SCC STAFF COMMENTS TO THE STRUCTURE AND TRANSITION TASK FORCE

OUTLINE OF RESTRUCTURING

Introduction

The Staff of the State Corporation Commission appreciates this opportunity to respond to the Structure and Transition Task Force with comments on alternative electric industry restructuring plans for the introduction of customer choice in Virginia.

While the Staff continues to have concerns with respect to the potential impact of electric industry restructuring within Virginia, we offer an outline for restructuring to accomplish the objective of providing retail customer choice as established by the 1998 session of the General Assembly. Consistent with other states that have legislated restructuring plans, it is necessary to define responsibilities with respect to the basic policy issues the General Assembly will resolve and those issues that should be addressed by the Commission. In this paper, we discuss twelve broad restructuring issues and alternative approaches for resolving decisions that must be made. Certainly, this is not an exhaustive list of restructuring issues, but we believe it includes most of the major issues that might require initial legislative attention.

The issues discussed are:

I. Commencement of Customer Choice
II. Last Resort and Default Service
III. Eminent Domain
IV. Market Power and Regulation of Generation Assets
V. Mixing Competitive and Noncompetitive Business
IV. Independent System Operator and Power Exchange
VII. Licensing
VIII. Stranded Cost
IX. Distribution Service
X. Municipals and Cooperatives
XI. Special Implementation Issues
XII. Deregulation

The Commission Staff views electric industry restructuring as a complex and evolutionary process. We encourage the consideration of legislation that both recognizes the desirability of maintaining flexibility and provides appropriate consumer safeguards of varying degrees as restructuring unfolds. The industry's current organizational structure and resulting physical infrastructure present the potential for enormous incumbent market power in the initial stages of restructuring. We believe that a prudent restructuring plan should entail a sequential process that: 1) provides for customer choice and the structuring of an environment conducive to the development of competition; 2) provides adequate time for the development of such competition while protecting consumers from potential market abuses during the transitional stages; and, 3) provides an opportunity for an objective determination that a sufficient level of competition exists and that Virginia's public interest will be adequately protected prior to a reduction in traditional regulation for any particular service. Similar legislative approaches have been employed in the insurance and telecommunications industries in Virginia.

From this perspective, we believe it is essential that legislation not treat restructuring as a one-time, final decision. In the following discussion of restructuring issues, we believe it becomes apparent that there should be a continuum of decision making so that an increasing level of competition corresponds with a diminishing level of regulation. As the forces of competition grow, the type and intensity of consumer protection imposed through traditional regulation can be relaxed. However, reductions in regulation should not be made at the initial stages of the restructuring process prior to the development of competitive forces that adequately provide the protections that have been afforded Virginia consumers through regulation. Such an approach would in fact jeopardize the ability to ensure reliable electric service at reasonable and just rates during industry restructuring.

I. Commencement of Customer Choice

The General Assembly envisions the commencement of retail customer choice in Virginia on January 1, 2004. Legislation which defines the Commission's responsibilities in this area should cover at least three items: (a) determining which specific services should be available for customer choice; (b) addressing situations where the prerequisites for customer choice may not be in place by the time of the legislative deadline; and (c) maintaining protective measures until competition becomes an effective regulator to protect consumers. Each is discussed below.

A. What Services Should Be Available for Customer Choice?

The General Assembly has not indicated which specific services, such as generation, metering and billing, are to be available for customer choice. As noted in the SCC Staff's prior submission to this Task Force, the appropriateness of whether to subject particular services to competition depends on physical and economic factors that can change over time.

The General Assembly has several options that include:

1. specifying in legislation the services which must be available for customer choice; or

2. directing the Commission to determine which services should be available for customer choice, applying criteria specified by the General Assembly. The criteria might include effects on cost and reliability, the likelihood that a sufficient number of competitors would enter the market, and effects on the Commonwealth's jurisdiction over these matters as compared to federal regulators.

B. What if the Prerequisites of Safety, Reliability and a Sufficient Level of Competition Are Not in Place by the Time of the Legislative Deadline?

The right to choose alternatives is not the same thing as having options from which to choose. Put another way, authorizing competition is not the same thing as having competition. Effective competition depends on factors not yet in place in Virginia, among them: a sufficient number of competitors, one or more independent system operators and power exchanges, educated consumers, and new metering and regional mechanisms necessary to assure reliability and accountability. These market factors may be in place before 2004; or they may still be absent.

The General Assembly has several options for addressing situations where the prerequisites, including safety, reliability and competitiveness, are not in place by the time of the legislative deadline. For example, the General Assembly could:

1. declare that customer choice for all services must begin on January 1, 2004 even if the prerequisites are absent; or

2. allow the Commission to authorize customer choice earlier than January 1, 2004 if the Commission finds that the prerequisites are in place and that the Commonwealth will benefit from this action; and

3. provide that if the Commission finds that prerequisites established by the General Assembly will not be in place in time, the Commission would be required to authorize customer choice at the earliest practical date after January 1, 2004 on which these criteria are met. These criteria might include safety, reliability, and an interim resolution of potential market power problems.

If the General Assembly were to require the Commission to delay the commencement date upon finding an absence of established criteria, the legislation could further define the use of such authority by: (a) requiring the shortest practical deferral; and (b) requiring the Commission to report to the General Assembly on any deferral decision, with reasons, in advance of the 2003 legislative session, so that the General Assembly could consider additional legislative direction if found appropriate.

C. Rate Protections until Market Power Is Eliminated

On the date customer choice is authorized, it is highly unlikely that there will be a sufficient level of competition to protect consumers from the market power of incumbent utilities due to a limited number of competitors and/or physical infrastructure limitations. While this situation necessitates the deferral of a decision to reduce the traditional regulatory protections afforded consumers with respect to the incumbent utility's generation assets, it does not necessarily require a delay in customer choice. Instead, the General Assembly could authorize the Commission to apply retail rate limits in the form of caps or freezes for the incumbent utility, or even all competitors, to prevent unreasonable pricing until sufficient competition develops. Virtually all states pursuing restructuring have instituted some form of rate protection during the transition to fully competitive markets.

II. Last Resort and Default Service

Legislative authorization of customer choice does not guarantee that every customer will choose, or be able to choose, a competitive supplier. In fact, it is probable that most retail customers, who are generally risk averse and may not fully understand the electric industry or its restructuring, will choose to "wait and see", at least initially. Less than one percent of residential customers in California chose an alternative supplier when retail choice was first offered earlier this year. States authorizing retail competition have sought to address this problem by making available some form of "last resort" or "default" service.

Assuming the General Assembly wishes to create such a service option, an important question is who should provide the service. The states' responses vary, and the options fall into the following categories:

1. require the incumbent utility to provide last resort / default service, either temporarily or permanently;

2. require the selection of one or more last resort / default service providers through competitive bid; or,

3. assign customers who need last resort / default service to competitive retail sellers, in proportion to the number of customers each retail seller has obtained through competition.

The choice among these options can affect the development of competition. For example, if last resort or default service is very restrictive (e.g., deposit requirements, payment terms and options, etc.) or high cost, consumers' support for the decision to introduce competition might diminish or never develop. It is also possible that if this service is provided by the incumbent utility, and no other seller has an opportunity to provide it, new companies might be discouraged from coming to Virginia.

Given this factual complexity, there is a fundamental question: Who should select among these options? For example, the General Assembly could:

1. require one of these options, and direct the Commission to implement it; or

2. direct the Commission to select among the options, applying criteria specified by the General Assembly. These criteria

might include safety, reliability, cost, convenience, and effects on the development of competition.

III. Eminent Domain

Currently, the power of eminent domain allows utilities to condemn private property for the construction of transmission, distribution and generation facilities needed to serve the public. In a restructured industry, generation facilities, and perhaps certain transmission and distribution facilities, will be built by new competing companies. The General Assembly may need to determine whether the power of eminent domain should continue to be available for these purposes, to whom and under what circumstances.

Questions the General Assembly may wish to consider include:

1. Should the General Assembly eliminate the power of eminent domain for generation?

2. With the advent of Independent System Operators of transmission, should the General Assembly broaden the powers of eminent domain to include non-traditional transmission service providers? Such action may be desirable in instances where the market power of incumbent utilities who continue to own both generation and transmission facilities serves as a disincentive to the construction of needed transmission enhancements.

3. If the power of eminent domain is eliminated in the future, how might the General Assembly or the Commission ensure that competition will be even-handed, given that the incumbent utilities already own generation and potential generation sites which may have been acquired by eminent domain or the threat of eminent domain?

4. If the power of eminent domain remains available for generation, should it be available to any entity licensed to sell power who wishes to build a merchant plant, or should applications for eminent domain authority be required on a facility-by-facility basis?

5. Should the power of eminent domain be granted by the General Assembly directly, or should the General Assembly assign that task to the Commission, local governing bodies, courts, or others?

6. If awarded on a facility-by-facility basis, what criteria should be applied to protect the public interest of Virginia?

VI. Market Power and Regulation of Generation Assets

To ensure reliable electric service at reasonable and just rates for all classes of consumers, generation market power must be mitigated prior to the relaxation of traditional regulation of incumbent utility generation assets. As discussed below, the enormous market power of incumbent investor-owned utilities is one of the largest and most difficult obstacles to overcome in successfully implementing a competitive restructuring of the electric industry in Virginia. These vertically integrated utilities own or control virtually all of the generation and transmission assets within their control areas which affords them significant vertical and horizontal market power.

Vertical market power, which arises from utility control of transmission assets needed by generation competitors to access customers, provides the utility with the ability to favor its own generation assets. Horizontal market power arises from concentrated generation asset ownership by a utility within import-constrained transmission areas or load pockets. It provides the utility with the ability to raise prices above competitive market levels by withholding generation. For example, the peak load of Virginia Power's control area is approximately 15,000 MW while the maximum power import capability of its transmission system is between 3,000 MW and 4,000 MW. For virtually all hours of the year, the control area load exceeds this import capability which means that at least some Virginia Power controlled units must be run if load is to be served. There are also individual generation plants within Virginia in more localized load pockets that must operate during certain system load periods for purposes of voltage support.

While the successful development and implementation of an ISO that is truly independent (currently an untested work-in-progress) may address vertical market power concerns, there are substantial questions as to whether such an entity should, or effectively could, monitor and mitigate horizontal market power. Some parties have suggested that incumbent utilities should be forced to divest a portion or all of their generation assets as a means of mitigating horizontal market power.

A well-structured divestiture plan could be an important tool in alleviating certain aspects of horizontal market power; however, without other safeguards it does not fully resolve such concerns. For example, divestiture does not address the market power of individual must-run plants operating in load pockets. The market power associated with these units would merely be transferred to the new owner. It must also be recognized that divestiture is a significant and irreversible step. Consequently, divestiture may be an option that should be reserved for consideration until restructuring has progressed further.

The General Assembly has several strategic options for approaching generation market power and adjustments to the regulation of generation assets, including:

1. deregulate generation assets by a date certain and rely on the FERC or the ISO, under FERC regulation, and the U.S. Department of Justice to monitor and mitigate market power abuse;

2. require or encourage incumbent utilities to divest their generation assets and either maintain State regulatory jurisdiction of must-run units or rely on FERC to regulate these units; or,

3. a) initiate customer choice in Virginia and create an environment which encourages the growth of competition, b) foster the development of the new competitive market organizations (ISOs and power exchanges) and infrastructure inclusive of new transmission investment to alleviate constraints and the local siting of new competitive generation facilities, and c) specify criteria for the relaxation of traditional regulation of generation assets as a sufficient level of competition develops and the market power of those assets is effectively mitigated.

V. Mixing Competitive and Noncompetitive Businesses

Electric utilities presently serving Virginia provide a full "bundle" of services, including transmission, distribution, generation, power supply planning, load management, metering, billing and many other services. Under customer choice, some of these services would be subjected to possible competition and

others would not be. For example, most observers believe that for the present time, the physical functions of distribution and transmission should not be subjected to competition.

If distribution and transmission remain noncompetitive services, provided by a monopoly, an important question arises: Should the company engaged in these monopoly services also be permitted to sell competitive services? Allowing the same company to sell both noncompetitive and competitive services creates risks, including the risks of cross-subsidies and unfair competition (unfair, because the company controlling distribution and transmission might have an advantage in the sale of competitive services).

The General Assembly could address these issues in various ways:

1. prohibit or restrict a corporate family (that is, a company and its affiliates) from offering both competitive and noncompetitive services in the same market; or

2. rather than establish absolute legislative rules, establish "fair competition" principles, and require the Commission to implement those principles by establishing standards and requirements for regulated companies and their affiliates with respect to (a) participation in competitive and noncompetitive services, or (b) ownership of assets relating to these services, as necessary to satisfy the legislative principles.

VI. Independent System Operator and Power Exchange

Conceptually, independent system operators "ISOs" and power exchanges should facilitate the development of effective competition. The creation of an ISO requires present owners of transmission facilities to transfer control of those facilities to the ISO; alternatively, the transmission owners could also transfer actual ownership of these facilities, making the ISO a "Transco." A power exchange, which may also be functionally provided by the ISO, serves to set an independent spot market price for generation allowing for the efficient deployment of generation resources. In concept, ISOs or Transcos in conjunction with power exchanges are intended to encourage the orderly and economical use of transmission and generation facilities, identify and resolve reliability problems, prevent those who own both generation and transmission from favoring their own generation, and reduce the potential for inconsistent or multiple transmission

charges. While we believe the successful development and implementation of ISOs and power exchanges are critical to competitive restructuring efforts, the creation of these new organizations is not without significant costs and risks.

First, a decision to create an ISO or power exchange (or both) means that responsibility for directing the operation, maintenance and construction of essential transmission facilities and the dispatch of generation facilities would no longer lie with existing Virginia utilities. Instead, such responsibilities would devolve to a new, untested organization directed and managed by personnel distinct from today's utilities. This new leadership will have to address many complex issues such as: organizational and procedural mechanisms to ensure independence from current transmission owners; development of coordination and scheduling procedures and information systems to accommodate an exponentially increased level of power transactions; coordination of facility maintenance schedules; fair and non-discriminatory access to capacity constrained transmission facilities; provision of system ancillary services and enforcement of standards critical to system reliability; mechanisms for ensuring the economic addition of properly situated new facilities in a timely manner; and controversial cost allocation and pricing issues.

An additional and distinct set of questions arises with respect to new power exchanges, including such basic issues as (a) maintenance of reserve margins, (b) validation of operational readiness, and (c) whether the power exchange is mandatory (that is, all generators must sell to the power exchange and all buyers must buy from it) or voluntary.

The actual benefits of ISOs and power exchanges will depend on how effectively the foregoing issues are resolved. While all of Virginia's investor owned utilities are actively pursuing the formation of or participation in ISOs/power exchanges, such efforts are at varying stages of development and, as would be expected at this point, none of these new institutions have been tested against the rigors of a fully competitive market.

Second, the introduction of independent system operators and power exchanges is not a cost-free decision. Both entail the shift of significant authority from the Commonwealth of Virginia and the State Corporation Commission to the Federal Energy Regulatory Commission. This shift in jurisdiction results in a substantial loss of State control and could result in significant harm if the FERC (or its enabling statute) is less protective of Virginia consumers than would be the State. Recent debate before the FERC has elicited an advocacy by some parties

for philosophical approaches ranging from "light-handed" FERC regulation to virtual FERC abstention from market interference.

Given the factual and jurisdictional complexity of ISOs and power exchanges, the General Assembly could choose among several approaches, including:

1. direct Virginia's utilities to form or join an ISO (including transfer of transmission control or ownership of transmission to the ISO), subject to the Commission's review, where the review would apply criteria established by the General Assembly to ensure that Virginia's public interest are served;

2. direct all owners of generation to join or form a power exchange, subject to the Commission's review, where the review would apply criteria established by the General Assembly to ensure that the Commonwealth's public interest are protected; or,

3. instead of directing utilities and generators to join an ISO or power exchange by statute, the General Assembly could authorize the Commission, after applying criteria specified by the General Assembly to preserve the Commonwealth's public interest, to address such activities.

With each approach, the General Assembly could specify criteria for protecting the public interest of Virginia which address probable risks or impacts with respect to safety, reliability, price, competitiveness, and/or loss of State jurisdiction.

VII. Licensing of New Sellers

If competitive restructuring proves effective, new sellers will enter the market. Experience in other industries moving from monopoly to competition shows that a licensing process can afford the State an opportunity to verify that the new sellers have some level of viability and competence necessary to ensure that "customer choice" is truly beneficial to consumers.

The General Assembly can determine whether a licensing process should be necessary, who should administer it, and what standards the process should apply. For example, legislation could some of the following options:

1. direct the Commission to establish a licensing process for some or all services, with the specific license requirements determined by the General Assembly or the Commission;

2. specify criteria to be applied by the Commission in issuing licenses, including some or all of the following: financial viability, physical preparedness, absence of previous regulatory violations; and

3. establish special procedures for Commission review and revocation of licenses, based on criteria established by the General Assembly.

VIII. Stranded Costs and Benefits

The subject of stranded costs and benefits is to be addressed mainly by another task force. We also mention it here because the treatment of stranded investment and benefits can affect the industry structure. The General Assembly has a wide range of options, including:

1. permitting limited net stranded cost/benefit recovery, as calculated by the Commission;

2. requiring full net stranded cost/benefit recovery, as calculated by the Commission; or,

3. directing the Commission to determine a just and reasonable level of net stranded cost / benefit recovery, applying criteria specified by the General Assembly, such as whether the utility has been compensated previously for the risk of stranded investment, utility efforts to mitigate its stranded costs, the existence of stranded investment or benefits, the effect of cost recovery guarantees on the development of competition, the level of cooperation demonstrated by the utility's actions in aiding the development and implementation of competition, and other factors.

Another structural effect of stranded cost and benefit recovery concerns the recovery device. Examples of net stranded cost recovery devices include a "wires charge" (an adder on the distribution charge that all consumers pay) and "exit fees" which are paid by those who choose a new supplier.

IX. Distribution Service

It is likely that, for the present, physical distribution service will remain a monopoly service. The successful implementation of customer choice in other services will require, however, attention to the regulation of distribution service, in at least three areas.

A. Nondiscriminatory Access to Distribution Service

A retail seller cannot reach its customer without distribution service. If the distribution facilities are owned by the incumbent utility, and that utility, or its affiliate, also is engaged in the competitive sale of electricity, it has an incentive in the provision of distribution service to favor its own generation customers and disfavor its competitors' customers. For example, favoritism could be shown through preferential treatment with respect to service extensions, service restoration efforts, or perhaps even customer billing, deposit and disconnect policy.

While the Commission currently has regulatory jurisdiction with respect to electric distribution service (excluding municipals), the General Assembly could provide specific direction to the Commission with respect to ensuring nondiscriminatory access to distribution service. The General Assembly could:

1. establish rules for nondiscriminatory access to distribution service and direct the Commission to enforce such rules; or

2. direct the Commission to establish and enforce rules and tariffs for nondiscriminatory access to distribution facilities based on criteria established through legislation.

B. Rate Methods

Although distribution service will be, for the present time, a monopoly service, some believe that new methods of rate regulation can induce more

innovation and efficiency than traditional "cost-based" methods. The General Assembly therefore might consider directing or authorizing the Commission to consider innovative methods for pricing distribution service, consistent with criteria established by the General Assembly.

C. Exclusivity of the Distribution Service Territory

Future changes in distribution technology may make its feasible and economical for some customers, or competitors, to "opt out" of the present utility's distribution system and build separate lines. This practice would raise environmental, cost and competitive issues. The General Assembly might consider reviewing and clarifying the Commission's authority to review, approve or disapprove these actions.

X. Municipals and Cooperatives

As recognized by the General Assembly, municipals and cooperatives differ from investor-owned utilities in many respects, including ownership, management structure, taxation, financing and statutory standards. Their role under competition, and the Commission's role with respect to them, may need to be addressed separately, particularly with regard to taxation issues.

XI. Special Implementation Issues

A. Generation Sufficiency

Historically, the assurance of sufficient generation has been the legal responsibility of electric utilities holding the privilege of serving on a monopoly basis. The utility's activities in carrying out that responsibility are monitored by the Commission.

Insufficient generation not only poses a potential for the economic disruption and social inconvenience caused by service interruptions, but also creates significant price volatility in a competitive market which could result in similar impacts. In a June 26, 1998, news account on its web site, the New York Times reported that in response to the demand generated during last week's heat wave across the Midwest, prices for wholesale power temporarily soared as high as $4,000 per megawatt-hour (or $4.00 per kilowatt-hour) in some cases. Rotating blackouts were averted largely due to voluntary conservation efforts initiated

through general public appeals and direct appeals to industrial, commercial, and governmental customers, some of which closed facilities, reduced production, or shut down operations for a shift.

Ultimately, under competition, each seller would have responsibility only for the customers signed up with that seller. In this situation, it is not clear whether the responsibility to make sufficient generation available will remain with any particular entity. This issue has arisen in other places in this document; for example, in the discussion of the independent system operator and power exchange, and in the discussion of last resort service. The General Assembly may wish to address who, if any one, should be responsible for generation sufficiency.

B. Customer Education

For customer choice to succeed, consumers have much to learn: how to evaluate suppliers, how consumption impacts their bills, and how to adjust consumption behavior to take maximum advantage of new price and product offerings, to name only a few areas of needed consumer information. Another task force is addressing this subject. The General Assembly may want to consider which methods of consumer education are likely to be most effective in providing necessary and impartial information in an economical and expeditious manner.

C. Nuclear Plant Generation and Decommissioning

The decommissioning of nuclear plants, and the storage and disposal of their waste, raise cost and safety issues. With the introduction of competition, the ownership, operation and pricing of nuclear generation may change. Although safety issues are regulated by the U.S. Nuclear Regulatory Commission (NRC), that agency is revisiting its own policies in light of the introduction of competition. The financial responsibility for decommissioning remains a state-regulated matter, but the lines between federal and state regulation are not clear, and become less clear if a nuclear generation unit, or its output, is transferred from a retail utility to a wholesale entity such as a power exchange.

Given these uncertainties, the General Assembly may want to consider options such as clarifying the Commission’s authority to review and condition the use and transfer of nuclear generating units.

D. Environmental Issues

Environmental issues are being addressed by another task force, and we will comment on them in that context.

XII. Deregulation

Under the present system of monopoly regulation, the Commission administers an array of consumer protections, related to a utility's rates, its assets and its sales and service activities. Each measure plays a distinct role in ensuring that ratepayers in a regulated environment can obtain adequate and reliable electric service at just and reasonable rates under nondiscriminatory terms and conditions.

Competition's supporters believe it will lower costs and increase innovation. However, a distinct question is whether competition will be an adequate substitute for the array of consumer protections presently in place. "Competition" is not an absolute state. There are degrees of competitiveness, not all of which will be sufficient to protect consumers. Particularly in industries long characterized by monopoly service, the evolution to full competitiveness -- many sellers, experienced buyers, low entry costs -- will not happen overnight. On the day customer choice becomes legally permissible, there may be an insufficient number of competitors to give most customers real choice. If so, "deregulation" -- that is, the elimination of all traditional consumer safeguards -- will leave customers unprotected in an environment which is, in fact, if not in law, a monopoly.

Competition can co-exist with certain forms of consumer protection. As noted previously, the General Assembly could direct the Commission to continue price regulation if there are insufficient competitors to make competition effective. Rather than ban competitors, such a step would provide necessary protections while adhering to the goal of introducing competition.

It is for this reason that this paper has provided the General Assembly with options that reflect a spectrum of regulatory responses to actual facts. At the outset of competition, it is unlikely that full competitive forces will exist. Protective tools will be necessary. But as competition develops and strengthens, the General Assembly can direct the Commission to adjust, reduce, or eliminate various traditional protections as well as to provide any necessary additional safeguards or protections, based on legislation-specified criteria which protect the Commonwealth's public interest.