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WAYNE SHIRLEY¹

Application of National Association of Regulatory Utility Commissioners Principles to Guide the Restructuring of the Electric Industry to Issues of Bypass^{**}

At its summer committee meetings in Los Angeles, on July 25, 1996, the National Association of Regulatory Utility Commissioners adopted its "NARUC Principles to Guide the Restructuring of the Electric Industry." The NARUC Principles are set forth as a general principle followed by 10 specific principles. Each principle has a primary statement which is followed by a short explanatory statement. Although not written to specifically address issues related to bypass, public policy choices relating to bypass, as well as all other policies implicated by restructuring of the electric industry, should be analyzed in light of these principles. Each of these principles is presented below with commentary on their relationship to bypass issues.

GENERAL PRINCIPLE

Consumers should have access to adequate, safe, reliable, and efficient energy services at fair and reasonable prices at the lowest long-term cost to society.

Structural changes in the industry should be encouraged when they result in improved economic efficiency¹ and serve the broader public

* Chairman, New Mexico Public Utility Commission. B.B.A. University of Texas, 1973; J.D. Southern Methodist University, 1976.

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1. The NARUC Principles include the following footnote relative to economic efficiency: By economic efficiency we mean efficiency in the production and consumption of goods and services. Societal welfare is improved as economic efficiency is increased, which is to say that scarce resources are put to their most highly valued uses and are used most efficiently in production. There are several components of economic efficiency: (a) allocative efficiency (when society's resources have been organized for productive purposes in such a way that it would be impossible to reorganize them to benefit one part without making another part worse off); (b) productive efficiency (a given quantity of output is produced at the lowest possible total cost); and (c) other production efficiencies (associated with management of the production process).

interest. This principle should remain the goal for all restructuring proposals. Many of the specific principles listed below will be in tension and will require balancing in light of this principle.

Ideally, decisions to bypass the incumbent utility system should be made in light of this general principle. The key provision of this principle regarding bypass is the provision relating to improved economic efficiency and service of the broader public interest. From a state regulator's viewpoint, bypass in violation of this principle should be discouraged. Nonetheless, sorting out actual proposed bypass decisions is not a simple matter. Traditional regulation is founded on the notion of natural monopoly, which is, in turn, embodied in the notion of allocative efficiency set forth in the footnote. This definition may be in direct conflict with the concept of dynamic efficiency. Indeed, it is this conflict which has, in many ways, driven the current restructuring of the industry.

This analysis is further complicated by distortions in pricing brought about by the regulatory process itself. This distortion occurs in two ways. First, regulators may make certain policy choices which knowingly distort prices to achieve specific policy goals. For example, Demand Side Management and renewable technology development may be furthered through price adders. The other distortion comes from rate design which is clearly as much art as science and which necessarily has some noise or distortion in its result.

Distortion caused by rate design may be further aggravated by a policy of assuring recovery of all costs (as opposed to preserving an "opportunity" to recover those costs). When a customer leaves the system in an act of bypass or otherwise, if the lost revenues are reallocated to other customers, the concept of allocative efficiency seems to be put in play. Full cost recovery is not assured in a competitive market. Thus, reallocation of revenues to a dwindling customer base (i.e. raising the price) creates a result contrary to competitive market principles which would lower prices. This traditional regulatory paradox is the single most complicating factor in addressing bypass issues.

Furthermore, this notion of efficiency is not merely static efficiency, but also includes dynamic efficiencies (such as innovation and technological development) that arise over time from the stimulus of competition in an environment in flux.

PRINCIPLE I: NETWORK INTEGRITY

The safety, reliability, quality, and sustainability of electric service should be maintained or improved in a restructured electric industry. Market-based decisions, driven by economics and competition alone, could jeopardize critical safety and reliability and long-term strategic resource and facilities planning. Public policy should ensure the integrity of the electric grid and encourage prudent long-term resource planning, acquisition, and utilization.

While bypass, in and of itself, is unlikely to directly impact network integrity,² it should, nonetheless meet this litmus test before being embraced. Bypass will most likely impact long-term resource planning, acquisition and utilization, especially when associated with dynamic efficiency. Therefore, care should be taken to avoid creating uneconomic incentives which run counter to these long-term issues. This may occur under traditional "fixed revenue" regulation, discussed above. For customers who elect to bypass, but continue to need some services from the system, regulators should assure that those services are fairly priced and do not lead to system modifications which are paid for by non-bypass customers.

PRINCIPLE II: UNIVERSAL SERVICE

Universal Service at reasonable rates, including adequate protections for low-income customers, should be maintained. Because electricity service is vital for health, safety, and economic opportunity, universal service is a cornerstone of the public interest. Customers are entitled to access to reasonably priced power, and to a forum for dispute resolution.

In some circumstances, bypass may further the principle of universal service. For example, there may be situations in which the most economic way to extend service to those who currently have no service is to bypass the system through on-site generation options. This choice meets the tenets of this principle, the NARUC General Principle and its underpinnings of economic efficiency. However, where the effects of bypass by existing customers are allowed to be passed on to a utility's remaining customers, low-income customers are likely to be impacted the most. Accordingly, policy makers should assure that this type of residual cost

2. Bypass should not impair the operation of the existing system.

recovery is discouraged or, where allowed, that this principle is not undermined.

The Federal Energy Regulatory Commission's [Hereinafter FERC] approach to this issue, in its Order 888, is to create a "non-bypassable" stranded cost charge. Such charges are "non-bypassable" only so long as the customer remains on the system in some manner. Insofar as recovery of stranded costs is appropriate, there is nothing inherently wrong with the FERC approach.³ However, when such charges force complete bypass, there is no mechanism for recovery of these costs. In such a case, if uncollectible charges are reallocated to remaining customers, then Principle II is violated. Accordingly, regulators should be vigilant in addressing the impact of these events on low-income customers.

The direct effects of competition should not be viewed as violative of Principle II. Where a customer (low-income or otherwise) is given a power supply choice and ends up paying more than he would have paid by choosing an alternative, it is not the role of regulation to protect the customer from the effects of that choice. Indeed, assuming a viable market with an absence of market power, the market should, by definition, provide reasonable prices. Subsidies to low-income customers utilized by regulators or legislators should be explicit in order to keep the quality of information at its highest.

Consistent with the final statement of Principle II, customers must be provided a forum for dispute resolution. At a policy level, the courts arguably provide such a forum. However, due to the expertise needed to fully understand the market, state commissions will likely continue to provide some sort of consumer protection function.

PRINCIPLE III: CUSTOMER CHOICE

Customers should have the opportunity to make informed choices among electricity providers and services. The potential for competition to improve economic efficiency rests on having multiple service providers as well as informed consumers. Market development should be guided in a way that increases the role of competition among energy service providers and the role of choice for consumers.

Standing alone, Principle III is the strongest principle in support of individual customer bypass decisions. The concepts of informed choice and

3. This statement is intended to express agreement with the cost recovery mechanism used by the FERC for true wholesale stranded costs and does not include the FERC's "retail-turned-wholesale" policy which may infringe on state authority and policy.

economic efficiency are critical to the issue of bypass. Where both the informed choice and economic efficiency tests are met, bypass may be appropriate. Where there are no non-explicit regulatory policies or market structures which distort the customer's decision-making, customer choice provides the single greatest force in driving the market toward economic choices.

Municipal bypass decisions may serve to undermine this principle where the municipality does not offer direct customer choice, but chooses instead to interject its own choices by functioning as an aggregator for its customers or as a vertically integrated utility. However, municipal bypass may be as much a political decision as a policy decision. Thus, it carries an underlying state policy determination through the empowerment of the municipality to make that choice. Nonetheless, care should be taken to avoid policies which distort the economic signals presented to municipal decision-makers. Municipal utilities should be encouraged to provide open access systems to their customers, as opposed to serving as a surrogate aggregator.

PRINCIPLE IV: CONSUMER PROTECTION

Consumers should be protected from anti-competitive behavior, undue discrimination, poor service, and unfair billing and disconnection practices. Regulatory processes should continue where effective competition is absent and where monopolies and other forms of market power remain. Market power concerns are particularly relevant when considering electric utility mergers and acquisitions.

Actions taken to prevent bypass and in response to bypass, may violate Principle IV. For example, under many traditional approaches to regulation, utilities are allowed to offer discriminatory "load retention rates" to keep customers from leaving the system. In a competitive environment, such rates are only appropriate, if residual costs (or lost revenues) are not passed on to remaining customers. The same issue regarding load retention rates is present after a customer has elected to bypass.

The reallocation of such costs to remaining customers is an attribute of the market power of the company and should be guarded against. Where market power exists, the discriminatory effect of selective pricing likely outweighs the "benefits" of retaining the customer on the system. These issues are particularly aggravated in situations where a single entity or family of companies provide both competitive and monopoly services. Regulators must be vigilant in protecting consumers from undue discrimination hiding behind the veil of "competition."

PRINCIPLE V: PUBLIC PARTICIPATION

Industry restructuring policies should be developed in public processes with participation open to all. All stakeholders should receive fair consideration in public processes.

This principle is not directly invoked by any bypass issues. However, care should be taken to assure that all participants who may be involved in bypass decisions are allowed an opportunity to participate in the restructuring debate. This is true regardless of whether the forum is private or public, legislative or regulatory. Exclusion of stakeholders may result in uninformed bypass decisions.

PRINCIPLE VI: SHARED BENEFITS

All classes of customers should benefit from improvements due to structural changes in the industry. Electric industry restructuring should be done in a way that benefits all customer classes fairly and does not unduly disadvantage any customer class nor preserve any undue cross-class subsidy.

As services are unbundled and bypass decisions occur, cross-subsidies embedded in current rates will become more apparent. While elimination of these subsidies will benefit the classes and customers who have been subsidizing others, the subsidized class may view this as a detriment of restructuring. Techniques of gradualism, used by many state commissions, may not be available to ease the impact of this phenomenon. Access to market-based prices, however, should mitigate the problem. Therefore, as regulators attempt to address this essentially political issue, they should seek to prevent pricing signals which could induce uneconomic bypass.

Assuming the mitigation of distortions which might encourage uneconomic bypass, policy-makers must assure that the market is restructured for all customers. Bypass choices will then be presented to all customers, although the economics of those choices may vary by customer or by class. While the economics on paper might argue for a residential bypass choice, the transaction costs of exercising that choice might overwhelm the savings which the customer perceives. Thus, it is critical that transaction costs be appropriately priced and not be used as a tool to undermine economic bypass.

PRINCIPLE VII: PUBLIC BENEFITS

The public benefits of energy efficiency, renewable resource technologies, and research and development should be maintained through existing or new mechanisms. Energy efficiency, renewable resource technologies and research and development provide significant economic and other benefits for the nation and are critical to achieving a long-term, sustainable, and efficient electricity future.

In the last two decades, regulators have used varying levels of affirmative policies to encourage energy efficiency, renewable resource technologies and research and development. Demand Side Management, market information and market transformation programs have also significantly impacted the industry. The current challenge to policy makers is to assure that the long-term benefits of these programs are identified and included in the economic reality of the market place. Many of these areas represent direct bypass of the system.

In some cases, bypass may actually further this principle, by reaching niche markets which an "exclusive territory" policy might exclude. This may occur with respect to both energy efficiency and renewable technologies. To the extent that state commissions make policy choices encouraging energy efficiency and renewable technologies through traditional or other mechanisms (e.g. wires charges), bypass could serve to undermine those policy choices. If such revenue sources are seriously undermined, the long-term social benefits of such technologies would be deferred, if not lost.

Because the market tends to focus on short-term economics, policy-makers must keep an eye on the long-term issues facing society and assure that the market is kept on track to achieve the long-term objectives stated in this principle. Indeed, it may be that the long-term results will produce a complete bypass of the system through distributed, renewable technology. The benefits to be achieved from this "end state," however, should not be lost in the process of restructuring the industry.

PRINCIPLE VIII: ENVIRONMENT

Structural changes to the electric industry should maintain or improve the quality of the environment. The electric industry affects the environment, and environmental protection continues to be a high priority for society. The environmental benefits and costs of different

generation, delivery, and service options should be recognized through market mechanisms, where they are effective, or by regulation.

Bypass choices may not be consistent with broader environmental policies currently followed by state commissions which may be driven solely by customer perceived economics. As a result, state commissions should have a heightened concern over the environmental impact of bypass and should seek to assure that bypass decisions do not undermine environmental policies.

Policy-makers should also attempt to capture externalities in resource choices through market-based mechanisms. Traditional regulation has provided a partial, if imperfect, forum for addressing this issue. However, the problem becomes more difficult in a competitive environment. New mechanisms must be designed to address this issue. This is particularly evident in bypass choices, where consumers elect "cheaper" but "dirtier" supplies which bypass the system. In the bypass scenario, many of these issues will be beyond the reach of state commissions and environmental regulators will be required to address this problem.

PRINCIPLE IX: STRANDED COSTS

Existing commitments of utilities arising from past decisions made pursuant to historical regulatory and legal principles should be addressed in a fair and reasonable manner by states. Claims to recover net, verifiable, and non-mitigatable costs potentially "stranded" in a restructured market should be decided by states.

Regardless of the propriety of allowing the recovery of stranded costs, when recovery is allowed, bypass decisions are implicated in two ways. First, because stranded cost recovery reduces the economic benefits of competition in the non-bypass regime, it places great pressure on decision-makers to choose bypass where such a choice can avoid cost recovery. Thus, to the extent stranded costs may be bypassed, there is a built in distortion in pricing favoring bypass.

Second, where bypass successfully avoids stranded cost recovery, the pool of stranded costs grows relative to remaining customers, or must be borne by the utility. Thus, this principle may be in conflict with most of the other principles. Providing a fair mechanism to recover appropriate stranded costs, without incurring unintended consequences, is a significant challenge facing regulators in restructuring.

It remains to be seen how tolerant a competitive market will be for stranded cost recovery schemes. Even where the principle stakeholders

agree that such cost may be recovered, the distortions in pricing that such recoveries present to the consumer may force suppliers to compromise recovery of stranded cost in order to avoid loss of market share.

PRINCIPLE X: STATE RESPONSIBILITIES

States and state commissions should determine retail electric policies, including restructuring policies. Restructuring should recognize the unique characteristics of the various states. State legislatures and state public utility commissions are most accountable to the people and are closest to the people, problems, and opportunities that restructuring will present at the retail level. Accordingly, the policy and implementation decisions related to retail electric service should be determined by the states.

Because state officials are closer to and more accessible by the consuming public, state institutions should be the principle forums for retail restructuring decisions, including decisions relating to bypass. Municipal bypass decisions may be beyond the reach of state commissions and should be addressed by legislatures and the courts with commission input or guidance. Where municipalities are given unilateral control over such decisions, remaining non-municipal customers should be protected from those decisions by state policy-makers.

Regardless of form, bypass at the retail level is fundamentally a state issue to be addressed by state legislatures, state commissions and possibly other state agencies (e.g. environmental agencies). Some states may adopt aggressive competition policies which make economic choices transparent to consumers, thus accommodating economic bypass decisions. Other states may attempt to be more protective of their incumbent utilities. However, in the long run, market forces will tend to erode the differences among the states and bring more uniformity to the market.