

STATEMENT OF

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**Before the Pennsylvania House
Consumer Affairs Committee**

House Bill No. 2537 -

**The Electric Utility Retail Customer
Choice Act**

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Good morning Chairman Durham, and members of the House Consumer Affairs Committee. My name is Jay S. Pifer. I am Senior Vice President of Allegheny Power. West Penn Power Company is one of the Allegheny Power Operating Units. While West Penn Power will continue to be a legal entity, we will be doing business using the name Allegheny Power.

I am particularly pleased to have the opportunity to comment on Pennsylvania House Bill 2537, the Electric Utility Retail Customer Choice Act, because of our unique position in the electric utility industry in Pennsylvania. I also want to take this opportunity to commend the committee and Representative Tulli for undertaking this important legislation. It's obvious a lot of thought and preparation has gone into this effort.

West Penn is an example of a success under the existing utility regulatory system. The PUC has indicated we are well-managed and we are recognized as a reliable and efficient producer of electric power. West Penn customers enjoy the lowest rates in Pennsylvania. We have some of the most efficient generating plants in the country. Allegheny Power has been in the top ten utilities nationwide for twelve of the past sixteen years in heat rate, the efficiency rate in converting a BTU of fuel into a kwh of electricity. In short, we believe we are positioned to succeed in a competitive environment.

Competition will inevitably come to the retail electric market as it has to the wholesale market. Legislators and regulators must take steps to assure that retail competition is open and fair to all customers and providers. To accomplish this, several fundamental principles must be observed.

(1) Service reliability must not be compromised. Customers expect and deserve that the present high level of service reliability will continue in a more competitive environment. The transition must insure that proper funding exists for spinning reserves, voltage support, fuel supplies, and vegetation control, just to mention a few.

(2) All customers should have a choice of their electric supplier as soon as possible. It seems practical that large customers should have a choice earlier. This will help to ensure a smooth transition to a competitive market as problems - which are bound to surface - are solved before millions of customers are moved to a new system.

(3) Uniform rules among the states are required. We are an advocate of states' rights. But 50 or 51 sets of different rules will only ensure that the system will not work for everyone's benefit. Some regional or national guidelines are needed. This is especially important to Allegheny Power because our retail service territory stretches into five states.

(4) All generation, and we mean all utility and non-utility generation, including PURPA purchases, should be deregulated and priced by the market as quickly as possible.

(5) We agree that the transmission and distribution portion of the business, the "wires" business, should continue to be regulated, but the regulation should maximize and not impede competition. And what should be regulated is the delivery system, the wires, and not the energy delivered. New approaches are needed and cost of service regulation must be abandoned. Owners of distribution facilities are entitled to fair compensation for the use of their facilities and should be rewarded for efficiencies.

(6) Social costs must be recognized and provided for. Obviously there must always be a safety net for persons who cannot afford electric service. The fairest method of funding low income and universal-access programs is through a broad-based tax that includes all competing energy markets, gas, electric and oil.

We believe House Bill 2537 generally addresses our concerns in many areas.

The bill provides for an orderly transition to a more competitive retail market with a five-year transition period for customer choice to be in full operation by the end of 2002. However, the five-year period could be shortened.

The bill requires utilities to functionally separate generation, transmission and retail distribution operations, and it provides that prices for unbundled generation services are to be determined by competitive market forces. This comports with the standards we believe appropriate for moving towards a more competitive utility market.

Distribution

Sec. 5(b)(3) of the bill provides that the Commission is to establish rates for unbundled local distribution services based on cost of service, performance-based or incentive rates. This represents a step forward. We believe cost of service ratemaking, however, should be abandoned because it penalizes efficient utilities.

It often rewards those who least deserve it by allowing profits on inefficient capital investments while at the same time prohibiting any incentive or reward for the efficient companies.

Transmission

Sections 5 and 8 of the bill provide that the transmission system must be run by an independent system operator (an ISO). An ISO, if properly structured, could be a practicable alternative in the transmission arena. But it is not the only, or necessarily the best, alternative. Present federal policy expressed in FERC Rule 888, issued April 24, 1996, provides that "the Commission is not requiring any utility to form an ISO at this time."

The transmission of electric energy is a matter that is within FERC's jurisdiction, not the States'. State attempts to legislate on transmission will only cause litigation and confusion. We therefore suggest the transmission portions of the bill be deleted.

Generation

We have some concerns with the generation provisions of the bill in Sections 5(d) and 6. But the problems seem to be more in the drafting than the intent.

We believe the intent of the bill is that all generation will be deregulated and sold at market price. In other words, a truly competitive generation market will be created.

We fully endorse that concept - and to accomplish it we believe that all subsidies for any segment of the generation market should be ended. Some subsidies will have to be ended by the federal government, such as the mitigation of existing PURPA contracts. But others, such as stranded cost matters, should be addressed by the states. I will get back to this shortly.

A concern we see with the bill includes the limitation on the local distribution company selling generation to its own "wires" customers. There is no reason to prevent customers of a low-cost company to benefit from that generation. There is also language indicating the local distribution company must be the aggregator of last resort and that customers could remain under existing regulated structure. Neither of these provisions are compatible with a competitive model, nor are they necessary. These drafting problems may stem from the failure to distinguish clearly between the "wires business," which is the delivery system that requires some regulation, and the "energy business," which is what is delivered over the system.

There may be some concern that low prices paid by customers of the low-cost utilities not be subject to large increases. This could be addressed by provisions that during the transition period, electric bills could not increase by more than some percentage of an index tied to inflation. We do not believe this will be a long term problem, if it is a problem at all, because competition will prevent it. On the other hand, if we are going to

have a competitive market model, the market should determine prices for everyone, not just for those paying more than market.

As I stated before, any concern about providing electric service to those unable to pay can and should be addressed as a part of a suggested broad-based energy tax.

One additional point you might want to consider -- Section 5(d) (3) seems to inject the Commission into the anti-trust/unfair competition arena. We believe this is inappropriate. The Commission should regulate the "wires business," but the energy business is to be competitive.

The Commission has no expertise in the area of antitrust and unfair competition. These matters are best left to the Department of Justice and the Federal Trade Commission, as they are with all other businesses.

Stranded Cost Recovery

Simply put, stranded costs are above market costs which are created in a regulatory environment, but unrecoverable in a competitive market.

West Penn has, or will have, stranded costs. However, our stranded costs will be significantly less than others, primarily because we have no nuclear units. There are three major categories of stranded costs:

- (1) By far the largest are nuclear generation assets reflecting a high capital cost of nuclear units. These were incurred because of management decisions to use nuclear rather than other types of generation;**
- (2) Costs for PURPA power plants imposed by PURPA; and**
- (3) deferred taxes not yet collected from customers.**

We believe that a true competitive solution would preclude recovery of stranded costs, or at least those stranded costs that were not the result of governmental requirements.

Further, recovery of stranded costs could subsidize the operations of high-cost suppliers by granting them an artificial advantage over lower-cost competitors. This would result from allowing high-cost utilities to sell their high-cost power to new customers at less than its total cost (capital and operating) while requiring their existing customers to pay the unrecovered costs. This is not unlike high tariffs and dumping in international trade, where the home market is protected by high tariffs while exports are dumped on the foreign market at whatever minimal price the market will bear. Unfortunately, the likely targets of such subsidized power will be the most lucrative customers of low-cost utilities.

The plan established by the bill, in Section 7, unfortunately favors the full recovery of stranded costs by high-cost utilities in a manner that will, or at least could, disadvantage low-cost utilities, in effect punishing them for their low-cost status.

How is this so? It must be remembered that nuclear units have very high fixed costs (capital costs) and very low fuel costs. Coal plants tend to have much lower capital costs but, relative to nuclear, higher fuel costs. Therefore, if the fixed costs of nuclear units are protected as "stranded costs," they will be able to undersell coal-fired generation. To allow such a possibility is uneconomic and certainly contrary to fair competition. As I said before, it is not unlike high tariffs and dumping in international trade. It must not be allowed to occur.

We therefore suggest that Section 7 of the bill be extensively rewritten to prevent this potential abuse, and to significantly limit, if not totally prohibit, recovery of at least those stranded costs incurred by management decisions, as opposed to governmental and regulatory requirements. In the alternative, if consideration is given to recovery of any portion of stranded investment, ways must be found to place these costs on the cost of generation so that a utility's customers, both inside and outside the utility's service territory, pay the same price for generation. Finally, the transition period should be significantly shortened from five years.

Conclusion

This legislative initiative is not occurring in a vacuum. Legislation concerning competition is pending in the Senate. Various proposals are pending in Congress and more are expected. Regulatory authorities in most states, including Pennsylvania, are considering the difficult issues surrounding any restructuring of the electric utility industry. Ultimately, what Pennsylvania does is affected by what happens at the federal level and perhaps elsewhere in this region.

We believe competition in generation will be beneficial, and the challenge is to create a system which benefits customers as a whole and in which winners and losers are determined by the market rather than by governmental action such as requirements applicable to only some market participants but not others, and subsidies for some market participants.

We would be happy to assist the committee in any way possible to achieve these laudable goals.

That completes my testimony. I appreciate the opportunity to present these comments and am available to answer any questions.