Competition for the Monopoly — Why So Rare?

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Storms bring outages, outages bring anger, and the angry ask: Can we replace the utility? Long Islanders ask it about the publicly-owned Long Island Power Authority; D.C. area residents ask it about the investor-owned Potomac Electric Power Company. During their 1999–2001 price and supply crisis, Californians asked it about their utilities. Crises are bad times to make long-term decisions, but good times to ask big questions, like "Why do we do things this way?"

Commissions revoke franchises rarely—those of major utilities (as opposed to small water companies) nearly never. To raise the question is to lose credibility. It's "politically unrealistic." It's "never been done before," "The devil we know is better than the devil we don't." "It'll upset Wall Street." "The Governor will have our heads." So many ways to say "no."

This mental blockage, this consensus against curiosity, undermines the regulatory cause. It creates an expectation as entrenched as it is unstated: that the incumbent's tenure is lifelong. The common penalty for inadequacy is a fine and a second chance: the fine calculated to sting but not disable, the second chance wrapped in a rate increase to fund the fix, a reflex described by Peter Bradford (paraphrasing a former New England Chairman) as "And if you do that again, we'll clobber you."

If we award a secure profit stream for adequacy rather than excellence, the inevitable slippages will be departures from adequacy rather than excellence. In real markets, markets with alert, active consumers, sellers walk on the high wire. Their choice is simple and stark: Excel or lose. Is there a way for regulators of monopolies to replicate this performance pressure?

One answer is to host a periodic competition for the right to be the monopoly. The competition would have five components.

1. *Term of years:* With no specified term there is no election day: no challenger, no competition of ideas, no sense of survival dependent on excellence. That is why most utilities have stayed in office for a century. Accountability would be enhanced by a stated franchise term: some period long enough to deter distorted decisionmaking (e.g., putting off capital expenditures to keep rates low—like cutting funds for schools and road repairs, it lowers taxes now but raises costs later), and short enough to ensure responsiveness to customers' needs. The 20- to 30-year range makes sense. (To clarify: The goal is not to term-limit the incumbent but to make it compete to keep its job.)

2. *Bidding procedure and ranking criteria:* Pre-qualification standards would screen bidders for experience, skill, and financial strength. Then come the subjectivities: Is there a corporate culture plan that places public service first, that accepts the mission and role of regulation? Is there a business plan that identifies the products and services customers need and

the cost-effective means to design and deliver them? (The commission will need to provide prospective bidders all essential data about the service territory and customer base; otherwise the incumbent will have an unearned advantage.)

3. *Post-selection policies:* No investor wants a pig in a poke. Before the bidding, the commission and legislature must give guidance on expectations, rewards, and penalties. While policymakers should not pour cement around their policies—change over 20 to 30 years is inevitable—they should promise that prudent costs incurred to accommodate changes are recoverable.

4. *Path for property transfer:* This is where discussions bog down: How does the bid winner get control of the incumbent's infrastructure? The property transfer path must be predictable and litigation-free, the buyout price known at the time of the bid. This is not hard, if one follows mainstream regulatory principles. Utility infrastructure has two key features: (1) It is immobile, so its value depends on using it for the franchise purpose; and (2) the utility's customers have paid for it through their rates, so they deserve to receive its remaining economic value. Given these features, the proper price for the incumbent's property is depreciated book value. This price gets the incumbent its constitutionally guaranteed "just compensation": recovery of and return on its investment. (Anything more is, technically, an economic windfall: a payoff exceeding the investors' legitimate expectation.) Since this same departure payment will apply to both the current incumbent and new franchisee when the latter's term ends, bidders will face no uncertainty about recovering their prudent investment. And this fixed price principle prevents a bidding war for the target company. Competitors can design their bids to serve the public rather than to please incumbent shareholders—a marked difference from utility acquisition strategy today.

The preceding paragraph assumed the new franchisee would own the infrastructure. The alternative is a one-time transfer from the incumbent to the state government, which then is operated by the winning franchisee. Each approach—private and public ownership—has its pros and cons, all needing more study. Plenty of U.S. utilities are owned by governments—local, state and federal. On the one hand, government ownership reduces customer cost by using tax-exempt financing and eliminating return on equity investment (and income taxes on that profit). It avoids the classic shareholder–customer struggle, known as the "Averch-Johnson" effect, whereby all else equal, utilities prefer actions that grow the profit-earning rate base over actions that reduce total customer cost. (The non-asset-owning franchisee can still profit handsomely from its performance; the key is to design the franchisee's compensation to align shareholder and customer interests rather than making them adversaries.) On the other hand, government ownership, even with operations in private hands, creates risk that investment and maintenance decisions will be distorted by political pressures, such as pressures to lower costs for current voters at the expense of future voters, or to "create jobs" through investments that are not cost-effective.

5. *Financial uncertainty:* The prospect of losing its franchise will make the franchisee's business profile riskier (although unlike non-utilities, it knows it will recover its prudent investments). That higher risk means higher capital costs. But there are ways to reduce risk, at no cost to customers. To reduce lenders' risk, the bidding process can make clear that (a)

physical collateral for the loans (the physical assets used to provide utility service) will remain in place and in use (with prudent cost recovery assured) regardless of the franchisee's identity, (b) any loan obligations will transfer automatically to the new franchisee (whose financial ability to take on those loans would be among the selection criteria), and (c) all prudent outstanding debt will be reflected in rates.

Shareholder uncertainty is another matter—assuming the new franchisee is shareholder-owned. The company's cost of equity will reflect the risk that it might lose its franchise (but not its investment) after 20 years. That cost is legitimate; customers must pay for it. So policymakers must compare that cost to the performance gains from franchise competition.

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And that is the unknown. Would shareholders, facing the risk of losing the franchise, elect different kinds of board members, who would hire different kinds of executives and managers, to lead these companies? Would those board members and executives make the utility more dedicated to performance for the customer, so that the utility generates ideas for innovation rather than requests for "rate relief"? Would regulators, knowing it was their job to select the best, become more active in pressing for improvement? Regulators are gaining experience with using competition to supply essential franchise services formerly the incumbent's responsibility. Maryland, New Jersey, and Ohio oversee the bidding from wholesale supply of capacity and energy. Hawaii, Maine, Oregon, and Vermont have selected new franchisees to supply energy efficiency services. Maine is investigating alternative suppliers of smart grid services.

There is no intent here to spell out all possible facets of a franchise competition process. Employee rights, customer-financed expertise built up within the company, liability for unknown environmental damage committed by the predecessor—all these factors, and more, require attention. But a predictable, periodic competition for the franchise could change a service territory's psychology. Today, franchise revocation is the nuclear bomb in the regulator's arsenal of accountability, never to be mentioned, let alone used. Better to view franchise competition as a mainstream means of extracting best practices, by attracting the companies most likely to create them. The legal and political burden should not be on the regulator to justify replacing the incumbent; the burdens should be on the incumbent (and any prospective replacement) to justify its privileged role. That way, franchise competition can align the interests of all: regulators, customers, executives, and investors.