

# Integrating Municipal Utilities into a Competitive Electricity Market

BY ADRIAN MOORE WITH JEFF WOERNER

## Executive Summary

Electric-industry restructuring is already a reality for half the states in the nation, and more will soon follow. Given time for markets to develop, competition in generation of electric power should bring consumers more choices of electricity services and lower prices. But so far, the restructuring debate has focused on integrating private utilities into competitive markets, while paying little attention to the issue of integrating the nation's over 2,000 municipal utilities (munis) into competitive markets. Participating in competitive markets is not easy for government-owned entities, and markets don't function well when groups of participants play by different legal, tax, and regulatory rules.

Integrating munis into competitive electricity markets requires grappling with both public-policy challenges and management-policy challenges. The public-policy challenges begin with defining a new role for munis in the electric industry as it evolves toward competition. Munis were born in an era without competition as an alternative to poor service from private utilities. As the market becomes competitive, what role remains for munis? Part of the answer is the second public-policy challenge: munis have become an often critical source of municipal revenue; when they have to compete for customers, they can no longer be a city's cash cow, and some cities may find that competition brings a financial crisis.

A third public-policy challenge is financial subsidies provided to munis. They get preferential access to cheap federal hydropower, do not pay federal income taxes, and can use lower-cost, tax-exempt bonds to pay for capital projects. All give munis a financial edge over private utilities that will distort a competitive market. How do we change these policies as the market moves from monopoly to competition?

The management-policy changes that munis face are no less thorny. Typical munis have much higher debt levels than private utilities. They are often managed through politicized city bodies that react slowly to change and make decisions for political rather than economic reasons. And competitive markets are a far riskier environment than monopoly—a muni that makes the wrong decisions, or is simply outsmarted by a

competitor, will lose money. That is one reason why services with competitive risk are best left to private firms. If city and muni officials cannot overcome these challenges, they will likely have to answer to taxpayers for the financial costs of their failure.

Some munis are seriously working to cope with the public and management-policy challenges they face. Others are trying to avoid competition or are striving to seize upon ways to distort competition in their favor. They are striving to expand their service areas, create new munis, and launch risky commercial ventures unrelated to electricity, such as cable TV and home-security businesses. In each they are trying to earn profits, all the while professing to be nonprofit entities. Their actions seek to expand government participation in the electricity market precisely when policy is seeking to make it more competitive.

To help public officials understand the options available to them to help transition munis into a competitive market, we examine several options and provide a matrix for evaluating the merits of each option:

- **Corporatization:** turning the muni into a private corporation with the city as sole shareholder;
- **Selling the Utility:** an option increasing popular in the rest of the world, with a number of methods that can be tailored to a local government's needs and goals;
- **Contracting for Operations:** hiring a private firm to operate and manage the muni; and
- **Alliances:** teaming up with a private partner to jointly manage the muni.

Finally, we make a series of policy recommendations for making the transition from monopoly to competition and establishing a competitive electricity market where consumers can enjoy sovereignty to choose providers and services:

- Focus on Competition;
- Address the Tax-exempt-debt Problem;
- Open Access to Federal Power;
- Put an End to Municipalization; and
- Put an End to Commercial Ventures by Government Utilities.

## Part 1

# Introduction: The Restructuring Context

Electric-industry restructuring is transforming how Americans receive electric power. Twenty-four states have already passed restructuring laws or issued regulatory orders (see Figure 1).<sup>1</sup> Many of the other 26 states may act soon as well—nine states adopted restructuring plans in 1999, compared to two in 1998.<sup>2</sup> Meanwhile, Congress is considering a string of bills that would impose a nationwide mandate to restructure the industry, and few doubt that one of those bills will pass eventually.

The underlying key to electric-industry restructuring is to allow customer choice and competition in what has traditionally been an almost exclusively monopolistic industry. Current restructuring schemes are focused on making the generation of electric power fully competitive and offering customers greater choice in selecting power providers. Most likely, the transmission and distribution of electricity will remain a regulated monopoly service. But, not surprisingly, moving even part of an industry from monopoly to competition means big changes in the industry. Change brings opposition—a quick glance at the debate over restructuring the electric industry shows that some participants want to keep the industry very static, with the same players and many of the same rules. Some players in this debate want the cost savings that competition brings but not the new business structures, new approaches, innovation, winners, and losers—in a word, change—that competition brings.

As economist Irwin Stelzer remarked in the *Electricity Journal*:

*Joseph Shumpeter would be delighted were he around to see what is going on in the electric utility industry. For rarely has a gale of creative destruction hit any segment of the economy with the force that competition is hitting the electric, gas, oil, and related industries. The discomfort that many of the industries' executives feel at being exposed to weather so inclement as Shumpeter's gale of creative destruction would add to the great economist's joy, for above all he championed the notion that capitalism survived because, snake-like, it knew when to shed dead skin to make room for new growth.<sup>3</sup>*

<sup>1</sup> The Department of Energy's Web page "Status of State Electric Industry Restructuring Activity" ([www.eia.doe.gov/cneaf/electricity/chg\\_str/regmap.html](http://www.eia.doe.gov/cneaf/electricity/chg_str/regmap.html)) provides a regularly updated picture of restructuring activity. As of December 1, 1999, the DOE showed the following breakdown of state activity. States that have restructuring legislation: Arizona, Arkansas, California, Connecticut, Delaware, Illinois, Maine, Maryland, Massachusetts, Montana, Nevada, New Hampshire, New Jersey, New Mexico, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, Texas, and Virginia. States that have restructured through a regulatory order: Michigan, New York, and Vermont. All other states are investigating the issue in their legislatures or by commission.

<sup>2</sup> *Update: Summary of Electric Utility Regulatory Developments Through October 1999*, GRI-99/0240 (Washington, D.C.: Gas Research Institute, December 1999), [www.gri.org](http://www.gri.org).

<sup>3</sup> Irwin M. Stelzer, "Have Sympathy for the Unloved 'Undecideds,'" *Electricity Journal*, vol. 12, no. 5 (June 1999).



Meanwhile, the U.S. Department of Energy has proposed nationwide restructuring based on the conclusion that competition will cut rates and “save consumers over \$20 billion a year, spark innovations in technology and bring benefits to the environment.”<sup>5</sup> The Energy Information Administration (EIA) has explored how restructuring will affect the distribution of prices, concluding that even if competition does not change industry structure or practices, the range of prices across the nation will narrow.<sup>6</sup> Right now, prices in the highest-cost region (New York) are nearly 2.3 times prices in the lowest-cost region (the Pacific Northwest). The EIA estimates that competition will narrow that kilowatt-hour price variation from 6.3 cents to 4.2 cents by 2005. But competition cannot completely close the differences in prices. Local conditions, such as taxes, environmental policies, access to certain fuels, and difficulties that remain in transmitting power between some points, ensure that some price variations among regions will remain.<sup>7</sup>

---

Change brings opposition—a quick glance at the debate over restructuring the electric industry shows that some participants want to keep the industry very static, with the same players and many of the same rules.

---

It is hard to understand how doubt remains that overall electricity prices will fall.<sup>8</sup> The one consistent lesson to be learned from restructuring in other industrial nations is that prices go down. In the United Kingdom, prices fell more than 2 percent per year each year after restructuring until 1997, when they fell more than 7 percent in one year, and they have continued to drop.<sup>9</sup> In Germany, deregulation saw prices fall 20 percent for residences and 30 to 40 percent for businesses in just a little over a year.<sup>10</sup> And in Australia, prices have dropped 40 percent since deregulation.<sup>11</sup>

Locally, competition will change not just prices but also pricing strategies and such fundamental management decisions as debt levels and labor/capital ratios. The pricing maneuvers by munis facing only the prospect of competition, not actual competition, are indicative of the incentive to change that competition yields. In California, munis and IOUs are changing their pricing schemes to end the long-running practice of commercial and industrial users paying a little more so that residential rates are kept lower. And many munis, which have charged rates as much as 15 to 25 percent lower than neighboring IOUs, fear that

---

<sup>5</sup> See <http://home.doe.gov/policy/ceca.htm>.

<sup>6</sup> J. Alan Beamon, *Competitive Electricity Prices: An Update* (Washington, D.C.: Energy Information Administration, July 1998), [www.eia.doe.gov/oiaf/archive/issues98/cep.html](http://www.eia.doe.gov/oiaf/archive/issues98/cep.html).

<sup>7</sup> For information on the causes of price variations, see Beamon, *Competitive Electricity Prices*; and Edison Electric Institute, *Why Doesn't Electricity Cost The Same Everywhere?* [www.eei.org/issues/comp\\_reg/power3.htm](http://www.eei.org/issues/comp_reg/power3.htm).

<sup>8</sup> There is some skepticism and a lot of impatience. In California, the law mandated a 10 percent rate cut, but there has been little additional rate cutting for residential consumers. The law also allows substantial recovery of stranded costs (investments made under the old regulatory regime), which means that the total on customers' bills may not have gone down at all. Some skeptics of deregulation overlook these complexities and the fact that markets take time to take root—as competition increases with new entry, price reductions will likely follow.

<sup>9</sup> Data for 1990 to 1996 from National Economic Research Associates, *Prices and Service Quality*, vol. 4 of *The Performance of Privatized Industries* (London: Centre for Policy Studies, 1997); data for 1997 from “UK Electricity Prices Fall 7.4%,” *Public Works Financing*, August 1997, p. 15.

<sup>10</sup> “Germany’s Electrical Storm,” *Economist*, November 13, 1999, p. 65; and “Power Failure,” *Financial Times*, November 29, 1999, p. 16.

<sup>11</sup> “UK Electricity Prices Fall,” p. 15.

competition will threaten their ability to keep their customer base.<sup>12</sup> Some are using the grace period to streamline operations by cutting their debt burden and tightening their workforce.<sup>13</sup>

Restructuring is also bringing change to local politics. Both munis and IOUs are a source of significant revenue for local governments, through tax payments from IOUs and revenue transfers from munis. But competition creates pressure to reduce those payments to government—pressure from utilities that want to be more competitive and from governments that want their utilities to be more competitive.<sup>14</sup>

While few are certain how restructured markets will look over time, participants are acting on their own preconceptions. Policy is being made and firms reorganized to prepare for the unknown “creative destruction” to come.



---

<sup>12</sup> Jon Steinman, “Jolt Coming for Utilities, Customers,” *Los Angeles Times*, November 3, 1997, p. B-1.

<sup>13</sup> Ibid.; Carrie Peyton, “Scathing Report Finds SMUD Not Ready for Free Market,” *Sacramento Bee*, April 28, 1998, p. A-1; and Energy Information Administration, *The Changing Structure of the Electric Power Industry: An Update* (1997), [www.eia.doe.gov/cneaf/electricity/chg\\_str/summary/contents.html](http://www.eia.doe.gov/cneaf/electricity/chg_str/summary/contents.html).

<sup>14</sup> Edward T. Howe and Donald J. Reeb, “State and Local Electric Utility Taxes: Evolutionary Taxation of a Deregulating Monopoly,” *American Journal of Economics and Sociology*, vol. 58, no. 1 (1999), pp. 115–28; and Howard Fine, “Deregulation Means Less Utility Tax Money for Cities,” *Los Angeles Business Journal*, December 14, 1998, p. 11.

## Part 2

# How Is Restructuring Policy Integrating Munis?

**R**estructuring policy makers must grapple with many contentious issues, including when competition should begin, who should compete, where the market for power exchanges will be and who will run it, how investments made under the old regulatory regime (stranded costs) will be paid for, and so on.

States that have put in place restructuring plans have each devised their own solutions and compromises to manage these many issues, and vying federal restructuring bills have done the same. In most of the policy debates, the role of government-owned utilities has been peripheral.

Yet, as Figures 2 and 3 show, munis are an important part of the total electric-utility industry. While munis tend on average to be small (though there are some very large ones), with only a 13 percent share of the market, there are a lot of them—almost nine times as many as IOUs. So in many local competitive markets, munis will be players, and policy must account for their presence.

Munis, as government-owned entities, create special policy issues as markets are restructured to be competitive. Municipal utilities would like to retain all of the advantages that government policies have created for them over the years and use these advantages to compete against private providers of electricity. For example, municipal utilities don't pay taxes; they have access to lower-cost, tax-exempt debt; and they have preferential access to cheap power generated by federal hydropower facilities.

Of course, investors in private electric utilities would like to see municipal utilities compete without any special privileges, paying full tax equivalents, forgoing lower-cost, tax-exempt debt, and competing with all comers in bidding for electricity from the federal Power Marketing Authorities.<sup>15</sup>

The battle over these policy issues is largely being fought in Washington, D.C., in the context of the seemingly ever-imminent federal restructuring bill. Most state restructuring plans were confined to determining whether munis would be forced to compete or have that option.<sup>16</sup> Most cities with munis wish to ensure their survival and have lobbied the federal government to leave the issues regarding the role of munis alone or to maintain current privileges for munis.<sup>17</sup> But this is shortsighted. Many local governments are

---

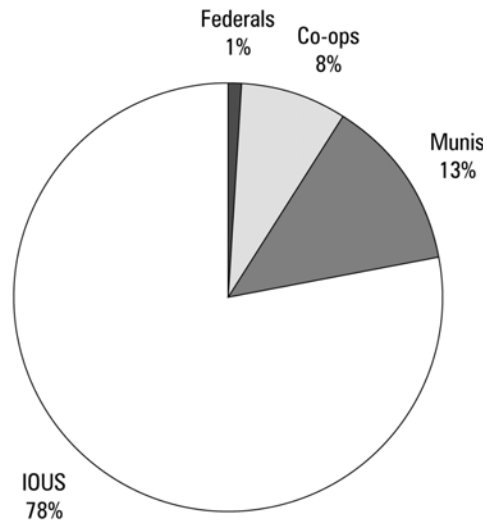
<sup>15</sup> A great deal about both points of view can be learned from the American Public Power Association Web site ([www.appanet.org/appahome.html](http://www.appanet.org/appahome.html)), the Edison Electric Institute Web site ([www.eei.org](http://www.eei.org)), and the testimony archived at the House Commerce Committee Democrat electricity restructuring page ([www.house.gov/commerce\\_democrats/comdem/electric/elechome.htm](http://www.house.gov/commerce_democrats/comdem/electric/elechome.htm)) and the House Judiciary Committee hearing page ([www.house.gov/judiciary/fc0728.htm](http://www.house.gov/judiciary/fc0728.htm)).

<sup>16</sup> Most observers think that few munis will be able in the long run to successfully opt out of competition in the face of pressure from within and without their service areas.

<sup>17</sup> The National League of Cities and the American Public Power Association have been consistent in advocating that all muni privileges be maintained, and that the federal government avoid imposing restructuring nationwide.

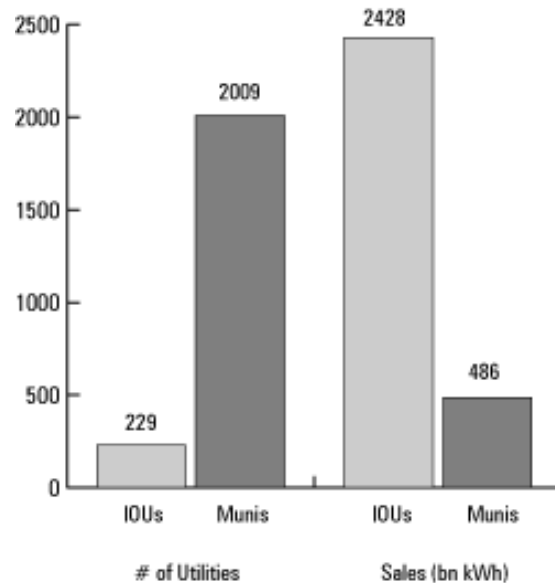
ignoring policy challenges to integrating munis into a more competitive market and opportunities to make the most of competition. Yet the central battlefield in the war over a dynamic versus a static view of industry restructuring is likely to be at the state and municipal level as issues of taxes, management, and market structure are resolved.

**Figure 2: Retail Market Share (Revenue) by Utility Type**



Source: Energy Information Administration, as reported in "U.S. Electric Utility Statistics, 1996," *Public Power*, January–February 1998, p. 43.

**Figure 3: The Size and Scope of Munis vs. IOUs**



Source: Energy Information Administration, "Electric Sales and Revenue 1998," 1998, [www.eia.doe.gov/cneaf/electricity/esr/esr\\_sum.html](http://www.eia.doe.gov/cneaf/electricity/esr/esr_sum.html).



## Part 3

# Policy Challenges: Municipal Utilities and Competitive Markets

The transformation to a more competitive electricity market and the role munis will play in that market present challenges for all concerned, and at several levels. Policy makers must grapple with a number of public policy challenges, ranging from adapting the role of municipal utilities in the industry to specifying the use of tax-exempt debt by munis. At the same time, the city governments and muni managers must decide how munis will be managed and set new management policies for competition rather than monopoly. An overview of these many challenges gives one a new appreciation of the amazing change and opportunity that even partial restructuring and competition can spawn.

## A. Public Policy Challenges

Public policy will determine many of the institutions and much of the shape of electricity markets as they develop. Several key public policy issues cannot be ignored if the market is to be as competitive as possible. They begin with the role of munis themselves. What is a muni's purpose from the perspective of the taxpayers who own it? And is the purpose different in a more competitive market? There are more prosaic issues as well, including the revenues munis provide to city general funds (and the free electricity they provide to city agencies), exemptions for munis from many costs that IOUs must pay, and muni access to lower-cost, tax-exempt debt.

### 1. *The Role of Municipal Utilities*

Municipal utilities go back to the infancy of the electric-utility industry, when cities unhappy with private utilities or unable to attract a utility created their own city-owned utilities.<sup>18</sup> By the New Deal era, municipal utilities were seen as a source of potential competition for investor-owned utilities. Municipal creation of a utility when dissatisfied with the service provided by an IOU is often called "franchise competition," which, in Franklin Roosevelt's words, is the "birch rod in the cupboard" to help ensure good service and low rates from investor-owned utilities.<sup>19</sup> To further foster the creation of municipal utilities, a series of New Deal and later laws

---

<sup>18</sup> For an overview of the birth of municipal utilities as a substitute for more direct competition, see Clinton A. Vince and Cathy J. Fogel, "Franchise Competition in the Electric Utility Industry," *Electricity Journal*, vol. 8, no. 4 (1995), pp. 14–27.

<sup>19</sup> *Ibid.*, p. 17.

hammered out a system of “preference power” in which state and local government utilities would receive preferential access to low-cost federal hydropower, and IOUs would not.<sup>20</sup>

In subsequent years, the role of munis has evolved somewhat. Most customers of munis probably don’t think about why their city owns the electric utility when other cities do not. As with most government-delivered services, people take for granted that there is a reason why the city offers the services directly. The American Public Power Association (APPA) characterizes munis as a fundamental outgrowth of populist politics and says that “citizen’s control of the destinies of America’s cities and towns was a good thing.”<sup>21</sup> Moreover, the APPA argues that “the right of state and local governments to exercise local choice to provide their citizens with essential services” is fundamental and remains the justification for the existence of municipal utilities.<sup>22</sup> But with competition in power generation and consumer choice of power providers, electricity is no longer significantly different from phone, Internet, cable TV, and other network industries. Few think it good public policy that local governments get into those businesses and compete with the private sector.<sup>23</sup>

---

With competition in power generation and consumer choice of power providers, electricity is no longer significantly different from phone, Internet, cable TV, and other network industries. Few think it good public policy that local governments get into those businesses and compete with the private sector.

---

The conditions that existed at the dawn of the electric era are no more—there is no failure to serve certain areas, and regulation of monopoly utilities is robust. With restructuring, electricity provision becomes more fully a market activity in which government businesses only create distortions. There is a lesson to be learned from the observation that “almost everywhere it is legal, the publicly-traded, limited-liability corporation with elected directors dominates economic activity.”<sup>24</sup> That is the institutional form that best solves challenges of financing infrastructure development and other investment problems and so mobilizes capital to its best use. Meanwhile, munis define themselves as nonprofits, owned by the public and operated and managed by government employees whose salaries are not dependent on the amount of energy sold, the amount of efficiency, or the amount the utility grows.<sup>25</sup> Appealing to a bygone era of no competition and feeble regulation, the APPA offers no reason why *today* electricity is one of the special cases where private, market-based provision will not work and government provision offers some necessary or desirable advantage.

---

<sup>20</sup> Ibid., p. 17; and Randall W. Hardy, “Federal Power at Market Prices? Be Careful What You Ask For,” *Public Utilities Fortnightly*, vol. 137, no. 15 (August 1, 1999), p. 24 ff.

<sup>21</sup> Bill Beck, “The Populist Impetus for Public Power,” *Public Power*, November–December 1998, p. 44.

<sup>22</sup> Alan H. Richardson, “Preparing for the Next Century,” *Public Power*, January–February 1999, p. 6.

<sup>23</sup> But, as discussed below, munis are quickly moving to enter into all of those industries.

<sup>24</sup> Robert J. Michaels, “Would Anyone Invent Public Power Today? Can Anyone Reinvent It?” *Electricity Journal*, vol. 10, no. 9 (November 1997).

<sup>25</sup> Alan H. Richardson, “Defining Public Power and Its Future,” *Public Power*, September–October 1997, p. 4.

Consultant Scott Ridley offers a more extreme form of the APPA's basic argument:

*Wherever the reader is sitting to review this article, it is likely that the lights are being powered in part because of the original exercise of consumer authority to grant a right and privilege to conduct business. It is important that this authority not be diminished or swept aside by blind pressures to "clear market barriers." Otherwise, consumers could become literally "disenfranchised," reduced to responding to marketers without the full ability to determine the competitive terms and standards under which they would be served.<sup>26</sup>*

Ridley's argument is odd, implying that businesses operate not because of entrepreneurial initiative and consumer acceptance, but because consumers grant them the right to operate, and that decisions by past consumers should bind those of the present, regardless of changes in circumstances. His view denies the dynamic nature of markets and consumer choice arising from unplanned coordination between entrepreneurs and consumers and evolving as consumer wants change and entrepreneurs react.

---

Appealing to a bygone era of no competition and feeble regulation, the APPA offers no reason why *today* electricity is one of the special cases where private, market-based provision will not work and government provision offers some necessary or desirable advantage.

---

When they strive to keep the rules of competition and market participation unchanged from the prerestructuring context, munis embrace Ridley's static market view. They do not acknowledge that the creative destruction of competition is a healthy process or accept that some of them may be part of the "dead skin" shed to make room for new growth. As economist Robert Michaels put it:

*The lure of profit drives private competitors to use resources efficiently and to innovate. Elected officials and government employees probably outperform profit-seekers in monitoring fairness, respecting precedent, maintaining openness, and negotiating compromise. In the old electrical markets these virtues made government a credible utility operator, but in the new markets they will disadvantage it as a competitor. [And] public power will soon have no choice but to compete in markets where losers are bankrupted.<sup>27</sup>*

Government officials who want their constituents to enjoy the benefits of competition should not be looking for ways to shape the market and competition to ensure survival of munis. Instead, they should be exploring ways to restructure muni goals and management to fit into a fully and fairly competitive market. These options are explored later in this study.

---

<sup>26</sup> Scott Ridley, "Local Government: The Sleeping Giant in Electric Industry Restructuring," *Electricity Journal*, vol. 10, no. 9 (November 1997).

<sup>27</sup> Michaels, "Would Anyone Invent Public Power Today?"

## 2. Utilities as a Source of Public Revenue

Utilities provide an important source of revenue for local governments. IOUs pay property and other local taxes, as well as state and federal income taxes. Indeed, they are one of the most heavily taxed industries.<sup>28</sup> And most munis pay a percentage of revenues to the city general fund. That revenue is essentially a hidden (regressive) tax with no strings attached, one that city leaders hesitate to relinquish.

The muni “tax equivalent payments” to local governments from 1992 to 1996 averaged a bit over 3 percent of revenues for those with generation assets, a bit less for those without. Their average payments have fallen since 1994, nearly 20 percent for munis with generation assets and nearly 5 percent for those without. In contrast, IOUs during the same period paid an average of more than 12 percent of revenues in taxes and have seen their payments increase slightly in recent years.<sup>29</sup>

### What? Me Pay?

Munis don’t just provide city general funds with revenue transfers. They also often provide power free of charge to city-owned buildings and to other government agencies, use utility workers for non-utility work, and provide non-utility services to other city departments. Munis in Kansas were found to provide city governments an average of \$87 per capita per year in free power and non-utility work and services.<sup>1</sup> Forced to streamline and be competitive, munis will not be able to continue to provide these benefits to the city, and the cities will have to pay for the power it uses and forgo the free labor and services, or else pay for them as well.

1. “Study: Retail Wheeling” 1997 n 6

While munis don’t generate nearly the government revenue that IOUs do, for city governments, muni revenue payments can be much larger than IOU local tax payments. And city officials can far more easily manipulate a muni’s revenue transfers than they can a local tax—a muni is a city government’s cash cow. Consider Tallahassee, Florida. In 1998, Mayor Scott Maddox believed that with electric-industry competition rapidly approaching, the city’s muni simply would not be able to compete, given its high rates. While debating the issue with the Tallahassee City Council, he asked: “Why are we in the electricity business? Is it to provide electricity? To preserve energy? Or is it for the money?”<sup>30</sup> It didn’t take long for everyone to realize that the city was in the electricity business for the money—one-third of the city’s revenues came from the utility.<sup>31</sup> Talk of selling the utility was quickly dismissed.

The city of Austin went through a similar debate. Competition in the electric-utility industry would most likely force the Austin Municipal Utility to cut rates to stay competitive, and rate cuts would reduce the amount transferred annually to the city’s general fund. In 1990, the annual transfer was 28 percent of the

<sup>28</sup> Just in state and local taxes, electric utilities pay more than half again the taxes (percentage of revenue) that the communications industry pays, more than twice what mining and manufacturing firms pay, and more than three times what textile and retail firms pay. Kim Martin, “Utilities Overhaul May Jolt Municipalities,” *Wall Street Journal*, August 13, 1997, p. A-2. Randall G. Holcombe in “The Tax Cost of Privatization,” *Southern Economic Journal*, v.56, No.3 (January 1990) indicates that tax law changes in the 1980s ensure that a private firm will almost always generate more government revenue in tax payments than the same firm could earn in direct revenue as a government enterprise.

<sup>29</sup> Data from Energy Information Administration, *Electric Power Annual 1996*, vol. 2 (Washington, D.C.: U.S. Department of Energy, February 1998).

<sup>30</sup> Christopher Swope, “Power Politics,” *Governing*, July 1998, p. 43.

<sup>31</sup> *Ibid.*, p. 43.

city's budget. This threat inspired the Austin City Council to hire a consulting firm to develop a long-term plan to reduce the city's dependence on the utility. Currently, the transfer is only 12 percent of the budget, and that amount should be reduced to 8 percent by 2004.<sup>32</sup>

Austin's predicament is one that many cities will face. Falling electricity prices due to competition will reduce government revenue both from IOU taxes and from transfers of a percentage of muni revenues. And for cities with munis, the problem does not stop there. Many observers argue that munis must cut their revenue transfers to city general funds if they are to compete successfully with the IOUs.<sup>33</sup> The Los Angeles Department of Water and Power transfers only 5 percent of its revenue to the city, but since adopting a streamlining and cost-cutting program to prepare for competition, it has cut back on payments. In 1995 and 1996, those cutbacks cost the city \$59 million from what it had budgeted.<sup>34</sup>

Even for cities less dependent than Tallahassee and Austin on muni revenues, reducing funding is likely to generate a political crisis. In many cases, muni revenue transfers are not just made to the general fund, but are tied to specific services, such as police, fire protection, and schools. A study of the 121 munis in Kansas found that utility revenues are so intertwined with other municipal services that "any price changes for electric service will have non-price effects revealed through higher taxes [and] reduction in general city services."<sup>35</sup> In Iowa, the state passed a law that replaced muni revenue transfers with a "tax on deliveries" paid by any utility that serves customers in a muni's territory. The cities thus maintain a revenue stream that depends on consumption of electricity within city boundaries, not on who sells it.<sup>36</sup>

Whatever revenue solution city officials arrive at, competition will force them to treat their munis less like agencies of government and more like commercial enterprises.

### **3. Financial Subsidies to Munis and the Thorny Issue of Tax-exempt Debt**

Table 1 lists the subsidies (both direct benefits and exemptions from costs) that the federal government provides to municipal electric utilities. The imbalance in how federal policy allocates benefits and costs to munis versus IOUs results in munis experiencing a 30 percent lower capital cost and a 10 percent lower total cost to provide new generating capacity (see Figure 4).<sup>37</sup> In competitive wholesale and retail electric markets, those cost advantages are considerable.

Looking at each of the subsidies listed, it is apparent that they arose in a context of monopoly service with a unique role for munis in the industry. But with competition, few if any of those subsidies have merit. If munis are making profits in commercial trades of wholesale power or serving customers in new service areas, an exemption from income taxes does not make sense. And as muni income is derived more and more from competitive commercial activities, applying the same antitrust and financial oversight regulation faced by the IOUs is also warranted.

<sup>32</sup> Darrell Preston, "Austin's Powers: Laid Back Texas Town Seeks Way to Cope with Dizzy Growth," *Bond Buyer*, February 17, 1998, p. 1.

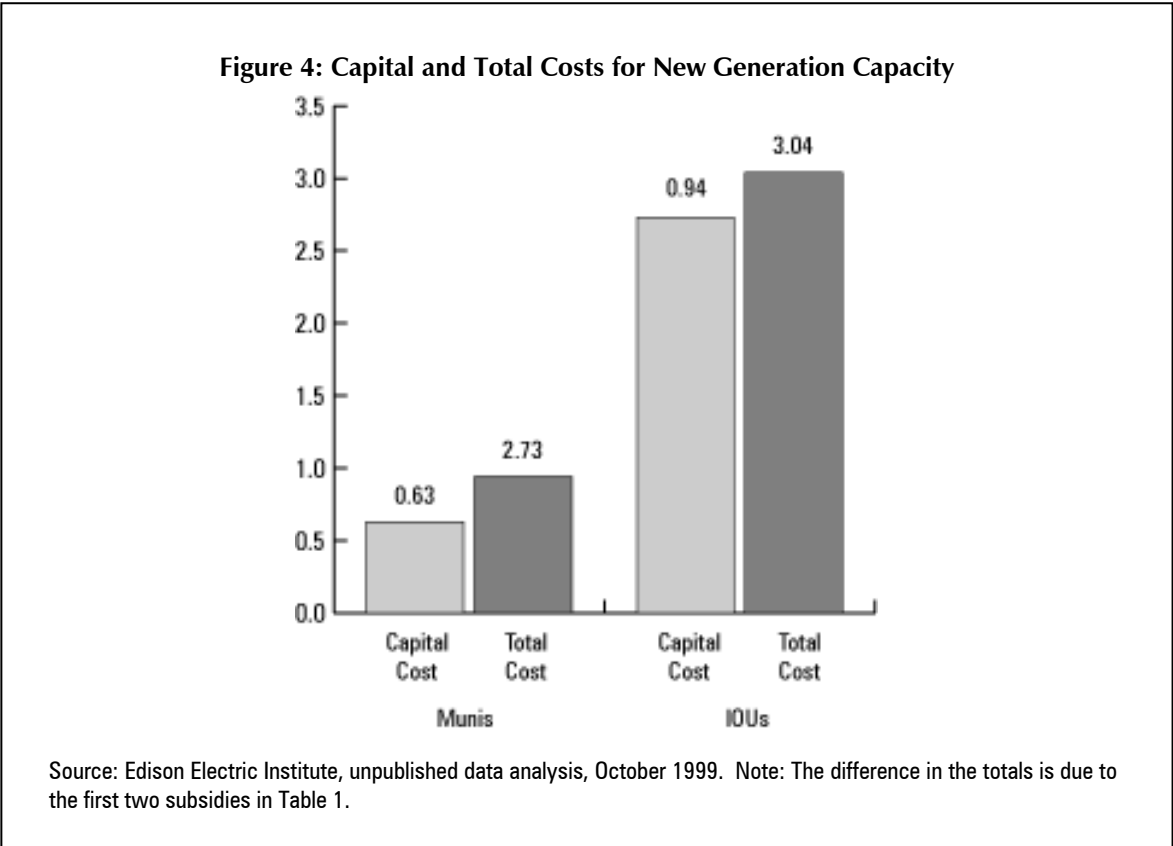
<sup>33</sup> Ola Kinnander, "Public Power: Muni Utilities Need to Curb Fund Transfers Before Deregulation," *Bond Buyer*, June 23, 1999, p. 7; and Matthew C. Cordaro, "What Future for Public Power?" *Electricity Journal*, vol. 10, no. 9 (November 1997).

<sup>34</sup> Jean Merl, "City Reliance on Profitable Departments Threatened," *Los Angeles Times*, March 25, 1996, p. B-1.

<sup>35</sup> "Study: Retail Wheeling Would Up Taxes, Cut Services if Kansas Munis Were Covered," *Electric Utility Week*, September 1, 1997, p. 6.

<sup>36</sup> Kinnander, "Public Power: Muni Utilities Need to Curb," p. 7.

<sup>37</sup> Data from unpublished research by Edison Electric Institute, Washington, D.C., October 1999.



Two of the subsidies—preference power and tax-exempt debt—particularly deserve further discussion.

<b>Table 1: Federal Subsidies Provided to Munis vs. IOUs</b>		
Type of Federal Subsidy	Munis	IOUs
Federal income tax exemption*	Yes	No
Federal income tax exemption on debt issued by utility*	Yes	No
Federal disaster assistance	Yes	No
Exemption from FERC regulation and reporting	Yes	No
Exemption from SEC financial oversight	Yes	No
Exemption from federal antitrust statutes	Yes	No

Source: Edison Electric Institute, unpublished data analysis, October 1999.

\*These subsidies are included in the cost differences in Figure 4.

**a. Preference Power**

Munis enjoy preferred access to low-cost (subsidized) federal hydropower. With generation becoming a competitive market, governments should be exiting from the business of owning generation assets. Sound arguments exist for privatizing the Tennessee Valley Authority (TVA) and the Power Marketing Authorities

(PMAs).<sup>38</sup> An even stronger case exists for selling federal power on an open-auction basis to all comers. Open auctions would ensure that the taxpayers no longer have to support the TVA and PMAs. Instead, they would get a fair price for the power generated by assets built with their tax dollars. It would also make federal hydropower a simple, cheap source of power for the whole nation and not a regionalized source of distortion in the marketplace.<sup>39</sup>

#### b. Tax-exempt Debt

Perhaps the thorniest issue of federal financial subsidies to munis is that of tax-exempt debt. The issue is difficult to capture in just a few sentences, but the sense is as follows.<sup>40</sup> Current tax laws allow munis to issue tax-exempt debt, which means they pay 2 to 4 percentage points less interest on their debt, for a cost of capital roughly 20 to 25 percent lower than that of IOUs. In the old, noncompetitive world, that differential didn't matter much. But in a restructured electric industry, the difference in debt costs is significant, giving munis a marked advantage in competing with IOUs. Munis want to maintain that advantage for generation facilities even as they begin to compete.<sup>41</sup> IOUs want munis to convert all debt into taxable debt if they decide to compete.<sup>42</sup>

Tax-exempt bonds are designed to make it as easy and low-cost as possible for government entities to invest in infrastructure. Purchasers of tax-exempt bonds do not have to pay federal taxes on the income earned from them. As a result, buyers are willing to accept a lower interest rate on the bond, which saves the issuer money. One unintended consequence of tax-exempt debt, though, is to create a bias toward government ownership of infrastructure facilities even where private providers exist, such as in the electric industry.<sup>43</sup>

<sup>38</sup> See Douglas A. Houston, *Federal Power: The Case for Privatizing Electricity*, Policy Study No. 201 (Los Angeles: Reason Public Policy Institute, March 1996).

<sup>39</sup> The market distortions and subsidies associated with federal preference power are discussed in General Accounting Office, *Federal Electricity Activities: The Federal Government's Net Costs and Potential for Future Losses*, AIMD-97-110 (Washington, D.C., 1997).

<sup>40</sup> To read a much more detailed discussion, see the pair of reports issued by the congressional Joint Committee on Taxation: *Federal Income Tax Issues Arising in Connection with Proposals to Restructure the Electric Power Industry*, JCS-20-97 (October 17, 1997); and *Federal Tax Issues Relating to Restructuring of the Electric Power Industry*, JCX-72-99 (October 15, 1999).

<sup>41</sup> Munis are not wholly unified on tax-exempt-debt issues, though they have remained consistent on many basic and compromise issues. The source of their division is telling. Some observers point out that it is the larger, more-indebted munis who are screaming about the need to protect their existing tax-exempt debt and that some munis would have no problem with having to convert to private debt if they were going to compete. Ola Kinnander, "Public Power: Muni Utilities Vary in Their Need for Legislative Relief," *Bond Buyer*, June 30, 1998, p. 5. To cover refinancing debt at private rates, munis that have used high debt and arguably fiscally imprudent strategies in the last decade would have to raise rates far more than would munis that have chosen lower debt and arguably more-prudent strategies. Depending on how final legislation treats debt used to finance different types of facilities, the total tax-exempt debt that could be affected is between \$70 billion and \$100 billion. The American Public Power Association Web site, [www.appanet.org/appahome.html](http://www.appanet.org/appahome.html), is a rich mine of information on public-power positions on issues and on specific legislation. Also, see the bills supported by the APPA, such as HR 721 (106<sup>th</sup> Congress).

<sup>42</sup> The IOU position is not monolithic. For one thing, some IOUs see a market niche in partnering with munis that seek to expand and compete, so they see no problem with the current rules. But many other IOUs are concerned about a level playing field for future competitive markets. For an overview of the main IOU position as represented by the Edison Electric Institute, see Todd H. Cunningham and Dan M. Reidinger, "Regulatory Review," *Electric Perspectives*, July/August 1998, pp. 68-72; and the EEI Web site, [www.eei.org](http://www.eei.org). The *Bond Buyer* has assiduously covered the various relevant bills before Congress. For example, see Michael Stanton, "Senator Says Power Debt Can Maintain Tax Exemption," *Bond Buyer*, November 12, 1997, p. 1; Ola Kinnander, "Senate Committee to Debate Municipal Utility Bond Limits," *Bond Buyer*, July 23, 1999, p. 1; and Ola Kinnander, "Deregulation: Public Power Community Scowls at Electricity Restructuring Bill," *Bond Buyer*, October 29, 1999, p. 5.

<sup>43</sup> In many other nations around the globe, where there is no tax-exempt debt, there is far more private investment in infrastructure than in the United States. See, for example, *Privatisation International Annual Report 1998* (London: Privatisation International, 1999).

This and other unintended consequences of municipal utilities' access to tax-exempt debt have tremendous consequences for the electricity market emerging as restructuring moves forward. As discussed in other sections of this study, munis are using tax-exempt debt in order to expand their numbers by encouraging cities to municipalize IOUs in order to gain access to tax-free financing for these operations. They are also using tax-exempt debt to expand their service areas and operations at the expense of IOUs. Finally, they are using their access to tax-exempt debt to enter into a wide range of purely commercial ventures. These include selling power wholesale or to retail pools for a profit and providing nonelectric services such as cable TV, bottled water, and appliance repair, areas where government entities compete head-on with a robust private market.

---

The imbalance in how federal policy allocates benefits and costs to munis versus IOUs results in munis experiencing a 30 percent lower capital cost and a 10 percent lower total cost to provide new generating capacity.

---

In 1998 and 1999, the battle in Congress over national restructuring legislation revolved around the issue of tax-exempt debt. The crisis over use of tax-exempt debt by munis in a restructured market erupted soon after California restructured its market at the beginning of 1997. If any of the state's munis wanted to participate in the market, they were required to participate in the Independent System Operator (ISO) arrangement, meaning they had to let the ISO control use of their transmission facilities. But muni facilities' assets were financed with tax-exempt debt, and some thought ISO participation would violate the rules on use of tax-exempt debt, because nongovernmental entities (IOUs) would also be using the muni transmission facilities. (The ISO will send whatever power down whatever transmission line is most efficient.) The munis pressed for an analysis, and a joint congressional committee concluded in October 1997 that ISO participation did violate the limits on the use of tax-exempt debt.<sup>44</sup>

The munis argued that the current rules did not reflect restructuring and pushed hard for a resolution. For the California munis, especially the largest, serving Los Angeles and Sacramento, time was critical. They could not enter the market until the issue was resolved. Key federal legislators working on federal restructuring bills wanted to resolve the crisis through legislation, but when no bill was passed in 1997, the Internal Revenue Service (IRS) decided to issue temporary regulations.

The IRS temporary regulations, effective for three years, for the most part established the munis' ability to compete in the marketplace, within and outside current service areas, using facilities financed with tax-exempt bonds.<sup>45</sup> If a private use (a use that may not be eligible for tax-exempt debt financing) by muni facilities is triggered by a state or federal mandate, the IRS will likely consider such use permissible. Only when munis take deliberate actions that lead to private use will they violate the conditions of using tax-exempt debt.

---

<sup>44</sup> Joint Committee on Taxation, *Federal Income Tax Issues*.

<sup>45</sup> The rules were published in the January 22, 1998, *Federal Register*. For summaries and discussion, see Howard A. Cooper, "New Tax-exempt Bond Regs Assist Governmentally-owned Utilities in the Competitive Marketplace," *CCH Power and Telecom Law*, May/June 1998, p. 45; Cunningham and Reidinger, "Regulatory Review"; and Frank Shafroth, "Treasury Offers Guidance for Municipal Utilities," *Nations Cities Weekly*, January 26, 1998, p. 1.



But many directly competitive actions by munis are defined not to be deliberate actions. If a muni has power made excess by a loss of customers to competitors, it can sell that power outside its traditional service area without creating a private use. Also, any short-term contracts (less than 180 days) to sell power outside their traditional service areas are permissible, and the rapid changes unleashed by restructuring have made short-term contracts dominate the market.<sup>46</sup>

Finally, in 1997, the IRS issued a private-letter ruling that will likely allow munis to use tax-exempt debt to finance a portion of a generation facility if that portion will serve government utilities.<sup>47</sup> In essence, munis can draw an imaginary line through a generation asset based on their plans regarding whom they will sell to. Inadequate controls are in place to ensure that the load generated by the portion of the facility financed with tax-exempt debt would go only to government utilities—there is no firewall. Taken together, the IRS rulings allow munis wide latitude in deciding how to participate in the marketplace.

Once the IRS regulations were issued, the Los Angeles and Sacramento munis both decided not to open up to the competitive market.<sup>48</sup>

---

The goal of policy must be to create a legal framework for a competitive electricity market that does not pick winners but allows customer choice and market forces to determine who will succeed and who will fail.

---

#### ***4. Integrating Munis into a Competitive Market: Policy Framework***

The goal of policy must be to create a legal framework for a competitive electricity market that does not pick winners but allows customer choice and market forces to determine who will succeed and who will fail. Innovative, well-managed utilities that focus on customer service, whether privately owned or government-owned, will thrive while others fail, provided there is no policy that shores up the fortunes of poorly run utilities. If the market is allowed to work, consumers will determine who provides them with electricity.

If public policies create an artificial advantage to some participants in a market, prices and trade will be distorted, and competition will diminish. At the same time, public policy makers must take into account the transition from monopoly to competition and the changes it effects on the industry. As the Joint Committee on Taxation put it, “If certain electric service providers [are] permitted to retain their ability to receive tax-exempt financing in a competitive marketplace, those providers might have a considerable cost advantage

---

<sup>46</sup> A recent examination of Federal Energy Regulatory Commission (FERC) rate filings showed that all were for sales lasting three months or less, revealing that the current rules would allow munis to compete for almost all market transactions taking place in today’s market using tax-exempt debt. See the study by the EOP Group and OnLocation, Inc., cited in a letter from Edison Electric Institute to the IRS regarding the temporary regulations, dated April 22, 1998, p. 20.

<sup>47</sup> Amy B. Resnick, “Regulation: IRS Ruling on Power Generation Will Let Utilities Issue Tax-Exempts,” *Bond Buyer*, December 21 1999, p. 5.

<sup>48</sup> For a great deal more about the tax-exempt-debt issue, its politics, the positions of the opposing sides, and discussion of possible solutions, see Adrian Moore and Jeff Woerner, *Muni Power Grabs: Municipal Utilities, Tax-exempt Debt, and the Competitive Market*, E-brief No. 103 (Los Angeles: Reason Public Policy Institute, 1999), [www.rppi.org/ftbrief103.html](http://www.rppi.org/ftbrief103.html).

over other competitors in a deregulated market.”<sup>49</sup> And the Congressional Research Service argues that “general economic welfare would be enhanced” by halting the use of tax-exempt debt for new facilities.<sup>50</sup> An objective of policy should be to avoid causing differences between the players’ capital costs. The Clinton Administration reached the same conclusion, and its restructuring plan recognizes that the cost-of-capital playing field must be level for restructuring to work.<sup>51</sup> Both the IOUs’ and munis’ baseline positions are too extreme to meet that goal.

In the policy recommendations section of this report, we set forth principles for a short-term solution to the problem of financial subsidies, especially the tax-exempt-debt problem (the long-run solution will evolve naturally if the other policy recommendations we suggest are enacted). In brief, we argue that the goal of restructuring is not to preserve or expand government provision of electricity; nor is it to eliminate it. However, munis that want to enter the competitive market must be treated like corporate entities. Those that can compete will survive. The others will likely be bought out or otherwise privatized. Since the only justification for monopolies is overwhelming problems with competition, and since restructuring is predicated on the ability to have competitive generation markets and to give customers choice, *all munis should be required to compete on a “level playing field.”*



---

<sup>49</sup> Joint Committee on Taxation, *Federal Tax Issues*, p. 9.

<sup>50</sup> Congressional Research Service, *Electricity Restructuring and Tax-exempt Bonds: Economic Analysis of Legislative Proposals* (Washington, D.C.: Congressional Research Service, January 20, 2000), p. 1.

<sup>51</sup> The administration’s act is called the Comprehensive Electricity Competition Act (Department of Energy), [home.doe.gov/policy/ceca.htm](http://home.doe.gov/policy/ceca.htm). It is also embodied in the revenue proposals of the administration’s *Budget of the United States Government, Fiscal Year 2001, Analytic Perspectives*, p. 68, at [w3.access.gpo.gov/usbudget/fy2001/pdf/spec.pdf](http://w3.access.gpo.gov/usbudget/fy2001/pdf/spec.pdf).

## B. Management Policy Challenges

Responses to the public policy challenges of integrating munis into a competitive market will determine the context in which they must adapt. At the same time, muni managers and city officials must contend with internal structural and management changes to prepare munis for competition. Until recently, a muni's relative debt levels were of little importance, political interference in muni operations was only an irritant to managers and workers, and there was little opportunity for munis to take financial risks. All of that has changed, and many cities will have to change how they manage their munis. Otherwise, munis may become financial liabilities.

---

All munis should be required to compete on a "level playing field."

---

### 1. Debt

High debt levels can reduce a muni's competitiveness, especially debt that will be "stranded." Like IOUs, some munis invested in generating assets and long-term power purchase agreements that they could justify in a monopoly paradigm, but which do not provide power at rates expected to prevail under competition. The latest data, for 1996, reveal that IOUs' average debt level is at 31.6 percent of total assets, while munis with more than 100,000 customers have an average debt level at 60.3 percent of total assets.<sup>52</sup> Many IOUs quickly reacted to competition by reducing their generation-related debt and buying out of uneconomic power purchase contracts; munis were much slower in doing the same.<sup>53</sup> Thus, the difference in debt levels between the IOUs and munis has likely widened since 1996.

This difference gives the IOUs an edge in setting competitive prices for power. Of course, many munis recognize this challenge and are taking steps to reduce their debt. Some have been able to raise rates and take other streamlining measures to help pay down debt,<sup>54</sup> but many are facing political difficulties in doing so.<sup>55</sup> Others, like the Los Angeles Department of Water and Power, have cut their debt through laying off workers, selling excess property, and selling excess power in the competitive wholesale power market.

Perhaps the worst muni debt crisis is in North Carolina. There, a group of 51 towns and cities owes a total of \$5.9 billion on two power plants that are not likely to be competitive when the market opens up. The cities have repeatedly refinanced the debt, so now it is larger than when it was first issued in the 1960s and 1970s.<sup>56</sup> Since the munis already charge rates 20 to 30 percent higher than the state's IOUs, the debt

<sup>52</sup> IOU data from Energy Information Administration, *Financial Statistics of Major U.S. Investor-Owned Electric Utilities* (1998), Table 9, [www.eia.doe.gov/cneaf/electricity/invest/t9.txt](http://www.eia.doe.gov/cneaf/electricity/invest/t9.txt). Muni data from American Public Power Association, *Annual Directory and Statistical Report* (1999), p. 254. Debt/asset ratios for smaller munis (fewer than 100,000 customers) are on average one-third those of larger munis, and smaller than those of typical IOUs. Most smaller munis thus do not see debt as a significant impediment to their competitiveness. Kinnander, "Public Power: Muni Utilities Vary," p. 5.

<sup>53</sup> Ivan Cintron, "Sector Spotlight: Some California Muni Utilities Restructure Debt to Fend off IOU Competition," *Bond Buyer*, October 12, 1998, p. 8.

<sup>54</sup> Steinman, "Jolt Coming for Utilities, Customers," p. B-1.

<sup>55</sup> Cintron, "Sector Spotlight," p. 8.

<sup>56</sup> "North Carolina's Stranded Cost Mess," *Energy Insight*, November 9, 1999, p. 1.

threatens to destroy them once they have to compete. And the state cannot bail them out—the munis’ debt is one-third of the state’s total public debt.<sup>57</sup> There is little agreement about how to solve the crisis.

Munis cutting their debts are finding the hard trade-offs they must make unpalatable at best. The city of Pasadena, California, has tentatively approved an 11.5 percent increase in residential electricity rates to pay off its municipal utility’s outstanding debt and prepare for the competition it will face in 2002. While some members of the city council realize the necessity of this increase, others believe they are not listening to the voices of their constituents. Councilwoman Anna-Marie Villicana opposed the increase and cited the more than 1,000 letters received opposing any rate increase. She believes the council is not listening to the public.<sup>58</sup> However, other members of the council realize that if they cannot supply electricity at competitive rates in 2002, they will lose much of their ratepayer base.

Political resistance to layoffs and asset sales further narrows the munis’ options. For the more indebted munis, managers and city officials must recognize these as management issues, not political issues, or city taxpayers will ultimately pay the price if the muni fails financially.

---

To be competitive, munis will have to move at the speed of business, not the speed of politics.

---

## **2. Politicized Management**

To be competitive, munis will have to move at the speed of business, not the speed of politics. This means a radical change away from the status quo for many munis laboring under the yoke of local politicking. But the problem presents a bit of a catch-22 for munis. Customer control through political oversight is one of the virtues they tout when comparing themselves to IOUs. But that same oversight can make it difficult or impossible to make the sound business decisions necessary in a competitive market.

A past general manager of the Los Angeles Department of Water and Power (DWP) put it well when he complained: “I am chief executive officer of what amounts to a \$2.5-billion company, and I can only appoint seven people in an 8,900-employee company, and of these seven, five of them must have 15 years experience in the DWP.”<sup>59</sup> His successor repeated complaints about having to answer to 31 bosses (including five Water and Power Commissioners, 15 city council members, and the city mayor, chief administrative officer, and chief legislative analyst), each with some power to slow or stop any management changes.<sup>60</sup> Most major policy decisions must pass through a five-stage approval process, and many inside and outside the DWP argue that it cannot compete and survive if it is not relieved of political meddling.<sup>61</sup>

But the incentives for city officials to meddle in muni management are powerful. Munis are a significant source of city revenues, and elected officials like to keep their eyes and hands on the purse strings. The

<sup>57</sup> Ibid., p. 1.

<sup>58</sup> “Official Business: Pasadena Council Backs Electric Rate Hike,” *Los Angeles Times*, October 29, 1997, p. B-4.

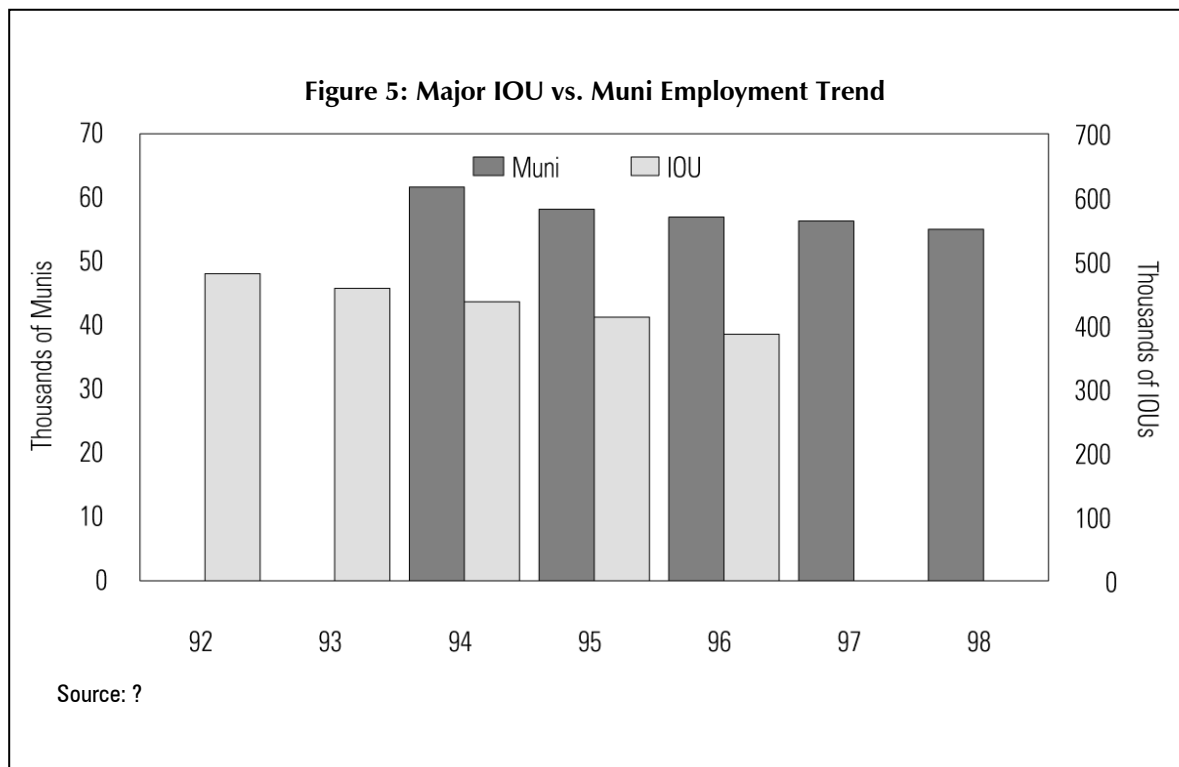
<sup>59</sup> Michaels, “Would Anyone Invent Public Power Today?”

<sup>60</sup> Richard Nemeč, “Utility Guru Discusses DWP Fate,” *Los Angeles Daily News*, May 17, 1998, p. 1.

<sup>61</sup> Richard Nemeč, “Government as Fast as Yesterday,” *Los Angeles Times*, February 21, 1997, p. B-9.

revenues are not always direct—munis provide nonutility services, give free power to city agencies, and cross-subsidize other services. Both the Los Angeles DWP and the Arizona Salt River Project have wrestled with how to wean water services off cross-subsidies from the electricity side of operations.<sup>62</sup>

Munis represent a substantial pool of jobs, and preparations for competition often entail reducing inflated workforces.<sup>63</sup> But few city officials want layoffs on their watch, and munis are running into political roadblocks to streamlining efforts. Indeed, for IOUs, reducing their workforce has been a key part of preparing for competition—major IOUs have reduced their total number of employees by nearly 100,000, or 20 percent, since 1992.<sup>64</sup> Major munis have reduced their workforce by only 10 percent (see Figure 5). Private entities almost always use fewer employees per unit of output than do similar public entities, so their more aggressive streamlining has likely widened the productivity gap between IOUs and munis. It is likely that munis have made fewer personnel reductions because of internal and political resistance, not because they were already at more-efficient employment levels.



Even before munis begin to compete, political meddling is proving costly. As California began in the mid-1990s to prepare for competition, credit-rating and investment firms issued a string of press releases warning

<sup>62</sup> Ken Brown, “SRP Faces Many Issues in Competition,” *Phoenix Business Journal*, March 13, 1998, p. 9.  
<sup>63</sup> Energy Information Administration, *The Changing Structure of the Electric Power Industry: An Update* (Washington, D.C., 1997), chap. 9, p. 3.  
<sup>64</sup> Energy Information Administration, *Financial Statistics of Major U.S. Investor-owned Electric Utilities, 1992–1996* (Washington, D.C., 1997), Table 11, [www.eia.doe.gov/electricity/invest/t11.txt](http://www.eia.doe.gov/electricity/invest/t11.txt).

that political obstacles would put munis behind the competitive power curve and ultimately affect their credit ratings. Here are some sample comments:

*Without the political will to stand behind the initiatives and take them one step further, municipals could jeopardize their utilities' competitive stance. The point is that no utility can afford to do nothing; municipal systems are no exception.*

—Standard & Poor's, April 10, 1995

*But all these decisions require approval from city councils—political bodies that respond to voter pressures. These political bodies often postpone decisions.*

—California Energy Markets, January 3, 1997

*The rating downgrade on Los Angeles Department of Water and Power bonds reflects concern regarding the city council's willingness to approve and implement strategic plans in a timely manner that will allow the department to lower costs and rates to be competitive by 2005.*

—Standard & Poor's, October 28, 1996

*In turn, this leaves the public utilities with the problem of how to recover "stranded costs" at a time when city councils or boards of directors may be unwilling to raise rates.*

—Standard & Poor's, September 23, 1996

*Public power's hurdles include the crucial need to educate and then convince city councils and governing boards that strong, timely, and sometimes radical strategic initiatives are necessary to keep pace with competitors.*

—Standard & Poor's, March 4, 1996

### **3. Managing the Risks of Competition**

Competition by its very nature entails risks of financial losses. Bad management decisions or even just slow-moving management creates opportunities for competitors to siphon off customers. Thus, it is no surprise that for-profit enterprises dominate competitive markets—they have the strongest incentives to avoid poor financial performance.

For munis, competitive generation markets and consumer choice of providers mean entering a world of new incentives. Attracting new customers becomes as vital as keeping current ones satisfied. And that won't be accomplished by maintaining the status quo—it requires innovation, flexibility, forward thinking, and risk taking. Munis will have to develop a market culture while competing with IOUs that are years ahead of them in that regard.

But the deepest and most important risk difference between munis and IOUs is who ultimately bears the consequences. With IOUs, financial losses can hurt investors—individuals and groups who voluntarily risk their money by investing in an enterprise they believe will be successful. Investors are not forced to risk their money. But when a muni takes financial losses, city taxpayers are at risk. Even if a majority of city taxpayers supports the city having a municipal utility, others are forced to take financial risks they did not choose. This raises questions about the wisdom of government ownership of enterprises in competitive markets.

Already, some munis are learning the hard way about the risks of competition. The Sacramento Municipal Utility District opened its market to limited competition in 1997 and sought to acquire new business outside its traditional service area. However, it failed to win any new customers and promptly lost significant business to outside competitors.<sup>65</sup>

The risks of competition come home to munis in other ways as well. Two examples surface in investments in new generating plants and entry into new commercial markets.

The conventional wisdom for the last few years has been that with burgeoning wholesale power markets and competition in generating power, investment in new generating plants is increasingly risky, so much so that selling generation assets is a surefire way to improve a utility's credit standing.<sup>66</sup> Since the stranded costs that have haunted the restructuring debates are mostly generating assets predicted to produce power at costs too high to recover at competitive power prices, owning generation assets, or building new ones, is understandably considered risky. If a firm builds a plant that seems to offer competitive power and then prices drop 20 percent per year due to competition, the firm may lose virtually the entire investment in the plant.

---

Investing millions of dollars in a generating plant that might be worth little or nothing in a few years is a long-term risk with substantially greater potential consequences for a muni's financial health.

---

Yet in recent months, a number of munis, including ones in Nebraska, Texas, Colorado, South Carolina, and Florida, have announced plans to build new generating facilities.<sup>67</sup> These munis' decisions are examples of the worst kind of static thinking, based on the old way of judging need and suspicion of markets. Rather than looking at their ability to compete and meet promises to customers, and making decisions about needed capacity based on that, these munis are looking at population and job growth as indicators of future demand, just as they did before competition. As one muni official put it, "We and our customers got to the point where we are just a little uncomfortable with relying on the market too much, and decided that we need to go ahead and build some new capacity that we can own and control."<sup>68</sup> But taking risks on market purchases is short-term. Investing millions of dollars in a generating plant that might be worth little or nothing in a few years is a long-term risk with substantially greater potential consequences for a muni's financial health.

Oddly, many muni officials seem unperturbed by these risks and are actively taking on additional risks. They have begun to enter into numerous commercial ventures unrelated to the electricity business. As discussed later, these ventures range from cable TV to employment training programs. The common theme is that all the ventures provide commercial products in competitive markets where private producers already exist; hence, there is no justification for government to be a producer. And, just as important, these ventures entail

---

<sup>65</sup> "Market-Driven Competition, SMUD Discovers, Is a Double-edged Sword," *Power Markets Week*, April 28, 1997, p. 6; and "SMUD's Direct-access Pilot Program Gets off to a Slow and Shaky Start," *Electric Utility Week*, July 21, 1997, p. 14.

<sup>66</sup> "Moody's Favors Generation Sales," *Public Works Financing*, June 1999, p. 7.

<sup>67</sup> Ola Kinnander, "Public Power: As Market Changes, So Does Attitude Toward Construction," *Bond Buyer*, August 30, 1999, p. 5.

<sup>68</sup> *Ibid.*, p. 5.

considerable risk—already a number of munis have lost millions of dollars in cable TV businesses, and city taxpayers are footing the bills. But this outcome does not seem to deter other munis—the American Public Power Association actively encourages their commercial ventures and touts them in its publications.

#### **4. Addressing Management Challenges**

The most important aspect of these management challenges is that city officials not be blind to them. Planning for a muni’s transition to competition requires knowing its debt situation and how that will affect its competitiveness. It also requires knowing what strategies are available to manage any problems. And it means recognizing the risks inherent in commercial ventures and asserting control over the muni’s business ventures. If market response is positive, the muni will make profits; otherwise, it is city officials who will answer to the taxpayers asked to pay for losses.

Finally, there has to be a willingness to establish new management structures that depoliticize decision making and encourage munis to operate like commercial entities. Achieving these goals may require radical change, including new rules and structures for accounting, legal, human-resource, and capital-investment decisions.



City officials have a number of models and structures available to manage these transition issues, and we explore many of them in a later section of this study. Each relies on a deliberate and planned approach, reflecting the realities of competition. Often, when new information arises showing that IOUs are better prepared for competition, muni credit ratings drop; even before actual competition begins, these effects are felt.<sup>69</sup> Each city must decide how deeply it wants to be involved in the uncertainties and risks of a competitive electricity market and pick an appropriate strategy. For most cities with munis, the time to start this planning is now. Already the munis themselves are taking steps, most of them in a very ad hoc fashion from a citywide perspective. It is up to the city’s elected leaders to decide how their munis will make the transition to competition and how the munis will be structured to operate in that new paradigm.

---

<sup>69</sup> Ola Kinnander, “Public Power: New Moody’s Study May Lead to More Muni Utility Downgrades,” *Bond Buyer*, November 3, 1999, p. 5.



## Part 4

# Munis: Current Preparation for Competition

Some munis are already reacting to the prospect of competition by seeking to reduce their debt in order to be more competitive. Other munis are preparing by educating themselves and elected officials on competition, enhancing their marketing skills, reorganizing their staffing structures, and figuring out the costs to deliver each component of their services.<sup>70</sup> All are admirable changes that allow them to deliver services better and at lower cost, and none of them occurred until the specter of competition was raised.

Santa Clara, California, is one city where the muni has taken a proactive approach to competition. A plan proposed by the utility and approved by the city council will save \$100 million annually by the year 2002, when munis in California must enter the competitive market. Savings will come from reducing debt-service costs by \$30 million, purchased-power costs by \$30 million, and other costs by \$40 million.<sup>71</sup>

Santa Clara's muni has already refinanced its debt several times. Steve Klein, of Tacoma Public Utilities, argues that refinancing debt is the simplest and most straightforward way to save money and should be the very first savings measure taken by munis looking to lower costs.<sup>72</sup> In addition to cost savings, refinancing creates an opportunity to relax bond covenants to give a muni more flexibility to perform such activities as the buying and selling of assets.

Unfortunately, because of either political gridlock or management myopia, many munis are not preparing at all for competition, and others have chosen questionable strategies. For those unable or unwilling to act, the last few years have been frustrating—many recognize the need for change to prepare for competition but cannot agree on what steps to take. Austin's city leaders and muni managers recognized in 1995 that competition would require change, and they hired a consultant to help them devise a strategy. The consultant recommended that the city initiate a program of cost-cutting and sell the utility, which did not appear likely to be competitive while remaining government-owned. This set off a years-long political battle between

---

<sup>70</sup> Steinman, "Jolt Coming for Utilities, Customers," p. B-1; Cintron, "Sector Spotlight," p. 8; Ola Kinnander, "Public Power: To Remain Competitive, Power Companies Need to Offer Varied Services," *Bond Buyer*, March 17, 1998, p. 5; and Ola Kinnander, "With Deregulation Around the Corner, Utilities are Trying to Shave Expenses," *Bond Buyer*, August 6, 1998, p. 1.

<sup>71</sup> Kinnander, "With Deregulation Around the Corner," p. 1.

<sup>72</sup> *Ibid.*, p. 1.

those who agreed with the idea of selling the utility and those who did not.<sup>73</sup> In 1997, the city took a bold step—hiring another consultant. Only after that report came back with recommendations to help make the muni more competitive could the city council agree on a course of action.

Other munis are more deliberate in their failure to prepare for competition. After analyzing their prospects in a competitive market, they have concluded that they want no part of it. Instead, they suggest that IOUs be deregulated but that a “fence” be placed around the muni’s service area—they cannot compete for customers outside it, and others cannot compete to serve the customers inside it.<sup>74</sup> Munis with this strategy have had mixed success: some states, such as California, allow munis to delay competition for a time; others, such as Texas, allow munis to stay out of the competitive market for as long as they choose. The long-run effects of munis opting out of the market are uncertain. In California, where munis have been free to enter the competitive market for several years, they have chosen not to open up their areas to outside competition. In the short run, they have little incentive to do so—they can go after customers in IOU service areas, while their own service areas are safe from reciprocal competition.<sup>75</sup> However, pressure from consumers who want choice will likely force most munis to compete eventually.<sup>76</sup>

While some munis hide from competition and others vacillate about how to prepare, still others are moving aggressively in directions that may not be in the public’s interest. These strategies include expanding muni service territories, using government condemnation powers to create new munis, and launching munis into commercial profit-making ventures in electricity and non-electricity-related fields.

## A. Expanding Muni Service Areas

One of the main bones of contention in the fight over terms of the federal restructuring bill is whether munis can use tax-exempt debt to finance efforts to expand outside their traditional territories.<sup>77</sup> Munis do not just want to compete to keep their current customers; they want to grow, expand, and serve new customers in new places. To avoid conflict with rural cooperative utilities, munis have formed a gentleman’s agreement not to go after rural co-op customers. However, they see the territories of the IOUs as prime hunting

---

<sup>73</sup> Bruce Hight, “Find Cuts in Utility, Council Tells Staff,” *Austin American-Statesman*, March 1, 1996, p. A-1; Laylan Copelin, “Council Rules out Sale of Utility,” *Austin American-Statesman*, March 22, 1996, p. B-1; and Laylan Copelin, “Utility Issue Splits City Staff,” *Austin American-Statesman*, August 11, 1996, p. A-1.

<sup>74</sup> Richard Munson, “Public Power in a Competitive Electricity Market,” *Public Utilities Fortnightly*, July 1, 1997, pp. 24–30; and Clinton A. Vince, Sherry A. Quirk, and J. Cathy Fogel, “The Future of Public Power and Electric Cooperative Systems,” *Electricity Journal*, vol. 10, no. 9 (1997), pp. 40–46. However, munis are not the only ones guilty of trying to avoid competition. Florida Power & Light, an IOU, announced plans to cut rates by 2 percent, offering the cut as proof that competition is unnecessary. As many pointed out, that cut is absurd in light of the potential competition offers. See James McNair, “FPL Wants to Cut Rates, Keep Its Monopoly Intact,” *Miami Herald*, October 14, 1999.

<sup>75</sup> A disturbing outgrowth of this situation is the argument that customers in the service areas of munis should not be allowed to choose providers. Ridley in “Local Government,” argues that individual desires for choice of electricity provider undermine the “need for collective leverage in the market,” which he assumes only the city government, through the muni, can provide. He goes on to argue that customer choice forces munis to market their services, which “undermine[s] the potential benefits of competition.”

<sup>76</sup> Vince, Quirk, and Fogel, “The Future of Public Power,” p. 45.

<sup>77</sup> For more on this, see Section IV-C below.

grounds.<sup>78</sup> In California, for example, Arizona’s government-owned Salt River Project has used a for-profit arm called New West Energy to capture 12 percent of industrial customers that have switched providers.

Expansion is important to many munis.<sup>79</sup> In 1999, rural electric co-ops, which usually work closely with munis on public policy issues, pushed for legislation that would bar munis from using tax-exempt debt to support annexing rural co-ops as a means of expansion.<sup>80</sup> Naturally, the munis opposed the co-ops in this case, and the co-ops eventually agreed to stop pursuing the legislation and to seek a compromise.

The American Public Power Association has focused on the ability of munis to expand in its lobbying efforts over restructuring. The association’s executive director argues that any restriction on munis’ ability to expand would emasculate them. He describes one bill, which would require munis to refinance their debt as taxable debt should they decide to compete outside their traditional area, as a “fix” to the problem that “is more like the way a veterinarian ‘fixes’ a pet.”<sup>81</sup>

---

Unfortunately, because of either political gridlock or management myopia, many munis are not preparing at all for competition, and others have chosen questionable strategies.

---

## B. Municipalization: Creating New Munis

The number of municipal utilities in the United States has shrunk steadily, from roughly 3,000 in the 1920s to just over 2,000 today, as munis have consolidated or been privatized.<sup>82</sup> In the last decade, only 12 new municipal utilities were created, but that may be about to change, as about 150 communities are now considering municipalization.<sup>83</sup>

Some argue that this trend reflects a reaction to perceived problems with IOUs. They claim that restructuring has shifted the attention of IOUs away from their local service areas alone and toward regional and national opportunities for growth.<sup>84</sup> They also argue the merits of government-owned power, including promoting noneconomic goals such as “green power” and maintaining the utilities’ local nature.<sup>85</sup>

---

<sup>78</sup> David W. Penn, “Competition, the Consumer, and Local Decision Making: Public Power’s Important Role,” *Electricity Journal*, vol. 10, no. 9 (November 1997).

<sup>79</sup> The munis’ attitudes are not monolithic. Some would just as soon be fenced off from competition, and some IOUs share that attitude. Along with opportunity, competition brings risk and requires vigorous effort to stay ahead—monopolies can be much more comfortable.

<sup>80</sup> Ola Kinnander, “Rural Power Group Backs Off on Proposal Limiting Expansion,” *Bond Buyer*, July 13, 1999, p. 5.

<sup>81</sup> Michael Stanton, “Senator Says Power Debt Can Maintain Tax Exemption,” *Bond Buyer*, November 12, 1997, p. 1.

<sup>82</sup> This does not mean that munis are a shrinking industry. Between 1993 and 1997, munis’ sales (in kilowatt-hours) increased 13 percent, and revenues increased 11.9 percent, compared to growth of 8.5 percent and 7.7 percent, respectively, by IOUs. See the Energy Information Administration table titled “U.S. Sales to Ultimate Consumers and Associated Revenue by Class of Ownership, 1992 through 1997,” at [www.eia.doe.gov/cneaf/electricity/esr/t40.txt](http://www.eia.doe.gov/cneaf/electricity/esr/t40.txt).

<sup>83</sup> Ola Kinnander, “Communities’ Drive to Acquire Utilities May Lead to Increased Debt Issuance,” *Bond Buyer*, July 24, 1998, p. 1.

<sup>84</sup> *Ibid.*

<sup>85</sup> Vince, Quirk, and Fogel, “The Future of Public Power,” p. 43.

But in many cases, cities pushing for municipalization are actually trying to capitalize on restructuring to gain access to tax-exempt debt to fund some utility improvements and expansions and to gain access to a new revenue stream. In other cases, municipalization is a way for cities to evade stranded-cost payments. If the IOU serving a city has significant stranded costs, a city might calculate that municipalizing would let it avoid paying for some of those costs.<sup>86</sup> In summer 1999, Wichita, Kansas, began investigating municipalization of the distribution system that serves the city and belongs to Kansas Gas and Electric (KGE).<sup>87</sup> KGE's rates are significantly higher than surrounding IOUs' rates, due to stranded costs associated with a nuclear power plant. City officials see municipalization as a way to get out from under KGE's stranded costs.

The politics of municipal electric utilities go well beyond issues of service quality and stranded costs. As discussed above, munis are a source of jobs and revenue for cities. Virtually all munis pay a percentage of revenues to the city general fund. That revenue is essentially a hidden tax with no strings attached, one that city leaders hesitate to give up.

Revenues can drive municipalization as well. Since the beginning of 1999, the City of Long Beach has been exploring municipalizing the portion of Southern California Edison's system that serves the city. Why? "I saw an opportunity to create financial capacity by municipalizing," said city manager Henry Taboada.<sup>88</sup> At a time when cities are reducing revenue transfers from munis and considering tax cuts for IOUs, Long Beach is looking at municipalization as a way to extract more revenue from the utility. In a competitive market, that strategy may be especially risky.

Long before industry restructuring was an issue, in 1960, the town of Elbow Lake, Minnesota, municipalized its utility explicitly to use preference power and tax-exempt debt in order to lower costs—not to cut rates, but to generate surplus revenues for the city government.<sup>89</sup> Unfortunately for city officials with big dreams of new revenues, and ultimately for city residents, despite cutting their capital costs and the cost of acquiring electric power, the new muni actually lost money.

The allure of tax-exempt debt makes municipalization even more attractive.<sup>90</sup> The Long Island Power Authority (LIPA) bought out Long Island Lighting Company (LILCo) in 1998 and was able to cut rates 20 percent by refinancing the IOU's debt as tax-exempt.<sup>91</sup> LIPA cannot claim it brought better management or

---

<sup>86</sup> Ibid., p. 43. FERC rules govern stranded-cost recovery when there is a change of supplier, as do most state restructuring plans. But in some cases, FERC rules that would apply to a newly formed muni allow less stranded-cost recovery than do state restructuring plans. So municipalizing might let residents of a city reduce their payments for stranded costs.

<sup>87</sup> "Wichita Looking into Forming Municipal Utility," *Current Competition*, June 28, 1999.

<sup>88</sup> "Long Beach's New City Manager on Plans to Municipalize City's Electric Utility," *Metro Investment Report*, March 1999, pp. 4–6.

<sup>89</sup> Andrew N. Kleit and Robert J. Michaels, "Antitrust, Rent Seeking, and Regulation: The Past and Future of Otter Tail," *Antitrust Bulletin*, vol. 39, no. 3 (1994), p. 689 ff.

<sup>90</sup> The incentive that tax-exempt debt creates to municipalize even efficient IOUs has long been recognized by economists. See, for example, Michael Crew and Paul R. Kleindorfer, *Public versus Private: Alternative Ownership Scenarios for Electric Utilities*, Policy Study No. 121 (Los Angeles: Reason Public Policy Institute, June 1990), p. 21. Though cities usually cannot use tax-exempt debt directly for purchasing an IOU, they can use it to upgrade and expand the system after the fact.

<sup>91</sup> Nationwide, munis' average power rates are 25 percent lower than IOUs' rates for residential customers, 15 percent lower for commercial customers, and the same for industrial customers. The munis have long claimed that only a small fraction of that price difference is due to using tax-exempt debt. But the LILCo story paints a different picture. Moreover, the munis have consistently maintained that if they had to pay for capital at the same price that IOUs do, their ability to compete would be severely hampered, and many would opt out of competition. For more details on the

service to LILCo's operations, as it for some time considered contracting with another IOU to operate LILCo after the buyout.<sup>92</sup>

Many other cities are looking to follow suit, municipalizing IOUs and getting into the electricity business. Tax-exempt debt is making it attractive to convert private companies into government agencies, just when the nation is restructuring the electric industry to bring it into the world of markets and competition. That coming competition is making the electricity business riskier, as competition always does. Municipalization will put that risk squarely on the heads of local taxpayers. The costs of buying out an IOU alone usually require taking on considerable new debt, and much of it is in the form of more-costly taxable bonds.<sup>93</sup> (The law does not allow cities to use tax-exempt debt to finance buying out IOUs.)<sup>94</sup> The risk and expense of paying off that debt fall on city taxpayers, and it isn't trivial: LIPA borrowed \$7.3 billion to buy out LILCo.<sup>95</sup>

Is this risk real? Professional analysts say yes. Moody's has criticized public utilities for taking on debt in order to cut rates, calling it a risky and financially unsound practice.<sup>96</sup> And there are several examples of municipalization efforts that have not worked out the way city officials envisioned.

---

deal, see "Inquiry into How LIPA Chose Bond Underwriters Is Ended," *New York Times*, August 26, 1999, p. B-5, column 5.

<sup>92</sup> Charles E. Bayless, "Time's Up for Public Power," *Public Utilities Fortnightly*, vol. 136, no. 13 (July 1, 1998), p. 34.

<sup>93</sup> Kinnander, "Communities' Drive to Acquire Utilities," p. 1.

<sup>94</sup> The Omnibus Budget Reconciliation Act of 1987 changed the tax code so that tax-exempt debt used to municipalize an IOU is subject to the state volume cap, where it must compete with other uses of tax-exempt debt. Hence, tax-exempt debt is mostly used to finance only small municipalizations. But, since the new muni will be able to use tax-exempt debt for new capital investments and be exempt from federal income taxes, tax policy still favors municipalization. For more on the details of the 1987 act, see Cooper, "New Tax-exempt Bond Regs," p. 45.

<sup>95</sup> "Inquiry into How LIPA Chose."

<sup>96</sup> Charles Gasparino, "New York Power Authority Moves to Issue Bonds to Help Utilities Compete Against Private Firms," *Wall Street Journal*, February 4, 1998, p. C-24.



In 1996, the city of Dover, New Hampshire, conducted a feasibility study of municipalization and predicted substantial cost savings. In 1997, the city began looking for a partner to help accomplish municipalization.<sup>97</sup> After two years of negotiations with prospective partners, the city decided to kill the municipalization idea, because the city's financial risks were high should municipalization fail or should the muni ultimately go bankrupt.<sup>98</sup>

Las Cruces, New Mexico, has been wrestling with municipalization for even longer than Dover. In 1987, the city, unhappy with service and prices from its IOU, began to look at options. Based on a consultant's recommendations, the city in 1991 passed an ordinance to municipalize its utility. When El Paso Electric refused to sell, a 1994 city referendum approved condemning the utility to municipalize it.<sup>99</sup> Subsequent years have been a tangle of legal and regulatory battles over the value of the assets to be condemned. The 1999 mayor's race turned on the issue of municipalization, with the challenger to the incumbent mayor calling it a waste of taxpayer money but losing the election with 43 percent of the vote.<sup>100</sup> The challenger still contends that after all these years, competition may soon make the municipalization process moot.

Municipalization is an antiquated policy tool devised as a substitute for competition. With real competition on the horizon, the risks are not justifiable in most cases. Cities are likely to spend years of effort, only to realize that municipalization is not worthwhile or to find that operating an efficient, competitive utility is not so easy after all. Likewise, basing decisions on subsidies like preference power and tax-exempt debt, which may be changing with restructuring, is not sound policy making. City officials can serve their cities better by focusing on ensuring the benefits of competition for the residents, rather than on creating new government enterprises in an increasingly commercial market.

---

But in many cases, cities pushing for municipalization are actually trying to capitalize on restructuring to gain access to tax-exempt debt to fund some utility improvements and expansions and to gain access to a new revenue stream

---

## C. Commercial Ventures

One of the most recent and hottest trends for munis has been establishment of purely commercial ventures, many completely unrelated to the electricity business. In some cases, they are purely profit-seeking operations capitalizing on deregulated power and telecommunications markets. In other cases, they are a means of raising revenue to shore up retail electricity operations.

The biggest profit-making venture for munis has been the selling of power in the deregulated wholesale market or in newly created retail power pools. For example, groups of munis have formed companies such as

---

<sup>97</sup> "Dover, N.H., Seeking Private Group as Partner in Potential New Muni," *Electric Utility Week*, September 1, 1997, p. 4.

<sup>98</sup> "Dover, N.H., Drops Bid to Municipalize," *Electric Utility Week*, September 27, 1999, p. 17.

<sup>99</sup> "Showing the Way for Munies in a Deregulated Environment," *Nations Cities Weekly*, April 21, 1997, p. 2; and "FERC Sets Las Cruces' Stranded-Cost Liability at \$52.9 Million," *Foster Electric Report*, June 2, 1999, p. 1.

<sup>100</sup> "Smith Wins Third Term as Las Cruces Mayor," Associated Press, November 3, 1999.

The Energy Authority and Energy New England to trade their excess power in the deregulated wholesale power market. They are for-profit ventures that do not serve the customers of the munis, yet they can use tax-exempt debt to finance the power they sell, and they do not pay federal income taxes on the revenues they earn. The revenues they earn have nothing to do with their “public service” mission—they are pure, tax-free profits. And those profits may be considerable. Some munis have been reluctant to release profit figures, but the *Bond Buyer* reports that The Energy Authority’s net income in the first nine months of 1999 was \$55.7 million, up from \$33 million in all of 1998,<sup>101</sup> and that some munis have made millions in profits and enjoyed profit margins “in excess of 8 percent of sales.”<sup>102</sup>

Some government-owned utilities are using tax-exempt debt to build new power plants, confident that they can sell excess power for profits, despite the fact that industry restructuring makes the future value of generating assets and future prices of power very uncertain. For example, Santee Cooper, a state-owned utility in South Carolina that operates like a muni, is planning a new 500-megawatt plant financed with \$275 million of tax-exempt debt. Santee Cooper officials note: “Some regions in the country are going to need more capacity, . . . so why not have a public utility provide it?”<sup>103</sup>

---

Tax-exempt debt is making it attractive to convert private companies into government agencies, just when the nation is restructuring the electric industry to bring it into the world of markets and competition.

---

In California, an Arizona government-owned utility has seized a significant share of the market, and the Los Angeles Department of Water and Power made \$80 million in profits in less than a year by selling electricity to the state power exchange.<sup>104</sup> Ironically, the DWP considers itself “the primary beneficiary” of California’s restructured market so far, and thus may not open itself to competition any time soon.<sup>105</sup> And no wonder—currently, it can make millions in profits by selling to a competitive market without having to risk losing any of its customers to competitors.<sup>106</sup> Both of these utilities use tax-exempt debt to finance their profit-making ventures in direct competition with IOUs.

The practice of munis selling power for profit raises three major problems. First, the munis tend to look at the upside of selling their excess power for profit and even invest in more capacity to generate more excess power, but they often ignore the risks inherent in profit-making ventures. If power prices fall as other generating plants come online, munis could wind up with excess power and no market; they may have trouble paying off the debt used to build their generating plants. Or they could have trouble meeting

<sup>101</sup> Ola Kinnander, “The Energy Authority Inc. Earns Healthy Returns for Members,” *Bond Buyer*, November 5, 1999, p. 1.

<sup>102</sup> Ola Kinnander, “Municipal Utilities Finding the Wholesale Energy Trade Lucrative,” *Bond Buyer*, October, 11, 1999, p. 32.

<sup>103</sup> Robert Whalen, “S.C. Utility Builds Again,” *Bond Buyer*, February 22, 1999, p. 1.

<sup>104</sup> Ola Kinnander, “Wild West Power Plays: Salt River Unit Gains; LA May Delay Competition,” *Bond Buyer*, May 21, 1999, p.1.

<sup>105</sup> *Ibid.*

<sup>106</sup> Current rules allow municipal utilities to sell power to power exchanges or pools, thus indirectly competing with other utilities to sell power, without having to take the formal step of competing head-to-head to gain new customers or to retain existing ones. And in the process, they retain the right to use tax-exempt debt and don’t pay federal income taxes on their profits.



contracts—the Springfield, Illinois, muni is being sued because it could not provide the power it promised in several contracts.<sup>107</sup> Profit-making ventures are always a gamble—that is their nature—but when a muni loses money, it is not voluntary investors who lose, but the muni’s captive customers and, all too often, city taxpayers.<sup>108</sup>

A second problem is that government-owned utilities arose to provide electricity when the private sector had failed to do so. Selling power for profit in a competitive market—competing with IOUs—does not further that mission. Instead, it involves government-owned firms in direct competition with private firms in the market. Their access to tax-exempt debt and their exemption from paying federal taxes on profits distort the market and discourage competition.

A third problem is that the public cannot get information about the profit-making ventures *of the munis they own*. Officials at munis who claim to be making large profits in the wholesale power market will not divulge the size of those profits. Customers and taxpayers might be concerned that they would do the same if they suffered losses. Unlike the IOUs, who have to disclose profits and pay taxes on them, no regulatory or taxing authority requires munis to reveal their profits or losses—so they do not generally do so. Indeed, one muni official indicated that the reason why they would not disclose the size of their profits is the battle in Congress over their use of tax-exempt debt.<sup>109</sup> Another reports that “from a competitive standpoint it’s not really in our long-term interest to release that [information].”<sup>110</sup> Any financial information about a government-owned entity is public information—a muni’s accountability is to its customers and city taxpayers, who should be told what is being done with their money.

---

Cities are likely to spend years of effort, only to realize that municipalization is not worthwhile or to find that operating an efficient, competitive utility is not so easy after all.

---

When munis make profits from power sales, they don’t necessarily use the revenues to cut rates or spend the revenues to prepare for competition. Instead, they sometimes reinvest the funds in further commercial ventures. Tacoma City Light raised \$100 million by selling wholesale power in recent years and chose not to cut rates but to invest the money in building a cable TV system, hoping to gain a 25 percent market share in short order.<sup>111</sup>

This is one example of how some munis go well beyond electric-power profit ventures and compete with private industry in many products and services, including package delivery, health care, emergency services,

---

<sup>107</sup> Kinnander, “Energy Authority,” p. 1.

<sup>108</sup> Both ratepayers and taxpayers have had to pay for failed muni commercial ventures. One group or the other will have to pay for any judgments against the Springfield muni, and see examples of muni cable TV ventures below.

<sup>109</sup> Kinnander, “Municipal Utilities,” p. 32.

<sup>110</sup> Kinnander, “Energy Authority,” p. 1.

<sup>111</sup> Ola Kinnander, “Utilities Branch Out from Core Business, Aiming to Cultivate Loyal Customer Base,” *Bond Buyer*, June 2, 1998, p. 1. Tacoma City Light (TCL) is a recipient of preference power from the Bonneville Power Administration. So it is using that subsidized power to serve its customers and selling excess power it generates for a handsome profit. That means taxpayers all over the United States are paying not so that Tacoma residents can have cheap power for economic development, but so that TCL can make a profit and open new business units.

consulting, home security, job training, wastewater treatment, and education.<sup>112</sup> Indeed, the American Public Power Association has endorsed these ideas, publishing a guide with the heft of a telephone book called *Business Opportunities for Public Power: A Comprehensive Guide for Understanding and Implementing New Products and Services*. The guide explores business opportunities for munis in a broad range of commercial fields.

Munis often profess lofty goals for their commercial ventures. They argue that branching out into other businesses will make for stronger relationships with customers and cement the muni in the economic development of the community.<sup>113</sup> The APPA argues that munis are uniquely positioned to provide services such as telecommunications where private providers do not and to help foster economic development.<sup>114</sup> But the munis getting into telecommunications are almost all in cities that already have private providers of telecommunications service. And any local Yellow Pages directory lists companies providing most of the other commercial ventures that the APPA touts. In essence, munis are using commercial ventures to earn profits in order to sustain their existence in the face of competition in electricity, or even to expand.

---

In a time when the leading government management trend is to focus on the government's core mission, munis diversifying into many businesses seems ill-advised at best.

---

This trend ought to be of real concern to policy makers for several reasons. First, commercial ventures are by their nature risky. As with wholesale power marketing, munis prefer to gloss over and ignore these risks. An article in the APPA's *Public Power* about the world of commercial opportunities available to munis does not mention the possibility of losing money.<sup>115</sup> Commercial ventures unrelated to power can threaten the munis' core business—electricity. In a time when the leading government management trend is to focus on the government's core mission, munis diversifying into many businesses seems ill-advised at best. For one thing, it may divert management attention and even cash flow from their electricity business. With competition in electricity opening up and munis just learning to compete, they can ill afford such a diversion of resources.

To see just how real the risks can be, consider fiber-optic telecommunications systems, one popular commercial option for munis these days. More than 70 munis have built or plan to build such systems and will compete directly with telecommunications companies.<sup>116</sup> Some of them have already lost millions of dollars—and have had to raise taxes to cover the losses. For example, Paragould Light & Water, in Arkansas, spent \$3.2 million to build its cable TV business, and now the city has had to raise taxes to cover

---

<sup>112</sup> Ibid., p. 1; Ken Brown, "SRP Faces Many Issues in Competition," *Phoenix & Valley of the Sun Business Journal*, March 13, 1998, p. 9; and Susan Ryba, "Winning the Customers," *Public Power*, January–February 1999, p. 36.

<sup>113</sup> Kinnander, "Utilities Branch Out," p. 1; Kinnander, "Public Power: To Remain Competitive," p. 5; and Ryba, "Winning the Customers," p. 36.

<sup>114</sup> APPA, *Overcoming Anticompetitive State Barriers to Entry for Municipal Utilities in Telecommunications* (April 1999), [www.appanet.org](http://www.appanet.org); and "The Lure of Becoming an Internet Service Provider," *Public Power*, January–February 2000, pp. 47–49.

<sup>115</sup> The article is Ryba, "Winning the Customers," pp. 36–40.

<sup>116</sup> Len Grzanka, "Utility Diversification: Munis Find Cable TV a Costly Business," *Public Utilities Fortnightly*, September 15, 1998, p. 34. A look through the November–December 1999 issue of the American Public Power Association's journal, *Public Power*, finds two full-page advertisements, plus a smaller one, from technology firms offering to partner with munis on cable TV, Internet, and other telecommunications ventures.

losses.<sup>117</sup> In other towns, customers who don't use cable TV are still paying for cable facilities in their electric rates. Glasgow, Kentucky, has lost more than \$1.4 million on its utility's cable TV venture, a loss made up by "ratepayers . . . and the Tennessee Valley Authority."<sup>118</sup>

Neither the customers of these munis nor city taxpayers had any say about risking their money on a cable TV venture. Customers thought they were just signing up for electricity.

A second concern about these muni commercial ventures is that there is no way to shield many of the capital investments for such commercial ventures from the utility operations of a muni. Hence, muni utilities may use tax-exempt debt to finance buildings, repair yards, fiber-optic systems, and other facilities that can be used for commercial ventures. This outcome corrupts the purpose of tax-exempt debt, which is to fund infrastructure for the public good, not offices for cable TV operations.



---

<sup>117</sup> Ibid., p. 34. Grzanka examines a number of case studies and shows how overoptimistic revenue projections and lack of knowledge about competition and marketing have led to financial losses and tax increases in many cities where utilities have tried the cable TV business.

<sup>118</sup> Ibid., p. 34.

## Part 5

# Structural Options for Munis in a Competitive Market

There are a number of options available to city officials in restructuring their munis for competition. We offer a discussion of several that go beyond fine-tuning the status quo and provide a matrix for evaluating the trade-offs of using each option.

## A. Corporatization

A common theme among muni managers as they prepare for competition is that they need freedom to operate competitively. The president of the Nashville muni writes in the *Electricity Journal*:

*Public power companies will not only have to compete for customers but also for talent, therefore they cannot be hampered by unrealistic restrictions on hiring, promotion and compensation packages. Furthermore, a business simply cannot be run by government disclosure rules. Finally, public utilities need the flexibility to expand their service territories through mergers, acquisitions, and contract with strategic partners.*<sup>119</sup>

The general manager of the Los Angeles DWP holds similar views and has stated many times that munis need flexibility to make decisions at the speed of business to keep private firms from overwhelming them.<sup>120</sup> In Texas, during a battle over the state electric-industry restructuring bill, muni managers argued that to be competitive, they need to be exempt from purchasing and bidding rules and from public notice requirements that apply to government agencies.<sup>121</sup>

What these muni managers are describing is the need for munis to function as a corporation—the ability to operate as a corporation free of many political restrictions. But as government entities, the munis would not be subject to corporate accountability mechanisms. The muni managers do not explain what new accountability mechanisms will be in place.

---

<sup>119</sup> Cordaro, “What Future for Public Power?”

<sup>120</sup> Carol Heiberger and Al Senia, “A Tale of Two Cities,” *Utility Business*, vol. 2, no. 2 (1999), pp. 36–40.

<sup>121</sup> Bruce Hight, “In Bill, Cities May Hand Over Utilities Without a Vote,” *Austin360.com*, March 8, 1999, [austin360.com/news/features/legislature/1999/03/08austinelectric.html](http://austin360.com/news/features/legislature/1999/03/08austinelectric.html).

However, there is a mechanism for reorganizing a muni to operate as freely as a corporation and with similar accountability mechanisms in place. The process is called corporatization and involves the transition of government-owned utilities into true corporate entities that work within the same rules as do IOUs. This transformation not only would prevent market distortions but would restructure munis so that they could more readily compete, free of politicized decision making and bureaucratic red tape.

The process of corporatizing a muni involves no change of ownership, but it does involve a major restructuring of the enterprise. Instead of being a government department, the muni is legally converted into an incorporated, for-profit business, with the government as its sole shareholder. The new corporation has a board of directors, run by a chairman (usually from the private sector), and the board selects a chief executive officer (also recruited, in most cases, from the private sector). The corporation is freed from all government personnel and procurement regulations and is instead subject to ordinary corporate and antitrust law. It pays the same taxes as any other business, including local property taxes to the municipalities where it has facilities, and it is subject to corporate accounting standards. To the extent that it makes a profit, it pays dividends to its shareholder, the government that owns it.

Other key elements of the corporatization model include:<sup>122</sup>

- Management and budget standards are based on outputs, not inputs.
- The government would set overall policy, but it would not approve itemized budgets (which are inputs, not outputs) or subject management decisions to second-guessing. Only management's major investment decisions and overall performance goals, on a several-years-at-a-time basis, would be subject to city oversight. The muni would have full control of its assets, personnel, and programs.
- Munis could be regulated in one of two ways: (1) oversight could be provided by a municipal utility commission, a kind of a miniature public utilities commission, charged with overall output-oriented policy responsibility and protection of consumers from any form of monopoly pricing or practices, but having no power to review inputs, or (2) the muni could be subject to full regulation by the state public utilities commission and the Federal Energy Regulatory Commission.
- Munis would have full control over personnel decisions (personnel are inputs), and they would be free to hire, fire, and compensate based on merit.
- For management, success would be based on performance agreements holding the enterprise accountable. The city would negotiate an annual policy statement with the muni's board, and the board would translate this into a performance contract with the CEO. The CEO, in turn, would work out performance agreements for his management team, and so on, down the line. In this way, while politicians give up the ability to micromanage, they gain far more in terms of ultimate control over outputs.
- This model also entails accrual accounting (generally accepted accounting procedures) to aid policy makers and taxpayers in realistically assessing the utility's true financial situation.

---

<sup>122</sup> Our model for corporatizing municipal utilities draws upon a breadth of experience with similar efforts in the United Kingdom, Australia, and New Zealand. See Barry Spicer, David Emmanuel, and Michael Powell, *Transforming Government Enterprises: Managing Radical Organizational Change in Deregulated Environments* (Australia: Centre for Independent Studies, 1996). The General Accounting Office and the National Academy of Public Administration have recommended corporatization of the federal PMAs. See General Accounting Office, *Federal Power—Options for Selected Power Marketing Administrations' Role in a Changing Electricity Industry*, RCED-98-43 (Washington, D.C., 1998).

Corporatization would convert a muni into a more productive and competitive enterprise, free of politicized decision making and held accountable by its customers and city taxpayers for its financial performance, while insulating them from the business risk of traditional government enterprises. For the city, a corporatized muni, paying property taxes, represents a more predictable revenue stream than a traditional muni that transfers revenues in a market that makes revenues uncertain.

There can be drawbacks to corporatization as well. Often, the city charter or other laws must be revised to accomplish the change, and the process of conversion can be complex and requires a well-developed plan with thorough legal and accounting preparation. The people involved must also adapt. Managers have to get used to operating under a new set of technical and accountability rules. And city officials must get used to their role as shareholder representatives, one quite different from what they are used to with a city agency.

---

Corporatization would convert a muni into a more productive and competitive enterprise, free of politicized decision making and held accountable by its customers and city taxpayers for its financial performance, while insulating them from the business risk of traditional government enterprises.

---

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—tax-exempt debt no longer enters the picture. Once a muni is corporatized, the city can look at the company’s capital structure and see whether seeking equity investors makes sense.

The corporatization model has been extensively applied overseas but is only beginning to be explored here in the United States. Several cities in California are looking at variations on corporatization for their munis. Pasadena city staff have recommended that the city muni be restructured as a private, nonprofit entity that would gain much freedom to compete but would be subject to many corporate accounting rules and allow the city to impose accountability controls.<sup>123</sup> The Los Angeles DWP has proposed converting itself into a private agency overseen by a publicly appointed board and obligated to turn over a portion of its revenues to the city.<sup>124</sup>

## B. Selling the Utility

The most dramatic transformation of a muni would be selling it—converting it into a regulated IOU. “Franchise competition works both ways: where a municipal utility does not meet the needs of its citizen-owners, a city may be forced to sell its system.”<sup>125</sup> This may be particularly true of munis that decline to participate in competition—citizens may prefer that an IOU, which cannot opt out, own their distribution system.

---

<sup>123</sup> “Pasadena’s City Manager, Cynthia Kurtz: An Update on Her City’s Utility Deregulation Plans,” *Metro Investment Report*, January 1999, p. 9.

<sup>124</sup> Heiberger and Senia, “A Tale of Two Cities,” p. 38.

<sup>125</sup> Vince, Quirk, and Fogel, “The Future of Public Power,” p. ?

Selling government utilities is the restructuring option of choice in virtually the entire rest of the world.<sup>126</sup> In the 1990s alone, 62 governments outside the United States privatized a total of more than 500 electric utilities to some extent.<sup>127</sup> Yet selling government utilities is a little-considered option in the United States. As one observer noted, the U.S. Department of Energy and U.S. Agency for International Development actively urge other nations to privatize their electric systems, but in the United States, governments continue to support government ownership.<sup>128</sup> One exception is the city of Fairbanks, Alaska—in 1997, the city sold its entire electric utility.

Cities in the United States might learn a lot from the foreign trends. The Canadian province of Ontario has for two years been preparing for widespread sale of municipal utilities.<sup>129</sup> Italy is partially privatizing its major electric utility—when the sale of shares is completed, the utility will be the largest publicly traded electric company in the world, with 29 million customers.<sup>130</sup> The United Kingdom privatized its utilities in 1990; since then, prices have steadily fallen and service quality and reliability have increased.<sup>131</sup>

---

The U.S. Department of Energy and U.S. Agency for International Development actively urge other nations to privatize their electric systems, but in the United States, governments continue to support government ownership.

---

Sales of electric utilities overseas have shown that there are several methods available. Some countries have put assets up on the auction block, allowing the highest bidder to take ownership. Others have used the initial public offering (IPO) model, selling shares of all or a portion of the company. A variation on the IPO model involves vouchers, which grant persons a right to purchase a set number of shares—a method used to assure that certain individuals or groups, such as employees, get a chance at owning part of the privatized utility. Also, there are methods designed to allow management, employees, or both to “buy out” ownership of the utility.

Despite the strength of the international trend in privatizing electric utilities and the improvements that privatization has brought to electricity consumers worldwide, cities in the United States have not embraced it as a method of transitioning their munis into a competitive market. But, as cities prepare for competition, transitioning into private commercial entities may often be the most appropriate structure in a competitive market.

Resistance by city officials to the idea of muni sales is strong. One reason is the tax-exempt-debt issue—it is hard to make the economics of a sale work out when it will raise the cost of capital by several percent. Another reason is strong resistance by the munis themselves. The APPA has published a guide for munis trying to fend off privatization, *Challenge of Competition: A Guide for Responding to Buyout and Sellout Attempts*. Many of its strategies rely on emotive and political arguments rather than sound management or fiscal issues. Moreover, the

---

<sup>126</sup> U.S. Department of Energy, *Privatization and the Globalization of Energy Markets*, chap. 1, p. 1, [www.eia.doe.gov/emeu/pgem](http://www.eia.doe.gov/emeu/pgem).

<sup>127</sup> Ada K. Izaguirre, “Private Participation in the Electricity Sector—Recent Trends,” *Private Sector* (World Bank), Note no. 154 (September 1998), pp. 5–6.

<sup>128</sup> Bayless, “Time’s Up for Public Power,” p. 34.

<sup>129</sup> James Small, “Ontario Plans for Electric Utilities’ Future,” *Privatisation International*, April 1999, pp. 38–39.

<sup>130</sup> “Italy Electric Co. Being Privatized,” Associated Press, October 25, 1999.

<sup>131</sup> National Economic Research Associates, *Prices and Service Quality*, pp. 10 and 27–34.

APPA guide almost completely neglects to discuss the dynamic nature and risks inherent in competition. The level of economic analysis provided by the report is exemplified by the argument that the value of a publicly owned utility is not what others would pay for it. There are no similarly well-organized groups looking at the merits of privatization on behalf of the citizen-owners of munis.

City officials are understandably reluctant to buck such organized resistance. And they would likely have difficulty determining the ultimate revenue effects on the city of replacing muni revenue transfers with local taxes. Nonetheless, forward-looking city officials should consider how privatization has worked overseas and consider the risks to the city from a muni striving to compete in the market. They should also consider some of the information available to help them steer the course of selling their muni. For example, the Department of Energy has done a thorough examination of privatization of electric utilities and published a report that discusses methods used, provides dozens of case studies, and documents outcomes.<sup>132</sup> Reason Public Policy Institute (RPPI) has published a guide for selling public enterprises that walks through the steps of the process and provides guidance for evaluating the options available.<sup>133</sup>

---

Forward-looking city officials should consider how privatization has worked overseas and consider the risks to the city from a muni striving to compete in the market.

---

## C. Contracting for Operations

Muni managers may want to consider capitalizing on private-sector expertise to help them become more competitive through contracts for specific or general services. A number of munis already contract with private firms to provide customer service, human-resource functions, meter reading, and even facility or system operations and maintenance.<sup>134</sup> Some cities, such as Pasadena, California, are considering contracting as a means of focusing on core missions to prepare for competition.<sup>135</sup> Some cities considering municipalization have developed plans that call for taking over ownership of facilities by the city but contracting with a private utility to operate and maintain the entire system.

## D. Alliances

One way that some muni managers believe they can gain competitive skills more quickly than through internal change is through an alliance with other munis or with a private utility or power marketer. Typically, alliances share both profits and losses, so munis can mitigate their risk while gaining access to a new organization, which can be chosen to provide complementary skills.<sup>136</sup> Proponents of this strategy argue that it can provide “public power with more effective and efficient energy supply management, broader product

<sup>132</sup> U.S. Department of Energy, *Privatization and the Globalization of Energy Markets*.

<sup>133</sup> Henry Gibbon, *A Guide for Divesting Government-owned Enterprises*, How-to Guide No. 15 (Los Angeles: Reason Public Policy Institute, 1996).

<sup>134</sup> *Outsourcing: Solutions for the New Utility* (Atlanta: Chartwell, 1998).

<sup>135</sup> “Pasadena’s City Manager,” p. 10.

<sup>136</sup> Donna Ladd, “What Is the Allied Utility Network?” *Colorado Springs Business Journal*, July 24, 1998, p. 1.



offerings, the ability to manage risk more effectively, new types of financing structures, nationally branded products, and a strong partner.”<sup>137</sup>

The Allied Utility Network is a good example. Colorado Springs Utilities joined with a Nebraska muni, a Georgia co-op, and an Idaho IOU to form this alliance.<sup>138</sup> The alliance not only shares energy-related services and marketing but intends to offer long-distance phone service, Internet service, home security service, and billing services. Its intent is to build “a national company that markets products and services across the country.”<sup>139</sup>

The alliance strategy is not without problems. Residents and the press in Colorado Springs have been angered by their government-owned muni’s refusal to release financial and other documents about its alliance-related activities.<sup>140</sup> The muni argues that the information is sensitive in a competitive environment, but others argue that a public entity’s obligation of public disclosure is more important than protecting its profits.

This debate highlights one of the incompatibilities of government participation in competitive markets—does it answer to market imperatives or to public imperatives? Often, one undermines the other. Alliances pose even more complex challenges, because a muni in an alliance does not have sole ownership of information that may be required to be public. Munis may find that local laws, city charters, and debt covenants restrict their ability to enter into alliances or create accountability problems once they do. The alliance structure could impair local elected officials’ control of assets ultimately owned by the public, and legal obligations in the alliance structure may give outside partners control over municipal revenue.<sup>141</sup>

---

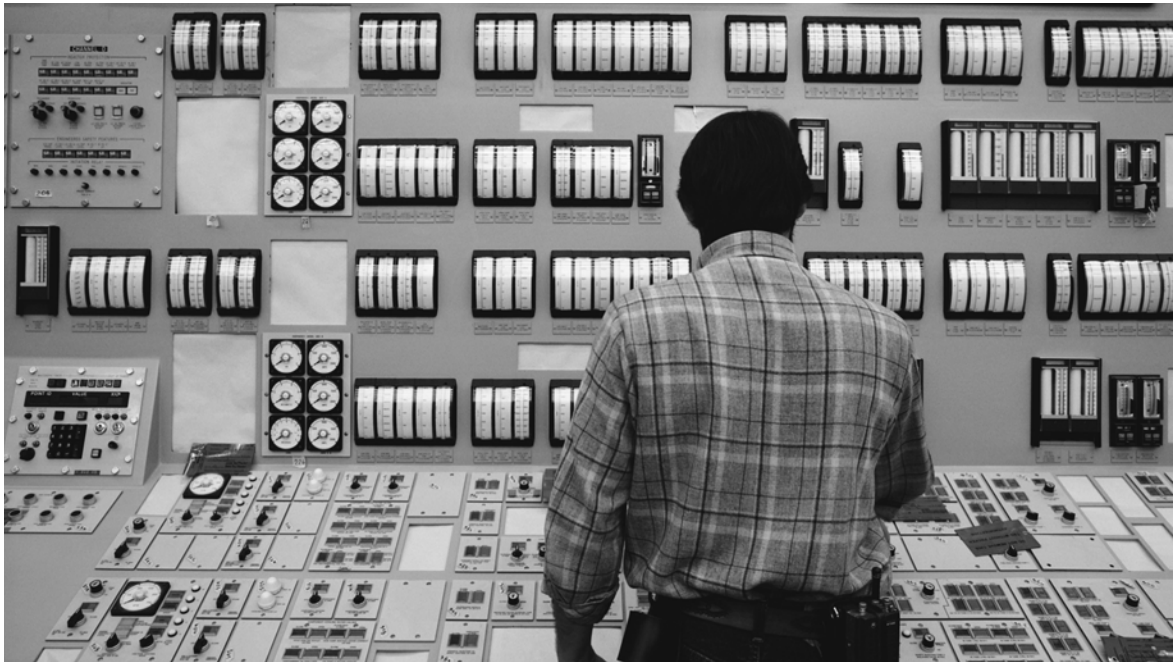
<sup>137</sup> Kenneth D. Rice, “Public Power: Creating Success in the Evolving Electricity Industry,” *Electricity Journal*, vol. 10, no. 9 (1997).

<sup>138</sup> Ladd, “What Is the Allied Utility Network?” p. 1.

<sup>139</sup> *Ibid.*, p. 1.

<sup>140</sup> *Ibid.*, p. 1.

<sup>141</sup> Michaels, “Would Anyone Invent Public Power Today?”



## E. Evaluating Options

Each of these options has its prospects and problems. City officials must evaluate their goals and circumstances in choosing the appropriate approach. As in most such choices, the decision involves trade-offs. Table 2 shows how each option (including several types of sale) stacks up against a number of criteria.<sup>142</sup>

The particulars of local circumstances and the particulars of how each option would apply allow many of the spaces in the table marked with a question mark to be filled in by local decision makers. This decision process leaves city officials with an initial rough idea of what trade-offs they face. Corporatization, the newest of the options presented, and sale to an outside owner offer the greatest number of positive qualities, at least as viewed generally. But local circumstances might make another option more attractive. Also, decision makers may want to add their own columns to reflect objectives omitted in this chart. Perhaps more important, local decision makers may want to assign weights to each column to reflect the relative importance of the objectives.

Method	Objective					
	Better Corporate Governance	Speed and Feasibility	Better Access to Capital & Skills	More Government Revenue	Greater Fairness	Better Accountability to Owners
Corporatization	+	-	-	+	+	+

<sup>142</sup> This table is based on one in *From Plan to Market: Executive Summary* (Washington, D.C.: World Bank, 1996), p. 8. We have added the nonsale rows and the last column to make it applicable to muni utilities.

Sale to Outside Owner	+	-	+	+	-	+
Management and Employee Buyout/ESOP	-	+	-	-	-	+
Equal-access voucher sale	?	+	?	-	+	+
Contract Operations	?	+	?	+	?	+
Alliance	?	+	?	?	-	-

+ = the method is relatively better in achieving the objective than other methods.

- = the method worse in achieving the objective than other methods.

**Part 6**

# Policy Recommendations and Conclusion

**T**he role of munis in a competitive market will depend a great deal on how public policy shapes the rules under which they compete and how management policies are selected to structure individual munis. Federal and state officials must seek to establish policies that will foster competition and choice and maximize the benefits to consumers. Municipal officials have to make fundamental decisions about how their muni will transition to competition and how much competitive risk they are willing to face. Indeed, they have to decide if the city still has a role as a provider of electricity. As economist Robert Michaels puts it:

*Debating public power's market role obscures important non-economic questions. If abandoning public power can cut collectively-held risk without narrowing consumer choice, should it continue to exist? Assuming public power survives, should its profits be returned to citizens as cash, sent to the general fund, or invested in further risky ventures? If public power takes losses, should they be made good from electric bills or agency budgets?<sup>143</sup>*

Weighing the economic and political trade-offs of each option for integrating munis into a competitive market is no simple or trivial task. For both public policy makers and management policy makers, we offer the following recommendations as guideposts marking crucial elements and principles of reform.

## A. Focus on Competition

Munis, as noted above, have undertaken a number of changes to prepare for competition—they have renegotiated debt, streamlined their operations, and put a new emphasis on customer service. Those actions—and their benefits to consumers—have always been available to munis, but the specter of competition fostered action. Competition is changing the incentives in the industry and putting power, in the form of choice, back in the hands of the consumers.

The main purpose of any federal (or state, for that matter) restructuring legislation should be to create a competitive order. Restructuring legislation should create the basic rules of the road that allow competition and markets to flourish and innovation to occur. Restrictions should be minimal and only where there remain

---

<sup>143</sup> Michaels, “Would Anyone Invent Public Power Today?”

significant problems with free competition. The focus now is on generation, but a case can already be made that distribution is more contestable than most people recognize and that technology makes it more so every year.

One source of competition is nongrid power. Cogeneration and other sources of distributed power are increasingly attractive to firms and other good-sized consumers of power.<sup>144</sup> Competition is already showing that a few will pay a premium for power from renewable sources such as solar, and such steps as repealing the Public Utilities Regulatory Policies Act would help the alternative-power industry innovate, rather than relying on mandated market share. This will put competitive pressure on transmission and distribution systems and help move them toward deregulation as well.

## B. Address the Tax-exempt-debt Problem

Public policies that provide special advantages to some participants in a market distort prices and trade and diminish competition. At the same time, public policy makers must take into account the transition from monopoly to competition and the changes it effects on the industry. As members of the Joint Committee on Taxation put it, “If certain electric service providers [are] permitted to retain their ability to receive tax-exempt financing in a competitive marketplace, those providers might have a considerable cost advantage over other competitors in a deregulated market.”<sup>145</sup> An objective of policy should be to avoid causing differences between the players’ capital costs.

For a short-term approach, RPPI recommends the following principles:

- The goal of restructuring is not to preserve or expand government provision of electricity; nor is it to eliminate it.
- However, munis that want to enter the competitive market must be treated like corporate entities. Those that can compete will survive. The others will likely be bought out or otherwise privatized.
- Since restructuring is predicated on the ability to have competitive generation markets and to give customers choice, *all munis should be required to compete on a “level playing field”*.
- Some reasonable (not overlong) period may be granted to allow munis to prepare for competition, but they should remember that their delay gives the IOUs a head start.
- Munis should be able to choose whether to compete outside their traditional service areas or not. Short-term sales that are expected to be ongoing, and requirements contracts, along with longer-term actions outside their traditional service areas, constitute such a choice.
- Upon making the choice to enter the market, munis must forgo any future use of tax-exempt debt and must refinance a portion of their existing tax-exempt debt as taxable debt. The portion refinanced will be equivalent to the share of the utility’s total revenue represented by the revenue from sales outside its traditional service area. The refinancing must occur by the end of its current term.

---

<sup>144</sup> There are even specialty software programs to help customers figure out if distributed power makes sense for them. William D. Siuru, “Solving the Distributed Energy Puzzle,” *Public Power*, November–December 1999, pp. 18–19.

<sup>145</sup> Joint Committee on Taxation, *Federal Tax Issues*, p. 9.

A longer-term approach grows out of some of the choices for restructuring munis. Selling or corporatizing a muni places it in the world of private capital financing with no more access to tax-exempt debt. Existing debt would be refinanced as part of the transition.

## C. Open Access to Federal Power

Along with tax-exempt debt, preferential access by munis and co-ops to subsidized federal hydropower is one of the two government policies that most distort electric markets. Preference power distorts the market by creating arbitrary power price differences where markets otherwise would rationalize prices. And it encourages wasteful behavior (rent seeking) by utilities to get or retain access to preference power.<sup>146</sup> Favoring certain providers benefits some customers and not others, though public power is “owned” by all U.S. taxpayers. Since generation is becoming a fully competitive market, governments should exit from the business of owning generation assets. Sound arguments exist for privatizing the Tennessee Valley Authority (TVA) and the Power Marketing Authorities (PMAs).<sup>147</sup> An even stronger case exists for selling federal power on an open-auction basis to all comers. Open auctions would ensure that taxpayers no longer have to support the TVA and PMAs. Instead, they would get a fair price for the power generated by assets built with tax dollars. It would also make federal hydropower a simple, cheap source of power for the whole nation and not a regionalized source of distortion in the market.<sup>148</sup>

---

Restructuring legislation should create the basic rules of the road that allow competition and markets to flourish and innovation to occur.

---

## D. Put an End to Municipalization

Municipalization is an antiquated policy tool devised as a substitute for competition. In today’s increasingly competitive electricity market, there is no justification for municipalizing more electric utilities. Municipal governments should no longer be allowed to get into the commercial and competitive business of providing electricity. Taxpayers should not allow their city governments to municipalize electric utilities; nor should federal tax policy encourage it.

## E. Put an End to Commercial Ventures by Government Utilities

As with municipalization, there is no compelling public interest that justifies government-owned utilities embarking upon commercial ventures such as appliance repair and cable TV service. Already, we see two inimical results of utilities’ commercial ventures:

---

<sup>146</sup> Kleit and Michaels, “Antitrust, Rent Seeking, and Regulation,” p. 689 ff.

<sup>147</sup> See Douglas A. Houston, *Federal Power: The Case for Privatizing Electricity*, Policy Study No. 201 (Los Angeles: Reason Public Policy Institute, March 1996).

<sup>148</sup> The market distortions and subsidies associated with federal preference power are discussed in General Accounting Office, *Federal Electricity Activities: The Federal Government’s Net Costs and Potential for Future Losses*, AIMD-97-110 (Washington, D.C., 1997).

- Taxpayers and electricity customers are footing the bill for losses in utilities' commercial ventures, which are inherently risky; and
- Government enterprises inherently distort competition. They are often exempt from regulations that constrain private firms; they have access to taxpayer funds in ways private firms do not; and they are often politicized in their management. Consequently, they never really compete on a level playing field with private firms.

The solution to this set of circumstances is to require government utilities to stick to their core mission—providing electricity. A lead might come from the Texas legislature and Georgia regulators, who have not allowed munis to get into commercial telecommunications businesses.<sup>149</sup>

## F. Conclusion

Each of these policy recommendations has much to offer on its own, but as a package, they go much further toward structuring a competitive market for electricity. The U.S. markets that were deregulated before—trucking, telecommunications, and airlines, for example—did not have large numbers of government-owned providers to integrate into competition. If policy does not account for the challenges of integrating munis into the market without distorting it, at best some people will not enjoy the full benefits of competition, and at worst true competition will never emerge.



---

<sup>149</sup> Kinnander, “Utilities Branch Out,” p. 1.

## About the Authors

**A**drian T. Moore is Director of Economic Studies and Deputy Director at Reason Public Policy Institute. He is an expert on transit and infrastructure trends and issues and has written extensively on government management, infrastructure, transit, and privatization policy. Moore is co-author of *Curb Rights: A Foundation for Free Enterprise in Urban Transit* (Brookings Institution Press, 1997). Moore received an M.A. in history from California State University, Chico, and an M.A. in economics from the University of California, Irvine, and he is completing his Ph.D. in economics at the University of California, Irvine.

**Jeff Woerner** is a research assistant for Reason Public Policy Institute. He has written on transportation and electricity policy. Woerner received an M.A. in economics from California State University, San Diego.



# Table of Contents

---

<b>INTRODUCTION: THE RESTRUCTURING CONTEXT.....</b>	<b>1</b>
<b>HOW IS RESTRUCTURING POLICY INTEGRATING MUNIS? .....</b>	<b>5</b>
<b>POLICY CHALLENGES: MUNICIPAL UTILITIES AND COMPETITIVE MARKETS.....</b>	<b>7</b>
<b>A. Public Policy Challenges .....</b>	<b>7</b>
<b>B. Management Policy Challenges .....</b>	<b>17</b>
<b>MUNIS: CURRENT PREPARATION FOR COMPETITION .....</b>	<b>23</b>
<b>A. Expanding Muni Service Areas .....</b>	<b>24</b>
<b>B. Municipalization: Creating New Munis.....</b>	<b>25</b>
<b>C. Commercial Ventures .....</b>	<b>29</b>
<b>STRUCTURAL OPTIONS FOR MUNIS IN A COMPETITIVE MARKET .....</b>	<b>34</b>
<b>B. Selling the Utility.....</b>	<b>36</b>
<b>C. Contracting for Operations.....</b>	<b>38</b>
<b>D. Alliances .....</b>	<b>38</b>
<b>E. Evaluating Options .....</b>	<b>40</b>
<b>POLICY RECOMMENDATIONS AND CONCLUSION.....</b>	<b>42</b>
<b>A. Focus on Competition .....</b>	<b>42</b>
<b>B. Address the Tax-exempt-debt Problem.....</b>	<b>43</b>
<b>C. Open Access to Federal Power .....</b>	<b>44</b>
<b>D. Put an End to Municipalization .....</b>	<b>44</b>
<b>E. Put an End to Commercial Ventures by Government Utilities .....</b>	<b>44</b>
<b>F. Conclusion.....</b>	<b>45</b>
<b>ABOUT THE AUTHORS.....</b>	<b>46</b>