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U.S. House Budget Committee. June 20, 2001

Mr. Chairman, Members of the House Budget Committee,

It is an honor to appear before you as a representative of the American Legislative Exchange Council. The American Legislative Exchange Council is comprised of 2400 Democrat and Republican state legislators who have a keen interest in free market enterprise and individual freedom.

ALEC's Energy, Environment, Natural Resources, and Agriculture Task Force has been carefully monitoring the situation in California. We have created an Energy Working Group tasked with evaluating the current status of energy generation and distribution in all 50 states. Specifically, our goal is to provide a menu of policy options to assist state lawmakers who wish to adopt an effective energy legislative package that provides affordable electricity in a competitive market to the homes, businesses, schools, and health care facilities of our citizens. Today, I would like to provide you with an update on restructuring in the states and list what responses, if any, the states had to the California energy crisis.

CURRENT STATUS IN RESTRUCTURING

Since the early 90's, the states have individually been studying whether they should deregulate their utility markets. To date, 26 states and the District of Columbia have enacted some form of electric utility restructuring, through legislation or regulation, but not all of those states have adopted final rules governing restructuring. Many are phasing in components of a market-based structure either through legislation, regulation, or by executive order.

All of the states have initiated a review of the fiscal implications of deregulation and are considering a revision of portions of their tax codes to accommodate restructuring in a variety of ways. However, it should be noted that in light of the recent black outs in California, a few states have delayed restructuring until the situation is thoroughly evaluated.

The states that historically had the highest prices for electricity, such as California, Pennsylvania, New York, Connecticut, and other New England states were among the first to enact deregulation and opened their retail markets to allow customers to choose suppliers. Other states proceeded cautiously, limiting the number and type of customers getting access to competitive markets. The major goal of deregulation was to lower the price of electricity through a free market system. We have to remember, that at the time of the national debate over deregulation, the driving issue was the high cost of

electricity in a regulated environment. To that end, industry analysts cite Pennsylvania as a success story, and California as providing us with lessons to be learned.

Market Structure

States have used two types of structures to facilitate operations in a restructured market. The Independent System Operator is designed to provide nondiscriminatory open access to transmission. A Power Exchange is an open bulk power market for sales of electric power for resale. Primary regulatory authority over these entities resides at the Federal Energy Regulatory Commission and not in the states. A majority of the restructured states assumed this type of system as a basis for their restructured markets.

Nine states (AZ, AR, IL, MI, OH, TX, VA, and WV) and the District of Columbia directed their utilities to transfer the control of their transmission assets to an independent transmission organization. (AR,MI,OH,VA, and WV) A few of these states allow other types of regional organizations. Michigan and Ohio allow utilities to choose between transferring operation and control of their facilities to an ISO or divest their transmission assets. Texas is unique in that it divides itself into four power regions that correspond to the four NERC regions that are within Texas. Each power region must establish an ISO or a transmission company.

The Power Exchange was first formed in California under their restructuring legislation. The northeastern state power pools began as PX, but changed to ISO's.

Divestiture

In the restructuring language of several states, divestiture of generating assets has either been required or encouraged for the purpose of increasing competition between power generators, reducing the risk of electric company monopolies, and providing an opportunity for stranded cost recovery incurred by utilities for investments in power plants or long term contracts under a regulatory environment that may not have been recovered in a free market competitive environment. According to the Department of Energy only 16% of all electric utility generating capacity had been sold to unregulated companies or transferred to subsidiaries by the year 2000.

Some states have only allowed competitive services to be provided by separate affiliates, which is a structural approach to regulate affiliate transactions, rather than governing the relations between competitive business functions through regulation. CA, CT, ME, NV, NM, and RI require competitive services only through affiliates. New Jersey has authorized the NJBPU to impose competitive services. CA, ME, NV, and VA require a public service commission pre-approval of certain competitive activities.

Divestiture has been required in statute by two states, New Hampshire and Maine. Most of the states that have restructured have encouraged or required incumbent utilities to divest all or some of their generation assets through regulatory orders. The thought

was to reduce the market power of the incumbent utilities or use the sale of an asset to determine its value for stranded cost calculations.

Michigan and Texas use divestiture as an alternative in a menu of options. They use capacity auctions with parameters. CA and NY encourage divestiture, but have not required it. Utilities in both states have divested most of their non-nuclear assets. Several states differentiated between nuclear assets and fossil fuel assets. Divestiture of nuclear assets were either deferred or delayed for long period of time. Five states, AR, DE, NJ, NV, and OR have permitted their public utility commissions to order divestiture. AR, DE, and NJ have standby authority to intervene if they desire, NV chose to limit ownership of generation and transmission facilities. Oregon provides incentives for divestiture.

CT, MA, and RI linked divestiture with stranded cost recovery. MA requires all utilities that seek stranded cost recovery must divest all non-nuclear generation assets; RI requires at least 15% of non-nuclear generation divestiture. CT requires divestiture or transfer to an affiliate. If the assets were transferred to an affiliate, then the utility may not recover stranded costs.

Pricing and Marketing

Pricing for transfers of assets and services between competitive and regulated operations has been an issue in some states. Asymmetrical pricing, which bases prices for transfers from utility to affiliate on the higher of fully allocated cost or market value, and from affiliate utility at the lower of fully allocated or market value is in effect in CA, MA, and NV. Symmetrical pricing, (market value pricing for all transactions) is only in effect in Texas.

There are a wide variety of rules for marketing between competitive and noncompetitive operations in a number of states. Joint marketing is banned in eight states. (CA, CT, IL, ME, MA, OR, TX, and West Virginia.) Five require affiliations with a corporate name to use disclaimers. (CA, CT, MA, OR, and Texas.) Maryland and Maine require royalty payments by the affiliate for using the corporate name.

Energy Efficiency

Most of the state restructuring plans have provisions for energy efficiency programs. These programs are funded through a mechanism called a System Benefit Charge (SBC). This is a use charge levied on end users by the distribution utility. Twelve states have this type of fee (AZ, CA, CT, DE, DC, MA, MT, NJ, NY, OH, PA, and RI.). The amount varies state to state. Only four of those states have set a time limit on the SBC. Twelve states that have initiated a System Benefit Charge. In OH, the SBC funds a revolving loan program for energy efficiency.

States Delaying Restructuring

As I mentioned previously, a few states have delayed implementation of restructuring. Oklahoma, Oregon, Nevada, New Mexico, and a power pool in Texas fall into this category. I would like to speak to those states specifically.

Oklahoma enacted Senate Bill 440, which establishes an electric restructuring advisory committee to the Governor and the Legislature. The previous deadline for restructuring of July 1, 2002 has been eliminated. Restructuring will be implemented subsequent to the issuance of the final report of this advisory committee and the adoption of electric restructuring legislation by the Legislature and signed by the Governor. Tax credits were put into place for electric generators that have zero emission facilities.

Oregon drafted a bill, to delay deregulation until 2003. The debate is focused on the crisis in California and the continuing drought in the northwest. The two most contentious issues are the establishment of a 3% “public purposes” surcharge and a potential date for deregulation. This has passed the House and is now in the Senate.

Nevada passed legislation, signed by the Governor, to halt electric restructuring until they can determine the impact of California’s crisis upon the western grid. Their primary concern related to the stability of power supply due to the increase in natural gas prices and the drought. However, A.B. 5 (formerly HB 661) which passed both houses allows large users the ability to purchase electricity on a competitive basis is pending the Governor’s signature.

New Mexico delayed implementation of deregulation for a variety of reasons. The price of electricity is low and there is not a lot of political pressure to deregulate. Of utmost concern was revamping their tax code, and legislation was introduced to compare their tax structure in a regulated and deregulated environment.

Texas passed legislation that delayed restructuring in only one portion of the state that is covered by the Southwest Power Pool until 2007. This delay is in compliance with their restructuring law that allows the state to delay any portion of their grid if it appears that there would be a lack of choice. (The bill, is pending signature by the Governor.) That portion of the state, the Panhandle, shares a grid with New Mexico that has one dominant power supplier. The rest of Texas is fully deregulated and has a 40% over supply of power. Their intent is to build another power plant and transmission lines in their western grid to complete restructuring throughout the state.

States that have not formally deregulated by legislative action are actively studying restructuring to determine how their individual states may be impacted. It is important to note that state revenues are tied to public utilities and that electric restructuring requires a review of the tax code to ensure that the existing tax system does not distort a competitive market.

California Crisis

The electricity crisis in California, while it has serious short-term effects for residents in California, can best be described as an anomaly for the rest of the nation. There are many factors that came into play and no one, in industry or policy, predicted the current situation.

The faulty regulatory scheme in California is only one aspect of the power supply problem. The current prices of natural gas, coupled with a gas pipeline breakage incident in August of 2000, and lack of significant generation and transmission infrastructure development have adversely affected the availability of power. 46% of the electricity consumed in California in 1999, was fueled by natural gas. Furthermore, the drought over the past 2-3 years has decreased the availability of hydropower further increasing California's dependence upon natural gas as a fuel for electricity generation. Given the significant growth in electronic commerce in the high tech industry over the past five years, no one in 1996 anticipated the high demand for electricity today.

No new power plants of a significant size had been built in California in ten years. Typically, 20% of the power supply had been imported. That percentage has increased and has been affected by the amount of growth and increased demand for power in neighboring states in the Western grid. What new power plants that have been built in the west have been fired by natural gas. The price of natural gas quadrupled between 1998 and 2000, from \$2/millionBTU to \$8/millionBTU. In the California market, which had a pipeline break, the price jumped to \$60/millionBTU. (1000 cubic feet). Now with more than 50% of its power supplied by natural gas, it is no wonder that California is paying a high price for electricity. States with a more diverse source of power have been better able to absorb the national price spike of natural gas.

When evaluating California's restructuring scheme, it is clear that deregulation, did not, in effect, take place. The biggest structural defect is the requirement placed on utilities to purchase all of their energy needs on the daily spot market, which is the California Power Exchange. No other state has this requirement. Unfortunately, about 60% of the current supply is purchased on the spot market. In comparison, other power markets, such as the Pennsylvania, New Jersey, Delaware, and Maryland area only have a maximum level of 20% purchased on the spot market. The second structural defect is the capped retail rates. The three utilities in California ran up over \$12Billion in debt purchasing electricity from the CalPX and selling it at capped retail rates. This is no way to run a business in any market, much less a free market. Because rates are capped, consumers have no incentive to change their behavior. In short, California has a pricing problem, not a deregulation problem.

Economic Impacts of Deregulation

Very few states have fully deregulated their electric utilities. Each state has developed a unique market structure and has implemented its own timetable for full restructuring. To that end, there is very little quantifiable data that effectively measures

the economic impact of deregulation. In their fiscal survey released in December 2000, the National Association of State Budget Officers did not indicate any significant adjustments in state budgets that correlate to deregulation or the energy crisis. In reviewing state revenues, it is clear that the states are collecting funds through a variety of mechanisms that can be utilized for relief if necessary.

The critical question at this point is to determine if the federal government should intervene with any legislative actions. In my opinion, it would be premature to introduce legislation at this point in time. You would run the risk of hampering the efforts at deregulation or even worse, exacerbating the power supply shortage. We should evaluate California carefully and use it as an opportunity for lessons learned. No states have fully implemented restructuring for a length of time to collect sufficient data to evaluate the economic effects of deregulation. There simply is not enough information to determine the positive or negative impacts of electric restructuring in the states.

Mr. Chairman, now is *not* the time to constrain market forces, but to unleash them. The market forces will correct the current shortage of supply as we build more power plants and enhance our infrastructure. The states should proceed as they see fit. The states collect a significant amount of revenue through their utility and fuel taxes. For example, when the gasoline prices escalated last year, Illinois and Indiana suspended their gasoline tax for a short duration. Michigan reduced its electricity tax. The states always have the option of repealing or suspending their utility tax or fuel tax if they are concerned about high prices.

I would like to recommend two options to the Committee. I do think it would be appropriate for this Committee to commission a comprehensive study of the current state of electric restructuring in the nation and its impact upon the fiscal status of the states. This should be done before any federal legislation is considered.

Secondly, small businesses can be adversely affected in an energy crisis. They may not have reserve power generators like the large commercial enterprises. They could easily shut down in ninety days. A rational way to provide relief would be to relax the regulatory guidelines that govern the allocation of small business grants or low-income assistance funds to maintain fiscal stability, on a prorated basis, for those small businesses that are clearly struggling in a power shortage.

Thank you.