

## **Electricity Deregulation is Sure to Set Off Sparks**

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The electric utility industry in the United States is presently undergoing a structural transformation, the outcome of which may be that Arkansans will soon be able to select their electric company just as they choose a long distance service provider. To date, 16 states have adopted plans to introduce competition to retail markets for electricity. But the state legislature and Arkansas Public Service Commission (PSC) must first resolve some thorny issues before a more competitive retail market for electricity in Arkansas can become a reality. One issue has to do with allowances made for the recovery of so-called "stranded costs" by integrated power companies that stand to lose their regional monopolies as a result of deregulation. Another tough issue: should the PSC saddle incumbent utilities (such as Entergy and the Arkansas Electric Cooperative Corporation) with "competitive handicaps" to prevent them from retaining dominance in their former service territories?

State regulatory commissions have generally mandated that public utilities subject to their authority maintain generating capacity sufficient to meet peak demand. Power plants are typically financed through the issue of long term debt, a method that establishes a future stream of contractual payments of interest and principal. Also, many companies have long-term contracts to purchase fuel and other materials. These are expenses that could not be avoided even if the company suffered a substantial loss of market share in a deregulated environment (hence the term "stranded cost").

The forthcoming deregulation bill will likely permit utilities to recover their stranded cost through the imposition of a competitive transition charge (CTC). So even if you decide to dump Entergy as your power company (Entergy currently has 620,000 customers in Arkansas), you may still wind up paying for its Grand Gulf Nuclear Station by way of a CTC. The problem is to make sure that the CTC is an offset for legitimate, unavoidable costs and not a gratuity to big power. Much will depend on whether the PSC is able to arrive at reasonable estimates of stranded cost (no simple task, as it turns out).

The term "electric utility industry" in fact refers to three activities (or stages of production): power generation, transmission and distribution. Power transmission and distribution fit into the category of "natural monopoly," the term used by economists to describe a market situation wherein, due to the presence of

economies of scale, a single firm can supply a socially optimal quantity of output at the lower total cost than 2, 3, or any number firms could. Most likely we are describing a basic service (natural gas, telephone, water, cable TV) provided to a vast number of users. The provision of these services normally entails the construction of a costly delivery infrastructure. As the customer base expands, the fixed cost of infrastructure can be spread more thinly across users--thus diminishing average cost as the scale of output expands.

No one is suggesting that the exclusive franchise of distribution units be eliminated. Electricity deregulation is really about the unbundling of power generation from power transmission and distribution. The integrated utilities will continue to have a monopoly on distribution in their service areas, but will be faced by competition in the retail segment by power marketers located both in Arkansas and out of state. The danger is that the former utility monopolists will be able to leverage their control of distribution networks to foreclose the market to retail competition. For example, the distribution unit may gain advantage over rivals by offering cheap retail rates that have been cross-subsidized by distribution charges. Moreover, incumbents may be able to create barriers to entry by the unfair use of competitively advantageous information they gain as the customer's regulated distribution company.

Several states, in an effort to create a level playing field in retail electricity, have imposed competitive handicaps on incumbent utilities. In the most extreme case, integrated utility companies are forced to divest of power generation assets. For example, the Massachusetts plan makes the recovery of stranded costs contingent upon the spin-off of power generating facilities. Another handicap entails placing an upper limit on the share of total retail electricity the distribution monopolist can sell in its service territory. Regulated utilities as a rule oppose competitive handicaps and claim that they undermine consumer choice.

If history is any guide, the deregulation of the electric industry will produce both winners and losers. The almost certain winners will be large industrial and commercial users of electrical power. Will residential users end up in the "winners" category? A lot depends on the answers that the state's politicians and regulatory officials ultimately provide to the difficult questions raised above.