The Changing Structure of the U.S. Utility Industry

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The United States electric industry restructuring debate continued to broaden and expand on a number of fronts in 1998. The outlook is for such activity to intensify in 1999.

The debate is being played out in a number of forums. Congress is expected to consider the matter next year. The Administration has submitted its own plan for comprehensive restructuring. The Federal Energy Regulatory Commission (FERC) is gearing up to regulate a competitive electric system from a national perspective. The individual states and the National Association of Regulatory Utility Commissioners are re-evaluating and strengthening their own roles in the regulatory process and the transition to a competitive regime.

Electric companies have continued to take actions to lay the foundations for future growth in a competitive era. In the process, the electric industry achieved solid financial results. In 1997, operating revenues grew by 18 percent to $264 billion, and sales of electricity increased for the 15th consecutive year. Cash flow remained robust for the third year in a row, enhancing company options by enabling share repurchase programs, debt retirement, new investment and other strategic uses.

Investments reflected on balance sheets grew significantly. New investment approached $66 billion in 1997, up nearly 78 percent over the past three years. It has more than doubled over five years. Stock performance reflected the industry's successful year as the EEI 100 Index's total return exceeded 27 percent for 1997 and is up 11.8% for the first nine months of this year.

Companies carried forward the work of preceding years, adapting to a system of less government regulation and greater reliance on market forces in the electric industry. They have worked in earnest to execute strategies in accordance with their vision of future markets. Generation assets were bought or sold as companies made moves depending on whether they wanted to expand their generation business or preferred to turn their sights on other opportunities in the changing energy markets.

Trading of electricity and natural gas increased, accounting for approximately 75 percent of the industry's revenue growth in 1997. Driving the increase in trading was robust competition in the electricity wholesale market and increasing convergence between electricity and natural gas. Other areas of diversification included telecommunications, cable and home security systems as companies explored new markets and acquired the building blocks to create new products.

One aspect of this increased trading activity was the so-called "price spikes" which occurred last June, when the one hour pricing reached as high as $7,500 per Mwh. The staff of the Federal Energy Regulatory Commission (FERC) concluded recently that these price dislocations resulted from an unusual combination of factors and that a recurrence of price increases of similar magnitude was unlikely. These factors included the following: an above-average amount of generation capacity was unavailable; temperatures were unseasonably hot; transmission constraints reduced utilities 'ability to move power where it was needed; and inexperience in dealing with these conditions hampered effective responses by some market participants.

Competitive forces and privatization abroad continued to shape an increasingly international electric market. U.S. companies, many of which are already global players, have significantly boosted their overseas investment in search of further growth and opportunity. Diversification and international investment continue to provide strong earnings growth.

Eighteen states, representing nearly half the U.S. population, have officially committed themselves to competition. They have continued to act responsibly on stranded costs, and recovery will remain a key to market development.

At the federal level, Congress continued to investigate electric issues, primarily through a series of hearings and workshops in both the House and Senate. Edison Electric Institute (EEI) and its members were successful in making the industry viewpoint heard and in airing key issues. Several restructuring bills were introduced in 1997 and 1998. None was acted upon, but we expect consideration to resume when the new Congress convenes in January.

A number of issues affecting competition and company profitability remain to be addressed by Congress. Among these are reform of the Public Utility Holding Company Act (PUHCA) and the Public Utility Regulatory Policies Act (PURPA), and state-federal jurisdictional matters.

Meanwhile, the thrust of federal regulation continues to evolve. FERC is undertaking a sweeping self-assessment to see what it needs to keep pace with competitive markets which its own Orders 888 and 889 helped put in motion two years ago. The review reflects the new makeup of the commission. Commissioner James Hoecker became Chairman in 1997, and two new members came on board. Three of the five commissioners are now former state regulators.

The U.S. Department of Energy has coordinated Administration policy on competitive electricity as a basis for possible federal legislation. The Administration plan, announced in March 1998, would provide for customer choice by 2003 unless states exempt themselves. The concepts support stranded cost recovery and give FERC new authority with regard to reliability, independent transmission system operators, divestiture and public power. A range of environmental provisions is proposed, including a $3-billion public benefits fund to support conservation and for other purposes. In June 1998, the Administration plan was introduced as a bill in Congress.

The evolving industry continues to focus on a range of public policy priorities. Among them are areas such as mergers and acquisitions. Twelve mergers were announced and thirteen were consummated in 1997. The latter included six convergence mergers between electric and natural gas entities as companies reached for economies of scale, broader geographic markets and the capability to offer comprehensive energy packages and thus greater value to customers. In 1998 there have been two mergers announced and five completed. It is important that companies retain flexibility to structure themselves in ways that best enable them to meet the new competitive environment. The market and companies themselves should continue to be the determining factor in restructuring decisions.

Another public policy priority affecting the development of competitive markets involves the tax subsidies of municipal utilities. The majority of munis are small operations that provide mostly distribution service within their historic territories. We respect their right -- and the right of munis of all sizes -- to continue as they have been. Of concern, however, are the two dozen or so largest munis with major generation and transmission operations. Some want to compete outside their territories in competitive markets using their tax-exempt financing and income tax exemptions.

Government-subsidized competition is not in the best interests of competitive markets.
The issue was the subject of a congressional hearing in 1997. New Internal Revenue Service (IRS) regulations in 1998 make it easier for munis to compete outside their historic service areas using their tax subsidies. Bills introduced in both House and Senate would give public power entities the option of continuing to serve their existing customers with existing tax subsidies or going outside their historic territories to participate in competitive markets without tax subsidies. Our CEOs have designated this a major issue, and we will continue to work for constructive solutions.

Another important public policy front involves the rules for retail competition. These rules are now being written in a number of states that have officially committed themselves to a competitive future through law or regulation. Public policy will affect the development of open markets and will have an impact on company operations. Market rules should provide a basis for equitable competition. They should ensure, for example, that regulated parts of the business do not subsidize the unregulated, competitive parts.

But some proposals go much farther and offer rules that would actually handicap traditional utilities in competing. For example, codes of conduct or affiliate relationship rules are being offered that would limit the market share of utilities, ban use of company names and logos by marketing affiliates, prevent cost-effective synergies that occur by sharing resources and people, and otherwise seek to restrain full participation in the retail market by traditional suppliers. Such rules would be detrimental to the marketplace and consumers. This is a key issue, and we are fighting for efficient competition and fair choice. Shareholder-owned electric companies asserted their case in a number of regulatory proceedings. EEI appeared with its members in more than 20 states, supplying research, opinion polling, witnesses and other support.

Elsewhere on the public policy agenda, the industry carries forward its initiatives for constructive solutions on environmental and global climate issues. The electric industry recognizes the importance to everyone of a clean environment and has exerted strong leadership in this area. Environmental measures need not be incompatible with the economy, but solutions must work for everybody. That means jobs and the efficiency of the economy must also be considered. Efficient electrotechnologies are a major factor in a cleaner environment.

The benefits of the Environmental Protection Agency's (EPA) NAAQS (National Ambient Air Quality Standards) on ozone and fine particulate matter and their regional haze proposals come up short under cost-benefit analysis. In a competitive electric regime, environmental requirements need to be structured so costs do not consume the economic benefits of competition. EEI is a founding member of the Air Quality Standards Coalition which brings together a wide range of allied industries to work for more effective solutions. In 1997, bills introduced in Congress to deal with this issue attracted more than 200 co-sponsors. In 1998, the industry focused on enactment of legislation that will set us on the path to constructive resolution of the NAAQS issue.

In global climate matters as well, the electric industry supports voluntary, flexible, cost-effective solutions. We agree that any international agreement, such as the Kyoto Protocol, should meet the criteria of the Byrd-Hagel resolution -- it must not harm the U.S. economy and it must apply to all nations. The resolution was supported and adopted overwhelmingly by the United States Senate, and we continue to work for solutions based on its precepts.

Our Climate Challenge program proves the voluntary approach works. Four years ago, we signed an agreement with the government by which we promised to control 40 million tons of greenhouse gas emissions by year 2000. We now expect to control more than 170 million tons -- quadruple the original goal. We began with a nucleus of about 30 electric companies; now more than 640 companies are participating in Climate Challenge programs. These are impressive results. We continue to work for Administration recognition of these accomplishments in the form of credit for early action. We are pleased that just last month a bill was introduced in the Senate authorizing the President to give regulatory credit for voluntary early action to mitigate greenhouse gas emissions. This will spur further achievement in climate matters. Flexible, market-based solutions will find the most cost-effective way to supply electricity and to maintain a healthy environment.

Environment/climate issues, mergers and acquisitions, tax subsidies and retail market rules are among the most active public policy priorities currently involved in industry restructuring. The transition into a competitive marketplace continues and the industry has responded by implementing a series of strategic moves aimed at increasing long-term competitiveness and maintaining financial strength.

The bottom line is -- we are on course in our journey to competition. The electric industry has advanced a positive transition in key areas and is preparing for even more prosperous financial results in the years ahead.