**Legal Q&A**
**By Scott Houston**, TML General Counsel

*Note: Cities have various interests relating to how they and their citizens get electric service, how cities with municipally owned electric utilities provide service, and the prices that everyone pays for electricity. Cities also receive franchise fees from utilities that use their rights-of-way, and they have original jurisdiction over the rates of investor owned utilities in their cities.*

*How electricity is provided in Texas is complex and based on many moving parts in an always changing puzzle, there's no doubt about that. The following questions and answers attempt to provide a "primer" on the issues facing cities in this area.*

**What are the different ways cities and their citizens get their electricity?**

Cities and their citizens generally get their electricity in one of three ways: (1) from a municipally owned utility (MOU); (2) from an investor owned utility (IOU); or (3) from a rural electric cooperative (Coop). Each of those providers usually has a monopoly in the areas they serve, based on a certificate from the state Public Utility Commission (PUC). (Note: A few areas of the state are served by river authorities and municipal power agencies. Also, with regard to an IOU, only the transmission and distribution component, discussed below, has a geographical monopoly in the deregulated market.)

After deregulation, MOUs and Coops retain that monopoly status, unless they choose—by a vote of their governing body—to adopt customer choice. The reasons for allowing MOUs and Coops discretion to retain their monopoly status are many, but one of the most important is that MOU and Coop rates are governed by a city council or board, the members of which are elected by the customers. The city council or board of directors is therefore accountable directly to the customers they serve.

IOUs are also governed by a board of directors, but they are accountable to their shareholders, rather than their customers. The rates of investor-owned transmission and distribution utility (discussed below) are regulated by the Texas Public Utility Commission (PUC) in a way that should—in theory—cover costs of operation and allow for a reasonable profit.

**What is electric deregulation, and why should city officials care?**

In 1999, legislation was enacted to deregulate the portion of the state that is served by IOUs. MOUs and Coops are given the option to participate in the deregulated market by "opting in" to competition. However, to date no MOU has opted in.

Prior to deregulation being fully implemented in 2002, a single IOU performed all the things necessary to provide service to customers within its designated service area. In simple terms, the legislation "broke up" or "unbundled" investor owned utility monopolies. Those utilities were divided up into different components: generation, transmission and distribution, and retail service. Some utilities sold one or two of those parts of their business, while others created subsidiary companies to run them.

Generation companies obviously make the power with power plants, wind farms, and other means. Transmission and distribution companies move the power from the generators to other parts of the state with huge transmission lines, and ultimately distribute it to the customers through smaller distribution lines.

While the generation and retail portions of the market are now deregulated, the rates of transmission and distribution utilities are still regulated by cities and the PUC. That is necessary because the companies that generate power must have a reliable way to get that power to the retail companies, which actually sell the power to customers.

The retail companies are numerous and essentially speculate as to how much generation will cost them. They then offer price plans to consumers accordingly. They are the ones with which customers in a deregulated area interact. Customers can switch retail companies to try to get the best possible rate.

Certain areas of the state—including the Panhandle, El Paso, and certain areas in the northeast and southeast portions of the state—are served by IOUs, but have not been deregulated. Those areas are not a part of the main transmission grid in Texas. Thus, deregulation is impractical.

Whether deregulation has been beneficial to cities and their citizens remains the subject of heated debate. One thing is sure: Deregulation has changed the way cities in the deregulated market purchase power for city facilities. One way cities and other political subdivisions do that is by a process called aggregation. Aggregation means just what it says: Cities join together, or "aggregate," to purchase energy at a better price than they could obtain by themselves. (Note: State law also authorizes citizens to aggregate, but the logistics of that process have made it all but useless. Previous legislative efforts to allow cities to automatically bundle-up their citizens and negotiate on the citizens' behalf have failed.) The most well-known aggregation group is called the Texas Coalition for Affordable Power, which represents more than 100 cities.

**Does anyone oversee the complex deregulated electricity market?**

Yes. The PUC is supposed to monitor the generation, transmission, distribution, and sale of electricity and protect against any company attempting to manipulate the deregulated market. Reviews of the PUC's performance in this role have varied.

In addition, the law provides that an independent entity will oversee important operational aspects of the deregulated market. That entity is known as the Electric Reliability Council of Texas (ERCOT). ERCOT is not a governmental entity; rather, it is a non-profit corporation that is supposed to maintain the flow of power across the market, oversee the operations of the wholesale electricity market, supervise transmission planning, ensure that there is always adequate power available on the grid, and take action to minimize congestion on transmission lines.

As with the PUC, reviews of ERCOT's performance have varied. Most recently, pointed questions were directed to ERCOT regarding its accountability for rolling blackouts. Increasing

prices, claims of market manipulation by certain companies, internal scandals, and administrative difficulties have somewhat marred ERCOT's reputation.

**How are electric service areas defined?**

The PUC issues certificates for most entities that provide electric service. Once an entity has received a certificate, it is an arduous process to modify it. Note that the PUC is authorized to, and has, issued "dual" certificates to allow more than one entity to serve an area.

**Why aren't MOUs opting into the deregulated market?**

Even though they are not required to do so, MOUs have the discretion to opt in to the deregulated market. Many state leaders continue to applaud the Texas deregulated market as one that has created lower prices. For a number of reasons, that is questionable. It would also appear that MOUs aren't convinced, and that their citizens prefer the consistently lower prices and better service that they provide. It's a case of "if it ain't broke, don't fix it." MOUs can wait and see if opting in to deregulation would really benefit their customers. Also, an MOU that opts in is essentially stuck with that decision. Further, opting into competition would require an MOU to undertake the complex and expensive process of breaking up its service into the three components of the deregulated market (that is, generation, transmission and distribution, and retail).

**What are recent criticisms levied against MOUs?**

Some MOUs have been criticized recently for transferring some of their profits to the city's general fund. Interestingly, even larger cities that transfer large amounts of revenue have electric rates that are comparable to, or lower than, IOUs serving the deregulated market.

In addition, cities may or may not charge their MOUs franchise fees for the use of the city's rights-of-way. Thus, the transfer is often analogous to a franchise payment that the city would receive from an IOU that uses the city's rights-of-way. In any case, it is currently up to each city's council to decide how to handle transfers. Another way to look at transfers is that they are very similar to the return on investment that IOUs give back to their shareholders. But in the case of an MOU, the "shareholders" are the taxpayers of the city. Transferred revenue is used to pay for services (police, fire, EMS, streets, and so on) that are used by the customers of the MOU. The transferred revenue is used to keep property tax rates low, which benefits the taxpayers served by the MOU.

**What are electric franchise fees?**

Electric franchise fees are fees paid by IOUs or coops (and in some cases, MOUs that provide service in other cities) that use a city's rights-of-way to provide service. Both state law and the Texas Constitution provide that a city may not allow a private entity to use city property for free.

Electric deregulation changed the way in which municipal franchise fees are charged and collected. Traditionally, cities and IOUs or coops operated under a franchise agreement that

governed the amount the utility paid for use of the city's rights-of-way, typically stated as a percentage of the utility's gross receipts for service provided within the city limits.

Prior to deregulation, cities and electric utilities were free to enter into franchises that provided for a fee of two percent or greater, and it was on that basis that many cities negotiated for and received franchise fees of three or four percent of gross receipts.

Since deregulation was implemented, a city's electric franchise fee has been based on the number of kilowatt-hours (kwh) that a utility delivered to customers located within the city's boundaries in 1998. The total franchise fees for the year 1998 are divided by the total kwhs for that year to arrive at a "per kwh rate." That rate is multiplied by the current kilowatt hours used by all customers within the city to arrive at the franchise fee amount due to the city. (Note: Some coops still pay the fees according to a percentage of gross receipts, and that is allowed by state law.)

**What do critics of electric franchise fees say?**

Some argue that franchise fees of any type are a "hidden tax" on utility service. Of course, the municipal position is that the fees are authorized by state law. In fact, the Texas Constitution prohibits a city from giving away anything of value (for example, the use of city property) to a private entity. Thus, the city position is that the fees are nothing more than "rental" payments for the use of city property.

**How are IOU electric rates regulated?**

In a city served by an MOU or a coop, the rates are set by the governing bodies of either the city or the coop. In a deregulated market, the practice is much more complex.

Cities have a long history of participation in the ratemaking process for electric utilities. Prior to the enactment of the Public Utility Regulatory Act (PURA) in 1975, electric rates were set exclusively at the city level, with appeals going to the courts. Cities were originally granted the authority to regulate electric rates, because most utilities operated within cities. Later, the state began regulating electric rates outside of cities, and ultimately took over appeals from city jurisdiction as well.

Currently, cities have original jurisdiction over the electric rates of transmission and distribution IOUs within their city limits. The PUC has original jurisdiction over electric rates outside city limits and appellate jurisdiction over the actions of cities. (In addition, some cities have ceded their original jurisdiction inside the city limits to the PUC.)

A transmission and distribution utility that is within a city and wishes to increase its rates is now subject to the original jurisdiction of that city. In practice, however, most cases are now appealed, consolidated, and heard and decided by the PUC. The rate-setting process is a complex one. Essentially, a utility submits reams of information to the city relating to investments in infrastructure and operational costs. The goal of the city, and ultimately the PUC on appeal, is to ensure that the proposed rates are fair, just, and reasonable.

**What is a city's role in setting IOU electric rates?**

When a rate increase is submitted to a city, the city council in practice usually denies the increase or suspends its implementation. Because the case will eventually wind up at the PUC, those actions give the city time to work with lawyers and consultants to review whether the increase is justified.

As a matter of course, cities that seek to participate in the rate-setting process join coalitions. The pooling of resources with a coalition avoids duplication of effort. And when the case ultimately ends up before the PUC, the cities present a unified front and reduce costs. Under state law, the utility seeking the increase pays for the legal and consulting fees of the cities. Those costs can easily reach into the millions of dollars, and they are added to the rate increase to be paid for by customers.

For a number of years, many city officials have believed that they are the only thing standing between utility companies and their constituents. That is because the PUC, understaffed and underfunded, does not have the resources to ferret out unnecessary increases in the reams of paperwork provided by the utility as justification. It is a fact that municipal intervention has saved money for customers. In one 2010 case, municipal intervention reduced a transmission and distribution company's rate increase from $253 million to $130 million. If cities are denied original jurisdiction, or the ability to intervene (and to be reimbursed for that intervention), electric rates would undoubtedly go up.