

Choice in Electricity: Sound Public Policy

By William F. Hecht*

After intense study of a topic that is of supreme importance not only to our business but to the nation's economy, at Pennsylvania Power & Light Co. we have concluded that increased competition in the electricity generation business is good public policy that will ultimately result in benefits for all the stakeholders of the utility business.

To fully explain why increasing customer choices in choosing electricity suppliers is good public policy, we need to look at why we have had a regulated industry in the first place – and why the electric utility business is among the last to be deregulated.

Economic regulation may make sense in a business that doesn't lend itself to multiple suppliers necessary to create a competitive marketplace – in a situation where there is a so-called natural monopoly.

Historically, we have thought of the electric utility business as such a monopoly. When we look more closely, however, we recognize that the utility business can be thought of as at least two distinct businesses: transmission and distribution: the delivery of the commodity; and, generation: the production of electricity.

The delivery business retains the characteristics of a natural monopoly. It is not appropriate – because of the high capital costs and environmental impacts – to construct competing transmission and distribution facilities.

On the other hand, most of us today would conclude that generation is no longer a natural monopoly – if it ever was. Therefore, as a matter of public policy, we should be working toward a deregulated generation market because a competitive marketplace more effectively encourages efficiencies than does even the best of regulation.

In fact, our current system of economic regulation for electric utilities can actually reward inefficient companies. By setting rates based on the physical plant in service, we actually are encouraging inefficient companies to build more inefficient facilities. For example, by increasing capital investment, a utility can – all things being equal – increase its rates. And, while it's true that the company rate of return may remain constant, the higher rates do result in an increased cash flow – and the perception of stronger financial performance.

A competitive marketplace will change that. In any competitive marketplace, business will shift away from the high-cost supplier to the lower-cost supplier. Over time, more efficient entities will be encouraged to build new facilities to serve customers and the less efficient operations will be discouraged from doing so.

The basic economic rules of the marketplace will produce the desired results: customer needs and supplies will drive prices.

We are convinced that such a system will result in prices for customers that will be lower than they would be under economic regulation. Even though we have done business in a regulated atmosphere for more than 75 years, we at PP&L

believe that economic regulation should be the exception and not the rule.

We should not, generally, have economic regulation if the marketplace can set prices and encourage efficiencies. And, we think that is the case in the generation portion of the electricity business. If one accepts the fact that it is no longer necessary to regulate all aspects of our business, then what would this industry look like if we were inventing it today?

First, there would be an open generation market. Multiple vendors would be in the generation business – and customers would have the opportunity to buy from the vendor they choose. Second, there would be an independent agent operating transmission systems to provide for both reliability and comparability of service for all users.

And, third, there would be one company granted exclusive delivery rights in geographic areas, as is the case today.

Such a system would provide customers with the reliability that they have come to expect at competitive prices. Obviously, my discussion until now has been a bit of an oversimplification in at least two respects:

First, we are not building a new industry. On the contrary, we have in place a complex, reliable and valuable system that has served us well up to this point.

Second, few economic systems operate in a purely free market. Social and other considerations must be accommodated.

The real challenge, then, is designing a transition to get us from where we are today to that competitive future – and to do it in a way that meets the needs of all constituents.

As we have been involved in this process, we are articulating four important principles that we believe are essential to this transition process:

1. All customers and suppliers must have access to the competitive marketplace; certain classes must not benefit disproportionately.

As the debate on customer choice has matured, we have all but discarded a notion that industrial users should be treated as wholesale customers, a concept that was expressed early in these discussions.

Today, there is general agreement that choice must be made available to all customers; residential users must be offered options as well as larger customers.

2. This transition must not endanger the reliability of the United States electricity system – which is widely considered the best in the world.

An important component in ensuring continued reliability is the concept of an Independent System Operator. The ISO, in a properly designed system, will ensure reliability by actually handling the day-to-day operation of the transmission system in a given region. The ISO also will ensure that there is comparable access for all customers and suppliers.

At PP&L, we believe that the consensus proposal filed earlier this year by the Pennsylvania-New Jersey-Maryland Interconnection represents an excellent example of how an ISO could accommodate a competitive marketplace while providing for competitive pricing.

First, let me explain how PJM operates today: All utility companies share information regarding the incremental cost of operation for each unit. The PJM office then dispatches facilities according to costs, regardless of which company

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owns a particular plant. As a result, none of the nine utility members of PJM actually generates exactly its load. Instead, the most efficient units run and the energy that is exchanged among companies is priced at the point midway between incremental and decremental cost.

Obviously, in a competitive marketplace, utilities and other suppliers will no longer be willing to share cost data as they are today. Instead, under the proposal we have filed with FERC, each supplier will place a bid with the ISO for supplying power on the following day. The ISO then will set a price for the following day and all suppliers that are dispatched the following day would receive that price – basically the market clearing price.

The plan also accommodates two-party transactions. Of course, this is a simple explanation of the concept, the filing is much more complex than this. We believe this ISO structure will provide us with the best of both worlds: continuing high reliability and competitive pricing.

3. Social programs now being supported by utilities must remain intact.

We must ensure that those who have difficulty paying their electricity bills are not disadvantaged by the move

toward competition. We also must make sure that environmental programs are not endangered by an increase in competition.

4. We must address recovery of utilities' stranded costs.

This component of the transition process has been discussed in great detail in a variety of forums, so there is little reason to fully examine it here. Suffice it to say that it is now generally accepted that the transition process must include a method for ensuring that utility shareowners are treated equitably as we move into a more competitive marketplace.

By addressing these basic principles, we believe that an equitable transition process can be designed – and implemented promptly. It is entirely possible for customers to be choosing their electricity suppliers before the end of this decade in Pennsylvania, for example.

In summary, we believe that more competition in the generation market is good public policy – a policy that should be adopted nationwide. This more competitive marketplace will result in further improvements in the competitiveness of American business and industry in the global marketplace.

Deregulation of the Electricity Sector in Germany

After many years of negotiation between the member countries of the European Union, a new European directive regulating the electricity market will be issued shortly.

The philosophies of regulation in the various member countries range from the market oriented pool system in the United Kingdom to the state controlled national monopoly in France. The European Union does not have the power to change the internal legal framework of member countries. The directive, therefore, leaves many details to national legislation. The basic idea of the directive is to open the electricity market at least for large customers. This requires access to the grids which can be achieved either by so-called negotiated third party access (private negotiation between customer, grid owner and supplier) or the single buyer model. In this model (tailored for French needs), the monopolist retains control of all activities but has to guarantee free access at published network prices.

The German government proposes to abolish all restrictions on electricity trade within the country. If the proposed reform law goes through parliament, all electricity customers will be able to choose their supplier in the future. Access is via negotiated third party access. At present no regulation of access pricing is being considered. According to German tradition the government would prefer for interested parties to reach agreement on these controversial issues by themselves. The law, however, has to pass the second chamber (Bundesrat), the representatives of the states (Laender).

In the Bundesrat there is strong opposition against this far reaching reform. Many states fear that a far reaching deregulation without clearly regulating access might lead to discrimination against local utility companies which traditionally produce a high share of power used in large urban areas, often in combination with heat. The union of electricity producers (VDEW) is at present developing a model for

network pricing which is based on American experience. This will require that a specific network price be calculated for each case of third party access. As the government proposal does not require the publication of network prices but leaves them to the parties involved, industrial customers fear that the possibility of trade will remain rather theoretical due to the high transaction costs involved in setting up individual contracts case by case.

In addition, critics argue that a dedicated regulatory agency would be required to resolve all disputes over TPA matters whereas the government maintains that the general competition law will be sufficient and resolution of conflicts should be left to the courts. Considering the time required for court proceedings (often years) and that judges and lawyers are not experts, it is assumed that this will slow down the process of change in the sector. It is quite clear, however, that due to the high level of electricity prices in Germany, industrial customers are willing to make use of any probable benefits of competition and also will make use of small margins.

Whatever the legislative outcome will be, deregulation is being anticipated now in utility companies of all levels. Some large companies are reorganizing in order to separate production from grid activities. Most companies have realized that marketing will be a very important tool in the future to keep customers. Also energy services are being considered as additional products to be offered. The GEE (Gesellschaft fuer Energiewissenschaft und Energiepolitik) – the German affiliate of IAEE – is actively involved in the ongoing process of reform by conducting meetings and seminars. Information about our activities is available from the Internet at the following address: <http://ourworld.compuserve.com/homepages/ged>

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