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The Honorable John D. Dingell, Ranking Member
Commerce Committee Democratic Office
564 Ford House Office Building
U.S. House of Representatives
Washington, DC 20515

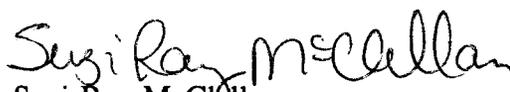
Dear Representative Dingell:

Thank you for the opportunity to provide comments about the impact of electric competition on residential and small commercial customers.

The Texas Office of Public Utility Counsel (OPUC) has been participating as a resource in the current session of the Texas State Legislature's discussions on electric utility deregulation. Whether the state or federal government takes action on retail competition, we believe that many of the issues raised in your questions must be addressed.

Thank you again for contacting our office, and please let us know if we can provide additional information.

Sincerely,


Suzi Ray McClellan
Public Counsel

SRM/jt

Enclosure

Office of Public Utility Counsel's Responses to Committee on Commerce's Questions Dated April 10, 1997

1. How has the increased competition in wholesale electric markets affected consumers in your State to date?

The expected effect of wholesale competition, based upon current economic conditions, is to place downward pressure on retail rates. However, so far the overall impact upon Texas has been relatively small. We anticipate that the benefits of wholesale competition will materialize gradually over the long term.

The reasons for this conclusion are as follow. First, the Texas Public Utility Commission (PUC) has implemented open access transmission rates and IRP resource solicitation requirements only within the last few months.¹ Wholesale competition should increase as open access and competitive bidding gradually affect the market structure. Second, given that a segment of the market is served by unexpired long-term contracts, opportunities for reducing contract costs are limited. Third, for large utilities the potential for fixed cost savings is available only as new incremental resource additions are required. Because of current excess generating capacity in Texas, most of the major utilities have no immediate need for new generation. To this point in time, the most significant cost reductions from wholesale competition have benefited some of the smaller distribution utilities.

We are concerned that some utilities may try to prevent retail ratepayers from receiving the benefits of wholesale competition. Fearing the prospect of retail competition, some utilities advocate the imposition of a rate freeze, which allows them to use generating cost reductions for stranded cost write-downs. One utility (Texas-New Mexico Power Co.), which forecasts major purchase power contract savings in 1998, proposed a transition plan that allowed the utility to retain purchase power savings. Contrary to TNP's proposal, we believe the primary purpose of encouraging wholesale competition is to reduce rates for the ultimate consumer.

2. What role has your office played in any state proceedings on retail competition? What position has your office taken on the issue of whether or not retail competition would benefit consumers and on the issue of whether or not federal legislation mandating adoption of retail competition by a date certain, or any other type of federal legislation, is needed? Do you believe there are substantial

¹ Texas is somewhat unique, in that most customers are served by utilities which are part of the Electric Reliability Council of Texas (ERCOT). ERCOT transmission rates are subject to Public Utility Commission of Texas, rather than FERC jurisdiction.

differences among the various states' consumer advocates, and why or why not?

Over the past two years, our Office has actively participated in workshops and proceedings of the PUC which addressed the wide range of issues pertaining to the implementation of retail competition. In addition, the Office of Public Utility Counsel (OPUC) has been an active intervenor in three contested cases filed by electric utilities in which all or part of the proceeding has been devoted to competitive transition issues.

Retail competition within the power generation sector has the potential to benefit ratepayers. However, whether retail competition is beneficial to consumers depends upon the resolution of numerous issues regarding its implementation. The positions we have taken on some of those issues are exemplified below.

- (a) All classes of customers must have equivalent access to competitive opportunities on a concurrent basis.
- (b) Utilities do not have a constitutional right to full recovery of stranded costs. However, if recovery is granted to further some social good, then costs should be fairly allocated. Such cost recovery should be based on customer's usage, mitigated and offset by other economic variables, and be recovered from all participants and customers.
- (c) To the extent that stranded cost recovery is allowed, ratepayers of utilities with under valued generating assets (i.e., negative stranded costs) should be credited for the difference between those assets' book value and market value.
- (d) So long as market power persists in the generation market, some form of regulatory enforcement should continue. Market shares of incumbent generators must be reduced to levels consistent with workable competition through corporate restructuring or other means.
- (e) Universal service must be assured for all customers, regardless of location or income level.
- (f) Adequate consumer protection is necessary to prevent abusive marketing, sales, and disconnection practices.
- (g) Reasonable regulation of transmission and distribution rates and services must be maintained.

Our impression is that the positions of utility consumer advocate offices regarding the merits of retail competition may vary, depending upon the state. In

large part this is due to substantial differences in electric utility costs among the states. Notwithstanding differences of opinion as to whether competition will be beneficial to particular states' ratepayers, consumer advocate offices are in agreement on some of the important issues which need to be addressed, as evidenced by the resolutions enacted by the National Associations of State Utility Consumer Advocates.

At this time, our office has not taken a position as to whether federal legislation is needed to address retail competition. The response to this question may depend upon how states address the issue.

3. **Some proponents of federal legislation mandating that states adopt retail competition by a date certain argue that substantial numbers of large industrial customers recently have negotiated favorable rates with their public utility commissions. Such proponents have further argued that residential and small commercial consumers lack bargaining power to achieve similar rate reductions. Finally, these proponents argue that federal legislation is essential to ensure that smaller consumers are not economically disadvantaged relative to large industrial customers.**

- a. **Please indicate whether or not you agree with the three premises outlined above.**

We agree that large industrial customers currently are in a superior bargaining position compared to residential and small commercial users, and that many of them have used that advantage to negotiate discounted rates. Industrial customers have more available competitive options than residential ratepayers, including self-generation, co-generation, as well as the option of relocating a manufacturing plant. In some cases, the threat of pursuing one of these options is sufficient to induce a price concession from the utility. Also, some utilities anticipate that industrial customers will be the first users to be given effective access to retail wheeling. As a result, discounted rate deals which have multi-year contract durations can be used by the utility to "lock up" large customers and protect the utility's market share.

Residential and small commercial customers are captives of the utility and thus have no similar bargaining position. In theory, the regulatory commission should use its authority to provide captive customers with equivalent bargaining power. Regulators can set the utility's overall cost of service at a level which more closely emulates competition and reject discriminatory discounted rates. However, frequently regulators have encouraged the promotion and retention of industrial sales as a benefit to the monopoly system. That view becomes less appropriate during a period of transition to competition. At this time we do not have a position as to whether

federal legislation is necessary to address this problem.

- b. In particular, please indicate whether you have reason to believe that large industrial customers are being favored in rate negotiations before public utility commissions relative to smaller commercial and residential customers. What type of state statutory direction generally governs such rate determinations? Historically, how have states balanced the interests of different customer classes? Is this changing?**

The data indicates that average real electricity prices between 1989 and 1994 in Texas declined for industrial customers and increased for residential customers. This divergence reflects a shifting of costs among customer classes as nuclear generating capacity was added to rate base. The cost shifting results from adoption of biased cost allocation methodologies and the creation of discounted rate schedules and riders for large industrials. We believe the Legislature and PUC are now becoming more conscious of cost-shifting. Two years ago, the Legislature enacted a provision which prohibits the shifting of utility costs from discounted customers to captive ratepayers. We are encouraged that recent rate orders of the Commission recognize that industrial customers are not paying for a fair share of generation costs.

- c. What position has your office taken in recent rate proceedings concerning large industrial customers' requests for rate reductions?**

Given the context of the question, we assume that this refers to large industrial customers' requests for discounted rates. OPUC's positions have depended upon the facts in each case. The following illustrate OPUC's typical recommendations: (1) The utility's shareholders should absorb the difference between the standard tariff and the discounted rate; (2) The discounted tariff should be sufficient to pay for generation costs based upon long-run marginal cost, and must recover fully allocated (undiscounted) transmission and distribution costs; (3) The discount should be the minimum required to retain the customer, and must account for all avoided costs and additional revenues which would offset the impact of losing the customer; (4) The contract must not include anti-competitive provisions; and (5) The utility should respond to its uncompetitive cost position by lowering rates for all customers and not just large industrial users.

- d. **In general, have customer electricity prices in your State been rising, holding steady, or falling, and why?**

The answer to this question depends upon the specific time frame, since the trajectory of gas prices varies considerably for various segments of time. In general, electricity prices have followed a declining trend in Texas subsequent to the period (1988-1993) when rates were increased for nuclear plant costs added to rate base. This is due to declining trends in both fuel and base rates. Until recently, fuel costs were generally declining. Fuel rates are adjusted on a frequent basis. Electric utilities' base rate revenue requirements are expected to decrease due to sales growth, depreciation of plant, reductions in utilities' costs of money, and declining work forces. The price of electricity will reflect these reductions to the extent that the Commission promptly engages in overearnings inquiries. The Commission has ordered several base rate reductions for individual utilities over the past three years, and several more inquiries are either pending or are expected to be pursued.

4. **What are the most difficult issues to resolve in connection with utilities' stranded costs? To the extent your State has adopted, or is considering adopting, retail competition, has there been an attempt to distinguish between costs which were prudently incurred and those which were not? If Congress were to enact legislation mandating that states adopt retail competition by a date certain, what, if any, provisions relating to stranded costs should be included? Is securitization a useful tool, and how would it affect different interests?**

The most contentious issue related to stranded costs is determining what proportion of stranded costs, if any, should be recovered by a utility entering a competitive regime. This question is inseparable from many other transition issues, including accelerated depreciation, performance based regulation, and the duration of the transition period. Almost as difficult is the measurement of stranded cost. A proper administrative determination requires a reasonably accurate forecast of market prices over a 20-30 year period. Such a calculation also requires a determination regarding the categories of costs which are "strandable." Finally, the allocation of stranded cost recovery among customer classes is a question which engenders considerable disagreement between residential/commercial customers, on the one hand, and large industrial users. Large industrial customers who have received favorable discounted rates advocate an allocation based upon each class' current contribution to utility revenues. Captive customers oppose such an allocation because it locks in the industrials' free ride for the next 10-15 years of stranded cost recovery, thereby shifting those stranded costs to residential and commercial users.

We are not aware of any interest group in our state who advocates the recovery of stranded costs which were previously disallowed as imprudent. However,

traditional utility rate regulation applies a dual criteria for including invested capital in rate base: the investment must be *used and useful*, as well as prudently incurred. Unlike the prudence test, the used and useful nature of utility property may change over time as market conditions change and the usefulness of the asset changes. Not surprisingly utilities oppose the application of the used and useful criterion to stranded cost. In our view, the used and useful criterion is an important regulatory tool for balancing utility and ratepayer interests.

We do not support any federal legislation which mandates the recovery of stranded costs at the retail level. The equitable issues which surround the resolution of this question are very fact-specific. The state commissions are in a better position to understand the details of their previous rate decisions, the current financial condition of utilities within its jurisdiction, and the nature of the historic allocation of risks between customers and utility shareholders in that state.

Our office has strong reservations about securitization. Securitization places utility shareholders in a better position, with respect to stranded cost recovery, than they now enjoy under regulation. Under regulation, shareholders are entitled to an *opportunity* to earn a reasonable return on investment; securitization *guarantees* the return on stranded investment. If the goal is to achieve interest rate reductions, then similar interest rate reductions may be obtained from more conventional techniques, such as modifying the utility's capital structure. Furthermore, securitization may have anti-competitive consequences. Obviously securitization is a financial benefit which is available only to incumbent utilities, not to any new entrants. By providing utilities with a huge, immediate pool of cash, the move toward increased mergers and acquisitions in the industry will be accelerated. Ironically, the utilities which have made the most costly investment mistakes in the past will be rewarded the most with securitization. The more assets which are securitized, the more these concerns are heightened.

5. **Some proponents of retail competition hold the view that all electricity resources should be sold at market prices and that state authority to regulate retail rates should be eliminated. Could such a policy result in rate increases for customers that currently receive the benefit of such low-cost resources? In a restructured electric utility industry, who should receive the benefits of these low-cost resources -- utility ratepayers, utility shareholders, or simply the highest bidder?**

Even within a restructured electric industry, the states' authority to regulate retail rates should not be eliminated. Although the generation sector is potentially competitive, there is broad agreement that the transmission and distribution functions remain a monopoly which must continue to be regulated. Given the essential role of the "wires" monopoly in enabling effective competition for generated power, regulation of that function becomes more important in a restructured environment.

Furthermore, for the generation sector, limited price regulation role may be necessary until market power problems have been eliminated.

If competitive market pricing is applied to all existing generating resources, it is true that the customers of some utilities with low cost resources will face the prospect of higher rates. In Texas, at least three investor-owned utilities are expected to have net generation costs below market price levels.²

In our opinion, the customers of such low cost utilities should receive a credit or refund for the "negative" stranded costs. In most cases, the current low embedded costs have been achieved because of ratepayers' past payments for depreciation. Under the traditional system of regulated cost recovery, customers paid higher costs in the initial years of plant operation with the promise that they would receive the benefits of lower plant costs in the later years of the plants' lives. Allowing utility shareholders to pocket windfall profits when existing generation plants are deregulated is not consistent with the "regulatory bargain" which high cost utilities use to justify stranded cost recovery.

6. Recently there has been increased discussion of the need for Congress to enact "reciprocity" requirements barring retail sales of power by parties located in states which have not adopted retail competition to parties in states which have adopted retail competition.

a. Do you have a position on this issue?

We do not believe that reciprocity provisions are in the public interest. Reciprocity laws will act as a barrier to entry in generation markets which are in an early stage of development. At least initially, such markets are likely to be highly concentrated. Reciprocity laws will only exacerbate the exercise of market power.

b. Which interests would benefit from a federal reciprocity requirement, which would not, and why?

The interests of incumbent electric generators, who are exposed for the first time to competition, will be protected by reciprocity. The interests of ratepayers in those newly created markets will be harmed. Prices are likely to be higher as a result of the limited number of competitors. The objective of reciprocity may be aimed at a legitimate concern: the possibility that a utility

² Two of those utilities, West Texas Utilities Co. and Southwestern Electric Power Co., are part of a holding Company (CSW) which owns a utility (Central Power & Light Co.) with high stranded costs.

holding company will use its monopoly generation service to cross-subsidize its entry into competitive markets. However, this concern is better addressed through heightened regulation of monopoly/affiliate relationships.

- 7. Does your State currently have adequate tools to protect the interests of low-income electricity consumers if Congress were to mandate retail competition by a date certain? If such legislation were enacted, do you have any recommendations as to how Congress should approach this important issue?**

At the current time our state does not have adequate legislative guidance with respect to this issue. Retail competition raises three potential problems for low-income users: (1) Availability of reasonably priced service; (2) Loss of customer service regulations currently governing utility billing, deposit, and disconnection policies; and (3) Affordability of service. Universal availability of service should be protected by designating a provider of last resort. All marketers and suppliers must be subject to customer service regulations at least equivalent to current PUC requirements. The problem of affordability could be addressed in a manner similar to the universal service fund established for the telephone industry. Any such funding for lifeline services should be supported equitably by all service providers.

- 8. Do you have any concerns about reliability of service or the ability of the interstate transmission or local distribution systems to handle the transactions that would occur if retail competition became more prevalent?**

A major change like electric utility restructuring involves some degree of risk. The integrated utility's transmission, distribution, and generation system was designed to operate together in order to ensure reliable service. The question is whether the measures used to coordinate the restructured industry will be successful in creating an equally reliable system. We are hopeful that the Independent System Operator (ISO) will be successful in ensuring transmission reliability. Because transmission constraints conceivably can be manipulated to affect the availability of low cost generation units, the issue of transmission reliability also has market power implications. For that reason, greater regulatory supervision of transmission operations will be necessary. At this point in time, we have no real experience regarding the impact of widespread retail competition on the distribution system. Ultimately the ISO concept may be required for the distribution network, as well as the transmission system. We have no reason to doubt that the reliability of the distribution system can be maintained in a competitive regime. However, the cost of doing so is subject to some uncertainty.

- 9. Are rural and urban consumers in different positions with respect to their relative ability to bargain for competitive electricity prices? Are all consumers similarly situated in terms of aggregation?**

We have reason to believe that some residential customers could be disadvantaged by the aggregation process which is necessary to achieve retail competition. Rural electric co-ops were initially created because existing utility systems were unwilling to "aggregate" rural customers at a reasonable cost. This fact leads to skepticism regarding the vigor of competition to serve rural customers with small demands. Marketing and metering costs are likely to be higher for aggregators serving those customers. Within urban areas, low income customers and other users regarded as less credit worthy may face an unsatisfactory bargaining position. Please see our response to question no. 7.

- 10. Some proponents of retail competition have argued in favor of federal legislation requiring states to adopt retail competition regimes which include mandatory unbundling of those services currently provided by local distribution companies. What advantages and disadvantages might this pose for consumers? Do you have any recommendations?**

In order to make retail competition feasible for aggregated residential customers, the distribution system costs must be sufficiently unbundled to permit suppliers and marketers to purchase the distribution network services, metering, meter reading, and billing/collection services which are essential to actually serving the end-user. Demand and usage data regarding sub-groups of end users which has been gathered at the expense of monopoly ratepayers should be made available on reasonable and equal terms to all retail marketers.

While we support the concept of unbundling, we believe it should be carried out in a manner which does not result in geographic de-averaging of the distribution utility's rates. The distribution system is expected to remain a natural monopoly for the foreseeable future. There is no need to create new urban/rural price differentials or treat various neighborhoods differently; nor is it practical to do so.

- 11. There is a wide divergence of opinion as to whether or not the Public Utility Holding Company Act of 1935 (PUHCA) should be modified or repealed. In view of the recent merger trend, PUHCA's projections have significance for all states, whether or not they traditionally have been served by a registered holding company.**
- a. Do you believe PUHCA is a significant impediment to competition, at the wholesale or retail level, or can "effective competition" be achieved**

regardless of whether Congress enacts changes to PUHCA?

Given the increasing trend toward mergers among and between utilities and other energy service companies, as well as the tendency for utility holding companies to diversify into unregulated or foreign energy investments, the potential for cross-subsidization of utility affiliates and anti-competitive holding company practices is more significant than ever. For that reason, the repeal of PUHCA is ill-advised at this time. At a minimum, the issue of repealing PUHCA should be deferred until such time as effective competition is flourishing at the retail level. So long as the monopoly utility (the transmission and distribution function) remains affiliated with competitive functions, PUHCA can serve a role of safeguarding the transition to competition.

- b. **Do you believe Congress should modify or repeal PUHCA, why, and under what, if any, conditions?**

See the answer above.

- c. **Should Congress enact legislation to modify the holding in Ohio Power v. FERC, 954 F.2d779 (D.C.Cir. 1992)?**

At the current time, most utility affiliate transactions in Texas are regulated for ratemaking purposes by the Public Utility Commission, rather than FERC. It is our understanding that the Ohio Power case creates a loophole which enables affiliate transactions approved by the SEC to escape FERC scrutiny. The SEC's review of affiliate allocations is performed for purposes other than ratemaking treatment and should not preempt appropriate reviews of those costs by the rate setting authority. We agree that Congress should enact legislation to modify the holding in the Ohio Power case.