Alaska Policy Forum Report

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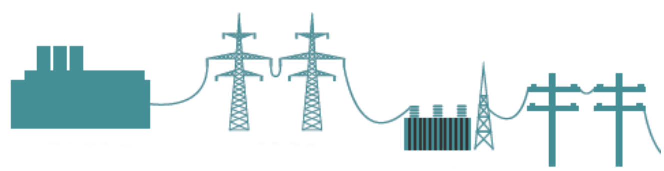
by

Ray Kreig

Former President, Chugach Electric Association

March 2018



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Alaska Policy Forum
201 Barrow Street #8
Anchorage, Alaska 99501
(907) 334-5853 - info@alaskapolicyforum.org
www.alaskapolicyforum.org

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Prop. 10 - ML&P sale to Chugach Electric is a poison pill that will block REAL customer savings for years

By Ray Kreig - Former President, Chugach Electric Association

March 17, 2018

Is the process employed by the Municipality of Anchorage for the sole-source sale of Municipal Light & Power to Chugach Electric Association questionable and flawed?

YES. I recommend a NO vote on Proposition 10[1].

But there are more important reasons to vote no on this sale. For one, the 2-4% savings claimed are meager. This sale to Chugach will politically block achievement of long-overdue, big savings from drastic reform of the entire Railbelt electric utility structure.

If all six utilities were merged, privatized and/or sold to a world-class, best-performing utility company we should ultimately be seeing rate savings well north of 25% ($150 million) each year. This is the kind of action we need to take to salvage our ailing state economy. But stuck with munis or cooperatives this is politically impossible.

Other reasons to vote No include:

- The Prop 10 deal is a tax on Chugach customers for the benefit of ML&P and to give the Muni a temporary cash injection to defer the day of reckoning for our expensive municipal government.

- It is unfair for electric rate payers to be stuck paying for featherbedded redundant employees who cannot be laid off and who have no purpose after the sale. These employees should be treated fairly with customary severance packages instead of being given lifetime sinecures.

- The municipality needs instead to redo the sale by conducting an independently-administered, professional and honest sale process for ML&P, its most valuable asset, which all prospective buyers will see is truly fair. Anchorage will then receive even better offers and more innovative and creative solutions.

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[1] The Alaska Policy Forum does not endorse legislation, propositions or candidates. This research study is meant to inform the general public. The recommendation on Proposition 10 is solely the author's, an expert in electric utilities.

DISCUSSION

Everyone agrees that Municipal Light & Power and Chugach Electric Association should have been merged decades ago. In fact, all of the Railbelt Utilities should merge most of their functions. There are six of them for only 250,000 meters (GVEA, MEA, ML&P, CEA, HEA, and Seward[2]). This is very costly and inefficient but remains the case because those benefitting from the duplication and waste have powerful political allies that protect them[3].

The rate shock hitting ML&P customers because of 19% rate increases[4] needed to pay for ML&P's new plant 2A has finally registered with the Municipality of Anchorage that it must divest of the utility. While replacement of aging generation with new higher efficiency units was certainly indicated, the race of utilities with each other to "keep up with the Joneses" has left the Railbelt with about 700 MW of costly new generation. That's twice the capacity that was needed[5]. These new plants will be underutilized, but debt service charges will continue and raise rates. More on this later.

So the city administration looked to adjacent Chugach Electric to absorb ML&P and cushion its cost burden. This deal will channel sale proceeds into muni general government financial accounts and the trust fund originally created for the sale of the Anchorage Telephone Utility for general government services.

HISTORY

The Railbelt co-ops and municipal utilities have delivered good reliability but at a cost which is much too high. They have traditionally absorbed most cost savings opportunities leaving little to be passed through for customer rate reduction and

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[2] NORTH to SOUTH: Golden Valley Electric Association, Matanuska Electric Association, Anchorage Municipal Light & Power, Chugach Electric Association, Homer Electric Association, City of Seward Electric Dept.

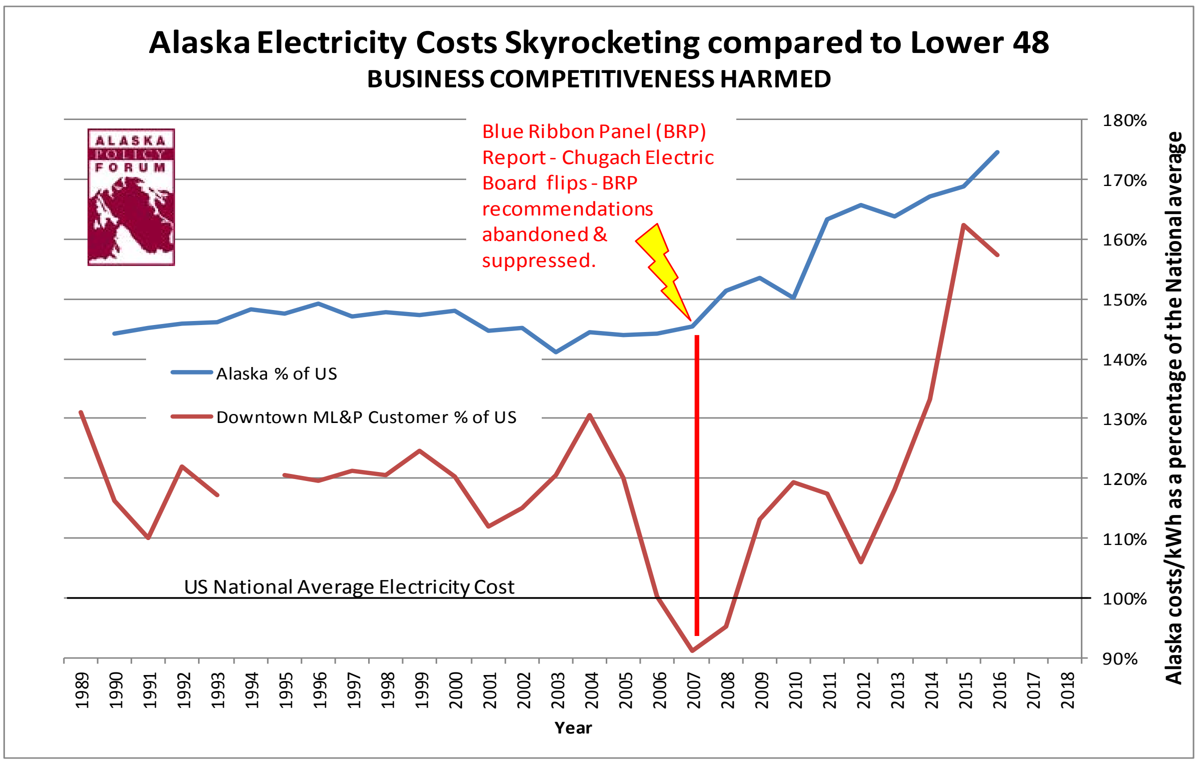
[3] The reason why no merger to date has taken place is the co-op business structure which has built-in governance impediments. Management and labor want to keep their jobs. This builds a high bar to scale for any consolidation effort.

[4] Also reported as a 37.3% increase but that would only be on base rates; the 19% is on the total bill including fuel surcharge.

[5] The committed generation that was built after the 2010 RIRP study totaled 726 MW. Making sense from a new capacity standpoint (but not necessarily built at reasonable cost) would be about 380 MW at ML&P Plant 2a, the Chugach/ML&P Southcentral Plant, the LM2500 Aero at ML&P's Hank Nickels as well as Golden Valley's Healy 2. Not economic is about 346 MW of capacity overbuilt at MEA's Eklutna and HEA's Bernice Lake. See also: Alaska Railbelt Regional Integrated Resource Plan (RIRP) Study, Final Report, February 2010. By Black & Veatch for the Alaska Energy Authority. www.akenergyauthority.org/Policy/RegionalPlanning

benefits. This is not the way customer owned utilities should act. In a resource-rich state like Alaska with low fuel costs they have tended to keep Railbelt electric rates around national averages and internally captured fuel benefits by not controlling non–fuel costs.

The situation has deteriorated so far that Alaska now has the second highest residential electricity rates in the nation (21.6¢/kWh)[6].



[6] Rankings: Average Retail Price of Electricity to Residential Sector, December 2017 (cents/kWh) U.S. Energy Information Administration. State Profile and Energy Estimates. Alaska. www.eia.gov/state/rankings/?sid=AK#series/31

CYCLES OF THWARTED REFORM

In 2007 major changes were recommended by a Blue Ribbon Panel of top business executives appointed by a reform Chugach Electric board[7]. The BRP's key findings included:

- Take all steps necessary to deliver the lowest possible cost power.
- Political action efforts on the part of Labor have compromised the natural balance between the board/management and labor, resulting in high costs that cannot be justified.
- Chugach distribution costs could be as much as 60% higher than those of utilities with similar systems. That's on the order of $25 million a year or 2¢ per kwh. Other cost components are reported to be twice national norms suggesting that Chugach has several major and systemic deficiencies in its cost and delivery structure and operations, including among its collective bargaining units.
- Take steps to eliminate the co-op as the business model and concentrate on other models to achieve a more efficient, cost effective and financially healthy utility.

"Political action efforts on the part of Labor" changed the Chugach board majority the following year and the BRP's recommendations were quietly buried. This most important report is now scrubbed from Chugach Electric's website.

As can be seen from the graph above, rates exploded after that event. The generation building binge then began. With virtually unlimited resources (staff, consultants, lobbyists and money) the utilities control information and data as well as the public agenda. The Anchorage business community was kept unaware of the advice from the BRP, a group drawn from their own ranks. Thus, it ignored the BRP effort and has listened only to the utilities themselves in formulating its organizational support for the purchase of ML&P by Chugach Electric. I suggest this was misguided.

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[7] Chugach Electric Blue Ribbon Panel Members: David R Gottstein – President, Dynamic Capital Management; Robert J Hickel – President, Hickel Investment Company; Loren H Lounsbury – Former APUC Commissioner, Commerce Commissioner; Richard L. Lowell – President, Ribelin Lowell & Co. Insurance Brokers (retired); John Niles Wanamaker – Vice President, Seattle-Northwest Securities Corporation. Panel facilitator and primary staff member -- William C. Noll, former Alaska Commissioner of Commerce, Community and Economic Development. Elizabeth Vazquez, Chugach Electric Board Chair. www.chugachconsumers.org/Lib/BRP.htm

Had the Chugach board not flipped and the BRP recommendations been fully implemented,[8] in my opinion, the generation overbuilding would have been substantially cut back and other foundational restructuring and Railbelt utility rationalization well underway with significant savings pouring into the Railbelt now.

The wedge of cost growth on the graph above from 2007 to 2016 (from 145% to 175% of national average rates) represents about 4.7¢/kWh in rates (about $90 million for the nine year period in the Railbelt)[9].

The 4.7¢/kWh rate increase from 2007 to 2016 is 35%. Considering the very meager savings being discussed by the Mayor and Chugach Electric in the Prop 10 ML&P sale to Chugach Electric (1/2¢/kWh, 2%-4%, saved -- and that not in place until many years have passed), much more radical reform is needed.

Other cycles of truncated reform efforts at Chugach and Matanuska Electric Associations have occurred, only to be ended by "Political action efforts on the part of Labor" after beginning to have results and save money for electric customers.

In the late 1990s, under that reform board, Chugach Electric's goal was redefined, "To be in the best 10 percent of electric utilities in economic efficiency while maintaining national standards of reliability and safety." That meant Chugach was committed to giving customers better value than 9 out of 10 consumers in the country and was going to internally compete against the nation's most efficient utility practices[10]. That goal, one that a member-owned co-op should unquestionably be eager to follow, was also abandoned.

GENERATION OVERBUILDING

In the last ten years each utility wanted its own brand new generation and 726 MW was constructed. The Alaska Energy Authority found that only the first one built, the Chugach/ML&P South Central Plant was economically viable[11]. Matanuska Electric, ML&P, Homer Electric and finally, ML&P Plant 2A pushed ahead and built 346 MW of unnecessary generation saddling electric customers with $300-400 million of plant debt to pay for 30 years into the future. The RCA

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[8] As was intended to begin the next year by the reform Chugach board.
[9] 4.7¢/kWh in rates is $26 million per year statewide. For the nine years that is about $117 million. The Railbelt is 77% of statewide electric consumption.
[10] The Chugach Outlet, September 1996, March 1997 www.chugachconsumers.org/Lib/outlet.htm
[11] Although, as earlier footnoted, others do contribute some amount of benefit, but at higher cost.

was powerless to stop it ahead of time and it's now powerless to stop the costs from being exacted from electric customers.

The utilities should have adhered to joint planning for this new generation. They did not. Furthermore, if the generation was owned by a private, investor-owned utility under an appropriate state regulatory regime, shareholders would have paid the cost for these mistakes, not the customer-owners of a muni utility or cooperative. Likely, the overbuilding would not have occurred in the first place.

FLAWED ML&P SALE PROCESS

The flawed and unprofessional, insincere sales process managed by the municipality has already been widely covered, as well as causing the resignation of ML&P commission chair Judy Brady[12].

To our knowledge the Mayor has not released the selection process documentation that supports the Municipality's decision to select Chugach Electric Association, Inc. as the buyer.

SILVER LINING

The good thing about the controversy of the ML&P sale proposal is it has brought the attention of customers and the business community back to the urgent need for reforms in the electric utilities.

However, overlooked to date in the discussion is valuable insight on the amount of savings that truly could be realized by electric customers benefitting from a best value sale or merger of ML&P. The public would never have known had alert reporting by Devin Kelly with the Anchorage Daily News not pried the other five offers out from the municipality[13].

Most significant was the offer from a respected private sector utility, Avista, which has 340,000 customers in Juneau, Eastern Washington and Northern Idaho. In addition to its being better than any of the others, it contained an important pledge that they would bring operating efficiencies of, as much as, $7 million per year to benefit ML&P customers (4% off rates, 0.7¢ off ML&P's 17.2¢/kwh residential rate). And they believe they can achieve these results by bringing the

[12] Anchorage Daily News, 3/8/18 - Combining utilities is laudable, but ML&P ballot measure manipulates city charter - Dan Sullivan
[13] From Avista Utilities, CIRI Energy, Ares Management, Matanuska Electric Association, Golden Valley Electric Association. Anchorage Daily News, 2/20/18 - 5 other companies expressed interest in buying Anchorage power company - Devin Kelly.

best practices of an investor-owned private company -- even without the low hanging fruit presented by merging with an adjacent utility like Chugach.

CRUMBS

By comparison, by exploiting just that low-hanging merger fruit, Chugach Electric is only offering eventual savings of 2-4% off rates out of the much greater potential that elsewhere in the U.S. has come from merging adjacent utilities. Chugach's own advisor states:

> "The savings from merging electric utilities typically falls in the 8% to 12% range, and for individual mergers savings higher than 20% have been announced. Factors particular to the merger of ML&P and Chugach should lead to savings on the higher end, even above the 8% to 12% range"[14]

This gap between what Chugach is offering (2-4%) and what its own consultant is describing from the rest of the country (8% to 12% to 20%) represents the long-standing failure of the Railbelt cooperative/municipal utility structure to deliver real value to its customers.

WHAT REALLY NEEDS TO HAPPEN

The entire Railbelt electric utility structure needs drastic reform. If all six utilities were merged, privatized and/or sold to a world-class, best-performing utility company we should ultimately be seeing rate savings well north of 25% ($150 million) each year. This is the kind of action we need to take to salvage our ailing state economy. But stuck with munis or cooperatives this is politically impossible.

We also need changes with the way the Regulatory Commission of Alaska oversees the electric utilities to be sure that the bulk of these savings pass through to the customers. Currently, because of the political power of the same cast of characters mentioned in the Blue Ribbon Panel report, there is not much the RCA can do with publicly owned munis and cooperatives when they waste money such as what has happened with the generation construction binge. With an investor-owned utility, regulators can punish shareholders. They can't do that with munis or cooperatives because the customer's own equity in the co-op or muni would be harmed. We also need a revamping of the RCA statute[15].

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[14] 1/23/18 - NERA Economic Consulting - Proposed Sale by the Municipality of Anchorage of Municipal Light & Power to Chugach Electric Association

[15] We need RCA statute changes for approval of Utility Integrated Resource plans, formation of regional utility entities, requirements for transmission line and generator siting approval. The RCA

These next two sections are after excellent comments made by Pete Brown in the Anchorage Daily News on 3/11/18 and preserved at: *www.chugachconsumers.org/Lib/Prop10.htm#PeteBrown*

PROP 10 DEAL IS A TAX ON CHUGACH CUSTOMERS FOR THE BENEFIT OF ML&P AND THE MOA

An ML&P merger with Chugach Electric makes some sense but not as structured or priced. This is a stealth tax in the form of future utility rate increases to fund a cash injection to the Muni, mortgaging us, especially as Chugach rate payers, instead of as taxpayers.

It's favorable to the Muni and the ML&P customers (who are worried about looming ML&P rate increases) at the expense of Chugach members. Chugach is overpaying and the entire Chugach service area will be burdened by the cost of this deal. Chugach Electric will be going to the bond markets instead of the Muni.

Chugach Electric directors are bailing out the Muni at the expense of the ratepayers and are breaching their fiduciary obligation to their member-owners, the electric customers by going along with this financial sleight of hand by the Mayor to give the Muni a temporary cash injection to defer the day of reckoning for our expensive municipal government.

PROP 10 DEAL PREVENTS SAVINGS THAT NEED TO HAPPEN NOW

As proposed by the Mayor and Chugach Electric, departments will be merged and there will only be personnel reductions through attrition and normal employee turnover and retirements.

That's precisely the problem. The redundant employees, be they at Chugach Electric or ML&P, will be sleeping at their desks collecting paychecks for years until they die or collect their retirement.

During normal corporate mergers, layoffs usually occur relatively quickly and economies of scale are achieved in part because the new single entity no longer needs two accounting departments, two billing departments, two purchasing departments, two HR departments, two data processing departments, etc, etc, etc. Redundant employees are usually let go quickly and given a termination package.

But not here. The Mayor has guaranteed his labor supporters that these efficiencies cannot be achieved in any reasonable period of time.

The rate payers should not be stuck with this featherbedding.

We will probably need most of the existing lineman and generator operators. We won't need all the, soon to be redundant, administration. The same is true for existing regulatory staff, etc.

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statute has only rate making, quality of service and certificate powers spelled out. There is no case law to support anything else (per former RCA Commissioner, Jim Strandberg).

POISON PILL

Selling ML&P to Chugach Electric will not advance the objective of Railbelt utility reform. It will make it very difficult or impossible to bring the utility culture change necessary that would come from a privatized investor-owned utility presence in the Railbelt.

Cooperatives cannot be sold unless there is a two-thirds Yes vote in an election where at least 50% of the members vote. There has never been a co-op election with that many members voting. The highest ever Chugach Electric election had only 30% participating. Typical now is less than 10%.

So selling ML&P to Chugach Electric will effectively be a poison pill condemning the entire Railbelt to a failed cooperative model of utility governance that will never achieve world-class efficiency and best value for customers. Over the next decade, the amount of savings forgone from such a mistake could easily be $1 billion or more.

NO ON PROP 10

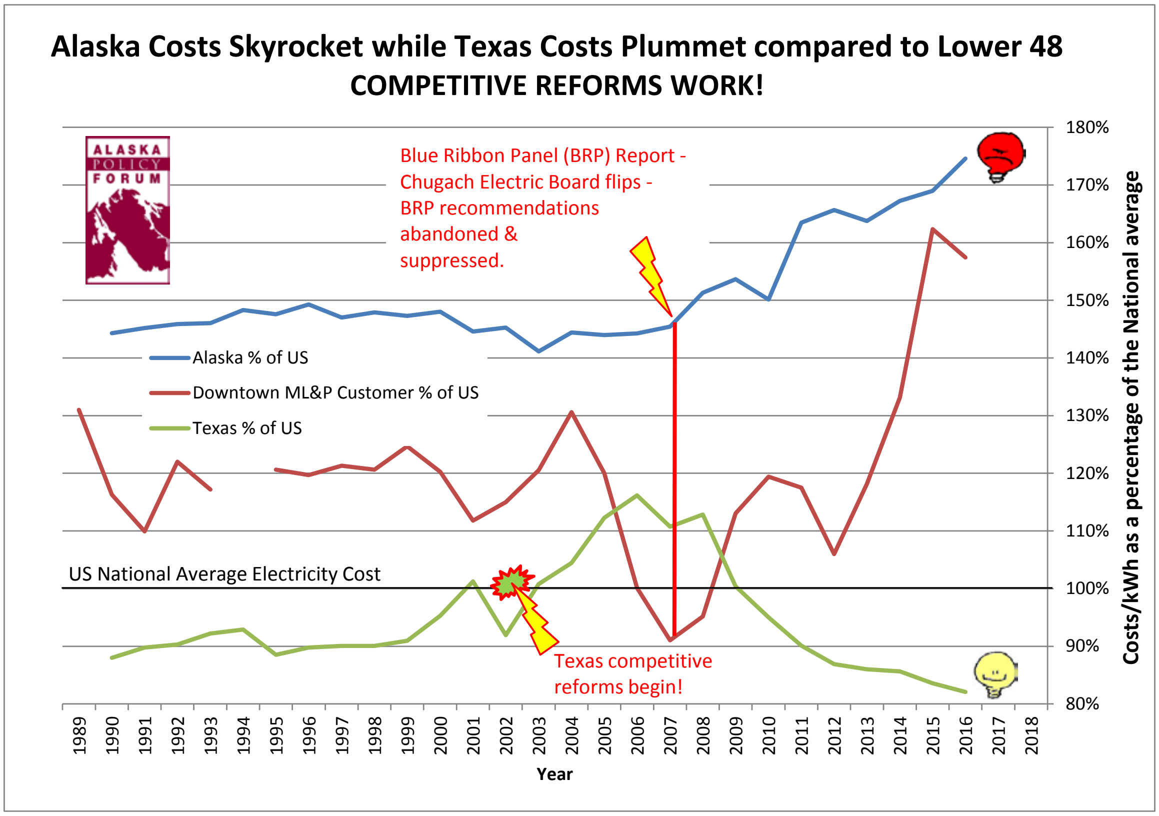
The wise approach is for Anchorage voters to vote No on Proposition 10. Over the next year the municipality should conduct an independently-administered, professional and honest sale process for its most valuable asset that all prospective buyers will see is truly fair. We will then receive even better offers and solutions. There is too much at stake not to do it correctly this time.

WHAT NEXT?

The public, especially the business community, needs to decide if it wants our electric utilities to deliver electricity to consumers at the lowest possible cost while maintaining reliability. If the answer to that is Yes then it needs to organize and demand electric utility reform action from the next governor and legislature. The failure to do so years ago have cost electric utility customers billions of dollars. And that’s not counting the business stimulus lost because Alaska’s Railbelt was never able to exploit what should have been lower electricity cost advantages in attracting new enterprise.

A REFORM FUTURE?

What could Alaskans expect from a properly done electricity reform? When Texas adopted its competitive reforms, the results were astounding.



Texas now has the most competitive, successful electricity market in the U.S., if not the world. These reforms have allowed Texas to keep up with a massive increase in demand for electricity. Since competition started in 2002, demand for electricity in Texas has increased 80 percent faster than in the rest of the country. But **Texas electricity prices have actually decreased by 14% in real dollars and by 57% relative to national prices.**[16]

This tremendous benefit to Texas consumers has been accomplished solely at the risk of investors and generators, who were allowed to invest more than $36 billion in new generation capacity to meet this demand. **In every other state, much of the risk of investing in new generation is placed on consumers — they pay for the generation whether they need it or not.**[16]

Of course, Railbelt Alaska is very different from Texas. Our electrical grid is isolated and very small. An open, competitive generation market here would

[16] Bill Peacock, Texas Public Policy Foundation, www.texaspolicy.com/blog/detail/peacock-since-competition-started-in

need to be designed differently and the state is likely to always be a bigger player as owner of much of the transmission system and the Bradley Lake hydro project. But there are still many ways that competitive forces can be unleashed that will bring truly lower prices and better value to electric utility customers.

MORE INFORMATION

See chronology and media summary maintained by ratepayer group Chugach Consumers: www.chugachconsumers.org/Lib/Prop10.htm