

GAS AND ELECTRIC DISTRIBUTION COMPANIES FACE UNCERTAIN FUTURE



At the beginning of 2002, the Center for the Advancement of Energy Markets (CAEM) issued its annual predictions for the year ahead. Looking back at what we said then, boy, were we wrong about a few things.

We were amazed that Enron's collapse could hardly cause a ripple in the markets, that other traders would fill the space left by Enron, and that the movement toward competitive energy markets had turned a corner.

Yet, now, we see the stock value of major power traders falling every day, people are losing their jobs, and the heads of these corporations are rolling. And, except for Texas and a few other states, we see retail energy deregulation stalled and stuck in an interminable transition period.

Please pass the crow. Enron's collapse has spawned "Enronitis" and the infection is spreading.

Focus On Gas & Electric Distribution Companies

In particular, CAEM has focused on and is concerned about the increased risk now faced by gas and electric distribution companies (DISCOs). Enron's collapse is an important factor but just one of many increasing the risk profile of these companies.

The gas and electric industries are currently undergoing the most fundamental transformation in their histories, moving from a heavily regulated monopoly model to one based more on competition and customer choice. In the current transitional period, new challenges and opportunities

are arising, many of which were not foreseen even five years ago.

As part of restructuring, utilities which were once vertically integrated are now being "unbundled," meaning that the functional components of the utility—exploration, production, generation, transmission, distribution, basic and premium customer services, and marketing—are being separated from one another and re-organized along horizontal lines. It has been generally assumed that the transportation functions (the "pipes and wires businesses") will remain under regulation, with some new and/or different regulatory obligations due to restructuring.

However, this assumption is now being challenged by the evidence garnered in states such as California. Distribution companies not only bear some or all of the traditional costs and regulatory obligations under the old regulatory regime, but now also face a number of new risks and costs that could threaten their viability. In turn, everything from the utility's stock price to its corporate structure is being impacted by changes caused by restructuring.

It is now clear that gas and electric industry restructuring and technology developments create a number of challenges, to both local distribution companies and their regulators, that will impact the core of the DISCO's business and ultimately the welfare of the consumers they serve. There are also many open questions regarding the role

of marketers in the services of the DISCO of the Future.

The DISCO Of The Future Forum

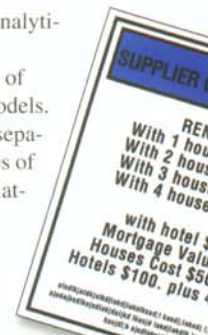
In response to growing concerns about the viability of gas and electric distribution companies, CAEM determined over a year ago that it was necessary to convene a national forum on these issues, known as "The DISCO of the Future Forum."

The Forum was comprised of approximately 50 stakeholder organizations representing a broad array of the industry and regulatory bodies which govern the industry. The primary purpose of the Forum was to thoroughly examine the issues and challenges facing distribution companies, and to make consensus-based recommendations that work to ensure healthy companies and happy customers in the future.

The Forum first met in April 2001 to establish a set of priorities to guide its work and focus its discussions. The Forum determined that it would examine the future of regulated pipes and wires utilities by focusing on:

- ▶ Future markets and competition,
- ▶ Public policies necessary for the portions of the industry that will remain regulated,
- ▶ Development of an analytical framework, and
- ▶ Analysis of a variety of potential business models.

The Forum conducted separate but coordinated analyses of (1) business models and relat-



	PROVIDER OF LAST RESORT	REGULATORY RISKS	TARGET MARKET?	DISCOs 	SELL ELECTRIC ASSETS 	BALANCE PORTFOLIO	INCREASED COMPETITION 	TEXAS	CALIFO
	PRICE \$300	PAY \$75.	\$300.			\$300.	\$500.	\$300.	\$300.

ed financial considerations, (2) future regulatory policies, and (3) technology advancement and integration. The Forum also adopted a set of principles to guide its discussions:

1. All parties should have the opportunity to benefit from energy industry restructuring.
2. There are DISCO functions, which can be provided competitively, and competition in these functions should be permitted, if the long term net benefits exceed the short term transaction and transition costs.
3. All current DISCO functions which cannot effectively be provided competitively should be subject to revised regulation designed to optimize prices and encourage capital attraction and new investment to the maximum extent possible.
4. All DISCO customers should have access to information and tools which would provide them the opportunity and ability to respond to price signals, if they choose to do so, and should have access to a stable rate, if they prefer.
5. Customer charges for the services associated with physical delivery of the energy commodity should reflect the real costs of providing those services, including a reasonable return on the DISCO's rate base.
6. Customer prices for the energy commodity should be determined competitively.

Challenges & Opportunities

The final report contains many observations about the challenges and opportunities faced by distribution utilities. On the one hand, policymakers and industry stakeholders must address a number of problems that are currently eroding the share prices of DISCOs, driving up their cost of capital, and threatening the reliabil-

ity and affordability of service to residential and small business consumers.

The Forum found the potential for increased market consolidation and market power in the generation sector (in some cases), permitting the generation sector to more easily dictate terms and price of power delivery to DISCOs or the marketers which serve their customers.

Distribution companies, as evidenced by PG&E in California, face an increased risk of insolvency. In some cases, utilities are being required to divest generation and yet are not being allowed to hedge against price increases in the wholesale market. Linked to this finding is the increased price volatility for both electricity and natural gas in the wholesale market which the utility may or may not have the expertise and experience to hedge against.

In the transition period, probably the biggest risk distribution companies face is serving as the "provider of last resort," in other words, providing energy when a marketer is not willing or able to do so, or when a customer desires to return to the utility. This role makes it very difficult to plan for what DISCOs may need to contract for in the future, oftentimes putting DISCOs in the position of contracting for power when it is the most expensive and yet not being assured of cost recovery by the regulators.

Finally, there is the added uncertainty and risk associated with a very fluid regulatory regime governing the DISCO. Regulatory risk ranges from costs and risks associated with standard offer service to delays in approving new pipes and wires facilities.

On the other hand, the distribution utility could be in a prime position to benefit from a restructured market for electric and gas services, even while remaining regulated. DISCOs are uniquely positioned to utilize distributed energy resources as both a business opportunity and as a means to address some of the risk factors described above. Moreover, DISCOs, as the owners of the local grid, have a number of other potential advantages, including:

1. Access to consumers and long-term relationships with those consumers;
2. A regulated rate of return that repre-

sents a secure revenue stream;

3. The promise, if not the reality, of lower capital costs;


4. The potential to extract additional value from the local grid, by moving from a radial system to a true network;

5. A wealth of knowledge of the local market; and

6. Franchise rights and eminent domain for the siting of new investments.

Last Words

The future of DISCOs is very uncertain. Whether DISCOs will face a boom or bust period will largely be determined by policy decisions made during the transition toward increased competition over the next few years. Moreover, a high-level discussion is necessary to examine the question of whether DISCOs should even remain regulated in the traditional manner or whether the evolution of a different regulatory regime is warranted.

CAEM issued the final report of the Forum, with more than 200 findings and recommendations, in May 2002. The report's significance was immediately obvious to policymakers. As Chairman Cartagena of the DC Public Service Commission stated, "The Final Report of the DISCO of the Future Forum needs to be under every regulator's Christmas tree this year." CAEM will provide the final report to the public free of charge. For a free copy, visit www.caem.org. 

Author's Note: Jamie Wimberly, CAEM's co-founder and president, has initiated and directed many of CAEM's projects, including the DISCO of the Future Program, the Distributed Energy Task Force, and the Grid Enhancement Forum. In addition to his work with CAEM, he serves on the Board of Advisors of V Finance, a portfolio management and investment banking company headquartered in New York City with approximately \$1 billion in investments. Before joining CAEM, he served as Vice President of the Consumer Energy Council of America (CECA), the nation's oldest consumer organization, and as a congressional staffer focusing on U.S. trade policy.

