TEXAS BUSINESS REVIEW

Bureau of Business Research
College and Graduate School of Business, University of Texas at Austin

August 1996

Regulatory Reform, Texas-Style: The Electric and Telecommunications Industries

The electric and telecommunications industries account for more than $350 billion annual sales in the United States; $21 billion in Texas. Because both the electric and local telephone industries have natural monopoly characteristics, government regulation has been in place for many years. In Texas, for example, the passage of the 1975 Public Utility Regulatory Act (PURA) brought state regulation to both industries.

The 1992 passage of the federal Energy Policy Act (EPAct) and 1995 corresponding amendments to the Texas Public Utility Regulatory Act (PURA 95) increased competition in the electric market. Similarly, the 1995 amendments to PURA and the Federal Telecommunications Act of 1996 (FTA 96) brought competition to the telecommunications market. As these industries undergo significant changes, market forces are replacing government regulation. For example, the Texas Public Utility Commission (PUC) is proceeding with implementation of *wholesale competition* by allowing all market participants nondiscriminatory access to the Texas transmission network. Also, in August 1996, the PUC convened telecommunication industry representatives and customers to work toward resolution of issues surrounding the entry of Southwestern Bell Telephone Company into the long-distance market and of long-distance companies, cable companies, and others into the local telecommunications market.

Retail competition may become a reality in Texas and other states within the next few years, and it is important that government ensure that all customers benefit from a more competitive marketplace. Regulators must put in place appropriate mechanisms both to preserve universal service in a competitive environment and to protect the reliability and quality of service. In this article, we discuss some of the issues surrounding the move toward greater competition and examine some of the efforts undertaken by regulators to facilitate the transition.

Electric Industry

Background

Texas is served by ten investor-owned electric utilities, nineteen municipal utilities (including San Antonio and Austin), 86 electric cooperatives and four river authorities. These utilities provide electric services to about 7 million households and businesses, employ more than 40,000 workers, and earn annual revenues of about $15 billion. Texas Utilities Electric Company, serving the Dallas-Forth Worth metroplex and Central Texas, and Houston Lighting & Power Company are the two largest electric utilities in Texas.

The 1992 federal EPAct brought increased competition to wholesale markets. Unregulated exempt wholesale generators, power marketers, and power brokers now compete with electric utilities for bulk power sales. In 1995, the Texas Legislature amended PURA, which allows wholesale competition: that is, regulated and nonregulated electric energy providers compete for a piece of total Texas electricity generation.

However, these changes in the laws did not authorize retail competition, which would allow customers (residential, commercial, and industrial) to select their electricity supplier, and full competition will not exist until there is retail competition. At this time, only a few states are moving to implement competition at the retail level, while many are adopting wholesale competition. The future of deregulation and retail competition will remain a topic of debate in Texas and elsewhere for the next few years.

Industry restructuring

Supply-side competition is still new and gaining momentum in the electric industry. However, dually certified service areas, where customers have more than one choice of utility for power, have been in existence in Texas for years. *Demand-side competition* has always been available to electricity customers on a limited basis. Customers, for example, could replace electricity with natural gas for home heating and cooking or rely on self-generation instead of buying from electric utilities.

Some Basic Terms

Competition:

• *Demand-side.* A situation in which producers of different products and services compete to meet a particular need of customers. Example: competition among electric and gas utilities to provide heating services to customers.

• *Supply-side*. In this stage, different producers of a single product or service compete to obtain a bigger share of the market for that product or service. Example: competition among different telephone companies to provide long distance services.

Stranded benefits. Socially beneficial activities that might not survive in a competitive market. Example: long-range research and development or utilities' low income demand-side efficiency programs.

Stranded investments. Utility investments that may have been prudent at the time of approval by a regulator, but that will become uneconomical in a competitive market. Example: nuclear plant investment costs.

Among states that are addressing the emerging competitive issues facing the electric industry, California took the lead in April 1994, proposing massive restructuring of its electric industry. In 1996, PUC proposed its own innovative plans for restructuring the industry, and, in fact, its work on the open-access comparable transmission service rules may become a model for other states and the Federal Energy Regulatory Commission.

In addition, the PUC has proposed a plan, known as the "Texas Model," that would foster competition by requiring utilities to divest their generation assets. The PUC's open-access comparable transmission service rules have guided the Federal Energy Regulatory Commission in the development of a similar rule being applied nationally.

The changes to the PUC's enabling legislation in 1995 were a landmark for the electric industry in Texas. To implement the new law, the PUC reorganized, developing new rules and procedures to better address emerging issues. The changes implemented include:

• Transmission service. The PUC now requires transmission-owning utilities to provide service on a comparable and nondiscriminatory basis, and the commission is considering a proposal for an Independent System Operator for the Electric Reliability Council of Texas (ERCOT), which may make Texas the first state with fully comparable access to transmission facilities.

• Competitive electric resource acquisition. The PUC recently adopted an integrated resource planning rule, which focuses on public participation, market-based competitive resource acquisition, and well-balanced utility resource portfolios.

• Pricing flexibility. The PUC has approved discounted rates for several large customers who would otherwise leave the utilities to self-generate. These proposals include safeguards to prevent any harm to captive customers.

• Wholesale competition. As of May 1996, 35 exempt wholesale generators and power marketers have registered with the PUC to compete with utilities in the wholesale market.

• Cooperative deregulation. The PUC has issued certificates of deregulation to 34 electric cooperatives: more than 40 percent of such cooperatives operating in Texas.

Issues

Two major divisive issues in Texas are retail competition and *stranded investment.* Large industrial customers insist that retail access and full competition in the electric industry are needed. Competition limited to the wholesale market is advocated by most utilities and some consumer advocates and environmental groups.

Most utilities insist on fully recovering the costs of their stranded investments because these costs were approved by the regulatory authority. In contrast, consumer groups have recommended cost sharing among shareholders and ratepayers. Exceptions among the major utilities are Texas-New Mexico Power Company and Southwestern Public Service Company, each of which has officially announced the need for utility shareholders and customers to share the costs of restructuring.

The PUC will present the 75th Legislature with recommendations on stranded investment and the scope of competition in the electric industry in Texas. Among the electric industry issues to be considered in the legislative session are:

• Deregulation of generation. It is likely that legislators will take additional steps to complete the deregulation of the generation segment of the electric industry.

• Competitive alternatives. Legislative activities are expected to create a competitive environment for alternative resources such as renewables and energy efficiency programs.

• Stranded investment. Stranded investment amounts to about $8 billion in Texas. Legislative decisions may be made on the way these stranded costs will be shared by utility shareholders and ratepayers.

• Existing socially beneficial activities (*stranded benefits*). Utility activities such as low-income rates, energy efficiency and conservation programs, and research and development, which may not survive under a more competitive environment, may be protected by legislative actions.

• Customer protection/quality of service. Additional safeguards may be imposed, strengthening the utilities' obligation to serve and the quality of service provided.

• Reform of ratemaking. Performance-based regulation may replace cost-of-service regulation in certain areas. Emphasis will be on achieving certain benchmarks before utilities are allowed to recover their costs.

• Retail/self-service wheeling/power exchange. On a limited basis, large industrial customers in Texas may be allowed to bypass their host utilities to shop for lower rates.

Telecommunications Industry

Background

The 58 local exchange telephone companies in Texas took in $5 billion in revenues in 1994, providing service to 10.2 million access lines. Local telephone companies together employ more than 35,000 workers. The largest of these companies are Southwestern Bell (SWB) and GTE, which together serve 93 percent of the state's access lines. The parent companies of both GTE and SWB have moved their headquarters to Texas in the last few years.

The remaining 7 percent of Texas telephone customers receive local dial tone from one of the 26 telephone cooperatives or 30 smaller investor-owned local telephone companies. More than 91 percent of Texas households have telephone service, yet Texas ranks 43rd among the 50 states in this measure of universal telephone service.

The structure of the industry was dramatically changed by the divestiture of the Bell system on January 1, 1984. While AT&T still holds more than 60 percent of the long distance telephone market, other competitors such as MCI and Sprint have been increasing their shares in recent years.

Industry restructuring

Within three years, under the provisions of the FTA 96, AT&T will be competing against its former subsidiary, SBC Corporation (formerly Southwestern Bell), in the interLATA (Local Access and Transport Area) and interstate long-

distance business.

In September 1995 major revisions to PURA 95 took effect in Texas. Important provisions include:

• A voluntary incentive regulation framework that suspends for four years the regulatory review of company earnings and expenses and establishes rate caps for basic services. In exchange, electing companies commit to interconnect public entities such as schools and libraries.

• A Service Provider Certificate of Operating Authority (SPCOA) enables the holder to purchase local service wholesale at a 5 percent discount and resell it. A Certificate of Operating Authority (COA) allows the holder to enter the local market, but it entails an obligation to build facilities to serve at least 60 percent of the service area and does allow the 5 percent discount.

• The establishment of competitive safeguards to create a market climate in which new entrants can compete.

Since PURA 95 took effect, 38 firms have been certified to compete in the state's local telecommunications markets. The PUC has established interim rates for unbundled loop service, which connects a customer's premises with the telephone company's switch, and interim number portability, services that new market entrants need from the incumbent in order to provide competitive service.

List of Acronyms

EPAct–Energy Policy Act
ERCOT–Electric Reliability Council of Texas
FTA–Federal Telecommunications Act
ILEC–Incumbent Local Exchange Carrier
LATA–Local Access and Transport Area
PUC–Public Utility Commission of Texas
PURA–Public Utility Regulation Act
SPCOA–Service Provider Certificate of Operating Authority
SWB–Southwestern Bell

As competition grows in Texas, the market changes will be accompanied by a blurring of the distinctions among industries. Local calling, traditionally billed at a flat rate, may be provided on a per-minute or per-message basis. New entrants may define their own calling scopes, effectively providing long-distance service at flat monthly local rates. Cable companies may bundle TV service with telephone service, and other local competitors may offer packages including long-distance calling, Internet connection, and other services. This "one-stop shopping" promises customer confusion as well as convenience.

Issues

Southwestern Bell may fully participate in the Texas long-distance market when the Texas market for local telephone services is sufficiently competitive, as measured by a fourteen point checklist specified in FTA 96. Several items related to the fourteen points are on the agenda for the PUC's Forum for Comprehensive Resolution of Telecommunications Issues. Among the major issues to be mediated are:

• Market entry. Some of the distinctions between operating certificates (SPCOA and COA) have been blurred by PUC interpretation. The Forum will discuss eligibility—who can enter the market as a reseller?—and the build-out obligations of a COA holder.

• Resale of local service. Resale is addressed by both FTA 96 and PURA 95, and their provisions are quite different. FTA 96 removes all resale prohibitions by the state's incumbent local exchange carriers (ILECs). The resale provisions of PURA 95, which are the subject of preemption petitions before the FCC, prevent certain entities from entering the market as pure resellers.

• Competitive safeguards. For telephone competition to work well for customers and competitors, issues such as local number portability, interconnection and resale of local facilities, and service pricing must be resolved.

• Affordable local service. The transition to competition will tend to move local service rates toward cost. To the extent that this process puts upward pressure on some local rates, the state must establish a system to ensure affordable local service for all Texans. This will involve replacing hidden subsidies (like high rates for access to the local network) with explicit support mechanisms.

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Conclusions

The electric and telecommunication industries that emerge in the next decade will be shaped largely by market forces rather than by regulators' orders. While the move toward a more competitive environment can benefit customers as well as service providers, regulators must be concerned about several issues affecting the public interest.

First, regulators must protect universal service. Issues of competition and relaxed regulation have direct implications for the continued provision of electric and telephone services to rural and high-cost areas. Current support mechanisms, which rely heavily on implicit subsidies included in service rates, do not work well in a competitive framework. FTA 96 instructs regulators to replace implicit price supports with explicit ones.

Second, regulators must monitor the operation of the competitive marketplace and enforce the competitive safeguards provided for in state and federal law. State and federal commissions play an important role in policing anticompetitive abuses by firms operating in a partially competitive environment.

Finally, regulators must protect the reliability and quality of service and provide a forum for the resolution of consumer complaints in the new competitive industries. Although customer choice is one of the great benefits of competition, more options inevitably increase customer confusion. To reduce this confusion, the PUC should require regulated utilities to provide accurate and beneficial information to their customers to facilitate their choice among available options in the market.

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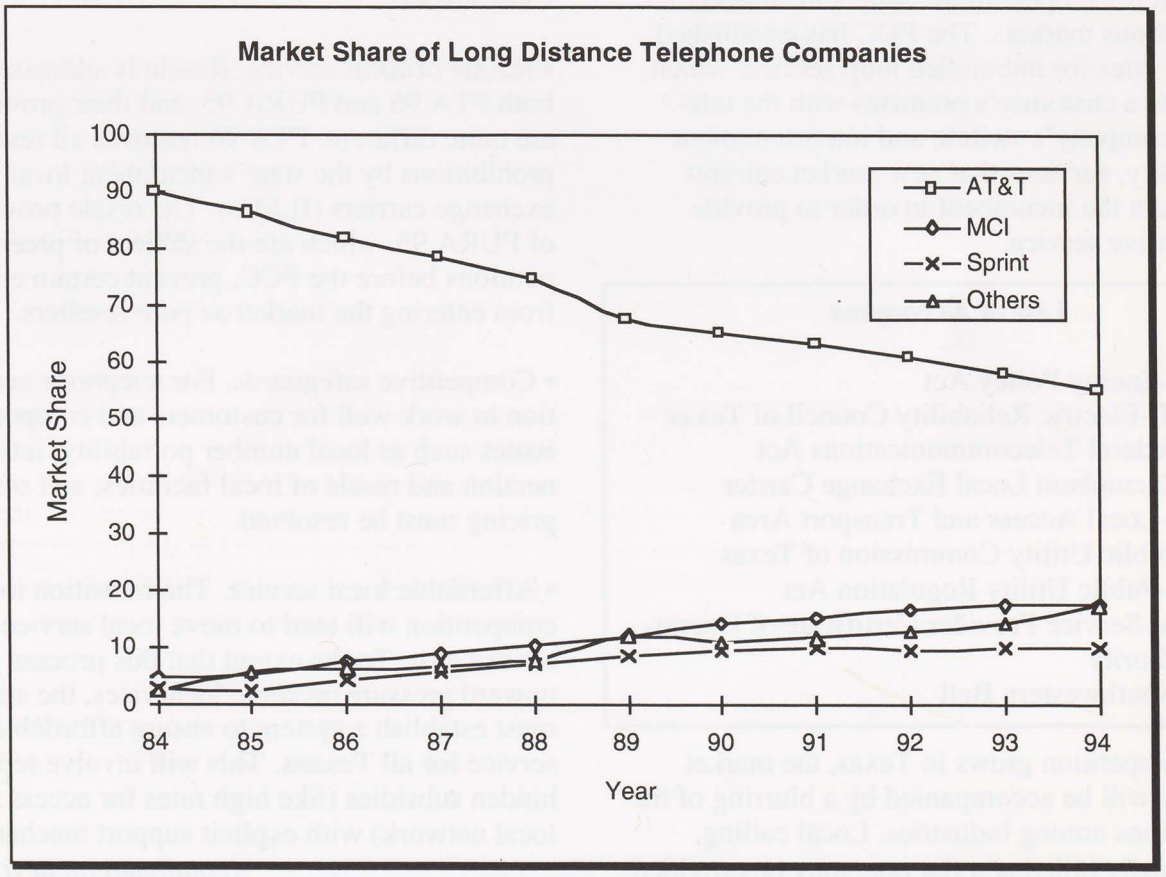
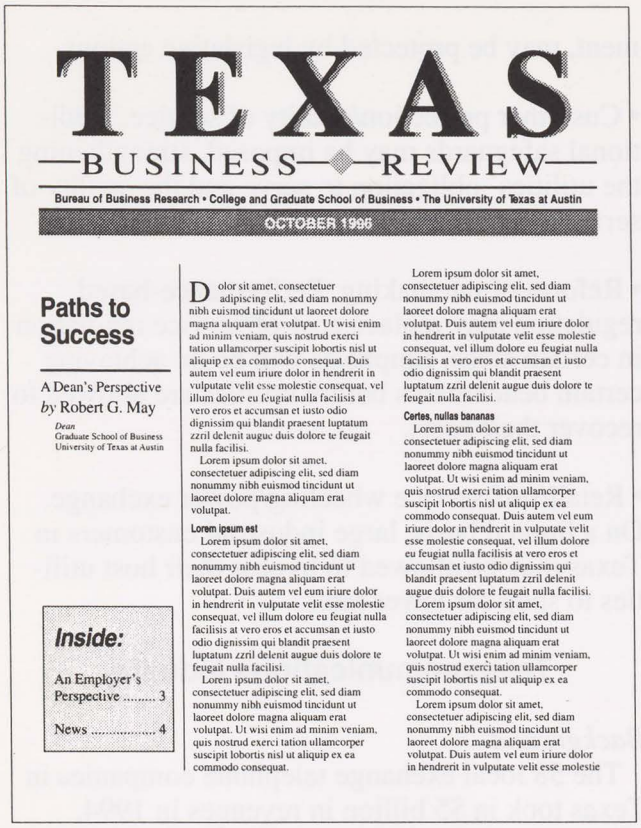
Note: The opinions expressed in this article are those of the authors and do not represent the opinion of the Public Utility Commission of Texas.





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OCTOBER 1996

Paths to Success

A Dean's Perspective
by Robert G. May

Dean
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Inside:

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Announcement

Beginning with the October issue, the *Texas Business Review* will have a new look. The image you see on the left is a preview of the format, in miniature. (Please don't strain to read the article; it's just simulated copy.) I hope you like the change; we do. The redesign makes article titles and authors' names more prominent and allows for natural page sequencing, page numbering, and more efficient use of available space. Michael Ambrose designed the format and provided the electronic templates we'll use to produce future issues. Please let me know what you think of the changes.

—Lois G. Shrout, Editor

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