Politically Correct Thoughts

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The electricity supply revolution marches ahead, preceded by a vanguard of banners proclaiming a quartet of politically correct thoughts designed to pacify all interest groups and entitlement holders. They proclaim:

No policies that will disadvantage any customer class— Code for: no price increase to residential customers.

Honor all contracts and social commitments—Meaning: do not abrogate high cost supply contracts or costly social and environmental programs.

Assure recovery of prudently incurred stranded costs— Translation: do not stick the utility's shareholders for losses on investments made under old regulatory regime that lose value with the onset of a competitive market.

Maintain system reliability at current levels—In reality: don't let the lights go out when a host of new users tries to get on a system that was not built to handle them.

Sounds wondeful? Do people believe those assurances? Will this revolution demonstrate that you can make an omelet without breaking an egg? If regulators and utilities honored all those commitments, however, would deregulation produce any tangible benefits for consumers? If not, why bother deregulating?

Commitment #1 really says that no customer should lose. Yet the old system fostered cross subsidies. The subsidizer lobbies for a competitive system in order to stop paying subsidies. Doesn't the recipient of the subsidy lose when the subsidy is withdrawn? A number of regulators have come to that conclusion, as have some investors. They believe that deregulation is a zero sum game. Either the loser of the subsidy has to pay more for electricity or the utility shareholder has to eat the loss. Are we encouraging seismic changes in order to simply re-shuffle costs? Competition produces benefits to consumers when it forces firms to reduce costs so much that they can furnish services to most consumers at lower costs. When other industries deregulated, overhead expenses came down 20-40% and prices fell 30-50%. Yet regulators may stand in the way of the cost reduction process either by stopping the process because it produces uncertainty about winners and losers or by fencing off certain costs from attack.

That brings us to commitment #2 which says that the utility should avoid aggressively cutting or eliminating certain costs, even if they constitute a major part of the cost problem. Good costs, such as those derived from power purchased from IPPs and from environmental and social programs, are off limits. Protecting the producers of some costs puts them on notice that they need not cede much to the cost-cutting utility, unless they think that the utility will go bankrupt. Fencing off some costs should push the utility to slash costs deemed less important by regulators, such as unprotected suppliers, employees, the research budget and tax payments to school districts.

Commitment #3 is music to the ears of beleaguered, elderly utility shareholders, already worried about losing Medicare benefits. They will not foot the bill for the transition to competition. That is the face-saving sop thrown by regulators to utilities. "Accept competition, and we will take care of you," the regulators say. But, if customers want lower prices, if a large part of the costs are off limit to paring, and the utility cannot raise prices to non compensatory customers, who will pay the costs other than shareholders? "Don't worry," reply the regulators. "We'll let you recover all the transition costs from customers by means of a nonbypassable charge on the wires. Everybody has to use the wires. Or we will give you money up front that compensates you for the impending losses."

Commitment #4 belies the fact that the existing system was not built to handle the new market. Obviously we can rebuild the system, using new technologies, but people who put in capital for investment want a return commensurate with the risk, and regulators seem unwilling to admit that even the transmission market has become riskier, so we may see resistance to investment in transmission enhancements. Not to mention that we are grafting a competitive generating market on a still regulated systems operations market, a situation that could produce the kinds of misallocation of resources that will degrade reliability. One big blackout after deregulation will give competition and deregulation a bad name, but my guess is that the cause of the blackout will be an unwillingness to use market forces to discipline suppliers, rather than too little old fashioned utility regulation.

At this point, I think of that cultural icon from my days at Stuyvesant High School, the face that graced the cover of *Mad Magazine,* Alfred E. Newman, who declared, "What, me worry?" Is any charge completely nonbypassable? Are regulators more ingenious than business people trying to save money? The utility can charge only what the market will bear. Too high a charge on the lines could tip the scales in favor of distributed generation, making electricity supply in some areas an appendage of the gas supplier, to cite one plausible means of bypass. In other words, the price of the alternative service—not the regulator—may set the maximum price, which, in turn, may determine how much of the transition cost that the utility can collect. Recently, regulators have come up with an ingenious solution. They demand a set percentage reduction in prices as the *quid pro quo* for their acceptance of a transition plan that gives the utility a shot at recovering costs stranded by the introduction of competition. The transition plans, almost invariably, have caused Wall Streeters to reduce their estimates of utility net income, which means that shareholders do not come out whole.

Essentially, investors in and the managers of the electric industry must get beyond irrelevant PC promises. Instead they need to answer two questions:

Can utilities reduce costs enough to lower prices to some customers, not raise prices to other customers, and really recover much of the stranded costs under a reasonable regulatory framework?

Will the utility's price of service, after achieving the above goals, be low enough to keep out competitors of all sorts?

I haven't noticed many people tackling those questions. Not in public, anyway. People seem lulled into complacency by the promises. I'd rather not depend on the promises. I'd like to invest in an industry that is harder to bypass, has low costs, is unregulated where regulation is inappropriate, but, above all, one that does not take seriously politically correct promises of succor.