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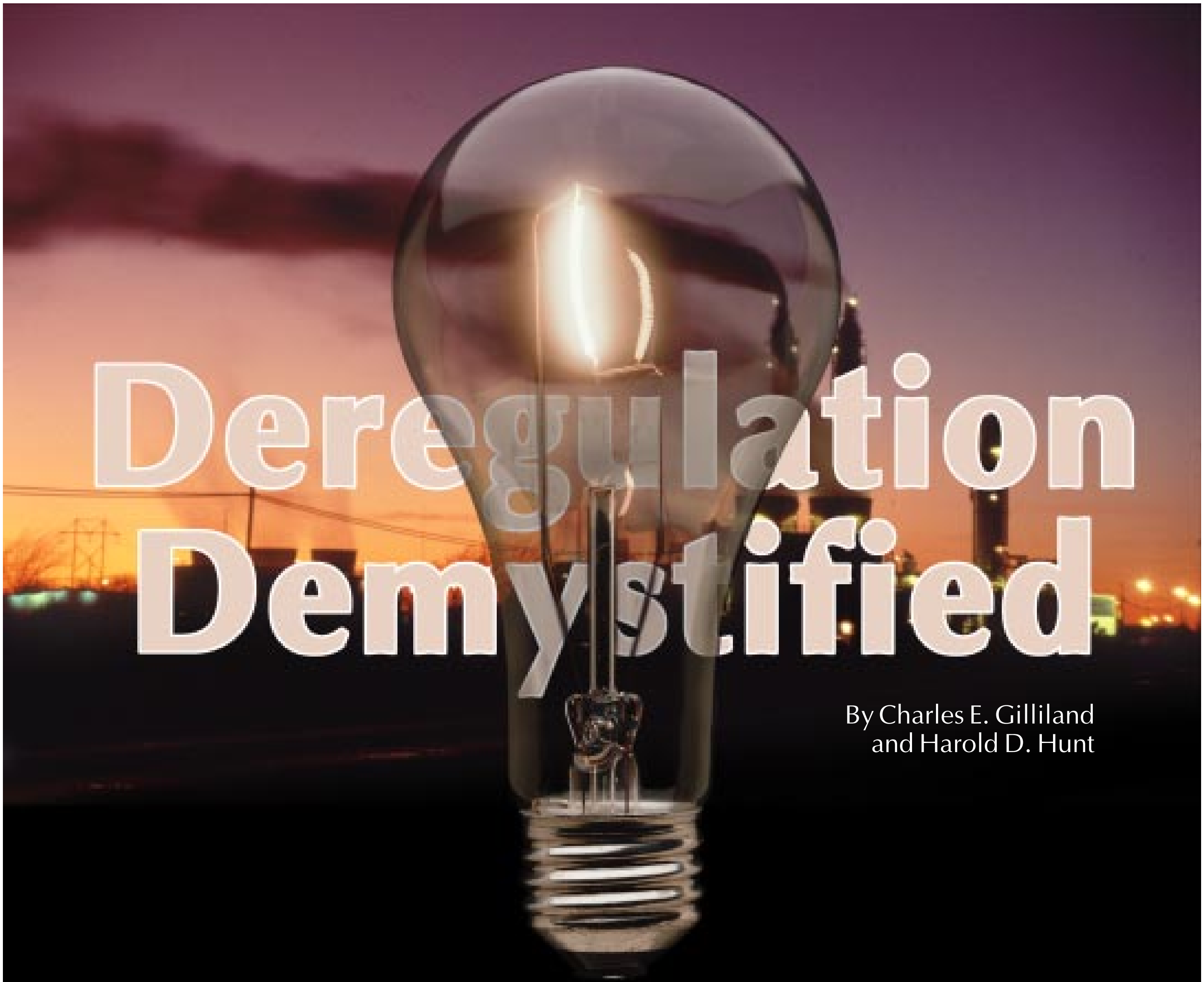


Deregulation Demystified

By Charles E. Gilliland
and Harold D. Hunt

"If you don't like the service from the electric company, go to the competition." That cynical advice provided comic relief to customers experiencing difficulties with their electric service in the past, when a complaint lodged with the Texas Public Utility Commission (PUC) offered the only avenue for redress of grievances. Now, as Texas approaches the January 2002 initiation of competition among electric power suppliers, Texans have misgivings about "shopping" for electricity. In the wake of California's deregulation fiasco, they wonder if power outages are in their future, too.

Why did the PUC regulate utilities in the first place? What has changed to make competition the preferred way to market electricity? How will competition work and what will residential customers and small business owners need to know to choose an electric provider? What does all of this mean for real estate?

Why Regulation?

Regulation has been the norm for electric utilities throughout the nation since shortly after the electrical power industry's inception. State after state adopted regulations based on the contention that a competitive market would fail to supply power at the lowest possible cost.

The industry argued that the immense investment required to generate, transmit and distribute electricity precluded the price cutting that characterizes competition in any marketplace. In an unregulated competitive market, rival electrical suppliers would each have a large initial capital outlay and would duplicate resources such as generating plants and power lines, draining returns. Competition among suppliers would eventually force rates to less than production costs. Consumers would temporarily enjoy low rates, but as time passed, the quality and reliability of service from financially hemorrhaging providers would deteriorate. Analysts concluded that the industry could survive financially only by excluding competition.

Government regulation of electric utilities prevented providers from gouging consumers with artificially high prices and ensured that providers earned a normal return on invested capital. This rate-base regulation protected these so-called natural monopolies from competitors while obligating them to serve all customers in their franchised areas at officially determined rates.

Power utility monopolies operated all three elements of their industry — generation, transmission and distribution — in an integrated system. Government controlled the rates and approved plant construction plans but did not manage everyday utility operations.

What Has Changed?

Recently, analysts have begun to argue convincingly that this system biased the industry's decision making in favor of overuse of capital. After all, why would a utility provider search out low-cost machinery and equipment if it can earn a guaranteed return on every dollar invested?

Over time, this "cost-plus" system began to inflate the cost of power. The economy had in the meantime grown enough to support direct competition in the power generation segment of the industry. Industrial and manufacturing electricity users realized that they could secure power in a competitive market at lower cost than in the rate-base regulated environment.

Pressure mounted to shift to a deregulated, market-driven system. Proponents argued that the economy could support competing power plants and that a competitive market would ensure power supplies at minimum cost. Construction of competing transmission lines and distribution systems would be unnecessary duplication, however. Those segments of the industry retained critical traits of a natural monopoly, and, said proponents, should remain regulated. However, the generation and retail supply portions of the industry could withstand competition.

To prevent regulated operations (transmission and distribution) from subsidizing competitive operations (generation and retail supply), Senate Bill 7 required existing utilities to split retail supply operations from generation, transmission and distribution, creating two separate entities. In the competitive environment, retail suppliers will have equal access to generators and transmission and distribution systems.

How Will Deregulation Work?

In the competitive market created by deregulation, the retail electric provider (REP) will deliver electricity to homes and businesses. The REP might be a subsidiary of a well-known energy corporation or an unrelated third-party purchaser of electrical power. Texas homeowners and small business owners will have choices in REPs analogous to the choices they had when the long-distance telephone market was deregulated.

When deregulation begins in January 2002, the utility currently supplying power for an area must create an independent company known as the "affiliated" REP to supply power at the retail level. The affiliated REP must then lower its rates for residential and small commercial customers by 6 percent. That reduced price becomes the "price to beat," and all other REPs may offer power in that franchise area at a lower price. The only constraint on competing providers is their production cost. The affiliated REP of the original franchised utility must continue to charge and cannot further reduce the price to beat for three years or until 40 percent of their customers switch to competing providers, whichever comes first.

A pilot program began in mid-July allowing as much as 5 percent of all Texas power users to choose their REP. Large power users were so eager to sign up for the program that a lottery was used to choose participants. Residential users were less enthusiastic about joining the pilot program.

THE CHOICES CONSUMERS HAVE NEXT JANUARY *will depend on whether their power is currently provided by a municipal electric utility, an electric co-op or an investor-owned utility.*

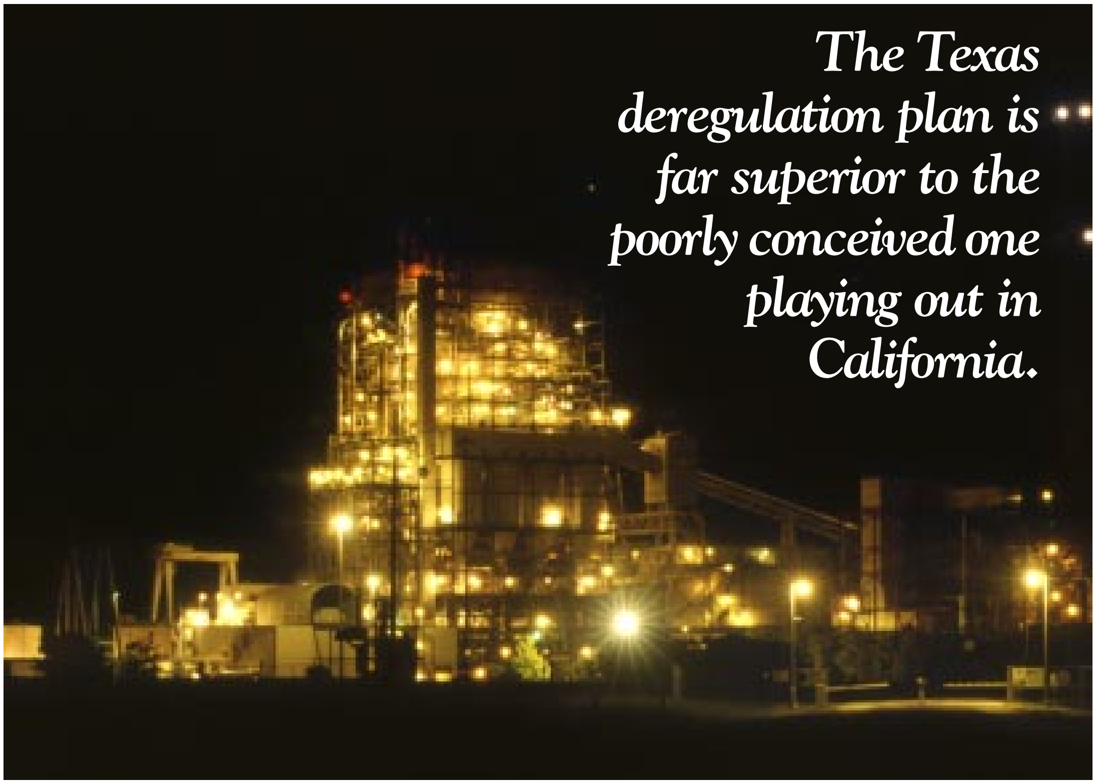
What choices residential and commercial power users will have next January depends on what type of entity currently provides their power. Customers served by investor-owned utilities (IOU), which are controlled by stockholders, will be able to choose a REP with a few exceptions (see What Choices Will I Have?).

Customers served by municipal electric utilities (munis), which are controlled by city governments or electric cooperative utilities (co-ops), which are controlled by co-op members, will be able to choose a REP only after their utility elects to allow consumer choice in its service area. Muni and co-op customers can influence their provider's decision to accept or reject deregulation through their city councils or boards of directors, while customers of IOUs have no influence in the decision.

Reducing Costs Through Aggregators

Residential and small commercial customers may be able to reduce their electricity costs by creating or joining an aggregator group. An aggregator is a person or organization that registers with the PUC to buy electricity for a group of members. The aggregator negotiates for lower electricity prices for its members based on volume usage. Electricity suppliers sell electricity at lower prices to larger customers because marketing costs are significantly reduced for these bulk sales. Aggregators are much more profitable for electricity suppliers than small residential or commercial users.

Aggregators typically secure electric power for their members either by serving as brokers who shop for the cheapest power on an ongoing basis or by contracting directly with electricity generators to buy power at a fixed price over longer periods.



Aggregators may include cities and towns, nonprofit organizations and business associations (see Deregulation Information for a list of registered aggregators). They may offer other services to their members such as bill consolidation, energy management and energy-use analysis. Through aggregation, small electricity users in effect share the cost of an expensive energy consultant and increase their overall electricity buying efficiency.

Consumers wishing to maximize cost savings should contact a number of REPs or aggregators to compare prices and services. The Texas PUC website (see Deregulation Information) provides a list of certified REPs along with guidelines for comparison shopping. PUC will begin a statewide consumer education initiative before competition begins.

As time passes, aggregators and REPs are expected to consolidate until a limited number of large providers remain, as was the case when long-distance telephone services were deregulated. This means that some aggregators and REPS may be entering the market only to become buyout candidates in the future.

Unlike California, which prohibits bilateral long-term contracts, large power users in Texas can enter into long-term contracts if desired. A large user is defined as an entity using one megawatt or more at peak demand. By entering into long-term contracts, large electricity consumers and aggregators will have a way to protect themselves against price increases. This should result in a more stable pricing environment and more accurate forecasts of need for additional generating facilities.

Current estimates are that Texas will have 25 to 30 percent more generating capacity than needed when deregulation begins in 2002 compared to California's 15 to 20 percent deficit. That supply should be sufficient to prevent blackouts like those in California.

Residential and small commercial customers who have not chosen a REP by the time deregulation begins will continue to receive power from their affiliated REP at the price to beat. However, larger commercial and industrial customers should be able to negotiate prices even lower than the price to beat. Historically, the largest electricity users have benefited most from deregulation. Building managers in Pennsylvania, which has successfully implemented electricity deregulation, reported as much as a 15 to 18 percent drop in their electric bills during the first year of deregulation. However, this level of savings decreased as excess power capacity began to decline over time.

Customers' affiliated REPs should provide a free record of historical power usage after January 1, 2002, that consumers may use to negotiate with competing REPS. If consumers choose a provider that subsequently goes out of business, they will be transferred to a provider of last resort (POLR) with no interruption in service. Those customers can choose a new provider at any time or remain with the POLR.

Customers who choose a REP and then fail to pay their bills will be transferred to a POLR as well. Except for emergency situations, only the POLR or a customer's affiliated REP (which

For More Information

Electricity Consumer Information Website
www.powertochoose.org

List of Registered and Pending Electric Aggregators in Texas
www.puc.state.tx.us/electric/business/agglist.htm

Aggregator and REP Application Forms
www.puc.state.tx.us/electric/forms/index.cfm

List of Residential Retail Electricity Providers (REPs) in Texas
www.powertochoose.org/residential/choosing/choosearep.html

List of Business and Commercial Retail Electricity Providers (REPs) in Texas
www.powertochoose.org/business/choosing/choosearep.html

Environmental Protection Agency's Energy Star Program
www.epa.gov/nrgystar/about.html

will often serve as the POLR) will have the right to terminate a customer's service for nonpayment under deregulation.

Large power users may be able to choose between "firm" or "interruptible" power service contracts from their provider. If service can be interrupted during specific time periods without negative consequences, cheaper interruptible service can be negotiated for those time slots.

Real Estate Implications

Firms that manage but do not own multiple properties may want to encourage property owners to aggregate to reduce electricity expenses. Multitenant property owners such as commercial building owners who provide electricity for their tenants should promote the benefits of negotiating rates based on the building as a whole compared with tenants negotiating individual agreements. Property owners may want to consider adding "indemnification clauses" to leases, limiting any liability from power interruptions. In Pennsylvania, most new multitenant properties are being constructed with individually metered tenant space.

The Texas deregulation plan is far superior to the poorly conceived one playing out in California. In fact, the state's excess power may attract businesses away from California and other areas with power reliability problems. Electricity retail competition, if carried out correctly, should provide Texas with power at the lowest possible cost for years to come. The Texas real estate industry can look forward to the prospect of a marketplace provided with favorably priced cost of electric power compared with most of the nation.

Dr. Gilliland is a research economist with the Real Estate Center at Texas A&M University. His e-mail address is c-gilliland@tamu.edu. Dr. Hunt is an assistant research scientist with the Real Estate Center at Texas A&M University. His e-mail address is hhunt@tamu.edu.

What Choices Will I Have?

Your choices under deregulation will depend on the type of electrical provider you have now and whether you live within or outside the Electric Reliability Council of Texas (ERCOT) grid (see map).

If you are a residential or commercial electricity user within one of three regions outside the ERCOT grid system:

- For most customers, electricity will continue to be supplied by your current provider. Retail competition will be either delayed or subject to provisions peculiar to your particular area. However, some parts of the East Texas non-ERCOT area will offer retail competition. Check with your local electricity provider.

If you are a residential or commercial electricity user within the ERCOT grid system and your electricity is currently provided by either a co-op or a municipality that has not chosen to participate in retail electricity competition:

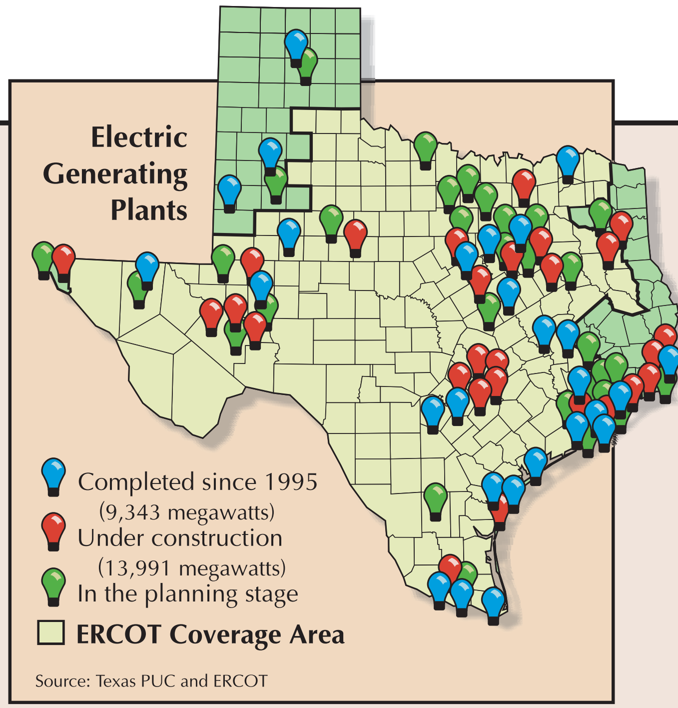
- Your electricity will continue to be supplied by your current provider. Your co-op or municipality can choose to enter retail competition after January 1, 2002. Once a provider decides to compete, the decision cannot be reversed.

If you are a residential electricity user located within the ERCOT grid system and your current power provider is an investor-owned utility:

- You can do nothing and remain with your current utility company's retail affiliate, receiving a savings of 6 percent from your rates that were in effect on September 1, 1999, (subject to a final fuel adjustment to be determined by the Texas PUC).
- You can choose a different retail electric provider. You must do your own research or rely on marketing efforts by retail providers operating in your area to compare the costs and services being offered.
- You can choose to join an aggregator group that will pool you with other users to obtain a lower rate than you could get on your own.

If you are a small commercial electricity user such as a small apartment complex, office building, retail property or warehouse-industrial facility located within the ERCOT grid system whose peak usage is less than one megawatt and your current power provider is an investor-owned utility:

- You can do nothing and remain with your current utility company's retail affiliate, receiving a savings of 6 percent from your rates that were in effect on September 1, 1999, (subject to a final fuel adjustment to be determined by the Texas PUC).
- You can choose a different retail electric provider. You must do your own research or rely on marketing efforts by retail providers operating in your area to compare the costs and services being offered.
- You can choose to join an aggregator group that will pool you with other users to obtain a lower rate than you could get on your own.



Source: Texas PUC and ERCOT

If you are a large commercial electricity user such as a large apartment complex, office building or warehouse-industrial facility located within the ERCOT grid system whose peak usage is greater than or equal to 1 megawatt and your current power provider is an investor-owned utility:

- You can negotiate your own bilateral contracts for power with retail power providers in your area. Typically, large commercial and industrial power users will be contacted directly by retail electricity providers, so search time should be minimal.
- You can choose to join an aggregator group that will pool you with other users to obtain a lower rate than you could get on your own.
- You can do nothing and remain with your current utility's retail affiliate, receiving a rate and service terms that were determined on June 1, 2001.

LOWRY MAYS COLLEGE & GRADUATE SCHOOL OF BUSINESS

Texas A&M University
2115 TAMU
College Station, TX 77843-2115

http://recenter.tamu.edu
979-845-2031
800-244-2144 orders only

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