



A Spotlight

On Electric Deregulation

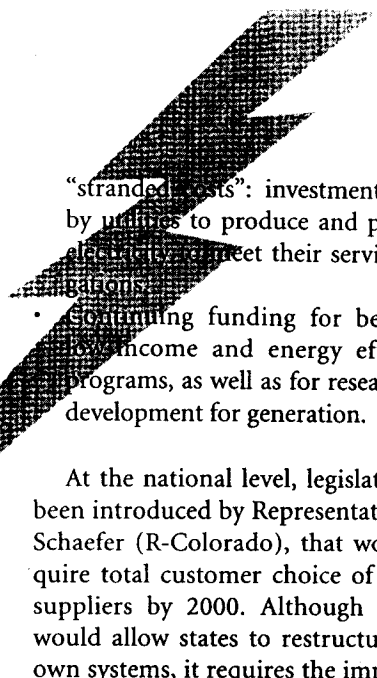
Pamela S. Easter

Over the past decade, we have seen the deregulation of many previous monopolies, including the telecommunication, natural gas, trucking, and airline industries. Now, there is a national and state movement afoot to deregulate the \$300 billion-per-year electric utility industry. What exactly is being proposed? How will the industry differ from what we have now? And finally, how do we learn more about deregulation and begin developing plans that benefit our individual local governments?

The purpose of this article is to start a discussion of electric restructuring and its potential impact on local government. Deregulation of the electric industry is currently unfolding; many major decisions, laws, and regulations still are being made and written. As new developments occur, ICMA and other organizations will be important resources in providing the information and support that managers will need in structuring the right programs for their local governments.

Where We Have Come From

For most of the twentieth century, the provision of electricity has been a monopoly, with privately and municipally owned utilities having their own exclusive service areas.



With this situation has come the traditional obligation to serve all customers in their areas at regulated, "bundled" rates that include the cost of power generation and delivery. Most utilities—especially the investor-owned ones (IOUs)—have typically been vertically integrated, with the same provider owning and supplying generation, transmission, distribution, and metering/billing. Some municipal utilities, however, have chosen to focus on the distribution of power to their customers and to purchase power from others. Three-quarters of the electric power in America is provided by nearly 215 investor-owned utilities, with the remainder being supplied by municipal, rural cooperatives, or other government-operated entities.

Government has been heavily involved in the regulation of the electric industry. At the national level, the Federal Energy Regulatory Commission (FERC) oversees wholesale electric rates and service standards, as well as the interstate transmission of power. State commissions are responsible for regulating their IOUs' retail rates, safety standards, and relations with customers. For municipal-owned utilities, local government councils and boards set rates and oversee utility operations, with some interaction with FERC.

The current movement toward deregulation began in the 1970s. The Public Utilities Regulatory Policy Act (PURPA) of 1978 and the more recent Energy Policy Act (EPACT) of 1992 opened the generation portion of the industry to competition by requiring utility companies needing new capacity to entertain bids from alternative suppliers. FERC Order 888, issued in 1996, further opened up the wholesale electricity market, that is, power provided by utilities and FERC-approved power marketers. It mandated that all transmission-line owners offer transmission ("wheeling") services to any electric utility, as well as to any retail customer taking transmission service as part of a state-mandated, direct-access program. With these various aspects of electricity now open to

competition, some states are considering "retail wheeling" or direct-access programs that would require all utility lines be made available to any customer.

Other factors leading to deregulation have included the movement away from government regulation and protected monopolies, advances in technology, privatization, and low-cost power generation. And finally, demand is increasing for lower utility rates, "direct access" to electricity, and wider customer choices.

More than 47 states currently are considering some form of electric deregulation/restructuring. No one, uniform structure is being proposed. Some states are looking at implementing statewide reform through their state public utility commissions, like New York. Other states, such as Michigan and New Hampshire, are conducting pilot programs in which some customers may choose alternate suppliers. In Illinois and elsewhere, utilities are independently conducting retail wheeling experiments. California and Rhode Island have passed legislation that will bring competition for retail, residential, commercial, and industrial customers by as early as 1998.

Although each state is structuring its legislation differently, policymakers are dealing with several common issues and appear to agree on certain fundamental principles of equity and fairness, including the importance of the following:

- Evaluating the impact of retail competition on the state and local economies, as well as on unique state energy priorities (e.g., renewable, "green" energy in the northeastern states).
- Ensuring that all types of customers benefit or at least are not harmed by deregulation.
- Preventing the shift of costs and rates from large industrial customers to small businesses and residential customers.
- Continuing the provision of reliable, universal electric service for all customers.
- Dealing with the recovery of

"stranded costs": investments made by utilities to produce and purchase electricity to meet their service obligations.

- Continuing funding for beneficial environmental and energy efficiency programs, as well as for research and development for generation.

At the national level, legislation has been introduced by Representative Dan Schaefer (R-Colorado), that would require total customer choice of electric suppliers by 2000. Although the bill would allow states to restructure their own systems, it requires the implementation of some type of choice for all customers.

Where We Are Headed

While each state's deregulation plan will have unique elements, there is general consensus on what the overall, deregulated environment of the future will look like.

Power generation will be competitive, with customers able to choose their power providers in much the same way as they now choose their long-distance telephone providers. Customers will be able to purchase electricity from power producers through "direct access," through an independent power exchange, or by contract for differences (a financial type of contract that enables a customer to buy electricity at a fixed price). Consumers' electricity bills also will resemble their telephone bills, with itemized charges for the purchase of power, for transmission and distribution lines, and, at least in the initial years, for the continuation of some "stranded-cost" charges to repay the utilities for their previous generation investments. Utility companies probably will not continue to operate within a vertically integrated structure.

Technology will have a great influence on the types of electric services that are provided in the future. Smaller power plants that serve individual or small groups of facilities are becoming

more economically feasible and can be useful in addressing a customer's specific requirements. Newly developed fuel cells will be available that can supply all utility needs, including steam, hot water, cooling, electricity, and other uses. Energy plants fueled by cogeneration, wind, solar power, and other "renewable" sources also can fit unique circumstances.

Fiber-optic technology will be used increasingly to package services to the customer and to deliver them more efficiently. In experimental use now, "smart" meters may allow customers to track their electric usage, assist in energy efficiency, and allow lower-use customers to select their suppliers. In cooperation with utilities and other service providers, technology-oriented companies also are beginning to develop products and services that could deliver a wide range of communication, information, and entertainment services beyond

the meter. The city of Anaheim California, for example, currently is considering partnering with a private company to install this type of capability locally. In the Phoenix area, the Arizona Public Service Company is beginning to sell home-security systems to its customers.

How to Prepare a Local Government for Electric Deregulation

In such a dynamic environment, how can managers help their local governments get ready for electric deregulation?

First, they can participate in shaping the restructuring legislation and regulations now being developed in their states and at the federal level. The National League of Cities and the state leagues are becoming involved in this issue and working with interested cities and counties to recommend policy to their state and federal commissions and legislators.

Check these organizations' calendars for upcoming restructuring workshops, and monitor their publications for information on electric restructuring.

Second, managers should stay abreast of deregulation issues and of the structure that is being proposed in the state. Many future policy decisions will be influenced by the specific structure that the state chooses.

Third, become educated on electricity usage at the local government's facilities. Conduct an energy audit, and evaluate how much and when the facilities use power. Employ this analysis to identify ways to reduce use and improve efficiency. One valuable

source for this type of information will be the existing utility provider.

Fourth, evaluate how the local government should purchase power. In this new world, there will be a variety of options to consider. One will be simply to continue with the existing utility provider. A second option will be to buy power through some type of aggregation, that is, through the pooling of electric demand and purchasing power for multiple customers and/or locations. Local governments can aggregate their own facilities or join with others in a larger aggregation that may include other governmental agencies, businesses, and/or the residential community. Another option will be to buy from a power supplier through "direct access" or through an impartial power exchange. Finally, localities can consider forming their own utilities.

When considering all of these options, however, keep in mind the importance of these factors: reliability, overhead costs, cost savings and effectiveness, revenue gains or losses, and the experience and background of those who will be administering the program.

In addition to its own facilities, a local government will need to consider the role that it wants to play with its own residents and businesses on this issue. As mentioned above, a local government can potentially serve as an aggregator for some, or all, of its residents and businesses. A locality also may want to help educate the community on deregulation and on the available options, through workshops, community newsletters, and other means.

As deregulation is finalized in the state, managers can anticipate being inundated by power marketers and energy brokers who want to sell them power and to manage their local governments' electricity programs. A word of caution: Don't necessarily jump at the first proposal received—especially a long-term contract that appears attractive on the surface. Take time to become educated, consider the various options, and decide which proposal best meets the goals that the local government is trying to

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achieve. As deregulation is finalized in the state, be sure to understand the time frame and guidelines for implementation, including the phase-in process for direct access and aggregation.

Managers may wish to get some help in becoming educated and in deciding on their best options. Local governments are using a variety of resources to help them; some agencies have the expertise in-house, while others are hiring experts. An additional option is to partner with other local governments to study the issue. In the next section of this article is a list of organizations that also may be able to provide assistance.

For local governments that already own their own utilities, there are additional issues to be considered. In the deregulated world of the future, municipal utilities (munis) will probably not remain monopolies and therefore may be required to compete to retain their customer bases. Many munis have a large existing debt, due to their investments in generation plants, infrastructure improvements, or "take-or-pay" power contracts (agreements that require a purchaser to pay for electricity, whether or not the purchaser decides to take it). These debt burdens have the same impact as "stranded costs" have on IOUs in determining a utility's ability to compete in the new marketplace.

Munis also traditionally contribute revenue to their jurisdiction's general funds through an overhead or franchise fee, which they consider to be comparable to the IOUs' return-on-investment/shareholder dividends. To ensure their competitiveness in the new environment, munis will need to take a look at these financial obligations, as well as at their organizational structures and customer service programs.

For example, as the California legislature has recently approved its statewide deregulation plan, the city of Pasadena and its city manager, Phil Hawkey, are dealing with these issues. The city has a large stranded-cost issue because of generation obligations, which force it to produce electricity at double the marketplace

cost. To position its electric utility for market competition, Pasadena is looking at temporarily raising rates for the next five years and permanently reducing the transfer to the general fund. These resources then would be earmarked for a sinking fund to draw from, once competition occurs and Pasadena has to reduce its energy rates to be competitive.

Pasadena also is considering moving the utility into a nonprofit corporate structure, so that it can be freed from some of the bureaucratic structure that makes competitiveness difficult in the power marketplace. It also is considering competing outside of the city limits to provide service to additional customers. And the department will need to reduce its cost of operation and strengthen its customer relations.

Where to Go for Assistance

A number of organizations can help local officials learn more about electric deregulation and can help to structure the right program for a local government. As mentioned, the National League of Cities and the state leagues can provide information on the current deregulation activity in any given state, as well as on what other localities are doing. ICMA also is

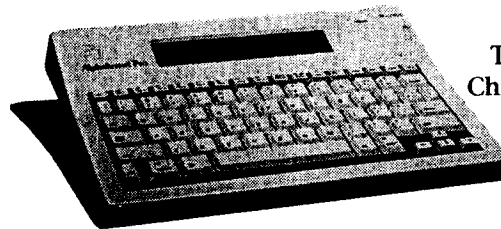
becoming active by forming a Utility Restructuring Consortium and planning related seminars and workshops.

Additionally, Public Technology, Inc. (PTI) has published *Keeping the Lights On: A Primer for Local Governments on Utility Industry Restructuring and Competition*, which is an excellent overview of deregulation and the ways in which a local government can begin preparing. PTI's Urban Energy Consortium is actively working on this issue. The American Public Power Association also is available to assist municipal utilities. A city or county's existing electrical supplier can be another source of information.

In an era of challenges facing local government, the deregulation of electricity is yet another one to add to the list. It is a complex issue, and public managers will need to weigh carefully the various options available. In making a decision, try to find opportunities that will reduce costs and provide reliable service for the locality's facilities, as well as for residents and businesses. **EM**

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