

# Current Happenings in Electric Utility Deregulation

## NOW IS THE TIME FOR USERS TO RENEGOTIATE THEIR CONTRACTS

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For energy users, the driving force that makes renegotiating an electric contract realistic is the deregulation of the electric utility industry. Monumental changes are occurring that has the whole industry in chaos at the moment. Utilities are scrambling to retain or gain market share. New alternatives for power supplies will become available. Regulatory agencies are becoming more flexible.

Many users are finding the utilities very willing to change from a rigid approach to a customer oriented attitude in anticipation of further changes in the deregulation process. **Now is the time to renegotiate your electric contracts!**

### STATUS OF ELECTRIC DEREGULATION

Deregulation of the electric utility industry began with the Energy Policy Act of 1992. It began at a wholesale level and is rapidly gaining speed. Since many utility companies' transmission systems cross state lines, wholesale deregulation is managed by the Federal Energy Regulatory Commission. By contrast, retail deregulation (Customer Choice) is regulated at a state level by legislatures and utility commissions.

As a consequence, retail deregulation moves at a different pace in each state. Less progress is usually experienced in states where the utility

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companies have the greatest influence. It is reasonable to guess that most states will have some level of retail deregulation in the next three to five years.

## NEW TECHNOLOGY

Just as in the telecommunications field, new technology is beginning to impact the utility companies' traditional generation patterns. In the 60's and 70's, large central coal or nuclear plants took up to 10 years to build; cost \$1,000-\$5,000 per kW; and required 10,000 Btu to generate a kW of energy.

Now, gas fired turbines take one year to build; cost \$300-\$500 per kW; and require 7,000 Btu to generate a kW of energy. These smaller units can be easily located out in the service area, rather than being concentrated in a few central spots. The distributed location of the new units utilizes the transmission system more efficiently.

Better monitoring, controls and communication are allowing the utilities to use the generation more efficiently. Generating units are being more fully utilized.

## UTILITY COMPANY REACTIONS

Utility company reactions to deregulation vary. Most are still opposing change. Others are accepting the inevitable and see many opportunities in providing new services in new territories. All are taking steps to prepare for a future without the security blanket of the regulatory process. There are mergers, downsizing, reinventing, new purchasing alliances, management services between companies and diversifying.

One is reminded of the U.S. auto industry several years ago when everyone realized that they were no longer competitive with the Japanese. Some fought hard for trade barriers to protect them while others got busy and markedly improved their quality and manufacturing proficiency. Now, most of them are quite competitive.

The same will probably hold true with the utility companies. The adaptable will survive. We customers must change also, while taking advantage of their changes so that we can break free from the tightly limited rate structure that we have faced for many decades.

## REGULATORY AGENCY ATTITUDES

The state commissioners are currently charged with the responsibility of administering that portion of the deregulation process that is intrastate. As you might guess, with fifty different agencies, there is a wide variation of attitudes. Some say that the degree that they are favorable to the deregulation effort is strongly related to their ties to the utility companies in their states. In some cases, there has been an exchange of personnel that might raise eyebrows.

Commissions in states with high power costs are the most likely to be aggressive in the deregulation process. The movement favoring some degree of retail wheeling is impressive. Key dates are January 1, 1998, when a number of additional retail wheeling experiments began, and the year 2001, when many think there will be full deregulation. In all states, their legislature has a direct effect on the deregulation process. Many states will see a strong legislative push in the next few sessions of the legislature.

## INDEPENDENT POWER PRODUCERS

A major change in the way that electric utilities do business has been brought about by the independent power producers (IPPs) who are more agile, cost effective and less hampered by some of the regulatory constraints of the utility companies. Their new units are quicker to install, lower in first cost and lower in operating costs. As a consequence, they are very competitive with the utility companies' older, larger plants.

In spite of a considerable effort to hold them down, they are now adding more generation than the old utilities. IPPs offer significant competition that will be helpful for industrials in the future by driving down power costs and offering alternative sources of power.

## POWER MARKETERS AND BROKERS

Another major change is being caused by a new breed of fast-moving operators who have moved over from gas brokering and are now making a market in wholesale power. Power marketers will buy surplus power from one utility and sell it at a profit to a second, who will save money by backing down on some high cost generation or postpone construction of new plants with the purchase. Power brokers do the same but do not take title to the power.

Utilities are selling or retiring their less efficient units and increasing the capacity of their remaining units to meet growing needs. More are also buying power from others rather than generating themselves. As a result, their need of services, such as provided by brokers, is increasing.

Power marketers are doing for the electric utility industry what Sprint and MCI did to the long-distance telephone industry by convincing AT&T customers to change to their service. Some, such as Enron, are now purchasing their own utility companies.

### WHEELING OR TRANSPORTING POWER

FERC 888 provides that no utility can charge more for the use of their transmission lines to wheel power than they charge themselves. This prevents the possibility of a major surcharge that would make wheeling uneconomical.

Currently, there are two types of wheeling charges under study. Postage stamp rates, which charge the same regardless of distance the power is moved, and the kW-mile rate which does consider the distance. Transmission service charges are in the \$1.00-\$1.75 range. It is clear from these figures why there is a rule of thumb stating that it is uneconomical to wheel power more than two utilities away.

### COMMODITIZATION OF ELECTRICITY

A very active futures market is another development caused by deregulation. Again, this addition is patterned after the natural gas futures trading. The new market gives utilities a chance to make more money on their surplus generation rather than leaving it idle. They can optimize their generation and power purchasing to lower their costs.

Energy trading and risk management to dampen the effects of the resulting price volatility present options not previously available to optimize the pricing of electricity. Price discovery is also quite helpful in planning future management actions. Hedging strategies, future basis risk, swaps, and related tools made possible by the market at the New York Mercantile Exchange greatly improves flexibility of power utilization.

Gas is cheaper to move than electricity. Electricity is cheaper to move than coal. There is a strong movement to lump all together as just energy in different forms and buying the cheapest form available. For example, a power plant might be located near a coal mine rather than using unit

trains to move coal to the power plant. The transmission system would move the electricity rather than the coal.

## POWER COSTS

The United States is divided up electrically in regions called reliability councils. The utility companies in each of these councils or power pools, band together to manage power availability within its borders and the inter-ties with other power pools. Although there were power sales on a wholesale basis among the members of each pool, the pricing of this power was not generally known.

FERC mandated that this information be publicly available and we now have access to wholesale power whose price is tracked on an ongoing basis. This is a useful tool in determining what the marginal costs your utility company has to pay for any power purchases. It is interesting to compare this figure with that which your power company is charging you.

## STRANDED INVESTMENT

With deregulation, most utilities will have some generation and power purchase contracts which are no longer cost effective due to lower cost power from other sources. Writing off this investment is vehemently opposed by many of them. Their preferred alternative is to pass these costs on to those who exit their system in order to buy power elsewhere. Utility companies are making an extremely strong effort to be compensated for all of this investment that will no longer provide them revenue.

Currently being debated is one mechanism to recover stranded costs called "securitization." It will allow a utility to recover its stranded costs up front in a single lump sum payment. The term means converting into marketable securities ("securitizing") the present value of the revenue stream anticipated to be produced by customer payments of stranded cost recovery surcharges over a period of, say, five to ten years. Under this plan, the legislature or utility commission irrevocably orders that customers must pay a surcharge as part of their electric bill to complete the bailout of the utility with stranded costs.

Since the bonds are likely to be favorably rated, they will bear interest at rates less than the utility's other borrowings, and some of the proceeds of the stranded cost recovery bonds can be used to pay off pre-exist-

ing debt and thus lower the utility's overall cost of capital. This may result in a token reduction in electric rates but electric rates would be reduced a greater amount and years earlier, if customers could buy electricity in an open competitive market without paying stranded cost recovery surcharges in the first place.

Many say that there are strong indications that some utilities are inflating their estimate of stranded costs, now estimated at \$135 billion. By comparison, the gas industry originally estimated their gas restructuring costs at \$44 billion. The final number was around \$13 billion. These costs were finally allocated between pipeline companies and gas consumers.

There appears to be little interest among utility companies to follow this pattern. Many prefer to delay retail wheeling until this investment can be depreciated in their normal manner.

## UTILITIES' WILLINGNESS TO NEGOTIATE NEW CONTRACTS

For the first time, utility customers are moving from a captive status to having a choice in suppliers. Utility companies can see the day when they must (like private industry) rely on price, good service, customer relations and other benefits to keep their customers. The specter of competition is forcing them to make concessions that were unheard of just a few years ago. Many utilities are attempting to realign their relationships quickly with customers before they lose them to other suppliers.

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### ABOUT THE AUTHOR

**Paul Cunningham, P.E.**, has over thirty years' experience as a consulting engineer and utility executive. He has performed over 100 studies of engineering, financial, managerial and political feasibility for a variety of projects.

In the area of planning and organizing, he developed studies to establish a unique joint electrical utility for four cities with a ten-year capital improvement plan of \$1.7 billion, including a 400 MW lignite generating plant, participation in a nuclear plant, and related transmission facilities.

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