

BRIEF ANALYSIS

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Power For Sale

For most of the 20th century, electric power has been produced and sold by local monopoly utilities. Consumers were prohibited from buying power from rival producers and other sellers were prohibited from entering utilities' protected markets. Deregulation of other industries, such as long-distance telephone service and natural gas, has reduced prices and increased the variety and quality of services available. This has led to increasing pressure to deregulate the electric power industry.

A major obstacle to deregulation is the existence of uneconomical power plants (called "stranded costs"). Utilities argue that they made investments in such facilities, including a lot of nuclear and coal-fired power plants, because they were encouraged, and in some cases were required, to do so by government policies. However, under free market competition the utilities could not charge rates high enough to cover the cost of these plants. Therefore, a completely free market would force them to incur unfair losses.

How valid is this argument? It turns out that some of these assets are worth more in a free market than utilities previously thought they were worth. Moreover, utilities frequently have other assets that are rising in value because of new market forces. These windfall gains for the utilities may more than offset any "unfair" losses due to stranded costs.

The Deregulation Debate: The Problem of Stranded Costs. Stranded costs are investments in power plants that are thought to be uneconomical in a competitive market. The U.S. Department of Energy's Energy Information Administration estimates stranded costs could range from \$70 billion to \$170 billion. The states that have adopted utility deregulation plans are allowing utilities to recoup their stranded costs — usu-

ally through a special charge on all electric customers' bills. There is concern that it could take several years for stranded costs to be recovered, and until such charges are dropped, consumers will not receive the full benefits of free market competition.

The Growing Market for Generating Plants. Privately owned electric utilities are mostly vertically integrated companies — which means the utility owns the electric power plants, transmission lines and wires leading down to the individual consumer. But many of these utilities have been selling off generating plants in preparation for competition. They are transforming themselves into separate generation and wires companies. Generation companies are producing electricity for sale to consumers anywhere. Wires companies are transmitting and distributing electricity produced by others to homes and businesses.

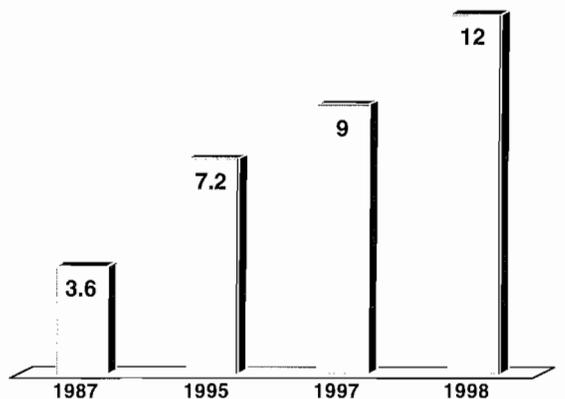
The states are encouraging this divestiture in the belief that without unbundling (separating generation from transmission and distribution), a vertically integrated company may give its own generation units access to its transmission and distribution grid on more favorable terms than the terms it gives competitors. Divestiture assures that rival power plants

can get nondiscriminatory access to transmission and distribution.

The number of such sales and the total amount of divested assets have grown over the past two years. According to Stone & Webster's Utility Asset Database:

- About 76,500 megawatts (MW) of utility capacity were sold from August 1997 to November 1999 (these figures exclude capacity sold by nonutility generators).
- In 57 separate transactions, 31 utilities sold some or all of their generation assets to 30 separate buyers for more than \$25 billion.

FIGURE I
Nonutility Generators'
Share of the Electricity Market
(percent of capacity)



Source: Energy Information Administration.

- Another 30,000 MW of utility capacity are on the blocks.

The most active buyers of generating plants are competitors of the monopoly utilities: independent power producers, called nonutility generators, and subsidiaries formed by utilities to sell power outside their local markets. Primarily due to these sales, nonutility generators' share of electricity production capacity rose from 9 percent in 1997 to 12 percent in 1998. [See Figure I.]

As utilities have sold generating plants, they have found that the market places a much greater value on their assets than did the utilities themselves. Generating assets have been auctioned off for two to three or more times their value as shown on the company's account books. [See Figure II.] The profit from these sales can be used to offset stranded costs, instead of having consumers shoulder the burden. In fact, primarily due to the above-book-value price it received for its power plants, San Diego Gas & Electric paid off its stranded costs last July and reduced basic electric rates 2 and 1/2 years ahead of schedule.

Separating Generation and Wires Companies. Competition with nonutility generators and other utilities is also forcing electric power companies to specialize. Small to medium-sized utilities with little or no experience in competitive markets are focusing on operating as wires companies. Montana Power, for instance, was among the first to recognize this economic reality. Although its costs were low and it faced no pressure from regulators to divest, the company determined that it was too small to succeed in the generation business and sold off its generation capacity to become a wires company.

The companies buying generating plants apparently place a higher value on those assets than sellers because

the assets better "fit" the buyers' focus on generation. For example, in August 1997, New England Electric System (NEES) became the first utility to sell off its non-nuclear generation.

- The market valued New England Electric as an integrated utility at around \$3 billion.
- The utility valued its generation assets at \$1.1 billion, but the assets sold for \$1.6 billion — about 1.5 times their book value.
- In December 1998, the rest of New England Electric was auctioned off to British National Grid Company (NGC) for \$3.2 billion — a 25 percent premium over the stock market's estimate of its value.

The remaining wires companies can grow by providing other wire and regulated services — for example, Boston Edison is venturing into cable TV and Montana Power is investing more in telecommunications.

Conclusion. The higher-than-expected proceeds from auctions of generating assets have enabled utilities to mitigate stranded costs, pay down debt, buy back shares and channel investment into new

businesses that enhance shareholder value. Studies have shown that consumers could save from \$20 billion to \$50 billion annually from competition in the electric power industry. That cost saving will come sooner as stranded costs are retired earlier than projected, allowing electricity prices to fall in deregulated, competitive markets.

Some of the information in this Brief Analysis is based on an article by David Haarmeyer and Dan Donoghue (Stone & Webster Management Consultants, Inc.), "U.S. Utility Asset Divestiture — A Look at an Industry in Transformation," Project Finance International, Americas Report, May 1999.

FIGURE II
Ratio of Generating Asset
Sales Prices to Book Value
(1997-99)

