



Electricity Restructuring and Rate Caps

With electricity rate caps expiring, state lawmakers are concerned that Pennsylvanians will see steep increases in their utility bills. What will happen as the electricity deregulation, which is more accurately called electricity restructuring, process ends? What should lawmakers do?

BACKGROUND

- In the 1990s, Pennsylvania's electricity rates were **15% above the national average**.
- The General Assembly passed the Electricity Generation Customer Choice and Competition Act (HB 1509) in 1996, to **allow retail competition among generation companies** in order to lower consumer rates (transmission and distribution continue to be tightly regulated).
- According to the PUC, **generation accounts for approximately 60%-80%** of each electricity bill.¹

RATE CAPS AND STRANDED COSTS

- Rate caps based generation costs on 1996 prices to give consumers **temporary protection from price fluctuations** as electricity generation became subject to wholesale market competition.
- Rate caps were placed on both the generation and the distribution of electricity. The distribution caps have expired, but generation caps are still in effect for the majority of Pennsylvanians.
- Unlike other states, Pennsylvania's rate caps were set to expire incrementally. Rate caps have already expired for six utilities in Pennsylvania with mixed results—**some have experienced rate increases, others had rate decreases**.²
- If rate caps are extended, competition will continue to be stifled, leading to higher rates. **Rate caps only offer the illusion of price stability**.
- After the Competition Act became law, utilities petitioned the PUC for \$18 billion in stranded costs (generation-related investments a utility expected to recover from consumers under old regulations). They were **allowed to collect approximately \$11 billion in stranded costs from consumers in the form of itemized charges called "competitive transition charges" (CTCs)**.
- When rate caps end, these stranded costs or CTC's will end.
- Rate caps were extended to 2010 or 2011 because the original expiration dates arrived before companies recovered their total "stranded costs."

HAS DEREGULATION LOWERED PRICES IN OTHER STATES?

- Texas has been successful, with rates slightly lower than they would have been under regulation. Today, consumers can choose from 28 providers offering almost 100 different plans, compared to four providers with 17 plans in 2002.³
- Recent data from the U.S. Energy Information Agency demonstrates **there is no relationship between deregulation and increased electricity rates**, which have consistently risen for all 50 states since 1996. While deregulated states have high power costs, they also had higher costs before deregulation.
- The California meltdown occurred largely because the Golden State's generation industry was not fully deregulated. Utilities were forced to buy power on the more expensive spot market (buying power as it is needed), and were barred from long-term contracts. As a result, "deregulation" was repealed, leaving utilities with excessive debt and consumers with high-priced, long-term power contracts.

WILL RATES INCREASE?

- Generation **prices will rise at different rates throughout the Commonwealth** because rate caps were frozen at each utility's regulated rate in 1996.
- According to recent PUC price estimates comparing capped rates and current market prices, residential rates are expected to fluctuate from a 7% decrease to a 30.4% increase with a weighted average of an 11.84% increase.⁴
- This information is helpful, but some utilities have already purchased **future long-term supply contracts**. These purchases allow utilities to **hedge against extreme price fluctuations** in the marketplace, but also create a lot of unknowns for the supplier.

WHAT IS DRIVING THE COST OF ELECTRICITY?

- When adjusted for inflation, Pennsylvanians are paying **12% less** for their electricity today than they were in 1996. Meanwhile, the market price for electricity, like most commodities, has increased.⁵
 - **Fundamental market changes.** Rising manufacturing costs have made the entire process of generating and delivering electricity more expensive.
 - ⇒ The cost of fuel has risen rapidly; between 1999-2008 the **cost of coal increased 200%**, while **natural gas experienced a 300% increase**; however, prices have recently decreased.⁶
 - ⇒ The **cost of building an electricity plant has risen 130%** in the last seven years.⁷
 - **Taxes.** Pennsylvania's Gross Receipts Tax on electricity generation suppliers is the **only tax of its kind in the nation**. Currently, the rate stands at 5.9% (the tax generated \$730 million for State government in 2005) —a cost passed on to consumers.⁸
 - ⇒ The Gross Receipts Tax on natural gas was eliminated during that industry's deregulation process.
 - **Mandates.** Mandates, including mercury emission regulations and the Alternative Energy Portfolio Standards (AEPS), will make energy more expensive to produce and more costly to consumers to purchase.
 - ⇒ By 2015, the AEPS will require 18.5% of all electricity generated from alternative sources—in 2007, only 5.7% did. Included in this is a requirement that 900 Megawatts come from solar power generation—this is 50% higher than solar power capacity for the **entire United States in 2007**. Current legislation, HB 80, would increase these standards
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by 83% before the impact of the original mandates are felt. Furthermore, alternatives like solar and wind energy require expensive back-up generation. Forcing resources to be used for inefficient and expensive alternative energy increases the cost of electricity.

- ⇒ Act 129 of 2008 places more restrictions on the operation of utilities in the name of conservation. The law mandates that utilities cut annual consumer electricity usage by 1% as of May 31, 2011, and 3% by 2013, along with reducing use during the 100 peak hours of the year by 4.5%.

WHAT ARE THE BENEFITS OF RESTRUCTURING ELECTRICITY?

- Before competition existed among generators, consumers could not choose how or where their electricity was produced, and they had no freedom to shop for cheaper rates. **Since 2001, all Pennsylvanians have been free to shop, but little competition has developed.** Approximately 20% of customers in Duquesne Light territory, who consume 50% of the load delivered by that utility, have opted for alternative suppliers.⁹
- The **incentive for innovation increases** if generation companies are free to respond to market forces with their own prices. If plants refuse to improve their efficiency, they can be replaced by independent providers.
- With competition, generators have an incentive **to reduce operating costs and continually invest in the clean generation technologies consumers are eager to support.** One example is the wind energy options unveiled by Allegheny Power.
- Investors will bear the burden of risky investments instead of consumers.

LEGISLATIVE PROPOSALS TO ADDRESS RATE CAPS EXPIRING

- **Extending rate caps.** Some legislators have suggested maintaining rate caps, but **this will only prevent competition and push inevitable rate hikes further down the road,** discouraging conservation and construction of additional capacity.
 - **Phase-in plans.** Many lawmakers and utility companies favor phase-in plans, whereby rates will gradually rise for all consumers; however, deferred payments and customer credits do little to mitigate the cost to consumers, and could produce legal action from utilities who have made critical decisions based on the current timeline.
 - **Pre-payment plans.** Already in place for PPL and Met-Ed customers, these allow consumers to pay more now so they can gradually increase payments and avoid a sudden jump later. The PUC has also approved PPL's deferred payment plan.
 - **Conservation.** Many believe conserving power is the best way to decrease costs.
 - ⇒ Conservation methods embrace **demand-side response mechanisms like real-time pricing and time-of-use rates.** Using these technologies, customers would see when electricity is more expensive and conserve accordingly.
 - ⇒ Recently, legislators have begun to mandate the type of conservation measures utilities must use, namely "smart meters."
 - **Education.** As rates increase, consumers will have greater incentive to shop for electricity. As most consumers have never done so before, consumer education will spark competition.
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RECOMMENDATIONS

- **Allow rate caps to expire.** Other states, like Texas, have seen greater competition and lower prices than would have occurred under regulation. Continuing to cap rates will delay real competition and undermine the financial viability of new generators. The short-term pain will lead to long-term gain.
- Retarding the restructuring process at a time when the federal government is debating further environmental regulations will exacerbate the situation, leading to a dramatic rise in electricity rates.
- **Reduce or abolish the state Gross Receipts Tax on electricity.** When electricity prices increase, the taxes paid by consumers on their energy bills will also rise. Reducing the Gross Receipts Tax rate will lessen the burden on consumers.
- **Repeal excessive environmental regulations,** which inhibit fuel-based coal and other low-cost options while driving up the price of electricity. State regulations that are more severe than federal EPA regulations place an unnecessary burden on electricity generators, increase the cost of doing business in Pennsylvania, and increase the costs passed on to consumers. If anything, **legislators should reward environmental consciousness instead of punishing the lack of innovation.**
- **Repeal mandates on power companies to use a certain percentage of wind, solar, and other sources as part of an “alternative energy portfolio.”** These mandates make electricity more expensive to consumers by forcing producers to rely on higher-cost sources. Alternative energy sources are desirable, and many consumers will choose alternative energy sources, but competition and market prices will incent generators to develop new, cost-efficient technologies without subsidies.
- **Allow utilities to craft and implement their own rate mitigation plans and keep politicians out of rate-setting processes.** A free market is the best mechanism for setting prices, giving electricity providers an incentive to provide a competitive rate. Government pricing schemes are always set incorrectly.
- Legislators should not mandate explicit types of demand-side response technology such as smart meters. Electricity providers are already implementing smart meters, which may not conform to those required under new legislation.
- Consider **real deregulation of the electricity markets,** reevaluating the best way to structure a truly competitive marketplace.

Endnotes:

1. PUC, “Energy Restructuring and the Transition to Competition in PA” September 2007.
2. Rate caps have not expired in PP&L, West Penn Power, Penn Electric, Med-Ed, and PECO territories.
3. *Texas Electric Meter*, a publication of the Texas Public Policy Foundation, March 2008, <http://www.texaspolicy.com/pdf/2008-03-RR02-ElectricMeter-proof.pdf>
4. PUC Electric Price Estimates, April 2009.
5. Testimony of Lisa Crutchfield before the House Republican Policy Committee, July 30, 2008.
6. Testimony of Doug Biden on behalf of the Electric Power Generation Association before the Pennsylvania Public Utility Commission, December 18, 2008.
7. Ibid.
8. Carnegie Mellon Electricity Industry Center, “Competitive Energy Options for Pennsylvania” January 11, 2007, http://wpweb2.tepper.cmu.edu/ceic/pdfs_other/Competitive_Energy_Options_for_Pennsylvania.pdf.
9. Percentage of Customers Served By An Alternative Supplier, provided by the Pennsylvania Office of Consumer Advocate, April 1, 2009.