QUANTIFYING INCUMBENT ELECTRIC UTILIITIES' STRANDED COSTS

Legislative Transition Task Force
November 19, 2002

Subsection C of § 56-595 of the Restructuring Act provides that members of the Legislative Transition Task Force shall:

> "[A]fter the commencement of customer choice, monitor, with the assistance of the Commission, the Office of the Attorney General, incumbent electric utilities, suppliers, and retail customers, whether the recovery of stranded costs, as provided in § 56-584, has resulted or is likely to result in the overrecovery or underrecovery of just and reasonable net stranded costs . . .

§ 56-584 of the Restructuring Act provides:

> Just and reasonable net stranded costs, to the extent that they exceed zero value in total for the incumbent electric utility, shall be recoverable by each incumbent electric utility provided each incumbent electric utility shall only recover its just and reasonable net stranded costs through either capped rates as provided in § 56-582 or wires charges as provided in § 56-583.

The Restructuring Act provides that shopping customers choosing to purchase generation from a nonincumbent must pay a nonbypassable wires charge as a surrogate for the stranded cost recovery that an incumbent would recover from nonshopping customers. The recovery mechanism will be in effect until mid-2007.

EXAMINATION OF STRANDED COSTS BY JOINT SUBCOMMITTEE

The Joint Subcommittee Studying Electric Utility Restructuring under SJR 91 convened a Stranded Costs Task Force. Members included Senators Watkins and Holland and Delegates Parrish, Plum and Kilgore.

1. Rationale for Stranded Cost Recovery

Stranded cost recovery was one of the most critical policy hurdles the joint subcommittee had to clear as it developed Virginia's restructuring bill.

Arguments for allowing recovery of stranded costs term are based on the "regulatory compact," implicit in the relationship between regulated utilities and their regulators, which provides that in exchange for fulfilling their obligation to serve all customers within certificated service territories, costs prudently incurred by regulated utilities in furtherance of providing such service will be recovered in regulated rates.

Under this theory, any departure from a regulated, cost-of-service environment must make allowance for utility recovery of costs (prudently incurred while fully regulated) rendered uneconomic because of restructuring.

If generation is deregulated, then market price for generation could drop below the rate a given utility is receiving in the current, regulated market. Consequently, the utility's generation assets -- constructed and financed at a time when cost-of-service regulation was in place -- could lose substantial portions of their pre-restructuring book value. Similarly, power purchased from nonutility generators by investor-owned utilities may be at above-market prices in a deregulated market for generation. Additionally, "regulatory assets" (previously deferred, generation-related costs or obligations incurred by a regulated electric utility in providing electricity prior to generation deregulation) were also identified as costs potentially stranded in connection with generation deregulation.

Since Virginia's prevailing electricity prices are low to moderate, some suggested that utilities may realize measurable increases in generation prices above their current, regulated levels following generation's deregulation. This could increase the value of a utility's generation assets above their pre-restructuring book value, resulting in a windfall of "stranded benefits."

Neither stranded costs nor stranded benefits could be calculated in advance of restructuring. The market prices for generation, which is a key variable, is unknown until a competitive market for such generation exists.

2. Elements of Stranded Costs

The report of the Stranded Costs Task Force illustrates the difficulty in agreeing upon a definition of "stranded costs." Task force members distinguished stranded costs and its elements from "transition costs," or costs which utilities may incur in transitioning from a regulated to deregulated market for generation. Illustrative of transition costs are utilities' costs in (i) establishing or joining an independent system operator or regional power exchange and (ii) funding mandatory consumer education programs concerning restructuring.

Primary sources of potential stranded costs were identified as (i) generation asset devaluation, (ii) potential losses associated with above-market purchased power contracts (including cooperatives' wholesale power purchase contracts), and (iii) regulatory assets. Perspectives were provided to the task force by:

> **Virginia Power:** Stranded costs are losses in the economic value of an electric utility's investments and obligations related to the supply of electric generation that result from the implementation of competition in the purchase and sale of electric energy. Virginia Power proposed permitting utilities to recover net losses associated with the onset of retail competition, including the costs of increased consumer and employee benefits, mandated obligations (NUG contracts, nuclear decommissioning, and other governmental requirements imposed prior to competition), transition costs (including the formation of an ISO/RTE), and the net losses in the economic value of generation investments (stranded costs).

SCC: Stranded costs will occur if there is a net loss in economic value of existing generation-related utility assets and contracts from a restructured industry. The change in economic value will be based upon the difference between embedded-cost electricity rates calculated under regulation and competitive market-based electricity prices.

AOBA: Stranded costs represent costs that are recoverable by a utility under existing regulatory policies that are not recoverable under competitive market pricing of services if current regulated rates are above competitive market prices. Stranded value represents profits in excess of a regulated fair rate of return that the owners of regulated generation resources would derive if they are permitted to price energy and capacity services on the basis of market values that are in excess of current cost-based ratemaking levels. The most consistent approach to measurement of the future value of a utility's generation assets is obtained when the utility sells its generation resources through an open competitive bidding process.

Virginia Citizen's Consumer Council: Stranded costs are the difference between the value of generation-related assets currently in rates that have a net book value equal to or above their market value and the value of generation-related assets that have a net book value below their market value, after mitigation efforts, and excluding costs that are avoidable in the future. Stranded costs should be recoverable only when management had no discretion over incurring the costs or when failure to recover these costs would drive the utility into bankruptcy.

Consumer Counsel, Office of Attorney General: Stranded costs in a competitive market are a utility's lost revenues associated with prudently incurred and unrecoverable costs related to utility investments in power production assets. Stranded benefits in a competitive market are a utility's net profits over and above earnings that would result under the continuation of traditional cost-based regulation.

The Division of Consumer Counsel's comments to the SJR 91 subcommittee on stranded costs, a copy of which is attached, illustrates the complexity of the issue. The Division notes that unless and until there is effective competition in the retail electric generation market and customers leave their current provider in favor of a competitor, no stranded costs or benefits can exist.

3. Determining Stranded Costs and Benefits Generally

Senate Bill 1269 as introduced was silent on the issue of who would determine stranded costs. Section 56-595 was amended in committee to direct the Task Force to monitor the issue. Prior to its introduction, the report of the SJR 91 stranded costs task force notes that stakeholders agreed that the State Corporation Commission should play a significant role in addressing stranded costs and stranded benefits. Several proposals specifically enumerated factors that the SCC would use in calculating and determining stranded costs and stranded benefits.

SCC COLLECTION OF STRANDED COST RECOVERY INFORMATION

On October 19, 2000, the SCC entered its final order in the matter of the functional separation of the generation, distribution, and transmission services of incumbent electric utilities. The order discussed requirements for the reporting of information relating to ascertaining to incumbent electric utilities' recovery of stranded costs.

As originally proposed, 20 VAC 5-202-40 B 6 would have required that incumbent electric utilities provide the fair market value of generation assets, even if they intend to transfer these assets at book value. Incumbent utilities opposed the requirement on grounds that, to the extent that transfers to functionally separate units will be made at book value, a market valuation is unnecessary. Some incumbents and independent power producers opposed a related requirement in proposed 20 VAC 5-202-40 B 6 that would have required incumbent electric utilities to provide a year-by-year fair market valuation of long-term power contracts.

The Commission concluded that information about (i) the fair market value of generation assets at the time of their sale or transfer and (ii) the fair market value of long-term power contracts on a year-to-year basis is critical to the Task Force's assessment of stranded cost recovery. However, the SCC added that while it is required to assist the Task Force in monitoring stranded cost recovery, it "will defer to the Task Force to determine as soon as possible, by resolution or some other specific directive to the Commission, whether it will want this information for its use in monitoring utilities' recovery of stranded costs." The SCC's final version of the rule provides that the fair market valuation of generation assets and purchase power contracts will be required "if and when the Task Force directs the Commission to obtain that information for its use pursuant to the Task Force's obligations under § 56-595 of the Act."

The Task Force agreed during its meeting in December 2000 that it would want information regarding the fair market valuation of generation assets and power contracts for use in monitoring utilities' recovery of stranded costs. However, the Task Force was subsequently asked to reconsider this issue. The Task Force revisited the issue at its December 21, 2001, meeting, and unanimously agreed to inform the Commission that it would want the information for use in monitoring utilities' recovery of stranded costs. By letter dated October 21, 2002, SCC Commissioner Clinton Miller observed that the Restructuring Act neither defines stranded costs nor provides any formula or statutory framework for their calculation. In order to monitor the progress incumbent utilities are making toward their recovery of stranded costs, the amount of stranded costs will need to be determined, and some part of the wires charges and capped rates will need to be allocated to their recovery.

STRANDED COSTS METHODOLOGY IN MICHIGAN

The SCC's 2002 report on the status of competition pursuant to section 56-506 of the Restructuring Act discusses the methodology for determining net stranded costs that was adopted by the Michigan Public Service Commission (Part II, p. 53). Net stranded costs are defined as the difference between (i) the revenue requirements associated with fixed generation assets, generation-related regulatory assets, and capacity payments associated with purchase power agreements and (ii) the revenues available to cover those costs.

STAKEHOLDER PROPOSALS ADDRESSING STRANDED COSTS

Proposal 5 in Part III of the SCC's 2002 report on the status of competition pursuant to section 56-506 of the Restructuring Act states that the SCC or General Assembly should calculate recoverable stranded costs for each utility and the pricing of standard offer service should reflect an amortization of those costs over a fixed period of time.

In its response, the SCC notes that the Restructuring Act neither defines stranded costs nor provides any formula or statutory framework for their calculation. "Since there was no determination of reasonable net stranded costs going into the transition (nor any statutory structure for their calculation, thereafter), this may be a challenging task for the LTTF." (Part III, p. 18) The SCC's report further notes:

> [S]ince measuring the 'underrecovery' or 'overrecovery' of stranded costs under § 56-595 C requires their quantification, it will be necessary to adopt a formula or method for their calculation. Moreover, and with respect to monitoring their levels of recovery, it will also be necessary to determine what part of the utilities' capped rates (together with wires charges) should be allocated to stranded cost recovery. Simply put, two things must be done in order to monitor the progress Virginia's utilities are making toward recovery of their stranded costs. First, determine the amount of stranded costs; second, allocate wires charges and some part of capped rates to their recovery. Undertaking any of the foregoing presupposes, however, that authority exists within the Restructuring Act's current statutory framework for doing so.