

Energy Regulation Insights

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From the Editor

National energy legislation is an important element of the "regulatory compact" in the US, providing direction on the future structure and operation of the US electric utility industry. The newly-enacted Domenici-Barton Energy Policy Act of 2005 (EPAcT 2005)—particularly the Electricity Modernization Act of 2005 (EMAcT 2005), which is Title XII of EPAcT 2005—will have important effects on the US electric utilities, while creating new tasks for federal and state utility regulators.

—Wayne Olson, Editor

US EPAcT 2005 and State Utility Regulation in the US: What Every Utility Needs to Know

By Wayne Olson

With wholesale competition, federal legislation and regulation has increasing clout in the generation and transmission segments of the US electric utility industry. But state regulation continues to play an important role both for distribution utilities in states that have restructured their industry to accommodate retail competition and for traditional vertically-integrated utilities in the rest of the US.

The electricity industry has experienced federal and state regulation almost since its inception. However, the advent of wholesale electric competition required that previous legislation be revised. Further, the Public Utility Holding Company Act of 1935 (PUHCA of 1935) and the Public Utility Regulatory Policies Act of 1978 (PURPA) had out-lived their usefulness and needed to be repealed and modified, respectively. EMAcT 2005 allows some US states to proceed with wholesale and retail competition, while other US states maintain traditional utility regulation.

Key Elements of a 1,725 Page Bill

From the standpoint of the utility industry, the two most important elements of EPAcT 2005 are its repeal of PUHCA of 1935 and the termination of mandatory purchase and sale requirements of the PURPA.

Historical Context

The Energy Policy Act of 2005 will create new tasks for federal and state utility regulators. The last major piece of US electricity legislation was the Energy Policy Act of 1992 (EPAcT 1992). This precursor to EPAcT 2005, created a new class of power producers called "exempt wholesale generators"



exempt from requirements mandated by the PUHCA and gave the FERC broad direction to order and establish rates, charge and terms and conditions of third-party transmission services. By the late 1990s, 24 states had begun to engage in restructuring of the electricity industry (7 states of these states effectively backed away by 2003). Table 1 provides a brief summary of key regulatory developments in the US.

What Changes Lie Ahead?

EPAAct 2005 eliminates PUHCA of 1935 and modified PURPA. Further, Congress has asked the US states to consider whether they want to implement certain standards, recognizing that the states (and not the federal government) have jurisdiction on these questions.

PUHCA of 1935

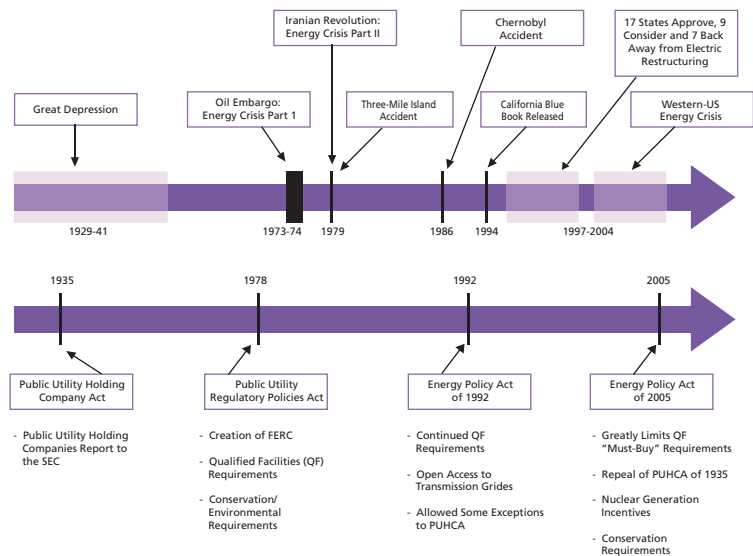
The Public Utility Holding Company Act of 2005 (PUHCA 2005) repeals PUHCA of 1935, but ensures that federal and state regulators have access to the books and records of utility holding companies and their associated companies. It also trans-

fers federal jurisdiction from the US Securities and Exchange Commission to the US Federal Energy Regulatory Commission. Repeal of PUHCA realigns regulatory boundaries, tilting significantly in the direction of state regulation.

With the repeal of PUHCA of 1935 and passage of PUHCA 2005, state regulators will have the access to utility

Table 1

Key Regulatory Developments in the Electricity Industry



holding company books and records needed to ensure that: (1) utility customers are not cross-subsidizing a utility affiliate; and/or (2) costs are not being shifted to the utility and its customers. FERC will have a similar role when approving the rates of FERC-jurisdictional regulated entities.

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Termination of PURPA's Mandatory Purchase Requirements

Section 210 of PURPA required electric utilities to purchase electricity from Qualified Facilities (QFs), at a price based on the cost that the utility was expected to avoid by purchasing power from the QF. PURPA allowed cogeneration and alternative power generator to enter the generation business, but the cost was high. State regulators in a number of states required that the utility sign a long-term contract—perhaps 15 to 30 years—to support the resource. Many utilities (and their regulators) found to their chagrin that these QF contracts quickly became uneconomic, requiring rate hikes to retail customers. By the mid-1990s, these contracts were an important category of “stranded costs” and a major issue of contention in electric restructuring.

Now, with wholesale competition, the Section 210 is no longer needed in many parts of the US and Congress has substantially narrowed the obligation to buy from QFs. Thus, utilities in much of the US can avoid these obligations by showing that new QFs

have nondiscriminatory access to competitive wholesale markets, provided the markets meet a standard set in Section 1253.

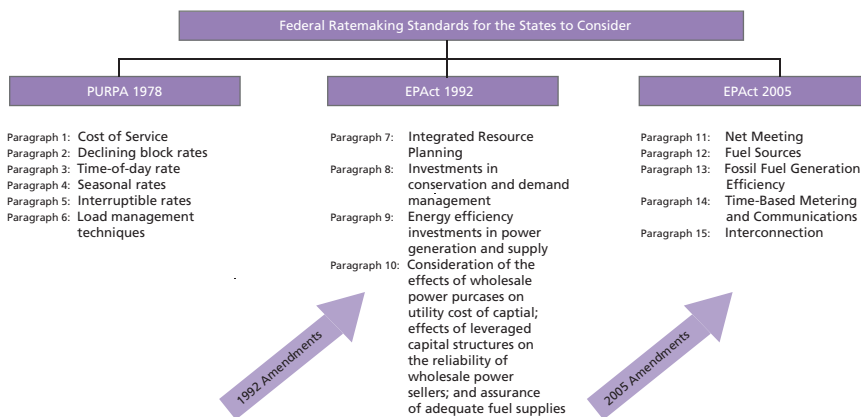
Section 1253 gives FERC the authority to issue and enforce regulations ensuring that electricity utilities can pass through prudently-incurred costs of purchasing power from future QFs. However, it will be interesting to see how this works out in practice given that pass through of these costs normally occurs at the state-regulated retail level.

Federal Ratemaking Standards That States Are to Consider

EPAAct 2005 continues the practice of requiring that state regulators study certain ratemaking issues and decide whether to adopt a “standard.”¹ This practice began in PURPA of 1978 and was continued in EPAAct of 1992. Table 2 illustrates the issues that were considered in PURPA of 1978 and EPAAct of 1992 and the new issues on the table as a result of EPAAct 2005.

Other sections set out standards for coordinating electricity markets and a

Table 2
Table Requirements that States Must Consider and Then Determine Whether to Adopt Certain Ratemaking Standards



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timetable for their application. Section 1251 amends PURPA by inserting “standards” for net metering, fuel sources, and fossil fuel generation efficiency. PURPA requires that state regulators consider whether to adopt these standards.

Net Metering. Paragraph 11 requires that each electric utility must make “net metering service” available to any customer upon request. Net metering is defined (Section 1251 (a) (11) as “service to an electric consumer under which electric energy generated by that electric consumer from an eligible on-site generating facility and delivered to the local distribution facilities may be used to offset electric energy provided by the electric utility to the electric consumer during the applicable billing period. The key problem with “net metering” is the disconnection between the price paid to the “on-site generating facility” and the cost avoided by the utility. It may

be necessary to restructure rates so that unavoidable costs are recovered in components other than the per-kWh charges, and are thus not subject to net metering.

Fuel Sources. Paragraph 12 requires that each electric utility must put forward a plan to minimize dependence on one fuel source.

Fossil Fuel Generation Efficiency. Paragraph 13 requires that each electric utility develop and implement a 10-year plan to increase the efficiency of its fossil fuel generation.

Section 1252 encompasses a section on time-based metering and communications standards:

- *Time-of-use Rates.* Each electric utility must offer each of its customer classes—and provide individual customers upon

request—a time-based rate schedule. This may include options such as seasonal and time-of-day rates, real-time pricing, critical peak pricing, credits for interruptible peak load and others. Time-of-use rates require careful examination of the utility’s marginal costs of providing the service.

- *Smart Meters.* Each utility shall provide each requesting party a time-based meter capable of enabling the utility and customer to respectively offer and receive that time-based rate.

Section 1254 amends PURPA by adding a standard associated with interconnection service:

- *Interconnection Standards.* Paragraph 15 requires that each electric utility will make interconnection

Our Practice

NERA is at the forefront of the continuing transformation of the energy industries worldwide. We developed approaches for introducing competition in segments such as power generation and gas supply where competition is workable, and for improving the regulation of sectors where it is not. We work with companies, governmental bodies, and regulators worldwide to design competitive gas and electricity markets, and to develop tariffs and rules of access for regulated transmission and distribution systems for electricity and gas, and the transport of oil and oil products.

We help companies develop strategies for exploring new opportunities and minimizing new risks, including issues related to climate change and other environmental initiatives. We help our clients to develop new regulatory strategies and, support them with analysis and testimony before regulatory commissions, antitrust and competition policy agencies, and domestic and international courts.

Our work includes designing and conducting energy auctions, providing strategy and valuation, advice on mergers and acquisitions, the financing of energy companies and the financial restructuring of distressed companies.



service available upon request to any electric consumer; the services will be based on the standards developed by the Institute of Electrical and Electronics Engineers.

The EPart sets out periods of up to five years, within which state regulators have to consider whether to adopt a standard and then to apply it.

Conclusion

EPart 2005 brings federal regulation of the electric industry into line with the modern development of a wholesale electricity market. It realigns the boundaries of regulation between federal and state authorities. Working out these new roles will create room for surprises.

Notes

- 1 Unlike the standards that were considered for adoption by the states following passage of PURPA of 1978 and EPart of 1992, EPart 2005 allows the a state to avoid considering these standard if certain "prior state action" criteria are met.

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