

Should Energy Users Pay for Their Utilities' Stranded Costs?

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Millions of senior citizen shareholders are happy: Electric utility stocks are selling near their historic highs, having completely recovered from the big deregulation-competition scare of 1993-1994. Why worry? Regulators have made a solemn promise: Nobody will lose out when competition comes, least of all the shareholders.

High-cost electric utilities, of course, face the same problem as did other high-cost equated industries at the onset of competition. Once energy users, who are their customers, can choose their suppliers, utilities won't be able to charge more for electricity than the competitive market price. The high-cost utilities will argue that they incurred their costs at the behest of regulators who ordered them to buy overpriced power from favored generators, who prevented them from marketing their product, and who demanded support of costly social and environmental programs. They will claim that their colossally expensive nuclear power stations were constructed at a time when the nation's leaders sought to reduce air pollution and minimize our reliance on foreign oil supplies, and that they built power plants designed to burn government-favored—rather than economical—fuels.

Changing the rules of the game now and leaving the utilities hanging seems unfair because, after all, they argue, they were only acting as good citizens.

All true, but energy users don't care. They know that new, small, clean, modern generating plants produce electricity at costs below what many utilities charge. They know that the next generation of power plants will produce at still lower costs. They surely know that, with the oversupply that exists, they can buy electricity on the spot market at even lower prices.

Electricity suppliers themselves must believe that price will remain

low, because they are signing long-term contracts to sell electricity at prices that don't cover the full costs of existing plant.

To illustrate the situation, the average energy user pays about 7.0¢ per kilowatt-hour (kWh) for electricity. Of that amount, approximately 4.5¢ pays for generation and 2.5¢ for transmission and distribution. New facilities could produce power for about 4¢ or so, depending on location, but planned, highly efficient generation could bring the price down to about 3¢. Spot market purchasers can pick up power at 2¢.

The real problem lies with those utilities—roughly two-fifths of the industry—that price their generating output higher (sometimes 6¢ or more per kWh) because their costs are higher. Those utilities will face serious financial difficulties when they can no longer charge users more than market prices. Can they somehow recover the difference between their total costs and market prices, now called “stranded costs” or, even better, “stranded revenues?”

Regulators, bond rating agencies and brokerage houses have calculated the discounted present value of those lost revenues. Moody's Investors Service, for instance, proposed a \$135 billion figure, a complete disaster considering the common equity of the entire industry is only \$171 billion. Of the 114 companies in the Moody's sample, only 27 would suffer no damage while 24 would face a total equity wipe-out, even after the inclusion of tax credits. The no-harm and the wipe-out groups each account for about 17% of total industry capacity. If Moody's is right, millions of utility investors are in deep trouble.

60% EQUITY LOSS

I attempted a similar exercise, using a more generic approach which assumed that, in the long run, utilities would have to compete against power generation priced in the 4¢-5¢ range, and I arrived at an estimate of \$64 billion in losses. After adjusting for possible tax credits, the affected utility systems would lose 60% of their equity through writedowns if they took no remedial action. In order to offset the loss of revenue, these utilities would have to reduce their power production and purchase costs, excluding depreciation and capital costs, by 25%, or else find a way to recoup the revenues from captive users.

Other industries have undergone similar transformations. They managed to wring out costs, but they also suffered profit declines and

writedowns. Can electric suppliers evade a similar day of reckoning?

Believe it or not, regulators think they have the answer. They will force energy users to pay for the stranded costs by placing a special surcharge on the use of the wires. They reason that whether the user buys electricity from the utility or from an outside source, the user must rely on the utility's wires as the means of transport.

Even a user that generates its own electricity will want that connection to the electric grid as a backup. Users, therefore, continue to be trapped: They will either pay more for the utility's electricity or pay more to transport electricity from others. This surcharge is designed to be unavoidable or "non-bypassable" in the words of California regulators.

(To be fair, though, regulators do characterize their efforts as giving utilities the opportunity to recover stranded costs, rather than guaranteeing actual recovery.) If stock prices are any indication, a lot of people believe that this scheme will succeed.

Unfortunately, the regulators may be out of touch with technology. Energy users, entrepreneurs or the local gas company could install low-cost gas turbines attached to the gas lines—not the electric lines—to serve a neighborhood, office complex or factory. This model is called distributed generation. Attachment to the gas lines presumably provides as much security as connection to the electric grid, so if utilities and regulators impose too high a surcharge, users will opt to leave the electric system.

In other words, the regulators and the utilities can charge as much as they want, but the price and availability of alternative energy supplies, determined by turbine technology and the price and availability of natural gas, will set the upper limit on what they actually collect.

Defending the investments of those millions of shareholders while still bringing the benefits of competition to energy users is a delicate balance that will not be achieved by business as usual. What is needed is a dramatic reduction in operating costs, expansion of sales in order to spread overhead, the realization of what is economically feasible, and the cooperation of regulators. Otherwise, the regulators and utilities will misprice their service and deny lower prices to users of electricity, creating a niche for competitors and adding to the risk of investing in the utility business.

Business acumen and technology—not regulation—will ultimately determine recovery of stranded costs.

ABOUT THE AUTHOR

Leonard S. Hyman, CFA, is a senior industry advisor to Smith Barney. Previously he was managing director of Fulcrum International Ltd., as well as an independent consultant specializing in the economics and finances of energy and telecommunications utilities.

Mr. Hyman has written and spoken on utility finance and deregulation, presenting papers on three continents. He has testified before Congress, served on four advisory panels for the U.S. Congress Office of Technology Assessment, and on one for the National Science Foundation. He was a member of task forces on electric utility efficiency for Pennsylvania and on fusion and other energy sources for NASA. He is on advisory boards for the Electric Power Research Institute and EXNET, and on the editorial board of *Forum for Applied Research and Public Policy*.

Author of *America's Electric Utilities: Past, Present and Future*, co-author of *The New Telecommunications Industry Evolution and Organization* and editor of *The Privatization of Public Utilities*, he has contributed to other books and to professional journals.