

# Restructuring the Electric Utility Industry in Montana

## EXECUTIVE SUMMARY

The electric utility industry is undergoing major change. Congress and the Federal Energy Regulatory Commission have already mandated that the nation's transmission grid be opened to competitive use, allowing the wholesale market for electricity to become extremely competitive and blocking utilities from controlling access to wholesale purchasers. Legislation is being proposed at both the state and federal levels to extend competition to the retail market.

Montana must face policy choices on how far changes to the industry should go. It is too late to "just say no." Large industrial customers will use every effort to acquire cheap retail power on their own. The state must decide whether to extend choice to all retail customers. The Montana legislature cannot avoid the issue.

Several bills are being prepared for the upcoming legislative session by the Montana Power Company, the Montana Electric Cooperative Association, and Representative Scott Orr. Others may also introduce bills. The Northwest Comprehensive Regional Review, established at the request of the four Northwest governors, also asks for state action. Congress has seen five bills on restructuring that affect the states this session, and if Montana takes no action Congress will decide the issue.

Utilities traditionally have held a monopoly over retail sales in their service areas. Customers have had no choice, even if a lower cost supplier had wires nearby. This monopoly had legislative blessing through territorial protection laws (in Montana the Territorial Integrity Act prevents any utility from extending its distribution wires into a competitor's service area).

Pressures for restructuring come mainly from the availability of cheap power from natural gas turbines and from the brokering of utility surpluses. This power is significantly cheaper than the average cost power the utilities produce from their existing resource base. In most industries faced with such changes, producers would write down their assets and cut their losses. Utilities have tried to avoid this by using their monopoly control to keep their captive customer base. Since their ability to do this is eroding in the face of federal legislation and customer pressures for access to cheaper power, and the success of some large customers at changing suppliers, some utilities are seeking ways to accommodate restructuring while recovering some of their at-risk (or "stranded") costs. Others seek ways to preserve the status quo.

Montana is facing policy choices on how far to extend the availability of retail choice and how fast, on whether and how to extend competition and choice to customers of the rural electric cooperatives or leave it to the local boards, and on whether and how to allow utilities to recover stranded costs, and how to preserve

"stranded benefits." Stranded benefits are public purpose programs that were funded and operated by regulated utilities but which are likely to be abandoned to make the supporting utilities competitive with other market participants that have no such responsibilities.

Finally, the Legislature and the Public Service Commission must make policy choices on how to ensure competition takes place on a fair and level playing field, how to ensure a viable market with good information available for all participants, and what to do with the Territorial Integrity Act and with tax and stranded cost issues that will arise in restructuring.

## **BACKGROUND BRIEFING:**

# **RESTRUCTURING THE ELECTRIC UTILITY INDUSTRY IN MONTANA**

## **I. Introduction**

The electric utility industry is undergoing a wave of change. Congressional action and Federal Energy Regulatory Commission (FERC) regulatory changes have opened up the electric transmission lines of the country to facilitate a highly competitive wholesale market. The monopoly that utilities have held over their retail customers is weakening. Efforts are underway at both the state and federal levels to let retail customers choose their electric suppliers. Some customers are themselves seizing the initiative. Montana saw the biggest customer switch in the country when the Columbia Falls Aluminum Plant switched from the Bonneville Power Administration (BPA) to service from the Flathead Electric Coop, PacifiCorp and ENRON. Other large industrial customers are trying to gain access to cheap power sources and are a driving force in changing the electricity industry.

This process of changing the electricity industry, "restructuring," will entail the partial deregulation or re-regulation of the industry. Restructuring will significantly change the industry, including the methods for determining electricity prices and regulating utility profits.

## **Possible Changes in a Restructured Industry**

Currently, a large portion of the electric industry is vertically integrated. Utilities own the customer meters, distribution wires, transmission system, generation facilities, and in some cases the fuel sources for those facilities. With the exception of the fuel sources, the entire vertical structure is subject to average cost rate-of-return regulation by state and federal regulators, or to pricing at cost by member-owned cooperatives. Restructuring will involve changes to all sectors of the industry.

- **Generating facilities** -- will probably be unregulated, held by utility

subsidiaries or separate companies competing with non utility generators and brokers. Owners may have to risk their own resources to build future facilities with no guarantee of cost recovery. Sell at market prices.

- **Transmission facilities** -- will probably be regulated, held by separate companies, independent grid operators or independent system operators, and managed as common carriers. Prices regulated, may reflect congestion and incremental costs and be location- and time-specific.
- **Distribution facilities** -- will probably be regulated much like today, but primarily a wires service for retail customers, and may be default providers of basic service.
- **Retail suppliers** (including utility subsidiaries and independent aggregators) - - will probably be regulated only to extent necessary to ensure competence and financial viability. Will compete to serve some (or possibly many, or all) retail customers.

Restructuring is not a new phenomenon in Montana. The telecommunications industry has gone through similar changes, driven in part by changes in technology and in part by the desire by customers to gain access to cheaper service rather than continue with a traditional monopoly supplier. The natural gas industry also is in the midst of restructuring. While these industries are different from the electricity industry, valuable lessons have been learned from them.

Montana is now faced with policy choices on how far these changes should go. It is too late to "just say no." Large industrial customers will use every effort to acquire cheap power on their own, and the universities, large retail establishments and state agencies will also search for ways to gain access to low cost sources. However, the state must decide whether to extend choice to all retail customers. The Montana legislature cannot avoid the issue. Several bills are being prepared for the upcoming legislative session by the Montana Power Company (MPC), the Montana Electric Cooperative Association (MECA), and Representative Scott Orr. Others may also introduce bills. The Northwest Comprehensive Regional Review, established at the request of the four Northwest governors, is also asking for state action. Congress has seen five bills on restructuring that affect the states this session, and if Montana takes no action, Congress will decide the issue.

## **II. Activities Underway That Affect Montana**

### **Open Transmission Access.**

FERC has issued Order 888 on open access transmission tariffs, and it has issued a Notice of Inquiry on capacity reservation tariffs. In the context of open access transmission, the transmission-owning utilities of the Pacific Northwest are negotiating the formation of an independent grid operator (IndeGO) that will take over control and operation of their bulk system (generally 230 kV and higher)

transmission facilities. In addition, Montana is a participant in two regional transmission groups, the Western Regional Transmission Association (WRTA) and the Northwest Regional Transmission Association (NRTA). The RTAs are associations of all stakeholders involved in transmission planning, pricing and governance.

### **Retail Competition.**

Congress: At least five restructuring bills are under discussion in Congress that would affect retail competition nationwide.

Other states: Restructuring legislation has passed in several states, most notably in California.

Northwest Regional Review: The four Northwest governors convened the Comprehensive Regional Review. This is a collaborative effort by all stakeholders to agree on how to restructure the energy industry in the northwest, with a focus on what to do with BPA, how to retain the benefits of the Columbia River power system, and what the future role of the Northwest Power Planning Council (NWPPC) should be.

Montana Public Service Commission: In Montana, the Public Service Commission (PSC) has a docket open on restructuring and is considering what changes, if any, it should make on its own and what position it should take on legislative proposals. It has adopted principles governing restructuring and has asked MPC to file its restructuring plans.

Montana 1997 Legislative Session: MPC has drafted three electric restructuring bills for its package: an electric restructuring bill, a tax bill, and a bill to revise the Territorial Integrity Act. These have been distributed for wide discussion and change with successive drafts. MPC's large industrial customers are considering introducing a bill of their own if their interests are not satisfied in MPC's bills. In addition, MECA has drafted a bill calling for a two-year interim study, and Representative Scott Orr has a bill draft request for model legislation developed by the American Legislative Exchange Council.

### **III. Risks and Benefits for Montana**

Certain risks to Montana from restructuring need to be considered, even though it will not be possible to isolate Montana from the changes coming to the industry.

- Some fear that the value of low-cost power generated in Montana will be bid up by larger markets elsewhere in the region. (Actually, current market prices in the Northwest are well below the cost of "low-cost" Montana electricity supplies.)

- If the Montana market is not attractive to marketers and aggregators, utility retail marketing subsidiaries will not face competition, and residential and small commercial consumers may see higher prices reflecting abusive market power.
- If competitive markets are significantly riskier for investors than the traditional utility arrangements, the cost of capital will rise, investors will want shorter payback periods, and the cost of power from new power plants will go up.
- It has been argued that many residential and small commercial customers have benefitted from rate structures that favor them at the expense of large industrial customers. In a competitive industry such subsidies probably would disappear.

These risks must be weighed against restructuring's benefits, such as the effect of competitive pressure on prices, product choice and innovation, and lessened regulatory costs. The downward pressure on prices could save Montana customers millions of dollars as they are allowed to access low cost electricity.

#### **IV. Forces Driving Restructuring**

On the national level, the move to a restructured electrical industry is being driven by technology advancements, low natural gas fuel prices and past regulatory policies. The combination of these factors has led to major disparities between utility electricity prices, on the one hand, and the cost of power either from new gas-fired combustion turbines or from the brokering of utility surpluses, on the other. Large customers want access to cheaper power, and have great incentive to find ways to switch suppliers. If they switch, utility prices may spiral upwards as utilities try to collect their costs from remaining users. Some utilities have responded to these pressures by trying to enforce their traditional monopolies, to keep their customers captive. Others are proposing restructuring legislation that they hope will satisfy their customers' demands while avoiding the need for major writeoffs, and that also will preclude legislation that would hurt the utilities more.

#### **V. The Electricity Industry in Montana**

Montana is not isolated from the driving forces at the national and regional levels or in other states. Montana is part of an integrated transmission grid covering the entire western United States and a single marketplace for electricity. Nevertheless, the driving forces behind restructuring will affect Montana differently given Montana's current electrical structure.

According to the Department of Energy, in 1994 industrial customers, less than 1 percent of the customers in the state, used 45 percent of the electricity consumed in Montana. Residential customers, on the other hand, made up 84 percent of the electrical users but consumed only 27 percent of the electricity. The industrial sector

looms larger in Montana than in most other states, and is a large force behind electric utility restructuring. Large industrial customers want the ability to shop around for cheaper market-priced electricity that will suit their specific needs, while avoiding what they believe is a subsidization of the residential sector. Loss of industrial customers would have a major impact on the utilities that serve them. (This appears to be a much greater threat for MPC than for MDU.)

Retail sales within the state are supplied either by investor-owned utilities (IOUs) or member-owned rural electric cooperatives (RECs). The territory that can be served by these utilities is strictly defined in Montana's Territorial Integrity Act. Three major IOUs in the state are regulated by the PSC: MPC, Montana-Dakota Utilities (MDU), and PacifiCorp. In 1994, MPC supplied 56 percent of the total electric sales within Montana and had all of its retail sales within the state. PacifiCorp supplied 6 percent of Montana's total electric sales and had 2 percent of its retail sales within the state. MDU supplied 4 percent of Montana's total electric sales and had 25 percent of its retail sales within the state. Thirty RECs in Montana supplied 14 percent of Montana's total electric sales. The cooperatives are regulated by themselves rather than by the PSC, and are generally viewed and treated differently than the IOUs. These IOUs and RECs will be very important in restructuring the electrical industry of Montana, particularly in redrafting the Territorial Integrity Act and in shaping retail access.

## **VI. Montana Policy Choices**

Policy choices must be made in restructuring the electric utility industry. Some of these are federal choices while others are primarily within state jurisdiction. The major federal choice is the opening of the transmission system to facilitate wholesale competition. Retail competition is the key policy choice for the state, but without action by the PSC or the legislature, Montana's future may be written in Washington, D.C. by the U.S. Congress. Five bills have been introduced in the current session of Congress. The progress of these bills will be driven by the interests of consumers in the east, who face an industry with problems very different from those of the west. The best chance for Montana to control its future is by decisive action on restructuring. The major focus of discussion on issues about restructuring is at the state level, and Montana's best chance to control these issues lies in PSC and legislative action.

The major policy choice for Montana is whether to open utility service territories to customer choice of supplier. The PSC can act to extend retail choice to the customers of the IOUs. The PSC has requested MPC to provide a restructuring plan, and has indicated it will consider restructuring plans from Pacificorp and MDU at some future date. However, since the PSC has no regulatory authority over the rural electric cooperatives or the Troy municipal electric utility, legislative action would be required to bring the same choices to the customers of these utilities. Yet many cooperatives oppose a legislative mandate, believing that they should only follow the wishes of their members. Without positive action by the PSC or the legislature, the issue will be settled in federal legislation that is unlikely to account for

Montana's circumstances or wishes.

## **VII. Major Issues in Restructuring**

A number of issues must be addressed by the legislature, the PSC or both, before retail competition can work in Montana. In no particular order, these are:

- A. Each utility's generation, transmission, distribution and retail marketing systems must be either functionally separated or fully divested. (Legislature and PSC)
- B. Decisions must be made about what to do with stranded costs and stranded public benefits, on to what extent they will be funded by meter charges that cannot be avoided and how they will be managed. (Legislature and PSC)
- C. Decisions must be made about what to do with the customers of the rural electric cooperatives. The coops are not regulated at the state level and traditionally have been treated differently than the investor owned utilities. (Legislature)
- D. Some tax issues (including revenue losses to the state) may need to be addressed if utilities move into a competitive environment. (Legislature)
- E. The Territorial Integrity Act, which currently protects the service areas of public and private utilities from competition, may need to be amended. (Legislature)
- F. Provision of basic service. (Legislature and PSC)
- G. The issue of cost shifting needs to be addressed. (Legislature and PSC)
- H. The future role of the PSC in a restructured industry needs to be thought out. (PSC and Legislature)

### **A. Functional Separation vs. Full Divestiture**

For competition to work in the retail sector, utilities cannot use their transmission, distribution and retail marketing systems to block competitors. Generation, transmission, distribution and retail marketing systems must operate independently. The portion of a company controlling the distribution network must provide even-handed access both to its affiliated retail company and to competitors.

The question is how to separate the systems: (1) Full divestiture, selling off utility generating and transmission assets, leaving the distribution company; or (2) functional separation, splitting the company into corporate subsidiaries or independent operating units while retaining common ownership. Proponents of full divestiture argue that selling off the assets is the only way to prevent the utility from favoring itself over its competitors in access, system operation and expansion. Proponents of functional separation argue that divestiture will be complicated, and that if functional separation does not eliminate the incentives to favor corporate assets, divestiture can be sought at a later date.

Some degree of functional separation is now underway. MPC proposes to place generating assets in the non-regulated arm of the utility parent company. MPC is

negotiating with other transmission owners in the region to turn over their transmission lines to IndeGO, a regional non-profit "independent grid operator."

MPC's first draft restructuring legislation, however, did not separate distribution wires service from retail marketing, but left the two functions in a single, regulated distribution utility. Without separation of these two functions, the distribution facilities could be used to disadvantage competitors. At a minimum these functions may need to be functionally separated.

## **B. Stranded Costs and Public Benefits**

Stranded costs are the costs of resources above their market value. These include:

- High cost power purchase contracts and Qualifying Facility contracts;
- High cost generating resources;
- "Regulatory assets" that cannot be marketed at all, e.g., Past demand-side management program costs Deferred taxes.

These costs are generally recoverable under traditional regulatory arrangements, but probably cannot be recovered under conditions of retail competition and customer choice.

Stranded public benefits are public purpose programs that have been imposed on utilities and funded through utility bills. Such benefits probably cannot be sustained under conditions of retail competition without special legislation.

**Stranded costs.** Utilities will not support a move to retail competition without some means of recovering the costs that they feel were incurred in good faith under the traditional regulatory arrangements.

Regulatory Compact. Under the traditional utility regulatory compact, utilities were guaranteed the opportunity to earn a return on investments, as long as the investments were both prudently made and "used and useful" to serve loads. Protection from competition also insulated them from much of the market risk of choosing a fuel or technology that eventually was found to produce expensive electricity. Much of the industry is now burdened with the recovery of costs that are above market. If consumers are given the right to choose their suppliers the utilities will not be able to sell power at an above-market price. In a competitive market, price would be driven down and the utilities would have to write down the assets or fold.

Government Mandates. Some of the costs at risk with retail competition were mandated by government action, such as demand side management (DSM) investments, and the "avoided cost" contracts with Qualifying Facilities (QFs).

Other costs at risk, such as deferred taxes, exist only because of compliance with government regulations. Utilities assert that if the rules are to be changed on them, they have the right to fully recover these costs. On the other hand, there are legal precedents that indicate the regulatory compact was not intended to shield utilities from market risk.

Sharing of Stranded Costs. The appropriate sharing of stranded costs between customers and shareholders is probably a matter for debate and public policy. Utilities should try to mitigate stranded costs by renegotiating contracts, cost control, marketing efforts and other means. Recovery of stranded costs could be conditioned upon demonstration that such means were exhausted.

Cost Recovery. Stranded costs probably would be recovered through a meter charge on all current customers of the utility.

Calculating Stranded Costs. Market prices are very low now, due to low natural gas prices, new technology for gas-burning power plants, and a significant surplus of power. An estimate of stranded costs based on today's market value of power is likely to be quite high. However, if gas prices rise and the current surplus shrinks or disappears, the market value of power will rise and stranded cost estimates will fall. Under these circumstances a reopener (later opportunity to review the cost estimates in the light of actual experience) might be appropriate to review the equity of stranded cost recovery.

Financing stranded costs. MPC is proposing that the state float tax exempt bonds to cover stranded costs. The bonds would be repaid out of "competitive transition charges" (meter charges) to customers. This proposal may provide a starting point for considering proposals on a sharing of stranded costs between ratepayers and shareholders, using tax exempt bonds to provide an early recovery of the company's share while stretching customer payments over a longer period while holding down rates to residential and small commercial customers.

**Stranded benefits.** Regulated utilities have acquired some public purpose obligations which may need special legislative support in a deregulated environment, or perhaps should be dropped or weaned from utility support. These include special programs for low-income utility customers (discounts, weatherization programs, low income energy assistance programs, and prohibitions against winter service cutoffs). Others are utility DSM programs, renewable resource programs, and inclusion of environmental costs in utility resource decisions. All these will be at risk as competition increases pressure to hold costs down.

- Low income programs. It is difficult to argue with the needs of low-income people for special consideration. A broad range of assistance programs are provided by the state and federal governments. Low-income programs supported by utilities provide a valuable supplement to the governmental programs. It may be difficult or impossible for utilities to sustain their

programs in the face of competition from non-utility suppliers. While it might be desirable to move the responsibility for these programs into general assistance programs, this may be impossible in the current climate of shifting responsibilities from the federal government to the states and severely constrained state budgets. Until this climate changes, the programs should not be abandoned but should be funded from a source that does as little damage to efficiency pricing as possible.

MPC proposes funding low-income programs out of a "universal systems benefits charge" (USBC). The Governor-appointed Low Income Energy Advisory Council is also exploring the use of a USBC as one of the most viable approaches to ensuring that restructuring still allows low income consumers to obtain affordable energy services. A USBC would ensure that all stakeholders share in the stranded benefit responsibility, extend these programs to all low income customers in the state, and also provide make-up funding as necessary to continue adequate low income energy assistance. This would alleviate problems with current utility programs, where coverage is incomplete (e.g. low-income coop members do not receive the same programs or the same benefits) and the costs are not spread evenly or equitably (electricity bills are not necessarily correlated with ability to pay).

- Energy Efficiency. Utility support of cost effective DSM programs has always been unenthusiastic because of these programs' impact on the price per kWh, and on sales and revenues. Competitive pressures will make utilities in a restructured market reluctant to continue programs that must be funded out of electricity sales and that reduce those sales. Both the Regional Review draft and MPC's proposed legislation recommend funding of DSM out of a USBC that would apply to all consumers and could not be escaped by switching suppliers.

Other parties have argued, by contrast, that, with the maturity of the DSM industry, it is now appropriate to move these activities to a free-standing, competitive format. Conversion of utility programs into for-profit subsidiaries might provide incentives for DSM. These parties argue that a clear and explicit timetable for phasing DSM programs out of utility funding and making them free standing, self-sustaining and self financing entities, should be included in restructuring legislation..

- Renewables. Wind and other renewables have been promoted for their low environmental impact, modular expansion capability, and independence from fuel price risk. However, renewable resources are generally not cost effective, because of low cost power from gas turbines and the availability of low cost surplus power. Most large renewable projects in this country are relics of the early days of PURPA, when regulatory commissions sometimes set very high purchase rates to encourage the development of qualifying facilities. Most current renewable development, along with other independent power development activity, is focused on overseas or "niche" markets. Yet proponents continue to demand special treatment in utility resource evaluation, and funding for R&D projects.

The Northwest Comprehensive Regional Review draft recommendations call for renewables development and R&D to be funded out of a wire charge. MPC's proposed legislation proposes that renewables be funded by the "universal system benefits charge." However, renewables should be promoted only when and where they make sense, and it would be inappropriate to force investments in renewables when they are neither needed nor cost-effective. Any transitional promotion of renewables through public benefits charges should be limited to R&D investigations of applications of cost-effective renewables.

- **Consideration of Environmental Externalities.** The PSC requires regulated utilities to use Integrated Resource Planning (IRP) to weigh both internal costs and environmental impacts in resources choices. This requirement will not apply to a deregulated generating sector, raising concerns that the environment may suffer. However, IRP has had limited success as an environmental protection tool. There has been little new plant construction, and the currently cheapest alternatives, natural gas-fired generation and existing surpluses, have little impact on the environment.

Restructuring alone probably will not do great damage to environmental quality. Utilities are subject to a wide range of direct environmental regulations, including facility siting regulation, air and water quality regulation, and the use of tradeable SO<sub>2</sub> allowances. Maintaining the integrity of existing environmental laws will ensure that the deregulation of generation and the restructuring of the industry does not result in wholesale damage to the environment. Nevertheless, concurrent efforts to relax environmental regulation, combined with restructuring, could in the future lead to significant loss of regulatory control over environmental degradation. This is a particular risk if changes in prices or technology make a polluting technology the most attractive generating alternative.

To protect the environment in a restructured industry, we should consider greater use of market-based environmental regulation such as tradeable emissions allowances, and pollution taxes. A commitment to maintain siting and environmental regulation, together with restructuring legislation, might alleviate the worry some may have about a future return to dirty plants in a competitive industry.

### **C. Incorporating the Rural Electric Cooperatives**

Montana RECs have never been regulated by the PSC, and they have received only the most cursory regulatory oversight from the Rural Electrification Administration. They receive tax treatment that results in a different cost structure than that of the private IOUs. They mostly serve areas of low population density, with a high distribution cost per customer and per kWh. They have preferential rights to some low cost power supplies, including BPA's 24.5-mill power from a blend of hydro and nuclear facilities, and the Western Area Power Administration's 7-mill Pick-

Sloan power. They are member-owned and controlled, and many feel that they should respond only to their members' wishes and not have choice dictated by the legislature.

Legislation would be required to mandate choice for customers of RECs. MPC's proposed legislation allows a combination of mandatory reciprocity and voluntary participation. RECs that want to participate in the competitive arena would have to participate fully and offer choice to their members. Other RECs with no inclination to compete for loads could choose to remain monopoly distributors with the ability to take advantage of and bear the risks of opportunities in wholesale markets. However, it would be questionable public policy to free the formerly captive customers of the IOUs to seek lower power costs but to force those customers served by cooperatives to remain captive.

#### **D. Tax Issues**

The current Montana tax code treats investor owned utilities differently from cooperatives or other types of businesses. Under regulation taxes are passed through in rates, like all other utility costs. This will no longer happen in a competitive environment. Utility generating assets will be competing with generation from non-utility suppliers and with power marketing activities of brokers. This argues for more comparable treatment of generating assets regardless of ownership. However, it should be pointed out that utility property accounts for significant amounts of centrally assessed property tax revenue in Montana: Electric utility property (IOU's only) comprise 17.44 percent of Montana's total property tax base. Because of the property tax revenue dependence of many Montana counties, the potential revenue loss arising from the disaggregation of utility property assets could have a severe impact.

#### **E. The Territorial Integrity Act**

The Territorial Integrity Act was put into place to prevent large private utilities from raiding the service territories of cooperatives. The Act may need to be rethought if retail choice is allowed. If full retail choice is available, territorial integrity might be appropriate only to define the responsibility for extending the distribution wires and meters, to avoid duplication of investment and excessive costs.

#### **F. Provision of Basic Service**

If the utility is functionally separated into unregulated generation, an IGO-controlled transmission system, a state regulated distribution wires company, and a competitive, but licensed, retail service company, what is the utility mandate to serve? The distribution company probably has an obligation only to connect, and should be able to disconnect a customer only if he does not pay the distribution company's charges. Who is the default provider of retail services? Who must provide basic life-support-type service to low income customers who may miss some payments? The Vermont Public Service Commission has proposed a

reasonable solution. The regulated distribution wires company would be obligated to provide default service to those who do not select another provider, and during the period of transition would be required to keep its preexisting tariffs available to customers during that period. After the transition default service would be provided by a retail supplier under contract to the distribution company, selected by competitive bid. Similarly, the distribution company would contract with a retail supplier to provide basic service to customers that no other retail supplier wants to serve.

### **G. Cost Shifting**

Utilities are worried about shifting of cost responsibility for the sunk costs of the existing transmission system. In an open access system cost responsibility, assigned by marginal cost, may be different than historic sharing. Utilities are trying to come up with pricing methods to avoid the costs of other utilities being shifted to their own customers. Nevertheless, in the long run it probably is not possible to protect against some degree of differential cost increases.

Commissions and consumer advocates are worried about costs being shifted between customer classes. Industrial customers argue they have been charged above the cost of serving them to reduce the cost responsibility of residential rate payers. Consumer advocates charge restructuring is a means for industrial customers to seek cheap power and to shift higher-cost power to less powerful consumers.

Competition would eliminate possible inter-class subsidies. In a truly competitive industry, rates will reflect the marginal cost of providing service to each customer or customer class. All customers would be shielded from costs in excess of marginal costs unless a regulatory decision were made to impose these costs on them.

Finally, some argue that Montana will lose the benefits of its low cost electricity as its price is bid up to some average of western regional generating resources. This would be a form of cost shifting between high cost states and low cost states. This argument reflects a misunderstanding about how prices are set in competitive markets. All prices tend toward marginal cost, not toward some average of historic, sunk costs. The high cost of California nuclear plants, for example, is totally irrelevant to the equilibrium market value of power in the region. All states, including Montana, could see lower power costs if the cost of new gas fired generation stays around 20-25 mills.

### **H . Montana's Future Regulatory Structure**

A competitive generating sector does not need economic regulation. The open access transmission system will be a monopoly, regulated by FERC outside the control of state economic regulators. The distribution system will be a monopoly, regulated at the state level by the PSC.

Retail service providers will require licensing regulation. Assuming adequate

competition and separation of utility retail service activities from management of the generation, distribution and transmission segments of the company, no economic regulation will be required. Oversight of licensing and of the adequacy of competition and of separation could be carried out by the PSC.

Transitional restructuring oversight of currently regulated utilities belongs with the PSC. Each utility in the state should file with the PSC a report on how it will comply with any proposed restructuring legislation. The PSC probably should have approval responsibilities for the investor-owned utilities. For coops and municipal utilities, the PSC probably should have only the responsibility to monitor compliance with reporting requirements.