Never Sell Your Most Valuable Asset

Why Middletown Borough Owns an Electric Utility

The complexity of the electric power industry makes it difficult for the average citizen to have an informed opinion, but rest assured that owning an electric utility makes sound financial sense for the Borough.

Background

Middletown has been in the electric business since 1893 when it operated its first Thomas Edison hydroelectric plant on the Swatara Creek. Middletown operated an electric utility before Houston or Los Angeles had electricity. Middletown has always operated the electric system with the goal of providing our residents and businesses with low-cost energy and reliable service. Owning and operating an electric utility enables the Borough to meet both of these goals.

The electric industry has gone through significant and dramatic changes in the ten years since deregulation. The industry was deregulated through a series of Pennsylvania and Federal laws that changed electricity from a resource to a commodity. Resources are bought through competitive bidding at set delivery prices. Rock, concrete, road salt, or computers are examples of “resources.” Although their prices fluctuate based on the economy, a supplier can deliver the resource at a flat rate through the bid process. Electricity is now a “commodity;” bought, sold and traded like pork bellies, crude oil, frozen concentrated orange juice or precious metals. Commodities are sold through contracts; long-term contracts with stable prices, futures contracts with estimated future pricing, and spot contracts with minute-to-minute prices. Electricity assets are controlled by Wall Street firms such as UBS, JP Morgan Chase, Lehman Brothers and Goldman Sachs.

Electric utility companies such as Middletown, or investor-owned utility companies (IOUs) such as PPL and MetEd, all buy electricity through these traders in a marketplace called PJM. PJM is a stock market for electricity. Called a Regional Transmission Organization (RTO), PJM was the operator of the electric grid in Pennsylvania, New Jersey, and Maryland. When the Federal government changed the rules, PJM became a commodity marketplace and, like the stock market, trading of electricity has driven up costs without creating any additional supply or value. PJM is now a huge corporation with massive authority over wholesale electricity.

IOUs pay prices similar to Middletown for wholesale electricity. However, IOUs are currently prohibited from charging proportional and realistic retail rates to their customers because of artificial price caps. The artificial price caps are soon ending (2010 and 2011). Pennsylvania’s IOUs say they are having trouble waiting for the caps to be lifted. They claim they are hemorrhaging money. Twice they have requested relief, but the State has yet to grant it. The actual retail rate increases that will occur when the caps are lifted are a subject of debate. PPL, for example, states that residential customers should anticipate a 30%-35% increase. However, recent rate hikes resulting from the removal of caps in Maryland and Pike County, PA were more in the 70%-72% range. It is likely that the actual number is somewhere between 30% and 72%.

The lifting of the rate caps will have no effect on Middletown. We are not regulated by the Pennsylvania Public Utilities Commission (PUC). Rates and policies (deposits,

disconnection, etc.) are set by Borough Council. Our rates are already floating with the free market.

Selling our electric system would have a huge, costly, and catastrophic effect on Middletown's finances and the services provided by the Borough. Contemplating a sale is an absurd reaction to changes in the electric business which will not save any property owner or business any money and that will have long-term disastrous financial consequence to the Borough.

Acquiring Power Supply in a Deregulated Marketplace

The nation's journey through electric deregulation has been a bumpy one. Of the two types of deregulation, wholesale and retail, Middletown is only directly impacted by wholesale deregulation. The Federal Energy Policy Act of 1992 established the basic parameters under which electric generating companies (such as PPL and MetEd) must sell their power through the RTO commodities marketplace. Companies can no longer sell the power they generate directly to their customers. Now that electricity is bought, sold, and traded the commodities trading process has evolved in the same way breakfast cereal manufacturers buy, sell, and trade grain through the Chicago Mercantile Exchange. This introduces an erratic component to the price of power as speculators and other Wall Street types joined in the "action."

The practicality of Middletown's former method of letting out flat competitive bids to IOUs disappeared shortly after the Med Ed settlement ended in 1999. The same thing occurred with all utilities. To capitalize on this set back, some IOUs put pressure on the State to enact laws that would drive public utilities out of business; but our professional organization successfully lobbied the State to protect us. Municipalities then pooled together through organizations such as AMP-Ohio in order to obtain power at the same wholesale rates as the big players and to lobby legislators.

Pennsylvania municipalities were to suffer another setback. As part of retail deregulation, IOUs were locked into rate caps that are set to expire around the end of this decade. The purchase price of electric now exceeds these caps in some cases, and IOUs' prices are sometimes lower than municipal utilities for the first time in history. This creates a temporary risk that some IOUs will become insolvent. This happened in California where their largest utility, Pacific Gas and Electric, filed for bankruptcy, and Southern California Edison had to be bailed out by the state.

Where rate caps have ended, the result has been an astronomical increase in retail rates, as tales from California, Maryland, Delaware and Pike County, Pennsylvania all attest. Municipal prices hold steady, while those of the IOUs surge. The historic equilibrium is then restored as municipals again undersell the IOUs. There is little doubt that the same will happen in the Harrisburg area over the next two years.

Electric System Finances

Middletown's electric system buys wholesale electricity at the lowest cost possible. Through the 81 member municipal-only consortium known as AMP-Ohio, Middletown buys wholesale electricity in the form of long-term contracts, short-term contracts, and on-the-spot markets. AMP-Ohio operates its own trading desk, and it has made wholesale arrangements on our behalf that are considerably better than the rates PPL is

paying for future wholesale needs. PPL recently contracted for base load electricity for the Year 2010 at $107 per mwh. Middletown has already purchased our base load for Year 2010 at $71 per mwh.

Middletown has already purchased electricity contracts through the Year 2012 at extremely desirable rates. We are lucky we were able to commit to AMP-Ohio, and to do so for such a length of time when we did, as prices continue to dramatically increase.

The Borough anticipates its separate and segregated Electric Operating Fund will generate between $1.2 million and $2.0 million in additional money each year. This surplus is then used by the Borough to offset expenses in the General Fund, the Fund that provides all the municipal services of the Borough. This "payment-in-lieu-of-taxes" is important, because if the Electric Operating Fund (the Borough's electric company) were a separate private company, it would have to pay corporate and gross receipt taxes to the State of Pennsylvania (from which it is exempt). Therefore, the $1.2 to $2.0 million transfer is a proper, necessary, and carefully monitored expense for the Electric Operating Fund.

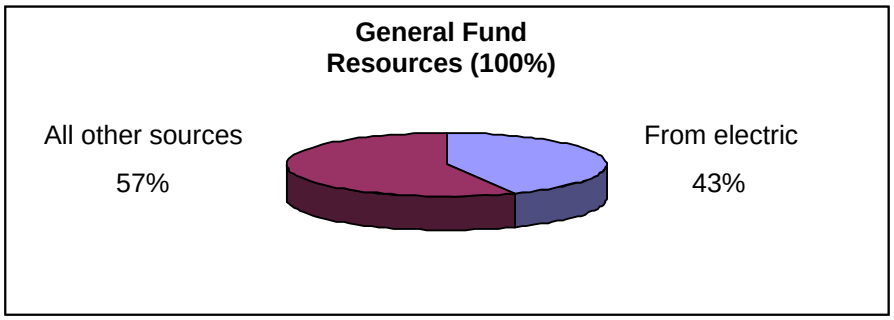
If the system was privatized, the corporate and gross receipt taxes would be paid to the State, and no money would be paid to the Borough to offset operations. The loss of this annual and recurring revenue source would utterly devastate the Borough's finances. The 2008 General Fund budget has anticipated spending of $6,052,620 of which the $2,000,000 Electric Operating payment is approximately one-third. In addition to the $2 million payment, the Borough's General Fund enjoys $1.062 million in additional shared services. The total financial impact is, therefore, $3.062 million; the single most important revenue source for general government operations.

The fact is that of the $11.4 million budgeted in the Electric Operating Fund for 2008, less than $1.3 million will be spent on Electric Department operations. About $6.7 million is to be used to pay for electricity purchased through AMP-OH, and most of the remaining balance will benefit other Funds.

The 2008 budgeted effect on the General Fund of $3.062 million equates to a real estate tax avoidance of 12 mills (the current levy is less than 5 mills). The direct transfer and other transfers and supplements that the General Fund would otherwise have to pay (assuming service levels were not reduced) are as follows:

$ 10,940	Central Garage
20,710	Communications Center
57,000	Traffic signals (est.)
98,000	Street lighting (est.)
149,370	Codes
283,500	Capital Projects fund transfer
474,550	Administration and Finance
2,000,000	General Fund transfer
$3,062,420	Total General Fund benefit

The General Fund gets over two-fifths of its resources directly or indirectly from the Electric Fund:



Therefore, two-fifths of every service provided by the Borough (two-fifths of our parks, two-fifths of our police, two-fifths of our code enforcement, two-fifths of our highway workers, two-fifths of the library, etc.) would have to be eliminated.

Even if the Borough were to realize money from the sale of the system, that money would be a one-time benefit. Even if that one-time benefit was millions of dollars, all of that money would be spent and gone within a matter of years. Once gone, two-fifths of all operations would need to be eliminated as we would have literally killed the goose that was laying golden eggs. By preserving and protecting our revenue source, the Borough can preserve its services. Without this revenue source, police, parks, code enforcement, and the library would have to be cut. There would be dramatic and significant layoffs in all departments. Meanwhile, given the wholesale cost of energy, rates would be skyrocketing at the same time that any money earned from the sale runs out.

Shared Services

In addition to the payment-in-lieu-of-taxes, the Electric Fund contributes to Borough operations in other important and immeasurable ways. From simple assistance projects (Electric Department employees act as our in-house electricians); to manpower improvements (when there is a storm Electric Department employees are out plowing snow); to sharing equipment and providing support to Code Enforcement, Communications, and the Finance Department; the Electric Department is invaluable. By selling the system the Borough would lose all shared services; the IOUs do not share services with municipalities.

The question might arise as to how other communities handle not having their own electric systems. Other communities do not illuminate their trees and signs because the maintenance of such decorative lighting and the cost of power are prohibitive. Other communities have many fewer street lights and charge street light property taxes. Residents of Lower Swatara, for example, pay a Street Light Tax based on the lineal foot of lighted property frontage (95¢ per lineal foot). Other towns don't hang banners. They don't have lights in their parks (it just costs too much), and they have fewer traffic signals. Although the Electric Department pays for all the electricity used by street lights and traffic signals, they do so for considerably less than what IOUs charge towns for similar services. Once the Borough sells our electric system, Middletown would then be in a position of having to overpay the new electric company higher electric rates for the energy at Borough facilities. These details, for example higher operating expenses as a result of higher electric rates at Borough facilities, are often lost in evaluating the benefits

of operating our own electric system. There is, in fact, a popular movement among other towns to find unique and alternative methods to cut their dependence on the high electric rates at IOUs. Speculators who propose selling the Middletown system are actually proposing a thought contrary to logic: specifically, that Middletown should find a way to buy more electricity from IOUs.

Reliable Service

As the system is locally owned and controlled by our residents, the town has a direct say in policies, procedures, and rates through its elected officials. It is a public trust to preserve and protect this important community asset. Given our concentration on such a small service area, down time for the system and response time in emergency situations is much better than private companies; i.e., during the December 2007 ice storm the Borough power was out only 30 minutes while some surrounding communities were without power 3-4 days.

Middletown's distribution system is one reason why the Borough will always undersell the IOUs (barring rate caps). Since every utility is buying electricity at the same price, the competitive edge comes with other efficiencies. The cost per customer of distribution correlates almost perfectly to the distance between customers. The average distance between Middletown customers is 26 feet, whereas the distance between PPL and MetEd customers is almost ten times that.

The IOUs maintain very few local maintenance crews. When there is an emergency, they bring in crews from other states. This can take days. There are no towns of approximately 10,000 residents who purchase electricity from IOU's but who still have their own electric crews on stand-by for emergencies. What is the value to local businesses to have power restored so quickly? During the December 2007 ice storm, the Hershey Outlets were without power for 24 hours during the holiday season. David Ober of PA Outlet Management estimated they lost $1 million in sales in just that one day.

The Electric Department employees are mostly local; many are Borough residents. Our crews are working on our lines on a daily basis making sure the system is well maintained. This preventive maintenance is unheard of in the IOUs.

The Finance Department employees are mostly local too; many are Borough residents. Every day they answer questions, process bills, and help out customers right here in town. We do not use a far-away call center; we use good old-fashion local customer service. Other utilities use call centers, have odd hours, can only be reached by telephone, and have no idea about the people or issues affecting Middletown. Often when discussing what services are appreciated by the average resident, having a local place like our Front Office, where they can pay their bills or get assistance is mentioned. Without our own electric system, such customer service would go away. Our customer service is far superior to other utility companies such as Comcast, Verizon, or UGI.

Additionally, the Borough does not have to pay corporate tax, shareholder dividends, or employ sales and marketing departments. Additionally, a much larger percent of Middletown's sales revenue is distributed within the local economy, whereas very little sales revenue earned by the IOUs (i.e., revenue earned by UGI for natural gas sales) makes its way to into the Borough. For example, most of the salaries paid for in the

Electric Operating Fund, go to support local commerce by employees who live or work inside the Borough.

Electric Trust Fund

The Borough originally enjoyed an open-ended contract for electricity at 1¢ per kWh with MetEd. An agreement was reached in 1998 to end that contract as of January 1, 1999. In the settlement, MetEd agreed to pay $3.6 million in 1999 plus $1.6 million every year thereafter through 2008. Borough Council, at that time, created an irrevocable trust for this money that limits its use to payment of direct electric-related expenses and indirectly limits the amount that can be transferred to the General Fund by the Electric Operating Fund.

There are two reasons why the Borough is not currently drawing down settlement money. A well-attended a public hearing on the Electric Trust Fund was held on July 17, 2002. A major directive from that meeting was unanimous support to gradually wean from the Trust money and to retain a sizable principal. Second, the complicated manner in which the Trust limits General Fund transfers causes unavoidable "cash drains" upon the Electric Operating Fund which can only be eliminated by ending our dependency upon Trust money; the Trust was established to be a *safety net*, not a revenue source.

Early Borough Councils did not grasp this difference and spent down the Trust money, destroying the benefit and harming Borough finances. By 2005, the Electric Operating Fund did not have enough cash to make the full amount of the budgeted General Fund payment-in-lieu-of-taxes, and by mid 2006 there were serious doubts that the Electric Operating Fund would stay solvent for more than six months.

Beginning in October 2006, the Borough Council set customer fees directly proportional to the wholesale energy charges being incurred. This action assured solvency, provided customers with the lowest possible long-term rate structure, and weaned the Borough from the Trust money. The Trust now has over $9 million. (This is important, as it is a common misperception held by several residents who are angered because they believe the Trust money has been exhausted.)

The principal of the Trust can no longer be touched for operating revenue, but consideration has been given to using the investment earnings for electric-related capital investment in the system. This would help alleviate future bond issues. Further discussions will take place once investment revenue accumulates in the Trust Fund.

Selling the System is Complex

Many people do not realize that selling a valuable asset such as the Borough's Electric Department is restricted by State law. One cannot flip a switch and turn on PPL electricity. The process for selling the system would be the same as the process for selling a used dump truck, just a lot more complex and much more time-consuming.

First, the Borough would have to hire a consultant to place a proper value on the system. Council has a fiduciary responsibility to prove that it would receive maximum value for the sale of a multi-million dollar asset that generates annual cash flow for its owner. There are specialized consultants (similar to property appraisers) who value utility systems. The consultant would complete a financial analysis (reviewing contracts, liens,

property, easements, debt, financial obligations and receivables) for the electric system. The consultant would also evaluate the condition and value of the entire infrastructure (the age of equipment, meters, and trucks; the cost of necessary capital improvements; and an honest third-party evaluation of system needs for the next 50 years). This process of study is required in order to properly value and calculate the depreciation of the system. This is a complex and unsettling process. For example, one can imagine that obscure items such as our aging substations or lack of legally documented easement agreements (just to name a few items) might typically lower the value of our system. One might honestly determine through this process that keeping the system (and its annual revenue generation) is much more significant than a one-time sale.

Finally, once the system is properly valued, it would have to be auctioned off. It could not be sold to PPL or MetEd merely because they are adjacent to our service area. For example, the winning bid might be a utility speculator from another state (such speculators do exist) or a company whose intention is to flip or resell the system to another buyer. Such trading of utility systems is not uncommon in an industry where electricity itself is traded.

Regardless, Council would have to take the high bid, as required by law. Not only would we relinquish control of the system (and give up all its revenue), but the new control might rest in a private company in Texas or California. When Enron, the failed electricity and natural gas trader, purchased Portland General Electric no one thought the new owner would lose a billion dollars in net worth and drive the electric system into receivership. However, companies like Enron and its successors are still investing in utility systems.

It is envisioned that the auction process for liquidating the system would take approximately 36 months. By that time, the artificial rate caps will have been removed from the Pennsylvania investor-owned utilities and any poorly-informed-belief of financial benefit will have clearly disappeared.

Conclusion

Public power in Pennsylvania has historically enjoyed the advantage of lower electric rates coupled with General Fund contributions. Municipal electric is currently going through a period of the doldrums as rate caps force the IOUs to sell at prices below their cost. This practice will not continue much longer; public power will once again enjoy an advantage.

Middletown's General Fund is dependent upon the Electric Fund to a greater extent than many people realize. This relationship provides the current mix of services and real estate taxes that would change drastically should the electric system disappear.

Electric settlement money was not squandered as many believe. Although a large amount of it was used, at the public's insistence Council took steps to preserve it indefinitely.

- Middletown buys electricity on the wholesale market and sells it to residents and businesses. We are one of 81 municipalities who have formed a consortium to band together to buy electricity contracts.

- Every time we have bid out the contract, we have taken the lowest available power supply. For example, Ephrata Borough chose to purchase from AMP-Ohio by using their Time or Price Purchase Strategy in place of a traditional bid.
- The electric industry has gone through significant and dramatic changes in the last ten years since deregulation.
- IOUs pay similar and often higher prices for wholesale electricity as Middletown pays. They are currently prohibited, however, from charging proportional and realistic retail rates to their customers because of artificial price caps. The artificial price caps are ending soon (2010 and 2011).
- Middletown has already purchased long-term contracts for electricity through 2012. We are lucky we were able to commit to AMP-Ohio, and to do so for such a length of time when we did, as prices continue to dramatically increase.
- The Borough anticipates the separate and segregated Electric Operating Fund will generate between $1.2 million and $2.0 million in additional money each year. This surplus will then be used to offset shared expenses in the General Fund, the Fund that provides all the municipal services of the Borough.
- In 2008 a $2.0 million transfer is scheduled as payment-in-lieu-of-taxes. In addition, the electric system provides $1.062 million in shared services. Together, this $3.062 million provides two-fifths of the revenue in the General Fund for two-fifths of every service provided by the Borough; i.e., parks, police, code enforcement, highway workers, library, etc.
- Even if the Borough were to realize money from the sale of the system, and even if that one-time benefit was millions of dollars, all of that money would be spent and gone within a matter of years as we attempt to make up for the lost payment-in-lieu-of-taxes.
- $2.0 million in lost revenue can be replaced only by significant cuts in services or with a seven to eight mill property tax increase (almost tripling our current taxes).

Overall, every leading indicator of Middletown's electric health indicates improvement, and the prospect of a large and sustainable public benefit is very likely. In general, there seems to be little value and tremendous downside to contemplating a sale of the electric system.