

The Direct Costs and Benefits of US Electric Utility Divestitures

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Thomas P. Triebs, Michael G. Pollitt and John E. Kwoka

Against the advice of several economic studies on the benefits of vertical integration US regulators encouraged or mandated electric utilities to divest their generation assets. Were they wrong? Our study shows that they were right and divestitures produced an economic benefit of about US\$ 11.3 billion.

We study a sample of 30 divestitures taking place between 1997 and 2003. Our entire sample covers 138 firms over the years 1994 to 2006. Our analysis consists of two parts. First, we correlate the efficiencies of distribution and power sourcing (i.e. own generation and purchased power) with indicators for divestiture. We find that divestiture reduced distribution efficiency but increases power sourcing efficiency. The effects are strongest at the time of divestiture and decline as time moves on. Second, we compare the weighted costs between divested and non-divested firms where the weights are the efficiencies. Also, we account for any initial cost differences to make sure we isolate the actual effect of divestiture itself.

When taking into the account the costs of distribution, transmission, and sourcing power we find that the cost reduction due to divestiture is \$11.3 billion or 5.5 percent of the total cost of the divesting firms. Last we show that though not very strong there is a tendency for firms that have higher distribution cost increases to also benefit more from lower costs of power sourcing. Thus not only is the aggregate benefit positive but also is there a tendency for the benefits to out-weigh the costs at the firm level.

A remaining question is what are the drivers of our results? It could be changes in technology, efficiency, or transaction costs. Also, lower costs of power might be the result of favourable contracts put in place at the time of divestiture. Despite our aggregate result there are differences between firms that are likely to have an impact on whether firms divest and if so how it affects their performance. There remains room for learning.



**UNIVERSITY OF
CAMBRIDGE**

**Electricity Policy
Research Group**

Contact
Publication
Financial Support

t.triebs@aston.ac.uk
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ESRC, TSEC 1, Aston University



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