

**Remarks Of
Thomas F. Farrell, II
Executive Vice President, Virginia Power
Before The
SJR 91 Subcommittee
Of The Virginia General Assembly
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Good morning, Mister Chairman and members of the Subcommittee. My name is Tom Farrell, and I am here to speak on behalf of Virginia Power.

I first want to commend this Subcommittee for the important work it is doing to restructure Virginia's electric utility industry and bring competition to the supply of electricity and lower costs to the citizens of the Commonwealth. To ensure that Virginia is able to make the transition to competition in a timely fashion, we strongly endorse the need for additional legislation in 1999 that addresses the details of how a competitive electricity marketplace would function.

Such legislation would strengthen the Commonwealth's competitive position, promote continued economic growth, and enable its citizens to realize the benefits of competitive electricity markets.

Virginia Power believes that the transition period provided for in HB 1172 is appropriate, with the interval between 2002 and 2004 as the target for the phase-in of competition. Although it may not be the most politically popular implementation method, we recommend that the phase-in occur by customer classes over that three-year period. That is, implement retail competition for industrial customers on January 1, 2002, commercial customers on January 1, 2003, and residential customers on January 1, 2004.

We believe that this particular phased method of introducing retail competition is best since it allows for the initial testing of new systems and structures on the fewest number of customers.

Deregulation of generation is the only means of fostering competition among generators to benefit consumers. Generation should be deregulated as of January 1, 2002 – the beginning of the transition to retail competition as provided for in HB 1172.

The transmission and distribution of electricity will continue to be regulated by the FERC and the 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 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 in the Commonwealth to sell power to customers. Those customers also should have reasonable and non-discriminatory access to any supplier seeking to sell electricity to them. And suppliers should be permitted to buy electricity for or on behalf of their retail customers.

Also with regard to suppliers, 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, however, 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.

On the matter of consumer education and protection, Virginia Power supports third-party programs designed to educate consumers about electricity competition. Such programs should be subject to SCC review and approval.

We also support energy conservation, environmental and other public purpose programs and protections, including retraining and other services for utility employees whose jobs could be affected by the implementation of retail competition in Virginia.

As for the issue of stranded costs, we agree with the principle contained in HB 1172 that "[j]ust and reasonable net stranded costs shall be recoverable..." We believe these costs should be recovered in full over a reasonable period of time through a non-bypassable wires charge paid by those retail customers living in the area that was once the incumbent utility's service territory. This principle should include full recovery of all above-

market costs related to power purchase contracts with non-utility generators, most of which came about as a result of the federal law known as PURPA.

Any restructuring legislation enacted by the General Assembly should apply to all utilities doing business in the Commonwealth. However, we believe that municipally-owned or operated electric utilities that confine their operations to their existing service areas should be authorized to opt out of the competitive structure if they choose to do so. On the other hand, a municipality that elects to participate in competitive electric markets and serve customers outside its existing service area should be governed by the same rules that apply to other utilities that are operating in a competitive environment.

Transmission Constraints and Market Power

As for concerns related to transmission and market power, we believe 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 largely 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 by this Subcommittee.

Market power concerns are important, and they must be resolved at the appropriate time. However, the task before the General Assembly and this Subcommittee should be the creation of a structure that allows for the effective operation of competitive markets in Virginia, while maintaining reliable and affordable electric service.

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. Several ISOs to our north and in California have already received FERC approval, which only would have been granted if rules designed to prevent market power abuses had been put in place.

HB 1172 sets the right schedule: The ISOs and RPXs must be up and operating for at least one year before deregulation starts. FERC will only approve an ISO that contains stringent rules to prevent market dominance. That means that competition can only proceed in those cases where the absence of market dominance has been clearly demonstrated. In addition, remedies for transmission constraints have been proposed and implemented in existing ISOs in order to deal with localized constraint problems.

The point I'm trying to make is this: Let's be sure we put the horse before the cart. 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.

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. An additional plant within Virginia would also mitigate whatever transmission constraints exist.

As this regional market grows and evolves, concerns about transmission constraints will diminish in importance. 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.

The fact is, there are only a few times a year during periods of peak demand when any transmission constraints are actually felt. FERC rules governing the operation of already existing ISOs address the rare cases in which transmission constraints interfere with the ability of generators to bid power into the RPX and with the market's ability to set prices. In fact, pricing remedies have been implemented in the existing ISOs to address this concern.

As further evidence of strong FERC involvement in transmission issues, just last week FERC found three midwestern utilities guilty of discriminatory practices regarding use of their transmission grids. The FERC ordered these utilities to free up transmission capacity they had previously said was unavailable.

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 vibrant generation market as the transition proceeds.

Market power issues in large part depend on the size of the market. Virginia Power does not ask for a "Virginia only" market for generation, nor would one ever receive regulatory approval. Even in a "Virginia only" market, Virginia Power may not have market dominance, depending on the

actual operating rules. In a regional, multi-state ISO, Virginia Power clearly would not have market power.

The point is, market power factors will have to be evaluated over a broader area than just Virginia, which means they would be more appropriately addressed by the FERC. That should not, however, deter this Subcommittee from acting to establish a competitive market structure in Virginia.

Mr. Chairman and members of the Subcommittee, all of the issues and principles I have discussed today are critical to the comprehensive restructuring legislation we wish to see enacted in 1999. Virginia needs such legislation in order to keep pace with what's happening around the nation, and to protect its economic health and competitive position.

Virginia Power is committed to a course of cooperation and collaboration with electricity providers and other stakeholders in the Commonwealth. We want very much to reach agreement on restructuring principles that make sense for Virginia. We plan to continue the negotiations that are underway and to work with the four task forces established by this Subcommittee.

Thank you for the opportunity to present Virginia Power's views on this important subject.
