Electric Industry Deregulation

BACKGROUND

In many states, policymakers and regulators are debating the merits of opening up the electricity market to greater competition. In the past, generation, transmission, and retail distribution of electricity have been available to a customer by a single, regulated company that is permitted by regulators to provide power in the customer's geographic location. The argument for this was straightforward: Since the cost of building and maintaining the infrastructure (e.g., power plants, poles, lines) necessary to sell electricity was so high, firms could not effectively compete in providing electricity to customers. Therefore, it was necessary for the state to approve a single company that would provide electricity in a pre-determined service area, free of competition. Moreover, the price charged to customers was set by a government agency, assuring (1) the customer a reasonable rate and (2) the utility company a "fair" rate of return on "prudent" investments. In exchange for the government's granting the utility a monopoly in the service area, the company would provide reliable service to anyone within that area.

Technology has changed the old relationships. Following deregulation in airlines, natural gas, telecommunications, trucking, and railroads, many analysts and policymakers argue that the investment initially necessary to build and maintain power plants to generate electricity has shrunk so dramatically that many firms now can efficiently compete in the market. They envision a market in which all customers may choose their electricity supplier, and the price of electricity will be determined by supply and demand in the marketplace, not a government regulatory body.

Under this vision, there still will be regulated, monopoly utility companies, but they will be involved only in the *transmission and distribution* of power to customers; the *generation* of power will be competitive. Instead of a single, "bundled" service provided by one company, the provision of electricity will be broken into two phases: generation and transmission/distribution; the former will be competitive, the latter controlled by government and delivered by regulated companies.

In Michigan

In January 1996 Gov. John Engler sent to the Michigan Public Service Commission (MPSC), the agency responsible for regulating the electric industry, a list of recommendations from the Michigan Jobs Commission to restructure and deregulate the industry. The view of the Jobs Commission is that the electricity rates charged to Michigan business exceed those charged in competing states. These higher rates, from the administration's viewpoint, deter business development and cost the state jobs.

GLOSSARY

Cost-of-service regulation
A traditional method for setting utility rates in a regulated market; rates are based on the utility's cost to provide service.

Deregulation
The process of reducing or eliminating government control over the quantity and price of a service or good, in this case the generation *(but not transmission) of electricity.*

Direct access
An arrangement in which customers may purchase electricity directly from any supplier *in the competitive market. (The electricity will be transmitted through existing lines, however, and the owner of the lines will continue to be regulated.)*

Divestiture
As a part of deregulation, some states have required utility companies to sell a portion of their assets, such as power plants or transmission systems.

Independent system operator
A regional system that would be established that would be clearly separate from existing utility companies, with the objective that customers have access to all generators on a comparable, nondiscriminatory basis.

Mitigation
In this context, the state requirement that a portion of a utility's stranded costs will be financed by utility stockholders, not directly paid for by customers.

Securitization
A legislatively mandated surcharge on electricity customers that would back (secure) bonds issued by utility companies to enable them immediately to recoup stranded costs.

Stranded costs (stranded investment)
Investments made before deregulation; under deregulation, they no longer may be economical.

In response, in December 1996 the MPSC staff issued a detailed report on restructuring the electric industry. The report recommends that over the following five years (1997 to 2001), customers be given the opportunity to select the power supplier of their choice. The report is based on the following two fundamental principles:

- All customers, including business and homeowners, should have the option of choosing their electricity supplier
- Rates should not be increased for any class of customers

The report also defines "stranded costs" (investments made before deregulation) and limits, to five specific cost categories, the reimbursement for past investments to which utilities are entitled.

In June 1997 the Public Service Commission issued an order generally endorsing the staff report. Currently, an electric utility performs two basic functions for its customers: it generates (or purchases from another generator) power and then delivers that power to customers. A customer pays for both services in a single, "bundled" bill. The MPSC order recommends that these functions be unbundled, meaning that (1) customers would gain direct access to sellers of electricity (that is, they may choose to buy power from *any* electricity supplier), but (2) the utility that *currently* serves a customer's geographic area would continue to deliver that power (through the poles and lines already in place) to the customer, for a regulated fee.

At this time, discussion continues at both the MPSC and in the state legislature about how and when deregulation shall be accomplished in Michigan.

Elsewhere

More than half the states are debating deregulation of the electric industry; to date, nine have passed legislation to implement it. Some, such as California and Pennsylvania, are further along than Michigan. California, for example, allowed direct access to customers beginning April 1, 1998.

Issues

There are many complex issues in moving from an industry heavily regulated for almost half a century to a competitive market, but generally, there are two questions: What will be the shape of the deregulated electric industry? How do we get there? While oversimplifying, there are five broad categories into which the issues may be grouped.

Market Power

Under the current system, Detroit Edison and Consumers Energy are the two investor-owned Michigan companies that supply approximately 81 percent of the electricity in this state (the remaining power is supplied by non-Michigan companies, publicly owned municipal utilities, and rural cooperatives). How can we assure real competition once government oversight is reduced?

Stranded-Cost Reimbursement

For all these years, the investor-owned utility companies have made significant investments in supplying electricity to Michigan customers. Under cost-of-service regulation, they could recoup their investment costs, plus a return on their investment, from MPSC-ordered rates. Under deregulation, these companies may lose generation customers, or the market price of power may be below the level necessary to enable the companies to recover their cost of investments already made. In large part, these "stranded" costs result from past investments in nuclear-power plants, long-term contracts to purchase power at a given price, and regulatory assets such as deferred taxes. Should the utility companies be fully reimbursed for these past investments? How do we assign a monetary value to the past investments that no longer will be economical in the new market? Should customers be required to fully pay stranded costs or should the costs be shared by the company's stockholders?

To enable them to recoup stranded costs immediately, utility companies across the country are proposing that they be permitted to issue bonds backed (secured) by a legislatively mandated fee on all electricity customers. What are the advantages and disadvantages of "securitizing" stranded costs in this way?

Customer Protection

Some customers, including many homeowners, may not immediately have the option or desire to choose another energy supplier. How should these customers be treated in the new market? Should their price and the reliability of their service be protected? If so, how?

Phase-in Schedule

How quickly should the market be open to competition, and what groups of customers should be first in choosing an alternative energy supplier?

Social Policy

In addition to financial issues, restructuring the electricity market raises numerous social policy questions. How shall the environment be protected? How shall universal and uninterrupted service be preserved for all who rely on electricity for everyday living, including low-income families?

DISCUSSION

Most observers support the concept of deregulating the electricity market. The disagreement centers on how best to implement a new system.

Supporters of restructuring argue that a competitive electricity market will lead to lower prices, customized services, and service innovations. The December 1996 MPSC staff report concludes that "direct access (competition) should be an attractive means of reducing electricity costs." The staff estimates that the combination of competition and securitization could drop electricity rates an average of 3.3 cents a kilowatt, totaling more than $300 million annually. (In some cases, securitization, despite the fact that it will involve every consumer paying an additional fee for it, can reduce electricity rates by replacing high-cost equity financing with lower-cost debt financing.)

Proponents further contend that Michigan cannot risk falling behind other states in reducing electricity costs through deregulation. Data for 1996 from the U.S. Energy Information Administration show that in comparison to Ohio, Indiana, and Wisconsin, Michigan's electric rates for all customers (business and residential) already are higher—an average of 14 percent, 36 percent, and 37 percent higher, respectively—and the price differential is even greater with some of the southern states. These higher rates in Michigan, it is argued, are a major reason that some firms do not move or expand in this state. If Michigan fails to deregulate, and its competitors do, the gap between rates in Michigan and competing states will widen even more.

While acknowledging that issues in moving to a deregulated environment are complex, proponents believe that there is a reasonable solution for every problem. The market power of Detroit Edison and Consumers Energy, they argue, can be curbed by establishing an independent system operator—a regional system clearly separate from the "big two" utility companies—which would ensure that customers have access to all generators on a comparable, nondiscriminatory basis. Deregulation proponents further propose to functionally separate the utility companies' generation of power from their transmission and distribution components.

These proponents also argue that Detroit Edison and Consumers Energy should be guaranteed full recovery of past investments that will be stranded. They believe that decisions made in the 1970s about nuclear-power plant construction and the long-term purchase agreements made in the 1980s were not unilateral decisions by the electric utility industry. They were societal decisions, encouraged by both the government and large customers. Now that these investments no longer will be economical, the utility companies are entitled to recoup their past investment plus a rate of return. Moreover, they argue that without full stranded-cost reimbursement, the existing utility companies cannot compete in the new competitive world and may face bankruptcy.

These groups usually propose an extended phase-in schedule for competition. They argue that the new system will require so many technical changes in the industry—e.g., billing practices—that a longer phase-in schedule is necessary for the utility companies to adjust. They also point out that the faster competition is phased in, the higher the stranded costs.

Observers on the other side of the debate raise significant concerns about the proposed implementation of deregulation. They fear that the changes may lead to the worst of scenarios, a deregulated monopoly. Since the existing utilities in Michigan will continue to control the *transmission* and *distribution* of electricity, these companies will be in a position to limit the choice customers actually have. They fear that deregulation, if not done correctly, will result in the utility companies continuing to exert market power but without government oversight.

A draft MPSC staff discussion paper on market power warns that "restructuring brings with it the very realistic potential for abuse of market power (and resulting increased prices) as well as an increase in litigation over antitrust violations." The paper outlines five steps the staff believes will minimize the potential for abuse; one is to clearly separate regulated business operations from the competitive-generation business, and another is to create a truly independent regional transmission system operator and power exchange.

Many diverse national groups, from the conservative Heritage Foundation to the liberal Public Citizen (an environmental and consumer group founded by Ralph Nader), are opposed to the utility industry's proposal for recovering stranded costs. They characterize the utilities' estimate of stranded costs as nothing more than a bailout for the industry. A 1997 Heritage Foundation report likens stranded-cost reimbursement to the 1980s bailout of the savings and loan industry, arguing that past uneconomical investments are mistakes made by the utility companies and should be absorbed by company stockholders. They also argue that firms in the trucking, railroad, and airline business were not paid for their losses when those industries were deregulated. The groups believe that requiring customers to pay a surcharge to reimburse the utility companies for stranded costs will, in effect, delay competition for years.

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