June 10, 1998

Hon. Clifton A. Woodrum
Member, Virginia House of Delegates
Co-Chair, Structure and Transition Task Force, SJR 91
Post Office Box 1371
Roanoke, VA 24007

Hon. Thomas K. Norment, Jr.
Member, Senate of Virginia
Co-Chair, Structure and Transition Task Force, SJR 91
Post Office Box 1697
Williamsburg, VA 23187-1697

Re: SJR 91 Subcommittee Task Force on Structure and Transition

Dear Messrs. Woodrum and Norment:

Virginia Power has reviewed the memorandum to the Restructuring and Transition stakeholders and interested parties from the Staff of the SJR 91 Joint Subcommittee dated May 29, 1998. In the subject memorandum, it is stated that the Task Force will convene next on June 15 at 9:00 a.m. and will focus on three interrelated issues identified by stakeholders as critical:

- ***Determining which electricity services will be competitive services following restructuring***
- ***Market power (particularly that related to transmission constraints).***
- ***Supplier of last resort and default providers.***

Virginia Power is pleased to offer the enclosed comments on these three issues.

Sincerely yours,

(signed)

Eva Teig

Enclosures

COMPETITIVE SERVICES FOLLOWING RESTRUCTURING

Electric Energy Supply and Generation

The supply of electricity should be the primary area for the introduction of competition in the electric energy business, and suppliers should be served by a competitive generation market.

Competition among generators is generally acknowledged to be the major source of the potential economic benefits of restructuring. By allowing competition to work effectively through deregulation of generation, market forces will work to lower costs through increased efficiencies. Generators will strive to control their costs in order to sell into a competitive market and consumers will benefit from these lower production costs. Market forces will drive the use of innovative technologies that will enhance efficiency and reduce emissions. Deregulation of generation will lead to investment in merchant plants that will provide the new generating capacity that will be needed in the near future to sustain Virginia's economic growth. Continued regulation of incumbent utilities' generation assets would place Virginia utilities at a disadvantage in a competitive multi-state market. A key principle embodied in House Bill 1172 is the deregulation of generation facilities after January 1, 2002. Only full deregulation of generation provides maximum incentives for efficient production and allows the potential benefits of competition to be realized.

Other Aspects of the Electric Energy Business

As the Commonwealth undergoes the transition to a competitive electric energy market, there will be an opportunity to evaluate the appropriateness of competition for electric energy services other than supply and generation. It may be that some of these other services at some point could be provided by competing suppliers. We agree with the November 1997 State Corporation Commission (SCC) staff report (at pages 42-43), however, that it is premature at this time to determine which of these other services should be subject to competition:

"Although some customer related services may not have monopoly characteristics and could potentially be deregulated, such deregulation may unnecessarily complicate initial restructuring efforts. However, competitive suppliers may also view the provision of these potentially competitive services as business opportunities and as a means to enhance their provision of other energy supply services. These potentially non-monopoly services include metering, billing, payment collection, and customer accounting. Although metering, billing and collecting can easily be provided by competitive suppliers, the deregulation of these services may cause customer confusion and may complicate unresolved issues, such as the collection of gross receipt taxes. The provision of these services is also relatively inexpensive and the benefits associated with their deregulation would likely be minimal.

Some customer related services may also raise safety concerns. For example, utilities currently provide meter bases, or specify standards for meter bases, to assure that substandard equipment is not installed on a customer's home. Local building codes do not typically address standards for this type of equipment. Consequently, the deregulation of the installation of meter bases would require the development and enforcement of additional minimum equipment standards.

In short, while many services that are currently provided by distribution companies may be good candidates for deregulation over the longer term, the deregulation of such services requires careful attention to detail in order to assure that adequate consumer protection measures are in place and to avoid unnecessary customer confusion. Consequently, it may be inappropriate to initiate the deregulation of specific customer related services while dealing with the complexities of introducing retail choice. Such efforts could be addressed during a transition period to a competitive market or at a later time. Given the complexities associated with the implementation of

> retail choice, distribution utilities are appropriate entities for providing customer related services during a transition to a competitive market."

The structure of the electric energy industry and structure of the market for electric energy following restructuring also will be key factors in determining which functions and services, in addition to the generation and supply of electric energy, should become competitive in the future. The establishment of a generation market structure (through a regional power exchange, or RPX) and transmission structure (through an independent system operator, or ISO), for example, will have a major impact on that determination, especially with regard to ancillary services such as scheduling, system control, dispatch service, reactive supply, and voltage control, etc.

In addition, some customer related services that might be made competitive in the future probably would be provided through suppliers and would not require direct customer choice. Billing activities are an example. If billing were subject to competition, billing services ordinarily would be a requirement of a supplier and the supplier would procure these services, not the individual retail customer. Meter reading is another example. Even if meter reading were subject to competition, individual retail customers would not, in general, be expected to select their meter reading company, but, instead, meter reading would be an associated service offered through suppliers. Thus, since few, if any, of these customer related support services are likely to involve procurement by customers, and since the initial focus of restructuring in Virginia has been on the implementation of competitive generation, it will only complicate matters to expand that focus at this time to include the potential for competition in these other customer related services.

It is clear that the transition to competition will take several years. The focus of the debate to date is, as it should be, on those areas that potentially will result in the greatest benefits to retail customers -- the generation and supply of electric energy. For the various reasons noted above and as suggested in the November 1997 SCC staff report, it is not clear at this point what benefits, if any, will be realized from competition in these other services. Thus, in order to allow for the smoothest and most reliable

transition to competition for retail electric energy, and to narrow the risks, we suggest that the focus of restructuring the electric energy industry in Virginia remain on generation and supply at this time and that the advisability of making services other than generation and supply competitive be evaluated later in the transition period.

MARKET POWER AND TRANSMISSION CONSTRAINTS

Virginia Power fully supports the goal of the SJR 91 Joint Subcommittee to develop a workable legislative package for the 1999 General Assembly session. This package should detail the structure of a competitive market for electric energy in the Commonwealth and the elements of the transition to competition. In working toward its goal, the Joint Subcommittee should not be unduly distracted by the "market power" issue, which, while an entirely legitimate concern, has its own place in the transition timetable. Furthermore, the means for an appropriate resolution of market power concerns already are in place.

Market power, or the ability of one company or group of companies to control barriers to market entry, set prices and restrict output, is an issue that necessarily will be confronted during the transition from a regulated monopoly electric service to a fully competitive generation market. The issue really is not whether market power needs to be dealt with, but rather, understanding that there are procedures presently in place for identifying and addressing, at appropriate junctures, any unreasonable constraints on competition posed by any potential market dominance.

SCC Authority to Address the Market Power Issue

The experience of other states demonstrates that market power abuses are avoided or corrected through a combination of state regulatory, FERC, and industry self-policing efforts. Other states and their electric utilities have undertaken or are undertaking the process that House Bill 1172 initiates: the establishment of one or more independent system operators (ISOs) and one or more regional power exchanges (RPXs) to serve the state's electric energy industry. As enacted by the General Assembly, House Bill 1172 seeks to have at least one ISO and RPX in operation by January 1, 2001, a year before the transition to retail competition and the deregulation of generation are slated to commence.

Accordingly, Virginia Power and the Commonwealth's other transmission-owning utilities are engaged in discussions with utilities and other stakeholders regarding the formation of regional ISOs. (Under SCC

Case No. PUE980138, the status of these discussions must be reported monthly to the SCC, and the SCC staff is involved in these discussions.) It is in defining and delineating the rules for such ISOs or any RPX, and in seeking the regulatory approval necessary to establish either, that concerns about transmission constraints and market power have been and will continue to be addressed.

It is vital that any future restructuring legislation allow considerable flexibility in terms of the precise structure and number of ISOs that may serve Virginia. Under existing law, however, the State Corporation Commission will exercise appropriate authority with regard to an incumbent electric utility's participation in an existing or emerging ISO or RPX if the Commission, among other things, is not satisfied that the entity's rules or structure adequately mitigate market power. The SCC staff acknowledges this role in the "Draft Working Model for Restructuring the Electric Utility Industry in Virginia" that was presented to the Joint Legislative Subcommittee on Restructuring the Electric Utility Industry on November 7, 1997 staff report (page 27) which states:

> "States may also influence ISO policies through approval processes that may be required for transfer of transmission control from a utility to another entity and through participation in FERC proceedings."

FERC Authority to Address the Market Power Issue

It is widely acknowledged, of course, that FERC will play a major role in ensuring the mitigation of market power through its supervision over ISO and RPX formation and its continuing oversight of their operation. There are workable markets in place today in several other states, with functioning ISOs and RPXs. Each such ISO and RPX has a set of rules that has been approved by FERC. These entities and FERC have confronted and dealt with the issue of market dominance. When a structure for a competitive electric energy market is in place in Virginia, each relevant ISO and RPX, and FERC, will establish rules to prevent market dominance and remedy transmission constraints in what surely will be multi-state, regional competitive generation markets.

Specifically, the ISOs serving Virginia, like ISOs elsewhere, will be responsible for administering the Open Access Transmission Tariff, which was developed to implement FERC Order No. 888. That FERC order includes eleven principles relating to the required structure and operation of an ISO, four of which (Principles 3 through 6) are particularly relevant to the issues of market power and transmission constraints. They are as follows:

> 3. An ISO should provide open access to the transmission system and all services under its control at non-pancaked rates pursuant to a single, unbundled, grid-wide tariff that applies to all eligible users in a non-discriminatory manner.
>
> 4. An ISO should have the primary responsibility in ensuring short-term reliability of grid operations. Its role in this responsibility should be well-defined and comply with applicable standards set by North America Electric Reliability Council (NERC) and the regional reliability council.
>
> 5. An ISO should have control over the operation of interconnected transmission facilities within its region.
>
> 6. An ISO should identify constraints on the system and be able to take operational actions to relieve those constraints within the trading rules established by the governing body. These rules should promote efficient trading.

Application of these principles is intended to ensure that the ISO will dispatch generation as required, based on system conditions, with no preference given to one utility's generation assets over another’s.

FERC rules further require that after generation is deregulated in Virginia and a competitive market is operating, each generation-owning electric utility in the Commonwealth that desires to sell into the wholesale market within its service territory at competitive prices must file with FERC for authorization to sell generation at market-based rates. In order to receive FERC approval to sell generation at market-based rates, the electric utility

must be able to demonstrate that it does not have market power. The electric utility can demonstrate lack of market power (as derived from the FERC guidelines for market-based rate approval) if it can show that it:

(i) does not dominate the generation of power in the relevant market;

(ii) lacks the ability to block buyers from reaching other sellers using transmission facilities which it owns or controls; and

(iii) cannot erect or control any other barrier to market entry.

FERC will not approve market-based rates for a utility if these tests are not met, and, consequently, a utility denied approval for market-based rates must continue to sell generation at capped, cost-based rates. Even after the electric utilities file for market-based rates, the SCC will have significant input into the granting of market-based or cost based rates by the FERC.

Various Mechanisms for Mitigating Market Power

As has been evident in other states, FERC can require mitigation of market power in the short term through a number of methods. FERC has mitigated market power by requiring RPX bid adjustments, imposing capped bids (essentially creating cost-based rates), requiring bids and analysis of bids to be made available to appropriate parties that may then investigate apparent inappropriate practices, exercising merger approval/disapproval as leverage, and even encouraging voluntary generation divestiture.

The long-term mitigation of market power also will be accomplished through a variety of mechanisms. The ISOs serving the Commonwealth will work with their member utilities to improve transmission grid efficiencies. Any necessary improvements to the transmission grid, as determined by the ISOs and constructed in accordance with existing regulatory procedures, will help to minimize any generation dominance. A major market power mitigation factor in Virginia will be the development of new merchant plants to provide electric energy to the competitive market. In regions of the country that already have established a deregulated, competitive generation market, there has been a substantial influx of proposed new power plant

construction by entrepreneurs. Technology also can contribute to the long-term mitigation of market power in the form of increased efficiencies in existing plants, the development of distributed generation, fuel cells, added levels of self-generation and increased efficiencies in end-use technologies.

The Evolving Nature of Generation and Transmission in a Competitive Market

Finally, it is important to bear in mind that the physical structure of the electric utility industry was created in a regulated monopoly in which each utility was responsible for the service and reliability of its electric energy system in its own service territory. Interconnections between systems were developed over time for reliability purposes, and the expanded use of these interconnections for broader market access is a relatively recent development. As a restructured electric energy market matures, price signals and FERC policy will drive the evolution of generation and transmission to better accommodate competitive services for suppliers and customers. In view of these market realities, legislative action to further define the transition to electric energy competition in Virginia should not be delayed by the market power issue.

Attached to this document are remarks made by Mr. Glenn B. Ross, Virginia Power's Manager of Transmission Planning, before the FERC's regional ISO conference in Richmond on June 8, 1998. Mr. Ross' remarks address several issues pertinent to the establishment of ISO's, including market power and transmission constraints.

SUPPLIER OF LAST RESORT AND DEFAULT PROVIDERS

With restructuring, the law should ensure that electric energy is provided to all retail customers, including those that fall into the following two categories:

- retail customers that are entitled to choose a supplier of electric energy but take no action to effect a change of supplier from their incumbent electric utility; and

- retail customers that are entitled to choose a supplier of electric energy but for which no supplier agrees to provide or is able to provide electric energy.

Retail customers in the former category (*i.e.*, those who take no action upon being given "customer choice") should be deemed to have chosen to continue to receive electric energy from their incumbent electric utilities. These customers should not be "slammed" (*i.e.*, assigned or transferred to another electric supplier without the customer's explicit knowledge and consent) by the legislature, the State Corporation Commission, the incumbent electric utility or any other electric energy supplier. Accordingly, the incumbent electric utility that serves each customer that does not affirmatively choose an electric energy supplier when given the opportunity to do so should be obligated to supply electric energy to that customer at market-based prices.

Retail customers in the latter category include those that are unable to secure an electric energy supplier or obtain electric energy from the supplier with which the customer has an existing contract. In each such case, the electric utility that was the incumbent electric utility in the area in which the retail customer is located should be obligated to supply electric energy to the customer at market-based prices. If satisfying this obligation results in costs to the incumbent electric utility, however, the utility should be compensated through some competitively-neutral recovery mechanism, such as a cost-sharing plan in which all licensed suppliers are required to participate.

The approach of relying on the incumbent utility to provide electric energy ensures the continuity of reliable service in both cases. In addition, it minimizes the customer's risk and provides a needed level of certainty during the transition to competition.

Attachment

Via Federal Express

June 8, 1998

The Honorable David P. Boergers
Acting Secretary
Federal Energy Regulatory Commission
888 First Street, NE
Room 1A
Washington, DC 20426

Re: Docket No. PL98-5-006

Dear Mr. Boergers:

Enclosed for filing is an original and 15 copies of the remarks of Glenn B. Ross made before the FERC's Richmond, Virginia Regional ISO Conference on June 8, 1998 on behalf of Virginia Electric and Power Company. Please return to the undersigned a timed stamped copy of Mr. Ross' remarks in the enclosed self- addressed stamped envelope.

Respectfully submitted,

VIRGINIA ELECTRIC AND POWER COMPANY

(signed)
By: _____
Michael C. Regulinski

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(804) 771-4311

Remarks of

Glenn B. Ross
Manager Transmission Planning
Before The FERC's Richmond, Virginia
Regional ISO Conference
June 8, 1998

Virginia Power is the largest utility in the Commonwealth and is celebrating the recent addition of its two millionth customer. We serve more than 80% of Virginia's population. We own, plan for, maintain, and operate over 6000 miles of transmission wires that have a value in excess of one billion dollars. In spite of this size, Virginia Power has been actively involved in the discussions to form a regional entity to operate a larger transmission network.

Virginia Power strongly supported passage of the Virginia House Bill 1172 earlier this year as a necessary first step in creating a competitive electric industry in Virginia. We are also supporting a transition period for a phase-in of competition. To meet this transition schedule the company is working with the Commonwealth of Virginia SJR 91 Subcommittee, the

Virginia SCC, and many other interested parties to support the development of an ISO for the region. Virginia Power is committed to a course of cooperation and collaboration with electricity providers and other stakeholders.

In my prefiled request to make a statement I focused on the appropriate size, scope, and membership of an ISO; the need to accommodate alternate end-states; and the need to include State initiatives and interests in the formation and deployment of any ISO. Today I will focus on supplier obligations, the issue of transmission constraints and market power, and on the size of the ISO. I have copies of my remarks and they will be at the back of the room at the conclusion of this session.

The transmission and distribution of electricity will continue to be regulated by the FERC and the Virginia SCC, respectively. The Federal Power Act of 1935 established FERC's jurisdiction over interstate transmission, while reserving to the states jurisdiction over facilities used in local distribution. Virginia Power agrees that the transmission function should

be managed by one or more Independent System Operators, as called for in HB 1172.

Our company and the Commonwealth's other transmission-owning utilities are currently involved in discussions with other utilities and emerging regional ISOs that are larger than the Commonwealth of Virginia. Given these ongoing negotiations and the evolving nature of the ISO concept, we believe that any future regulation or restructuring legislation should allow considerable flexibility in terms of the exact structure of the ISO and the precise number of ISOs serving the Commonwealth.

The primary focus of the ISO or ISOs will be system reliability. All suppliers of electricity should have reasonable and non-discriminatory access, at appropriate fees, to the transmission and distribution systems to sell power to customers. Those customers also should have reasonable and non-discriminatory access to any supplier seeking to sell electricity to them.

There should be a uniform set of rules that apply to all in-state and out-

of-state suppliers. Each ISO will certainly have rules that apply to all suppliers using the ISO. In addition, all suppliers seeking to operate in the Commonwealth should be required to obtain a license from the SCC. The SCC must be satisfied that all suppliers have demonstrated financial responsibility, operational ability and sufficient contingency planning. Substantial penalties would be imposed on suppliers who fail to comply with these requirements.

As for concerns related to transmission and market power, we believe strongly that a clear distinction must be made between the two. On the one hand, transmission issues– supply constraints, shortages, etc. – are physical in nature. They have to do with the actual flow of electrons. Market power concerns, on the other hand, are economic in nature. They are about the flow of dollars, and the ability of one company or group of companies to control barriers to market entry, set prices and restrict output. They are different issues entirely, and we recommend they be recognized as such.

There are workable markets in place today with functioning ISOs and

Regional Power Exchanges. They have confronted and dealt with the question of market dominance. It is important to set the right schedule: The ISOs and RPXs must be up and operating for at least one year before deregulation starts.

The point I'm trying to make is this: We must define what the market is before we can determine what constitutes market power. And the market we see evolving extends well beyond Virginia's borders. Its scope will be multi-state, encompassing regional competitive generation markets, thereby reducing any possible impact of localized transmission constraints. As this regional market grows and evolves, concerns about transmission constraints will diminish in importance.

Once this market structure is in place and uncertainty is reduced, we expect significant merchant plant development – similar to the New England experience, where more than 11,000 megawatts of new capacity has been proposed or built – an amount that represents about a 40 percent increase in the region's total existing capacity.

Although Virginia Power's import capability from the west is somewhat lower than from the north or south, our company's total power transfer capability is substantial, and the operation of a free market would not be constrained. Virginia Power's western transmission interface has transfer capability equal to or exceeding what exists across many other regions in the country. Furthermore, the expected construction of generating capacity in Virginia Power's service area by new market entrants will lead to the development of a robust generation market as the transition proceeds.

Let me point out that this import capability is not solely determined by the transmission system of any one utility. For example, Virginia Power's ability to import from the west is restricted to protect the transmission system from widespread outages that could result from the loss of a major transmission line in the Pennsylvania—New Jersey—Maryland interconnection to our north. New facilities built in other states could relieve this constraint and increase the import capability available to serve Virginia customers and the identification of the most beneficial system reinforcements

is a function of the ISO

Virginia Power has not determined an optimum size for an ISO but we believe that an ISO must be constructed with flexibility that allows it to accommodate various members and the resulting differences in size and location of its members. A balance must be struck to ensure that the ISO is sufficiently large to effectively manage relevant loop-flows and regionally identified constraints without just creating a massive centralized ISO structure.

One significant regional issue for Virginia Power is that the ISO footprint should include multiple control areas, but need not necessarily include all utilities within a state or NERC region. A key goal of ISO implementation is the efficient and cost-effective operation as an ISO within a reasonable timeframe without loss of operating security.

As size increases, the ISO may lose local operating and planning knowledge and with it an appreciation and responsiveness to local transmission concerns. In effect a Spruce Goose. Hughes' Aircraft Company proved it could fly, but now it's in a museum. An upper limit on ISO size

will depend upon how well, both economically and operationally, the ISO can meet its functional requirements and still demonstrate timely and appropriate handling of local transmission concerns.