

SCC STAFF COMMENTS TO THE STRUCTURE AND TRANSITION TASK FORCE

The May 29, 1998, memorandum from your Staff identified three inter-related restructuring issues that will be the focus of the June 15, 1998, meeting of the Structure and Transition Task Force. This document is to respond to the request to submit written comments relative to *competitive services, market power, and suppliers of last resort*. Our goal is to supply you with meaningful input to assist you in making decisions relative to these three issues. Such input will involve the presentation of facts, the expression of opinions and, as always, the framing of questions.

While the issues you have raised may be viewed as separate and distinct, they are also intricately inter-related. As a result, rather than attempting to discuss them separately, this document will at times interweave the discussion of these three issues to facilitate a logical presentation.

With regard to the determination as to whether a particular electric utility service should be unbundled and subject to competition, at least three distinct questions should be answered:

1. Will the provision of specific services be physically possible, reliable and safe? For example, just as it would not be reliable and safe to have competing air traffic controllers at the same airport, it would not be reliable and safe to have competing entities scheduling power flows in and out of the same area.
2. Will competition be economically efficient? Most analysts believe, for example, that physical transmission/distribution services are more efficiently provided by a single seller than by multiple sellers building duplicative lines and substations in overlapping control areas.
3. Will competition be effective? Will a sufficient number of new, viable, and competent sellers enter the market such that the market power of the incumbent can be overcome and a real competitive market can develop?

We believe there are essentially two main categories of services that should be evaluated as candidates for the competitive market. These services include: (1) generation/generation-related services, and (2) non-generation services such as metering, billing and customer service.

With regard to generation, we believe that competition is physically feasible and likely to be economically efficient, although there will always be a subset of generators that are necessary to support transmission stability and,

as a result, those generators should be identified and withheld from the competitive market, when operating in that mode.

Whether competition to supply generation will be effective is more problematic. Even though generation competition is physically feasible and economically sensible, as a practical matter, competition will not develop unless a sufficient number of new suppliers can and will enter the market to challenge the market power of the incumbent generation owner. The issue of which services should be competitive cannot be addressed in detail without focusing on this market power issue. Market power exists when a firm (or groups of firms acting together) can raise the price of its product or service for sustained periods of time without experiencing an unacceptable loss of sales.

There are a number of distinct issues associated with the potential entry of new generation suppliers into a regional market. Developing a market power policy with regard to generation requires the consideration of two basic questions.

1. What conditions might create market power?
2. What remedies best address the risk of market power?

With regard to those conditions that can lead to market power, decades of service as a monopoly provider of electricity give the present utilities many advantages. These advantages accrue at many levels including: the ownership of local generation; transmission and distribution ownership and control; control of generation sites and fuel sources; and knowledge of customers and their consumption patterns. First, we will focus on the market power associated with competitive generation.

One major reason that generation competition might not be effective is the existence of "load pockets." A load pocket exists when a geographic load area requires the availability of local generation to reliably serve the area because of transmission constraints. When load in an area exceeds the import capability of that area, generators within the load pocket are needed to serve that load and could under certain circumstances exert market power for generation and generation-related services.

The market power associated with the ownership of generation within a load pocket can be exacerbated by a number of factors such as:

- Existing generation sites could be ideal sites for incremental generation, with the advantage of existing land, existing

transmission interconnection, and existing fuel resources and delivery capability.

- If customers have paid to depreciate existing generation plant to levels where the cost of incremental generation is higher than much of the existing generation, new providers may be unable to compete with embedded generation.
- The incumbent utility may enjoy special legal treatment associated with the right of eminent domain, tax treatment or air pollution policies that favor existing rather than new generation.
- Stranded cost recovery could allow incumbent utilities to bid down the price of electricity, thereby keeping out competitive entrants. The loss in revenue associated with low bids might then be made-up via a stranded cost recovery mechanism.

As we have discussed before, a number of factors could act to reduce market power. These include the construction of new transmission facilities to facilitate competition between remote and local generation, the construction of more local generation by competitive entrants and perhaps the divestiture or partial divestiture of existing generation. Until the market power issue is resolved, however, total deregulation of generation should not be seriously contemplated.

There are also a number of market power issues that arise with the specific focus on the provision of a competitive generation market at retail. The previous discussion relative to the market power of generation is certainly applicable if generation is withheld from the retail market in order to extract a higher price. There are also issues associated with name recognition and goodwill that could provide the incumbent utilities with a significant retail advantage if customer inertia is a reality. These factors combined with the incumbent utilities' unmatched knowledge of customer consumption patterns may require a proactive legislative or regulatory effort to provide an atmosphere friendly to the development of a retail competitive market.

As noted earlier, there are a number of "generation-related" services that might also be candidates for a competitive market. The Federal Energy Regulation Commission (FERC) has identified at least six:

- scheduling, system control and dispatch
- reactive supply and voltage control
- regulation and frequency response service
- energy balancing
- operating reserve (spinning reserve service)
- operating reserve (supplemental reserve service)

The FERC has found that some of these services are appropriate for competitive market, while for others competition is not feasible, for physical reasons. For example, FERC has stated that scheduling, system control, dispatch, reactive supply, and voltage control must be purchased from the transmission owner. The other services may be purchased from competitors. However, inasmuch as the last four services listed above require generation, their competitive provision is largely a function of the effectiveness of the generation market.

In addition to the above list, the provision of long-term reserves might be considered as a candidate for the competitive market. With the advent of competition, this need for reserves will not diminish. As a result, sellers (or buyers) must be required to supply reserves. Whether that supply can be procured competitively is again largely dependent on the effectiveness of the generation market.

In addition to generation and generation-related services, the existing utility provides other services "closer to the customer." These include metering, billing and collection, and customer services. Metering includes:

- installation and ownership of the meter,
- operation, maintenance and testing of the meter,
- reading the meter; and
- organizing and analyzing the data supplied by the meter.

Meters may play multiple roles in the development of competition. For example:

- Meters will act as "cash registers" for all sellers of services measured by electricity usage. These may include competitive services such as the sale of electricity and regulated services such as the sale of distribution and/or balancing services.
- Meters will impact the provision of new types of electricity pricing, such as time of day or seasonal pricing.

When determining whether competition in the metering area is physically feasible and economically efficient and whether effective competition will develop, a number of factors must be considered. First as previously noted, meters may be used to measure competitive services (e.g., electricity sales) and noncompetitive services (e.g., physical distribution, and balancing by the distribution company). It is likely that for a particular customer, the same meter will be used in both instances. Because the regulated distribution company may be dependent on metering accuracy in the

provision of its services, there may be justification for a regulatory role in establishing rules or standards for metering.

Effective competition in metering may also depend on "who gets there first" as well as "what gets installed." If incumbent utilities install new meters before competition begins, it may be difficult for new meter suppliers to overcome that advantage. The meters installed by the incumbent may also be incompatible with pricing plans offered by new competitors and as a result may stifle retail competition or limit options available to consumers.

With regard to billing, bill collection and processing, there may be no physical or economic impediments to having the competitive market provide these services. It should be noted, however, that economics of scale may ultimately provide a supplier of these services with a monopoly position. We must also realize that the design and comparability of bills by multiple suppliers have real implications in terms of the ability of retail customers to make efficient and informed decisions. Billing and customer information must also be readily accessible if consumer inquiries are to be handled in a responsible fashion.

Incumbent utilities also interact with existing customers through the provision of specific services such as providing customer information, trouble reporting, resolution of consumer inquiries, etc. While some of these services could be provided competitively, many of them relate directly to the provision of distribution service. On the other hand, it can be argued that such interaction by the distribution company with the customers provides that company with some degree of market power in much the same way that metering and billing by the incumbent utility offer an advantage.

Decisions relative to the provision of a supplier of last resort must focus on a number of issues, a major one being "which entities should supply this service and how should these entities be selected?" There are a number of potential alternatives that should be considered. For example:

- The owner of the physical distribution could be required to provide the service; this could certainly be the incumbent utility.
- Each company selling electricity on a competitive basis could be required to accept a pro-rata share of last resort customers.
- The provider of the supply of last resort could be selected by a competitive solicitation process.

Regardless of the selection process, however, we must ensure, to the extent possible, that the candidate supplier can demonstrate an ability to provide reliable and reasonably priced service. There must also be some way of maintaining accountability for service failure. The often given, and perhaps, easiest response to this issue is to simply let the incumbent utility act as a last resort supplier. However, it should be noted that the provision of distribution service and electricity supply will be separate and distinct in an unbundled competitive environment. The supplier of last resort would not necessarily be required to own generation or distribution. That entity could simply be viewed as a large aggregator who purchases electricity from an exchange, through bilateral contracts, or a combination of both, and delivers that energy to the distribution company who would interact with the last resort supplier exactly as it interacts with all other aggregators. It can also be argued that requiring or allowing the incumbent utilities to serve all consumers who do not migrate to a competitive supplier creates a market power issue on a retail level. Customer inertia could mean that many, perhaps most, consumers will not choose an alternate supplier, the result being that a retail competitive market may be a long time coming. Perhaps a legislative or regulatory "jump start" may be necessary to achieve the goal of a competitive retail market for electricity.

In addition to focusing on whom supplies last resort service, issues relative to customer eligibility for that service must be addressed. Will any consumer, regardless of size, who fails to select a competitive supplier, be eligible for last resort power, or should consumers whose load exceeds a specified threshold be required to purchase power competitively? Should consumers who are rejected by the competitive market or who are terminated by a supplier for non-payment be entitled to last resort supply? What are the implications relative to the cost of this service if poor credit consumers flock to the last resort supplier? How often can a consumer return to the last resort supplier and how should a returning consumer service be priced? What about those consumers whose competitive supplier fails to deliver, and what kind of energy imbalances will be tolerated?

These are but a few of the issues associated with a supplier of last resort that must be dealt with from a legislative and/or regulatory perspective.

In closing, we certainly agree that generation and generation-related services are potentially competitive products. The market power issue must be overcome, however, prior to the full-fledged deregulation of generation. With regard to services such as metering, billing and customer service, a decision does not have to be reached today relative to the competitive nature

of those products. We would urge, however, that you maintain the flexibility to declare such services competitive if and when it is practical, efficient and effective to do so. The consideration of making some or all of these services competitive may ultimately play an important role in providing for a competitive retail market for generation.

Similarly, options relative to the supplier of last resort should be kept open if real customer choice is to become a reality.