Washington Gas Light Company appreciates the opportunity to address the members of the Senate Joint Resolution 91 Drafting Group ("Drafting Group") concerning the draft statutory language that has been prepared by the Division of Legislative Services in response to the decisions made by the Drafting Group during its working sessions. These comments are designed to give the members of the Drafting Group and the SJR91 Joint Subcommittee a better understanding of the impact of the issues raised by the draft statutory language from the perspective of Washington Gas. We do not intend by our comments here to provide an exhaustive review of all issues raised by the draft statutory language, or to propose specific, comprehensive drafting changes except insofar as to address specific issues. Rather, our comments are focused upon the public policy principles and implications of the existing language, as viewed from our perspective.

§ 56-579. Schedule for transition to competition; Commission authority.

Washington Gas supports the transition schedule set forth in § 56-579. We note that the "period of transition to customer choice" [§56-579(A)(2); defined in Senate Bill 688 in § 56-577] begins on July 1, 1999 and ends on December 31, 2003, unless otherwise extended by the State Corporation Commission ("SCC" or "Commission"). These dates should be retained for purposes of both the transition period and for the purpose for conducting pilot programs in the Commonwealth [§ 56-579(C)(2)].

Washington Gas also believes that § 56-579 sets forth appropriate, balanced and necessary roles for the State Corporation Commission in the following areas:

- SCC authority to establish a phase-in schedule, while assuring that residential and small business customers have at least the same opportunity to exercise choice as other customer classes, measured by percentage of load [§ 56-579(A)(2)(a)-(c)];

- Commission authority to accelerate choice, or to delay choice under certain limited circumstances, while remaining accountable to the General Assembly to explain any delays [§ 56-579(B)];

- Commission authority to examine electric rates, in particular the unbundling thereof, prior to and during the period of transition [§ 56-579(C)(1)]; and

- Commission authority to conduct retail choice pilot programs [§56-579(C)(2)].

As discussed more fully elsewhere in these comments, Washington Gas wants to underscore its view that the SCC must have the authority to examine electric rates prior to and during the period of transition to retail competition. Not only does the Constitution of Virginia assign this role to the SCC in Article IX, section 2, but the rationale for this role and authority has not changed: to assure that consumers are protected until and unless real competition can replace regulation. Further local wires charges and services will continue to be regulated after the restructuring has occurred.

§ 56-579.1. Rate caps.

Washington Gas is generally supportive of the Drafting Group's decision to direct the Commission to adopt rate caps as the mechanism to be used in establishing rates for bundled electric transmission, distribution and generation services applicable to customers receiving default service or supplier of last resort service [see §56-586(C)]. Implemented correctly, rate caps as a form of performance-based ratemaking can provide protection to captive ratepayers through a sharing of benefits of realized efficiencies between ratepayers and shareholders, while freeing the utility from the burdensome effects of multiple rate cases. Two principles of correct implementation are (1) that rates are set correctly and unbundled appropriately at the commencement of any extended period, and (2) that the mechanism attempts to account for

future factors. Washington Gas therefore supports an SCC examination of incumbent electric utility rates prior to the implementation of retail choice. As set forth in § 56-579.1, the mechanism for establishing capped rates for electric generation services for the purpose of effecting customer choice between January 1, 2001 and January 1, 2005 and any extended period raises questions.

The use of capped generation rates as a mechanism for effecting customer choice may have unintended consequences, which include an anti-competitive marketplace, further underscoring the importance of continued SCC authority over both rates and the generation rate cap. For example, an improperly set rate cap could permit an incumbent electric utility to exercise market power by permitting cross-subsidization of its competitive entry while engaging in predatory pricing. We offer a simplified numerical example of how this could happen.

Suppose the decision is made to "cap" the generation component of a utility's rates at $.07, its historic rate, without further examination (this $.07 rate presumably would also be part of the bundled rate for default and supplier of last resort services). Suppose also that the utility's generation costs have declined to $.05 with the passage of time since its rates were last examined, and the "competitive" market rate is $.04 (for the sake of this discussion, we also assume that there is no additional transmission charge or that the combined generation and transmission charge is $.04). Under these circumstances, an incumbent utility could use the sales to its "captive" (default and last resort) customers to sell below its costs of production ($.05) and below the competition (e.g., $.035) to retain market share and discourage entry by the more efficient ($.04) competitor. In addition, the $.07 rate could become the benchmark for determining the amount of stranded costs, when the true benchmark should be the $.05 cost of production (we shall refer to this example later in our discussion of stranded costs). While

Washington Gas supports the goal of lower prices for consumers that competition should bring, we are also supportive of fair and effective competition. Under the circumstances just described, such "competition" would be neither fair nor effective.

We are also concerned that the Drafting Group may have unintentionally circumscribed the SCC's authority to adjust the rate caps. As currently set forth in § 56-579.1(B), the Commission may only adjust capped generation or bundled rates in connection with recovery of fuel costs pursuant to §56-249.6 (which also includes the cost of purchased power) and emergency conditions as provided for in § 56-245. This approach amounts to a rate freeze with a one-way ratchet to increase rates in response to emergency conditions— unless the SCC is provided greater authority to adjust the cap, rates can never go down unless the utility voluntarily chooses to do so.

§ 56-580. Nondiscriminatory access to transmission and distribution system.

Section 56-580(E) addresses the related issues of transmission constraints and market power, and the need for the SCC to regulate rates until it has been determined that the transmission constraint has been relieved. FERC's *Order No. 888* addressed the inability of competitors to obtain non-discriminatory transmission service by tariff, but did not resolve the related issues of market power affecting retail sales and the inability to obtain transmission service to serve Virginia's retail customers due to physical constraints. As the Federal Power Act does not give FERC the ability to address these issues at the retail level, Washington Gas supports the decision by the Drafting Group to assure that the SCC has the authority to address these issues in the manner provided for in § 56-580(E). This authority is necessary to assure that a "regulatory gap" does not develop in this important area of retail sales.

§ 56-581. Independent System Operators.

Section 56-581(A), (B) and (C) set forth the requirement that incumbent electric utilities join or establish an Independent System Operator ("ISO"), the conditions under which ownership, operation, control or management may be transferred, ISO governance, and the role of the SCC in assuring that such transfers promote the public interest. Washington Gas generally agrees with the approach taken in the draft legislation, and the role assigned to the State Corporation Commission.

We note that the role assigned to the SCC in approving transfers of control, ownership or responsibility is generally consistent with the Commission's present authority under Chapters 4[1] and 5[2] of Title 56 to assure that such arrangements "protect and promote the public interest"[3] and that "adequate service to the public at just and reasonable rates will not be impaired or jeopardized[.]"[4] This is an important role for the SCC in the formation of Virginia's competitive retail electric markets, because once Virginia's incumbent electric utilities are part of an ISO, SCC authority with respect to transmission matters may be limited thereafter in many respects to a "seat at the intervenors' table at FERC" rather than as the regulating body.[5] Preservation of this authority helps assure that, to the extent not preempted by FERC, Virginians will be the initial

[1] *See* Chapter 4 of Title 56, *Regulation of Relations with Affiliated Interests*, § 56-76 *et seq.*.
[2] *See* Chapter 5 of Title 56, *Utility Transfers Act*, § 56-88 *et seq.*.
[3] *See* § 56-80.
[4] *See* § 56-90.
[5] FERC has concluded that it has exclusive jurisdiction over the rates, terms and conditions of the unbundled transmission in interstate commerce, by a public utility, of electric energy to an end user. This is also known as retail wheeling in interstate commerce. FERC's jurisdiction over the rates, terms and conditions of transmission in interstate commerce derives from Congress' power to regulate interstate commerce under the United States Constitution and the Federal Power Act. *See Order No. 888*, Appendix G.

decision makers in establishing the contours of the competitive market place for electricity in Virginia.

With regard to the exercise of eminent domain authority after January 1, 2004 [§56-581(D)(2)], we note that under certain circumstances such authority may be needed in conjunction or enlargement of a utility facility whose purpose is the generation of electric energy. For example, siting generation closer to load centers (i.e., areas of customer concentration) may create less stress on the transmission system, result in lower electric losses, and facilitate transfers of electric energy across the transmission system, particularly if there is not much generation near to the load. In such generation-deficient areas, generation siting may be difficult or impossible without the ability of a public service company to exercise eminent domain. This is *not* to say that such authority should remain with the incumbent electric utility, however. Rather, the Commission should maintain authority over siting by establishing rules and regulations to permit, by application and subject to competitive bidding, the exercise of eminent domain upon a showing that the competitive market cannot provide needed generation without the exercise of eminent domain.

§ 56-582. Regional Power Exchanges.

The draft legislative language does not address permissive regional power exchanges ("RPX"). Washington Gas supports the development of voluntary RPXs in conjunction with bilateral contract sales.

§ 56-583. Transmission and Distribution of Electric Energy.

§ 56-584. Regulation of rates subject to Commission's jurisdiction.

Our comments regarding the continued regulation of the generation component of retail electric service are addressed in the previous discussion of rate caps. With regard to competition for metering, billing and other customer services [§ 56-584(B)], Washington Gas encourages the Drafting Group to provide the Commission with the authority to determine when, and for whom, such "revenue cycle" services should be made subject to competition. We wish to point out that as long as these customer-related services are inseparable from distribution service functions, this results in a concentration of market power through the centralization of information collection and management.

§ 56-585. Licensure of retail electric energy suppliers.

Washington Gas supports the decision of the Drafting Group to direct the Commission to establish reasonable and nondiscriminatory requirements for the licensing of retail electric energy suppliers and suggests that licensure requirements for aggregators should be consistent with those for all suppliers. We believe that such requirements should not be so burdensome as to create a barrier to entry, but sufficient to instill public confidence in the development of a truly competitive retail electricity market.

With regard to access to generation and generation reserves [§ 56-585(B)(ii)], we suggest that this provision be clarified to permit the Commission to determine whether such access will be required, and under what circumstances. We also note that while such licensing is not required under § 56-585 prior to January 1, 2002, the Commission is presently examining interim rules for the implementation of electric and natural gas pilot programs in Case No. PUE980812. One area

to be examined in that docket relates to certification issues. It makes sense for the Commission and the participants to address these issues in that docket.

§ 56-586. Suppliers of last resort, default suppliers and backstop providers.

Washington Gas supports the Drafting Group's approach to the issues of supplier of last resort and default provider. The approach approved by the Drafting Group does not foreclose the Commission from designating parties other than incumbent electric utilities to provide either default or supplier of last resort services, while assuring that the Commission may order an incumbent electric utility or distribution utility to provide one or more components of such services. Washington Gas agrees that supplier of last resort service should not be eliminated for particular customers, particular classes of customers or particular geographic areas of the Commonwealth until such time as there is a sufficient degree of competition that elimination will not be contrary to the public interest.

§ 56-587. Licensing of Aggregators.

See **§ 56-585**.

§56-587.1. Municipal aggregation.

§ 56-588. Metering and billing, etc. [see §56-584 for discussion]

§ 56-589. Consumer education and protection; Commission report to legislative task force.

Washington Gas supports the development of an appropriate consumer education program designed to communicate accurate and competitively neutral information to consumers

concerning retail access. We wish to bring to the Drafting Group's attention that the Commission's completion of the development of the consumer education program and its report to the Legislative Transition Task Force (December 1, 1999) may not take place until after electric retail access pilot programs are underway in the Commonwealth. As consumer education is not specifically delineated as an issue to be addressed in the interim rules to be established in Case No. PUE980812, this may need to be addressed as part of the individual pilot programs being proposed.

§ 56-589.1. Retail customers private right of action marketing practices.

§ 56-590. Public purpose programs.

§ 56-590.1. Environment and Renewable energy; net energy metering provisions.

§ 56-590.2. Energy efficiency.

§ 56-590.3 Utility worker protection.

§ 56-591. Stranded Costs.

As a general principle, Washington Gas supports the competitively neutral recovery of just and reasonable net costs associated with assets and obligations that were prudently incurred by a utility on behalf of its customers. This determination requires an accurate identification and measurement of such costs and obligations. However, Washington Gas believes that all

customers should be subject to the non-bypassable wires charge because all customers, including those who choose to remain with the incumbent utility, will benefit from competition.

Section 56-591(A) sets forth the general principle that the SCC shall "determine the just and reasonable net stranded costs associated with all assets and obligations used to provide regulated service within the service territory of such incumbent utility as of January 1, 2002." This provision could be read to mean that the SCC must take a snapshot of the utility's assets and obligations, and the "market" for competitive generation, as of January 1, 2002, and determine the net amount stranded as of that date with no opportunity for a true-up or a requirement that a utility take steps to mitigate its stranded cost exposure. The only flexibility given the Commission would be to vary the length of the recovery period as set forth in § 56-591(B), so long as the utility "has recovered all stranded costs." If this approach to stranded cost determination and recovery is indeed what the Drafting Group had in mind by this language, we urge that this provision be reconsidered.

We return to the example given in discussing proposed § 56-579.1, which deals with rate caps. Under our example, a utility has the generation rate cap set at $.07, the utility's generation costs have declined to $.05 with the passage of time since its rates were last examined, and the "competitive" generation (or generation + transmission) market rate is $.04. If the $.07 rate is the benchmark for determining the amount of stranded costs as of January 1, 2002, stranded cost recovery would be set at $.03. When the true benchmark is set at the $.05 cost of production, the stranded cost recovery would be $.01. Thus, the utility could over-collect its costs that are claimed to be stranded by three times and use those funds to stifle competition by undercutting its competitors.

Now assume that because generation capacity has become more scarce due to load growth, outages and/or other factors, the "market" price climbs to $.07, but the Commission has no authority to revisit the stranded cost issue. In our $.07 example, consumers could continue to pay the $.03 stranded cost recovery charge, while the utility had net stranded margins (excess profits) of $.02 ($.05 production costs v. $.07 market rate for generation). As a result, the utility would realize an overpayment by $.05, which is equal to the utility's costs of production. This outcome would have a chilling effect on competition, competitors, consumers and economic development in Virginia.

As an example of the sensitivity of stranded cost calculations to calculation errors, Mr. Stephens of the SCC suggested at the December 29 meeting of the Drafting Group that a three mill ($.003) error in calculating Virginia Power's stranded costs would amount to almost a billion dollars over four years.

§ 56-592. Nonbypassable wires charges.

Washington Gas supports the use of a competitively neutral wires charge to recover just and reasonable net stranded costs. As the term "transition costs" has yet to be defined, we are unable to address this aspect of the wires charge at this time.

§ 56-593. Divestiture, functional separation and other corporate relationships.

Washington Gas supports the requirement that incumbent electric utilities separate their generation, retail transmission and distribution functions under the Commission's supervision; that such separation prohibit cost-shifting or cross-subsidies between functionally separate units; that functionally separate units be prohibited from engaging in anti-competitive behavior or self-

dealing; that affiliated entities be prohibited from engaging in discriminatory behavior towards nonaffiliated units; and that the Commission establish codes of conduct detailing permissible relations between functionally separate units [§56- 593 (B),(C), 3(sic)].

While we applaud these protections, we are still concerned that, under certain circumstances, such protections alone may be insufficient to adequately address the problem of market power. Market power is of concern because it can reflect the ability of one or a few firms to profitably maintain the price of a product above competitive price levels for a significant period of time. Courts often define market power as the ability to control prices or to exclude competition. *See, e.g., United States v. E.I. du Pont de Nemours & Co.*, 351 U.S. 377, 391-92 (1956). For example, functional separation does not address the related problems associated with transmission import limitations (constraints) and generation ownership concentration, which may permit a generation unit of an incumbent electric utility to price its output above its costs without concern that it will lose market share. While the Commission may determine the rates, terms and conditions for supplier of last resort and default services consistent with the provisions of Chapter 10 of Title 56 [see § 56-586(C)], § 56-593 does not address lawfully acquired market power, that may nevertheless be exercised to the detriment of consumers and competitors alike. In comments presented to the SJR91 Joint Subcommittee, the Federal Trade Commission has suggested that federal antitrust laws would not apply in the case of lawfully acquired market power, and changes to Virginia's antitrust laws may also be necessary for § 56-593(D) to have any coercive effect. We urge the Drafting Group to obtain an opinion from the Attorney General as to the effect of Virginia's antitrust laws under these circumstances.

We also urge the Drafting Group to consider how the treatment of generation price caps and stranded cost recovery will impact the requirement that a generation-function unit of an

incumbent electric utility refrain from "engaging in anticompetitive behavior or self-dealing" [§ 56-593 (C)(2)]. In particular, the impact of these key restructuring provisions should be examined for their impact on state action immunity from antitrust laws.

§ 56-594. Legislative Transition Task Force established.