6. CONTAINING THE COST OF DOING BUSINESS: THE HEART OF A COMPETITIVE BUSINESS CLIMATE

Oregon's businesses compete in a national and international economy. Because many firms operate on thin margins, the difference between profit and loss is often determined by the careful management of costs. The State influences the costs of doing business in a variety of ways, including regulations, mandated programs, and tax policies. Lowering these State-imposed costs will increase the competitiveness of Oregon companies and expand Oregon's business opportunities.

Some national surveys of state economic climates focus almost exclusively on operating factors affecting the costs of doing business. The best known of these is the *Grant Thornton Manufacturing Climates Study* published each year. This study has been roundly criticized for failing to recognize that public infrastructure, education programs, and other government services cannot be judged as business costs alone but also as public services critical to the economic climate and well-being of a region.

...Oregon does not expect to become the "lowest operating cost state." We intend to provide quality schools and government services while keeping costs as low as possible...

Oregon does not expect to satisfy such narrow perspectives and become the "lowest operating cost state." We intend to provide quality schools and government services for our businesses and citizens. However, we are committed to keeping these costs as low as possible in the context of sound public services and overall attention to quality of life.

The industry committees in the strategic planning process identified several costs of doing business which are controlled by the State and which impact nearly every business sector. There are five business costs that deserve special attention: 1) workers' compensation, 2) unemployment insurance, 3) health care, 4) taxes, and 5) energy rates. The committees have identified a number of ways the State can help contain these costs of doing business in Oregon.

6.1 WORKERS' COMPENSATION

Background

In 1913 Oregon's Legislature adopted the state's first workers' compensation law, which was strongly supported by the citizens in a referendum later that same year.

This law remained unchanged for more than 50 years until it was overhauled by the Legislature in 1965.

Despite the reforms, there were still flaws in the program. During the late 1960s and early 1970s, while the number of covered employees increased 30 percent and annual claims were relatively constant, employer premiums increased fourfold. By the mid 1970s, Oregon's workers' compensation rates were among the highest in the nation. In 1977 and 1981, further major changes were made to improve the system and control costs. But they provided only temporary relief. Costs and premiums again began to rise.

From 1984 to 1987, as the number of covered employees increased only 9 percent and annual claims increased only 10 percent, employer annual premiums more than doubled, going from $325.3 million in 1984 to $676.9 million in 1987. For the last several years, most national economic climate rankings have placed our premium rates among the top ten. The 1988 *Grant Thornton* survey ranks Oregon as the most expensive of the continental 48 states.

Workers' compensation reform has been a top issue for this State administration. The Governor's policy advisory group on workers' compensation developed seven specific recommendations to reform the workers' compensation system. These recommendations served as the foundation for the workers' compensation reform bill, HB 2900, which passed in the 1987 legislative session and initiated the most sweeping changes to the program in more than two decades. This bill contained provisions to make changes in scheduled benefits, standards of rating disabilities, and use of vocational assistance. And it established new working relationships in State agencies dealing with workers' compensation issues.

In 1988 there was no increase in the average pure premium rate for Oregon's workers' compensation program. In 1989 premiums will increase an average of only 5.2 percent. Workers' compensation premium rates are now rising faster throughout the nation than in Oregon. Nationally, premiums rose an average 10.8 percent in 1988, and they are expected to rise approximately the same amount in 1989. As a result, Oregon's ranking by the National Council on Compensation Insurance, will make a modest drop from sixth highest average premium rate to eighth highest.

Oregon's smaller rate increases in the last two years have been attributed to the recent changes in our workers' compensation program. However, because future rate increases are based on two to three years of loss experience, it will take two or three years to determine the real impact of the 1987 legislation on the workers' compensation system.

Next Steps

Workers' compensation remains high on the list of cost issues for Oregon businesses. Workers compensation was raised by nearly every industry committee as an important problem. Even with the 1987 legislative changes, it is clear that further legislative and administrative changes must be made in the system to reduce medical costs of injured workers and to return treated workers to employment as quickly as possible.

The primary objective for workers' compensation in the 1989 legislative session ought to be controlling health care costs and reducing time loss between injury and return to work. Since 1981, the average medical cost of Oregon's workers' compensation claims increased 111.4 percent, while the Medical Consumer Price Index increased only 66.7 percent. The costs of medical care for injured workers have soared to nearly 40 percent of the employer's premium costs.

Time loss payments to injured workers in the Oregon system have increased 51.1 percent since 1981, while the number of claims has increased only 10 percent. Time loss payments for injured workers off the job are now about 30 percent of the employer's premium costs.

Adoption of these recommendations will give the state new tools to control workers' compensation costs, thereby helping to reduce employer premiums.

Besides the recommended legislative changes, increased job safety and accident prevention are important long-term solutions to controlling the costs of Oregon's workers' compensation program. With fewer occupational injuries and illnesses, Oregon's employers will almost certainly experience the long-term benefits of higher productivity, improved employee morale, lower workers' compensation costs, and increased profits. More effective work place health and safety programs must be developed.

The Department of Insurance and Finance (DIF) recognizes this need and has initiated efforts to provide occupational safety and health consulting services to employers and their employees. As a part of this effort, DIF has prepared a new brochure describing how to develop safety and return-to-work programs. In addition, the department has prepared a specific legislative recommendation for the 1989 session to address this need. The recommendation calls for creation within the Accident Prevention Division of a Consultative Services Program, targeting high-hazard companies, while also maintaining a strong compliance and enforcement policy.

Summary of Actions

The Department of Insurance and Finance will present eight specific recommendations to the Legislature:

- Permit insurers to contract with health maintenance organizations and preferred provider organizations for medical services to injured workers.
- Define the limits of "palliative" and "maintenance" treatment.
- Require mandatory use of generic drugs unless specifically exempted by a doctor.
- Require job reinstatement within a specified time frame for a "physically able worker."
- Modify the Preferred Worker Program to provide greater incentives to employers to rehire injured workers.
- Reimburse employers for any workers' compensation premium increase which is due to injury of a "preferred worker."
- Emphasize work site modification to return treated workers to their original employer.
- Create the Consultive Services Program within the Accident Prevention Division, targeting high-hazard companies while also maintaining a strong compliance enforcement policy.

6.2 UNEMPLOYMENT INSURANCE

Unemployment insurance rates in Oregon are the fourth highest in the nation. The primary reason for these higher rates is that Oregon has been building up a relatively large program trust fund which is designed to provide the State with protection in the event of a major recession. As a result, Oregon's unemployment insurance system is more sound financially than those of most states. As the State's trust fund reaches certain thresholds of security, Oregon's unemployment insurance rates will decrease and become much more competitive.

Nationally, the unemployment insurance program was established in the 1930s as one element of the original Social Security program. Unemployment insurance remains a federally mandated program under which eligible unemployed workers receive weekly cash benefits from their states. This is a federal-state partnership in that some aspects of the program are within the states' jurisdictions and other aspects are controlled by federal requirements to which the states must conform. Therefore, although unemployment insurance programs vary from state to state, the federal government retains substantial control over the states' programs.

Employers pay two taxes related to the unemployment insurance system. The first is a federal unemployment insurance tax paid to the IRS under the Federal Unemployment Tax Act (FUTA). This tax is used primarily to pay the costs of administering the federal and state unemployment insurance programs. FUTA returns approximately $37 million to Oregon each year to administer the State's program. The federal FUTA tax and its requirements are the same in every state.

The second tax is the state unemployment insurance tax, which is collected in Oregon by the Employment Division of the Department of Human Resources. This tax is used solely for the purpose of paying unemployment benefits to Oregon claimants. Currently, Oregon has the fourth highest state unemployment insurance tax rate in the nation. It is this relatively high rate which contributes to Oregon's higher general business costs. This tax rate, compared to rates elsewhere, tends to put Oregon at a competitive disadvantage.

There are three key factors which have combined to make Oregon's unemployment insurance taxes relatively high in recent years.

First, Oregon's unemployment rates have been high until recently, and therefore, have required large benefit payouts. The seasonality of employment in Oregon's two major industries, agriculture and wood products, also strongly contributes to our high rates of unemployed workers.

Second, Oregon claimants receive an average weekly benefit which is slightly above the national average. The Oregon Legislature has established by law that unemployment insurance claimants may receive a benefit of up to 64 percent of the state's average weekly wage or a weekly benefit payment of up to $229. As it happens, Oregon's average weekly benefit amount is 40.3 percent of the state's average weekly wage, while the national average is listed at 36.3 percent. As a result, while Oregon's maximum potential entitlement ranks 14th in the nation, Oregon's average payment ranks 22nd nationally.

Third, and most important, Oregon has been rebuilding its unemployment insurance trust fund from the major payouts of the recession in the early 1980s. In other words, Oregon businesses have been paying unemployment insurance taxes based on our highest tax schedule for some time.

The Legislature implemented the current unemployment insurance tax schedule system in 1981 to insure that Oregon will have an actuarially sound unemployment insurance system to meet current benefit payout needs and to build a strong trust fund for future recessions. This system provides a "counter-cyclical" taxing approach which makes unemployment insurance tax rates higher during strong economic times when businesses are most able to pay and lower during a recession when businesses can least afford higher taxes. As a result, Oregon's unemployment insurance program does have higher tax rates now when the system is rebuilding from the last recession in preparation for the next one.

Under the current system, the Legislature has determined that the unemployment insurance trust fund should be funded to provide for 1.5 times the highest 12-month benefit cost rate in the last ten years. To build toward this goal has required Oregon businesses to pay unemployment insurance taxes at the highest unemployment insurance tax rate, Schedule 8, since 1982, when the trust fund was at its lowest level. However, it is expected that businesses will have to pay taxes based on Schedule 8 only until the end of 1989. In 1990, the Employment Division may be able to drop rates to Schedule 6.

This build-up of the unemployment insurance trust fund has put Oregon in a relatively unique and enviable position. Oregon is one of only a few states that did not need to borrow from the federal government during the last recession, and now the unemployment insurance taxes collected from Oregon businesses are helping to build up a large trust fund instead of paying off past loans. The result is to provide a more stable program and ultimately lower tax rates.

During the last ten years, Oregon's unemployment insurance program has worked well and built a solid trust fund to meet the program's needs based on our past experiences. However, in many parts of the country the philosophy of unemployment insurance programs is undergoing change. Traditionally, unemployment insurance provided a safety net for displaced workers while they sought new employment. In Oregon, the current unemployment insurance benefit payments are used to support the unemployed worker and his or her family during the search for a new job and to help maintain the local economy. However, many Oregonians are now structurally unemployed and cannot expect to find similar employment or a new job needing their outdated skills. These workers will probably remain on the unemployment insurance program drawing benefits for the full period of eligibility.

In recent years, some states have begun to recognize structural changes in the work force that require new jobs skills for displaced workers, and they have experimented with providing training benefits as part of their unemployment insurance benefits. These state sponsored retraining programs assist workers in finding employment more quickly. Also, the U.S. Department of Labor has the discretion to create pilot programs to test new unemployment insurance program concepts. Currently the agency is testing a self-employment demonstration project in four states, including Oregon, to distribute unemployment benefits to those unemployed who would like to use their benefits as seed capital to start a business. Oregon needs to pursue these and other innovative concepts to insure that our unemployment insurance program continues to provide the best services to the unemployed while working to keep rates as low as possible.

Opportunities in the Unemployment Insurance Program

The biggest opportunity for reducing unemployment insurance rates centers on the timing of shifts to lower tax rate schedules as the trust fund builds up. Because Oregon has one of the most sound unemployment insurance trust funds in the nation, businesses should be able to anticipate lower tax rate schedules as the trust fund goals are reached. The Governor's Office should appoint a task force of business, labor, and government leaders to study these issues and make recommendations for possible administrative and legislative actions. The Employment Division should provide the technical assistance to prepare the report on the timing of steps to lower rate schedules.

The task force, with assistance from the Employment Division, should also study if its most recent and highest 12 months of payouts remains the most suitable "worst-case model" upon which to plan our future, and if it remains appropriate for Oregon to amass a trust fund equal to 1.5 times our worst-case forecast. In addition, the task force and the Employment Division should analyze the alternative impacts of assigning lower rates to build the trust fund more gradually.

The Employment Division and the Economic Development Department should develop a presentation to better communicate to Oregon businesses the philosophy and operations of the unemployment insurance program and its strong trust fund. In addition, Oregon businesses should be informed that Oregon's unemployment insurance rates are scheduled to decline, and that Oregon's unemployment insurance costs are almost certain to improve substantially over the next two years. This presentation should be coordinated with the work of the task force described above.

Longer term, Oregon should examine the opportunities for tying retraining programs to unemployment insurance. While there are several existing job retraining programs in Oregon, they cannot meet the needs of all those seeking help. And it is obvious that anything that can be done to shorten a worker's time on unemployment insurance or keep the worker from needing to draw welfare will ultimately lessen the tax burdens of businesses and the general public.

The task force, described above, should also study the feasibility of an unemployment insurance financed program to identify structurally unemployed workers and to assist them in obtaining job retraining concurrently with unemployment insurance benefits. The Office of Educational Policy and Planning, in concert with the Employment Division and the Economic Development Department, should take the lead in providing technical assistance on such a study.

Summary of Actions

The Governor's Office will appoint an Unemployment Insurance Task Force of business, labor, and government leaders to study current issues and basic program assumptions which are essential to the operation of the unemployment insurance program. The task force will make recommendations to the Governor on possible administrative and legislative actions which can be considered during the 1991-1992 budget and legislative session. Specifically, the task force should work with state agencies to accomplish the following:

- The Employment Division of the Department of Human Resources will conduct a study and report to the task force on alternative rate schedules for the timing of unemployment insurance rate reductions, and make suggestions on a schedule of reductions. In developing its alternatives, the division should consider the dual goals of amassing an appropriate trust fund before our next recession and reducing, as quickly as possible, the tax rate schedules to make Oregon more competitive.

- The Employment Division of the Department of Human Resources will conduct a study and report to the task force on the continued appropriateness of using the program's current standards and assumptions for the creation and maintenance of the unemployment insurance program trust fund.

- The Employment Division and the Economic Development Department will prepare a report and presentation for the task force explaining to Oregon businesses the philosophy of Oregon's unemployment insurance program and the timing of Oregon's unemployment insurance rate reductions.

- The Office of Educational Policy and Planning, in concert with the Employment Division and the Economic Development Department, will conduct a study and report to the task force on the possible creation of an unemployment insurance financed program which will identify structurally unemployed workers and assist them in obtaining job retraining concurrently with their unemployment insurance benefits.

6.3 HEALTH CARE

Health care costs are a major component of business expense. Employment-based health insurance is the primary method of obtaining health care coverage in this country. Health insurance is a necessary ingredient for attracting and retaining a skilled work force and for reducing employee sick days. The peculiar way in which health care is delivered and financed in this country has dramatically affected the cost of business services and products. For example, the per employee cost of health care for Chrysler Corporation is said to be 400 percent higher than that of Mitsubishi. Such differences in costs have put American businesses at a competitive disadvantage.

The health care industry has not responded well to national cost containment efforts. While some states and a number of corporations have had some success in moderating the rate of growth, health care price increases have been the highest relative to overall consumer price inflation. According to a recent Wall Street Journal report, health insurance premiums are expected to jump an average of 22 percent in 1989 and, in some cases, to a range between 40 and 50 percent. Small firms have been hit hardest and are paying rates 10 to 25 percent higher than larger firms. Soaring health insurance rates were ranked the No. 1 problem by small employers surveyed last June by the National Federation of Independent Business. The cost of doing business and the cost of operating government will be directly and dramatically affected by such premium increases.

Next Steps

Given the recent history and current forecast of health care cost increases, government and business need to work together to find ways to reduce health care costs while providing quality care.

Independent strategies pursued by an individual corporation or by a single purchaser may create rewards in isolated cases, but may come at the expense of cost shifting[4], and do little to reduce costs overall. To assure competitive advantage for Oregon industries, the business community, working in partnership with the state, can and must identify and implement health care cost containment programs. Without such cooperative effort, cost containment will be accomplished through cost shifting and reduced access to care for the uninsured.

It is time now for the state to take a comprehensive look at the issue of health care cost increases, their impact on businesses, school districts, government, and society as a whole. To be successful, such an effort must be lead by the major

[4] This is a practice in which health care providers, typically hospitals, charge a good deal more than the cost of services to those who can afford to pay as a way of making up for providing services to those who cannot afford to pay

consumers of health care, Oregon industry, in cooperation with labor, government, and the health care industry itself.

State Government will therefore support an industry-lead initiative to examine and address the critical issue of health care cost containment. The initiative should include strong representation of health care consumers (including leadership from business and labor), as well as providers. The State will contribute its expertise and resources to the effort as well. The initiative should include a comprehensive review and analysis of state, national, and private industry experiences in containing health care costs. Such an effort should also evaluate the applicability and feasibility of adopting those successful strategies which will enhance the competitive advantage of Oregon businesses. Successful strategies are those that take comprehensive approaches, treat all sectors of the health care industry equitably, and promote greater access without cost shifting. The review should examine the costs, consequences, comprehensiveness, and applicability of all options, including the following:

- All payer systems, and mandatory rate setting

- Managed care systems, contracting and preferred provider organizations

- Self insurance and statewide or state operated insurance pools

- Mandated insurance benefit packages, co-pays and cost sharing, and wellness programs

- Limits on medical liability insurance.

The State Office of Health Policy will provide technical assistance for the effort. We would anticipate that industry would also wish to draw on other consults in this field as well. To be most useful, the effort should be completed during the next 18 months so its recommendations can be considered during the next session of the Legislature.

Any such effort should draw on the work of the recently completed study on improving access to health care for the uninsured population, which is relevant to the cost containment issues. The large number of uninsured Oregonians presents two problems. First, too many people are forced to defer or go without health care. Second, hospitals and health care providers who serve the uninsured typically shift those costs onto private insurers or the State. Reducing the numbers of uninsured could reduce insurance rates.

The initiatives recommended by the Governor's Commission include:

- Provide a small business employer tax credit of up to $25 per employee per month as an incentive for employers to offer insurance coverage for their employees.

- Expand the Medicaid program to reduce the number of uninsured among low-income groups.

- Continue health insurance coverage for the recently unemployed population through a surcharge on unemployment insurance.

- Implement a primary care clinic program to provide outpatient services to indigents who otherwise would fall through gaps in the system.

These recommendations, if fully implemented, would improve health care access for 127,000 Oregonians, just over a quarter of the total uninsured in Oregon, at a cost of about $198 million. These expenditures could help to reduce private sector health premiums by reducing cost shifting by hospitals from the uninsured to the insured. However, the benefit to society or business from such large proposed investments in health care access will be short lived if unaccompanied by effective strategies for containing cost increases.

Summary of Actions

- State Government will cooperate with a broad industry-lead effort to review possible health care cost containment strategies. Such a review should examine the following strategies:

  - All payer systems, and mandatory rate setting.

  - Managed care systems, contracting, and preferred provider organizations.

  - Self insurance and statewide or state operated insurance pools.

  - Mandated insurance benefit packages, co-pays and cost sharing, and wellness programs.

  - Limits on medical liability insurance.

The Office of Health Policy will provide assistance to such an effort.

6.4 TAXES

Oregon's per capita tax levels and its taxes as a percentage of total state income are about average among the states. However, because Oregon's state and local tax structure differs from other states, certain businesses and individuals pay more taxes than they would in other states, while others pay less. The finance system of most states rely on three primary sources for general fund revenue: property taxes, income taxes, and sales taxes. Because we have no sales tax in Oregon, our income and property taxes tend to be high compared with other states. In addition, because property taxes are imposed by local government, there are wide variations in the property tax rates around the state. Jurisdictions with a high concentration of valuable property are able to enjoy more services at lower rates than those with a relatively lower concentration.

The state's reliance on property and income taxes discourage some individuals and companies from locating in Oregon, while encouraging others. Capital intensive businesses may be discouraged by the relatively high property taxes. Individuals with high incomes may be discouraged by Oregon's relatively high income taxes. On the other hand, the absence of a sales tax lowers the cost of living in Oregon, and tends to encourage retail activity here. The literature on economic development concludes that tax policy is not a critical determinant when businesses make location decisions. However, it can be important in individual cases.

As discussed above in Section 3, tax structure issues as they influence business development need to be tied to a broader discussion of Oregon's ability to finance infrastructure and essential public services in a way that fairly treats individuals and businesses. Consequently, we propose that the Oregon Development Board address tax structure issues in the broader context of meeting infrastructure needs.

During the 1987-89 legislative session, income tax rates were reduced from 7.5 percent to 6.6 percent for corporations. They were reduced for personal incomes as well. Part of the reason for these reductions was adoption of tax simplification, which reduced exemptions but resulted in lower rates overall. To reduce costs broadly for businesses and individuals, this philosophy of adopting few tax exemptions should be continued.

There are some specific exemptions that can strengthen Oregon's economic climate, however. Three have been identified in the strategic planning process and have been proposed in the Governor's budget. First, an extension of the energy tax credit at the 25 percent rate will encourage energy efficiency, which is of particular importance to the state's metals industries. Second, a continuation of the pollution control tax credit will help share the costs for pollution mitigation. Finally, research and development tax credits in industries identified by the Science Council will support industrial development of those industries.

Summary of Actions on Tax Structure

- The Governor's Office will ask the Legislature for 1) an extension of the energy tax credit, 2) an extension of the pollution control tax credit, and 3) a research and development tax credit for industries targeted in the Governor's Science Council report.
- As part of a larger investigation of Oregon's capacity to finance infrastructure and essential services, Oregon's tax structure will be reviewed from the perspective of incentives it creates for economic development.

6.5 ENERGY RATES

The Northwest is blessed with an extensive system of hydroelectric dams which produce electricity at low cost. As a result, Oregon and Washington offer competitive electricity rates that have been the foundation for the development of significant industries in the region, most notably basic metals. The hydro system has been fully developed, and it is unlikely that the Northwest will be able to provide new sources of power generation at costs comparable to existing hydro facilities. Nonetheless, Oregon will continue to benefit from low-cost, renewable hydro resources, which should be a competitive advantage for retaining and attracting industries in the future.

However, Oregon and the rest of the Northwest do not enjoy a comparative advantage for natural gas service over other areas of the country. Because electricity has been the dominant source of Northwest energy and because the entry of natural gas service in the Northwest is a relatively recent phenomenon, the base of industrial and residential customers upon which the fixed cost of the natural gas system can be spread is smaller than it is elsewhere. As a result, residential and commercial rates are relatively high. Those industrial customers who can demonstrate that they have viable fuel alternatives to natural gas do enjoy rates that are competitive in national markets. This is because the Public Utility Commission allows the gas companies to lower prices below the full cost of service for those customers in order to keep them on the system and provide revenue margin contributions. Other customers, however, do not enjoy such rate levels.

In this strategic planning process, the metals industry strategy committee raised energy rate issues forcefully. Inexpensive electricity rates have been a key to the success of Oregon's metals industry, and the industry is concerned that this comparative advantage has eroded. For the reasons mentioned above, the state's large comparative advantage that we once enjoyed in energy rates is unlikely to return. However, given the importance of the metals industry in terms of the total number of jobs and the relatively high wage levels paid by the industry, the state needs to concentrate on providing the lowest possible energy rates for natural gas and electricity for industrial customers, consistent with equitable treatment of other customer classes. Furthermore, the state's energy utilities, the PUC and the Department of Energy should also move quickly to provide as many service options as possible to meet industrial customer needs.

We turn to these issues below.

Opportunities to Enhance the Competitiveness of Electric Service
Currently, industrial users are paying electric rates that, in effect, leave them shouldering a higher burden of the cost of providing electric service than are other customers. The Public Utility Commission has recognized this inequity and has been making progress in addressing this issue in recent rate cases. In several cases, industrial rates have been insulated from rate increases or given a large share of rate decreases. The PUC should be encouraged to move as quickly as possible to address any remaining imbalance.

In some cases, the PUC has allowed many industrial electric rates to be lowered below full cost of service to meet competitive situations. (The combined effect of these incentive rate offerings for Oregon electric and gas utilities has been to reduce the energy bills of industrial customers by nearly $50 million annually when compared to standard tariff rates.) On a longer term basis, the largest opportunity for continued competitive advantage in electricity centers on how the state manages growth and electricity demand. Thanks to low-cost hydro resources, electric rates in Oregon are low relative to the cost of constructing new electric generating resources. Therefore, as demand for electricity grows beyond existing capacity, construction of new plants could raise the average cost of electricity and reduce Oregon's competitive advantage. Rather than constructing new facilities (and there are no plans by Oregon's utilities to do so for the foreseeable future), Oregon can choose attractive, low-cost alternatives -- conservation through more efficient use of electricity by customers, and development of alternate resources. By encouraging these measures, Oregon can maintain its low rates longer.

In a proceeding on least-cost planning, the PUC is grappling with the issue of how to ensure that conservation opportunities are considered along with new generating facilities in response to demand. Because this proceeding has long-term implications for maintaining competitive rates in Oregon, it deserves support.

Opportunities to Enhance the Competitiveness of Natural Gas Service
Enormous changes have been instigated by the federal government in regard to the rules by which the natural gas market is regulated, creating challenges and opportunities for Oregon. First, the federal government has deregulated the price

of the natural gas commodity itself. Second, it has required interstate natural gas pipelines to transport gas purchased directly by customers (rather than exclusively selling a single bundled package of gas plus transportation). Third, it has allowed individual industrial customers to connect directly with pipelines to gain service (rather than relying solely on the local gas distribution system for access to pipelines).

The PUC is revamping its natural gas regulatory rules in a way that will fundamentally alter how natural gas service is provided in Oregon. The rules have given industrial customers the right to purchase their own gas supply, which is similar to the rules adopted by the federal government for interstate pipelines. The PUC may also develop new rate schedules that are more competitive with the costs of bypassing the local distribution system and connecting directly with interstate pipelines. These changes will provide greater options and, for some customers, may offer lower rates.

The stakes involved for industrial, commercial, and residential customers with these changes are large. By responding to the competition constructively -- by providing more options and responsive rates -- Oregon's local distribution companies may be able to retain and enlarge their industrial base. The revenues derived from this industrial base can help to hold down the rates for other commercial, industrial, and residential customers. In this environment, the state's local distribution companies and the PUC should continue to work closely with industrial customers to develop rate and service options that are sufficiently attractive to retain the distribution companies' industrial base and encourage new firms to locate in Oregon. This can be done, however, only while ensuring that cross-subsidization between customer classes does not occur.

The PUC and the gas companies are responding to these changes. However, judging from opinions gathered during the strategic planning process, there remains considerable uncertainty, confusion, and in some cases disgruntlement among industrial customers about the pace and nature of the changes contemplated. Therefore, the PUC and the gas companies should be urged to communicate closely with industrial customers to assure that the complex changes in rules are as responsive as possible to industrial customer needs. The Department of Energy, with the assistance of the Economic Development Department, should provide forums outside the more formal PUC process to encourage informal dialogue and sharing of information.

Energy Tax Credits

As mentioned in the previous section on taxes, the energy tax credit program should be extended. The tax credits have spurred major cost-cutting investments by energy-intensive firms in the paper, food processing, and lumber industries as well as primary metals. These improvements not only help to make these industries more competitive, the efficiencies gained relieve the need to make additional investments in expensive new facilities by the utilities.

Actions on Energy Rates

- The PUC should review the allocation of costs among customer classes for the electric utilities in the next general electric rate proceeding or at an earlier date, if possible.

- The PUC should pursue a least-cost planning process for electricity to help minimize electric rates.

- The PUC should revamp the natural gas rate structure to provide as many options to industrial customers as possible, and to provide rates that are competitive with customer alternatives.

- The Department of Energy and the Economic Development Department will work with the PUC and the gas companies to establish forums with industrial customers to discuss the complex changes occurring in the natural gas industry, and Oregon's response to it.