

PUBLIC UTILITIES

The Electric Discount and Energy Competition Act – A Landmark in the Evolution Toward Retail Choice

By [John A. Hoffman](#), [Anne S. Babineau](#), and [Matthew M. Weissman](#)

It has been hailed in the popular press as a "historic bill" that has "launched a revolution in the way New Jersey consumers buy their energy." Perhaps more realistically, one journalist described it as "one of the most important pieces of consumer legislation to come out of the Legislature in years." The product of several years of intensive effort by and debate among legislators, regulators, utilities, ratepayer and environmental interests, and non-utility energy suppliers and marketers, the Electric Discount and Energy Competition Act (the Restructuring Act, or the Act) was passed by both the State Assembly and the Senate on January 28, 1999, and was signed into law by Governor Whitman on February 9. While its passage is certainly a watershed event, when viewed in context, the Restructuring Act is actually a single step in the evolution of the state's retail electricity market, with much work still to be done by the numerous stakeholders that have played a part in the restructuring process to date.

The act requires that by August 1, 1999: (1) electric utilities in the state must reduce current rates by 5%, with an additional discount or discounts required so that at the end of three years, rates will be reduced by 10% relative to rates in effect as of April 30, 1997, and (2) all consumers of electricity be allowed to choose their electricity generation supplier. The four incumbent utilities in the State will continue to *deliver* the electricity generated, from whatever source, through their existing distribution systems.

Changes in the generation business and in federal regulation of the wholesale market have formed the backdrop from which the Restructuring Act has evolved. These changes, as well as the chronology of administrative and legislative activity in New Jersey leading to the drafting and passage of the act, are described below to provide a background for understanding the act. Some of the "nuts and bolts" of the act are then described.

Implementation of the countless changes imposed on the industry under the provisions of the 110-page Restructuring Act are ultimately subject to review and approval by the New Jersey Board of Public Utilities (the Board). The Board will retain significant responsibility to oversee the move toward retail choice, and eventually, the possible opening up of other utility services to competition. The Board will also continue to regulate the local transmission and distribution of electricity, which will continue to be provided by regulated utilities.

In addition, the Legislature has delegated to the Board responsibility for: (1) resolving certain difficult competitive questions concerning the conditions of market entry for new suppliers of generation, and (2) ensuring that in this move to "deregulate" a portion of the vertically-integrated electricity industry while requiring that utilities make their delivery systems available to competitors at regulated rates, utilities continue to receive an opportunity, but not a guarantee, to earn a fair return on their investments. These two aspects of the Restructuring Act are discussed in the second half of this article.

Fundamental Underpinnings – Changes in The Wholesale Market

The Restructuring Act implements an electricity policy vision that departs from over 80 years of traditional electric industry operation under which four vertically-integrated utilities have provided power at regulated rates to all consumers within their designated service territories. The restructuring now underway in New Jersey is consistent with several widely recognized changes in the technology of electricity production and distribution, and in the federal government's regulation of the interstate wholesale or "bulk power" market that have caused competition to start to develop in the production end of the business. For example, improved technologies have reduced the cost of generating electricity as well as the size of and fuel type used by typical new generation facilities (i.e., new capacity needs are generally being met by relatively small natural gas-fired units, rather than large nuclear or coal-fired units). This

development, along with Congress' passage in 1978 of the Public Utility Regulatory Policies Act (PURPA) and the Powerplant and Industrial Fuel Use Act (PIFUA), enabled independent, non-utility power producers to enter the wholesale market.

A provision of the PIMA (which was repeated in 1987) made it impermissible for utilities to use natural gas to fuel new capacity, allowing independent power producers to gain a toehold in the market by taking advantage of emerging natural gas-fired generation technology. Under PURPA, utilities were required to buy all power produced by non-utility "qualifying facilities" (QFs) at the utility's "avoided cost," or the estimated amount it would cost the utility to produce that power, further stimulating the growth of independent power production.

It should be noted that many utility purchases from QFs in the 1980s were made under long-term contracts running 20 to 30 years, with prices based on avoided cost projections made at the time the parties entered into the contract. These arrangements, which were promoted by state and federal authorities, resulted in high-priced contracts have left utilities, customers, and regulators in New Jersey and elsewhere with unavoidably high costs of generation, inhibiting their ability to take advantage of the potential benefits of lower-cost energy.

In 1992, Congress enacted the Energy Policy Act (EPACT), which further promoted the introduction of competition in the wholesale generation market by, among other things, giving the Federal Energy Regulatory Commission (FERC) authority to order that transmission owning utilities provide third-party suppliers access to their lines. Implementing this authority in 1996, FERC issued a set of rules requiring utilities to provide transmission access to all wholesale electricity producers under terms and conditions comparable to those available to the utilities' own wholesale supplies.

State Action – The Energy Master Plan and The 1998 Proceedings

While these changes, among others, have taken place at the federally regulated wholesale level, the states, which are each responsible for regulating the generally *intrastate* retail market, have also been busy. A database, updated monthly by the federal Energy Information Administration (EIA), indicates that New Jersey is the 14th state to enact electricity restructuring legislation, joining trendsetter California and northeastern states such as Massachusetts and Pennsylvania. In fact, EIA reports that most states are actively addressing electricity restructuring in some fashion, either through enacted or pending legislation, regulatory commission orders, and/or legislative or regulatory investigations.

In New Jersey, the process that has led to the passage of the Restructuring Act can actually be traced to the formation in 1988 of the New Jersey Energy Master Plan Committee. In its "Phase I Report" released in March 1995, the Committee "presented a vision for the state that was based on energy markets guided by market based principles and competition," and "provided a policy framework for the transition from power industry monopolies to competitive markets." The Phase I Report also made several policy recommendations to be implemented in the short term, including the passage of certain legislation that ultimately became known as the Rate Flex and Alternative Regulation Act (the Rate Flex Act). Finally, the Committee recommended that the Board investigate possible changes to the structure of the electric power industry in New Jersey as a more long term means of lowering the cost of electricity in the state.

On July 20, 1995, the Rate Flex Act was signed into law. In this bill, the Legislature declared as official state policy the objectives of lowering electricity and natural gas rates and improving the "quality and choices of service for all New Jersey consumers . . . to thereby ensure that New Jersey remains economically competitive on a regional, national and international basis"

In light of the sweeping changes imposed by the Restructuring Act, the Rate Flex Act of 1995, may now be seen as an intermediate step, authorizing the Board to permit utilities to enter into "off-tariff rate agreements" and to approve utility proposals that they be regulated in certain limited circumstances under "alternative forms of regulation" other

than traditional rate base, rate of return regulation as embodied in Title 48. Moreover, the Rate Flex Act directed that "whenever practicable, . . . the Board should implement programs that promote a transition to a market-based competitive environment for the production and delivery of natural gas and electricity and required that the Board periodically report on the status of its "investigations of programs to implement a restructuring of the electric power industry."

Also in mid-1995, consistent with the Legislature's findings and conclusions set forth in the Rate Flex Act, the Board initiated a formal "Phase II" proceeding to investigate the long term structure of the state's electric power industry. That proceeding ultimately involved extensive public participation, and concluded with issuance of the Board's findings and recommendations in a "Final Report" dated April 30, 1997. As part of those findings and recommendations, the Board directed the state's electric utilities to submit detailed filings concerning their proposals for restructuring. Those plans, submitted in July 1997, became the subject of wide-ranging, contested adversarial proceedings before the Office of Administrative Law (OAL) and the Board itself throughout much of 1998.

In the OAL proceeding concerning the proposal of Public Service Electric & Gas Company (PSE&G), for example, 31 parties were granted intervenor status, including local and out-of-state utilities; nationally significant traders and marketers of bulk power such as Duke Energy Trading and Marketing and Enron Capital and Trade Resources, Inc.; representatives of non-utility energy producers and marketers such as the Independent Energy Producers of New Jersey and the Mid-Atlantic Power Supply Association; labor representatives; several consumer groups representing the interests of various classes of ratepayers, as well as several individual ratepayers; and environmental and public interest groups such as the Natural Resources Defense Council and the New Jersey Public Interest Intervenors.

Many of these parties, as well as the state's Division of the Ratepayer Advocate and the Board's professional staff, offered witnesses and submitted testimony, cross-examined witnesses, and filed lengthy briefs with the OAL and the Board in 1998. The records developed in these proceedings will provide much of the material the Board will rely on as it performs its duties under the Restructuring Act in the months to come.

* * * *

The challenge facing the Board is to implement the requirements of the Restructuring Act -- which may appear to be extraordinarily detailed but which upon closer inspection are in many case actually quite broad -- guided by its experience and expertise, and by the detailed and voluminous records developed in the 1998 proceedings. In this article it is not possible to catalogue the full scope of the changes wrought by the Restructuring Act or of the Board's responsibilities under the legislation. Instead, some of the most significant issues at stake in the upcoming industry restructuring related to reliability of service and economic valuation are discussed below.

The Board's challenge includes: (1) assuring that basic generation service (BGS) is available to customers who for whatever reason do not choose an alternative energy supplier, and establishing a "shopping credit" to be applied to the bills of customers who do take electric generation services from alternative suppliers; and (2) affording utilities the opportunity to continue to earn a fair return on their investments as they are required to make their transmission and distribution systems available to competitors at regulated rates.

Unbundling BGS From Other Electric Utility Services and Opening Generation Service To Competition

The "Unbundling" Requirement

For many decades, vertically integrated utilities have provided consumers with what is generally referred to as "bundled" electricity service, at one price. This bundled service actually encompasses a number of discrete services, including generation, transmission (i.e., transporting bulk power from the generation site to the distribution system), distribution (i.e., delivering power from the transmission system to the end user), and customer services such as

metering, billing, and other administrative activities associated with maintaining a customer account. Offering consumers their choice of generation supplier requires a change in how electricity services are identified and billed, so that competitive elements of the service (i.e., generation) are separately identified, or "unbundled," and customers may thereby be able to compare alternative offers. The Restructuring Act therefore requires each electric utility in the state to unbundle its rate schedules to separately identify the "discrete services and charges" it provides, including "at a minimum" customer account services and charges, distribution and transmission services and charges, and generation services and charges.

Basic Generation Service – The Option to Choose Not to Choose

In its Phase II proceeding, the Board recognized a general consensus that as the State moves toward a competitive generation market, "a supplier(s) of last resort is necessary to ensure that all retail consumers have access to power." It is expected that some consumers, particularly residential users, will not eagerly become "the first kid on the block" to forsake the utility and try out a new energy supplier, and will simply "choose-not-to-choose." Moreover, while the Restructuring Act contains detailed provisions designed to enable smaller and even individual residential consumers to tap into the expected benefits of competition through combining, or "aggregating", their demands, it is generally expected that many non-utility or "third party" suppliers will, at least in the initial stages of retail access, focus their marketing efforts on the largest commercial and industrial consumers. Service also must be guaranteed for any customer who, after choosing an alternative electricity supplier, is subsequently dropped by that supplier for any reason.

The Legislature determined in the Restructuring Act, that "in order to provide for as orderly a transition as possible," the local utility, as provider of last resort, should be assigned the responsibility of providing BGS, which is to be provided by the utility as non-competitive service fully regulated by the Board. Under the act, each utility is to provide BGS for at least three years following the August 1, 1999, commencement of retail access, and "thereafter until the Board specifically finds it to be no longer necessary and in the public interest." Within three years after the commencement of retail access, the Board must formally decide whether to make the opportunity to provide BGS available on a competitive basis to any electric power supplier and/or any public utility.

The Intersection of Unbundling and BGS: Setting The Shopping Credit

As part of its unbundled rate structure, each utility is required under the act to establish a separate charge for billing purposes specifically for BGS, subject to the review and approval of the Board. BGS rates are to be based on the "reasonable and prudent cost" to the utility of providing such service, including the cost of power purchased by the utility at market prices in the "competitive wholesale marketplace," as well as "related ancillary and administrative costs," as determined by the Board.

While a full discussion of the development of a competitive wholesale electricity marketplace is beyond the scope of this article, it should be noted that in New Jersey as well as in certain parts of Pennsylvania and Maryland, the development of that marketplace, with "transparent" prices visible in real time to all players in the market, is well underway due to the intensive efforts over the past several years by the members of the Pennsylvania – New Jersey – Maryland (PJM) power pool, a voluntary association of eight member electric utility companies in the Mid-Atlantic region, originally formed decades ago.

In addition to providing a BGS rate for customers that continue to purchase generation service from the utility, each utility is required to provide "shopping credits" to be applied to the bills of its retail customers who choose to purchase generation service from duly licensed third-party suppliers. The Board is to determine the appropriate level of shopping credits for each electric public utility, in a manner "consistent with the findings and declarations of the Legislature" as set forth elsewhere in the act.

There are certain issues that the Board must consider and resolve in setting the BGS rate and the shopping credit. For example, the wholesale price of power may be based on the "spot" price at which such power is available in real time through the PJM wholesale market. Alternatively, the Board may rely on the price of power as revealed in the terms of contracts, through which parties may lock in fixed prices for bulk power at market-determined premiums.

Similarly, there are questions involved in determining the magnitude of the "related ancillary and administrative costs" of providing power. For example, the Board must determine whose ancillary and administrative costs are relevant (i.e., the utility's or the third party suppliers'), and the magnitude of those costs, in setting the BGS rate and the shopping credit. The Legislature has left it for the Board to resolve these issues in a manner that will be consistent with the development of competition while fair to all parties, including consumers.

Recovery of Stranded Costs Through Transition Bonds, and The Market Transition Charge

One of the most contentious issues faced by state legislatures and regulatory agencies grappling with industry restructuring relates to utility "stranded costs" occasioned by the shift from conventional utility regulation to the type of consumer choice model being put in place in New Jersey. Under the proposed restructuring it is expected that utilities will receive market prices for power in the future that will be substantially below the average cost of producing that power from certain older facilities, as well as below the cost to utilities of purchasing power under long-term contracts entered into pursuant to the requirements of PURPA. Simply stated, stranded costs are the amount by which the embedded cost of utility generation service exceeds the market price for that service.

It is well-established that a public utility is entitled to receive an opportunity, but not a guarantee, to earn a fair return on investment. In exchange for accepting and satisfying an obligation to provide safe, adequate and proper service in a designated territory, utilities have been promised a fair opportunity to recover the reasonable costs of the financial commitments incurred to satisfy their public service obligation. It has been argued that changing the "rules of the game" at this stage, indeed changing the rules while utilities were and are still obligated by statute to make substantial investments to ensure the safety and adequacy of the electricity generation and delivery system, would amount to a breach of what is sometimes referred to as the "regulatory compact."

The Legislature expressly determined in the Restructuring Act that it is in the public interest to provide each electric public utility in the state with the opportunity to recover its stranded power generation and supply costs associated with the restructuring which cannot be mitigated, "to the extent necessary to maintain the financial integrity" of each utility and subject to the achievement of the other goals and provisions of the act. Under the act, the Board will determine, based on the record developed in the 1998 proceedings before the OAL, the amount of stranded costs eligible to be recovered by each utility.

Stranded costs will be recovered under the act in two ways. First, the act anticipates the issuance by utilities of "transition bonds" and the recovery from all utility customers of a "transition bond charge," to be approved by the Board, in an amount sufficient to fully recover the utilities' "bondable" stranded costs. Because of the statutory authority conferred on the utility to collect this charge, the transition bonds will carry interest costs that are lower than embedded utility cost of capital. Proceeds from the sale of transition bonds are to be used by the utility to reduce the amount of its otherwise recovery eligible stranded costs, up to a defined limit, through the refinancing or retirement of utility securities or the buyout, buydown, or other restructuring of utility power purchase agreements. The entire amount of the cost savings achieved as a result of the issuance of these transition bonds is to be passed on to customers in the form of reduced rates.

Second, simultaneously with the commencement of retail choice, the Board is also required to permit each utility the opportunity to recover stranded costs through a "market transition charge" (MTC), also to be determined by the Board. Collection of the MTC is to be limited to a period of eight years, except in certain specified circumstances, and is to be paid whether or not the customer takes generation service from the utility or from an alternative supplier. The Board is

expressly precluded from setting the MTC at a level that would prevent achievement of the rate reductions required under the act.

The Legislature's decision to permit stranded cost recovery is consistent with the findings and recommendations set forth in the Board's Final Report, including the Board's observation that the ramifications of denying stranded cost recovery in New Jersey could include substantial financial turmoil and possibly large job reductions at utility companies. Moreover, stranded cost recovery is consistent with FERC's treatment of such costs.

In Order No. 888, in which federal regulators directed open access to electricity transmission capacity, the FERC reaffirmed its preliminary determination to allow utilities to recover their legitimate, prudent and verifiable stranded costs simultaneously with the adoption of any rule requiring open access. The FERC was expressly guided by federal appeals court decisions rejecting prior FERC natural gas deregulation orders because those orders had failed to recognize that in light of structural changes imposed on the industry, gas pipelines were entitled to stranded cost recovery. The FERC noted, moreover, that the D.C. Circuit had already upheld in more than one instance the FERC's ultimate decision to allow the recovery of costs stranded in the transition to a more competitive natural gas industry.

The FERC concluded that "both this Commission and the states have the legal authority to address stranded costs that result when retail customers obtain retail wheeling in order to reach a different generation supplier, and that utilities are entitled, from both a legal and policy perspective, to an opportunity to recover all of their prudently incurred costs."

The Legislature's decision in the Restructuring Act embodies, as did the FERC's stranded cost ruling in Order No. 888, a reasonable approach that is consistent with relevant precedent governing regulatory treatment of public utilities and that appropriately balances the interests of utilities, ratepayers, and new market entrants.

Conclusion

With its aggressive timetable for implementing full retail choice and its significant rate reduction requirements, the Restructuring Act places New Jersey among the vanguard of states pursuing electricity restructuring. At the same time, the provisions ensuring continued reliable basiservice to customers and facilitation of the development of a competitive market demonstrate the Legislature's intent that restructuring move forward in a fashion that is fair and equitable to ratepayers, utilities, and third party suppliers alike. It is now up to the Board, along with the various parties in interest, to take the difficult final steps.

Endnotes

¹ "Energy bill will force rate cuts," The Star-Ledger, January 29, 1999, p.1, col. 5; "Pound for pound, it's a weighty measure," The Star-Ledger, January 29, 1999, p.22, col.5.

² Allowing retail customers to choose their electric generation from any source and requiring that the electricity be delivered by the local utility is sometimes referred to as "retail wheeling."

³ Pub. L. No. 95-617, 92 Stat. 3117 (1978) (codified as 16 U.S.C. §§ 2621-27 (1988)).

⁴ Pub. L. No. 95-620, 92 Stat. 3291 (codified as 42 U.S.C. §§ 8301, et seq. (1995)).

⁵ Treatment of these utility "stranded costs" under the Restructuring Act is discussed below.

⁶ Pub. L. No. 102-486, 106 Stat. 2776 (codified as amended in scattered sections of 42 U.S.C.). 16.

⁷ FERC Order No. 888, Docket Nos. RM 95-8-000 and RM 94-7-001 (April 24, 1996), Order No. 889, Docket No. RM 95-9-000 (May 10, 1996).

⁸ The EIA database, which provides a snapshot summary of each state's electric restructuring activity at the regulatory and legislative level, is available on the Internet at www.eia.doe.gov/cneaf/electricity/chg_str/tab5rev.html.

⁹ The Energy Master Plan Committee was established pursuant to N.J.S.A. 52:27F-14, and charged with the adoption of the New Jersey Energy Master Plan. The committee is composed of seven of the governor's cabinet members, including the President of the Board of Public Utilities and the Commissioners of the Departments of Environmental

Protection; Transportation; Treasury; Community Affairs; Health; and Human Services. Pursuant to Governor Whitman's Reorganization Plan No. 001-94, the director of the Division of the Ratepayer Advocate was added to the committee.

¹⁰ New Jersey Board of Public Utilities, "Restructuring the Electric Power Industry in New Jersey – Findings and Recommendations" (the Final Report), April 30, 1997.

¹¹ *Id.* at 14-15.

¹² P.L. 1995, c.180 (codified as N.J.S.A. 48:2-21.24 through 48:2-21.30 (1997)).

¹³ N.J.S.A. 48:2-21.24.

¹⁴ N.J.S.A. 48:2-21.24, 48:2-21.29.

¹⁵ Public participation in the Board's Phase II proceeding included the submission of written comments and written testimony; public and legislative-type hearings; the formation and facilitation of informal working groups and a negotiating team to explore issues in depth; the issuance of proposed findings and recommendations, concerning which written comments were solicited and public hearings conducted; and, finally, issuance of the Board's findings and conclusions in the form of the Final Report. Final Report, *supra* note 10, at pp.16-18.

¹⁶ Following issuance of the Final Report, the Board directed that issues related to the "unbundling" of utility rates and recovery of utilities' stranded investments, discussed below, be initially addressed by the OAL, and separate unbundling/stranded cost proceedings were conducted in 1998 for each of the four utilities operating in the state: PSE&G; Atlantic City Electric Company; GPU Energy; and Rockland Electric Company. Other issues – including the potential for the exercise of market power in a restructured market and the utilities' plans for provision of electricity to customers who "choose not to choose" a new power supplier – were addressed in a single proceeding before the Board in which all four utilities as well as numerous intervenors participated.

¹⁷ Final Report, p.43.

¹⁸ Restructuring Act, subsection 4.a.

¹⁹ Final Report, p.138.

²⁰ Restructuring Act, sections 40-46.

²¹ Final Report, p.138.

²² Restructuring Act section 3, subsection 9.a.

²³ Restructuring Act, subsection 9.a.

²⁴ Restructuring Act, subsection 9.c.

²⁵ *Id.* subsection 4.b.

²⁶ *Id.* subsection 9.a.

²⁷ See, e.g., Final Report, pp.32-39.

²⁸ All entities wishing to provide generation service to customers in New Jersey must be licensed, and must satisfy detailed licensing requirements to be established by the Board in accordance with section 29 of the act.

²⁹ Restructuring Act, subsection 4.b.

³⁰ As noted above, utility purchases of power from qualifying facilities under PURPA have generally been made under long-term contracts, with prices based on avoided cost estimates made at the time the parties entered into the contract. To the extent that projections of New Jersey utilities' avoided costs have proven to be overstated, those utilities face substantial stranded cost exposure due to their commitments under "non-utility generator" or "NUG" contracts.

³¹ Final Report, p.92.

³² See, e.g., *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 585, 86 L.Ed. 1037, 62 S.Ct. 736 (1942).

³³ See, e.g., N.J.S.A. 48:2-23

³⁴ Restructuring Act, section 2.c.(4).

³⁵ Restructuring Act, sections 14, 15, 18.

³⁶ Restructuring Act, section 13.a., 13.c.

³⁷ Restructuring Act, section 13.a., 13.i.

³⁸ Restructuring Act, section 13.h.

³⁹ Final Report, p.10.

⁴⁰ Order No. 888, Docket Nos. RM95-8-000 and RM94-7-001 (April 24, 1996), pp.453-54 (citing Associated Gas Distributors v. FERC, 824 F.2d 981, 1021 (D.C. Cir. 1987)) (other citations omitted).

⁴¹ Id., p.455 (citing Public Utilities Comm'n of California v. FERC, 988 F.2d 154, 166 (D.C. Cir. 1993); Western Resources, Inc. v. FERC, 72 F.3d 147 (D.C. Cir. 1995)).

⁴² Id., p.553.

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