The PUC’s Electricity Deregulation Proposals: Point/Counterpoint

**INTRODUCTION**

*by Robert C. Fellmeth*

On April 24, 1994, the California Public Utilities Commission (PUC) issued its Order Instituting Investigation and Rulemaking to restructure the electricity industry. The Order represented the culmination of two years of study, and was based on three underlying judgments:

- “Command-and-control” and “cost-of-service” regulation and “central planning” have become obsolete in an “increasingly competitive electric services market.”
- California’s private power utilities charge some of the highest rates in the nation.
- The Commission has (successfully) used enhanced competition in other areas of regulation, including telecommunications.

The PUC’s initial order also criticized the disincentive to new investment caused by cost-of-service regulation, the “burden-some administrative proceedings” (of the PUC), and “unnecessary” barriers to public participation in its proceedings.

Electricity utilities have long been considered “natural monopolies” requiring maximum rate regulation. The high threshold costs necessary to create a utility meant that there was room for only one entrepreneur to operate efficiently. Because a single (monopoly) enterprise was inevitable, government regulation to preclude excessive prices and other abuses of monopoly power was compelled. But as U.S. District Judge Harold Greenes decision in the AT&T telecommunications case indicated, it may be possible to take that portion of a utility enterprise where “there is room for only one” and confine the utility to it, leaving the remainder of the enterprise subject to competition. In telecommunications, this was accomplished by narrowing the highly regulated utility to the wire and switches constituting the “loop” which gets the phone signal to a home, and allowing competition in the transmission of signals by microwave where there is room for many competitors.

In electricity, the same principle may apply where one confines close regulation to the network bringing in the power, but allows competition in power generation—where many competitors may flourish. Hence, utility deregulation involves allowing many separate companies to generate electricity and contribute it to the “grid”—or system of transmission wires. This “grid” remains a monopoly which distributes (or “wheels”) this power to customers for a fair charge.

The transformation of utilities from regulated to partially competitive raises the following common concerns: (1) prior regulation has often cross-subsidized some groups (the elderly or poor), which may not be as achievable with wider competition; (2) regulators are currently able to accommodate “external costs” (for example, encouraging energy conservation to extend nonrenewable resources for societal gain), which may also not be achievable easily with deregulation; (3) some customers are inherently organized and possess strong bargaining power vis-a-vis others (for example, industrial vs. residential users); (4) where the remaining utility enterprise is allowed to participate in the new competitive sector, it will use its remaining monopoly power to unfair advantage; and (5) the competitive sector is often subject to standard antitrust offenses which are not monitor-ed or prosecuted because of the presence of a regulator committed to “non-interference.”

Notwithstanding commonly cited concerns, neither utilities nor consumers have categorically opposed deregulation. Each of the five problems listed above is ad-dressable through legislation or through the details of remaining regulation. However, where historical monopoly power has been subject to deregulation (as in air transportation, telecommunications, and cable television), serious abuses have occurred—for example, failure to apply antitrust law (air transport), refusal to limit monopoly power participation and distor-tion of the new competitive sector (telecommunications), and statutory inability to control egregious practices by the monopoly enterprise (cable television). Accord-ingly, the details of deregulation determine whether enhanced efficiencies will occur, and whether new abuses will evolve from a pendulum-swing overreliance on the “market” without antitrust or fair competition oversight where still needed.

The basic structure of the Commission’s proposal is consistent with a trend to separate power generation from transmission. Part of that trend was reflected in the Public Utility Regulatory Policies Act of 1978 (PURPA) and the Energy Policy Act of 1992 (EPAct). The PURPA statute allows for contribution to the grid by power generators, and their required compensation by utilities. The EPAct sev-ered the automatic control of utilities over the power transmitted by their networks; it authorized the Federal Energy Regulatory Commission (FERC) to require utilities to “provide wholesale transmission service.” And in 1991, FERC approved the “Western Systems Power Pool” established by utilities to facilitate sale or trade of power between them.

Electricity deregulation—as originally proposed by the PUC in April 1994—would allow power consumers to contract directly with power generators. The original concept was to allow consumer choice to either remain with the existing utility, or to make alternative arrangements with power generators or with “brokers” for such generators. This plan anticipated “retail wheeling,” where large industrial users, then commercial consumers, and finally households (in separate stages) would be permitted to contract directly with power producers, and the utilities would simply collect a fee for use of the grid to transmit the power to the user. Consumers could choose to remain users of the utility’s own power generation, and would be subject to PUC rate review protection.

The PUC also proposed to initiate another policy called “performance-based ratsetting,” which could be implemented together with or separately from retail wheeling. Here, the utility’s maximum price would be set based on the average price of electricity. To the extent the util-ity is able to produce (or purchase from others) cheaper electricity and beat the
average price, the savings are divided between ratepayers and stockholders. If the utility becomes less efficient, the losses would also be split between ratepayers and stockholders.

The difficulty for utilities under both of these proposals is the fate of existing and inefficient powerplants. The utilities seek a return on existing and sunk investment, which gives them a bias to use costly power generation where they can pass those higher costs on to consumers. Retail wheeling and performance-based ratemaking are each intended to provide a market incentive to generate or find electricity generation more cheaply. Thus, the PUC’s initial proposal won the backing of some utilities by requiring ratepayers to pay for much of the costs of retiring uneconomic generators.

The initial reaction to the PUC’s original proposal included objections and concerns, and generated the following questions:

- Will the phase-in of industrial, then commercial, and then residential customers lead to industrial “skimming of the cream” of the best and cheapest power, with residential users getting what’s left? What will be left for residential users— who have little ability to bargain among providers—except high-cost power from inefficient, outmoded plants?

- What will happen in the proposed system to needed cross-subsidies which assist low-income ratepayers in securing basic services?

- What will happen to the state’s interest in long-run consequences as reflected in policies stimulating conservation, power from renewable sources, and pollution control? Utilities are currently required to obtain a percentage of their power from environmentally sound sources; will that societal interest be sacrificed for immediate energy gratification? What would happen to fledging biomass generation (the burning of discarded plant material—the largest source of landfill trash) for electricity?

Since April 1994, the Commission has been holding hearings throughout the state on its proposal, and fencing with both FERC and the state legislature about its jurisdictional prerogatives.

Consumer groups, including two of the state’s leading representatives of utility consumers—Toward Utility Rate Normalization (TURN) and Utility Consumers’ Action Network (UCAN), have been particularly critical of the details of the Commission’s electricity deregulation plan. TURN presented an alternative plan, termed “Community Access to Competitive Energy,” to the Commission in September 1994; TURN’s plan included the following elements: (1) cities, counties, and other local authorities would be authorized to set up “consumer-owned utilities” to purchase power transmission and distribution services from utilities at regulated prices (choosing their own sources of power); (2) rates for participating subscribers would be set by the authority, as would any cross-subsidies for conservation and nonrenewable resources; and (3) utilities would be phased out entirely as producers of power and confined to transmission.

Pacific Gas & Electric (PG&E) embraced the PUC’s initial plan in its broad outline. Southern California Edison, however, bitterly opposed it and—together with San Diego Gas & Electric Company—proposed an alternative now dubbed “PoolCo.” Under the utilities’ alternative, the Commission would create a statewide “wholesale pool” of power by 1997, and at the same time implement its “performance-based ratemaking” proposal. The energy combine would be accessible only by industrial users for two years, after which households would have the chance to participate. The concept is to create a private, independent vehicle for the marketing of power separate from utility carriers.

Following six days of PUC full-panel hearings and its review of comments submitted by 140 parties and hundreds of individuals in 16 public participation hearings over the past year, a three-member majority of the Commission now favors the “PoolCo” alternative. On May 24, 1995, the PUC released for public comment two alternative proposals—the original plan (now sponsored by Commissioner Jessie J. Knight, Jr.) and “PoolCo” (favored by PUC President Daniel Wm. Fessler and Commissioners P. Gregory Conlon and Henry Duque).

We present below a defense and critique, respectively, of the new “PoolCo” conceptual plan now being advanced by the Commission. The defense of “PoolCo” is authored by Jim Conran, with a background as a utility executive (with Pacific Bell), public official (director of the California Department of Consumer Affairs), candidate for Insurance Commissioner, and now president of Orinda-based Consumers First, a coalition of California ratepayers. The critique is written by Audrie Krause, until recently the executive director of TURN.

POINT: Consumers Should Be Turned On By “PoolCo” by Jim Conran

California may not be aware of what is happening in San Francisco, but—if all goes according to plan—electricity consumers in the state soon will benefit by an innovative policy proposed in May by the California Public Utilities Commission (PUC). The proposal, which would allow consumers to purchase electricity from a provider other than the utility currently monopolizing the area, reflects two recent trends in current public policymaking—facilitating an orderly transition from monopolies to a competitive marketplace, and representing the interests of all consumers over the concerns of large, special-interest parties.

Through the creation of a power pool which would dispense the lowest-cost power first, the PUC will establish a competitive market within the electric utility industry which will result in lower electricity rates for consumers. The current PUC proposal thus meets the two primary goals established initially by the PUC—lower electricity rates and a choice of electricity suppliers for consumers. Under the plan, California private utilities such as Pacific Gas & Electric, San Diego Gas & Electric, and Southern California Edison would be forced to compete against each other for the opportunity to deliver the lowest price to the pool. Then, they will have the right to directly serve, via the pool, consumers throughout the state.

In business, it is a generally agreed-upon principle that competition encourages lower prices; therefore, the PUC plan will result in lower electricity prices for all California consumers. However, this proposal is beneficial to consumers because of how they will benefit and because of how detrimental the other alternatives would be. Under the present scenario of providing electrical power to consumers, Californians are restricted to a designated electrical provider based upon their residence/business being located within a utility’s territory. This situation is not in the consumers’ best interests because there is only one electrical provider in each territory; thus, there are no factors which could influence competitive pricing.

Also, the current arrangement allows for big businesses and large-volume consumers to benefit at the cost of the residential consumers. Consumers, albeit often without knowing it, pay higher basic rates in order to compensate the utility for ac-
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commodating the need of bigger customers through special discounts, incentives, and pricing packages. In terms of customer service, the residential consumers obviously suffer since the prompt attention afforded big-volume users does not trickle down to the average electricity customer. This unfair situation is remedied by the PUC’s “pool” approach which ensures that the utility providing electricity to the pool already is offering the lowest competitive rates.

Another alternative floated by some proponents of deregulation is one of “tail wheeling.” This plan would allow utilities to compete for customers throughout the state without regulations protecting the interests of the consumers. This idea practically would defeat the whole purpose of deregulation since average consumers—already suffering under the current system—would enter the marketplace at an immediate disadvantage; their consumption patterns and electricity needs still would not attract the attention of the big, independent suppliers of electricity, and thus consumers would have no means to solicit competitive bids for service. Again, the pool proposal pending before the PUC addresses this disparity since the very nature of the pool guarantees that average consumers’ collective energy needs will warrant competitive pricing from the utilities.

In general, deregulation is good for encouraging competition within a marketplace. But with a commodity such as a public utility, complete and open competition cannot exist in the name of public policy. There must be some remaining elements of government control and regulation in place to ensure that the rights of citizens are not being violated. The PUC has masterfully compromised alternatives without compromising principles in its current electricity deregulation proposal. By implementing the pool concept, the state would introduce a competitive free market system to the electricity industry, while maintaining some control over the delivery of the actual electricity and services. If only the federal government had addressed deregulation of the cable and telephone industries as well as the PUC is handling the electricity issue, perhaps our cable and phone rates would be lower too.

The PUC’s approach also will assist in the stabilizing of the electric utility industry. For example, one of the major problems associated with the changes witnessed in the airline industry was the reduction of 22 major carriers in the nation to a total of approximately eight. The PUC’s proposal offers an opportunity for smaller, more rural electric and municipal utilities in the state to grow their grids and volume, as well as to expand their customer base. Heretofore these utilities have been prohibited, both legally and structurally, from entering the territory of another electric utility. Once all electricity providers in the state have access to all of California’s consumers, the corresponding customer bases of the respective utilities should reach more balanced levels. This result only could strengthen competition, and thus benefit consumers.

Perhaps the most reassuring development from the introduction of this pool proposal is the sign from the PUC that it is committed to being progressive, forward-thinking, and objective. By converting the electric industry from the current anti-consumer relationship to that reflecting more of a free market approach toward a utility industry that has been regulated heavily for over 100 years, the PUC will continue to guard the public’s safety and oversee our electric service. It is appropriate that, as we enter the 21st century, the Commission’s latest plan to deregulate offers the hope to residential customers originally intended by regulation of the electric utility industry.

Fortunately for California consumers, there are public officials who act responsibly, recognizing the concerns of the average citizen. All consumers currently disenfranchised by the existing regulatory framework should take heart in the anticipation that change—for the better—is near. The PUC wisely has proposed a plan for providing electricity fairly, a plan whose ramifications and shock waves could carry beyond California’s state lines. As Californians and consumers, we should be charged up for this momentous undertaking, and we must ensure that the PUC does not waver in its proposed decision.

... COUNTERPOINT: Consumers Will Lose With “PoolCo” by Audrie Krause

D id you ever stop to wonder why all the major airlines seem to offer virtually identical prices, despite all the hype about deregulation creating a more competitive market? Or why the airlines play “follow the leader” when it comes to raising prices?

There are two dirty words for this practice: It’s called “price-fixing.” In fact, several major airlines recently paid out a hefty $458 million settlement on a class action lawsuit alleging that the airlines fixed prices by signaling proposed fare changes to each other via the computer reservation system.

California consumers of electricity could be facing a similar scenario if the state Public Utilities Commission’s “PoolCo” proposal becomes the model for electric deregulation in the state.

Proponents such as Southern California Edison claim PoolCo would create lower electricity prices through competition. Under the PoolCo model, investor-owned utility giants like SoCal Edison, Pacific Gas & Electric, and San Diego Gas & Electric would vie with independent power producers by bidding into a “pool” administered by a supposedly neutral agency. That’s like setting up a contest between a pit bull and a Chihuahua. We know from the start who is going to win.

PoolCo backers spin a tale of a highly competitive energy marketplace, with bidders shaving their prices close to their costs and consumers reaping the benefits. But this rosy view is far from the reality the PUC’s PoolCo model would create. Instead, the PoolCo would allow the biggest players—utilities and a handful of well-financed independents—to maximize their profits and market share through price-fixing, a la the airlines. Meanwhile, consumers would be denied the benefits of true competition.

Here’s the rub: Edison and PG&E control 55-60% of the power generation capacity in the state. This skewers the game from the beginning. Because we need their power to meet the bulk of the state’s electricity needs, the law of supply and demand dictates that the big utilities can name their price.

Independent suppliers also would bid into the pool, but only a few—the largest, most financially secure independent power producers—would come up winners. After this initial shakeout of winners and losers, the dominant players could
begin to collude, in effect, on the price of the pool's power.

Because all the PoolCo players would be fairly knowledgeable about each other's costs, capital investment, and financial strengths or weaknesses, the dominant bidders could begin to signal each other through the bidding process. As with the airlines or the oil cartel, these key players could work together to raise the floor price, and punish low-bidding newcomers who disrupt their game.

But there is an even larger issue looming on the deregulation horizon. Whichever model is adopted eventually by the PUC, how consumers fare will largely depend on who is forced to pay for the utilities' high-cost nuclear powerplants and how much.

The high cost of power from nuclear plants such as PG&E's Diablo Canyon and Edison's San Onofre Nuclear Generating Station is the driving force behind California's high rates, which are 50% above the national average. With power selling at 12 cents per kilowatt hour, Diablo Canyon and San Onofre would not be players in a truly competitive market for electricity (although PoolCo would allow them to continue operating). Utilities say ratepayers should bail utility investors out from under these behemoths, and regulators have indicated that they will go along with this plan. If they do, rates will likely stay high no matter which model of "competition" is adopted. Utility investors should pay the price for their past mistakes, not ratepayers. After all, it was the investors who chose to build plants in the first place. Likewise, as long as the utilities continue to own and control the bulk of the state's electricity generating resources, PoolCo will fail to lower prices through competition.

Instead of choosing between the two plans advocated by the utilities—PoolCo and so-called "direct access," which would allow consumers to choose their utility company, the PUC should consider operations that would truly benefit consumers.

Finally, the PUC must ensure that a deregulated market for electricity is free from utility domination and benefits all consumers equally—even if that means divesting the utilities from the business of generating electricity.