Testimony of
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Summary of the Remarks of Suzi Ray McClellan

A properly structured competitive environment can lead to lower prices, innovative service offerings and customer choice. However, difficult questions must first be answered, especially the issue of whether incumbent utilities are entitled to recover costs for assets which are uneconomic in a competitive environment.

Although there is no constitutional requirement that the government guarantee recovery of uneconomic assets, recovery of some or all of a utility's stranded costs may be part of a comprehensive restructuring plan if it furthers a social good. Many industries have undergone the transition from a monopoly environment to a competitive environment without the guaranteed recovery of uneconomic assets. The central question, therefore, is what differentiates the electric industry from other industries to warrant special treatment and what will be expected of the incumbent utilities in return for the ability to recover these costs?

If stranded cost recovery is granted, certain principles should be applied. First, these costs should be fairly allocated. Payment of these costs should be based on a customer's usage because most "stranded" costs represent generation assets. Second, stranded costs should be mitigated and offset by other economic variables. Finally, the fairest recovery method is one in which all participants and customers contribute.

A bill which restructures the industry should recognize the significant continuing role the government should play in advancing consumer protection, ensuring quality of service standards, in prohibiting anti-competitive conduct, in maintaining the affordability of electric service for all customers regardless of where they live, and in protecting consumers against market failures.

Remarks of Suzi Ray McClellan

Good morning. My name is Suzi Ray McClellan. I am the Public Counsel of the Texas Office of Public Utility Counsel, which is an independent state agency charged with representing residential and small consumers in electric and telephone matters.

Introduction

The issue of electric deregulation is complex as we all know. Many competition proponents have touted deregulation as being in consumers' best interests. I agree that a competitive environment has the potential to benefit all consumers. However, the transition to such an environment, as well as the end result, must be crafted to ensure such benefits flow to all consumers. Additionally, The state and federal government must play a continuing role in advancing consumer protection, in ensuring quality of service, and in prohibiting anti-competitive practices.

I. Stranded Costs

One of the main issues in the debate is how stranded costs will be dealt with. Will the utilities be allowed full recovery? If so, will all consumers share in the costs? It is important to start the debate at *whether* these costs should be recovered. If we begin the debate at *how* these costs will be recovered, we have unnecessarily limited the discussion of the rights and responsibilities of all participants. Utilities will less likely see stranded cost recovery as an important concession, and be less willing to commit themselves to policies that benefit the public good, such as universal service concepts. Any legislation should be the result of a give-and-take process so that in the end we have a balanced, competitive environment among incumbent utilities, competitors, and consumers.

The electric industry is not the first monopoly to face the issue of what to do with investment, although prudently made at the time, which has become less valuable due to economic forces. For example, earlier this century, new railroad companies were challenging the regulated streetcar industry for the right to carry passengers. The streetcar industry sued the government claiming that its status as a regulated entity entitled it to recover 100% of its assets, even though the market value of those assets was substantially less than the streetcar industry's investment in them.

This issue of whether the government should guarantee recovery of uneconomic assets was finally resolved by the Supreme Court of the United States in 1945 holding that:

> [T]he due process clause never has been held by this Court to require a commission to fix rates on the present value of something no one would presently want to reproduce or on the historical valuation of a property whose history and current financial statements showed the value no longer to exist, or on investment after it has vanished, even if once prudently made … . It has not and cannot be applied to ensure values that have been lost by the operation of economic forces.

Market St. Railway Co. v. Railroad Comm'n of California, 324 U.S. 548 (1945).

Many regulated industries have undergone the transition from a monopoly environment to a competitive environment since then including railroads, airlines and telecommunications companies. Not one of these industries was guaranteed to have their assets completely paid off before consumers were able to take advantage of their choices. Should the electric industry be treated any differently? And if the electric industry is given special status, what will the industry give in return?

Despite the legal precedent, you will hear testimony from the industry that they are entitled to this money because of the "regulatory compact" that the company entered into with the

government. Under this theory, companies claim that they made investment in plant in return for a franchise to serve customers. In other words, the utilities were obligated to serve all customers within their territory in return for an opportunity to earn a reasonable return on that investment. However, the government never promised an exclusive franchise, nor did the government grant the franchise in perpetuity.

Nevertheless, if Congress determines that all or a portion of stranded costs should be recovered by the utility, it is important to allocate these costs fairly to all ratepayers. First, the fairest way to apportion each customer's share is to base the recovery on each customer's usage. Because the assets that are generally "stranded" are generation assets, then it is only fair that each customer pay for these assets on a proportional basis. Those customers which use more electricity, should pay for a greater share of the generation assets that are stranded.

Second, stranded costs should be mitigated and they should be offset. If Congress allows recovery for uneconomic assets whose market value is *less* than the remaining book cost, the calculation of what is stranded should be offset by assets whose market value is *more* than the remaining book cost. In Texas there are at least three utilities that have assets with *above* market value, West Texas Utilities ("WTU"), Southwestern Electric Power Company ("SWEPCO"), and Southwestern Public Service Company ("SPS").

Additionally, any economic benefits gained from stranded cost recovery should be used to offset the amount left to be recovered. For example, if the mechanism used to recover stranded cost results in interest savings to the utility, those savings should be used to reduce the remaining balance. Thus, if customers are required to pay for stranded cost recovery, the many economic variables should be reviewed to ensure that the utility is not granted an unintended windfall.

There are at least three major ways to accomplish recovery of stranded costs. First, money can be collected through a separate charge on customers' bills. This charge is a non-bypassable charge that would be levied on the transmission and distribution system. This method of recovery could thwart competition because utilities will recover this charge from consumers, regardless of who provides power to the customer.

Consumers will not see promised savings on their bills from competition because they will continue to pay both their old and new provider. Thus, bills will reflect not only the costs of competitors' plants used to serve the customer, but also for the costs of the utilities' plant that is not serving the consumer.

To the extent these charges are recovered over a long period of time such as 15-20 years, electric rates will not fall to competitive levels in the foreseeable future. Under this scenario, incumbent utilities would establish themselves in a unique competitive position: they would earn a market return on their competitive assets and a guaranteed return on their non-competitive assets, the effect of which is clearly anti-competitive.

The second mechanism that could be used to recover stranded costs is a rate freeze. A rate freeze recognizes that utilities' costs are declining over time. A rate freeze would keep rates at an artificially high level with the profits used to recover assets which would be stranded if competition were allowed.

When nuclear plants were being built, regulators required ratepayers to pay higher up-front costs in exchange for lower rates in later years. In addition, revenue growth and declining rate base are factors which are causing electric utility average rates to decline. For the first time, consumers are on the cusp of receiving the benefits of that bargain. Electric rate cases are

establishing overearnings by utilities, and as a result, the Texas Public Utility Commission is ordering lower rates.

A rate freeze will preclude consumers from reaping these lower rates. A rate freeze denies the consumer lower rates that would result from continuing rate regulation while also denying them the lower rates that would result in competition. It is simply the worst of all outcomes, denying the benefits of either monopoly regulation or the benefits of a competitive market.

The question remains then how to fairly allocate the burden of paying for stranded costs. Perhaps the fairest way is for all participants: incumbent utilities and their shareholders; new competitors; and customers to share in the responsibility. There is precedent for this notion. For example in the telecommunications market, incumbent utilities and their shareholders shared in the responsibility by writing off many uneconomic assets. New competitors were required to help pay for universal service funding to keep rates affordable and to contribute to the efforts of schools, libraries, and hospitals to obtain an adequate telecommunications infrastructure. And finally, customers share in the responsibility by paying for certain identifiable fees, such as the End User Common Line Charge, and by subscribing to services which make a contribution to joint and common costs. If Congress allows utilities to recover stranded costs, then the responsibility should be shared by all participants.

II. Role of the Government in a Competitive Market

Once the ground rules for competition have been set, the government still has a significant continuing role to play in advancing consumer protection, ensuring quality of service standards, in prohibiting anti-competitive practices, and in ensuring that electric service remains affordable for all customers regardless of where they live.

Protection Against Market Failures

Once a fully competitive market is in operation, regulation can be and should be relaxed. However, the form of regulation should be relative to the amount of competition in a particular market. An objective market power test should be available to determine if and when regulations can be modified. As long as incumbent utilities have the ability to control prices through domination of a particular market, states should continue to be able to regulate prices.

Currently, within the Electric Reliability Council of Texas (ERCOT), two of the state's largest utilities (Texas Utilities Electric Company and Houston Lighting and Power) account for over 67% of the generation capacity. During the peak, there is not enough capacity to meet demand without the generation capacity of one or both of these utilities. The concentrated market power of these utilities will inevitably allow them to control prices unless the regulatory authority is given the power to ensure against market power abuses.

A market which is controlled and dominated by a few players will not provide the benefits of a truly competitive market. Favoritism, self-dealing, and cross-subsidization give a competitive advantage to a provider. The states should be given the authority to investigate and correct anti-competitive conduct by industry participants.

Universal Service

A universal service policy must be inherent in a restructured electric industry. Universal service refers to the right of all consumers to have access to affordable, high quality electric service. Because electric service is essential for the health and safety of all consumers, universal service must be a basic right of all consumers. Specifically, a universal service policy must guarantee at a minimum: (1) obligation to serve protections; (2) a provider of last resort in each service territory; (3) universally affordable rates; (4) a basic package of firm electric service for all customers; (5) lifeline rates and services for customers who require them; and (6) service quality standards at least comparable to those of regulated utilities today.

Consumer Protection

Customers need increased protection when the market encourages multiple service providers to compete aggressively. For example, in the telecommunications industry competition in the long distance market produced significantly lower rates for many customers. However customer complaints regarding shady business practices skyrocketed. Billing problems and slamming top the list of consumer complaints received by both the Texas Public Utility Commission and by the FCC.

Customers also need access to clear and concise information on service and pricing options to facilitate educated service and pricing choices. The government can ensure that customers have this information through a variety of mechanisms such as customer education programs, by requiring clear disclosure of information, and by making available easy to understand price comparisons.

Customers should be protected from having their service switched without their informed consent. Consumer protections should include a ban on deceptive or misleading promotions and advertisements. Disconnection and billing policies should be fair. Consumers should have an adequate forum for resolving their complaints. Simply put, the government has a continuing duty to ensure that adequate consumer protections are in place.

Conclusion

Retail competition can benefit residential customers so long as certain criteria are met: all customers have equal access to competition; stranded cost recovery if granted by Congress is fairly shared by all participants and customers; market power is reduced, universal service concepts are adopted, adequate consumer protection and enforcement is available; and dominant providers continue to price regulated.