Presentation to the Task Force on
Stranded Costs and Related Issues
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This task force has the challenge of addressing one of the most controversial and complex issues related to electric industry restructuring. The estimates of the amount of stranded costs in the electric industry range from zero to over $200 billion. To put the upper end of that range in perspective, the total amount of equity in the U.S. electric industry is less than $200 billion.

Stranded costs will occur if there is a net loss in economic value of existing generation-related utility assets and contracts resulting 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.

There are some basic facts about the stranded cost issue that I think are important to keep in mind as you conduct your

task force meetings. First, stranded costs are actually a reclassification of existing costs, they are not a new cost. The costs that may potentially be stranded are reflected in current electric rates. Regulated rates are based upon the actual cost of providing electric service. The assets that are in danger of becoming stranded are sometimes referred to as strandable costs.

That brings me to fact number two: there can be no stranded costs until there is competition. As long as the strandable costs are in a utility's rate base and are included in the rates charged customers, nothing has been stranded and the utility is being fully reimbursed for the assets it uses to provide service.

Fact number three: the only strandable costs are those related to generation assets. As you are aware, electric service consists of generation, transmission and distribution. Since only the generation component of the business is thus far slated for competition, assets related to transmission and distribution will

continue to be covered in regulated, cost-of-service rates. At some point metering and billing may become competitive which then would involve distribution assets.

And fact number four: the embedded cost of some generation-related assets may be below competitive market prices, thus creating stranded benefits, sometimes called stranded margins. These stranded benefits must be netted against stranded costs. Some companies, particularly low-cost utilities, may have net stranded benefits.

There are three types of strandable assets that you will be discussing. Existing utility-owned generating units are an obvious class of strandable assets. A variety of factors will determine the value of the unit, including its age, fuel type, cost of operation and location. Fortunately, the embedded costs of the generating units of Virginia's utilities are relatively low and should not present a major stranded cost problem.

The newest and most expensive generating units are the two Clover coal-fired units jointly owned by Virginia Power and

the Old Dominion Electric Cooperative. When blended with the embedded costs of all of its owned units, the cost of Clover to Virginia Power should not present a problem. For ODEC, however, the high-cost of Clover generation may be significant.

Nuclear units must be viewed in a class of their own. The four nuclear units owned by Virginia Power have very low operating costs. If the units receive life extension approval from the Nuclear Regulatory Commission their value will be enhanced. The nuclear risks that are hard to quantify are the disposal of spent fuel and decommissioning costs.

The second type of strandable assets is the contracts signed by utilities with non-utility generators, or NUGs. This is the largest potential problem in Virginia, in particular the more than 3,000 megawatts of NUG capacity under contract with Virginia Power. In addition, municipals could have stranded costs due to existing wholesale power contracts. Since municipals are not regulated by the SCC, we don't have much information on their potential problem.

The third type of strandable cost is referred to as regulatory assets. These are expenses that were allowed by regulators to be deferred, but would have been expensed by a competitive company. The reason these deferrals have been allowed was to give the utility an opportunity to recover an expense over time. Often, under basic rate-making these expenses would not be recoverable by the utility. Deferrals are possible under regulation because future ratepayers will be there to pay the deferred expense. With retail choice, however, ratepayers may choose another energy supplier.

Let me give you a couple of examples of regulatory assets. During the last several years utilities have refinanced a lot of debt because of low interest rates. Refinancings generally require call premiums and other expenses. With regulatory accounting these expenses are allowed to be written off over the period of the replacement debt, which may be as long as thirty years. In a competitive industry the expenses would be reflected in the year they occurred.

Another example is the write-off of steam generator replacements for nuclear generators, an expense spread over several years under regulation, but a current expense under competition.

Remember, however, we are concentrating on the generation-related assets that are strandable. Regulatory assets, therefore, must be allocated to generation, transmission and distribution. While a steam generator replacement would be 100% generation related, debt refinancing costs would apply to all three segments of the business. An allocation factor would be determined for each utility. Generation is usually 60-70% of the total cost of service.

Now let's turn for a moment to the challenges faced in calculating the appropriate amount of net stranded costs or net stranded benefits. There are two basic ways to make such a determination, an administrative calculation using forecasting and modeling or a market valuation through divestiture of generating assets.

Divestiture certainly has an immediate appeal. By auctioning off generating assets a company can get an objective appraisal of the value of those assets. An auction should be much easier than trying to calculate stranded costs.

The use of divestiture to solve the stranded cost problem has its drawbacks, however. Mandated divestiture is a rather drastic action. Interestingly, where generating assets have been recently divested in other states most, if not all of them have been sold above book value, which would certainly indicate there were no stranded costs for those assets.

Senator Watkins, you may remember the gentleman in Williamsburg two weeks ago at the Regulatory Conference stating that the true value of generating assets may not be fully reflected in their book value. There may be value in the ability to put additional units on the site, the fuel delivery capability, transmission interconnections, the emissions offsets or a number of items that cause a generating unit's value to be above book value.

The timing of divestiture could be critical because it would appear unwise to divest until it was absolutely clear that competition was working and in the public interest. It would be very difficult, probably impossible, to undo a divestiture.

Another complication to divestiture in Virginia is that our largest class of strandable assets is NUG contracts. It may be more difficult to sell a contract than a company-owned asset.

If a market valuation is not used to determine the level of stranded cost, we must depend upon an administrative process, which has the benefit of flexibility but also has drawbacks. In particular, it will be very difficult to administratively calculate stranded costs and stranded benefits.

As previously discussed, stranded costs or benefits are the difference between regulated, embedded-cost rates for electricity and competitive market prices. Their calculation will require a forecast of what the embedded cost of existing generating assets would be over the life of the assets as if regulation continued and then discounted back to today's present value. We would have to

compare this forecast to another forecast of what the market price of electricity will be over the same time frame, once again discounted back to the present.

I don't think I have to tell you the number of assumptions that would be involved in each of those calculations. I can give you an example of how sensitive those assumptions may be. In the rate case of Virginia Power currently on file with the Commission, the Company provides an example stranded cost calculation under a given set of assumptions which reveals an approximate stranded cost exposure of $2.5 billion. However, a change in the projected market price of 15% up or down could either eliminate or double the stranded cost calculation.

A related challenge is that over time the level of stranded costs can change from positive to negative. For instance, the embedded cost of generating assets should come down over time due to depreciation. The market price may increase, especially when excess capacity dries up. Whether the market price goes up or not, the lines may cross at some point in time

making existing generation more valuable and changing a stranded cost into a stranded benefit.

Those types of possibilities beg for the greatest amount of flexibility possible to be built into the process for determining stranded costs. I hope you don't mind my making a brief editorial comment, but policy implementation which locks-in stranded cost recovery based on long-range forecasts of market prices under a market structure that does not currently exist could prove disastrous. Some flexibility can be provided by having an extended recovery period with the ability to true-up the level of recovery at appropriate intervals.

That, of course, assumes that stranded cost recovery will be allowed. Which brings me to the final segment of my presentation to you this morning. Over the next several months you will hear arguments for and against allowing utilities to recover stranded costs. I want to give you a preview of the types of arguments you will hear. This is by no means a

comprehensive list and my intention is to present it as objectively as possible.

From the proponents of stranded cost recovery one of the first arguments is that the so-called “regulatory compact” demands recovery. The regulatory compact involves the concept of a trade-off of obligations between a regulated utility and its customers and regulators. The utility historically had the responsibility to provide reasonably priced and reliable power to all customers within its service territory. If new generating capacity was needed to provide that reliable service, the company was expected to construct or contract for that power no matter what the economic conditions may be. In return, the utility was granted a franchise so that it was the only provider for that territory. It could depend on a relatively steady demand from its customers and the opportunity to earn a reasonable return on its assets.

With restructuring the rules are changing. If customers have a choice of suppliers, they may purchase energy elsewhere

leaving the utility with the generating assets it constructed or contracted for in response to its obligation to serve. Hence, costs are stranded and should be recovered from the customers the assets were intended for.

Proponents of stranded cost recovery claim that such recovery can smooth the restructuring process because anything other than recovery of a substantial portion of stranded costs will cause lawsuits to be filed which will delay the process. They may argue that recovery is required by the Takings Clause of the Fifth Amendment of the U.S. Constitution.

It may be argued that utility investors have consciously accepted a lower, regulated return in exchange for lower risk. Without stranded cost recovery bankruptcies could occur, harming not only utility stockholders but employees as well.

Proponents may point to Order 888 of the Federal Energy Regulatory Commission which allowed full recovery of legitimate, verifiable, non-mitigable stranded wholesale costs. The FERC left it to the states to deal with retail stranded costs.

Opponents of stranded cost recovery may deny that there was ever an implicit contract between utilities and its customers and regulators. They claim that there was a trade-off of exclusive service territory for the obligation to serve, but the consumer never had an obligation to buy.

Opponents argue that utility stockholders have received a rate of return that has adequately compensated them for their risk. If substantial stranded cost recovery is allowed it could provide utilities that made poor planning decisions an undue competitive edge. They argue that other industries that have undergone deregulation have not been provided stranded cost bailouts. AT&T had a massive write-off after its restructuring.

Opponents are also concerned that the allowance of stranded cost recovery will remove all incentives for the utility to mitigate those costs.

A final argument of opponents that I will mention is that stranded cost recovery can delay competition. Since stranded costs are the difference between market prices and embedded

rates, if you add the stranded cost charge to market prices there may be little or no room for competitors to compete. There is apparently some validity to this argument as evidenced by Enron's statements when it recently quit trying to compete in California.

From the customer's perspective, if there is full stranded cost recovery, until the recovery is complete the only way they can save on their electricity bill is if they can buy energy below the market price, which will be difficult to do, especially for smaller customers.

If a utility has net stranded benefits rather than stranded costs, there are similar arguments as to whether ratepayers should be allowed to recover the stranded benefits. There is certainly a symmetry to the issues of utility stranded cost recovery and ratepayer stranded benefit recovery.

You do have a challenging task ahead of you. The only forecast I can provide you with certainty is that the SCC Staff will be here to assist you in any way we possibly can.