UNREGULATED UTILITY AFFILIATES:
IT’S **NOT** TIME FOR A CHANGE

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It is easy to point to spectacular failures in the industry – situations in which utilities have been dragged down by the disastrous performance of unregulated affiliates.

There was far less concern when unregulated businesses were enhancing shareholder value and increasing bond ratings through diversification and high profits.
If the economic downturn had occurred in a regulated environment, utilities would have been stuck with excess generating capacity and ratepayers would have suffered anyway.

It is important to not be too hasty. Well-planned diversification into unregulated business can be a win-win situation for ratepayers and shareholders.
UTILITY AFFILIATE EXPANSION INTO UNREGULATED ELECTRIC ACTIVITIES CAN BE BENEFICIAL TO CONSUMERS

- Competition – at least at the wholesale level – is critical to economically efficient utility operations.

- Utilities cross-selling into each others’ service territories provide only limited benefits.
  - Incentives are limited because profits are returned to ratepayers.
  - Utilities “compete” only with unneeded energy.
UTILITY AFFILIATE EXPANSION INTO UNREGULATED ELECTRIC ACTIVITIES CAN BE BENEFICIAL TO CONSUMERS

continued

- Entirely independent companies are not making significant inroads in generation or transmission.

- Utility affiliates are the natural choice to enhance competition.
COMPETITION AND DEREGULATION MUST BE “MANAGED” TO PREVENT ABUSE

- Returning to a fully cost-based regime is impossible and unnecessary.
  - Non-utility generation accounts for a significant portion of the nation’s total capacity.

- BUT – the electric industry will never be fully deregulated.
  - Large generation owners can exercise market power in some instances.
  - Transmission monopolies may remain in some regions for a substantial period.
INTER-AFFILIATE RELATIONSHIPS ARE HEAVILY REGULATED

- Affiliate transactions are regulated by many states and (for registered holding companies) the SEC.

- FERC’s Code of Conduct requires separation of utility and non-utility operations.
  - The utility and its affiliate must operate separately.
  - The utility and its affiliates must exchange market information only pursuant to EBB-type postings.
  - The utility sales of non-power goods and services to an affiliate must be at the higher of cost or market.
The affiliate sales of non-power goods and services to the utility must be priced no higher than market.

Affiliate power sales transactions are closely regulated.

If an affiliate brokers utility energy (or vice versa) the utility's power must be offered first.

Many state utility commissions impose similar restrictions on affiliate relationships.
REGULATION OF UTILITY/AFFILIATE OPERATIONS CAN BE TOO RESTRICTIVE

- FERC has refused to explain the Code of Conduct or evaluate procedures designed to implement it.
- FERC’s procedures can adversely affect utility/affiliate risk management practices, increasing financial risk.
  - Exchanges of market information can be unreasonably restricted.
  - Coordinated credit risk and market risk activities can be impaired.
REGULATION OF UTILITY/AFFILIATE OPERATIONS CAN BE TOO RESTRICTIVE continued

- FERC rules on affiliate transactions have conflicted with SEC rules for years.
  - SEC requires affiliate transactions to be priced at cost.
  - In combination with FERC rules, affiliate transactions are at the lower of cost or market.
- State have imposed rules on affiliate wholesale power sales that exceed their jurisdiction.
FERC’s PROPOSAL TO REGULATE UTILITY CASH MANAGEMENT PRACTICES IS UNNECESSARY

- FERC proposed to prohibit utility participation in cash management arrangements unless:
  - the utility has a minimum proprietary capital balance of 30%;
  - the utility and its parent have investment-grade credit ratings.

- FERC’s proposed rules conflict with (or at least replicate) the rules applicable to registered public utility holding companies.

- The proposal also conflicts with or replicates many state utility commission requirements.
FERC’s PROPOSAL TO REGULATE UTILITY CASH MANAGEMENT PRACTICES IS UNNECESSARY continued

- FERC hasn’t established a persuasive legal or factual basis for its proposal.
- EEI recommended exemptions for utilities whose LMPs are regulated by the SEC or state commissions.
- EEI recommended liberalization of the capitalization requirement and the investment grade requirement.
HOW CAN UTILITIES BE PROTECTED FROM AFFILIATE OPERATIONS?

- There is no substitute for good utility management. Good management can be a result of a competitive, unregulated business.

- Commissions can provide oversight, but they cannot micro-manage utilities or their parent companies and affiliates.

- Capped rates or rate freezes frequently have been the quid pro quo for restructuring and managed competition.
HOW CAN UTILITIES BE PROTECTED FROM AFFILIATE OPERATIONS? continued

- FERC or State Commissions may want to establish guidelines on utilities lending money to affiliates and establish a rebuttable presumption that compliance with the guidelines is prudent.

- Traditional “imprudence” disallowances can protect ratepayers from bad management decisions.

- Commissions can adjust ROE allowances to offset increased costs related to depressed credit ratings.