

Would Anyone Invent Public Power Today? Can Anyone Reinvent It?

Public power will soon have no choice but to compete in markets where losers are bankrupted. It could once justify itself on grounds that one franchise competitor was better than none, but soon the market will be open to any seller that investors are willing to fund. What role then remains for it?

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Competition between governmental and corporate electricity has long been the stuff of legend and litigation. The forms it took in the past reflected electricity's peculiar circumstances, which will change as power comes to be traded in more ordinary markets.

The old competition was primarily for ownership of franchised assets and acquisition of the customers who were inseparable from those assets. Now customers are up for grabs, to be won by whoever provides them with the best deals. Generation

and marketing will become risky but potentially profitable for organizations that understand competition, while owners of transmission and distribution will have little more than the opportunity to earn regulated returns on open-access systems.

In most states, regulation directly affected few aspects of municipal utility operation, but its effects on corporate systems allowed public power to survive, and occasionally thrive.¹ Regulation left the organizational forms and cultures of corporate utilities looking less like those of unregu-

lated competitors and more like those of government bureaus. Public power systems could coexist with entities that were constrained to look and act like them.

Deregulation is already orienting the private sector toward aggressive competition for customers.² The nature of corporate organization will drive the change in private supply, but the nature of government will make any such change harder for public power, if it is even possible. If public power cannot adapt, both its underlying rationale and its survival are in question. If public power did not already exist, would there be any reason to invent it today?

In the next section, I provide a thumbnail history of the competitive relationships of public and private power. For the past 50 years the two systems have coexisted in a stasis that has survived upheavals in economics, technology, and the industry's legal environment. The stasis itself is evidence of the constraints that regulation placed on competition, which are discussed in the following section. I then examine the comparative economics of corporate and governmental institutions in order to determine the prospects for private and public power in markets dominated by competition for customers. I close with a critical look at strategies that public power systems are adopting to cope with the new competition.

I. The Old Competition

Technology and politics have driven electrical competition from the outset. The technologies of

generation, transmission and system operation originally constrained both corporate and public systems to small, self-sufficient territories. Within a territory, either type of supplier was able to operate a small natural monopoly competently. Whether regulation arrived by a "compact" or by politics-as-usual, it could (and sometimes did) limit returns on corpo-

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rate utility assets. Those utilities responded by expanding their systems and using capital-intensive production methods to increase their rate bases and earnings.³ Scale economies in generation and improved transmission technologies further motivated utilities to expand, serving some (but not all) of the previously unserved.⁴

The four municipal systems of 1882 had, by 1920, grown to 2,749.⁵ Limited by political boundaries, however, few could achieve the scale and network economies available to corporate systems. Franchise competition

was clearly active, since 30 percent of the municipal systems in existence in 1923 had formerly been served by corporate utilities.⁶ Through the 1920s, municipals declined as cheaper power became available at regulated rates. They increased in the 1930s as the depression brought corporate insolvency, the Federal Power Act, the Public Utility Holding Company Act, and a twenty-fold increase in federal hydropower production, preferentially allocated by law to municipal (and cooperative) systems.⁷ Franchise competition mirrored New Deal controversies over the appropriate roles of private and collective activity.

This vigorous competition ended with World War II for reasons that are unclear. Active franchise changeovers came to a virtual halt 50 years ago, with switches in both directions under 0.5 percent of existing municipal systems in every postwar year.⁸ This stasis occurred in the face of a second massive increase in federal preference power, from 4,488 MW in 1946 to 35,895 MW in 1981.⁹ Corporate utilities were understandably reluctant to wheel preference power to public systems, particularly new ones, but much of this power did find its way to municipals. Wheeling—the consensual transmission of power for other parties—only became an antitrust issue with the Supreme Court's 1973 Otter Tail decision, which held that refusal to wheel preference power violated the Sherman Act by harming franchise competition.¹⁰ Al-

though the Court allowed injunctive relief, in the form of orders to wheel, only a handful were ever issued.

Yet, perhaps sensing the sea change about to occur, transmission-owning utilities slowly opened their lines in the 1980s, and further liberalization occurred under the Energy Policy Act of 1992, which empowered the Federal Energy Regulatory Commission (FERC) to issue wheeling orders, and FERC Order 888 in 1995, requiring open access wholesale tariffs and electronic information on availability. Almost all of the prewar levers of franchise competition continued to exist postwar, and growing markets increased the potential benefits of public systems. Nevertheless, franchise changeovers virtually ceased.

II. Regulation and the Old System

In theory, regulated utilities should have functioned like unregulated firms in competitive markets. In practice, exclusive territories, regulated returns, and near-certain expense recovery lessened the penalties for inefficiency. Obligations to serve and mortgage bond indentures diminished utilities' discretion over their corporate scopes and asset holdings. Puhca and state regulation made hostile takeovers rare, and small investors who valued steady dividends seldom challenged management. Managers of utilities were more likely than those in other industries to be promoted upward rather than hired in the market.¹¹

Politically visible executives were paid less (but had more secure jobs) than executives in similar unregulated firms, and utilities seldom linked compensation to stock market performance. Utility corporate cultures were respectful of bureaucratic tradition and averse to entrepreneurship.¹² Having made a bargain with government, utilities came to look and

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act rather like government.

By changing the characteristics of corporate utilities, regulation allowed publicly-owned systems to survive. It constrained corporate options and attitudes, while fostering types of competition at which public systems could succeed. The most important competitions were to hold franchises and to influence public policy, particularly at the federal level. With little competition for individual customers, operating cost replaced market success as a yardstick. Most studies of cost differences found them quite small, but the interpretation of these find-

ings was unclear.¹³ Were government utilities as efficient as corporations, or had regulation made corporations as inefficient as government?

Public power could survive in a non-entrepreneurial form because regulation made private power equally unaggressive. The postwar stasis in franchise turnovers may reflect no more than the unaggressive cultures of both systems.¹⁴ Competition for franchises offered neither type of utility the rewards of unregulated competition. A new franchise gave its owner little more than regulated assets and additional service obligations. Restricted to its monopoly service territory, neither utility knew much about competing for customers, save for occasional promotions to attract industrial loads.¹⁵ Technical constraints on wheeling reinforced territorial barriers, as did restrictions that city charters and tax-exempt debt imposed on public systems.

III. The Corporate Organizational Form

Rivalry to gain customers and produce efficiently is but one face of competition. The efficient allocation of resources also requires a competitive market for corporate control that gives decision-making power to those who can best use to create economic value.¹⁶ An incompetently managed plant and workforce can become competitive when acquired by persons who are (or who will hire) better managers. Investors who believe they can put assets to

more valuable uses will outbid others (including existing holders) for corporate shares. Upon acquiring a controlling interest in a company, they will, for example, replace managers who are sentimentally attached to unprofitable lines of business with ones who will refocus the organization.¹⁷

Almost everywhere it is legal, the publicly-traded limited-liability corporation with elected directors dominates economic activity. In the U.S., it remains the preferred mode of business in the face of tax disadvantages. The corporation adapts easily to the distinct circumstances of nations and industries, and other organizational forms displace it only by exception.¹⁸ When a corporation's environment changes, its underlying legal and institutional structures facilitate adaptation to the change. The regulated corporate utility served its shareholders well in the face of requirements that it change its culture to a political one and live with unorthodox financial and operational structures.

The stock market gives investors more than liquidity. It provides prices that facilitate performance comparisons by investors and offers the opportunity to purchase shares in amounts sufficient to change a firm's management or orientation. The stock market allows investors to accumulate concentrated holdings of assets they wish to control and to diversify their holdings in order to achieve acceptable risk exposure. As com-

petition warms up, investors who sought the secure but low income streams of regulated utilities will sell their holdings to those with more of a taste for risk. The new investors will install and oversee managements better suited to make decisions in the changed industry.

Management often acts to fur-

Many of public power's problems stem from lack of a market for control of its assets. Unlike shares, votes cannot be purchased to intervene in utility management.

ther the interests of shareholders, but shareholders' problems in policing also allow some executive self-indulgence. Recent economic research finds that investors have greater influence on corporate policy than was found in studies on the separation of ownership and control that date back to the 1930s.¹⁹ With the coming of new personnel, utilities are increasingly shedding their autonomy and preparing for competition in ways that will be hard for public power to match. Without the need for takeovers, corporate systems are splitting their assets along regulatory lines, sometimes by

less-than-voluntary divestitures. Some are restructuring themselves financially with income from stranded asset payoffs.²⁰ Shareholders are overseeing reformulations of managerial compensation to better reward risky decisions made necessary by competition.²¹

In government there are few analogues of the mechanisms that facilitate corporate change. Many of public power's problems stem from the lack of a market for control of its assets. Citizens served by a public system have voting power, but individual votes, unlike shares, cannot be directly purchased by persons with financial incentives to intervene in utility management.²² Corporate shareholders can choose the risks they will bear by buying or selling stock at publicly visible market prices, a choice unavailable to municipal residents. A corporation can change its financial structure to better accord with market conditions, but debt-financed public systems lack ways to de-leverage themselves.

Many public power systems provide important sources of government revenue. Whether or not the system's contribution exceeds taxes that a corporate utility would pay, local officials often find it easier to increase a municipal utility's "in lieu of tax" contribution than to increase actual taxes.²³ Differences between the short time horizon to election and the long horizon of electrical investments can engender conflict between officials and utility personnel over investment

and maintenance. Necessary investments may include personnel from outside, but government may be slower to hire and stingier with competitive compensation than the private sector.²⁴ Prior to passage of a local ballot measure that modestly reformed personnel procedures in the Los Angeles Department of Water and Power, its outgoing General Manager described his plight:

I am a chief executive of what amounts to a \$2.5-billion company and I can only appoint 7 people in an 8,900 employee company [sic], and of these seven, five of them must have 15 years' experience in the DWP.²⁵

Political decisions differ fundamentally from corporate decisions. The polity must take the time and resources to consider the interests of individuals who have little choice about membership in it.²⁶ The corporation is a voluntary association of shareholders who can choose their risk exposures and express dissatisfaction by selling their stock in a matter of minutes.²⁷ Until recently, the difference did not matter because almost all utilities had low risk, few upside possibilities, and few competitive opportunities. In the new markets corporate power suppliers will come to resemble corporate suppliers of almost all other goods. Unless public power systems are somehow reconstituted they will go on resembling other government agencies.

IV. Some Options

Public power's first choice is to go on as usual, making whatever

quick fixes are absolutely necessary. The analogy regularly occurs in Washington as each new Congress discovers that its predecessor's fixes of Social Security and Medicare need redoing. No legislator wants to cope today with the fact that in three decades there will be only two working persons for every retiree, and few voters care as long as checks can be issued. Public power systems simi-



larly need to face reality while politics compels them to concentrate on short-term exactions from captive customers.²⁸ Utilities have typically been easy agencies in which to postpone reality. Electrical capital can be inadequately maintained to create near-term revenue at a long-term cost.²⁹ As retail competition arrives, a public system can offer special rates to placate vocal customers who want retail wheeling, making up revenue shortfalls by overcharging captives who will later depart en masse. Regulators of corporate systems have the further option of imposing shareholder liability for

insufficient revenue from antipass rates.

Public power's second choice is the alliance, a strategy corporate utilities have also embraced in hopes of developing competitive prowess more quickly than by internal action. Alliances may, however, be harder for public systems than private ones. Restrictions that laws, charters, and debt covenants put on the use of public assets can limit an alliance in ways that corporations can circumvent by contract.³⁰ Alliances that contract utility operations to others may impair local control over politically important assets, while giving outsiders some power over municipal revenue.³¹ Public systems with numerous decision-makers and rules of parliamentary procedure may find it harder to reach decisions than corporations, and the decisions they reach may be less clearly directed toward market competition.³² Politics may also pressure cities to form alliances with the wrong partners, or cause elected officials to second-guess departmental choices.³³ Operation of the alliance may be constrained by government procedure in ways that harm its abilities to compete.³⁴

Public power's third option is to reorganize functionally to separate competitive and natural monopoly activities along lines being taken by corporate systems. Beyond its effects on management and finance, reorganization of public systems may be more difficult to oversee than reorganization of private ones. Agencies that

regulate functionally split corporate utilities are fast gaining experience in detecting the use of regulated assets to subsidize unregulated activity. Municipal governments typically have less experience in this area and fewer regulatory resources at their disposal. Even with experience and resources, public regulatory boards may not want to prohibit activities that will increase government revenues if successful. Rules will be hard to make. Can the "safe" department use the "risky" department's profits for its own investments? If so, should it also be responsible for some of the risky department's losses?

What amounts will the two departments contribute to government, and how will government protect itself against the unstable revenues that competition will probably bring?³⁵ Assuming they properly separate the utility's functions, regulators of corporate utilities can leave oversight of the unregulated function to shareholders. Public systems, however, have no well-defined shareholders to take on this responsibility. Perhaps most importantly, if competitive provision of a certain service is available, why should government be in the business at all?

V. Conclusions: Who Governs What Well?

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 fair-

ness, 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. Successful competitors attract customers by being innovative, breaking with routine, and by individualizing rather than standardizing, as the law might require of public agencies. For-profit



transactors are consenting adults whose strategies and contract terms can be as private or as public as they wish. A collectively-held seller that must make public its strategies and terms can only advantage its competitors.

Public power will soon have no choice but to compete in markets where losers are bankrupted. It could once justify itself on grounds that one franchise competitor was better than none, but soon the market will be open to any seller that investors are willing to fund. With so many suppliers, there is no obvious value in adding local government to their

ranks, since competitive price is superior to booked cost as a yardstick. If public power is neither a necessary competitor nor a social guidepost, what functions remain for 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? When applied to corporate profit and loss, such questions have straightforward and legally clear answers.

Shareholders who have chosen their positions entrust decisions to management, profiting or losing only to the extent of their individual investments. If individual choice of suppliers is possible, public power's advocates can no longer justify it on grounds that the community must settle on a single seller. The U.S. can only have one army, and everyone must live with a single collective decision on the size of that natural monopoly. But now a city can have numerous power suppliers, all of whom use the same wires. If east-side residents all want private choice and west-side residents all want a collective system, members of both groups can fulfill their individual desires. There is no economic reason for

the west side to dictate supplier choice to the east just because more people live there. A public power system without retail wheeling can exercise wires-based monopoly power over residents in the same way that transmission-owning utilities once exercised it over transmission-dependent ones.

Regulation made corporate utilities exceptional by insulating them from competition for customers and guaranteeing them recovery of all but flagrantly imprudent expenses. It gave them financial structures, political savvy, and managerial cultures that were alien to competitive markets. The owners of a corporation that adapts poorly to market change will take visible capital losses; risk-taking investors who believe they can better utilize its assets will gain control over them. If public power adapts poorly to its new markets, what will happen to its assets and who will bear the losses? ■



Endnotes:

1. Corporate utilities usually refer to themselves as "investor-owned" and collective systems call themselves "publicly-owned." The terminology of the text is in keeping with my emphases on the resiliency of corporate organizations and the distinction between corporate shareholders and voters served by governmental systems. For want of a less emotive term, I refer to the latter as "public power."
2. See Robert J. Michaels, *Markets of the Future, Utilities of the Past*, ELEC. J., Oct. 1996, at 58, on the difficulties corporate utilities will face in adapting to retail competition. However large the transitional difficulties of corporate utilities may be, those of public power will probably be greater.
3. Harvey Averch and Leland L. Johnson, *Behavior of the Firm under Regulatory Constraint*, AM. ECON. REV., Dec. 1962, at 1053.
4. RICHARD F. HIRSH, *TECHNOLOGY AND TRANSFORMATION IN THE AMERICAN ELECTRIC UTILITY INDUSTRY 89-99* (Cambridge Univ. Press, 1989).
5. DAVID SCHAP, *MUNICIPAL OWNERSHIP IN THE ELECTRIC UTILITY INDUSTRY 9* (Praeger, 1986). Because municipal systems dominate the class of publicly-owned entities, the text sometimes refers to the entire class as municipals.
6. *Id.* at 28.
7. *Id.* at 86.
8. Constructed from Schap, *supra* note 5, at 9-10, and Clinton A. Vince and J. Cathy Fogel, *Franchise Competition in the Electric Utility Industry*, ELEC. J., May 1995, at 24.
9. Schap, *supra* note 5, at 94.
10. *Otter Tail Power Co. v. U.S.*, 410 U.S. 366 (1973). Andrew N. Kleit and Robert J. Michaels, *Antitrust, Rent-Seeking, and Regulation: The Past and Future of Otter Tail*, ANTITRUST BULL., Fall 1994, at 689.
11. Thomas F. Berg, *Quality Personnel: To Have and to Hold*, PUB. UTIL. FORT., Sept. 1, 1991, at 18.
12. *Changing Utility Entitlement Culture is Toughest Task, PECO CEO Tells EEI*, ELEC. UTIL. WEEK, May 23, 1994, at 5.
13. JOHN W. KWOKA, JR., *POWER STRUCTURE: OWNERSHIP, INTEGRATION, AND COMPETITION IN THE U.S. ELECTRICITY INDUSTRY 16-20* (Kluwer, 1996).
14. Why the stasis began in the 1940s can only be conjectured. Possibly the last of the Insull-style corporate managers vanished with Puhca, to be replaced by a less aggressive generation. On the other side, postwar prosperity may have muted the ideological controversies that encouraged aggressiveness by managers of public systems during the depression.
15. State laws and regulations vary in their provisions on service territories, but none gives either type of utility carte blanche to serve at will beyond its franchised area.
16. Gregg A. Jarrell, James A. Brickley, and Jeffrey N. Netter, *The Market for Corporation Control: The Empirical Evidence Since 1980*, J. ECON. PERSPECTIVES, Winter 1988, at 49; Michael Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept. 1989, at 69.
17. The takeover wave of the 1980s created substantial market value by reorganizing and refocusing taken-over firms. See Sanjai Bhagat, Andrei Shleifer, and Robert Vishny, *Hostile Takeovers in the 1980s: The Return to*

Corporate Specialization, BROOKINGS PAPERS ON ECONOMIC ACTIVITY MICROECONOMICS, 1-81 (1990).

18. E.g., professional partnerships usually have small capital requirements, and non-specialist outsiders probably cannot oversee the decisions of professionals as well as they can do for themselves.

19. For a summary of the issues, see *Corporations and Private Property*, J. LAW AND ECON., June 1983, at 26. Investors in nonperforming utilities are already displaying some activism. See *NU Shareholders Call for Resignation of Chairman Fox over Millstone Issue*, ELEC. UTIL. WEEK, May 27, 1996, at 5.

20. Some are also using the funds to acquire assets or enter lines of business that appear questionable. See Robert Michaels, *After Stranding Recovery, What?* PUB. UTIL. FORT., June 1, 1996, at 14.

21. *Annual Meeting Activity Up in 1994, Especially on Executive Compensation*, ELEC. UTIL. WEEK, July 17, 1994, at 5; *Utility Executive Compensation Seen Moving to Greater Risks and Rewards*, ELEC. UTIL. WEEK, Feb. 17, 1997, at 5.

22. Non-corporate systems are also subject to owner-manager conflicts. See *Strong Manager, Weak Board Helped Lead Colorado-Ute into Bankruptcy*, ELEC. UTIL. WEEK, Aug. 12, 1991.

23. Contributions can also take non-cash forms, such as free services to the city. See *City Reliance on Profitable Departments Threatened*, LOS ANGELES TIMES, Mar. 25, 1996.

24. *S&P Downgrades 6 California Public Systems, Citing High Debt and Costs*, ELEC. UTIL. WEEK, Oct. 28, 1996, at 4. This item includes a report that the Los Angeles City Council's failure to offer competitive pay allegedly caused the departure of the Department of Water and Power's General Manager.

25. *DWP Hopes Voters See the Light on Measures; Passage of Props. G, I, J called Crucial to Utility's Long-Term Survival*, LOS ANGELES TIMES, Nov. 2, 1996.

26. "Once financial troubles rooted in the region's economic decline became

apparent at Colorado-Ute, directors did not want to raise rates to help solve them. Their interests as customers and their interests as directors conflicted. ... " *Strong Manager, Weak Board Helped Lead Colorado-Ute into Bankruptcy*," ELEC. UTIL. WEEK, Aug. 12, 1991.

27. ROBERT HESSEN, IN DEFENSE OF THE CORPORATION (Hoover Inst. Press, 1979).

28. "South Carolina cities that owned electric utilities spent 33 percent more per capita on services, excluding utility operations, than cities that had no



such enterprises. ... North Carolina cities larger than 50,000 people and that own electric utilities had a 1990 average tax rate of 43 cents, compared with a 65-cent rate in cities without electric utilities." *Bond Rater: Public Power Agencies Need Clear Fund-transfer Policies*, ELEC. UTIL. WEEK, July 29, 1991, at 7.

29. A franchise turnover can provide a final windfall if the local corporate utility must acquire an abandoned public system at a legally-set price that does not reflect its physical degradation.

30. E.g., *Minnesota's United Power Ends Talks with Muni Group on Joining Operations*, ELEC. UTIL. WEEK, May 20, 1996, at 7. The choices available to corporate systems can also be restricted by bond

indentures, securitizations, and service obligations.

31. *Sale of Burbank, Calif. Muni Rumored as City Eyes Contracting for Services*, ELEC. UTIL. WEEK, Oct. 12, 1992, at 4; *Austin City Council Votes to Solicit Proposals to Buy or Manage Utility*, ELEC. UTIL. WEEK, Oct. 9, 1995, at 7.

32. Some heterogeneous alliances have withstood the test of time. The fifteen-member Northern California Power Agency was founded in 1968 by irrigation districts and municipal systems whose populations range from under 2,000 to over 100,000. The agency recently announced a marketing and risk management alliance with Enron Corporation. *NCPA, Enron in Energy Service Alliance; Enron to Kick Off Campaign*, ELEC. UTIL. WEEK, Jan. 20, 1997, at 4.

33. Supported by some elected officials, Southern California Edison recently approached the Los Angeles City Council in hopes of reversing a decision by the city's Department of Water and Power Commissioners to form an alliance with marketer Duke/Louis Dreyfus. The Commissioners set qualifications on bidding that eliminated SCE from consideration, allegedly to constrain monopoly power. If the City Council refuses the Dreyfus alliance, reopening the quest for a partner will require another year of search. *Edison International Joins with NGC in Hopes of Winning LADWP Business*, ELEC. UTIL. WEEK, Mar. 3, 1997, at 18. As of this writing, the issue is unresolved.

34. Richard Nemecek, *Government as Fast as Yesterday: The Five-Part Approval Process Could Sink DWP's Private Sector Alliance*, LOS ANGELES TIMES (Op-Ed Sec.), Feb. 21, 1997.

35. Corporate shareholders voluntarily accept this instability in expectation of wealth, and they can cut risk by diversifying. Without shareholders, municipal decisions will be biased toward avoiding bond-related risk, which may disadvantage them competitively by excluding from consideration high-risk strategies that have high returns if successful.