

# Special Report



Washington Research Council

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## Energy Market Skewed by Subsidies

### Background

Government-owned, public electric utilities and electric cooperatives enjoy taxpayer-subsidized cost advantages unavailable to private, investor-owned utilities. They have access to taxpayer-subsidized financing, they pay no federal income tax, and in the Northwest they have preferential claim to cheap federal hydropower marketed by the Bonneville Power Administration.

These advantages have not been hotly contested in recent years, because electric utilities have operated as monopolies with exclusive service territories. However, with federal legislation restructuring the industry to make it more competitive and with customers' increasing ability to choose their service providers, government subsidy of one class of competitors — public utilities — has become a significant public policy issue that lawmakers must resolve if restructuring is to succeed.

Restructuring began in 1992, when Congress introduced competition among wholesale suppliers of electricity by passing the Energy Policy Act. Congress, however, has left retail competition for end-users of electricity up to the states to sort out. At last count, 25 states have adopted plans for retail competition.

### Briefly

**Taxpayers subsidize the operations of publicly- and cooperatively-owned electric utilities. These subsidies – which include tax exemptions and preferential access to low-cost BPA power – all allow them to sell power at rates below those charged by investor-owned utilities. Loss of the subsidies would force the average government utility to increase rates by about one-third.**

**Nationally, these subsidies are being questioned as Congress and the states move to promote retail competition, the next stage of energy deregulation. At the same time, paradoxically, many public power advocates seek to use their competitive advantages to enter new lines of business and expand into markets currently served by private utilities.**

**Public policy should not favor one type of utility ownership over another. Successful retail markets depend on equitable regulatory and tax treatment of all competitors.**

### Current Volatility Reflects Market Changes

While Washington and the Northwest continue to enjoy comparatively low electricity rates, the 1998 figures used here pre-date run-ups in spot electricity prices experienced in recent months. Prices have begun to reflect the market that is developing at the wholesale level. High seasonal demand, low water levels, and generating capacity that has not kept pace with population growth have combined to drive up spot prices for electricity on the Mid-Columbia index. In June, market prices at one point tripled to more than \$100 per megawatt hour. As a result, Georgia Pacific's mill in Bellingham was shut down temporarily. Several aluminum plants are closing. Thousands of jobs are potentially in danger, and some say that without significant government intervention, the entire American aluminum industry is threatened.<sup>1</sup>

So far, Washington has not passed a retail-competition law. But even without one, some effects of such a law — including market positioning, competition for customers, and price volatility — already are evident here:

- ❑ Some local government electric utilities are venturing into new services, such as telecommunications and cable.
- ❑ Others are offering to supply low-cost electricity to large industrial users outside their service territories.
- ❑ And several other communities now served by higher-cost private utilities are debating whether to form their own public electric utilities.

The American Public Power Association has been urging government and cooperative utilities to emulate private utilities by adding new sources of revenue: “Investor-owned utilities (IOUs) are not constrained in their approach and see these mechanisms as vehicles for entering entirely new businesses and markets. Similarly, it has become important to many public power systems to consider equally aggressive strategies that guard or exploit a superior position.”<sup>2</sup>

The superior position enjoyed by public utilities is an artifact of government subsidies. And restructuring to allow competition raises the policy issue of whether those subsidies should continue.

The public policy question is simply stated: Should government subsidies favor one type of utility ownership, and its customers, over another? Should Seattle households in Madison Park and Blue Ridge pay 3.9 cents per kilowatt hour because they are served by a subsidized government utility, while a Renton household, served by a private utility, pays 5.8 cents?<sup>3</sup>

Other things equal, tax subsidies enable public utilities to charge less for electricity than private utilities can. The burden of those subsidies falls on taxpayers who must pay more taxes to make up for the subsidies or must make do with less government service.

## The Effect of Exemptions and Subsidies in Washington

Washington has relied more heavily on government utilities than has the rest of the country.

Utilities receiving tax exemptions and other financial subsidies include those owned by municipalities, public utility districts (PUDs), rural cooperatives and the Northwest’s federal government power marketing agency, the Bonneville Power Administration (BPA). Collectively, they deliver 67 percent of the electricity in Washington. The rest is delivered by private, investor-owned utilities.

Nationally, there are many more private utilities. Public utilities account for only 25 percent of all energy sales to ultimate customers. (See Figure 1).

Also contrasting with the rest of the nation, electricity in Washington, and in the Northwest generally, has been relatively cheap. Largely because of the region's vast and relatively inexpensive hydropower, electricity rates charged by utilities here, public and private alike, have been lower. During the past few decades, average electricity rates in Washington and the Northwest have been the lowest in the nation. (Figure 2 compares average rates for the nation and Washington by provider type for 1998.)

Locally, public-utility rates typically have been lower than private utility rates, primarily as a result of the government subsidies that public utilities have enjoyed. Take away the subsidies and public utilities would have to bill their customers at higher rates.

Recent analysis<sup>4</sup> shows that tax exemptions and other subsidies available to government utilities (PUDs and city-owned "munis") in 1998 enabled them to charge about 1.24 cents per kilowatt hour less – amounting to more than a third of their rates – than they would have charged without these advantages.

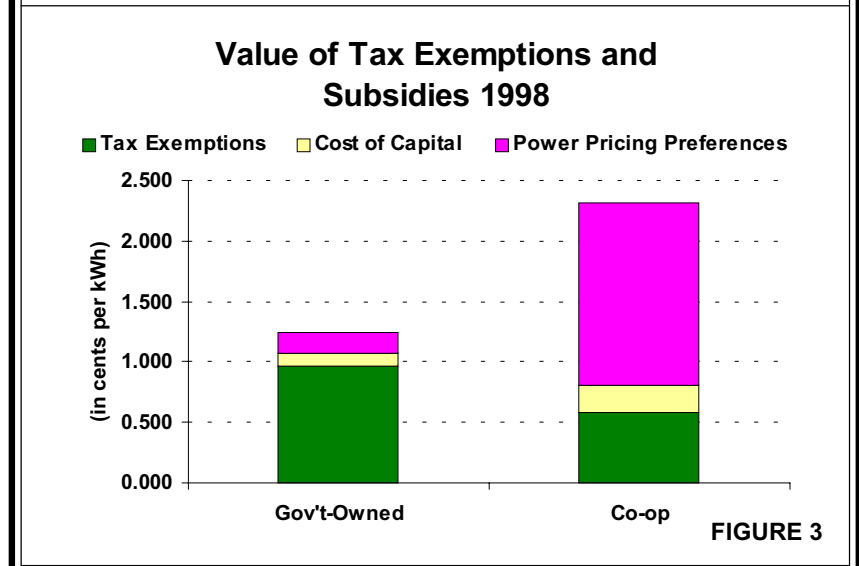
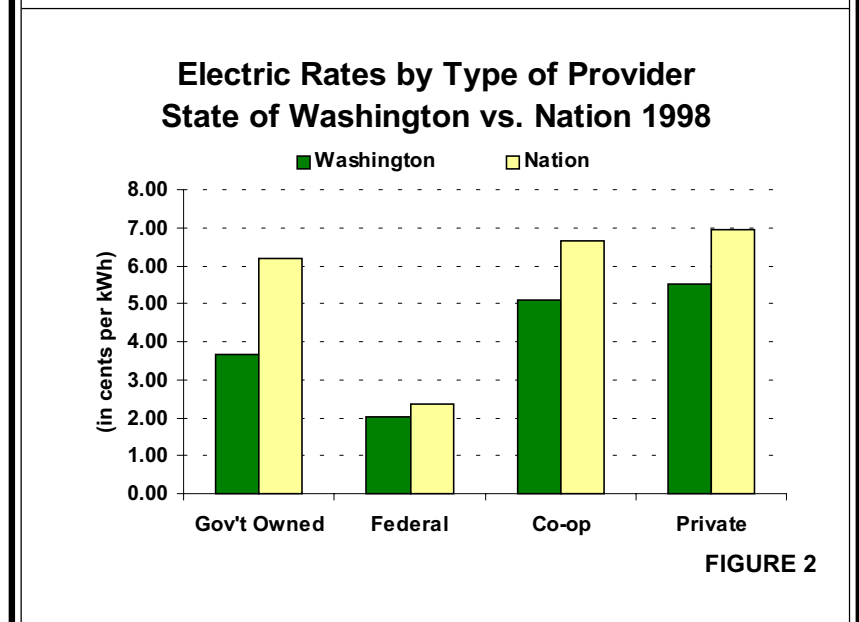
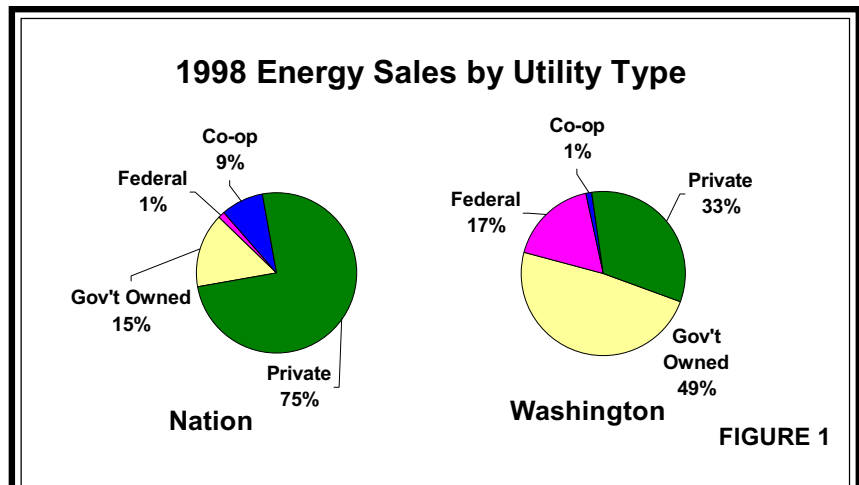
For rural cooperatives, the increase would have been even more dramatic. They would have had to raise their rates by about 2.32 cents per kilowatt hour, or 46 percent.

As shown in Figure 3, the different subsidies available to public utilities breakdown as follows:

**1. Tax Exemptions –**

Private utilities must pay federal income and other federal, state, and local taxes that are not levied on government utilities.

Based on 1998 data, government utilities in Washington would



have had to increase revenues by nearly 17 percent (0.97 cents per kilowatt hour) to pay federal, state and local taxes on the same basis as private utilities. For co-ops, the increase would have been 11 percent (0.58 cents per kilowatt hour).<sup>5</sup>

**2. Cost of Capital** – Government utilities have access to low-cost capital through various government-subsidized loans and loan-guarantee programs and through tax-exempt bonds.

Private utilities have access to none of these. If government utilities had not had these advantages, they would have had to raise 1998 rates by roughly 2 percent (0.10 cents per kilowatt hour) to cover the higher cost of capital. Cooperatively-owned utilities would have needed to increase rates by 4 percent (0.23 cents per kilowatt hour).

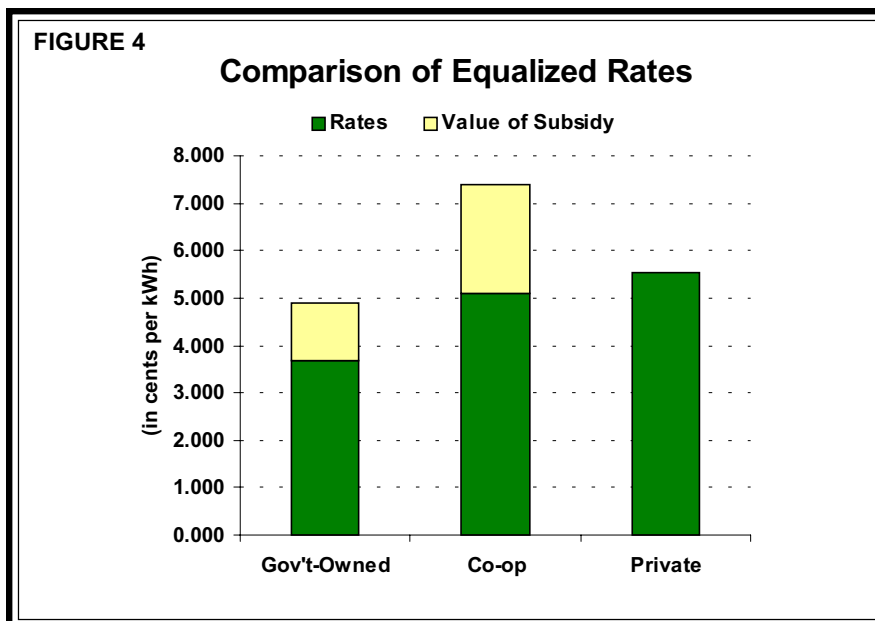
**3. Preference Power and Preference Prices** – Government utilities and cooperatives, and their customers, have first claim, or preference, to low-cost federal hydropower marketed by the Bonneville Power Administration (BPA). And not only do they have a priority claim, they also pay lower wholesale prices to BPA than private utilities are required to pay.

If government utilities here had the same underlying power costs as private utilities, they would have to raise their rates by about 3 percent (0.17 cents per kilowatt hour). Co-ops, few of which generate their own energy, would have to up their rates by 29 percent (1.51 cents per kilowatt hour).

All in all, if government utilities were to pay for taxes, capital costs, and federal power the same way the private utilities in Washington do, they would have to increase their rates to end-use consumers by nearly 34 percent, or about 1.24 cents per kilowatt hour.

Co-ops would have to raise their rates by nearly 46 percent, or 2.32 cents per kilowatt-hour.

These increases are averages; some public utilities would charge higher rates, some lower. On average, though, if exemptions and subsidies were eliminated, so that all utilities were treated equally, rate differences between private and government utilities would narrow significantly. For 1998, for instance, government utilities on average would have charged about 4.9 cents per kilowatt hour— their current average rate of 3.67 cents per kilowatt hour plus the 1.24 cents per kilowatt hour required when the subsidies are removed. This compares with an average private utility rate of 5.5 cents per kilowatt hour. Co-ops would have charged the highest rates, about 7.4 cents per kilowatt hour (see Figure 4).



Finally, it's important to note that the value of these tax exemptions, subsidies, and power pricing preferences to public utilities only include those advantages that are relatively easily quantified. Government-owned utilities enjoy other significant advantages, which add up to real cost savings, whose value is not captured in these figures. They include: preferential treatment in the licensing and relicensing of dams and other capital facilities; authority over land use, facility siting and permitting; powers of taxation and eminent domain; and other regulatory authorities.

## What Is Congress Doing About Subsidies?

Congress is still trying to pass comprehensive restructuring legislation. No final action is expected, however, before the end of this session.

Meanwhile, government utilities have been working hard to convince Congress that they not only need to retain their access to tax-exempt financing, but that they should have even greater flexibility in how they raise money to fund capital expansion.

As it now stands, government utilities may use funds raised from tax-exempt bonds to build capital facilities intended solely to serve customers located within their service areas. This restriction is based on the "private use" provisions in federal tax law, which make it illegal for private parties to benefit from public facilities financed with tax-exempt debt. In effect, it means that government utilities may not compete beyond their boundaries without jeopardizing the tax-exempt status of their bonds.

The Internal Revenue Service has issued temporary regulations allowing conditional private use in states with laws promoting retail competition. But they are only temporary. The real fix is up to Congress.

Sen. Slade Gorton (R, Washington) has proposed one version of such a fix in Senate Bill 386, The Bond Fairness and Protection Act of 1999. Many private utilities oppose this measure, however, and government utilities and the American Public Power Association have sought to defend Gorton's bill against their criticisms.

Said APPA's executive director last year, "Critics contend that the Gorton bill is unfair because it does not force public power to play by the same rules as private power. The response to that is, why should we? Public power systems are units of state or local government subject to their own unique set of rules, such as sunshine laws and open record requirements."

The Edison Electric Institute (EEI) and many private utilities claim Gorton's bill would jeopardize competition by expanding the ability of government utilities to finance transmission facilities and power plants with new tax-free debt. EEI backs a competing bill sponsored by Rep. Phil English (R, Pennsylvania).

The chairman of the Senate Energy and Natural Resources Committee, Sen. Frank Murkowski (R, Alaska), who has offered his own bill, has

summed up the issue this way: “No one wants to see the bonds issued to finance public power become retroactively taxable because a municipality chooses to participate in a state open access plan. At the same time, public power should not obtain a competitive advantage in the open marketplace based on the federal subsidy that flows from the ability to issue tax-exempt debt.”

Though a limited bill dealing with energy reliability may pass Congress this session, no comprehensive bill has yet garnered the votes necessary for passage.

## **BPA proposes a new rate schedule, continues subsidy to government and cooperative utilities**

At the regional level, BPA has proposed a new five-year rate schedule that continues to favor government utilities and cooperatives. The schedule gives them more power and at cheaper rates than it does to private utilities, which serve 60 percent of the region’s residents.

Government utilities defend their preferential treatment by BPA. But the issue is drawing attention from Congress, which has a national perspective and is largely impatient of the intramural quarrels of Northwest utilities.

As recently reported by The Wall Street Journal, “Roy Hemmingway, (Oregon) Gov. Kitzhaber’s policy advisor on salmon and energy, says that as the power industry moves toward the free market, ‘Bonneville’s policy of serving the minority of residents in the region is going to make it stick out like a sore thumb.’”

As if to confirm Hemmingway’s point, Congressman Bob Franks, (R, New Jersey) asked earlier this year: “As Congress restructures and brings competition to the utility industry, isn’t it time to eliminate these outmoded taxpayer subsidies to the select few beneficiaries of federal electricity?”

## **Critical Issues Remain**

No matter what action Congress takes, several larger issues will remain:

1. Even if subsidies and tax exemptions were stripped away, could government utilities and cooperatives compete fairly with private corporations?

Probably not. While government utilities correctly argue that their public status constrains them in ways that don’t apply to private corporations, the governmental powers and authorities held by public utilities give them an edge. These include: preferences in licensing and relicensing capital facilities; the power to tax; the authority over land-use planning, facility siting and permitting; the power of eminent domain; and the authority to

regulate various private actions and activities, including in some cases those of private utilities.

2. Taxpayer risks increase when their government enters the marketplace.

Existing public utilities that choose to enter new markets place their taxpaying constituents at a heightened financial risk. So too do governments that seek to “municipalize” their utility operations. This risk is not theoretical.

Municipalization occurs when cities or PUD’s buy out existing private utilities or build their own facilities to replace private service. Doing so involves issuing public debt. This debt is serviced by revenue from sales of electricity and other services. If competitors later lure customers away from public utilities, these utilities will lose revenue, and taxpayers will have to make up the difference.

A recent report by Reason Public Policy Institute highlighted the gamble taken by some government utilities when they attempt to use their cheaper access to capital to strengthen their competitive position. The authors note: “Moody’s has criticized public utilities for taking on debt in order to cut rates as risky and financially unsound practice.”<sup>6</sup>

3. Lower prices resulting from subsidies encourage resource over-use.

Friends of the Earth – a self-described association of taxpayers, deficit hawks, free-market advocates and environmentalists – has voiced concern about the environmental effects of subsidies of electric energy, and now advocates their elimination.<sup>7</sup>

In a recent report, Friends of the Earth criticizes power marketing administrations, such as BPA, and the Rural Utilities Service: “Selling power at below market rates removes any incentive for customers to use energy efficiently and provides unfair subsidies to certain regions of the country.” The report also scores the Rural Utilities Service for making “loans to utilities to subsidize electric service in rural areas, despite the fact that this program is now obsolete.”

## So what needs to be done?

The central question is, should government subsidies favor one type of utility ownership and its customers over another? And the answer is, no.

Subsidies favor one set of consumers over another, with no resulting public benefit. Subsidies distort market decisions, by encouraging wasteful use of valuable resources. Subsidies, approved in a different time and under different conditions to achieve different purposes, are now obsolete and should be eliminated.

One of two directions should be followed. Either the operating rules need to change for those government and cooperatively-owned utilities choosing to compete, or these utilities should transform into corporate entities, governed by the rules for private corporations.

In the first instance, Congress, primarily, would need to equalize government-subsidized financial advantages. Mostly this would involve changes to the federal tax code and to eligibility requirements for numerous federal finance programs.

In addition, all levels of government would need to identify and equalize their treatment of public and private utility competitors. Public agencies frequently are exempt from the taxes, fees, laws and regulations that are imposed on private entities. Disparities in private and public power costs, therefore, will continue to pop up in odd places until government entities are subject to the same conditions as their private competitors.

For instance, Washington's Department of Natural Resources recently increased fees to private utilities for running cables, pipes and lines over and under state wetlands and waters. Traditionally, the department charged only a nominal fee for permits to cross state-owned aquatic lands.

Puget Sound Energy last year sought a permit for which it expected to pay about \$4,000. The department, however, now intending to cover not only its administrative costs but what it believes is fair compensation for the private use of public aquatic lands, initially charged Puget \$18,000. And it later upped the bill to \$75,000.<sup>8</sup>

Government utilities are exempt from paying aquatic-lands permit fees at all. Under competitive conditions, such fees that are applied on the basis of whether an entity is public or private simply exacerbate the inequity of the competition.

The example underscores the difficulty of policymakers face in trying to equalize the treatment of public and private competitors. The Reason Public Policy Institute (RPPI) has suggested a better alternative: "corporatization."

In a 1999 report on utility subsidies in a competitive market,<sup>9</sup> RPPI concluded that government utilities choosing to compete in the market should have to give up their privileged status, including their use of tax-exempt debt. As a long-term solution, RPPI recommended that government utilities convert into corporate entities and operate under the same set of rules governing private utilities.

The report lists the characteristics of this "corporatized" entity. It would:

- Involve a major restructuring of the public enterprise, but no change of ownership.
- Be legally converted into a for-profit business;
- Have government as its sole shareholder.
- Be run by a board of directors, which would select a Chief Executive Officer.
- Be freed from all government personnel and procurement regulations, and instead be subject to corporate law and government regulations applying to corporations;



- Pay federal, state and local taxes and fees, just as any other business entity does.
- Be subject to corporate accounting standards.
- Pay dividends to its shareholder(s).

According to RPPI, *“Corporatization is not privatization – the government remains the shareholder in the firm. But the corporatized muni now functions financially, legally, and operationally in a competitive market as an equal player...”*<sup>10</sup>

Corporatization would carry a price. City charters would probably require revision, and extensive legal and accounting preparation would be necessary.

But corporatization has been successfully and extensively done overseas. And it would avoid the infinitely more cumbersome task of changing the myriad federal, state and local laws and regulations affecting public entities to reflect a different set of conditions for publicly-owned utilities.

Together with other policy analysts, RPPI has suggested other ways of dealing with public utilities competing in the open market, including contracting out for private management, selling public utilities to private investors, and entering into alliances with private providers.<sup>11</sup> But with the exception of selling the utility, which may be politically unfeasible in Washington, these alternatives add unnecessary cost, complexity and controversy to the same set of problems that currently distort a competitive market. And they do so without providing any tangible or certain benefit.

## Deregulation Thwarted by Subsidies

The 1992 Energy Policy Act changed some of the basic rules governing the electric utility industry. We are now in the midst of a period of transition filled with uncertainty. As recent experience has shown, the energy market can experience extreme price volatility, jeopardizing business operations and affecting residential consumers. An efficient marketplace should mitigate instability. But current legislative and regulatory ambiguities and inequities instead magnify the problems. Washington cannot stand alone against a national drive to complete deregulation. And deregulation simply cannot work under current conditions.

Our state and local elected officials and utility industry leaders need to work together with our Congressional delegation to identify a long-term solution that promotes fair competition, interferes as little as possible in the competitive marketplace, and moves us quickly to a state of long-term equilibrium in the Northwest. All energy providers should compete in a market place free of unfair government subsidies.

## End Notes

<sup>1</sup> *Aluminum Smelters' Woes May Have Only Just Begun*, Rob Eure, Wall Street Journal, June 21, 2000.

<sup>2</sup> *Business Opportunities for Public Power Utilities, A Comprehensive Guide for Understanding and Implementing New Products and Services*, Prepared by Stephen A. Marsh under a grant from the American Public Power Association's DEED program. No date

<sup>3</sup> Rates per kilowatt hour cited compare 1998 average rates charged by Seattle City Light and Puget Sound Energy as reported by U.S. Department of Energy, Energy Information Administration and the Federal Energy Regulatory Commission.

<sup>4</sup> *Government-Subsidized Electricity in Washington*, prepared for the Washington Research Council, by THE SIMEON PARTNERSHIP, June 2000.

<sup>5</sup> Ibid.

<sup>6</sup> *Muni Power Grabs: Municipal Utilities, Tax-exempt Debt, and the Competitive Market*, Adrian Moore, with Jeff Woerner, Reason Public Policy Institute, e-brief #103, November 1999. This reference in turn references an article in the February 4, 1998 Wall Street Journal by Charles Gasparino, entitled "New York Power Authority Moves to Issue Bonds to Help Utilities Compete Against Private Firms."

<sup>7</sup> *Green Scissors 2000, Cutting Wasteful and Environmentally Harmful Spending*, Friends of the Earth, 2000.

<sup>8</sup> Washington Research Council interviews, June 2000

<sup>9</sup> *Muni Power Grabs: Municipal Utilities, Tax-exempt Debt, and the Competitive Market*, by Adrian Moore with Jeff Woerner, Reason Public Policy Institute, 3-brief #103, November 1999

<sup>10</sup> *Integrating Municipal Utilities Into A Competitive Electricity Market, Part 5 Structural Options for Munis in a Competitive Market*, Reason Public Policy Institute, Policy Study 270, by Adrian T. Moore with Jeff Woerner, June 2000.

<sup>11</sup> Ibid.

