Montana. In short, the state would be hostage to a *de facto* deregulated monopoly. In stark contrast, the best case scenario is one in which consumers can choose from an array of competitively priced packages of safe and reliable electricity and related energy services. Customers could specify the type of fuels used in the electricity they purchase; they could opt for greater community self-reliance in lieu of continued dependence on regionally integrated grids. Trying to speculate accurately on the eventual outcome can drive a person nuts.