# UNDERSTANDING "REDLINING" IN A COMPETITIVE ELECTRIC UTILITY INDUSTRY

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While redlining is not an issue generally associated with electric utilities, it would be reasonable to expect a competitive, profit-maximizing, electric industry to fall into this discriminatory trap in the future.[1] Redlining is a process of geographic discrimination, where a company either refuses to serve, or to serve on equal terms, an area that is demarcated primarily by racial or socio-economic characteristics.

The issue of redlining in a competitive electric industry has been raised by consumer advocates who fear an industry disinterest in residential customers generally, and in hard-to-serve or payment-troubled residential customers in particular. Indeed, in many of the sets of "principles" being promoted around the country to govern restructuring the electric industry, an anti-redlining provision has merited explicit consideration. While a generalized opposition to redlining is easy to promote, however, articulating specifics on both the problems to be redressed and the remedies to use are somewhat more difficult. To date, such an explicit articulation has not occurred. This paper is designed to begin to fill that gap.

In defining the problem(s) presented by redlining within the context of a competitive electric industry, and developing solutions to that/those problem(s), specific answers to specific questions must be developed, such as:

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[1] Redlining has been an issue in banking (and financial services), insurance of all types, and telecommunications. There is no reason to believe that a competitive electric industry would be any different.

- What *type* of redlining is opposed: geographic or social?

- Is economically *rational* redlining appropriate, or should redlining be unlawful irrespective of its economic justification?

- What is the anti-redlining obligation: a negative one (to avoid particular *ex*clusions) or an affirmative one (to make specific efforts to *in*clude)?

- What activities are to be governed by redlining considerations, the mere extension of service on the one hand or the *type* of service to be extended (and terms under which it is extended) on the other hand?

An appropriate anti-redlining policy for a restructured electric industry depends upon the answers to these questions. And the answers may differ from state-to-state.

Within this context, the purpose of the analysis presented below is three-fold: (1) to provide a basic primer on redlining so as to allow a more concrete formulation of the concerns to be addressed; (2) to articulate some of the more specific redlining issues that might arise; and (3) to identify some of the potential public policy responses for a competitive electric industry based on the potential problems and the available solutions to those problems that have been adopted in other industries.

**WHAT IS "REDLINING"**

The primary emphasis of redlining concerns involves the definition of geographic areas based primarily on racial/ethnic and/or socio-economic factors. A group of advisory committees to the United States Committee on Civil Rights has defined *insurance* redlining as "canceling, refusing to insure or to renew, or varying the terms under which insurance is available to individuals because of the geographic location of a risk."[2] Similarly, redlining within the home mortgage market has been defined as "the process of drawing or outlining a geographic area within which lending will be denied due to the composition or characteristics of the area."[3]

These definitions of redlining are not self-evident. And, indeed, the term "redlining" is often mis-used within this context. The discriminatory treatment, generally, of minorities (or low-income households) does not necessarily constitute "redlining." Instead, the term redlining has a geographic focus. This distinction --between discriminatory treatment of persons and the discriminatory treatment of

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[2] Gary Williams, "`The Wrong Side of the Tracks': Territorial Rating and the Setting of Automobile Liability Insurance Rates in California," 19 ***Hastings Constitutional Law Qrtly*** 845, 861 (1992).

[3] Joan Kane, "The Constitutionality of Redlining: The Potential for Holding Banks Liable as State Actors," 2 ***William and Mary Bill of Rights Journal*** 527, 527, n.8, *citing*, Warren Dennis and J. Stanley Pottinger, ***Federal Regulation of Banking: Redlining and Community Reinvestment*** (1980).

geographic areas-- is discussed in more detail below. Suffice it to say for now, however, that *populations* are not redlined, *geographic areas* are.

## DIFFERENT ASPECTS OF THE ISSUE OF REDLINING

In addition to appropriately defining what "redlining" is, the issue of redlining presents a complex set of subsidiary issues that must be considered in developing an appropriate public policy response. These issues involve answering questions of against whom discrimination is practiced, what represents actions which constitute redlining, and what, if anything, might perhaps justify --legally or from a public policy perspective-- redlining activities.

### *"Geographic" vs. "Socially Sensitive" Redlining*

Despite the geographic-based definition of redlining set forth above, confusion often occurs because of the failure to distinguish between the two types of "redlining" which might raise concerns from the perspective of low-income and minority customers.[4] On the one hand, there is "neighborhood" redlining. On the other hand, there is "socially sensitive" redlining.[5] These two types of discriminatory actions present distinctly different issues and, just as importantly, call for distinctly different remedies.

The first type of redlining involves decisions to extend (or refuse to extend) service based purely on geographic considerations. This redlining involves the classic refusal to serve based solely on *location.* In fact, the name was taken from the practice of certain financial institutions carving out parts of a city where they would not make loans and literally outlining those areas with a red marker. Indeed, the formal legal definition of "redlining" refers to "a pattern of discrimination in which financial institutions refuse to make mortgage loans, regardless of credit record of the applicant, on properties *in specified areas* because of alleged deteriorating conditions."[6] Traditionally, redlining may have involved banks refusing to make loans to residents of certain parts of a city, insurance companies refusing to issue policies, and the like. While there was usually a heavy correlation between the geographic area and low-income or minority status, it was the *location* only and not the socio-economic, or the racial/ethnic, status which served as the foundation of the decision rule.

The second type of action commonly referred to as "redlining" in fact is not within the traditional

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[4] "Neighborhood redlining occurs when a lender limits or refuses to grant mortgage loans for houses in a specific geographic area. Socially sensitive redlining occurs when a lender uses a protected borrower characteristic such as race, national origin, or sex as a variable in the mortgage decision process." Stephen Trczinski, "The Economics of Redlining: A Classical Liberal Analysis," 44 ***Syracuse Law Review*** 1197 (1993).

[5] Jack Guttentag & Susan Wachter, ***Redlining and Public Policy***, at 11 (1980).

[6] ***Blacks Law Dictionary***, at 1279 (6th ed. 1990) (emphasis added).

notion of the practice.[7] These actions involve decisionmaking based on designated "socially sensitive" factors. These factors may include a consideration of race or ethnicity, a consideration of gender, or a consideration of socio-economic status. Redlining based on these factors might include denying home mortgages based on the belief that Blacks are not good credit risks; denying automobile insurance based on the belief that women are not good drivers; or refusing to provide advanced telecommunications infrastructure based on the belief that low-income households do not purchase high technology telecommunications services. While redlining based on socially-sensitive variables may often highly correlate with certain geographic areas, it is not the geographic area which drives the decision rule, but rather the presence (or absence) of some particular characteristic defining the individual.

It is important to distinguish between the two types of discriminatory actions for the public policy responses will likely differ. If the problem is traditional geographic redlining, the appropriate public policy response may be based on the constructs of the federal Community Reinvestment Act (CRA). If the problem is discrimination based on race, ethnicity or gender, however, a CRA response would be ineffective. What would be necessary is an anti-discrimination statute such as the federal Equal Credit Opportunity Act (ECOA), disallowing adverse actions based on protected grounds. The significance of distinguishing between the different types of discriminatory actions is discussed in more detail below.

***Consequences of Redlining***

A second aspect of defining redlining involves a consideration of the consequences which the anti-redlining remedy is seeking to prevent. The first consequence, of course, is a refusal to deal entirely. Perhaps the best example of this refusal to deal involves the denial of a home mortgage. In this instance, there is no commercial relationship which develops between the victim of the redlining practice and the institution engaging in the practice.

Defining and identifying a "refusal to serve," however, may not be as easy as finding an individual person to whom an institution "just said no." A refusal to deal may involve a myriad of gradations. A refusal to deal, for example, may involve a refusal to provide facilities in a particular geographic market. Within the banking industry, one study in Los Angeles found nineteen branch banks in South Central Los Angeles, a predominantly poor Black community having a population of 587,000 people. In contrast, the study found 21 branch banks in nearby Gardena, a middle class white community of only 49,800 persons.[8] This situation is certainly not unique. A study in Washington D.C. found that:

> residents in predominantly white neighborhoods have three times as many branches available, per person, as do residents of predominantly African American

[7] Unfortunately, many people, however, wrap both together without ever considering the distinction. This is unfortunate since they are driven by different considerations and call for different public policy responses.

[8] Brian Porter Zidek, "Discrimination in Lending: Community Adaptations and Government Responses," 1 ***Georgetown Journal on Fighting Poverty*** 460, 463 (1994).

> neighborhoods. In the mostly African American community of Anacostia, only two banks served the 69,000 residents. Customers of these banks had to wait, on average, thirty minutes to cash a check, and far longer if they hoped to speak with a loan officer. By contrast, in the largely white suburb of Chevy Chase, Maryland, the [Washington] Post found eight bank branches along a one-mile stretch of Connecticut Avenue. The Washington Post also found that institutions which served minority neighborhoods were generally staffed with fewer tellers and loan officers.[9]

The conclusion was that "the degree to which financial institutions choose to invest in their branches, and where they decide to locate them, helps to determine the flow of resources into a given community."[10] Given the observation that the offer of financial services arises out of proximity to and awareness of the needs of the community, it comes as no surprise, then, that fewer loans for consumer and home credit transactions were made in the Black communities than in the white communities. There is no reason to believe that the provision of electric services is any different from the provision of banking services in this regard. Electric providers could "refuse to serve" a community or neighborhood simply by choosing to have no presence in that geographic location.

The refusal to provide facilities is much akin to the refusal of some industries to provide the infrastructure necessary to serve a community. A recent study of the investment practices by the Regional Bell Operating Companies (RBOCs), those holding companies which own the local Bell telephone companies, found a distinct pattern of geographic redlining in this regard. According to the United Church of Christ Office of Communications:

> Over the years, the RBOCs have come to believe that households with the greatest disposable income are the most receptive and reliable customers for advanced communication services. Even when confronted with evidence to the contrary, this rule of thumb significantly influences marketing strategy. . .Despite facts that confirm the existence of market demand for advanced communication services among minority and low-income customers, RBOC test marketing and deployment plans are designed to capitalize on the high-income customer.[11]

The offer of new high technology services by the RBOCs depends in large part on the installation of appropriate infrastructure. The provision of video dialtone (VDT), for example, requires the installation of new cable. In its study of the deployment of VDT, the United Church of Christ found that:

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[9] *Id.*

[10] *Id.*

[11] ***In Re.: A Notice of Inquiry Concerning Universal Service and Open Access***, Comments of the Office of the Office of Communications, United Church of Christ, at 4, 6, in National Telecommunications and Information Administration Docket No. 940955-4255 (December 14, 1994).

- o Bell Atlantic's Maryland VDT test trial focused on consumers with a median household income of $54,809. The percent of minorities in Montgomery County (where VDT was test marketed) is 11.6 percent compared to 25.9 percent throughout all of Maryland.

- o Consumers test trialed in Falls Church, Virginia have a median income of $51,011 and are 7.5 percent minority compared to $33,328 and 19.8 percent for statewide data.

- o Richardson, Texas in Southwestern Bell's region has a median income of $50,240 compared to $27,016 statewide. The percentage of minorities in Richardson is 10.7 versus 20.6 percent for the state of Texas.

In this situation, in other words, the RBOCs did not refuse to provide service altogether, but instead refused to provide the same *level* of service to low-income and historically Black communities.[12]

Finally, in addition to this refusal to provide similar levels of service, the redlining to be prevented by public policy may address disparate terms on which service is provided. In this respect, the definition of redlining within the context of the insurance industry may well be a better source of guidance for utility policymakers than the home mortgage definition.[13] Like utilities, insurance involves an ongoing business relationship between the industry and the consumer. Hence, unlike the mere situation where "lending will be denied" in banking, redlining in the insurance industry may also involve: (1) canceling a policy; (2) refusing to renew a policy; and (3) varying the terms under which a policy is available. The utility counterparts to such insurance practices are easy to identify. These include the terms and conditions of the service, as well as the price of the service, itself.[14]

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[12] The significance goes beyond the mere illustrations cited here. The redlining found by the United Church of Christ did not involve isolated incidents. Indeed, the United Church of Christ investigation found that in only two of the ten market trials of video dialtone did the characteristics of the communities resemble the household income and racial composition of consumers statewide. *Id.*, at 6. The investigation also looked, for example, at the Ameritech deployment of video dialtone in 28 Illinois communities. ". . .of the 28 municipalities that Ameritech proposes to serve in Illinois. . .over 90 percent of them significantly exceed the median household income of the state. . .Racial minorities account for less than the state average in 22 of the 28 municipalities. . .In many instances, the proposed deployment area exactly borders communities with high concentrations of low-income and/or minority people." *Id.*, at 9.

[13] *See*, note **Error! Bookmark not defined.**, *supra*, and accompanying text.

[14] "Territorial rating" in the insurance industry, for example, did not involve a refusal to deal. It instead involved wildly more expensive prices based on

### *Economic Rationality as Redlining Consideration*

A third aspect of redlining that must be considered is whether redlining is objectionable only if economically irrational. The rationality of the redlining decision addresses the moral basis for objecting to the decision to redline. In addition, however, the economic rationality addresses the appropriate remedy that should be pursued. In any case, however, just because a decision to redline may be "rational" does not mean that it should be considered *a priori* lawful. Moreover, a decision which is "economically rational" from a business perspective is not necessarily socially optimal from the community's perspective.

A decision to redline may well be an economically rational decision.[15] One example may involve the decisions of the automobile insurance industry to engage in the practice of "territorial rating." Under such a system, auto insurers set policy premiums based in large part on the geographic location of the insured. Locations in large urban areas and inner cities are deemed to be more risky, and therefore more expensive to serve, than suburban areas. Accordingly, the rates charged to the predominantly low-income and minority auto owners in these areas are consistently higher than non-urban, non-poor, non-minority locations. The thing is, the conclusion that urban customers are more risky, and thus more expensive to serve than non-urban customers, may be true. Thus, while the geography-based decisionmaking may be "redlining," it is nonetheless economically rational.

Similarly, just because bank lending patterns are racially discriminatory does not *ipso facto* mean that they are economically irrational. It may well be, in other words, that households in certain geographic areas of the city, as a class, do not have the financial resources to support home mortgages. Even more possible, households in certain geographic areas of a city may not, without further inquiry, satisfy the indices of "creditworthiness" which historically have supported a decision to grant a mortgage. No question exists but that if a bank or other financial institution would pursue a further inquiry, it may ultimately discover the creditworthiness of the households in this area. Nonetheless, to pursue such an inquiry may be expensive and unmerited by the profit potential from that area.

In the alternative, a bank may simply decide that it can generate the same number of loans for an equal dollar value in a different geographic area of the city with*out* engaging in the additional inquiry. In the absence of the additional expense of the further inquiry, the profit margin per loan may be higher and a profit-maximizing enterprise may rationally be drawn to the second geographic area. In sum, ultimately, while the creditworthiness of the households in both areas of town may be equal, the transaction costs in making the creditworthiness decision may be vastly different, thus affecting the profit margin and the decision to serve. In this instance, even if unlawful, the decision of the financial institutional to redline is not economically irrational.[16]

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geographic location.

[15] *See generally*, ***The Economics of Redlining***, *supra*.

[16] As one commentator notes: "In summary, both neighborhood redlining and socially sensitive redlining are the result of rational lending behavior. `Such behavior is illegal, it may well be immoral, but it is rational.'"

In contrast to these rational decisions to redline are the irrational decisions. The irrational decisions involve decisions not to make loans to creditworthy customers based solely on locational considerations. Creditworthy potential homeowners in the inner city, in this scenario, are denied home mortgages even though their risk and/or profit characteristics do not differ from their non-urban counterparts. In this scenario, given identical credit risks, all other things equal, the institution is not responding to its best economic interests but, indeed, is acting to the detriment of its best economic interests.

### SIGNIFICANCE OF DEFINING THE TYPE OF REDLINING

Defining the type of redlining that one seeks to prevent, if nothing else, is important for purposes of deciding upon the public policy responses establishing appropriate remedies for the objectionable behavior. If, on the one hand, the redlining which one seeks to prevent involves irrational and uneconomic decisionmaking, the appropriate response might be simply to promote increased competition. This competition would increase the potential emergence of a firm that would serve this unserved, or under-served, yet profitable market. If, on the other hand, the redlining which one seeks to prevent involves economically rational decisionmaking, promoting additional competition would *not* be the appropriate public policy response. It was the economics of the situation which created the redlining in the first place and additional competition may exacerbate rather than alleviate the problem.

The same need for a definition of redlining is important for fashioning remedies for redlining based on geographic versus socially sensitive factors. Geographic redlining calls for a response along the lines of the federal Community Reinvestment Act (CRA). The CRA places affirmative obligations on financial institutions to serve geographic areas. Making home mortgages to middle class Blacks in suburban neighborhoods does not fulfill this responsibility. In contrast, discrimination based on socially sensitive factors calls for a response along the lines of the federal Equal Credit Opportunity Act (ECOA). The ECOA prohibits discrimination in any part of a credit transaction based on articulated "prohibited bases," including race, gender and ethnicity (amongst others).

The distinctions are not subtle. One remedy has an explicit geographic basis to it while the other does not. Moreover, one remedy seeks to *promote* specific actions by an industry (*i.e.*, community investment in specific communities) while the other seeks merely to *prevent* actions by an industry (*i.e.*, the consideration of prohibited factors).

### POTENTIAL REDLINING ACTIONS BY A COMPETITIVE ELECTRIC INDUSTRY

Given the discussions above, potential redlining decisions that could be expected from a competitive electric industry include:

I. **Refusal to serve:** Electric service providers could decide not to serve particular geographic areas. These might include inner cities, where heavy concentrations of poverty might threaten the easy collection of revenue. They might include various

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***The Economics of Redlining***, *supra*.

areas where lower incomes are viewed as associated with lower use and thus lower profit potentials. This refusal to serve could be evidenced not simply by a refusal to serve (as in the home mortgage industry), but by the cherry-picking found in telecommunications. A decision to serve *only* high income suburban areas, in other words, excluding every other place, would be a type of redlining.

II. **Territorial pricing:** Electric service providers could decide to vary the price for service based on geographic location. Like insurance companies who increased prices based on "territorial ratings," electric companies could allege that the cost of serving particular geographic areas (such as low-income and minority neighborhoods) is higher and thus merits correspondingly higher prices.

III. **Lack of infrastructure development:** Electric service providers could decide to refuse to provide newer technology that permits either a diversification of service or a higher quality service. The infrastructure needed to permit the time-of-day pricing, or real time pricing, underlying retail wheeling sales could be denied to markets that industry participants simply do not wish to serve.

IV. **Lack of facility development:** Akin to the absence of branch banks, electric service providers could refuse to serve certain geographic areas simply by deciding not to develop a presence in those areas. It is reasonable to expect service to follow facilities.

V. **Level and type of service:** Electric service providers could refuse to provide the same quality of service based on geographic considerations. A decision to offer certain neighborhoods or communities service based only on prepayment meters or service limiter adapters would be a type of redlining.

## REDLINING REMEDIES FOR A COMPETITIVE ELECTRIC INDUSTRY

In light of the discussion above, it is appropriate for public policymakers to adopt anti-redlining policies directed toward a competitive electric industry. Some of these policies are developed to promote desired behavior. Others are designed to prohibit undesirable behavior. Five anti-redlining initiatives are necessary and appropriate:

VI. **Disclosure:** The first and foremost anti-redlining device is disclosure. Market participants in the provision of retail electric service should be required to develop and disclose data based on the model adopted in the federal Home Mortgage Disclosure Act (HMDA).[17]

VII. **Licensing Conditions:** A second anti-redlining device is tied into licensing conditions. The operation of this remedy is, in turn, tied to the assumption that even within a competitive electric industry, firms that wish to enter the market in a particular state will be required to obtain a license from the state. Such a license is assumed to be required irrespective of the extent of other regulatory authority, if any, retained over electric producers, suppliers and

[17] Home Mortgage Disclosure Act of 1975, 12 U.S.C. § 2801 (HMDA).

distributors. In this scenario, states should create procedures akin to the Community Reinvestment Act (CRA).[18] Under CRA, different governmental agencies grant permits for branch bank openings as well as for bank mergers. The granting of permits is based upon ratings regarding nondiscriminatory loan-making. Similarly, licensing of electric service providers could be predicated upon ratings regarding the redlining practices of the applicant.

VIII. **Prohibition of *de facto* Discrimination:** A third remedy, which addresses both geographic and "socially sensitive" redlining, involves the adoption of a policy requiring nondiscriminatory access to and deployment of electric services. Such a public policy could be implemented through language based on recent legislation proposed for the regulation of access to and deployment of advanced communications services. A copy of that proposed legislation --modified to relate to the electric industry-- is attached as Appendix A. Similar prohibitions on discrimination can be found in federal statutes such as those governing employment, housing, education, and consumer credit.

IX. **Incentives for Markets to Work:** A fourth remedy, which addresses uneconomic or irrational redlining, is for states to provide incentives for the electric markets to work in serving protected classes. Such incentives might involve tax credits for facilities that are used to serve protected classes. Similar tax credits are used to promote private investment in low-income housing.[19] Under this type of program, the electric service provider would have an additional incentive (in the form of higher returns) to provide service to protected classes.

X. **Alternative Delivery Institutions:** A final remedy for states to pursue is the promotion of alternative institutions through which to deliver electric service to protected communities. Such promotional efforts could follow public policy designed to promote Community Development Financial Institutions (CDFIs) in the financial services industry. Agencies such as community development banks, community development loan funds (CDLFs), and community development credit unions (CDCUs) are serving substantial populations today. Similar government and financial assistance to community-based electric service providers should be considered. In addition, government financing and promotion of Rural Electric Cooperatives (RECs) helped bring electricity to Rural America at a time when investor-owned companies refused to pursue that undertaking. A new endeavor designed to bring competitive electric service to protected communities may be an appropriate policy response to consider.

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[18] Community Reinvestment Act of 1977, 12 U.S.C., § 2901 et seq. (CRA).

[19] Low-Income Housing Tax Credit, ***Internal Revenue Code***, § 42. *See generally*, Herbert Stevens and Thomas Tracy, ***A Developer's Guide to the Low-Income Housing Tax Credit***, National Council of State Housing Agencies (3d ed. 1994).

## PROPOSED ANTI-REDLINING AMENDMENT

### SECTION 1: NONDISCRIMINATORY ACCESS AND DEPLOYMENT OF ELECTRIC SERVICES.

(a) **Prohibition of Discrimination. --** It shall be unlawful for any electric service provider to refuse to provide access to or deploy retail electric services with either the purpose or effect of discriminating on the basis of race, national origin, income, or residence in a rural area. Evidence of a pattern of under-representation of members of classes protected by this section in the deployment of retail electric services shall constitute the effect of discrimination for the purpose of this section. Nothing in this section shall be construed to require the imposition of a quota.

(b) **Submission of Plan for Provision of Service. --** As a condition of receiving or renewing a license, franchise, permit or other authorization to provide electric service, each electric service provider shall submit to the responsible regulatory authorities a plan and periodic reports demonstrating compliance with subsection (a). Plans and periodic reports shall include all relevant tract-level census data in a standard form to be prescribed by the regulatory authorities. There shall be an opportunity for public review of said plans and reports, however, the regulatory authorities shall adopt procedures for the protection of proprietary information electric service providers submit in compliance with this section from access by competitors.

(c) **Rulemaking by the Regulatory Authorities. --** Within one year after the date of the enactment of this section, the responsible regulatory authorities shall complete a rulemaking procedure for the purpose of prescribing regulations that set forth the requirements for compliance with this section, an annual certification of compliance with the provisions of subsection (a), and procedures for monitoring and enforcement. In establishing the requirements for compliance with subsection (a), the regulatory authorities shall consider the best means of ensuring prompt availability of services at the lowest possible cost to members of the classes protected in subsection (a), as compared to the availability of services provided to other inhabitants of the same local area.

(d) **Definitions. --** For the purposes of this Section, the term "quota" shall mean a fixed number or percentage of persons of a particular race, national origin, or income, or a fixed number or percentage of residents of a rural area, which must be attained, or which cannot be exceeded, to which a service must be offered.