

Commission on Electric Utility Restructuring
December 19, 2006
Richmond, Virginia

The Commission on Electric Utility Restructuring met on the afternoon of December 19 to receive reports on the status of the implementation of electric utility restructuring and to review proposals for legislation that may affect the electric utility industry.

Development of a Competitive Market in Virginia

Howard Spinner, Director of the SCC's Division of Economics and Finance, presented the portions of the SCC's annual report that address the status of retail access and competition in Virginia. It was reported that:

- Virginia is administratively prepared for retail competition, but market conditions currently prevent voluntary customer participation. While six competitive service providers are registered in Dominion's service territory, a single marketer is providing power to about 1,300 customers who have switched from their incumbent provider. Four large customers have switched from Delmarva Power in recent months.
- Wholesale market prices for electricity are very high relative to the cost-based rates paid by most Virginians. PJM's real-time locational marginal pricing history has increased from around \$29/MWH from 1999 through 2002, to over \$66 in 2005-2006.
- When rate caps expire, PJM wholesale prices will greatly influence retail prices in Virginia. The single price auction used by PJM means that retail prices based on wholesale market prices may reflect the offer price of the last unit required to meet load, rather than the average cost of power from a diverse fleet of generating resources.
- The SCC cannot assure that the PJM market is competitive and that monopoly pricing power is effectively mitigated, because there is no independent monitoring of the PJM market and the SCC has had difficulty in obtaining data.

The implications of restructuring described by Mr. Spinner include the likelihood that after capped rates end the prices paid by Virginia's electricity consumers could rise precipitously. While post-2010 market conditions cannot be known with certainty, prices could be significantly higher than current capped rate levels. These higher prices are likely to yield extraordinarily high returns to base load coal and nuclear generating resources. However, to the extent that base load resources remain inside the incumbent utility, the units remain subject to state jurisdiction and the Commonwealth's policymakers could mitigate, in a non-confiscatory manner, potentially high retail rate levels.

Development of Regional Competitive Markets

Dr. Kenneth Rose provided the Restructuring Commission with his annual recap of the status of competition and restructuring activity nationally. Since last year, Arizona and Michigan have stepped back from market-based competition by allowing retail access but imposing generation price controls. The key to this year's report is the fact that transition periods are ending in many states, including New York, New Jersey, Massachusetts, Maryland, Delaware, and portions of Illinois and Pennsylvania, which is providing a view of retail rates set by wholesale market

prices. In several of these states, auction prices of electricity have sharply increased between 2005 and 2006.

Dr. Rose observed that rates in states that have implemented market pricing are higher, and are increasing at a faster rate, than in jurisdictions where retail rates are still regulated. While the national residential rate in regulated states has increased from less than 7 cents/kWh in the early 1990s to over 8 cents/kWh in 2005, the average of rates in four restructured states with expired rate caps (Maine, New Jersey, New York, and Massachusetts) have risen over that period from about 10.5 cents/kWh to 14 cents/kWh.

Dr. Rose also identified concerns with a wholesale market structure that he described as having characteristics of an oligopoly. Markets are concentrated regionally, and are highly concentrated locally. Significant entry barriers still exist, due to barriers for new generation capacity and from transmission constraints. Continuous interaction of suppliers increases the likelihood of strategic bidding and tacit collusion. These factors and other unique features of the electricity as a commodity, including the inelasticity of demand and the inability to store it, in addition to the high societal costs of "getting it wrong," have led to the conclusion that competition (or de-integration) may not produce better outcomes than regulation for this industry. However, he noted that while economists are re-thinking deregulation, states do not face an "either-or" choice, and there may be better alternatives than deregulation or traditional integrated utilities with rates based on cost of service. When asked where deregulation has worked, he responded that the answer may depend on how one gauges success. Texas has been called a success by some because its deregulation process has resulted in high rates of customers who have switched from their incumbent utility, but it does not feel like a success to Texans who are paying appreciably higher rates now than they would have paid had the industry not been restructured.

Stranded Cost Recovery by Incumbent Electric Utilities

Deputy Attorney General Maureen Matson introduced Scott Norwood, consultant to the Division of Consumer Counsel. For all Virginia utilities, stranded cost recovery in 2005 totaled \$108 million, which is based on earnings available from capped rates, assuming a 10% return on equity for investor-owned utilities. For the period 2001 through 2005, the cumulative recovery was \$1.444 billion. The utilities' stranded cost exposure for 2005, based on a market price for generation of 5.45 cents/kWh and a generation revenue requirement of 5.63 cents/kWh, was \$338.4 million. Using figures for a "low exposure" scenario, there was no potential stranded cost exposure for any Virginia utility in 2005. However, under a "high exposure" scenario, stranded cost exposure was about 47% of the cumulative stranded cost recovery from 2001-2005.

Mr. Norwood noted that while market prices are down this year, stranded cost results remain highly dependent on generation market prices. They are also dependent on assumed levels of the rate of return that would be permitted under a regulated system and on customer switching levels, for as long as no customers are switching, a utility has no stranded costs. At present, higher market prices and minimal customer choice participation significantly insulate Virginia's utilities from potential stranded costs.

PJM's State of the Market Report

Matt LaRocque of PJM Interconnection LLC, the regional transmission organization to which Virginia's largest utilities are members, addressed concerns with the SCC's report on the status of competition. He disputed assertions that PJM's wholesale markets are not competitive and transparent. He cited efforts of PJM's market monitoring unit (MMU) and FERC to monitor such things as collusion and market power. With regard to access to information, he noted that while regulatory commissions in other states have executed confidentiality agreements that allow them to access data, Virginia's SCC has chosen not to.

Mr. LaRocque defended the use of locational market pricing, noting that this market structure is used in nearly all of the world's commodity markets. He attributed rising market costs for power solely to increases in natural gas prices. He asserted that PJM is providing consumers with tremendous benefits in areas including markets, planning, reliability, and demand-side response programs.

Development of the Virginia Energy Plan

Stephen A. Walz of the Department of Mines, Mineral and Energy provided a report on the status of the agency's preparation of the Virginia Energy Plan. The Energy Plan legislation directs the Department to coordinate the development of the Plan with the Restructuring Commission. The Plan is required to be completed by June 30, 2007. The 10-year plan will be updated every five years. Mr. Walz pledged to communicate with the Restructuring Commission as the Plan is developed.

Legislative Proposals

The Restructuring Commission received presentations from four members who are planning to introduce bills in the 2007 Session affecting electric utilities. The Restructuring Commission announced that it would not take any action regarding the proposals at this meeting.

Senator Mary Margaret Whipple presented legislation that would institute a renewable portfolio standard for investor-owned utilities. It would require that by June 1, 2020, through May 31, 2021, and in subsequent years, 12% of the electric energy sold by utilities to retail customers in the Commonwealth be generated from renewable generation energy sources. The affected utilities would also be required to achieve reductions in the consumption of electric energy by its customers through the implementation of energy efficiency programs, in an amount equal to 5% of the amount of electric energy consumed in 2006. The requirements are phased in through increasing annual steps over a period commencing June 1, 2008, though Senator Whipple is considering alternative approaches. Generators of renewable energy will receive renewable energy credits for power generated through eligible renewable sources or conserved through energy efficiency programs. Suppliers who do not comply with the minimum percentage requirements are required to make alternative compliance payments into a new Virginia Sustainable Energy, Energy Efficiency, and Energy Conservation Fund. Distributors are authorized to recover incremental costs of compliance incurred during the capped rate period under the procedure for recovery of the costs of purchased power.

Senator Roscoe Reynolds presented draft legislation that attempts to address concerns of economic development officials and manufacturers in Southside and Southwest Virginia that looming rate increases in Virginia will cost the region jobs when rate caps end in 2010. North Carolina, which has not restructured its electric utility industry, may see this as a tool in efforts to lure businesses from this state. His proposal seeks to address these concerns by extending the period during which rates for electric service are capped from December 31, 2010, until July 1, 2013. The measure also provides that, upon the end of the capped rate period, rates for default service provided by distributors will be based on prudently incurred costs, rather than on prices in competitive regional electricity markets. Other provisions clarify that the capped rates and default service rates for utilities that have divested their generation assets will be determined in a manner consistent with the terms of the orders of the SCC approving the transfer of such assets. The measure revises the criteria for adjustments to capped rates to provide that after July 1, 2007, certain utilities may seek to recover increased costs through annual full rate cases, rather than through single-issue proceedings.

Delegate Harvey Morgan presented a bill that attempts to address concerns that competition will not develop in a way that will provide benefits to ratepayers in Virginia. His proposal provides that effective January 1, 2008, the rates for customers receiving default service will be determined by the SCC based on the cost of service under the provisions of Chapter 10 of Title 56. The measure also clarifies that the Restructuring Act's provisions do not modify or impair the terms of orders approving the divestiture of an electric utility's generation assets.

Delegate Clarke Hogan echoed Delegate Morgan's remarks that going to market rates will be detrimental to Virginians. His proposal focuses on default service rates, on grounds that without the development of beneficial competition all Virginians will be paying default service rates. The proposal he presented provides that if the SCC is unable to identify regional electricity markets where competition is an effective regulator of rates, it will establish the post-capped rate period rates for a distributor's generation component of default service at rates that are in the public interest, do not prejudice or disadvantage any class of customers, provide incentives for improved performance, are not excessive, and are adequate and seek to ensure the safe and reliable provision of default service. If a distributor asserts that these default service generation rates do not allow it to recover its prudently incurred costs and an adequate return, the SCC will establish the rates in a cost-of-service rate case. He added that inexpensive power must be generated from coal and nuclear generation, both of which require much capital investment. The capital markets, in turn, require an assuredness of the rate of return that the current law does not provide. Given the length of time required to plan and build base load generation facilities, he urged that the Commonwealth move forward without delay.

Dominion's Re-Regulation Proposal

Senator Norment observed the theme expressed by many that concerns exist with deregulation across the country. The Restructuring Commission has served a valuable role in providing legislative oversight through a very deliberate process. Virginia has expressed a willingness to amend the Restructuring Act when circumstances require. Persons concerned with the current track have held discussions regarding the need to revisit the issues and determine whether the

need exists to remake the model. He called on Eva Hardy and Paul Hilton of Dominion to describe the status of that utility's deliberations.

Mr. Hilton introduced a plan that would essentially end the push to the restructuring of Virginia's electric utilities. The plan has three main elements. Capped rates would end two years early, in 2008. Retail choice would cease for all but large industrial customers with a load of at least five megawatts. When capped rates end, rates of investor-owned utilities will be set under a new cost-of-service model that provides, among other features, that a return on equity will be set by adding 6% to the yields on investment grade long-term utility bonds, subject to adjustments of up to 0.5% based on generation performance, operations and efficiency.

The goal of the proposal is to have rates set at levels sufficiently high to make the utility attractive to financial markets. The financial markets would supply the capital for expansions to utilities' generation facilities. It was suggested that consumers would be better off if it built new base-load generation facilities within Virginia that it would if it met rising demand for power by purchasing it from the wholesale market. Mr. Hilton noted that his company is developing a legislative proposal that incorporates these elements.

Other Matters

The discussion of a work plan for the subcommittee on post-capped rate period default service rates was deferred to a future meeting. The chairman announced that members would be polled to set the date for a meeting prior to the 2007 Session, at which Dominion's legislative proposal is expected to be available for review. It was announced that the patrons of the bills presented at this meeting do not need to be present at the January meeting.